BAD INTER-COMPANY LOAN IS COSTLY FOR THE DIRECTOR

If (which seems common) directors believe that they can use one company as the “cash cow” for the corporate group and lend funds to another related company to keep it afloat (even if it is to assist in start-up costs for that other company), then a recent case should make them revisit those arrangements.

In *Bryve Resources Pty Ltd [2022] NSWSC 647* (23 May 2022) a director was held to be *personally* liable for the amounts of two common types of transactions by the company:

1. Loans made by the company to a related company ($1,514,828.52); and
2. Repayments by the company to reduce debts owed to the director ($417,501).

As regards the loans to the related company:

1. The company advanced funds to the related borrower over a period of time.
2. The advances were made at times when:
    a. The lender operated at a net loss (for the relevant financial years).
    b. The lender had assets of questionable value, and significant liabilities.
    c. The lender had other creditors to pay, and so couldn’t really afford to lend money to the related borrower.
3. The advances were recorded as loans in the lender’s financials, as well as in the borrower’s financials, but was otherwise undocumented.
4. There were no payment terms or deadlines for the loan. Accordingly, the Court held that the loan was repayable on demand.
5. There was no requirement for the borrower to pay interest.
6. There was no security taken over the borrower’s assets, despite the very real risk that the borrower could not afford to repay the loan; the borrower had minimal income, some assets (but a net asset deficiency), and operated at a loss.
7. The loan ultimately was not repaid by the borrower.
8. The lender (Bryve) entered Voluntary Administration and then Liquidation.
9. Bryve, controlled by its liquidator, commenced Court action against the director alleging breach of director duties in allowing the lender to make the loans to the borrower.

As regards the repayments made by the company to the director:

1. The director was owed significant monies by the company.

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2. The director caused the company to make some repayments to him, or to third parties for his benefit.
3. The payments were made in circumstances where:
    a. The loan owed to the director was unsecured.
    b. Payments were not being made to other creditors.
    c. The payments to the director left the company without funds to pay other creditors. The company traded at a loss, its assets were questionable, and its liabilities were significant.
    d. The company was also making loans to a related party, which it could not afford to do (see above).

The Court held that:

1. The director of the lender (Bryve) was liable *personally* for the amount of the loan to the related company, because the director breached his director duties to the lender; s180 (duty of care and diligence) and s181 (duty of good faith) of the *Corporations Act* 2001. The breach of director duties occurred because, amongst other things, there was no benefit whatsoever to the lender in making the loan, and no steps were taken to mitigate the very real risks associated with the borrower's capacity (or lack thereof) to repay the loan. It was all risk, and no reward, to the lender.
2. In the whole of the circumstances, a reasonable person in the company's position would not have made the repayments to the director, even though the company was significantly indebted to him. Accordingly, the payments to the director were unreasonable director related transactions (s588FDA *Corporations Act* 2001) and the director was required to pay an amount to the company equal to the repayments he had received.

SOME CONSIDERATIONS for directors when making inter-company related loans:

1. **Can the lender afford to make the loan?**
2. **Are there reasonable grounds to expect that the borrower can repay it?**
3. **What full commercial terms can be agreed and documented?**
4. **Is there a benefit to the lender (e.g. by charging interest)?**
5. **Can the risks to the lender be mitigated (e.g. by taking security)?**

SOME CONSIDERATIONS for directors when seeking repayment of debts owed to them by the company:

1. **Are the monies legitimately owed to the director?**
2. **What are the whole of the circumstances of the company at the time of each proposed repayment, not just limited to the financial position of the company itself, and is it reasonable to make any repayments in those circumstances?**
3. **Are there any questionable transactions or arrangements (such as bad inter-company loans) polluting the overall circumstances, and which could make the repayments unreasonable?**

Importantly, the above applies even if the company is solvent; for the purposes of unreasonable director related transactions (s588FDA), it is not necessary for a liquidator to establish that the company was insolvent at the time of the repayments.

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