USING THE COMPANIES CODE AND COMPANY LAW IN FAMILY LAW

delivered by

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at the

LAW COUNCIL OF AUSTRALIA

FAMILY LAW SECTION SEMINAR

13 APRIL 1991

I have previously written a paper with this title, which has now been published [(1990) 6 AFL Dec 1). I shall assume that those interested in the topic have read the earlier paper. The thrust of the previous paper was that, particularly in the light of the Cross-Vesting legislation, practitioners should look closely at the provisions of the Companies Code and principles of company law in charting the course that they take, on behalf of clients involved in family disputes, where corporate entities have been utilised by one or both of the parties to the marriage. In this paper I want to examine in more detail some of the problem areas.

Even though the only directors of the corporate entity may be the husband and wife, and the business and assets confined to the family, the fundamental principle that directors owe a fiduciary duty to the company applies with full force. The fiduciary duty of directors incorporates a general duty to act honestly and with due diligence in dealing with the assets of the company. It is a breach of fiduciary duty to misapply the company's assets. It is clear enough and does not require discussion that, if the husband, or wife, appropriate assets of the company to their own use without proper authority, then they have committed a breach of fiduciary duty. What is of more difficulty in this branch of the law is where the property is transferred not to the husband or wife, but to a third party. It is not difficult to think of factual situations where that occurs. In such context the words of Lord Justice Buckley in Belmont Finance Corporation Limited v Williams Furniture Limited (No 2) 1980 1 AER 393 have great relevance. In a judgment, in which Goff and Waller LJJ agreed, he said (p405):-

> "A limited company is of course not a trustee of its own funds; it is their beneficial owner; but in consequence of the fiduciary character of their duties, the directors of a limited company are treated as if they were trustees of those funds of the company which are in their hands or under their control, and if they misapply them they commit a breach of trust (In re Lands Allotment Co [1894]1 Ch 616,638 per Lindley and Kay LJJ). So, if the directors of a company in breach of their fiduciary duties misapply the funds of their company so that they come into the hands of some stranger to the trust who receives them with knowledge (actual or constructive) of the breach, he cannot conscientiously retain those funds against the company unless he has some better equity. He becomes a constructive trustee for the company of the misapplied funds. This is stated very clearly by Jessel MR in Russell v Wakefield Waterworks Co (1875) LR 20 Eq 474, 479 where he said 'In this court the money of the company is a trust fund, because it is applicable only to the special purposes of the company in the hands of the agents of the company, and it is in that sense a trust fund applicable by them to those special purposes; and a person taking it from them with notice that it is being applied to other purposes cannot in this court say that he is not a constructive trustee".

This principle was applied by Slade LJ in Rolled Steel Products (Holdings) Limited v British Steel Corporation & Ors 1986 1 Ch 246, 297:-

> "The Belmont principle thus provides a legal route by which a company may recover its assets in a case where its directors have abused their fiduciary duties and a person receiving assets as a result of such abuse is on notice that they had been misapplied. The principle is not linked in any way to the capacity of the company; it is capable of applying whether or not the company had the capacity to do the acts in question."

There must be instances without number where, as part of family arrangements, family companies transfer assets from one to the other or from the company to the family trust, or perhaps to one of the children. Many of these transactions cannot be justified on ordinary company law principles, and the directors would be regarded as acting in breach of their fiduciary duties in authorising them. What then can be done by a liquidator, or a dissatisfied spouse in attempting to recover such assets for the benefit of the company. The crucial question is the "knowledge" of the recipient of the property of the breach of fiduciary duty. Knowledge must be of the breach of trust, or breach of fiduciary duty. Such knowledge is not confined to actual knowledge. In Baden Delvaux and Lecuit v Societe Generale pour Favoriser le Development du Commerce et de L'industrie en France SA 1983 BCLC 325 Peter Gibson J divided the various mental states comprised in the concept of "knowledge" into five:-

1. Actual knowledge
2. Wilfully shutting one's eyes to the obvious

3. Wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make

4. Knowledge of the circumstances which would indicate the facts to an honest and reasonable man

5. Knowledge of circumstances which would put an honest and reasonable man on enquiry.

In Re Montagu's Settlement Trusts (Duke of Manchester v National Westminster Bank Limited 1987 1 Ch 264 Megarry VC suggested that knowledge within categories (4) and (5) are probably insufficient for the purposes of creating a constructive trust. Nonetheless it will be clear that an assiduous and aggressive investigation of the financial affairs of family companies could yield many a pearl in the form of assets which have passed out of the immediate control of the company, but in respect of which a proper claim of constructive trust may be erected for the ultimate benefit of one or other of the spouses. The obligations imposed by a constructive trust of course are not dissolved by the delinquent trustee disposing of the assets.

Importantly for present purposes the Common Law concept of fiduciary duty is supplemented by the provisions of the Corporations Act. Section 232 (2) requires that an "officer", which expression includes directors, secretaries and executive officers, at all times act honestly. Further sub-section (4) requires an officer of a relevant body corporate to exercise at all times "a reasonable degree of care and diligence in the exercise of his or her powers in the discharge of his or her duties". There are further weighty and important duties imposed on officers by the provisions of the Act. Where there is a breach, then under sub s (8) the body corporate may recover from the delinquent officer, as a debt due to the body corporate, any profit made as a result of the breach, or the loss, or damage as a result of the breach. It is appropriate to draw attention to the breadth of the provision. The requirement for a reasonable degree of care and diligence, called for by the section, removes the former opportunity for a sleeping director. This is clearly demonstrated, albeit in a slightly different context, later in this paper. Once again it is unnecessary to dwell on the openings that this provision makes available to a competent lawyer. It is true that once again the remedy has to be sought by the company and therefore the benefit to a spouse is indirect. However, at the worst, this will simply require that the company be put in liquidation at the suit of the spouse and the necessary proceedings may then be commenced by the liquidator.

In another respect the Corporations Act may have achieved a substantial and unwelcome change in the protection which the law has provided, particularly to wives, in relation to economic misconduct on the part of their spouse. One of the recurring themes of litigation in recent times has been the claim by wives that they executed documents obligating them, either directly or indirectly, to third parties as a result of misrepresentations or undue influence on the part of their spouse. Where a loan to a husband, or to a company substantially owned by the husband, was secured by a mortgage over the matrimonial home, and the security documents handed by the financier to the husband to procure the wife's signature, if the wife could show that the husband had been guilty of some inappropriate conduct in procuring her signature to the document, for example by misrepresentation, then the financier was affixed with the liability for the spouse's misconduct and the document rendered unenforceable. In this regard, in many ways, the law has stood still for the last 50 years since Dixon J in Yerkey & Anor v Jones (1940) 63 CLR 649 said:-

> "Although the relation of husband to wife is not one of influence, yet the opportunities it gives are such that if the husband procures his wife to become surety for his debt a creditor who accepts her suretyship obtained through her husband has been treated as taking it subject to any invalidating conduct on the part of her husband even if the creditor be not actually privy to such conduct".

The cases in which the principle in Yerkey has been relied on are legion, both in this country and in England. Furthermore, Clarke JA, (with whom McHugh JA agreed), was prepared to extend the operation of the Yerkey principle in Warburton v Whitely (unreported 10 February 1989). He said:-

> "One submission of counsel for the respondents can be quickly disposed of. He submitted that the principle in Yerkey extended only in respect of the guaranteeing by a wife of the past debts of a husband. It did not apply in respect of future advances nor did it apply unless the principal debtor was the husband of the surety. It would not apply, in particular, in respect of loans to a company controlled by the husband.
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> There would appear to me to be no reason in principle why the doctrine should not apply equally in respect of loans to, for instance, a company which was the alter ego of the husband or even to organisations in which the husband had, but the wife had not, a substantial interest. Nor do I see any reason why the doctrine should be limited to the guaranteeing of past indebtedness. If the wife undertakes an obligation to guarantee a proposed loan, and possible future loans, to her husband or to organisations in which he has a significant interest it is hard to see why in principle she should not be entitled to the same relief as a wife who is guaranteeing past loans."

In times of economic stringency, when many enterprises have been brought down, the principle has worked very favourably for the wife. However, possibly by some inadvertence on the part of the Parliamentary draftsman, where a husband instead of misrepresenting to the spouse the terms of the document, or overbearing her will and thus securing her signature to say a guarantee, simply forges her signature to a document purporting to be executed by the family company, unless the third party has actual notice of this forgery the document will be effectual against the company and therefore indirectly against the totally innocent spouse by depriving the company of an asset and therefore the spouse of the opportunity of looking to some corporate asset. How did this come about?

A financier has always had the protection of the so-called indoor management rule the scope of which has been recently considered by the High Court in Northside Developments Pty Limited v Registrar General (1990) 64 ALJR 427. Brennan J explained the nature of the rule as being a presumption of regularity. He said (p 439):-

> "It arises from the likelihood that a company has given to its officers and agents the authority needed to carry on its business and to act for its benefit within the limits of the authority which officers and agents in their respective positions would ordinarily possess. The presumption might reasonably be made when the officers or agents of a company engage in a transaction for the purpose of a company's business or otherwise for the benefit of the company and the transaction is one that officers or agents in their respective positions would ordinarily be expected to have the company's authority to undertake. In that situation, a party dealing with the company in good faith is entitled to presume that the officers and agents had that authority".

The scope of the rule has either been put beyond doubt or, on another view, substantially extended by the provisions of the Act.

As stated in the Explanatory Memorandum, the provision making even a forged document valid in favour of an innocent third party, was initially introduced in 1983 as S68D of the Companies Code (now s166 of the Corporations Act). The section was intended to do away with an interpretation that was placed on the decision in Ruben v Great Fingall Consolidated 1906 AC 439 to the effect that the indoor management rule did not assist where there was forgery unless the person so dealing had actual knowledge of the other person's fraud or forgery, or being connected with the company, ought to have known of it. It may be that the decision in Ruben had been misunderstood and that there was really no forgery exception to the indoor management rule (cf Northside Development supra Mason CJ @ 430; Brennan J @ 443; Dawson J @ 447;). In any event, the Act now appears to put the matter beyond doubt. S164 (3)(e) operates to entitle a person dealing with a company to assume that a document has been duly sealed by the company if it bears what appears to be the impression of the seal and appears to be attested by two persons appropriate to attest the affixing of the company's seal. Section 166 then takes the matter further in providing that s164 operates:-

> "(a) to entitle a person to make the assumptions referred to in sub-section (3) of that section in relation to dealings with a company; or
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> (b) to entitle a person to make the assumptions referred to in sub-section (3) of that section in relation to an acquisition or purported acquisition (whether direct or indirect) of title to property from a company,"
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> even if the person referred in Section 164 (3)(c)
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> (c) has acted or is acting fraudulently in relation to the dealings, or in relation to the acquisition or purported acquisition of title to property from the company, as the case may be; or
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> (d) has forged a document that appears to have been sealed on behalf of the company,

> unless the person referred to in paragraph (a) or (b) of this section has actual knowledge that the person referred to in paragraph 164(3)(b), (c) or (e), or the officer, agent or employee of the company referred to in paragraph 164(3)(d) or (f), has acted or is acting fraudulently, or has forged a document, as mentioned in paragraph (c) or (d) of this section."

I have respectful doubts concerning the accuracy of the comment by Cole J in Australian National Industries Ltd v Greater Pacific Investments Pty Ltd (in liq) (Unreported 14 December 1990):-

> "It may be doubted whether the legislature intended by s 68 A (4)(b) to amend rather than codify the common law position. The Explanatory Memorandum does not suggest such an intention".

It is of course no doubt fair that, as between a corporation and an innocent purchaser, the loss resulting from forgery should be borne by the corporation. However the fairness of that result is not nearly so clear in the case of a small family company where a spouse forges the signature of the other who then has to suffer the loss.

The third matter to which reference ought to be made in the present context is the recent decision of Ormiston J in the Supreme Court of Victoria in Statewide Tobacco Services Limited v Morley (1990) 2 ACSR 405. I should mention that the decision is under appeal. In substance, His Honour held that a wife who, although a director of a family company, took absolutely no role in its conduct or management, was nonetheless liable to a person to whom the company contracted a liability at a time when it was not in a position to pay its debts. This finding rested on His Honour's construction of s 556 of the Companies Code (now s 592 of the Corporation Act). His Honour defined the question as being "the extent to which a director who takes no effective part in the management of a company may be made liable for its debts in circumstances where it continues to trade while insolvent". The situation was the entirely common one where Mrs Morley was a director of a small family company for 29 years. During the first 20 years of its existence her husband had controlled the company and its activities. Thereafter the son took over the running of the business. No meetings of directors were held, and all that Mrs Morley learnt was gleaned from casual comments by her son. She saw no invoices, statements, or books. In fact, from May to July 1988 the company had become and remained insolvent and there could have been no reasonable expectation that it would be able to pay all its debts as and when they became due. The company managed to incur very substantial debts during that period. Mrs Morley relied upon the defence provided by s 556 (2)(a) that the debt was incurred without her "express or implied authority or consent." It will be noticed of course that the onus in this regard rested on Mrs Morley. In other words all that a creditor is required to do is to show is that, at the relevant time, when the debt was contracted, the defendant was either a director or took part in the management of the company which incurred a debt of the kind described.

His Honour examined some of the provisions of the Corporations Act relating to directors' duties and said (p 412):-

> "It is thus apparent, without considering the effects of s 556, that a director is obliged to inform himself or herself as to the financial affairs of the company to the extent necessary to form each year the opinion required for the directors' statements. Although that is only an annual obligation, it presupposes sufficient knowledge and understanding of the company's affairs and its financial records to permit the opinion of solvency to be formed - - -. Having regard to what I have already said about the broad structure of s 556 and the general scheme of the Code, it is thus apparent that, in enacting the present section, the legislature has deliberately sought to impose a heavier burden on directors and other officers of companies which happen to become insolvent. In my opinion, it is part of a consistent legislative pattern over recent years, whereby the duties and obligations of directors and company officers have been increased and made more onerous."

After explaining that clearly no difficulty would arise if the debt was incurred by the director's own acts, His Honour went on (p 415):-

> "If the debt is incurred by another, whether by a director or another servant or agent of the company, the director again remains liable unless he proves the want of the necessary consent or authority. In short, he is required to show that he bears no relevant responsibility for the authority given to incur the debt. In my opinion it would be contrary to the purpose of the section if the director could respond to a charge or claim by saying:
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> 'I was not the only person responsible for the giving of the relevant authority and therefore I myself did not authorise the incurring of the debt.'"

His Honour then turned to a consideration of what usually happens in day to day business. He pointed out that most debts will not be incurred as a result of the giving of an express authority by either the Board or an executive director. They will be incurred in the ordinary course of business by those who are given relevant general authority to act on behalf of the company whether they be the senior executives or minor purchasing officers. The real problem was how these debts should be characterised for the purpose of the section and for the purposes of determining whether a defendant may rely upon the defence. The basis on which His Honour eventually rejected the claimed defence by Mrs Morley appears in the following passage (p426):-

> "It is sufficient to repeat that she and her daughter agreed in 1979, albeit informally, with their co-director Mr Ian Morley, that he should continue to manage the company on their and its behalf. The general authority so conferred was sufficient to authorise the incurring of the debts, which the plaintiff now seeks to enforce against the defendant pursuant to s 556. It likewise follows that those debts were incurred with her implied authority within the meaning of the paragraph. I should add that I have been concerned that this conclusion may result in too rigorous an application of the provisions of the section. It does impose obligations which some directors may be surprised to discover, and which would be contrary to the impression they have formed, and I would concede since Lewis's case that impression may have been strengthened. On the other hand the interpretation which has been here applied is, in my view, the obvious consequence of the redrafting of the provision which is now s 556. If I may say so, it was a view formed by me when I happened to be a part time director of a small company for a short time after the

Code came into effect and that section, as well as s 269 (9) in the context of the new Code appeared then, as now, to require a degree of attention to the affairs of a company, especially its financial affairs, which had not been previously been expected."

Nor was the alternative defence under s 556 (2)(b) available to Mrs Morley. She was not able to show that she had reasonable cause to expect that the company would be able to pay its debts as and when they became due. As His Honour said (p 431):-

"What is reasonable, therefore, is related in part to the extent of the inquiries that the director has made and should have made about the company's solvency. A director should not in those circumstances be entitled to hide behind ignorance of the company's affairs which is of his own making or, if not entirely of his own making, has been contributed to by his own failure to make further necessary inquiries. - - -What each director is expected to do is to take a diligent and intelligent interest in the information either available to him or which he might with fairness demand from the executives or other employees and agents of the company. However, at the least, a director cannot now assert from a state of total ignorance that he or she had no reasonable cause to expect that a company could not pay its debts as they fell due, within the meaning of par (d).- - -Moreover, to fail to make any inquiries whatsoever is not excusable and an opinion on the company's solvency based on that ignorance could not be characterised reasonable. Even in a small company a director should ask for and receive figures, albeit of a basic kind, on a more or less regular basis. If that is sought and it reveals no difficulties and the director has no other reason to suspect the company may not be able to pay its debts as they fall due, then the director may be shown to have acted reasonably. Directors cannot be required to make their own further investigations or to 'audit' the accounts provided, unless they have particular responsibilities or expertise, and they can only be required to seek more information if the company's accounts, together with any other information from the company's executives, put them on enquiry.- - - Nevertheless, it is not appropriate in this judgment to provide a catalogue of the kinds of information that a

> director should be required to seek out, for that must depend on the nature of the company,its business or other affairs and the types of books and records it possesses or must be expected to possess. Nor is it appropriate here to provide an elaborate description of the degree of understanding which a director must display for his expectations to be shown to be 'reasonable' for the purposes of the paragraph. - - - Here the defendant took no interest in the day to day affairs of the company, attended no regular directors' meetings and sought no financial or other information from her son to whom she had delegated managerial responsibility. It may readily be believed that she trusted her son to manage the company competently. I also accept that she knew nothing of her responsibilities as a director and that nobody had informed her that they involved her doing more than signing a few documents from time to time upon the say so of her son, or possibly of the company's accountants. Those matters, unfortunately for her, do not excuse her failure to perform those duties. It may be that the company was set up for tax purposes, as appeared at one stage in the evidence, but if people choose to use a corporate vehicle to carry on their business activities then they accept the consequential responsibilities imposed by law. Even now those duties are not exceptionally onerous; they do not as yet involve any degree of competence, only a reasonable degree of diligence and honesty. But diligence does require attention to specific duties imposed by the code and by the law generally relating to directors, and that, in my opinion includes an obligation on each director to try to understand or discover sufficient of the company's financial affair as would enable him or her, as one of the board of directors to stop, if possible, it activities when it is no longer able to pay its debts as and when they fall due. - - - If monthly accounting figures (at the least) are not provided and there are no regular reports to the directors from those responsible for the management of the company, then a director may find it hard to show that he or she has acted reasonably for the purposes of the section."

Once again there is room for the imaginative spouse with a loan account in the books of the insolvent company, to seek to recover the money from the other spouse who had been a director when the money was lent to the company.

No one should think that the foregoing is any exhaustive account of the remedies that a spouse may find in the Companies legislation or in the general law as it impacts on companies. I have sought to do no more than illustrate the importance of considering with care whether a client in a seemingly difficult position may not be advantaged by resort to company law.