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A Storm Warning – Directors duties in tightly held companies

By ,

In Part 1 of our Storm Warning series, we examine **ASIC v Cassimatis (No 8)[1] (Storm 8)** for its salutary warning on directors duties, particularly in closely held companies.

In a judgment spanning 218 pages and 838 paragraphs, Justice Edelman ultimately found that Mr and Mrs Cassimatis breached their duties under section 180(1) of the Corporations Act (**Act**) not just for the actions they took but for the actions they failed to take.

Storm Warning

Storm 8 is important as it issues a clear warning to directors regarding section 180(1) and reaffirms that the obligations of care and diligence turn on the facts and circumstances of each case. The case also emphasises the obligations of directors in closely held companies and how the actions of directors in closely held companies can lead a director to breach section 180(1) of the Act.

When considering whether a director has breached his or her obligations under section 180(1), the courts will look at the actual level of control and the extent of the responsibilities in determining whether a reasonable person, placed in the same position as the director in the director's business, would have acted in the same way as that director did, or would they have taken a different approach (in all of the circumstances).

This is particularly relevant in closely held companies, where the director's level of control is usually more "intimate" than in widely held and larger businesses.

In the latest Storm Financial Ltd (**Storm**) saga, the Federal Court held that Mr and Mrs Cassimatis breached their duties of "care and diligence" under the Corporations Act by exercising their powers in a way which caused inappropriate advice to investors.

Section 180(1)

In order to understand Justice Edelman's decision, we must first examine section 180(1).

Directors (and other officers) owe several duties towards their companies. One of the main duties is the duty to exercise due care and diligence in discharging duties.

Section 180(1) of the Act states that:

A director is required to exercise their powers and discharge their duties which a reasonable person would exercise if they:

a. were a director of a company in the company's circumstances;
b. occupied the office within the company held by the director and had the same responsibilities within the company as a director. A director or officer must exercise the degree of care and diligence that a reasonable person would exercise if they were a director or officer of a company in the company's

circumstances and occupied the office held by, and had the same responsibilities within the company as, the director or officer.

In considering whether a director has met their duties in exercising care and diligence, various circumstances may be considered including the type of company, the size and nature of its business, the composition of its board and the distribution of the work between the board.

Breaching section 180(1)

In Storm 8, Justice Edelman examined the particular actions of the Cassimatis' in determining whether they had breach their duty of care and diligence.

The court found that Mr and Mrs Cassimatis had exercised their powers as directors:

1. to impose significant control over Storm and its financial affairs;
2. to specifically develop education workshops which were presented to potential clients and involved strong promotion of the benefits of leveraging high levels of debt (the **Storm Model**) as means for wealth creation;
3. were intimately familiar with the Storm Model, its promotion and its application, more than anyone else in the business; and
4. to create an environment where almost all clients were advised to use the Storm Model.

In determining whether a breach of section 180(1) occurred, the court considered what a reasonable director, in the Cassimatis' circumstances, would do.

Justice Edelman concluded that a reasonable director in the Cassimatis' position would have or should have been aware that if they exercised their powers in the way that the Cassimatis' did, there was a strong likelihood of contravention of the Corporations Act and therefore a breach of section 180(1). This was primarily because the Cassimatis' had caused or permitted clients to invest in the Storm Model in circumstances where those clients should not have been eligible to do so, thereby breaching the relevant provisions of the Corporations Act.

The fact that Mr and Mrs Cassimatis failed to act to prevent or prohibit the use of the Storm Model from being applied in indiscriminate circumstances, led to the court finding that Mr and Mrs Cassimatis breached section 180(1) of the Corporations Act.

In other words, the directors should have taken precautions to prevent the giving of inappropriate advice to investors who were the most vulnerable of Storm's clients.

What this means for you?

In tightly held companies, such as family companies and companies with few shareholders who may also be directors, it is common for directors to exercise a high degree of control over the business and influence the business activities intimately.

Storm 8 makes it clear that the more involved a director is in the business and controls the activities of the business, the more consciously they will need to act to ensure they observe their obligations of due care and diligence, including (amongst other things) taking positive steps to prevent the company being in breach or *likely* to breach of the Corporations Act.

These positive obligations require consideration of not just the duties and obligations of a director, but also an understanding of the Corporations Act more generally in order to be alert to any *likely* breaches. A director should also be cognisant of how their actions may be viewed by the "reasonable director" and consider whether their actions are reasonable in that context.

Knowing your obligations and duties is one thing.

Knowing what do to and how to fulfil them is entirely another.

Storm 8 provides a timely warning regarding directors duties in tightly held companies. For more information about your obligations as a director contact our corporate and commercial specialist: Gina Bozinovski.

It remains to be seen whether the Cassimatis' will appeal the judgment. Based on the history of these proceedings, we anticipate an appeal is more likely than not.

Stay tuned for further Storm Warnings.

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[1] Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023

Should you wish to discuss any matters arising out of this article, please contact the author:

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