CORPORATE GOVERNANCE AND THE DUTIES OF COMPANY DIRECTORS

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Part 1

Introduction

Chapter 1

The Corporate Governance Debate and the Role of Directors' Duties

Ian M Ramsay*

Introduction

This book explores a number of the important aspects of the corporate governance debate and, in particular, it examines the role of directors' duties in corporate governance. This introductory chapter is divided into three sections. First, I discuss some of the key issues relevant to the corporate governance debate. I include in this section definitions of corporate governance and I identify mechanisms that play a role in corporate governance. In the second section I examine a number of specific issues relating to directors including the corporate governance implications of the structure of the board of directors. Finally, in section three, I review the role of directors' duties in corporate governance.

Corporate Governance

Definitions of corporate governance

There are many definitions of corporate governance. A number of definitions refer to corporate governance as the system by which companies are directed and controlled. This is the definition provided by the Cadbury Committee in its Report on the Financial Aspects of Corporate Governance.[1] It is also the definition provided by the Working Group on Corporate Practices and Conduct.[2] Some definitions of corporate governance are narrow while others are more open-ended. A narrow definition is provided by Professors Shleifer and Vishney who state that corporate governance is concerned with "the ways in which suppliers of finance assure themselves of getting a return on their investment".[3] A broader definition of corporate governance encompasses a range of stakeholders in companies. Professor Prentice states that at its broadest level, the corporate governance debate "involves the issue of the relationship between the stakehold-

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1 Committee on the Financial Aspects of Corporate Governance (chaired by Sir Adrian Cadbury), *Report* (1992) at para 2.5.

2 Working Group on Corporate Practices and Conduct (chaired by Henry Bosch AO), *Corporate Practices and Conduct* (3rd ed, 1995) at 7.

3 A Shleifer and R W Vishney, *A Survey of Corporate Governance*, National Bureau of Economic Research Working Paper No 5554, 1996, quoted in W Vessler, F R Kaen and H Sherman, *Going Public: A Corporate Governance Perspective*, Working Paper, April 1997 at 2.

ers in a company and those who manage its affairs (the board of directors)".[4] Monks and Minow define corporate governance as:

> ...the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by the chief executive officer), and (3) the board of directors...Other participants include the employees, customers, suppliers, creditors, and the community.[5]

These definitions reflect different perspectives on the functions and role of corporate governance. As Vessler, Kaen and Sherman note:

> One perspective approaches the corporate governance debate as part of the larger question of how to organize economic activity to achieve more fundamental societal objectives related to equity, fairness, freedom and citizen responsibilities. The other perspective is more narrowly concerned with economic efficiency objectives and, at the risk of exaggeration, considers economic efficiency to be an end in itself rather than a means to non-economic societal objectives.[6]

According to one of these perspectives, good corporate governance should have as its objective the maximisation of shareholders' wealth. The broader perspective (which might be called the stakeholder perspective of corporate governance) focuses upon companies being "socially responsible" and often subordinating profit maximisation to other goals. It can therefore be seen that the corporate governance debate is intrinsically linked to the important question: For whom do directors govern? Do they govern for shareholders or for a broader range of stakeholders? This issue is further discussed below.[7]

Why is corporate governance an issue?

According to Oliver Hart,[8] corporate governance issues arise in an organisation whenever two conditions are present. First, there is a conflict of interest (or an agency problem), involving members of the organisation; and second, the conflict of interest or agency problem cannot be dealt with through a contract. In relation to the second point, Hart observes that there are several reasons why contracting to overcome agency problems might not always be possible. In particular, it is not possible to contract to cover all eventualities. In addition, there are costs associated with negotiating contracts and enforcing them. This means that there will not always be comprehensive contracts governing participants in companies.

What are some of the conflicts that may exist in companies? Many can be identified. For example, conflicts may arise between:

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4 D D Prentice, "Some Aspects of the Corporate Governance Debate" in D D Prentice and P R J Holland (eds), *Contemporary Issues in Corporate Governance* (1993) at 25.
5 R A G Monks and N Minow, *Watching the Watchers: Corporate Governance for the 21st Century* (1996) at xvii.
6 Vessler, Kaen and Sherman, supra n 3 at 3.
7 See nn 24-26 and accompanying text.
8 O Hart, "Corporate Governance: Some Theory and Implications" (1995) 105 *Economic Journal* 678.

- managers (including the chief executive officer) and directors – particularly between managers and non-executive directors over issues such as the appropriate level of remuneration for managers;[9]
- shareholders and directors and/or managers over issues relating to the degree of effort and loyalty expected of directors and managers;
- creditors and shareholders in relation to issues such as:[10]
  - the payment of excessive dividends
  - claim dilution (through taking on debt with similar or higher priority)
  - asset substitution (for example, substituting saleable for non-saleable assets)
  - excessive risk-taking (whereby shareholders in a leveraged company have incentives to invest the company's resources in risky projects: if a project is successful, the excess returns will be distributed among the shareholders as dividends but will not be shared with the creditors who are only entitled to a fixed return on their investment. Company losses, however, are shared among both creditors and shareholders);
- employees and managers/directors/shareholders over issues such as wages and other conditions of employment;
- shareholders themselves (for example, between small shareholders and large institutional shareholders); and
- different types of creditors (for example, between secured and unsecured creditors).

A key objective is to minimise these conflicts and there are a number of corporate governance mechanisms that may operate to achieve this.

Mechanisms that play a role in corporate governance

A number of mechanisms play a role in corporate governance by operating to minimise one or more of the conflicts outlined above. Each will have a different degree of influence in relation to particular companies. In the case of those corporate governance mechanisms which focus on conflicts between shareholders and directors and/or managers, the mechanisms include:

- *Directors' and officers' legal duties* which have, as their objective, ensuring that directors and officers act honestly, with appropriate care and diligence, and in the best interests of the company.[11]
- *The structure of the board*, including such matters as the proportion of independent directors constituting the board and whether the positions of chairperson of

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9 Although some of the early corporate governance literature viewed managers and directors as one group, it is clear that each may have separate interests and therefore should generally be viewed as being different stakeholders in public companies. Of course, in many small companies, the same people may be the managers and directors. In addition, it may not always be correct to view all non-executive directors as having similar interests. Some directors may be representatives or nominees of particular groups of stakeholders such as shareholders, creditors or employees. The interests of these stakeholders may conflict. The legal issues associated with nominee directors are discussed by Justice Thomas in Chapter 9 of this book and also by Robyn Carroll in Chapter 10.

10 The following four sources of conflict are identified in C W Smith and J B Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979) 7 *Journal of Financial Economics* 177.

11 These legal duties are discussed in detail in Part III of this book.

the board and chief executive officer are combined or separate. An important question is whether independent directors are better at monitoring managers on behalf of shareholders than executive directors.[12]

- *Auditors,* who assist in the monitoring of managers by attesting to the accuracy of companies' financial statements.
- *Institutional investors*. A major debate is occurring regarding the extent to which institutional investors are effective monitors of the companies in which they invest. This is an important issue given that members of the Australian Investment Managers' Association (the Association represents approximately 60 institutional investors) manage or own almost 45 per cent of the capital of companies listed on the Australian Stock Exchange and if the Australian shareholdings of major overseas investors are included, the aggregate percentage of institutional management or ownership of Australian listed shares is approximately 65 per cent.[13]
- *Takeovers*. Takeovers operate as a discipline upon managers who may be replaced if an acquiror believes it can operate the company more efficiently. The impact of takeovers as a corporate governance mechanism depends upon the effectiveness of the market for corporate control which can be impeded either by defensive tactics by the managers of target companies or by government intervention.[14] In relation to government intervention in the market for corporate control, a significant debate is underway in the United States regarding what are termed "non-shareholder constituency statutes". These have been adopted by a majority of states in the US and either require or allow directors of target companies to consider constituencies or stakeholders other than the shareholders of their companies. The question whether these statutes benefit shareholders, other stakeholders, or only benefit directors of target companies by making it more difficult for these companies to be taken over by giving target company directors greater latitude to engage in defensive tactics has been the subject of considerable empirical work.[15]
- *Disclosure of information by companies*. Such disclosure (which can be mandatory or voluntary) may be important for the proper monitoring of managers and directors.[16] A current example of disclosure relating to corporate governance is the recently introduced Australian Stock Exchange Listing Rule 4.10.3 which

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12 See nn 27-34 and accompanying text for discussion of these issues.

13 Australian Investment Managers' Association, *Corporate Governance: A Guide for Investment Managers and Corporations* (2nd ed, 1997) at 13. For detailed discussion of corporate governance issues associated with the rapid growth of institutional shareholders, see G P Stapledon, *Institutional Shareholders and Corporate Governance* (1996).

14 For discussion of the corporate governance aspects of takeovers, see I M Ramsay, "Balancing Law and Economics: The Case of Partial Takeovers" [1992] *Journal of Business Law* 369; R Romano, "A Guide to Takeovers: Theory, Evidence and Regulation" (1992) 9 *Yale Journal on Regulation* 119; S Deakin and G Slinger, "Hostile Takeovers, Corporate Law, and the Theory of the Firm" (1997) 24 *Journal of Law and Society* 124.

15 For a recent study, see J C Alexander, M F Spivey and M W Marr, "Nonshareholder Constituency Statutes and Shareholder Wealth: A Note" (1997) 21 *Journal of Banking and Finance* 417.

16 For evaluation of the possible rationales for mandatory disclosure requirements, see M Blair and I M Ramsay, "Mandatory Corporate Disclosure Rules and Securities Regulation" in G Walker and B Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994).

requires listed companies to disclose their corporate governance practices.[17]

- *The product market in which the company operates.* A company which is managed inefficiently may lose market share to more efficiently run companies in the same industry provided that the market is competitive.
- *The capital market.* Inefficiently managed companies may find it difficult to raise capital and, if they are successful in raising capital, the cost of the capital may be higher than for more efficiently managed companies.
- *The labour market for managers.* This market provides incentives for managers to work efficiently as this will enhance their prospects for taking up more senior positions in other companies.
- *Executive remuneration* – in particular, whether it is incentive-based.[18]
- *Shareholdings by managers/directors.* Some commentators suggest that increasing managers' and directors' shareholdings in their companies provides them with the incentive to improve corporate performance. Other commentators suggest that high levels of such share ownership may simply entrench managers and directors.[19]
- *Ownership concentration.* Does more concentrated share ownership provide greater incentives for those shareholders who have more at risk because of their significant holding to monitor managers and directors?[20]
- *Corporate financial policy* – in particular, the level of debt. Debt incurred by a company can serve as a device which bonds managers to shareholders. It may ensure (by reason of the regular interest payments required) that managers do not expand their empire too much by reinvesting profits unwisely.
- *Shareholder voting and litigation.* Shareholder voting may not be a powerful corporate governance mechanism where there is a significant free-rider problem in that the shareholder bears the cost of working out that the company is underperforming and then bears the expense of launching a proxy fight. In addition, it may be difficult to motivate other shareholders to vote in that rational apathy may be the norm. In relation to shareholder litigation, Professor Prentice notes that such litigation plays a relatively minor role in corporate governance in the United Kingdom and there have been only two reported cases of any significance involving a derivative action by shareholders.[21] Other disincentives to shareholder litigation in Australia and the United Kingdom (when compared with

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17 For an empirical study of the first year of operation of the Listing Rule, see I M Ramsay and R Hoad, "Disclosure of Corporate Governance Practices by Australian Companies" (1997) 15 *Company and Securities Law Journal* 454.

18 For an empirical study of the relationship between the remuneration received by chief executive officers and corporate performance in the largest Australian companies, see A Defina, T C Harris and I M Ramsay, "What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation into the Relationship between Pay and Performance in the Largest Australian Companies" (1994) 12 *Company and Securities Law Journal* 341.

19 For Australian evidence on the relationship between share ownership by directors and corporate performance, see A Craswell, R Saywell and S Taylor, "Ownership Structure and Corporate Performance: Australian Evidence" (1997) *Pacific-Basin Finance Journal* (forthcoming).

20 For Canadian analysis of this issue, see R J Daniels and P Halpern, "Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy" (1995-96) 26 *Canadian Business Law Journal* 11.

21 Prentice, supra n 4 at 39. The paucity of shareholder litigation in Australia to enforce directors' duties of care and diligence is the subject of comment by Professor Redmond in Chapter 11 of this book. See also I M Ramsay, "Enforcement of Corporate Rights and Duties by Shareholders and the Australian Securities Commission: Evidence and Analysis" (1995) 23 *Australian Business Law Review* 174.

shareholder litigation in the United States) include the absence of a contingent fee structure and the rule of costs whereby the loser pays the costs of the winning party.

- *Intervention by regulators*. Regulators such as the Australian Securities Commission and the Australian Stock Exchange may play an active role in enforcing corporate governance standards.

The relationship between corporate governance mechanisms

The corporate governance mechanisms just described should not be viewed in isolation from each other. Recent studies by economists have endeavoured to identify the degree of interdependence among various corporate governance mechanisms. For example, Agrawal and Knoeber present empirical evidence of interdependence among seven corporate governance mechanisms in a sample of almost 400 large US companies.[22] The corporate governance mechanisms they examine are: shareholdings of insiders, institutions, and large shareholders; use of outside directors; debt policy; the managerial labour market; and the market for corporate control.

In a recent paper, four economists examine the relationship in 49 countries between legal protection for investors and ownership concentration.[23] They find a strong negative correlation. In other words, those countries which offer poor legal protection for investors in companies have high ownership concentration. The authors view high ownership concentration as a substitute for poor investor protection. They note that their study is evidence of the fact that legal regulation matters for corporate governance and that companies have to adapt to the limitations of the legal systems in which they operate.

These studies have implications for the role of directors' duties in corporate governance. Corporate governance mechanisms may complement each other. In some circumstances, they may be substitutes. If corporate governance mechanisms can be viewed as substitutes then well designed directors' duties, combined with effective enforcement of these duties, may mean that less reliance has to be placed on some other corporate governance mechanisms.

Corporate Governance and Directors

We have seen that the role and functions of directors, as the senior decision- makers in companies, are central to corporate governance. However, determining the proper role of directors and ascertaining what types of directors might best suit the needs of companies are not without controversy. Familiar issues in this regard are the corporate social responsibility debate and the debate regarding the appropriate structure of the board of directors.

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22 A Agrawal and C R Knoeber, "Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders" (1996) 31 *Journal of Financial and Quantitative Analysis* 377.

23 R La Porta, F Lopez-de-Silanes, A Shleifer and R W Vishny, *Law and Finance*, National Bureau of Economic Research Working Paper No 5661, 1996.

Corporate social responsibility

Whether directors have obligations extending beyond that of maximising shareholder wealth is an issue that will be familiar to most readers and therefore does not warrant detailed analysis on this occasion.[24] Although the debate has been in existence for at least 70 years,[25] recently, the debate has re-surfaced in the context of analysis of the non-shareholder constituency statutes in the United States as well as the major restructurings of businesses that have been undertaken in recent years which have often led to significant lay-offs of employees.[26] For our purposes, the important issue is the fact that directors are central to this debate because although it is typically referred to as the corporate social responsibility debate, it is the directors who are called upon to balance the interests of various stakeholders and, of necessity, give priority to certain interests when the interests of stakeholders conflict.

The structure of the board of directors

Two recent issues demonstrate the relationship between corporate governance and the structure of the board of directors. These are first, the value of independent directors and second, the value of separating the roles of chief executive officer and chairperson of the board. In recent years we have seen a number of recommendations from committees and working groups that the boards of listed public companies have a certain proportion of independent directors. For example, the Working Group on Corporate Practices and Conduct recommended that boards of Australian listed public companies:

> include sufficient directors who are generally independent in their views to carry significant weight on the board. Their numbers will vary with the size of the board but it is unlikely that less than two will be able to exercise sufficient influence, and it is desirable that at least one-third of the board should be genuinely independent.[27]

The Australian Investment Managers' Association has recommended that boards of Australian listed public companies should have a majority of independent directors.[28] The UK Cadbury Committee recommended that boards of listed public companies should include non-executive directors "of sufficient calibre and number for their views to carry

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24 For an overview of a number of the issues relevant to the debate, see J Tolmie, "Corporate Social Responsibility" (1992) 15 *University of New South Wales Law Journal* 268.

25 It is reflected in the well-known debate between Berle and Dodd: see A Berle, "Corporate Powers as Powers in Trust" (1931) 44 *Harvard Law Review* 1049; E M Dodd, "For Whom are Corporate Managers Trustees?" (1932) 45 *Harvard Law Review* 1145; A Berle, "For Whom Corporate Managers are Trustees: A Note" (1932) 45 *Harvard Law Review* 1365.

26 For two sides of this recent debate, see D Millon, "Communitarianism in Corporate Law: Foundations and Law Reform Strategies" in L E Mitchell (ed), *Progressive Corporate Law* (1995) and E Sternberg, "The Defects of Stakeholder Theory" (1997) 5 *Corporate Governance: An International Review* 3. See also the comments of Justice Kirby on the implications of corporate restructurings for corporate governance in Chapter 4 of this book.

27 Working Group on Corporate Practices and Conduct, supra n 2 at 14.

28 Australian Investment Managers' Association, supra n 13 at 20.

significant weight in the board's decisions" and that all boards should have a minimum of three non-executive directors.[29]

An important issue is whether there is any positive relationship between board composition (ie, the proportion of independent or non-executive directors) and company performance. Many of the studies which have investigated this are reviewed by Stapledon and Lawrence who note that most studies generally find no evidence of a link between board composition and corporate performance.[30] Stapledon and Lawrence document a number of factors which may limit monitoring of managers by independent directors. These include limited time available to independent directors, lack of detailed knowledge of the company's business by independent directors, and there being too few independent directors on a particular board to be effective.[31]

A second important issue is whether there is any advantage to be gained in separating the roles of chief executive officer and chairperson of the board. Again, there have been a number of recommendations along these lines. The UK Cadbury Committee, the Working Group on Corporate Practices and Conduct and the Australian Investment Managers' Association have each recommended that the roles should be separate. It is stated in one of these Reports:

> The Working Group considers that the separation of the roles of chairman and CEO makes an important contribution to increasing accountability and ensuring that the interests of the shareholders as a whole are given due weight. The Working Group also considers that the chairman plays a crucial leadership role in ensuring that the board works effectively and that the combination of the roles of chairman and chief executive constitutes a concentration of power that can give rise to conflicts. Except where special circumstances exist [such as wholly-owned subsidiaries of overseas parents], the roles should be separate.[32]

A recent study by Brickley, Coles and Jarrell examines evidence relating to separation of the roles for a sample of large US companies.[33] They make a number of significant conclusions:

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29 Committee on the Financial Aspects of Corporate Governance, supra n 1 at para 4.11. Note that while the Working Group on Corporate Practices and Conduct refers to independent directors, the Cadbury Committee refers to non-executive directors. A definition of independent director is provided by the Australian Investment Managers' Association in its publication *Corporate Governance: A Guide for Investment Managers and Corporations* (2nd ed, 1997) at 20 where it is stated:

An independent director is a director who is not a member of management (a non- executive director) and who:
- is not a substantial shareholder of the company or an officer of or otherwise associated directly or indirectly with a substantial shareholder of the company;
- has not within the last three years been employed in an executive capacity by the company or another group member or been a director after ceasing to hold any such employment;
- is not a principal of a professional adviser to the company or another group member;
- is not a significant supplier or customer of the company or another group member or an officer of or otherwise associated directly or indirectly with a significant supplier or customer;
- has no significant contractual relationship with the company or another group member other than as a director of the company; and
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.

30 G P Stapledon and J Lawrence, "Board Composition, Structure and Independence in Australia's Largest Listed Companies" (1997) 21 *Melbourne University Law Review* 150. See also I M Millstein and P V MacAvoy, *The Active Board of Directors and Improved Performance of the Large Publicly Traded Corporation,* Yale School of Management Working Paper No 49, December 1997.

31 Stapledon and Lawrence, supra n 30 at 158-160.

32 Working Group on Corporate Practices and Conduct, supra n 2 at 16.

33 J A Brickley, J L Coles and G Jarrell, "Leadership Structure: Separating the CEO and Chairman of the Board" (1997) 3 *Journal of Corporate Finance* 189.

- There are costs to separating the roles such as agency costs of controlling the behaviour of the chairperson, information costs associated with separating the roles, and costs of having companies change their succession processes (this occurs where companies offer their CEO the prospect of also becoming the chairperson in the future).
- There are not significant numbers of large US companies which separate the roles (they note that other studies report only 15-25 per cent of US companies combine the roles. Stapledon and Lawrence in their study of the largest 100 Australian companies found that 83 per cent of these companies had a non-executive chairperson while 45 per cent had an independent chairperson).[34] Brickley, Coles and Jarrell suggest that the figure of 15-25 per cent is over-stated in relation to the US because many companies split the roles during periods of CEO transition but later revert back to a combined role by offering the CEO the position of chairperson.
- When companies separate the roles, the chairperson is almost always someone with detailed knowledge of the company with relatively high share ownership (which suggests that the roles are separated only when the information and agency costs of separation are low).
- A significant number of companies use the titles of chairperson and CEO as part of their succession plans for CEOs (that is, the title of chairperson is used as a reward for CEOs who perform well during a probationary period).
- Combining the roles is not associated with inferior financial performance and a share price event study undertaken by the authors did not find that changes in the roles (that is, companies either combining the roles or separating the roles) had any significant effect on share prices.

Corporate Governance and the Role of Directors' Duties

Directors' duties are generally seen as an important corporate governance mechanism. These duties address conflicts between shareholders and directors by focusing upon the possibility of shirking by directors (addressed by the duty of care, skill and diligence) and the possibility of a lack of loyalty by directors (addressed by the duty to act honestly and in the best interests of the company).

Part II of this book addresses general corporate governance issues that are related to directors' duties while Part III is a detailed analysis of specific duties owed by company directors. In Chapter 2, Chief Justice Norman Veasey explores the role of directors' duties in corporate governance in the United States. He commences by drawing a distinction between (1) "enterprise" and "ownership" issues in corporate decision-making, and (2) "oversight" issues in the board's non-decision-making monitoring role. Enterprise issues are those relating to the business of the company in terms of the goods or services it produces while ownership issues raise questions such as whether the company should merge with another company. A major focus of this chapter is on the duty of oversight which requires directors to exercise reasonable care to see that company

34 Stapledon and Lawrence, supra n 30 at 172.

managers carry out their responsibilities and comply with the law.

Chief Justice Veasey raises an issue which is a recurring theme in a number of the chapters. It is the role of the business judgment rule. This is a topical issue because the Federal Government, as part of its Corporate Law Economic Reform Program, has recently proposed that there be a statutory business judgment rule.[35] It is recommended that the following provision should be inserted into the Corporations Law:

> (1) An officer of a corporation is taken to meet the requirements of sub- section 232(4) and the general law duty of care and diligence in respect of a business judgment made by them if the officer:
> (a) exercises their business judgment in good faith for a proper purpose;
> (b) does not have a material personal interest in the subject-matter of the business judgment;
> (c) informs themselves about the subject-matter of the business judgment to the extent the officer reasonably believes to be appropriate; and
> (d) rationally believes that the business judgment is in the best interests of the corporation.
>
> (2) In this section "business judgment" includes any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation.
>
> (3) Sub-section (1) does not operate in relation to any other provision of this Law or any other Act or any Regulation under which an officer may be liable to make payment in relation to any of their acts or omissions as an officer.[36]

Justice Veasey notes that oversight responsibility does not implicate the business judgment rule because it does not involve business decisions. He then turns to analyse a series of United States cases which identify limits of oversight responsibility as part of directors' duties.

Another issue discussed by Justice Veasey is derivative shareholder litigation in the United States. Again, this is a topical issue in Australia because the Federal Government has proposed, as part of its Corporate Law Economic Reform Program, the introduction of a statutory derivative action.[37]

Justice Veasey then considers measures that directors can employ to ensure that they satisfy their oversight responsibility. The issues he addresses include whether directors are truly independent, whether they are active in developing strategic plans and monitoring management's performance against that plan, regularly evaluating the CEO, and establishing and monitoring law compliance programs. Finally, Justice Veasey discusses the increasing influence of institutional investors in US companies noting that although the interests of institutional investors and the concerns of courts reviewing actions or omissions of directors may often converge, they are analytically different. While institutional investors aim to enhance shareholder wealth and may be active in ensuring that directors pursue this objective, courts look to process, honesty and objectivity in decision-making by directors.

In Chapter 3, Justice Alex Chernov explores the role of corporate governance practices in the development of legal principles relating to directors. The specific corporate

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35 Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance*, Paper No 3 (1997).

36 Ibid at 28.

37 Ibid at 29-40. For evaluation of the merits of a statutory derivative action, see J Kluver, "Derivative Actions and the Rule in Foss v Harbottle: Do We Need a Statutory Remedy?" (1993) 11 *Company and Securities Law Journal* 7; I M Ramsay, "Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action" (1992) 15 *University of New South Wales Law Journal* 149.

governance practices and related legal principles Justice Chernov addresses are:

- the division of functions between the board and management;
- conflict of interest by executive directors and the chairman of the board;
- disclosure of conflicts of interest;
- board responsibility for subsidiaries; and
- the corporation as good citizen.

It is in the context of discussing this final point that Justice Chernov examines legal developments which have, to some extent, recognised that directors may, as part of acting in the best interests of the company, consider the interests of stakeholders other than shareholders. The conclusion of Justice Chernov is that there is evidence to support the proposition that corporate governance practices have influenced the development of legal principles.

In Chapter 4, Justice Michael Kirby argues that traditional notions of corporate governance are being rethought because of major changes to the environment in which Australian companies operate. These changes include growing globalisation of the markets within which companies operate, the rapid growth of institutional investors, corporate restructuring, and privatisation.

Part III of the book is a series of chapters in which the authors review specific legal duties owed by company directors. In addition, several issues such as nominee directors are discussed. In Chapter, 5 Chief Justice David Malcolm examines in detail directors' duties both at general law and also under the statutory provisions of the Corporations Law. These duties include the duty to act in good faith and for proper purposes, the duty of care, skill and diligence, the duty to act honestly, and the duty to refrain from making improper use of position. Justice Malcolm argues that when called upon to review directors' duties, courts have generally adhered, where possible, to traditional principles of non-interference in corporate management and what he terms the "non-prescriptive principle" which reflects an awareness that courts cannot prescribe in great detail the boundaries within which they will exercise jurisdiction over the affairs of companies. At the same time, courts have increasingly taken account of what Justice Malcolm terms "the principle of commercial reality" insofar as this reflects changing "reasonable expectations" of participants in the corporate world and of society in general.

The duty of care of company directors in Australia and New Zealand is the subject of analysis by Professor John Farrar in Chapter 6. The duty of care owed by company directors is further examined by Professor Robert Baxt in Chapter 7. Directors' statutory duties of honesty and propriety are examined by Michael Whincop in Chapter 8.

The role of nominee directors and the liability of their appointors is the subject of Justice Thomas's chapter. Justice Thomas delivered the judgment in the well-known and important New Zealand case *Dairy Containers Ltd v The Auditor-General*[38] which involved the potential liability of a parent company for the negligence of its employees who were directors of a subsidiary. Justice Thomas argues strongly that recent legal developments regarding the liability of appointors of nominee directors are inconsistent with commercial reality and practice. He argues that liability on the part of appointors should arise where the nominee directors are expected to act in accordance with some

38 [1995] 2 NZLR 30.

understanding or arrangement which creates an obligation or expectation of loyalty to the appointors.

In Chapter 10, Robyn Carroll examines shadow director and other third party liability for corporate activity. Her focus is on three areas of liability which have been the subject of consideration in recent cases: tort, breach of fiduciary obligation and liability under the Corporations Law. In relation to potential liability of third parties under the Corporations Law, Ms Carroll gives detailed attention to s 60 of the Corporations Law which provides that in certain circumstances, persons other than formally appointed directors may in fact be held to be directors and subject to the duties contained in s 232 of the Corporations Law. She also considers s 588V of the Corporations Law which imposes liability on a holding company for insolvent trading by its subsidiary.

As noted above, the Federal Government has recently proposed, as part of its Corporate Law Economic Reform Program, that a statutory business judgment rule be introduced into the Corporations Law. In Chapter 11, Professor Paul Redmond considers whether a statutory business judgment rule is needed. He first provides the history of the consideration of this issue in Australia. He then examines the principal elements of the business judgment rule as it has developed in the United States. Finally, he reviews a number of the more important arguments relating to the need for a statutory business judgment rule.

In the final chapter of the book, Alan Cameron provides the perspective of the Australian Securities Commission on the enforcement of directors' duties and the role of the courts. He also offers some views in relation to the need for a statutory business judgment rule (an issue that is also discussed by Professor Baxt in Chapter 5 and Professor Farrar in Chapter 6, in addition to Professor Redmond's detailed analysis of the issue in Chapter 11). The main focus of Mr Cameron's comments is on alternatives to courts in the area of corporate regulation. He examines the Corporations and Securities Panel, the possible use of a Financial Law Panel which would have the function of identifying and addressing areas of legal uncertainty affecting aspects of the financial markets, and the use of sentence indication hearings in criminal trials involving white collar crime.

Conclusion

The corporate governance debate is of critical importance given the connections between corporate governance and the financial performance of companies. We have seen that there are many corporate governance mechanisms. Some of these are market-based while others see a significant role for the law. In the latter category is a range of duties owed by company directors. The contributors to this book explore a number of the dimensions of directors' duties and corporate governance. These include the ways in which the development of directors' duties may have been influenced by corporate governance practices, whether a statutory business judgment rule will enhance corporate governance, and detailed analysis of the scope of the various duties owed by company directors. The many developments (both international and Australian) noted by the authors, the different perspectives they bring to bear and the many issues they raise for further debate will ensure that the recent focus on corporate governance will only increase.

Part II

Corporate Governance

Chapter 2

The Defining Tension in Corporate Governance in America

Chief Justice E Norman Veasey*

Introduction

American corporation law has progressed, as we all know, through the period of sovereign chartering to the general corporation law scheme. That form is based upon an enabling act with some statutory guideposts and wide latitude for private ordering. It depends on wise counsellors and independent judges who do not unduly interfere in business matters.

Since the "Genius of American Corporate Law" is its state-oriented federalism and its flexible self-governance, it is the independent directors and corporate counsellors who have to make the system work.[1] In this chapter, I will try to provide an overview of that "genius" in the context of the relationship between the role of courts in adjudicating corporate law and the interests of institutional investors in advocating aspirational models of corporate governance.

Enterprise, Ownership and Oversight Issues

Corporate governance issues often divide among "enterprise" and "ownership" issues in corporate decision-making and "oversight" issues in the board's non-decisionmaking monitoring role.[2] This is an oversimplification, of course, but I have found it to be a helpful analytical tool.

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* Chief Justice, Supreme Court of Delaware. An earlier version of this chapter was presented at the conference *The Courts and Corporate Law* held at The University of Melbourne on 31 October 1996 and hosted by the Centre for Corporate Law and Securities Regulation, the Australian Institute of Company Directors, the Australian Institute of Judicial Administration and the Business Law Section of the Law Council of Australia.

1 R Romano, *The Genius of American Corporate Law* (1993):
"The Genius of American Corporate Law is in its federalist organisation. In the United States, corporate law, which concerns the relation between a firm's shareholders and managers, is largely a matter for the states. Firms choose their state of incorporation, a statutory domicile that is independent of physical presence and that can be changed with shareholder approval. The legislative approach is, in the main, enabling. Corporation codes supply standard contract terms for corporate governance. These terms function as default provisions in corporate charters that firms can tailor more precisely to their needs. Firms therefore can particularise their charters under a state code, as well as seek the state whose code best matches their needs so as to minimise their cost of doing business" (p 1).

2 B A Manning, "Life in the Boardroom After Van Gorkom" (1985) 41 *Business Lawyer* 1 at 5-6.

Enterprise issues raise questions like: Should we manufacture cars or widgets and should the plant be in Perth or Pittsburgh? These issues are normally the proper domain of the senior management team. There is little or no court interference in enterprise issues. The board of directors should be responsible for formulating a strategic plan within which enterprise issues fit, although the board is usually not expected to carry out the detailed implementation. Stockholder involvement in enterprise issues is usually nonexistent.

It is the *ownership* issues that raise questions like: Should we merge our widget company with an automobile manufacturer and fend off unwanted suitors who wish to take control by a tender offer to the stockholders? It is the ownership issues which usually put corporate governance sternly to the test.

Finally, there is one other major area of directorial responsibility which must be kept in mind. That is the duty of *oversight* where there is no business decision of the directors. Directors must exercise reasonable care to see that company executives carry out their managerial responsibilities and comply with the law.

The Business Judgment Rule

The Business Judgment Rule can be stated simply as follows: In making a business decision, the directors are presumed to have acted independently, on an informed basis, in good faith, and in the honest belief that the decision is in the best interests of the corporation.[3] A business decision will normally be sustained unless the presumption is rebutted in either of two ways: (a) the process, independence, or good faith of the directors is compromised; or (b) the decision cannot be attributed to a rational business purpose.[4]

Ownership issues may sometimes implicate the traditional Business Judgment Rule, but often ownership decisions require an enhanced court scrutiny which goes beyond the traditional Business Judgment Rule. That enhanced scrutiny may take several forms, depending on the circumstances.

Oversight responsibility does not implicate the Business Judgment Rule because it does not involve business decisions. Directors may be exposed to potential liability for violation of their oversight responsibility if they knew or should have known of managerial malfeasance, misfeasance or nonfeasance and did nothing about it, or if they otherwise abdicated their responsibilities.[5]

A significant element of corporate governance in Delaware and in many other jurisdictions is the expectation that directors, in carrying out their duty to direct the management of the business and affairs of the corporation, will delegate many responsibilities to management, board committees and others.[6] Moreover, directors may rely in good faith on corporate records, management reports, board committees, and outside experts, provided that reliance is placed after due care is exercised in selecting those upon whom reliance is placed.[7]

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3 See, for example, *Aronson v Lewis,* 473 A2d 805 at 809-811 (Del 1984); 8 Del C s141(a).

4 *Sinclair Oil Corporation v Levien,* 280 A2d 717 at 720 (Del 1971). Stated affirmatively: "Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Paramount Communications Inc v Time Inc,* 571 A2d 1140 at 1154 (Del 1989).

5 *Graham v Allis-Chalmers Manufacturing Co,* 188 A2d 125 (Del 1963); *Lutz v Boas,* 171 A2d 381 (Del Ch 1961).

6 Ibid; 8 Del C s141(a); *Rosenblatt v Getty Oil Co*, 493 A2d 929 (Del 1985).

7 8 Del C s141(e); Model Business Corp Act, s8.30(b) (1984); American Law Institute, *Principles of Corporate Governance*, ss4.01(a)(2), 4.01(b), 4.02, 4.03.

Increasingly in the United States directors are aspiring to high levels of sound corporate practice and good corporate governance models in decisionmaking and oversight. This is true even though failure to adhere to those aspirational goals may not result in liability, and these governance models do not necessarily guarantee profitable management performance or freedom from lawsuits.

Let me now generalize somewhat about the typical kinds of corporate governance cases which come before the Delaware courts. I will mention briefly only a few categories which may be of some interest.

Oversight Responsibility

The oversight responsibility is broad and exacting, but the liability exposure is another issue. The two Delaware cases which represent bookends in this area are *Graham v Allis- Chalmers* and *Lutz v Boas*.[8] Both cases were decided in the 1960s.

In *Graham,* directors were held not liable to the corporation in a derivative suit when they failed to prevent junior officers and others from committing antitrust violations which damaged the corporation. In that case there were no "red flags" which the directors saw or should have seen regarding antitrust violations of subordinates. Hence, there was no liability. This is the essential holding of the court:

> [D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances. Their duties are those of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends on the circumstances and facts of the particular case.
>
> The precise charge made against these director defendants is that, even though they had no knowledge or any suspicion of wrongdoing on the part of the company's employees, they still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end...On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.[9]

In *Lutz v Boas*,[10] directors who virtually abdicated their responsibility were held liable for what the Chancellor found to be "grossly negligent" conduct. I am not going to consider the debate about gross negligence and ordinary negligence in the oversight responsibility because the Delaware Supreme Court has decided only that concepts of gross negligence apply to the due care component of the directors' decisionmaking process for purposes of the Business Judgment Rule.[11] We have not spoken on the quantum or degree or adjective which might be applied to the breach of a director's duty of care in the oversight context.

8 *Graham v Allis-Chalmers Mfg Co,* 188 A2d 125 (Del 1963); *Lutz v Boas,* 171 A2d 381 (Del Ch 1961).
9 *Graham,* 188 A2d 125 at 130.
10 *Lutz,* 171 A2d 381.
11 *Aronson,* 473 A2d 805.

In *Lutz* the issue involved the failure of non-affiliated (supposedly independent) directors of mutual funds to carry out their oversight responsibility to monitor the fund managers and investment advisors. In holding these directors liable for gross negligence in abdicating their responsibilities, Chancellor Seitz said the following:

> These non-affiliated directors...are prime examples of what can happen when a man undertakes a substantial responsibility with public overtones without any appreciation of his obligation thereunder. Based upon my view of the evidence I make certain findings of fact: these non-affiliated directors gave almost automatic approval to the Management Agreement; they did not examine the registration statements carefully; they did not discuss securities at their meetings or discuss any of the other facts which would have been pertinent to a reasonable discharge of their duties; most of the time at the directors' meeting was spent in determining dividends on the basis of work sheets provided by the [investment advisors]; the directors did not know who selected securities for purchase or sale; they did not inform themselves about the rate of turnover and how the brokerage business was being distributed.
>
> The record shows that the board of directors gave scant attention to the management of the registrant; made no efforts to be informed concerning registrant's policies and whether such policies were being followed; made no decisions concerning purchases and sales of portfolio securities; and generally permitted the [fund] to be managed by the [investment advisors] without consultation with or approval by the board as a whole.
>
> On the basis of the record it is evident that the directors failed to discharge their duties and responsibilities as directors...[12]

Most recently, in a case which will not be before us because there will be no appeal, Chancellor Allen discussed his view of the oversight responsibility. In *Caremark,*[13] the Chancellor approved the settlement of a derivative action in 1996. In the course of his analysis he discussed the potential liability for negligence of directors in carrying out their oversight responsibilities regarding health care law violations of subordinates. Without expressing approval or disapproval of the Chancellor's statements because they may come before us in another case, I will simply quote of what he said:

> [L]iability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.
>
> Legally, the board itself will be required only to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, appointment and compensation of the CEO, etc. As the facts of this case graphically demonstrate, ordinary business decisions that are made by officers and employees deeper in the interior of the organization can, however, vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals...
>
> Modernly this question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations...[Sentencing Guidelines give corporation credit for compliance systems.]

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12 *Lutz,* 171 A2d 381 at 395-396.
13 *In Re Caremark Int'l Inc*, Civ A No 13670, 1996 WL 549894 at 1 (Del Ch Sept 25, 1996).

> In light of these developments, it would, in my opinion, be a mistake to conclude that our Supreme Court's statement in Graham concerning "espionage" means that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.
>
> Thus, I am of the view that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.[14]

I cannot comment on whether the 1960s cases of *Graham* and *Lutz* are "still good law". I cannot comment on the Chancellor's observations in *Caremark*. I will say that in an article I wrote as a lawyer with my associate Bill Manning in 1980, we said this in commenting on *Graham* through a 1980 prism of what was then a 17 year-old case:

> [T]he broad legal principles announced in Graham provide only minimal guidance...
>
> With respect to the liability...for failing to install an antitrust compliance system...one might conclude that, because of...the standard expressed by the Graham Court, no liability would attach...[T]he final "core function" of the board identified by the Business Roundtable (compliance with the law) was discussed by the Roundtable in the following terms:
>
>> Some recent lapses in corporate behavior have emphasized the need for policies and implementing procedures on corporate law compliance. These policies should be designed to promote such compliance on a sustained and systematic basis by all levels of operating management.[15]

In our 1980 article, we concluded that the acceptance of compliance systems as norm shows a natural development in the role of an "ordinarily prudent director" since 1963 when *Graham* was decided.

Hence, the oversight responsibility is a dynamic one. That is not to say that *Graham* would or would not be decided the same way today on its particular facts. No doubt, however, some of the language would be edited as we now look at it through a prism of what is now 34 years of experience. As to disclosure, recent Delaware cases have intensified the directors' duty of candid disclosure of material facts reasonably available in proxy statements, prospectuses and in dealing with each other.[16]

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14 *Caremark,* 1996 WL 549894 at 8-11.

15 E N Veasey and W E Manning, "Codified Standard – Safe Harbor or Unchartered Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law" (1980) 35 *Business Lawyer* 919 at 929-930 (footnotes omitted).

16 *Zirn v VLI Corp*, 681 A2d 1050 at 1061 (Del 1966) *(Zirn II)*; *Arnold v Society for Savings Bancorp Inc*, 678 A2d 533 at 541 (Del 1996) *(Arnold II); Arnold v Society for Savings Bancorp Inc,* 650 A2d 1270 (Del 1994) *(Arnold I); Zirn v VLI Corp*, 621 A2d 773 (Del 1993) *(Zirn I).*

Derivative Suits

The derivative action is common in Delaware. But outside Delaware, the process for handling this type of litigation under Delaware law is sometimes perceived as arcane. I hope, however, that the decisions of the Court of Chancery and the Supreme Court in recent years have made that process more understandable.

A stockholder of a Delaware corporation may bring a derivative suit against directors and officers on behalf of the corporation in the Delaware Court of Chancery or in another state or federal court having jurisdiction. If the stockholder qualifies to proceed with the litigation and wins, the recovery or equitable relief goes only to the corporation, not to the stockholder. But the court may award the stockholder's lawyers reasonable fees and expenses, depending upon the benefit conferred upon the corporation by the efforts of counsel for the stockholder.

It is the corporation's cause of action which the stockholder seeks to vindicate. That cause of action is an asset belonging to the corporation and only to the corporation. Like all other corporate assets, the corporation's cause of action should normally be managed by the board of directors. Accordingly, the stockholder usually must demand that the board bring suit.[17]

But what if the directors have a conflict because they are claimed to be the wrongdoers? By merely naming the directors in the suit, the plaintiff may not thereby unilaterally disqualify the directors. But if the stockholder can state facts with particularity which assert some reason to believe that the directors may be wrongdoers, the stockholder need not demand that the directors sue themselves. The demand is then excused and the stockholder may prosecute the action on the corporation's behalf. But if the stockholder cannot plead facts showing a reasonable doubt that directors acted properly, the stockholder must demand that the board of directors take action. The board should respond promptly to that demand either by rejecting it (if the rejection is not wrongful) or by taking some action to vindicate the stockholder's demand. If the demand is excused or wrongfully refused, the stockholder may assert the corporation's claim.[18]

In addition to the plethora of Delaware case law on the complexities of derivative suits, there is also considerable writing on the philosophy and the procedural details regarding different approaches to derivative litigation. The American Law Institute's Principles of Corporate Governance[19] and the Model Business Corporation Act[20] are examples of different approaches.

Direct and Class Actions

When a stockholder is injured directly (as, for example, when the corporation commits a material disclosure violation when seeking stockholder approval for a merger), the stockholder may sue directly on her own behalf.[21] Sometimes a stockholder who is injured

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17 See Del Ch Ct R 23.1. See also Fed R Civ, P 23.1.
18 See, for example, *Grimes v Donald,* 673 A2d 1207 (Del 1996); *Rales v Blasband*, 634 A2d 927 (Del 1993).
19 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations, Part VII* (1992); C Hansen, *A Guide to the American Law Institute Corporate Governance Project* (1995).
20 Model Business Corporation Act, ss7.41-7.47 (1984).
21 *Grimes,* 673 A2d 1207 at 1213.

directly in such a manner may bring a class action, suing on behalf of all stockholders similarly situated. Class actions are governed by specific and detailed procedural rules.[22] If the stockholder wins a class action, the recovery is distributed among the class members and the plaintiff's lawyers may be awarded reasonable fees and costs by the court depending on the benefit conferred upon the class. Both derivative and class actions may be settled, but only with court approval which may also involve the matter of lawyers' fees and costs.[23]

Exculpation of Directors From Liability for Monetary Damages

Suppose there had been a material disclosure violation on a merger approval. Perhaps injunctive relief could be obtained at an early stage before the merger is consummated. But if that fails or is not sought, can there be monetary damages awarded against the directors to the stockholder or the class? Perhaps, unless an exculpation statute applies.

Delaware has a statute that permits the stockholders through the certificate of incorporation to exonerate completely or limit the exposure of directors for personal liability to the corporation or the stockholders for monetary damages for breach of fiduciary duty as a director. That statute does not allow exoneration if the director is found to have committed a breach of the duty of loyalty, acts or omissions not in good faith, intentional misconduct, a knowing violation of the law, improper payment of dividends or improper personal benefit.[24] Other states have similar statutes, and many corporations have adopted such charter provisions.[25]

It is to be noted that the Delaware exculpation statute protects only *directors acting as directors* from monetary damages.[26] Thus, for example, if the certificate of incorporation permits the maximum statutory exoneration, negligent but good faith disclosure violations would not subject the directors to liability for monetary damages.[27] Moreover, in such a case there would be no vicarious or other monetary liability against the corporate defendants if the directors were shielded by the statute.[28] But injunctive relief is nevertheless available against the directors or the corporation, if warranted.

Fiduciary Duties

Directors are fiduciaries to the corporation and the stockholders. They owe fiduciary duties of loyalty and care to both. They also owe a duty of full disclosure in certain circumstances.[29] The duty of care includes the requirement that directors inform themselves of all material information reasonably available to them before making a business decision. This is a process requirement, and directors may be liable (unless exonerated by statute and charter provision) if they are found to be grossly negligent in the process.[30]

22 See Del Ch Ct R 23. See also Fed R Civ, P 23.
23 Ibid.
24 8 Del C, ss 102(b)(7).
25 See American Law Institute, *Principles of Corporate Governance,* s7.19.
26 Section 102(b)(7) does not apply to officers acting as officers. See A Sparks, "Common Law Duties of Non-Director Corporate Officers" (1992) 48 *Business Lawyer* 215.
27 *Arnold v Society for Savings Bancorp Inc,* 650 A2d 1270 (Del 1994) *(Arnold I).*
28 *Arnold v Society for Savings Bancorp Inc*, 678 A2d 533 (Del 1996) *(Arnold II).*
29 *Arnold I*, 650 A2d 1270.
30 *Aronson v Lewis*, 473 A2d 805 at 812 (Del 1984); *Smith v Van Gorkom*, 488 A2d 858 (Del 1985).

This liability analysis may be subject to an entire fairness hearing.[31]

The fiduciary duty of loyalty may be implicated if directors have a material conflict of interest and cause the corporation to act or not act in a way that benefits them personally or if they do not act independently when making a business decision. In such a case, directors may be held personally liable.[32] Duty of loyalty violations may also result in demand excusal in a derivative suit.[33]

Sometimes it is not easy or appropriate to place the conduct of directors in sharply defined cabins of care or loyalty.[34] Similarly, the duty of disclosure requires candour in disclosing all material information which would be of importance to a stockholder in deciding how to vote.[35] The failure to disclose that material information could be fraud or a good faith omission.[36]

Litigation involving ownership issues presents the area where the lines between care and loyalty can sometimes be blurred. The intense takeover era of the 1980s, particularly the Delaware cases decided in the watershed year of 1985, brought these issues into sharp focus and influenced jurisprudence for years to come. When a director resists a takeover for the sole or primary purpose of entrenchment, a duty of loyalty violation may be implicated.[37] But sometimes it is only the mere perception of the "omnipresent spectre" of a conflict when directors in good faith believe that resistance to a takeover is in the best interests of stockholders. In that case, the intermediate burden of going forward with the evidence is on the directors to show that they reasonably perceived a corporate threat and acted proportionately in relation to that threat, but the ultimate burden of persuasion is on the plaintiff.[38]

Independence of Directors

Directors will not be protected by the Business Judgment Rule when making a business decision if they have a personal financial interest in the decision or if they do not act independently-free of domination or any motive except the merits of the corporate transaction.[39] Independence may become a critical issue in derivative litigation[40] or in transactions where directors are alleged to be dominated by an interested party, for example.[41]

Enhanced Scrutiny

If the Business Judgment Rule is rebutted, the courts may employ some form of enhanced scrutiny. Sometimes there is a requirement that the directors show the entire

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31 *Cinerama Inc v Technicolor Inc*, 663 A2d 1156 (Del 1995) *("Technicolor III"); Kahn v Lynch Communications Systems Inc*, 669 A2d 79 (Del 1995) (*"Kahn II"*).
32 *Guth v Loft*, 5 A2d 503 (Del 1939).
33 *Rales v Blasband*, 634 A2d 927 (Del 1993).
34 *In Re Santa Fe Pacific Corporation v Shareholder Litigation*, 669 A2d 59 (Del 1995).
35 *Arnold I*, 650 A2d 1270.
36 Ibid; *Zirn v VLI Corporation*, 681 A2d 1050 (Del 1996) *(Zirn II).*
37 *Johnson v Trueblood,* 629 F2d 287 (3d Cir 1980).
38 *Unocal,* 493 A2d 946; *Unitrin Inc v American General Corp*, 651 A2d 1361 (Del 1995).
39 *Aronson v Lewis,* 473 A2d 805 (Del 1984).
40 *Rales v Blasband,* 634 A2d 927 (Del 1993).
41 *Kahn v Lynch Communications Systems Inc,* 638 A2d 1110 at 1119-21 (Del 1994) *("Kahn I").*

fairness of a transaction.[42] Moreover, if there is a sale of control, the directors must obtain for the stockholders the best price which is reasonably available for their stock.[43]

Preventive Measures

So much for the adjudication of liability. What about preventive measures? First and foremost is the need for counsellors to the board to furnish independent, candid and unvarnished advice. Second, independent directors must act with due care on that advice in an independent manner.

There are structures which can enhance this independent advice and independent director action on that advice. There are some recommended protocols and procedures designed to establish models for the "ideal" board of directors. The aspirational corporate practices outlined in the *Corporate Directors Guidebook*[44] are salutary and should be consulted by boards and their advisers. The section of the *Guidebook* that is pertinent to both oversight and disclosure is as follows:

> B. Areas of Special Concern
>
> A director should be particularly concerned that the corporation has established and implemented programs designed to meet the following inquiries.
>
> 1. Quality of Disclosure. Do the corporation's disclosure documents, such as annual and quarterly reports to shareholders, proxy statements, and prospectuses, fairly present all material information? A director's primary responsibility in the disclosure process is to be satisfied that procedures are being followed that are likely to result in accurate and appropriate corporate disclosure. Although management has the primary responsibility for implementing these processes, directors should review drafts of the annual reports, proxy statements, and prospectuses.
>
> 2. Compliance with Law. Does the corporation have appropriate policies directed to compliance with applicable laws and regulations? For example, when appropriate, does the board receive periodic reports regarding compliance with environmental laws, including estimates of the costs of environmental compliance?
>
> Employees should be informed of corporate policies directed to compliance with applicable laws, including personnel policies designed to comply with health and safety, antidiscrimination and employment laws, and the securities laws, particularly those prohibiting insider trading. The corporation should establish appropriate procedures for monitoring compliance. All persons involved in the compliance process should have direct access to the general counsel or a designee so that sensitive compliance matters may be raised for consideration.

There are three "clutch" questions in these areas, as I see it. First, when does a breach of the duty of oversight necessarily result in liability if a loss results, causation is established, and there is no exonerating charter provision? There are those who would argue that something akin to tort principles should apply and that liability should auto-

42 *Kahn v Lynch Communications Systems Inc,* 669 A2d 79 (Del 1995); *Cinerama Inc v Technicolor Inc,* 663 A2d 1156 (Del 1995) *("Technicolor III"); Nixon v Blackwell*, 626 A2d 1366 (Del 1992).

43 *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34 (Del 1993).

44 ABA Commentary on Corporate Law, "Corporate Director's Guidebook – 1994 Edition" (1994) 49 *Business Lawyer* 1243; see also *Corporate Practices and Conduct* (3rd ed, 1995) (Australian Working Group consisting of the Institute of Company Directors, et al); *Guidebook for Directors of Non-Profit Corporations* (1993).

matically follow.[45] And there are those who would argue that tort principles should not apply.[46] This latter group might argue that only a sustained inattention to duty, tantamount to abdication, should be the basis of liability in this area. In the Chancellor's words, in *Caremark,* would an "utter failure"[47] to institute any monitoring systems constitute such an abdication?

Second, what kind of compliance systems should be established so that the duty of oversight may properly be fulfilled, and so that directors may be afforded maximum protection from exposure to liability? Well, I think that no court would require a perfect system. If a court were to require any system, it would probably be a reasonable system – one within a range of reasonableness, considering the custom of the times, commonsense, practicality and all the circumstances. To be more specific, I would have to wait for a case to come before the court. I can say, however, that it would be unwise for a board to adopt an ostrich attitude and do nothing.

Third, how far must the directors go in fulfilling their duty of disclosure? Let us start with the statement in one Delaware case[48] that it is virtually a per se requirement. That statement has been criticised as overbroad by at least one scholar.[49] Here again, it depends on the context of the case. Directors should assume that it would be prudent when communicating with stockholders, fellow directors or the investing public that one should disclose all material information reasonably available and that a partial disclosure may enlarge the scope of materiality.[50] This is not a prediction — just an academic exercise. Here again we will have to await a case.

In all of these areas, it may well be that the director's net worth will be saved by the parachutes of an exonerating charter provision adopted under the authority of a statute like Delaware's s 102(b)(7) or by indemnification[51] or by insurance. Even assuming that those parachutes will open, corporate governance depends on the professionalism[52] of directors. So, the duty is clear even if exposure to liability is not clear. I am optimistic enough to believe that directors take directorships to do a professional job. If they do, they may never have to worry about liability.

Since we are not talking about a direct relationship to profitability or issues of liability, but the professionalism of directors motivated by considerations of integrity and good faith, let me mention a few suggestions of protocols, which are not required, but which in my personal view would enhance the atmospherics in the eyes of a reviewing court. There are seven. In addition to usual (for example, audit, etc) and instead of ad hoc cobble:

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45 *Barnes v Andrews,* 298 F 614 (SDNY 1924).

46 C Hansen, "The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project" (1993) 48 *Business Lawyer* 1355.

47 *Caremark,* 1996 WL 549894 at 12.

48 In *Re Tri-Star Pictures Inc Litigation*, 634 A2d 319 at 333 (Del 1993). ("In Delaware existing law and policy have evolved into a virtual per se rule of damages for breach of the fiduciary duty of disclosure".)

49 L A Hamermesh, "Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty" (1996) 49 *Vanderbilt Law Review* 1087.

50 *Arnold I,* 650 A2d 1270.

51 8 Del C s145.

52 I M Millstein, "The Professional Board" (1995) 50 *Business Lawyer* 1427.

1. Heavy majority of directors who are truly — purely — independent.
   - For example, I would not consider as independent a lawyer-director whose firm receives significant fees from the company or its affiliates or senior officers.
   - The same is true for bankers, suppliers, etc.
2. A board engaged in actual governance[53] — not merely advisors to the CEO of the business and affairs of the company.
   - This means developing a strategic plan and monitoring management's performance against plan.
   - This does not mean running or operating the business.
   - Functioning forcefully on ownership issues (for example, mergers).
   - Giving management deference but being informed on enterprise issues.[54]
3. Directors who meet for face-to-face comprehensive meetings at least quarterly with homework that they read and ask questions about. Directors who spend at least 100 hours a year on the corporation's business — more when there is a crisis.[55]
4. Directors who limit their number of boards to a reasonable number to work hard at each.
5. Directors who regularly evaluate the CEO and regularly meet in executive session of independent directors and who have independent and an independently advised compensation committee.
6. Boards that establish — and monitor — law compliance programs.
7. Boards that carefully review disclosure documents to assure complete candor of all material information.

Some prominent companies have instituted these models. General Motors is a prime example. The General Motors Guidelines as adopted a few years ago in the wake of their corporate governance upheaval include plainly stated principles which, on their face, are very helpful on the perception (and presumably the reality) of independence. For example:

(11) Executive Sessions of Outside Directors

The outside directors of the Board will meet in Executive Session three times each year. The format of these meetings will include a discussion with the Chief Executive Officer on each occasion.

(12) Board Access to Senior Management

Board members have complete access to GM's Management.

...

(15) Mix of Inside and Outside Directors

The Board believes that as a matter of policy there should be a majority of independent Directors on the GM Board (as stipulated in By-law 2.12). The Board is willing to have members of Management, in addition to the Chief Executive Officer, as Directors.

But the Board believes that Management should encourage Senior Managers to understand that Board membership is not necessary or a prerequisite to any higher Management position

53 8 Del C s141(a).
54 B A Manning, "Life in the Boardroom After Van Gorkom" (1985) 41 *Business Lawyer* 1 at 5-6.
55 ABA Commentary on Corporate Law, supra n 44 at 1259.

in the Company. Managers other than the Chief Executive Officer currently attend Board Meetings on a regular basis even though they are not members of the Board.

On matters of corporate governance, the Board assumes decisions will be made by the outside directors.

(16) Board Definition of What Constitutes Independence for Outside Directors

General Motor's By-law 2.12 defining independent directors was approved by the Board in January 1991.[56] The Board believes there is no current relationship between any outside director and GM that would be construed in any way to compromise any Board member being designated independent. Compliance with the By-law is reviewed annually by the Committee on Director Affairs.

(14) Former Chief Executive Officer's Board Membership

Whether the [former Chief Executive] continues to serve on the Board is a matter for discussion at that time with the new Chief Executive Officer and the Board.

A former Chief Executive Officer serving on the Board will be considered an inside director for purposes of corporate governance.

...

(25) Formal Evaluation of the Chief Executive Officer

The full Board (outside directors) should make this evaluation annually, and it should be communicated to the Chief Executive Officer by the (non- executive) Chairman of the Board or the Lead Director.

These models are largely aspirational paradigms. They are not required to validate a particular transaction or to avoid directorial liability. But they could help in an adjudicative setting in two principal ways. First, these aspirational models could develop good working habits to condition directors to attempt to conduct themselves in a "bulletproof" manner in a crisis where liability concerns may become an issue, rather than fashioning ad hoc protocols only when a crisis develops. Second, the atmospheric effects of good governance aspirational models may help a court to come to a finding that the directors are truly independent and have acted with due care and in good faith.

Delaware Law and Institutional Investors

Nearly half of the stock of large public US corporations is held by institutional investors.[57] About 60 per cent of the Fortune Five Hundred Companies are Delaware corporations. So I will attempt to express my understanding (from the literature) of the general interests of institutional investors and my view (from experience) of the corporate jurisprudence of Delaware courts. That jurisprudence is followed in many other jurisdictions.

56 General Motor's By-law 2.12, in existence when their guidelines were established, provides the following:
A majority of the individuals to constitute the...board...shall consist of individuals who...would be Independent Directors.
(c) Definition of Independent Director...[one who] (i) is not and has not been employed by the corporation or its subsidiaries in an executive capacity within five years; (ii) is not...a significant advisor or consultant; (iii) is not affiliated with a significant customer or supplier; (iv) does not have significant personal services contract(s); (v) is not affiliated with a tax-exempt entity that receives significant contributions; (vi) is not a spouse, parent, sibling or child...

57 D Block and J Hoff, "Corporate Governance and Institutional Activism", *New York Law Journal*, 18 January 1996, at 5.

The interests of institutional investors and the concerns of a reviewing court may often converge, but they are analytically different. There is a logical convergence of the interests of institutional investors and the concerns of courts on a macro level, if not on a micro level. Institutional investors—indeed all stockholders— want to "enhance shareholder value" whether that means increasing short-term and long-term profits or elevating the stock price. Many institutional investors are activists.[58] Courts, on the other hand, look to process, honesty, and objectivity in decisionmaking. But courts are not activists. To quote one of my fellow Chief Justices, The Honorable Joseph Baca of New Mexico, in another context:

> The fact is that courts sit like clams in water; they wait for whatever is brought to them by the tides before taking necessary action. We do not issue advisory opinions, and we only rule on matters that are brought before us in which there is a real case and controversy. We do not reach out on our own to pluck the interesting issues of the day and make a ruling. Instead, we wait for our jurisdiction to be invoked.[59]

Independence, due care and good faith are concepts common both to the interests of institutional investors and the concerns of Delaware courts. For example, it is desirable that a board of directors be composed of at least a majority of directors who are not corporate executives, employees or agents. Institutional investors seem to assume that directors who are unaffiliated and independent will help with the goals (higher profits and stock prices) of the stockholders. That, no doubt, is a valid intuitive assumption, although I have seen one study which concludes that this assumption lacks empirical support.[60]

Whether or not the assumed value of independent directors is empirically supported, institutional investors prefer independent directors. So do courts, for different reasons. At the end of the day, corporate governance depends on the board of directors as an independent corporate decision-maker operating with due care and in good faith.[61]

There is no doubt that "institutional investor activism has played a constructive role in sensitizing boards and managements to the views of shareholders."[62] These investors want "oversight over management and, in turn, the strategic planning and financial performance of the company."[63] Perhaps institutional investors who are looking over the shoulders of directors who are expected to look over the shoulders of management are a "good" force for stockholders—unless it leads to corporate "myopia," ie, too much emphasis on short-term profits to the detriment of risk-taking and strategic planning.

There is a long checklist of issues which are regularly raised by institutional investors. Many of these may never become an issue in litigation. For example, courts might not find important in contested litigation those parts of an institutional investor's

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58 Ibid. See also J A Dobrzynski, "Board Members, Too, Are Getting Investor Scrutiny", *New York Times*, 12 March 1996, at D-1.

59 Chief Justice Joseph F Baca, State of the Judiciary Address Before the 42nd New Mexico Legislature, 2nd Sess 3 (February 8, 1996). See also *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34 at 51 (Del 1993) ("It is the nature of the judicial process that we decide only the case before us.")

60 S Bhagat and B S Black, "Do Independent Directors Matter?" (Columbia University School of Law, Working Paper No 112, 1996). See also R J Gilson, "Corporate Governance and Economic Efficiency: When Do Institutions Matter?" (Columbia University School of Law, Working Paper No 113, 1996).

61 *Nixon v Blackwell,* 626 A2d 1366 at 1375-79 (Del 1992).

62 Block and Hoff, supra n 57.

63 Ibid.

agenda which would urge: (a) separation of the office of CEO and the office of Board Chair; (b) creation of a position of "lead director"—an independent director who would be designated to stand in the wings to lead a critical evaluation of the CEO or manage independent board consideration of major "ownership" issues such as changes in control; (c) payment of directors in stock rather than cash and elimination of outside director pension plans;[64] and (d) the structural elimination of poison pills or staggered boards.

In this last category, it is important to be clear that poison pills and staggered boards, in most instances, may well be legal on their face.[65] But, in the case of poison pills, the board may have a fiduciary duty to redeem the pill in response to a specific hostile takeover attempt under the doctrines of *Unocal*[66] and *Unitrin*.[67] If a sale of control is involved, the board's duty is to obtain the best value reasonably available for the stockholders, thus invoking the enhanced judicial scrutiny of *Paramount v QVC*[68] or *Revlon*.[69]

On the other hand, some other "pet projects" of institutional investors might become relevant in the adjudication of director conduct in a particular transaction. It is almost a "given" of good corporate governance practice today that non-management directors should comprise the three key "overview" committees of the board—the audit, compensation and nominating committees.[70] Moreover, it would often be helpful if the corporation had a practice whereby the CEO is regularly evaluated by the independent directors. Indeed, if independent directors meet by themselves regularly for that and other purposes, the practice would be salutary—even if the corporation's history involved solely enterprise issues and not ownership issues.

Someday, the directors may well face a big ownership issue or a "bet the company" deal or litigation. That is not the time to invent the wheel and cobble together an ad hoc showing of independent conduct.

The Defining Tension

The defining tension in corporate governance today is the tension between deference to directors' decisions and the scope of judicial review. Decisions of directors which can be attributed to any rational business purpose will be respected if they are made by directors who are independent and who act with due care and in good faith. Otherwise, courts may be called upon to apply some form of enhanced scrutiny.

Let me illustrate the defining tension with some pages from history. These are excerpts from Delaware Supreme Court opinions. They are snippets from only five cases of many decided in the last decade dealing with the parameters of director liability in adjudicative settings. First, the good news:

> "Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Time-Warner*.[71]

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64 Ibid.
65 See 8 Del C ss141(a), 141(d), 157; *Moran v Household International Inc,* 500 A2d 1346 (Del 1985).
66 *Unocal Corp v Mesa Petroleum Co,* 493 A2d 946 (Del 1985).
67 *Unitrin Inc v American General Corp,* 651 A2d 1361 (Del 1995).
68 *Paramount Communications Inc v QVC Network Inc,* 637 A2d 34 (Del 1993).
69 *Revlon Inc v MacAndrews & Forbes Holdings Inc,* 506 A2d 173 (Del 1985).
70 See ABA Commentary on Corporate Law, supra n 44 at 1262-74.
71 *Paramount Communications Inc v Time Inc,* 571 A2d 1140 at 1154 (Del 1989).

"The Board's action in recommending the Recapitalization to the stockholders was the result of an independent business decision of the Board, protected by the presumption of the business judgment rule which was not rebutted. The fully informed stockholder vote... effected the Recapitalization...Plaintiff has not alleged or shown a violation [of the statute]...fraud, waste, manipulative or other inequitable conduct." *Williams v Geier*.[72]

* * *

Now, the bad news:

"[T]he Paramount directors...[were] prisoners of their own misconceptions and missed opportunities...[They] remained paralyzed by their uninformed belief that the QVC offer was 'illusory[,]'...chose to wall themselves off...and to hide behind the defensive measures as a rationalization for refusing to negotiate with QVC or seeking other alternatives." *Paramount v QVC*.[73]

* * *

"The board was torpid, if not supine, in its efforts to establish a truly independent auction, free of [the CEO's] interference and access to confidential data...[W]hat occurred here, including the lack of oversight by the directors, irremediably taints the design and execution of the transaction." *Macmillan*.[74]

* * *

"The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available'...In this case the coercion was extant and directed to a specific price offer which was, in effect, presented in the form of a "take it or leave it" ultimatum by a controlling shareholder with the capability of following through on its threat of a hostile takeover. Any semblance of arm's length bargaining ended when the Independent Committee surrendered to the ultimatum that accompanied Alcatel's final offer." *Kahn v Lynch*.[75]

* * *

Some of the words are comforting. Some of the other words, however, are chilling. Directors have to ask hard questions, and seek and receive unvarnished advice. Both lawyers and directors should ask themselves if they can or should "just say no" to a management which may be biased or bent on a problematic course of action. Counsellors would do well to recite the comfortable as well as the chilling words of these and other opinions when giving corporate advice.

It is a common sense axiom that a majority of independent, non-management directors gives the board flexibility to deal with threats to corporate control or the "demand" issue in derivative litigation.[76] Second, a board which has a general practice of acting independently by, for example, regularly evaluating the CEO or having the independent directors meet alone regularly—will tend to find it comfortable to act independently in a crisis. Such a board is not only practiced and capable of operating with genuine inde-

72 *Williams v Geier,* 671 A2d 1368 (Del 1996).
73 *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34 at 50-51 (Del 1993).
74 *Mills Acquisition Co v Macmillan Inc*, 559 A2d 1261 at 1279-81 (Del 1988).
75 *Kahn v Lynch Communications Systems Inc*, 638 A2d 1110 (Del 1994) *("Kahn I")*.
76 See *Rales v Blasband,* 634 A2d 927 (Del 1993); D J Block, N E Barton and S A Radin, *The Business Judgment Rule* (4th ed, 1993) at 891-915 (independence in the context of dismissal of derivative suits by special litigation committees); Balotti and Finkelstein, *The Delaware Law of Corporations and Business Organizations,* s 13.13 (1996 Supp).

pendence, it also *appears* credible and tends to "certify" the bona fides of management.[77] Perhaps a court will see it that way if litigation should ever become necessary.

Why should directors not be independent and why should they not act independently? Should a director who is truly independent agree to serve as an "independent director" in an atmosphere where a large contribution is made by the corporation or the CEO to the university of which the director is president?[78] Should a partner or associate of a law firm agree to serve as an "independent director" when his firm regularly receives substantial fees from the corporation? On this latter point, I will say only that there is no per se prohibition against the practice of a lawyer serving as a director of a corporation which is a well-paying client of the lawyer's firm. Indeed, that lawyer may be a very valuable board member. The issue is whether she will be found to be independent in a critical setting where the board must act through independent directors. The Comment to Rule 1.7, Model Rules of Professional Conduct, states: "A lawyer for a corporation...who is also a member of its board of directors should determine whether the responsibilities of the two roles may conflict ...If there is a material risk that the dual role will compromise the lawyer's independence [or] professional judgment, the lawyer should not serve as a director."

Directors who are truly independent are sensitive to appearances. This is not an argument that "structural bias" notions are uniformly valid. Friendship, golf companionship and social relationships are not factors which necessarily negate independence. There is no place in corporate America today for empty formalities, adversarial boards, chilly boardroom atmospheres, timidity, or risk-averseness. Likewise, there is nothing to suggest that, on an issue of questioning the loyalty of the CEO, the bridge partner of the CEO cannot act independently as a director. To make a blanket argument otherwise would create a dubious presumption that the director would sell her soul for friendship.[79] Yet the directors must be aware of any appearance that they lack independence. In short, the better practice is that each director should be like Caesar's wife – above reproach.[80]

Conclusion

In the end, the issue is integrity, isn't it? Corporate governance depends on the integrity of directors and their counsellors. If one skates close to the edge, or is seen to be doing so, and a court repudiates either the director's conduct or that of the lawyer or financial advisor, more than a transaction or one's net worth could be lost. A reputation could be irretrievably damaged.

There is a large universe of truly independent and careful people to choose from. Why not urge the Nominating Committee consisting of independent directors to select from that vast universe those directors who will be not only bright, knowledgeable, careful, collegial and objective, but who will also know how to say "no" at the right time?

77 Millstein, supra n 52; see also I M Millstein, "The Evolution of the Certifying Board" (1993) 48 *Business Lawyer* 1485.
78 See *Lewis v Fuqua*, 502 A2d 962 (Del Ch 1985).
79 See M P Dooley and E N Veasey, "The Role of the Board in Derivative Litigation: Delaware Law and Current ALI Proposals Compared" (1989) 44 *Business Lawyer* 503 at 537 ("to advance this argument in favour of closer judicial review on loyalty matters is to assert that independent directors are more likely to risk their reputations to excuse cheating than to excuse carelessness.")
80 See *Lewis v Fuqua*, 502 A2d 962 at 967 (Del Ch 1985).

(They must also be skilled enough not to be too risk-averse and to say "yes" when appropriate.) Why not have those directors meet together—alone—on a regular basis? Why not have them regularly evaluate the CEO?

Finally, when the director looks at herself in the mirror, how will she answer this question: Will I be comfortable to read an investigative piece in the financial press or the tabloids displaying in print my behaviour and my objectivity in carrying out my fiduciary duties as a director? That is the key question I will leave with you.

Chapter 3

The Role of Corporate Governance Practices in the Development of Legal Principles Relating to Directors

Justice Alex Chernov*

Corporate Governance

Corporate governance is defined by the working group chaired by Henry Bosch AO[1] (The Bosch Working Group) as the system by which companies are controlled. A similar definition was adopted by the UK Cadbury Committee.[2] The concept is concerned with achieving a balance between allowing the board and management the freedom to drive their company forward so as to improve performance on the one hand and, on the other, the need to ensure that this is achieved within a framework of effective accountability. At its broadest level, corporate governance involves the issue of the relationship between the stakeholders in a company (shareholders, creditors, employees, etc) and those who manage its affairs (the board of directors).[3]

Recent Emphasis

There is nothing new about public discussion of the concepts surrounding corporate governance. Concerns about the relationship between directors and shareholders and the proper measure of accountability have existed almost since the foundation of the joint stock company in its present form. Nevertheless, there is little doubt that this topic is currently the flavour of the month and is receiving more attention in the media than before. There are many reasons for this. In part, the recent recession has spurred shareholders to be more active in demands for better performance by directors and to assert their rights as owners of the company. In part, it is a reaction to the abuse of power practised by some directors and executives during the 1980s. Moreover, the fact that it has spilled over into the political arena has ensured that the topic is well publicised.

A driving force behind greater demand for corporate governance principles has also been the rise of institutional shareholders. Since the late 1980s, the proportion of equi-

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1 Working Group, *Corporate Practices and Conduct* (3rd ed, 1995) Henry Bosch (Chair), ("Bosch Working Group").

2 *Report on the Financial Aspects of Corporate Governance* (1992) Adrian Cadbury (Chair).

3 See D D Prentice, "Some Aspects of the Corporate Governance Debate" in D D Prentice and P R J Holland (eds), *Contemporary Issues in Corporate Governance* (1993).

ties held by institutional shareholders has grown considerably and they have come to consider themselves more as part owners of companies, rather than as buyers and sellers of shares. They have placed increasing pressure on boards to ensure that the managers are managing in the interests of shareholders and are steering the companies forward to create wealth in the most effective way.

As if anticipating the resurgence in the debate on corporate governance, major companies in particular had been engaged for some time in formulating and applying sound corporate governance principles. Unfortunately, little publicity has been given to this development, partly because it seems that good conduct as distinct from corporate excesses, does not warrant reporting and partly because the development and implementation of corporate governance practices occurred, in the main, on a company by company basis with relatively little publicity being generated by the individual institution about its practices. Not surprisingly, what has ultimately attracted the press was the disregard for sound corporate governance practices. During the 1980s, however, some sections of the media accorded people-like Skase, Bond, Johns and Connell — a larrikin, but almost hero, status. It was only when the press saw where such activities led, namely — to corporate collapses where ordinary shareholders and traders lost significant amounts — that it turned on those entrepreneurs.

More recently, there has been an important development in the area of corporate governance. Corporate regulators and industry organisations have become active in this field. For example, after some hesitation as to the route it should adopt, the Australian Stock Exchange ("ASX") now requires companies to set out their corporate governance practices in their Annual Reports. In an address to the Institute of Internal Auditors of Australia in December 1995, the managing director of the Australian Stock Exchange, Mr Richard Humphry, suggested the ASX had three options.

(a) Retain the status quo, that is — any disclosure of corporate governance practices should remain an issue between shareholders and the board.
(b) The ASX could have decided what set of practices constitute ideal corporate governance and require disclosure of adherence to those practices.
(c) The third choice which was ultimately adopted, was to require disclosure of corporate governance practices without prescribing what was the best practice.

On 1 July 1995, the ASX introduced Listing Rule 3C(3)(j) (now Listing Rule 4.10.3) which requires listed companies to set out their main corporate governance practices in their Annual Reports.

Industry organisations have also been active. They have developed guidelines and codes of conduct by directors on the more important governance issues. Although some of the guidelines are expressed only in general terms, their introduction is important not only because such principles provide guidance and a goal for the development of good practices, but they introduce cohesion in this area which has been absent as a result of the ad hoc development of governance practices by individual companies. Examples are the relevant Articles of the Australian Institute of Company Directors and its new Code of Conduct. Similarly, the Australian Investment Managers Association (representing the largest institutional investors) has produced a booklet on its recommended policy for corporate governance which goes well beyond the minimalist position for disclosure adopted by the ASX.

Corporate Governance Practices Relating to Directors

Corporate governance practices consist of a diverse range of activities, many of which are not relevant to the existence or development of legal principles relating to directors' obligations. Moreover, they vary considerably as between categories of companies and even between companies within the one group. Consequently, for present purposes, it is proposed to examine only some of the relevant practices of major public companies to see if they played a role in the development of legal principles applicable to directors' behaviour. It is recognised, of course, that even amongst the major companies, governance practices are not uniform, but they do have a common underlying basis, namely, to do "the right thing" by the standards of the company and, more importantly, by the judgment of those outside that company.

Before dealing with particular corporate governance practices, it should be mentioned that there is at once a similarity and a difference between the bases which underpin corporate practices and legal principles respectively. The similarity lies in the fact those both seek to achieve a compromise. In the context of corporate governance practices, it is the compromise between the aim of maximising profitability, while at the same time seeking "to do the right thing". The legal principles seek to resolve the conflict between the recognition of the business judgment rule on the one hand, and on the other, the need to ensure that business judgment is exercised properly (as distinct from correctly).

The difference which exists between them is to be found, not surprisingly, in the fact that corporate practices are based on a much wider foundation than are legal principles. Corporate practices reflect the expectations of the relevant corporate community as to how directors will behave. This expectation is driven partly by commercial and, on one view, partly moral, considerations. Legal rules, on the other hand, are based on relatively narrow grounds which are founded essentially on principles governing a fiduciary. They seek to lay down the minimum standard of behaviour required of directors of all companies. Hence, it would be unrealistic to expect direct correspondence between corporate governance practices and legal principles. On the other hand, because of the obvious connection between them, one can justifiably expect that corporate practices would play some role in the development of legal principles relating to directors' duties.

It is now convenient to turn to look at some of the corporate governance practices and related legal principles.

Division of functions — boards/management

Sound corporate governance practice requires an articulation of the different functions that are expected from the board on the one hand and from management on the other. As the Bosch Working Group put it, "the relationship between management and the board is crucial to the company's long term success". It states that it is good practice to clarify in writing the allocation of functions as between the board and management. (More specifically, it suggests at pages 8 and 9, the functions that should be performed by the board).

Case law, however, has not always drawn a clear distinction between the functions of management on the one hand and, on the other, the functions of the board. Courts have often described the functions of the board as including managing the business of the company, although that may have been due to the use of general language rather than being a definitive description of the role of the board.[4] Even Tricker, in his text on corporate governance,[5] says that in the classical approach, the board is seen as servicing the business with supervision by the shareholders in members' meetings.

When the respective functions of the board and of management are articulated, it becomes easier to determine whether, for example, the business judgment rule should prevail. It is obvious that at board level, many issues arise that call for business judgment and different directors will often have different views on such issues. That does not necessarily mean that the judgment of one group is prudent, or right, and that of the other imprudent, or wrong. But even if it were imprudent or wrong, it would not follow that these directors have acted negligently.

The courts distinguish between business judgment and negligence in the board room and they continue to state that the courts will not examine the business or commercial judgment of particular directors unless lack of due care or improper purpose is shown. For example, in *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* the High Court (Barwick CJ, McTiernan and Kitto JJ) said:

> Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.[6]

In *Howard Smith Ltd v Ampol Petroleum Ltd* the Privy Council expressed a similar view:

> There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.[7]

More recent judgments in which similar views are expressed are *Wayde v New South Wales Rugby League Ltd8 and Equiticorp Finance (in liq) v Bank of New Zealand*.[9]

Thus, the courts have long accepted that directors are permitted to make decisions that, with the benefit of hindsight, would not be made again, provided that at the time the directors made the decision they exercised their judgment in good faith and with reasonable care. But in deciding on which side of the line the case should fall, it is necessary to bear in mind the difference between the respective functions of directors and management. Until recently, the courts have rarely articulated this distinction in realistic terms.

Similarly, in the context of non-executive directors, cases rarely drew a meaningful distinction between their position and that of directors who took part in managing the company. Early cases merely defined a director's duty to the company as requiring the

4 See, for example, *Marquis of Bute's Case (*1892) 2 Ch 100 at 108 and, more recently, Byrne J of the Queensland Court of Appeal in *Glover v Willert* (1996) 20 ACSR 182 at 188.

5 R Tricker, *Corporate Governance: Practices, Procedures and Powers in British Companies and their Boards of Directors* (1984) at 186.

6 (1968) 121 CLR 483 at 493.

7 [1974] AC 821 at 832.

8 (1985) 3 ACLC 799 at 805.

9 (1993) 11 ACSR 642 at 675.

director to act with such care as is reasonably to be expected, having regard to the director's knowledge and experience.[10]

Corporate governance practices on the other hand, do recognise the relevant difference between the respective positions of the non-executive director and the executive director. It is recognised that the non-executive director does not have the detailed knowledge of the company's day to day operations that are known to an executive director. In effect, he or she relies to a great degree, at least in the first instance, on what is provided by way of board papers, reports of the chairman, the executive directors, etc. In that context, corporate governance practices seek to ensure that the lines of reporting are such that the non-executive director is provided with all relevant information so that he or she can determine the various matters before the board on an objective basis in the best interests of the company.

It was not until *AWA Ltd v Daniels*[11] that these relevant distinctions were stated by an Australian court with some particularity. Rogers CJ (Com Div) said that in examining the obligations of the various directors and others involved in the operations of the company, regard should be had to the proper division of functions between directors and management (and auditors).

(a) In general terms, the functions of the board are to set goals for the corporation, appoint the CEO, to oversee management and review progress towards obtaining the goals. His Honour recognised that the board of a large public corporation could not manage the company's day to day business; that must be left to executives. As to this conclusion Rogers CJ referred to what was said by Romer J in *Re City Equitable*.[12]
The Royal Commission into the Tricontinental Group of Companies[13] regarded this description of the board's functions as too "relaxed".[14] It summarised the responsibility of a board in paragraph 19.56 of its Report in the following terms.

> The evidence in this inquiry has brought home to the Commission how vital it is, as a matter of legal responsibility and as a matter of sound commercial practice, that a board should ensure that it retains effective control over management, whatever the size of the corporation. To do that, there must be workable systems which result in the board monitoring accurately the operations of the corporation. It is not enough merely to pronounce upon policy. There is the need to be satisfied properly that policy is being implemented fully and efficiently. To put the matter at its simplest, the board needs to know what is really going on, and that requires more than formal reports from a chief executive officer. It would be absolutely wrong, in a major public corporation, for the board to permit the chief executive officer to be a 'one- man band'. The board must retain effective control, but with that, of course, comes corresponding responsibility and accountability.[15]

(b) The degree of skill and participation in the decision making process that is required may differ between executive and non-executive directors, depending

10 See, for example, Neville J in *Re Brazilian Rubber Plantations Estates Ltd* [1911] 1 Ch 425 at 437.
11 (1992) 7 ACSR 759.
12 [1925] 1 Ch 407 at 426.
13 Royal Commission Report into the Tricontinental Group of Companies, *Final Report of the Royal Commission into the Tricontinental Group of Companies* (1992).
14 See, for example, ibid, paras 19.54, 19.55, 19.66.
15 Ibid at para 19.56.

on the circumstances. For instance, what is required of a chief executive (who is employed under contract) is measured objectively. The same objective standard does not apply to non-executive directors (who are not bound to give continuous attention to the affairs of the company).[16] This analysis was recently applied by Perry J in *State Bank of South Australia v Marcus Clark*.[17]

(c) His Honour also recognised the division of function as between directors and their chairman. The chairman is responsible to a greater extent than any other director for the performance of the board as a whole and each member of it. The chairman sanctions the agenda and the material to be placed before the board and is responsible for the formation of the policy of the board and the promotion of the company.[18]

Conflict — executive directors, chairman

A related aspect of corporate governance practices consists of putting in place steps that deal with the obvious conflict that arises where executives sit on the board of the company which they are obliged to manage so as to secure the maximum returns for the company. The conflict is the more apparent where the board has a chairman who is also the CEO of the company. Corporate governance principles recognise that there is a tension in such a case between the vested interests of the executive directors as managers with particular obligations to the company with the attendant tendency to protect their patch on the one hand and, on the other, the obligations to take part in the collective decision making process of the board in the interests of the company as a whole, which may require a critical analysis of the performance of executive directors, their requests for allocation of funds, etc. For example, in the allocation of scarce resources, there will be an inevitable tendency for an executive director to protect his or her existing situation and exploit it to the benefit of his or her managerial interests.

We only have to look at the recent experience of a large public company which has been forced to take its eye off the commercial ball, at least partially, because it was preoccupied with working through and adhering to corporate governance principles relating to the conflict which may arise from the position of an executive director. It is obvious that companies which have implemented governance practices which clearly define the lines of responsibility and communication as between the board and management, are less likely to get caught up in a debate on this issue.

Tricker suggests that a solution to the problem created by the presence on the board of company executives, is to appoint an appropriate number of non-executive directors to the same board on the basis that they are likely to take a more objective approach to board discussions.[19] According to him, that is the approach adopted in the United States where non-executive directors often form a majority of the boards of listed companies. Audit committees comprising mainly non-executive directors have also been widely used as vehicles for ensuring supervision and accountability at board level.

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16 Supra n 11 at 867.

17 (1996) 19 ACSR 606 at 627-629. See also the Tricontinental Royal Commission Report, supra n 13 at para 19.67 as to the obligation of executive directors.

18 Supra n 11 at 867.

19 Supra n 5 at 187.

In Australia, the board of a public company will usually comprise executive directors although the appointment of non-executive directors has become more popular, partly because it is perceived that they will "enhance the company's sense of responsibility and widen its strategic horizons"[20] and partly because such appointments are seen as diffusing the potential problems that may flow from the presence on the board of executive directors.

As has been mentioned, the distinction between non-executive and executive directors was recognised in *AWA*[21] and by the Tricontinental Royal Commission.[22] In its Report the Commission said that:

> there are strong reasons why non-executive directors should be encouraged to play a substantial part in the activities of the board of a major public corporation. They can bring to a board a wide range of relevant skills and experience, beyond those of the executive members. They are also capable of exercising an independence and objectivity of judgment that may be difficult for executive directors to achieve or maintain.[23]

The Commission went on to say that in broad terms a non-executive director is entitled to rely on information, reports or statements, including financial statements, prepared and presented by an executive, when the non-executive director reasonably believes that the executive has skills relevant to the matters presented, and is reliable.[24] On the other hand, the Commission recognised that if it appears to a non-executive director that an executive director, or some other officer or employee lacks the expected skills or is not exercising them, then continuing reliance without further enquiry is likely to be unreasonable.[25]

Disclosure — conflict of interest

In order to avoid conflict problems that may arise in the boardroom from directors having interests which may conflict with those of their company, sound corporate practices dictate that companies stipulate what interests such as shareholdings, directors are required to declare and what regular reporting they must undertake on those matters. Such guidelines deal with matters beyond the more obvious situation where, for example, the director has an interest in a contract which is being considered by the board. In most cases, corporate practices also require the director to be absent from the board room during the discussion of the relevant topic.

The common law did not always impose the latter requirement. In general terms, courts have adopted the test of real and sensible possibility of conflict[26] taking into account the extent of any likely conflict.[27] The law's requirements as to disclosure of relevant interests, however, are similar to those imposed by corporate practices.

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20 See Australian Institute of Company Directors, *Guidelines for Directors in Australia* (2nd ed, 1994) at 21.
21 Supra n 11.
22 Supra n 13 at para 19.57.
23 Ibid.
24 Ibid at para 19.62.
25 Ibid at para 19.67.
26 *Boardman v Phipps* [1967] 2 AC 46 at 124; *Chan v Zacharia* (1984) 154 CLR 178 at 199; *Hospital Products Ltd v US Surgical Corporation* (1984) 156 CLR 41 at 103.
27 H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (8th ed, 1997) at paras [9.070]-[9.080].

Thus, where the conflict arises from the director's interest in the transaction which the company is about to undertake, the law requires the director to do more than merely abstain from voting or from attending the meeting. The director must make full disclosure of his or her interest. For instance, in *Centofanti v Eekimitor Pty Ltd*,[28] the South Australian Full Court considered what action a director had to take when faced with such a conflict of interest. In that case, the notice calling the relevant meeting of directors recited the fact of the director's conflict of interest (namely, his interest in the proposed contract) and also set out the background to the matter. Moreover, Article 87 relevantly provided that:

> a Director shall be entitled to vote in respect of any contract or proposed contract with the company in which he is interested, or any matter arising thereout, notwithstanding such interests provided that he shall have first complied with the provisions of s.228 of the Code.[29]

At the directors' meeting the director did not vote and the proposed resolutions were duly passed and the relevant documents were executed. King CJ found that the director had not breached his fiduciary duties.[30] Olsson J said:

> In my view the sole obligation of the appellant in the instant case was to make proper disclosure of the nature and extent of his interest only to the board and it seems to me that the evidence indicated that he in fact probably did so as to the leasing transaction. Indeed it is clear that he was, in effect, actually being urged to enter into the transaction by the members of the family as a rescue operation.
>
> I can perceive no warrant for the proposition that he was under a duty to spell out to the board the inherent risks in the proposed commercial activities and the possible financial consequences if Benevino was not successful.[31]

In *Woolworths Ltd v Kelly*,[32] the issue was whether Sir Theo Kelly (who was chairman of Woolworths) and who was directly interested in a contract whereby Woolworths bound itself to pay him a pension, adequately declared the nature of his interest at a meeting of the directors. At the relevant meeting Sir Theo did not expressly declare his interest to the board. Samuels JA explained the underlying basis for the requirement of disclosure in the following terms:

> The requirement for disclosure seems therefore to be intended not to protect the company against bad bargains or the consequences of arrangements into which they enter as a result of the partisan interest of a director, but simply to ensure that the honesty and integrity which would inform corporate dealings and, in particular, the internal management of corporations is scrupulously observed...
>
> In other and more general words the requirement is to make full disclosure of the nature and extent of the interest.[33]

28 (1995) 15 ACSR 629.
29 Ibid at 630.
30 Ibid at 631-632.
31 Ibid at 642.
32 (1991) 22 NSWLR 189.
33 Ibid at 211.

In that case, Article 72 provided that "any director may contract or make any arrangement with the company and any contract or arrangement entered, or to be entered into by or on behalf of the company, in which any director shall be in any way interested shall not be avoided". Mahoney JA found that this Article permitted such a contract to be made, effectively at a board meeting, without the fully informed approval or consent of the company in general meeting.

On the other hand, in *Permanent Building Society (in liq) v McGee*[34] Anderson J of the Supreme Court of Western Australia found that in certain circumstances mere disclosure of a conflict and abstaining from voting or attending the meeting, may not be sufficient to satisfy a director's fiduciary obligations to the company. The director may be under a positive duty to protect the company's interests by taking steps to prevent the transaction from going ahead.

Generally, however, courts have not insisted that the director who has a conflict, be absent when the rest of the board considers the matter in respect of which the director has a relevant interest, provided the director does not vote and has effectively disclosed his or her interest. In a sense, this is not surprising because courts lay down general principles which apply to large as well as to two person corporations where management and ownership coincide in the same person. Hence, the courts seek to strike a balance as to what should be required where a director has a conflict. Moreover, the situation is often dealt with by the Articles which may permit a director to participate in board debate and to vote notwithstanding his or her interest in the matter. Corporate governance practices on the other hand have imposed more stringent requirements on the director as to attendance at board meetings where the relevant transaction is being discussed.

The legislation has now effectively adopted the prevailing corporate governance practice, at least so far as public companies are concerned. Section 232A of the Corporations Law forbids a director to vote or to be present at board or committee discussions in relation to a matter in which he or she has a "material personal interest" (notwithstanding that the Articles may state to the contrary).[35] The term "material personal interest" is not defined and it has been sensibly left to the courts to give that term meaning. It would not be surprising that in working out the meaning of this term, the courts will have regard to corporate governance practices in this area.[36]

Board responsibility for subsidiaries

In this context, two important areas have been addressed by corporate governance practices as well as by legal principles. One concerns the duties which managers or directors of the parent company who sit on boards of its subsidiaries owe to those subsidiaries and to those who deal with it. The other relates to the extent to which the parent board must supervise the subsidiary and ensure that its obligations are met. The degree of autonomy that may be enjoyed by a subsidiary will depend upon the policy of the parent com-

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34 (1993) 11 ACSR 260.

35 The position of directors of proprietary companies is dealt with in s 231, the requirements of which are not as stringent.

36 It should be noted that s 232A does not deal with the consequences of contravention. A decision by a company is likely to be held invalid if it is entered in breach of s 232A unless it is cured by the court under s 1322. See *Claremont Petroleum NL v Cummings* (1992) 10 ACLC 1685 (affirmed 9 ACSR 583).

pany as to how it wishes to operate the subsidiary's business. Hence, many forms of governance are feasible in relation to subsidiaries. At one extreme, the subsidiary may be no more than a legal convenience, its board having no real power for any aspect of governance. At the other, it may have considerable autonomy whereby its board is responsible for the direction, execution, supervision and accountability of the subsidiary with the parent company acting, in effect, as a remote outside shareholder. Between these two positions lie a wide range of alternatives. Nearly all situations, however, raise one or both of the issues mentioned earlier.

1. Directors of subsidiaries

Where the parent and subsidiary operate as a group, or where the parent conducts part of its business through a subsidiary, the problem often confronting directors of the subsidiary is: where does their duty (as compared to loyalty) lie as between the parent (or the group) on the one hand and, on the other, the subsidiary. Difficulties of choice sometimes arise where the subsidiary is requested to use its assets to prop up another member of the group or even the parent.

Where the subsidiary is called upon to use its assets to help out others in the group without there being any obvious direct benefit flowing to it from such use of its assets, corporate governance practices require the directors of the subsidiary to consider its interests. If they form the view that the proposed transaction will be inconsistent with the ultimate interests of the subsidiary, they should not allow the subsidiary to proceed with it, notwithstanding that such a course would be against the best interests of the parent.

In this respect, corporate practices do not differ in any material sense from the legal principles which apply to directors of such subsidiaries. For instance, Kirby P in *Equiticorp Finance (in liq) v Bank of New Zealand*[37] accepted the principles stated in *Charterbridge v Lloyd's Bank*[38] that each company in a group is a separate entity and the directors of the subsidiaries are not entitled to sacrifice the interests of that company merely for the benefit of the parent. The subsidiary can, of course, properly engage in particular conduct from which it gains no apparent direct benefit (which may go to the parent) providing it acquires a derivative gain from the transaction. This was recognised in *Walker v Wimborne*.[39] Mason J said that where company A pays company B to enable the latter to keep trading, such a payment by Company A is lawful if, for example, it is a shareholder of company B and it anticipates derivative benefits from the trading of company B. The transaction must be viewed from the standpoint of company A and judged according to the interests of company A.[40]

Nevertheless, a breach may arise where directors of company A enter into the transaction on its behalf because they consider it to benefit the group as a whole and do not give separate consideration to the benefit of A.[41]

37 Supra n 9 at 684.
38 [1970] Ch 62.
39 (1976) 137 CLR 1 at 6-7.
40 See also *Industrial Equity v Blackburn* (1977) 137 CLR 567; *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324; *Qintex Aust Finance Ltd v Schroders Australia* (1990) 3 ACSR 267; *Re Enterprise Goldmines Ltd* (1992) 10 ACLC 136.
41 See *Equiticorp,* supra n 9 at 726.

The common law, however, did not always adequately provide protection to the creditor of the insolvent subsidiary which has been abandoned by the parent after it has conducted its business as part of the group. This type of problem caused Rogers CJ to suggest in *Qintex Aust Finance Ltd v Schroders Aust Ltd*[42] that there was a need for legislative reform to cover the special problems presented by corporate groups. His Honour said:

> It may be desirable for parliament to consider whether this distinction between the law and commercial practice should be maintained. This is especially the case today when the many collapses of conglomerates occasion many disputes. Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bears the liability. If an illustration were needed of the futility and inappropriateness of arguments of this kind, it may be found in the facts which ground my decision in *Impact Datascape Pty Ltd v McIntosh* (3 October 1990, unreported). As well, creditors of failed companies encounter difficulty when they have to select from among the moving targets the company with which they consider they concluded the contract. The result has been unproductive expenditure on legal costs, a reduction in the amount available to creditors, a windfall for some, and an unfair loss to others. Fairness or equity seems to have little role to play.[43]

The authors of *Ford's Principles of Corporations Law* state that although it may seem commercially unrealistic to refuse to treat the companies in the group as a single financial entity, until such time as the law is changed, each member of the group must be treated as a separate entity.[44] The authors refer to the *Report on Reform of the Law Governing Corporate Financial Transactions*[45] where the Companies and Securities Advisory Committee expressed concern that "the lack of specific provisions regulating inter-corporate loans could be interpreted as a statutory licence to make these loans, without sufficient consideration by directors of their legal duties".[46] As the authors point out, the Report eventually led to the enactment of Corporations Law Part 3.2A.

Corporate governance principles, however, require the parent to stand behind the failed subsidiary, particularly where its demise has been brought about by activity, the benefit of which has been passed on to the parent or the group. Safeguards must be put in place by the parent to cover the situation where the subsidiary may be technically insolvent as a result of the conduct of its business for the overall benefit of the group. In tangible terms, the parent is required to provide the funds necessary to meet the subsidiary's outgoings, including payment to creditors.

Thus, historically, corporate governance practices were more protective of the creditor of the subsidiary than were legal principles. The introduction of s588V of the Corporations Law, however, has resulted in the legal rule moving closer to sound corporate governance practice. Section 588V provides that a holding company contravenes the section if at the time when the subsidiary incurs a debt:

- the subsidiary is insolvent or becomes insolvent in incurring the debt; and

42 (1990) 3 ACSR 267.
43 Ibid at 269.
44 Supra n 27 at para [8.140].
45 Companies and Securities Advisory Committee, *Report on Reform of the Law Governing Corporate Financial Transactions* (1991).
46 Ibid at 4.

- at that time there were reasonable grounds for suspecting that the subsidiary is insolvent, or would become insolvent; and
- the holding company, or any one of its directors, is aware of such grounds for suspecting; or
- it is reasonable to suspect that, having regard to the nature and extent of the holding company's control over the subsidiary's affairs, the holding company or any one of its directors would be so aware.

Section 588W provides that where a holding company contravenes s588V and an unsecured or partly unsecured creditor of the subsidiary has suffered loss and damage, the liquidator of the subsidiary may seek to recover from the holding company an amount equal to the loss and damage.

2. *Parent board responsibility for subsidiary*

There is no reason why a parent board should not leave the effective decision making as to policy and operations, almost entirely to the board of the subsidiary. The decision whether or not to give the board of the subsidiary complete discretion will depend on the prevailing circumstances, including the calibre of the subsidiary board. Where the parent gives the subsidiary such discretion, the question arises, what is the degree of overview which the parent board must pursue in relation to such a subsidiary, particularly where it is a major operating unit. This was one of the main issues before the Tricontinental Royal Commission in the context of the State Savings Bank board and its free operating subsidiary, Tricontinental. In such a situation, the legal and commercial obligations of the parent board would probably include the requirement to supervise the activities of the subsidiary board to the extent where it can meaningfully monitor the performance of the subsidiary. The Commission recognised that a subsidiary, like any other asset of the parent, must receive proper attention from the directors of the holding company in the sense of ensuring that the business and affairs of the subsidiary are properly conducted. But this does not mean that those directors are required to duplicate the proper functions of the subsidiary board or otherwise to supervise the activities of its executives so as to ensure that they are duly performing their role.[47] Moreover, the directors of the parent may owe no legal duty to the subsidiary as such, at least where the subsidiary has an independent board of directors.[48]

Corporation as good citizen

Corporate governance practices have also been directed at ensuring that the company behaves like a good citizen. In that context, the directors are required in certain circumstances to have regard to the interests of stakeholders in the company, the membership of which is wider than that contemplated by the law.

It is convenient to mention at this point that legal requirements relating to directors' duties have been founded essentially on the law as developed by the Court of Chancery, with the result that a primary guiding principle to which directors must adhere is one

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47 As to this, see the Tricontinental Royal Commission Report, supra n 13 at paras 19.84 to 19.87.

48 See *Lindgren v L & P Estates Pty Ltd* [1968] 1 Ch 572 at 595.

applicable to a fiduciary. Traditional company law principles have also been based on the notion that the corporation is owned by shareholders who can exercise their proprietary rights as they like, including validating breaches of duty by directors. Thus, although it has been said that as a matter of general principle, directors owe an overriding fiduciary duty to act bona fide in what they consider to be in the interests of the company,[49] the interests of the company are still measured primarily by reference to the interests of present and future members of the company.[50]

The courts have not accepted that directors owe stakeholders in the company any relevant obligation. In a sense, that is not surprising having regard to the relatively limited jurisprudential basis on which this area of the law rests. This limitation has been recognised on a number of occasions. For example, in his 1984 Southey Memorial Lecture, Lord Wedderburn of Charlton questioned the efficacy and adequacy of the "legal weapons" with which the court seeks to wrestle social issues that are present in society because of corporate activities.[51] His Lordship was of the opinion that it would have surprised the Law Lords in 1887 to learn that the principles laid down to govern the modest boot business of Aaron Solomon, his wife, their five sons and one daughter, were to be applied without modification, for example, to large multinational joint venture companies which can manipulate their arrangements so as to refuse to pay for the massive losses caused to creditors by their subsidiaries.

Professor Sealy[52] has also pointed out that the traditional rules and concepts of company law regarding directors' duties are under challenge and has argued that the law ought to require directors to have regard to the interests of stakeholders.

Recent company law reforms have also not affected this position to any great extent. Many of those reforms have been directed to strengthening the position of shareholders, particularly vis a vis the directors because it was perceived that shareholder control of company activities has been severely limited from a practical point of view and that the effective power over the company was in the hands of directors. The courts and in particular, the legislature, have recently brought about significant changes favouring shareholders' rights. There are, however, other groups which are affected by the operations of the company and as to them, traditional company law had relatively little to say.

As has been mentioned previously, corporate governance practices require directors, when making a relevant decision, to have regard to stakeholders in the company. This group includes shareholders as well as its management, employees, creditors and, where relevant, the public. To some extent, this is the by product of the recognition by the corporate world that the company should act as a good citizen and that the sole criteria of its performance should not be the amount of profit it generates for its shareholders. A company should also be judged by its treatment of those who are relevantly affected by its operations.

In fact, company directors have long seen themselves as owing duties to those beyond the shareholder group (although they have often rationalised such approach as

49 *Re Smith & Fawcett Ltd* [1942] Ch 304 at 306, per Lord Greene MR.
50 See *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 at 504, per Dixon J.
51 Lord Wedderburn of Charlton, "The Social Responsibility of Companies" (1985) 15 *Melbourne University Law Review* 30.
52 L S Sealy, "Directors 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 *Monash University Law Review* 164.

being in the overall interest of shareholders). For example, in the middle of World War 2, a group of 120 British businessmen issued a statement confirming that companies owe duties to consumers, employees and investors and to "the well being of the nation as a whole". In 1973 the Confederation of British Industry recognised that the company owed responsibilities to members, creditors, customers, employees and to society at large and that the company should behave like a good citizen in business.

More recently, in delivering the 1996 annual oration at The Centre for Corporate Public Affairs, J T Ralph AO addressed the question of whether companies have a responsibility to act in a manner other than that which maximises their profit. He noted that Friedman put the matter in stark terms: "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."

In rejecting the Friedman line, Mr Ralph said that the interests of shareholders would be best served by not following this view. Taken at face value, making as much money as possible in the short term, with little thought for the future, is not likely to deliver the best outcome for the enterprise or its shareholders.

Although Mr Ralph recognised that an overriding objective of companies is the generation of shareholder wealth, he argued that this is unlikely to be achieved if regard is not had to such matters as delivery of value to customers and the enhancement of the company's reputation for integrity, ethical behaviour and fair dealing. Without such an ethos, customers are unlikely to wish to repeat business and even more importantly, the company will not attract and retain good capable people. If business does not operate in a way that the community regards as reasonable, additional constraints may be imposed through legislation and regulation. Consequently, how business behaves and how it anticipates or reacts to community expectations will influence the ability of enterprises to maximise the long term wealth of their shareholders.

Hence, however rationalised, corporate governance practices recognise the interests of the stakeholder and the obligation of directors to have regard to their interests when making relevant decisions.

Legal principles, however, have only partially moved in that direction. When Lord Diplock said in *Lonrho Ltd v Shell Ltd*[53] that the "interests of the company" could sometimes include the interests of creditors, it was generally regarded as an innovative proposition. It is true that since *Walker v Wimborne*,[54] legal principles have evolved, albeit on a dubious jurisprudential basis, whereby it is now accepted that directors' duties to act in the interests of the company include having due consideration to the interests of its creditors where the company is in a vulnerable position so far as liquidity is concerned.[55] In *Winkworth v Edward Baron Development Co Ltd*[56] the House of Lords held that "a duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that the property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the

53 [1980] 1 WLR 627 at 634.
54 (1976) 137 CLR 1; 3 ACLR 529.
55 See Kirby P in *Equiticorp,* supra n 9 at 663.
56 [1987] 1 All ER 114.

creditors."[57] The Lordships did not develop the jurisprudential basis of the duty and did not cite any authority so that it is unclear whether their Lordships were stating that a director has a separate duty to creditors or whether it is part of the director's duty to the company. In Australia, the courts have held that directors do not owe a duty to creditors at common law[58] although they must give them due consideration when the company is in a financially dubious situation.[59]

There is, however, a light at the end of that tunnel in the sense that there is an indication that the law may be moving towards recognising that persons interested in or affected by the company's operations, other than its shareholders and creditors, may require the protection of the law. For example, Kirby P in *Equiticorp*[60] recognised that those relevantly affected by the operation of the company include not only shareholders, but also its employees, creditors and the public (the stakeholders) who, in certain circumstances, require the protection of the law. More generally, however, as has been said earlier, legal principles in this area have moved only partly towards corresponding corporate governance practices.

Conclusion

From this brief examination of corporate governance practices and related legal principles concerning directors' duties, it may be said that the practices have played some role in the development of legal rules. Nevertheless, the extent of that role remains debatable. True it is that the practices have provided the courts with a standard by which to judge directors' behaviour and with a relevant context in which to develop legal principles. Moreover, some legal rules have evolved to reflect at least in part corporate governance practices. The problem however, is that the courts have not, in terms, said that they were taking a particular line because of reliance on corporate governance practices. Similarly, they have not received evidence about such practices probably on the basis that normally such evidence is inadmissible. Hence, on the face of it, there is no direct evidence to show that legal principles have developed in reliance on corporate governance practices. On the other hand, there is indirect material to support such a contention.

First, it is more than mere coincidence that legal rules have evolved to coincide with some of the relevant corporate governance practices. Secondly, courts must have been at least generally aware of the existence of corporate governance practices and it is likely that they paid heed to them when developing and applying legal rules. Despite attempts by some to portray judges as living in cocoons where they are not tainted by the realities of the world, courts have usually been aware of what is going on in the commercial world. This is especially so with judges in the Commercial List.

Nevertheless, while accepting that corporate governance practices played a role in the evolution of legal principles relating to directors' duties, their role was not as significant as it perhaps should have been. This has been partly due to the failure by the cor-

57 Ibid at 118.

58 Street CJ in *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) ACLC 215 at 223; Gummow J in *Sycotex Pty Ltd v Baseler* (1994) 13 ACSR 766.

59 The only reasoned decision to the effect that directors can owe duties to creditors of the company is that of Cook J in *Permakraft v Nicholson* [1985] 1 NZLR 242.

60 Supra n 9 at 677.

porate sector to produce a more cohesive (as distinct from uniform) body of principles or practices or to give meaningful exposure of them to judges, legislators and others involved in that area. It is incumbent on the corporate community to ensure that those practices are properly exposed so that they become more widely known by those concerned with the formulation of directors' duties.

It is one thing for a company to develop standards for the behaviour of its directors and to take practical steps to ensure they are implemented. That should only be the first relevant step. The next step should be aimed at ensuring that those standards become more relevant in the legal process so that the courts and legislators have the opportunity of developing legal principles in that context. Accountants have achieved that type of situation through their Standards. It may not be possible or even desirable to try and duplicate that position in relation to directors' duties, but what can be achieved is a greater degree of cohesion and definition as to what are the expectations of the corporate world as to directors' duties so that the courts can develop the requirements in relation to them. In this context, it may be appropriate to recall what Sir Douglas Menzies said about directors in 1959 at the Australian Legal Convention, namely, "what is in general expected of directors will tend to become the measure of what is required of them".[61]

Put shortly, a serious effort will have to be made to bring together the relevant corporate governance practices into one cohesive body and to publicise their existence. It is for the corporate community to undertake this task. It will not be easy or inexpensive, but if it is achieved, it is likely to produce a worthwhile result in the interests of the corporate world and the community.

61 (1959) 33 *Australian Law Journal* 156 at 164.

Chapter 4

Corporate Governance, Corporate Law and Global Forces

Justice Michael Kirby*

A Moving Target

The Australian debate about corporate governance (indeed about corporate law) is at an important turning-point.[1] Curiously enough, the turn did not come with the enactment of the Corporations Law in 1991. In many ways, that profoundly, even overly, detailed statute was merely the continuation of the essence of the old company laws inherited from legislation enacted in England in the middle of the 19th century. But at least the final passage of as much national corporations law as could be squeezed into the permissible constitutional remit[2] encouraged lawyers, corporate officials, governmental officers, politicians and others in Australia to think in national terms and to contemplate a few new ideas and original approaches. That process is continuing.

My thesis is that these changes represent an overly conservative and belated response to radical challenges to corporate governance in Australia. As usual, lawyers and regulators are responding decades late to the corporate problems of earlier times. This is not an unusual position to be reached in law reform. The target moves. The reformer finds it hard to keep up.

The Corporation: A Brilliant Legal Idea

In John Tillotson's *Contract Law in Perspective*[3] there is a quotation from Lord Wilberforce which exemplifies that great judge's general approach to the law:

> If I am faced with the alternative of forcing commercial circles to fall in with legal doctrine which has nothing but precedent to commend it, or altering the doctrine so as to conform with what commercial experience has worked out, I know where my choice lies. The law should be responsive as well as, at times, enunciatory and good doctrine can seldom be divorced from sound practice.

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1 See A Corbett, "A Proposal for a More Responsive Approach to the Regulation of Corporate Governance" (1995) 23 *Federal Law Review* 277 at 281.

2 *New South Wales v The Commonwealth* (1990) 169 CLR 482. See also *The Commonwealth v Tasmania* (1985) 158 CLR 1.

3 (2nd ed, 1995) at 3.

This puts in a nutshell the lesson which we lawyers must learn when we are concerned with so intensely practical an area of the law as the regulation of corporate life. We must make clear the fundamental principles of honesty, integrity, transparency and regularity upon which the law insists for the governance of companies. We must help Parliament to give effect to those principles. But we must resist the ever-present tendency to turn companies into the playthings of the law, where virtually no important decision can be made without having a lawyer at the elbow of the company officer.

The reason why we must resist this temptation was explained by Lord Wilberforce in his Holdsworth Lecture "Law and Economics".[4] Delivered thirty years ago, this lecture described the way in which the limited liability company came into existence, first in England and very soon after in France in the middle of the nineteenth century. It was developed in England from the idea utilised when the Crown established charter companies for the conduct of very risky, but potentially hugely rewarding, overseas adventures in distant lands beyond the seas whose exotic produce could reap vast profits. The adaptation of the charter company by the enactment of legislation providing for the statutory corporation virtually changed England overnight from an agrarian economy into a modern commercial society:[5]

> The company, abolition of the laws of usury, the introduction of cheques, the formulation of Patent Law and trademarks, were all part of a movement which did not merely reflect the expansion of commercial practice; but also, perhaps more truly – gave an essential impulse to it.

According to Lord Wilberforce, our legal imagination ran out soon after this invention, as if exhausted by the brilliance and novelty of it. The maritime entrepreneurs went on with unlimited imagination. But the lawyers' ideas became fixed in stone. The concept of the limited liability company did not grow and adapt as the company tried to do. The notion of utilising the *ultra vires* doctrine, apt for a charter company but potentially devastating for a modern corporation, failed to change the "Berlin Wall between the corporate entity and its members"[6] established in *Salomon's case*.[7] This created many problems.

In short, according to Lord Wilberforce, the legal idea was both brilliant and creative. But it failed to adapt and grow as its creation, the company, did. Lord Wilberforce concluded:[8]

> The thought I want to leave with you is that we lawyers need to reorient our thinking in this whole field, in the interest of the survival of capitalism as a system combining modernity and obvious justice – through recognition of the completely changed function of limited companies – recognition, one must admit, of considerable abuses to which the system, and the superstructure which lawyers have put on it, has given rise...I want the climate of legal thinking to change.

Many other writers, in the 30 years since these words were written, have made similar calls for the fundamental rethinking of company law. So far, those calls have largely been ignored. Changes have occurred at the periphery. But the central features remain unchanged.

4 Lord Wilberforce, "Law and Economics" in P W Harvey (ed), *The Lawyer and Justice* (1978) at 73.
5 Ibid at 75.
6 Ibid at 76.
7 *Salomon v Salomon & Co* [1897] AC 22 (HL). Cf *Bank of New Zealand v Fiberi Pty Ltd* (1992) 8 ACSR 790; 10 ACLC 1557 (NSWCA).
8 Wilberforce, supra n 4 at 86.

If companies themselves had remained substantially the same as they were in the middle of the nineteenth century, a lawyer could have no complaint. One would continue to see the merit of upholding the separate legal identity of the company; the independent mandate of the board of directors; the general inability of shareholders, with few exceptions, to enjoy standing to bring an action against directors[9] and the fiduciary character of the obligations of directors. But a number of developments in the real world in which companies operate in Australia today, suggest reasons why it might be time for some fundamental rethinking in the field of corporations law.

Changing Times for Companies in Australia

Globalisation

The chief indication of a radically changed environment is the growing globalisation of the markets within which companies typically operate, with the consequence that many companies are now truly global, or at least regional, in character. Indeed, unless Australian companies accept a global perspective, it is increasingly obvious that they will enjoy diminished returns and fail to achieve the very purposes of their existence.

This point was recently made in an analysis by McKinsey Global Institute concerning Australia's relative economic performance.[10] The Australian economy and corporate environment were analysed along lines previously explored relative to the productivity and employment performances of other developed countries including France, Germany, Italy, Japan, Sweden and the United States. The immediate purpose of the study was to help the clients of McKinsey & Co, management consultants, to understand the performance and opportunities of Australian corporations in a global context. The study makes rather depressing reading.

Whilst acknowledging significant and extensive reform of Australia's financial system, business regulation, industrial relations environment and reduced trade protection during the previous 15 years, the study discloses that Australia's relative economic prosperity has not risen in real terms since 1970. It has a steady level of unemployment and needs "to step up the pace of productivity growth" if it wishes to "improve its economic standard of living".[11] That standard remains 30 per cent behind the best performing country over the past 25 years, viz the United States.

Various explanations are offered for the relatively poor performance of Australia's economy, which means, in reality, the poor performance of its corporate sector. They include less managerial innovation which is described as amongst the "primary causes of lower labour productivity in Australia";[12] inefficient product market regulation relative to Australia's smallish market size; slow adoption of innovative processes developed overseas; slower product and service innovation; lower use of collaboration with suppliers to improve processes of products; and lower management aspirations when compared to overseas countries. Amongst the external factors exacerbating these rather

9 *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189. See the discussion in Corbett, supra n 1 at 285-286.

10 McKinsey & Co Australia, *Growth Platforms for a Competitive Australia: Incentives, Aspirations, Innovations* (1995).

11 Ibid at 7.

12 Ibid at 9.

depressing problems are the legal restrictions imposed by market regulation and what are described as restrictive labour market regulation practices. According to the report, Australia must somehow lift the aspirations and innovation levels of its business leaders; develop better quality and effectiveness in middle management; introduce a pro-innovation culture that has been largely missing in the past and reduce the regulatory barriers and burdens that are seen as inhibiting entrepreneurship and risk-taking.[13]

One could be critical about various aspects of the McKinsey report. One could question some of the data and a number of the conclusions. One could question the confidence in the capacity of corporations, through market forces, to deliver all of the social objectives to which Australians aspire and be dubious about the importation of the cultural norms of other societies. But the point that is effectively made in the report is that the modern corporation can no longer retreat to fortress Australia. Increasingly, it is part of an economic world dominated by companies which know no national boundaries and owe loyalty to no particular nation state.[14] For such companies capital resources are shifted from one economy to another in such ways as advance the profitability of the corporation. Early in the century it might have been Australia. But more lately it became Korea and Taiwan. Today it is Thailand and Malaysia. Tomorrow it may be Vietnam and South Africa. Somehow, our corporations must operate in this global economic environment. Our corporations law must be conducive to successful operations in that environment. It must become part of the solution which assists corporate managers of intelligence and perception to meet the valid criticisms of corporate performance contained in the McKinsey report. The law should not be part of the problem.

Institutional investors

A second feature of the modern corporation which empirical analysis would oblige us to take into account is the growth in the 30 years since Lord Wilberforce's Lecture, of the power of institutional investors. Such investors, with huge funds at their disposal, have relatively little motivation to be specially concerned about "good corporate citizenship" or to devote corporate attention to social values. Their interests are safety for their investment and maximum returns. In the United Kingdom, institutional ownership of shares has risen from 35 per cent in 1963 to 75 per cent today. In Australia 60 per cent of publicly listed companies are owned by institutions. Sixty percent of this ownership is in the hands of the top ten fund managers.[15]

At a time when, belatedly, company law and theory were developing in common law countries towards the notion that the modern corporation owes duties not just to its shareholders but also to employees, the community and the country in which it is established, economic developments are occurring which tend to discourage these notions. The only way they can be reintroduced effectively is by an appreciation that, in the long haul, the

13 Ibid at 49.

14 See for example on the issue of legal globalisation, R T Nimmer and P A Krauthaus, "Globalisation of Law in Intellectual Property and Related Commercial Contexts" (1992) 10 *Law in Context* 80.

15 M Blair and I Ramsay, "Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies" (1994) 19 *Melbourne University Law Review* 153; J Hill and I Ramsay, "Institutional Investment in Australia: Theory and Evidence" in G Walker and B Fisse (eds) *Securities Regulation in Australia and New Zealand* (1994) at 293-297; D Macken, "The Soulless Corporations", *Sydney Morning Herald*, 13 April 1996 at 65; G Stapledon, *Institutional Shareholders and Corporate Governance* (1996).

companies which do best economically tend to be those which exhibit concern about their employees and about their community.[16] Sadly, institutional investors, which can shift huge funds overnight and are not generally limited to domestic investment, may not be overly concerned about the long run. They may be relatively impervious to the idealistic opinions of small shareholders whose voices are, in any case, muted amidst the clamour of powerful institutional investors. This is a second reality in which the Australian corporation today operates.

Corporate "down-sizing"

Thirdly, there is the phenomenon of corporate "down-sizing" which is usually associated with the introduction of new labour-saving technology by executives who are often themselves paid huge salaries for their achievements. Although the Australian position in terms of salaries remains modest by global standards (in some countries top executives annual salaries are expressed in multi-million dollar terms) there are many familiar examples where thousands of employees have been laid off at a time when executive earnings are reported to have risen substantially.[17] This reality must also be understood as a feature of the environment in which lawyers begin to suggest that directors' duties extend to the best interests of employees and of the community, as well as the traditional notion of pursuing the best interests of shareholders and investors. There is not much point speaking idealistically about the "larger mission" of the corporation in Australia if, in the real world, the Australian corporation, under pressure from overseas competitors and local fund- managers, is retreating from community concerns.

Privatisation

Fourthly, there is the phenomenon of privatisation of government services which is such a feature of the economy to-day. Former governmental corporations are privatised. Activities once performed by governments are sold, to non-governmental corporations. The extent to which this is occurring is well documented. The legal problems which it brings in its train are attracting the attention of academics.[18] Legislators may add "social responsibilities" to the duties of state-owned corporations.[19] Scholars may castigate the judicial failure to enforce a sense of social obligation upon the activities of state-owned corporations.[20] However, if the very purpose of corporatisation and privatisation is to take the government out of the marketplace, can courts really be blamed for giving full effect to this policy? As Nicholas Seddon points out in his recent book, the shift of formerly governmental functions to the private sector presents large challenges to the law

16 P Wildblood, *Leading from Within: Creating Vision, Leading Change, Getting Results* (1995) citing *Built to Last: Successful Habits of Visionary Companies* (1994), a book which examined 18 companies in the United States which had survived for 50 years to discern the common traits which they demonstrated. All of them put emphasis upon their staff and their chosen community as well as their shareholders. See Macken, supra n 15.

17 Macken, supra n 15, cites Coles Myer Australia Limited whose profits between the years 1990 to 1995 dropped 18 per cent in real terms. The group shed 24,000 employment positions. The number of employees earning over $100,000 a year reportedly quadrupled. The salaries of executives and directors reportedly more than tripled.

18 N Sedden, *Government Contracts: Federal, State and Local* (1995).

19 Cf *State Owned Corporations Act* 1989 (NSW), s 20E(1). There are similar provisions in the Acts of Victoria, Queensland and South Australia.

20 See, for example, M Taggart, "Corporatisation, Privatisation and Public Law" [1991] *Public Law Review* 77.

in developing effective mechanisms to protect the individual dealing with the corporation, where previously public administrative law could have been invoked.[21]

Particular local developments

Within the Australian scene, there are some additional and particular factors which affect the debates about the future directions of corporations law. They include:

Corporate crime: The sorry record of the high profile corporate offenders in the 1980s brought discredit to corporate activity in Australia. It has tended to discourage the most radical solutions of corporate law reform and the suggestion of the withdrawal of the regulators from this area of activity. The challenge remains that of retaining the entrepreneurial spark which is essential to the success of the corporation in the marketplace but in conditions of honesty to the general community and fidelity to shareholders. Whilst the memory of the serious corporate offenders is still so vivid in Australia, it is difficult to argue for significant withdrawal from regulation of corporations, at least in respect of dishonesty and breach of trust.

The courts: The annual reports of the Federal Court of Australia continue to demonstrate the shift of business in corporate law matters from the State Supreme Courts to the Federal Court.[22] A measure of competition between courts may be good for the corporate consumer. State Supreme Courts have certainly begun to fight back to retain or regain corporate law work. One result of this bifurcation of courts is the bifurcation of appellate authority in Australia. This produces the risk of disharmonious decisions in the corporate law area. Such decisions add to the difficulty of administering already complex legislation which, in the view of many, is over-detailed and over-technical.

Responses to the Changes

The responses of Australian society and its legal system to the foregoing changes (and others) may be various.

Traditional responses

Some will retreat to the notion that a sovereign state, like Australia, has a right and a duty to enforce its own notions of commercial morality. This approach will take us further down the track of traditional company law. Directors' liabilities for wrongful and negligent conduct will be increased, generally to a squeal of voices asserting that this does not occur in those competing economies of the region which are most successful. Directors will complain that lawyers are intruding too much and too often into the board room and casting their depressing spell over legitimate risk-taking. Without going the whole way with this special pleading, it is important always to keep in mind what the fundamental purpose of the corporation is. It is to take risks with other people's money. Those who take risks will, inevitably, sometimes fail. If they fail without illegality, dishonesty or neglect of fundamental duties, the law should be slow to impose personal or corporate

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21 Seddon, supra n 18.

22 See, for example, Federal Court of Australia, *Annual Report 1993-94* (1994) at 38 (Figs 5 & 6).

sanctions on them. In *Vrisakis v Australian Securities Commission*,[23] Ipp J in the Supreme Court of Western Australia, explained why this is so:

> The management and direction of companies involve taking decisions and embarking upon actions which may promise much, on the one hand, but which are, at the same time, fraught with risk on the other. This is inherent in the life of industry and commerce. The legislature undoubtedly did not intend...to dampen business enterprise and penalise legitimate but unsuccessful entrepreneurial activity.

It is timely for judges and other lawyers to remember the basic objectives of the corporation. Once law begins to approach the point of destroying, or seriously discouraging, the achievement of that purpose, it has begun to fail in the performance of its proper function in this area. In Australia we need to recognise this fact given the vulnerability of our economy and the reportedly mediocre performance of many of our corporations. This is happening in a region of the world where other economies and their corporations are doing spectacularly well. The law which should be the servant of society and a sustaining force for its institutions, should examine its own performance when its application deflects attention from "the main game of wealth creation which is, in turn, the driver of new investment and job creation".[24]

Simplification of the law

Another response may be to retain current doctrine but to chip away at the edges. This is basically what lawyers in Australia have been doing in recent years. The passage of the first *Corporate Law Simplification Act* 1995 (Cth), and the promise of further stages of that process, represent a serious effort on the part of the Federal Government and Parliament to address many particular concerns which have been voiced about the detail, complexity, unintelligibility and inefficiency of Australia's national regulation of corporations. The fact that more than simplification is required has been recognised by the present Federal Government in the announcement by the Treasurer, on 4 March 1997, that Australia's corporate law will be given a new economic focus to ensure that the law is not "out of touch with modern commercial practice".

A national general appellate court?

But it is not only in legislation that there has been inconsistency. As I have said, many court decisions in the field of company law have been inconsistent. A collection of some of the inconsistencies has been usefully made by Justice G F K Santow and Mr M Leeming.[25] The High Court of Australia has urged appellate courts throughout the nation, and single judges, not to depart from an interpretation placed upon national or uniform legislation – such as the Corporations Law – given by another court "unless convinced that the interpretation is plainly wrong".[26] If this injunction to respect the uniformity of

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23 (1993) 11 ACSR 162 at 212. See R Baxt, "Have the Courts Been Too Generous in Excusing Directors for Breaches of Duty? Not in Respect of Financial Matters!" (1994) 22 *Australian Business Law Review* 211.

24 F Hilmer, *Strictly Boardroom: Improving Governance to Enhance Company Performance* (1993).

25 G F K Santow and M Leeming, "Refining Australia's Appellate System and Enhancing its Significance in our Region" (1995) 69 *Australian Law Journal* 348.

26 *Australian Securities Commission v Marlborough Goldmines Limited* (1993) 177 CLR 485 at 492.

decisions in the interpretation of uniform national legislation, such as the Corporations Law, is not effective, a graded response must follow. The Australian Securities Commission could take a more active part in intervening (as by statute it may) in proceedings in the courts to help promote uniform and informed decisions. The Federal Court, which is accepting an ever-increasing proportion of cases under the Corporations Law could institute, internally, arrangements to constitute appellate benches in this area likely to provide consistent and informed authority.[27] An even bolder development, raised for consideration by the final report of the Constitutional Commission in 1988[28] would be the establishment of a national general appellate court, under the High Court of Australia. This would recognise the constitutional responsibilities of the High Court and the practical reality that the High Court can accept only a small proportion of cases seeking to come to it, including in the field of corporations law.

Regional issues

A further possibility is that we should learn from non-traditional sources of company law and practice. Are there lessons for us in the buoyant economies of the world, so far as their approaches are tolerable to our economic, social and legal cultures? Their law in the books may look rather similar. But how and why has it provided a more supportive legal environment and does this have any lessons for us?

There is an increasing understanding of the importance of the law of countries in our region. In this respect, the legal profession is simply reflecting the shifts in corporate activity directed to the region. A recent issue of the *Australian Journal of Corporate Law* contains essays on anti-trust law in Thailand; companies and securities legislation in Hong Kong; the new banking law regime in China; securities and investment law in China; economic reform in Vietnam; and an analysis of the insolvency law of six Asian legal systems: China, Hong Kong, Indonesia, Malaysia, Singapore and Taiwan.[29]Although in some ways the corporations laws of the countries of the region are undeveloped and the "economic miracle" of the region has occurred despite, not because of, law, there are undoubted lessons for Australia in the region. This is where our economic future lies.

Empirical research

The analysis of the Asian legal systems in the Journal just mentioned was based upon empirical research supported by the University of Canberra. The Centre for Corporate Law and Securities Regulation at the University of Melbourne has also emphasised the necessity of empirical research to understand the real operation of corporate law and

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27 For the growth of the jurisdiction of the Federal Court, see Federal Court of Australia, *Annual Report 1993-94* (1994) at 38 (Figs 5 & 6).

28 Vol 1 (1988) at 368-369.

29 S Supanit, "Antitrust Law in Thailand" (1996) 6 *Aust J Corp L* 154; K Arjunan and C K Chee, "Companies and Securities Legislation: Hong Kong" (1996) 6 *Aust J Corp L* 161; J O'Hare, "Regulation of the Securities Industry: Hong Kong SFC (1996) 6 *Aust J Corp L* 178; D K Srivastava, "China's New Banking Law Regime" (1996) 6 *Aust J Corp L* 201; Xi Qing Gao, "Developments in Securities and Investment Law: China" (1996) 6 *Aust J Corp L* 228; L D Doanh, "Economic Reform in Viet Nam" (1996) 6 *Aust J Corp L* 289; R Tomasic et al, "Insolvency Law: Six Asian Legal Systems" (1996) 6 *Aust J Corp L* 248.

securities regulation. I strongly support that tendency. My decade in the Australian Law Reform Commission taught me the importance of analysis that goes beyond the language of legislation and decisions of the courts. It is necessary to understand what actually happens in the boardrooms. That cannot be achieved by confining research to legal texts. It is essential to involve corporate officers with legal experts to derive lessons from their experience. Doubtless they will complain about complexity. Perhaps they will say that risk-taking is becoming next to impossible for fear of legal suits designed to distribute the loss of risks that fail. If these are their complaints, it is important that lawyers and law-makers should try to understand them. The days of self-congratulations have passed. In the corporate sphere, particularly, Australia finds itself in the harsh world of international and regional competition. It is essential that lawyers and law-makers should listen to the voices of the corporations, and not just corporate lawyers who may share our legal culture.

Conclusions

We can continue to approach company law by playing with words and adjusting time-honoured models of corporate regulation. But in my opinion, this is not good enough. Above all, we should be looking at company law, with the benefit of empirical data concerning the reality of the economy and the society in which corporations in contemporary Australia operate. Any study of company law which ignores globalisation, institutional dominance of investment funds, the impact of technology, down-sizing of employment and the growth of privatisation of formerly governmental corporations, is bound to come up with artificial and ineffective responses.

Governments and those tackling corporations law reform should familiarise themselves with the actual corporate environment in Australia. Beyond the bleating and generalities of complaint, they should particularly address the criticism of Australia's corporate performance and the reasons for its failings. They should consider whether, and in what way, the current Corporations Law is part of the problem.[30] To the extent that it is, that Law should be reformed to the fullest measure consistent with other national goals.

Courts, at least in a general way, should be aware of this backdrop of economic reality which I have sketched. In the past I have myself been most stern in my approach to the obligations of the duties imposed by law upon corporations and their officers.[31]Perhaps it is necessary, from time to time, to remind one's self (as Lord Wilberforce does in his Holdsworth Lecture) that the corporation began as a speculative adventurer. When it loses entirely the spark of adventure and risk-taking entrepreneurship, it has lost its way.

30 For an overview of statutory simplification, see I Govey, "Simplifying the Corporations Law – the First Stage" in *Law Institute Journal*, January 1996, at 29. See also I Govey, "Corporate Law Simplification: Major Changes Expected" in *New Directions in Bankruptcy*, November 1995, at 2. The simplification process has now been overtaken by the Corporate Law Economic Reform Program announced by the Federal Treasurer on 4 March 1997.

31 See, for example, *Metal Manufactures Pty Ltd v Lewis* (1988) 13 NSWLR 315 (CA); *Darvall v North Sydney Brick and Tile Co Limited* (1989) 16 NSWLR 260 (CA); and *Woolworths Limited v Kelly* (1990) 22 NSWLR 189 (CA).

Part III

Directors' Duties

Chapter 5

Directors' Duties: The Governing Principles

Chief Justice David Malcolm*

Introduction

There are a number of general principles which have guided the courts in their approach to corporate law, both in terms of the development of the general law and the interpretation of legislation. The first general principle could be called the 'non- interference principle'. The essence of that principle was described by Scrutton LJ as follows:

> It is not the business of the Court to manage the affairs of the company. That is for the shareholders and directors...I should be sorry to see the Court...take upon itself the management of concerns which others may understand far better than the Court does.[1]

The second principle could be called the 'commercial reality principle'. It reflects the awareness of the courts of changing realities in the commercial world, and the effect that this should have on the approach of the courts to their regulation of the corporate world. In this context, the courts will probably always be suspected of having been left in the wake of new commercial realities. For example, Professor Baxt has recently called for a "...a more commercial interpretation of legislation which will result in what many will regard as a sensible commercial conclusion."[2]

The third principle could be called the 'non-prescriptive principle'. It reflects an awareness that the courts cannot hope to lay down in great detail the boundaries within which they will exercise jurisdiction over the affairs of companies. Indeed, the law will lose its flexibility and ability to adapt to circumstances if this were done. As Lord Macnaghten observed some time ago:

> ...I do not think it desirable for any tribunal...to formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances; and, speaking for myself, I rather doubt the wisdom of attempting to do more.[3]

There is, in this principle I think a lesson for our legislators. That is, that even statutory provisions are often best expressed in broad terms, leaving it to the courts to sensibly apply them on a case by case basis.

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1 *Shuttleworth v Cox Brothers & Co* (1927) 2 KB 9 at 23-24.

2 R Baxt, "National Corporate Law – Two Steps Forward, One Step Back!" (1995) 23 *Australian Business Law Review* 148 at 149.

3 *Dovey v Cory* [1901] AC 477 at 488.

In order to demonstrate these general principles at work in the approach of the courts, this chapter will focus on the specific topic of directors' duties. I will consider both the development of the general law duties by the courts and the approach of the courts to the interpretation of the various statutory duties which have been imposed on directors in more recent times.

Directors' Duties At General Law

The duty to act in good faith and for proper purposes

Directors are fiduciary agents. As a result, their powers "...must be exercised not only in the manner required by law but also bona fide for the benefit of the company as a whole."[4] This 'company interest' test was generally regarded as a subjective test. Directors were required to "...exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company."[5] There would be no ground for the court to intervene if the directors acted upon the basis of "...a bona fide consideration of the interests of the company as the directors see them."[5]

In *Allen v Gold Reefs of West Africa Ltd,*[7] Lindley MR suggested that provided that a power was exercised "bona fide for the benefit of the company as a whole", there was "...no ground for judicially putting any other restrictions on the power."[8] That can no longer be regarded as an accurate statement. The courts clearly recognised at a fairly early stage that the 'company interest' test did not, if it was to be regarded as a purely subjective test, represent a complete statement of the limits to which the exercise of directors' powers were subject. This was reflected in the way in which the courts described the fiduciary principle. For example, in *Mills v Mills*,[9] Dixon J stated that "Directors of a company are fiduciary agents, and a power conferred upon them cannot be exercised in order to gain some private advantage or for any purpose foreign to the power."[10]

In *Richard Brady Franks Ltd v Price,*[11] he said that directors' powers "...must be exercised honestly in furtherance of the purposes for which they are given."[12] In other words, it was open to a court to hold that a director who acted in what he or she considered to be the interests of the company, had nevertheless been motivated by what the court would classify as a foreign purpose. To a similar effect was the statement in *Ngurli v McCann*,[13] that a director was required to use a power "...bona fide for the purpose for which it was conferred..."[14] Clearly the courts would no longer regard such a purpose as

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4 *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 at 135 per Latham CJ; See also *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438; *Harlowe's Nominees Pty Ltd v Woodside NL* (1968) 121 CLR 483 at 492 per Barwick CJ, McTiernan and Kitto JJ.

5 *Re Smith and Fawcett Ltd* [1942] 1 Ch 304 at 306 per Lord Greene MR.

6 Ibid at 309 per Lord Green MR.

7 [1900] 1 Ch 656.

8 Ibid at 671.

9 (1938) 60 CLR 150.

10 Ibid at 185.

11 (1937) 58 CLR 112.

12 Ibid at 142.

13 Supra n 4.

14 Ibid at 439-440.

necessarily sufficiently described by the negative condition that a director be motivated by his or her view of the interests of the company. Again, in *Harlowe's Nominees v Woodside Oil NL,*[15] it was said that:

> Directors in whom are vested the right and the duty of deciding where the company's interest lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes is not open to review in the courts.[16]

In other words, an exercise of power in good faith, that is, according to the director's best judgment of what would serve the company's interests, would still be open to review in the courts on the basis that it was motivated by a purpose which the court considered 'irrelevant' to the power. A 'proper purpose' test was, in appropriate cases, being applied in conjunction with the 'company interest test.

The distinction between the 'company interest test and the 'proper purpose' test is most apparent in those cases where the courts have accepted that the directors acted honestly in what they considered to be the interests of the company. For example, in *Advance Bank v FAI Insurances*,[17] the New South Wales Court of Appeal proceeded on the basis of the trial judge's finding that "...the directors concerned acted honestly and bona fide, believing that what they did was for the best interests of the company."[18]However, Kirby P nevertheless held that in not promoting what was described as the "proper corporate objective"[19] of a due election, in the sense of a "fair election by an informed electorate of shareholders",[20] the directors had "...abused their powers [and]...exceeded their authority."[21] As Mahoney JA noted in the same case "...what was done pursuant to the directors' purposes went beyond what could properly be done in pursuance of them."[22]

In *Whitehouse v Carlton Hotel Pty Ltd*,[23] Mason CJ, Deane and Dawson JJ, were similarly prepared to proceed on the basis that, in exercising a power to issue shares which would, upon his death, place control of the company in the hands of his sons, a director had acted in what he genuinely considered to be the interests of the company.[24] However, this was not regarded as conclusive because:

> In this case as in other areas involving the exercise of fiduciary power, the exercise of a power for an ulterior or impermissible purpose is bad notwithstanding that the motives of the donee of the power in so exercising it are substantially altruistic.[25]

Therefore, while the subjective nature of the 'company interest test prevents the courts from conducting a judicial review of the commercial merits of business decisions, the 'proper purpose test allows the court to intervene when a power is exercised for an

15 Supra n 4.
16 Ibid at 493.
17 (1987) 12 ACLR 118.
18 Ibid at 119.
19 Ibid at 141.
20 Ibid at 137.
21 Ibid at 139.
22 Ibid at 147.
23 (1987) 11 ACLR 715.
24 Ibid at 720 per Mason, Deane and Dawson JJ.
25 Ibid at 721.

improper purpose, whether or not the exercise of power might be subjectively considered, or even objectively established, to be in the interests of the company.

In *Ashburton Oil NL v Alpha Minerals*,[26] Barwick CJ suggested that the phrase "for the benefit of the company as a whole", as used in the 'company interest' test, was 'somewhat tautological , preferring to describe the test in terms of a requirement to act "for the benefit of the company".[27] However, in my view, the qualifier 'as a whole' is useful in that it directs attention to what might be called the principle of non- discrimination, or impartiality, which underlies this test and which has found expression in the application of the 'proper purpose' test. The courts may not be particularly well qualified to say what is or is not in the "interests of the company" regarded as a commercial entity. However, they are well qualified to say what is not in the "interests of the company as a whole", as opposed to a sectional interest within that company. For example, in *Whitehouse v Carlton Hotel Pty Ltd*,[28] applying the 'proper purpose' test, Mason CJ, Dawson and Deane JJ concluded that:

> It is simply no part of the function of directors as such to favour one shareholder or group of shareholders by exercising a fiduciary power to allot shares for the purpose of diluting the voting power attaching to issued shares held by some other shareholder or group of shareholders.[29]

The purpose for which a director exercises a power is a question of fact,[30] to be determined by "...collecting from the surrounding circumstances all the materials which genuinely throw light on that question."[31] This can represent a difficult task. Indeed, in *Grant v John Grant & Sons Ltd*,[32] Fullagar J considered that it was "...quite impossible to divide motives into mutually exclusive watertight compartments."[33] In *Mills v Mills*,[34] Dixon J acknowledged that:

> When the law makes the object...or purpose of a body of men, the test of the validity of their acts, it necessarily opens up the possibility of an almost infinite analysis of the fears and desires, proximate and remote, which, in truth, form the compound motives usually animating human conduct.[35]

As such an analysis would be "impracticable" Dixon J thought the courts should content themselves with discovering "...the substantial object the accomplishment of which formed the real ground of the board's action."[36] If that object was proper, the exercise of power would be valid. However, if except for an improper object, the power would not have been exercised, the exercise of power would be regarded as invalid.[37]

This is, in essence, the approach which the courts have subsequently adopted. For example, in *Advance Bank Australia v FAI Insurances*,[38] Kirby P described it as involv-

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26 (1971) 123 CLR 614.
27 Ibid at 620.
28 Supra n 23.
29 Ibid at 718.
30 See *Howard Smith Ltd v Ampol Ltd* (1972) 2 NSWLR 850 at 858 per Street CJ.
31 *JD Hannes v MJH Pty Ltd* (1992) 7 ACSR 8 at 12 per Sheller JA.
32 (1950) 82 CLR 1.
33 Ibid at 46.
34 Supra n 9.
35 Ibid at 185.
36 Ibid at 186.
37 Ibid at 186.
38 Supra n 17.

ing a search for "...the real purposes which primarily motivate their actions."[39] In *Condraulics Pty Ltd v Barry & Roberts Ltd*,[40] McPherson J said that a court would have to determine whether "...the substantial or primary motive influencing the directors is improper."[41] However, in *Whitehouse v Carlton Hotel Pty Ltd*,[42] Mason CJ, Deane and Dawson JJ pointed out that the test should be regarded more as one of causation than of characterisation. As they observed:

> ...the preferable view would seem to be that, regardless of whether the impermissible purpose was the dominant one or but one of a number of significantly contributing causes, the [exercise of power] will be invalidated if the impermissible purpose was causative in the sense that, but for its presence, 'the power would not have been exercised.'[43]

Therefore, where a court is satisfied that the primary purpose for the exercise of a power was proper, it should not be regarded as a reason to invalidate the exercise of power that, as an incidental result, a purpose is furthered which, were it the primary purpose for the exercise of the power, would be regarded as an improper purpose sufficient to vitiate the exercise of power.[44] This would seem an appropriate test to apply, considered in the context of what ought to be the 'reasonable expectations' of the members of the company. They are reasonably entitled to expect that a power will not be exercised for an improper purpose where it would not otherwise have been exercised at all.

In determining the purpose for which a power was exercised, the courts will give due weight to the assertions of the directors concerned. However, these will not be treated as determinative. As Kirby P has observed:

> ...statements by...directors about their subjective intention, whilst relevant, are not conclusive of the bona fides of the directors or of the purposes for which they acted as they did. In this sense, although the search is for the subjective intentions of the directors, it is a search which must be conducted objectively as the court decides whether to accept or discount the assertions which the directors make about their motives and purposes.[45]

As noted, the courts do not regard it as any part of their function to adjudicate on the commercial merits of a course of action pursued by directors. As Kirby P observed in *Darvall v North Sydney Brick & Tile Co*:[46]

> ...the purpose of the court's jurisdiction...is not to substitute an ex post decision for that of the directors, on the merits of a particular dealing. It is to assure the integrity of their decision at the time in the exercise of their fiduciary powers.[47]

However, in assessing the purpose for which a power was exercised, the courts are willing to consider whether a course of action was commercially justified for the strictly limited purpose of assessing the credibility of directors' assertions as to their motivation. For example, in *Pine Vale Investments v McDonnell & East Ltd*,[48] McPherson J observed that:

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39 Ibid at 137.
40 [1984] 2 Qd R 198.
41 Ibid at 206.
42 Supra n 23.
43 Ibid at 721.
44 Supra n 17 at 136.
45 Ibid at 137.
46 (1989) 15 ACLR 230.
47 Ibid at 250.
48 (1983) 8 ACLR 199.

> Each [director] was...insistent that he genuinely regarded the purchase ... to be commercially advantageous to the company. I have already concluded that in this their opinion is objectively justified. Had I formed a different view an adverse finding with respect to their motivation might well have followed, perhaps not of course, but certainly without great difficulty.[49]

To a similar effect, was the comment of Waddell J in *Winthrop Investments v Winns*,[50] that "...looking at the evidence as a whole...there is no warrant for concluding that the transaction into which the directors intended to enter was commercially disadvantageous so as to support an inference that the board had some ulterior motive for entering into it."[51]

The timing of directors' action may prove critical in allowing a court to draw an inference that it was the product of an improper purpose. For example, where a takeover is threatened the courts will closely scrutinise any exercise of power by the existing board of directors. However, the courts do not expect directors to be "reduced to inertia because of the pendency or possibility of a takeover offer."[52] Therefore, as McPherson J has noted, while the proximity between a takeover offer and a proposal which will have the effect of defeating that offer may, as he put it, "give rise to an eyebrow of suspicion":[53]

> A coincidence in the timing of [a] proposal with the making of [a] takeover offer is, without more, not ordinarily sufficient to raise an inference of the necessary impropriety of purpose.[54]

A court may, for example, be satisfied that the proximity of a takeover offer simply prompted the exercise of a power for a primary purpose which was proper, notwithstanding that the exercise of that power would have the effect of frustrating the takeover offer. In *Winthrop Investments v Winns*,[55] Waddell J reached this type of conclusion by characterising the substantial object of a purchase made by directors faced with a takeover offer as being "...to improve the company's financial position."[56] The takeover offer had simply brought home to the directors "...the business necessity of acquiring new retail outlets for the company."[57] He held that they also wished "...by increasing the profitability of the company, to deter...a take-over offer at below what they considered to be the 'true' value of the shares."[58] However, this was characterised as a "secondary object".[59] Therefore, the purchase could not "...be regarded as an ostensible exercise of power having an ulterior and illegitimate object of defeating a take-over offer which, incidentally, brought about a result within the purpose of the powers exercised and which the directors thought desirable."[60]

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49 Ibid at 209.
50 (1979) 4 ACLR 1.
51 Ibid at 12.
52 Supra n 48 at 210-211. See also supra n 46 at 249 per Kirby P.
53 Supra n 48 at 207.
54 Ibid at 206.
55 Supra n 50.
56 Ibid at 11.
57 Ibid at 12.
58 Ibid at 11.
59 Ibid at 11.
60 Ibid at 13.

The duty of care, skill and diligence

The early cases on directors' general law duty of care demonstrate a reluctance on the part of the courts to impose liability for conduct viewed as merely imprudent, mistaken or the result of an error of judgment.[61] This was reflected in the test adopted to determine liability, which required a plaintiff to show that a director had been guilty of "crassa negligentia"[62] or "gross negligence".[63]

This test, as was admitted at the time,[64] lacked precision. However, it did serve to distinguish, in broad terms, the *degree* of care required of directors from that required of other classes of persons.[65] To that extent it was thought to have some utility as being descriptive of "...a practical difference between the degrees of negligence for which different classes of persons are responsible."[66] As Romer J explained:

> I confess to feeling some difficulty in understanding the difference between negligence and gross negligence, except in so far as the expressions are used for the purpose of drawing a distinction between the duty that is owed in one case and the duty that is owed in another...if it be said that of two men one...is liable...for gross negligence, and the other is liable for mere negligence, this, I think, means no more than that the duties of the two men are different. The one owes a duty to take a greater degree of care than does the other...[67]

In this respect, the test did little more than confirm that directors would not be liable for a failure to take "all possible care",[68] having a duty to exercise "...some degree of care less than that."[69] Neville J suggested that this would be "...the care an ordinary man might be expected to take in the same circumstances on his own behalf."[70] However, Romer J regarded it as "impossible to describe the duty of directors in general terms", and the Earl of Halsbury LC thought it "...idle to talk in general terms of the duty of a director to look after the concerns of [a] company...without seeing what in the ordinary course of business he ought to...have done."[71]

In order to determine the extent of the duty in a particular case the courts considered:

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61 See, for example, *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 at 486 and 494 per Lord Hatherley; *In Re Forest of Dean Coal Mining Co* (1878) 10 Ch D 450 at 454 per Jessel MR; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 at 418 per Romer J; *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 at 437 per Neville J; *Re City Equitable Fire Insurance Co* [1925] Ch 407 at 429 per Romer J.

62 *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 at 487 per Lord Hatherley.

63 *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 at 494 per Lord Hatherley; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 at 418 per Romer J and at 435 per Lindley MR; *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 at 436 per Neville J; *Re City Equitable Fire Insurance Co* [1925] Ch 407 at 427 per Romer J.

64 See *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 at 418 per Romer J; *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 at 436-437 per Neville J; *Re City Equitable Fire Insurance Co* [1925] Ch 407 at 427-428 per Romer J. See also *Dorchester Finance Co v Stebbings* [1989] BCLC 498 at 501-502 per Foster J.

65 *Re City Equitable Fire Insurance Co* [1925] Ch 407 at 427-428 per Romer J.

66 *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 at 418 per Romer J.

67 Supra n 65 at 427-428 per Romer J.

68 *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 at 435 per Lindley MR; supra n 65 at 428 per Romer J.

69 Supra n 65 at 428 per Romer J.

70 *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 at 437. See also *Dorchester Finance Co v Stebbings* [1989] BCLC 498 at 501 per Foster J.

71 Supra n 3 at 483.

the nature of the company, the director's position within the company, the distribution of work within the company, and the director's knowledge and experience.[72] It was recognised that companies vary greatly in size and complexity, and that this affected both the degree of devolution of responsibility which might be necessary, and the duties which directors could reasonably be expected to perform. As Romer J explained:

> The position of a director of a company carrying on a small retail business is very different from that of a director of a railway company...The larger the business carried on by the company the more numerous, and the more important, the matters that must of necessity be left to the managers, the accountants and the rest of the staff.[73]

Provided only that the distribution of work within the company was reasonable, given "the exigencies of business",[74] and not inconsistent with the articles of association, the courts were prepared to take this into account in determining the extent of a director's duty of care.[75] As a result, directors were prima facie entitled to rely on the apparent skill and integrity of officials to whom responsibilities were properly delegated.[76] It was thought that any other rule would have made "...anything like an intelligent devolution of labour impossible."[77]

Where a director's reliance on officials proved to be misplaced, liability depended on whether the director ought to have been aware of the particular default. Because no director was "bound to presume a fraud",[78] directors were not required to keep a watch over officials, examine the company books or verify the calculations of auditors.[79] There was no general duty to make enquiries. In *Land Credit Company of Ireland v Lord Fermoy*,[80] where company funds which had been improperly used to purchase shares in the company had been disguised as loans to other persons, counsel for the appellant posed the questions: "If a director who was present at a meeting when an illegal thing was done is not liable, when is a director to be liable?...Could he escape by saying he was asleep at the time?"[81]

Lord Hatherley LC was able to confirm that "...their being asleep would not exempt them from the consequences of not attending to the business of the company."[82] However, where a director was present at a meeting, and awake, the duty to enquire into apparently proper transactions would be subject to appropriate limits. As Lord Hatherley LC observed "...it would be carrying the doctrine of liability too far to say that directors are liable for negligence, not because they did not ask whether [the borrowers] were solvent and respectable, but because they did not inquire what they were going to do with the

72 *In Re Forest of Dean Coal Mining Co* (1878) 10 Ch D 450 at 452 per Jessel MR; *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 at 437 per Neville J; supra n 65 at 426-427 per Romer J.
73 Supra n 65 at 426-427.
74 Ibid at 429.
75 Ibid at 427.
76 *In Re Forest of Dean Coal Mining Co* (1878) 10 Ch D 450 at 454 per Jessel MR; *Re City Equitable Fire Insurance Co* [1925] Ch 407 at 429 per Romer J; *Re Cardiff Savings Bank, Marquis of Bute's Case* [1892] 2 Ch 100 at 109 per Stirling J; supra n 3 at 486 per Earl of Halsbury LC and at 492 per Lord Davey.
77 Supra n 3 at 485 per Earl of Halsbury LC.
78 *Re Denham & Co* (1883) 25 Ch D 752 at 766 per Chitty J.
79 Ibid at 766; supra n 3 at 486 per Earl of Halsbury LC and at 493 per Lord Davey.
80 (1870) LR 5 Ch App 763.
81 Ibid at 770 per Sir R Baggallay QC.
82 Ibid at 770-771.
83 Ibid at 771.

money."[83] However, this might not be the case if there was anything which should have aroused the director's suspicions,[84] or caused the director to make further enquiries.[85]

The skill which a director was required to exhibit was only that which might reasonably be expected given the director's knowledge and experience.[86] Because there was no expectation that directors would bring any particular skills to the office, the courts were not inclined to impose liability for acts or omissions which resulted simply from a lack of skill.[87] For example, in *Re Denham & Co*,[88] a director described as "a country gentleman and not a skilled accountant"[89] was not held liable for having failed to detect the fraudulent conduct of a co-director on the basis that had he investigated, he would have discovered nothing.[90] However, a director with particular skills was required to "...give the company the advantage of his knowledge when transacting the company's business."[91] For example, in *Dorchester Finance Company v Stebbings*,[92] it was conceded by counsel for defendant directors that the court was entitled to take into account, in assessing liability "...the fact that of the three directors two are chartered accountants and the third has considerable experience of accountancy."[93]

Directors were not required to "give continuous attention to the affairs of his company",[94] "take any definite part in the conduct of the company's business",[95] or attend all the meetings of the board upon which they served, though it was said that they ought to attend when "reasonably able to do so".[96] This probably reflects a lower standard of diligence than would be generally expected of directors today. However, in the end the question may still be whether, in all the circumstances, the result would have been any different if the director had been more diligent. For example, in *Re Denham & Co*,[97] Chitty J described a director who had not attended a board meeting for four years as having "been guilty of considerable negligence in the discharge of his duties", and observed that "...a director who has abstained during the long period of four years from executing in any way the duties of his office cannot complain...if his conduct is called into question."[98]

However, the director was not held liable, because it would have been beyond his capacity to detect the fraud which was being committed, whether he was there or not.[99] *In The Marquis of Bute's Case*, the President of the Cardiff Savings Bank, who had attended one meeting in about 20 years, was not held liable, because if he had paid atten-

84 See, for example, supra n 78.
85 See, for example, supra n 80 at 772 per Lord Hatherley LC.
86 See supra n 65 at 428 per Romer J.
87 *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 at 437 per Neville J.
88 (1883) 25 Ch D 752.
89 Ibid at 767 per Chitty J.
90 Ibid at 768.
91 Supra n 87 at 437 per Neville J.
92 [1989] BCLC 498.
93 Ibid at 502 per Foster J.
94 Supra n 65 at 429 per Romer J.
95 Supra n 87 at 437 per Neville J.
96 Ibid at 429 per Romer J.
97 Supra n 88.
98 Ibid at 768.
99 Ibid at 767-768.

tion to any of the reports which were sent to him, or attended any of the meetings of which he was given notice, he would still have concluded that the affairs of the Bank were being properly run, in reliance on the apparent integrity and skill of the Bank's auditors and managers.[100]

It is possible to view the cases on directors' general law duty of care as being based on a central concept of 'reasonable expectations . As Clarke and Sheller JJA explained in *Daniels v Anderson*:[101]

> The idea that the shareholders were ultimately responsible for the unwise appointments of directors led to the duty of care, skill and diligence which a director owed to a company being characterised as remarkably low...However ridiculous or absurd the conduct of directors, it was the company's misfortune that such unwise directors were chosen.[102]

On this analysis, the critical question is: What is it reasonable to expect of the director in the circumstances? The 'circumstances' include the director's position within the company, given the type of company and distribution of work within it, and the director's knowledge and experience. The 'expectations' are not those of the court, but of the people who appointed the director, and will, in turn, vary according to the 'circumstances'. In that context, the following comment of *Lord Hatherley LC in Overend and Gurney Co v Gibb*,[103] is worth noting:

> It would be extremely wrong to import into the consideration of [this] case...those principles of extreme caution which might dictate the course of one who is not at all inclined to invest his property in...ventures of a hazardous character...Men were chosen by the company as their directors, to act on their behalf in the same manner as they would have acted on their own behalf as men of the world, and accustomed to business, and accustomed to speculation, and having a knowledge of business of this character.[104]

Consequently, the company is to some extent bound by the 'expectations' of its members, as expressed through the directors appointed and the division of work in which they acquiesced, even if those 'expectations' later prove to have been disastrously inadequate.

Directors' Statutory Duties

The duty to act honestly

Section 124 (1) of the Companies Act 1961 provided as follows:

> A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.

It prescribed a statutory duty to "act honestly" in discharging the duties of the office of director. However, what did it mean to "act honestly" in this context? In *Marchesi v Barnes*,[105] Gowans J held that it meant "...acting bona fide in the interests of the company in the performance of the functions attaching to the office of director."[106] Recognising

100 Supra n 76 at 109 per Stirling J.
101 (1995) 16 ACSR 607.
102 Ibid at 658-659.
103 (1872) LR 5 HL 480.
104 Ibid at 495.
105 [1970] VR 434.
106 Ibid at 438.

that breach of the duty involved an offence, he suggested that the "proper mental element", the "element of mens rea in the...offence created by the statute", would involve "... a consciousness that what is being done is not in the interests of the company, and deliberate conduct in disregard of that knowledge."[107]

Therefore, while the statutory duty was regarded as equivalent to the general law duty of good faith, breach of the duty was made to depend on an awareness on the part of the director that he or she was not acting in the interests of the company. It was that "awareness" which formed the basis of a finding that the director had engaged in "... conscious and deliberate conduct in disregard of those interests."[108] In some cases, conduct in breach of the statutory duty will also be "dishonest" in the ordinary meaning of that term. For example, in *Feil v Commissioner of Corporate Affairs*,[109] where the defendant director had been convicted for banking cheques payable to the company into his personal account, O Bryan J observed: "It cannot be gainsaid that in intercepting the [cheques] and banking the proceeds in his personal bank account and not in the company's account the appellant's acts were not done in furtherance of any interest of the company but purely for the purpose of benefiting himself."[110]

However, it is clear that Gowans J did not consider that a director's liability would depend on the existence of an intent to deceive, defraud or obtain personal advantage. As he acknowledged: "If the term fraud is applicable in this situation, it is only so in the sense of a 'fraud on the power'."[111] That term was explained in *Vatcher v Paull*,[112] as follows: "The term fraud in connection with fraud on a power does not necessarily denote any conduct...which could properly be termed dishonest or immoral. It merely means that the power has been exercised for a purpose, or with an intention, beyond the scope of or not justified by the instrument creating the power."[113]

On the other hand, there is no indication that Gowans J considered the statutory duty to be co-extensive with the general law fiduciary duty, so that it would be sufficient, for liability to be established, to show that the director had acted contrary to the interests of the company, or for an improper purpose. That would be to ignore the subjective element which Gowans J regarded as the basis of liability, albeit within the limited definition of "honesty" which he adopted. As O Loughlin J put it in *Flavel v Roget*,[114] a court still had to be satisfied that a director "...was deliberately and consciously engaging in a course of conduct which he well knew to be contrary to the best interests of the company."[115]

Where, objectively considered, a director's conduct is clearly contrary to the interests of the company, a court may well be justified in drawing the inference that the direc-

107 Ibid at 438.
108 Ibid at 438.
109 (1991) 9 ACLC 811.
110 Ibid at 818.
111 Supra n 105 at 438.
112 [1915] AC 372.
113 Ibid at 378 per Lord Parker.
114 (1990) 1 ACSR 595.
115 Ibid at 609.
116 See, for example, *Southern Resources Ltd v Residues Treatment* (1990) 56 SASR 455 at 477.
117 (1983) 1 ACLC 831.
118 Ibid at 837.

tor knew that he or she was acting contrary to those interests.[116] For example, in *Morgan v Flavel*,[117] White J was satisfied that a director had been guilty of the necessary "conscious dishonest conduct, contrary to the interests of the company"[118] because it was "...an irresistible inference from the evidence...that the defendant consciously acted in a way which he knew was not in the interests of the company."[119]

However, it is arguable that in *Australian Growth Resources v van Reesema*,[120] the Full Court of the Supreme Court of South Australia went a step further by suggesting that liability could be imposed simply on the basis that conduct was not in fact "... for the benefit of the company as a whole, as that concept is understood by the law."[121] In that case the defendant directors had been charged under s 229 (1) of the Companies Code which provided as follows:

> An officer of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties of his office.
>
> Penalty -
>
> (a) in case to which paragraph (b) does not apply – $5 000; or
>
> (b) where the offence was committed with intent to deceive or defraud...or for any other fraudulent purpose – $20,000 or imprisonment for 5 years, or both.

The court was satisfied that, objectively considered, the conduct in question could not be said to be in the interests of the company. As King CJ observed: "It is inconceivable, to my mind, that directors with any appreciation of their fiduciary responsibilities could cause a company to enter into such a transaction. It could not possibly be regarded as for the benefit of the company."[122] On the other hand, the court accepted that the account given for the directors' action was genuine and that they "... may have genuinely believed those purposes to be proper."[123] However, in King CJ's view, it was "...not to the point that a director genuinely considers his purposes to be honest if those purposes are not in the interests of the company."[124] Having referred to the distinction drawn by s 229(1) between acts done with intent to deceive or defraud, and other acts in breach of the provision, he concluded that:

> The section therefore embodies a concept analogous to constructive fraud, a species of dishonesty which does not involve moral turpitude. I have no doubt that a director who exercises his powers for a purpose which the law deems to be improper, infringes this provision notwithstanding that according to his own lights he may be acting honestly.[126]

The effect of *van Reesema's* case was to impose liability simply on the basis that a director's purpose was not "... within the scope of what the law regards as the interests of the company as a whole."[126] Statutory liability was to be imposed where a director acted for an improper purpose, notwithstanding that the director may have genuinely

119 Ibid at 838.
120 (1988) 13 ACLR 261.
121 Ibid at 271.
122 Ibid at 269.
123 Ibid at 271.
124 Ibid at 271.
125 Ibid at 271.
126 Ibid at 271.
127 (1991) 5 ACSR 473.

believed that he or she was acting in the best interests of the company. A director could be held liable merely for misapprehending the extent of his or her fiduciary duty. As Murray J observed in *Chew v The Queen,*[127] *van Reesema*'s case indicated that "...the basic requirement was simply that the accused act consciously and deliberately in a way which was not in fact objectively to be regarded as being in the interests of the company."[128]

The approach adopted in *van Reesema's* case, of treating the fiduciary and statutory duties as co-extensive, was not, as I have explained, consistent with *Marchesi's* case, and its correctness has since been doubted,[129] including by a differently constituted Full Court of the Supreme Court of South Australia.[130] In *Urban v Pressbank*,[131] Macrossan CJ pointed out that "...it is one thing for a person in a fiduciary position to render himself by his actions liable to account in equity ... it may be something different to assert that the person has thereby been guilty of conduct which within the meaning of the statute is correctly described as lacking in honesty."[132]

In *CAC v Papoulias,*[133] Allen J, while accepting that a director could "be guilty of dishonesty in the relevant sense without...deception or defrauding" noted that liability still depended on "...consciousness that what is being done is directed not to furthering any interest of the company but to achieving some collateral purpose."[134] As a result, he considered that "No offence is committed if the purpose of the director...is that the overall effect of what he is doing will benefit the company."[135] In *Southern Resources Ltd v Residues Treatment*,[136] the Full Court of the Supreme Court of South Australia considered itself "reluctantly bound...to follow" *van Reesema's* case. However, in so doing it noted that "cases abound...in which directors have been held to have exercised their powers for improper purposes without the stigma of dishonesty."[137]

In *Chew v R*,[138] Dawson J, having referred to the statement of Gowans J in *Marchesi's* case, and the cases in which his approach had been followed,[139] noted that King CJ had set out his understanding of s 229 (1) in *van Reesema's* case without referring to *Marchesi's* case, and observed that:

> For my own part I cannot...equate dishonesty in the context of s 229(1) with mere impropriety...the use of power for an impermissible purpose, viewed objectively as it should be, may be improper, but it is not necessarily dishonest. Whether the element of dishonesty is adequately encompassed by the remarks of Gowans J in *Marchesi v Barnes* is something which does not fall for decision in this case, but it is, I think, necessary to give to the word 'honestly' in a provision creating a criminal offence a somewhat wider scope than King CJ was prepared to give it in *Australian Growth Resources v van Reesema*.[140]

128 Ibid at 562.
129 See *Urban v Pressbank Pty Ltd* (1988) 15 ACLR 466 at 472 per Macrossan CJ; supra n 116 at 790 per Perry J; and *Chew v R* (1992) 10 ACLC 816 at 824 per Dawson J.
130 Supra n 116 at 476.
131 (1989) 15 ACLR 466.
132 Ibid at 472.
133 (1990) 2 ACSR 655.
134 Ibid at 657.
135 Ibid at 657.
136 Supra n 116.
137 Ibid at 476.
138 Supra n 129.
139 Supra n 117; supra n 114; supra n 109.
140 Supra n 129 at 824 per Dawson J.

In my view, the difficulty which the courts confronted in interpreting s 229 (1) was primarily due to the fact that it *appeared* to equate the breach of a civil duty with which the courts were familiar under the general law, with breach of a statutory duty for which there was a criminal liability. The temptation was to treat the general law duty and the statutory duty as co-extensive. However, as I have noted, the general law recognised that the civil duty could be breached, not only in the absence of any intent to deceive or defraud, but even where a director genuinely believed that he or she was acting in the interests of the company, but was nevertheless acting for what the courts would classify as an improper purpose. It is probably for that reason that the courts were, in the main, not prepared to treat the statutory duty as co-extensive with the general law duty.

In that context, and given the line of authority commencing with *Marchesi's* case, and the doubt which has been cast on *van Reesema's* case, the correct approach for a court to adopt in relation to s 229(1) and the equivalent in s 232 of the Corporations Law was probably as follows:

(1) If the court accepted that the director acted in what he or she considered to be the interests of company there was no criminal liability. That would be so whether or not, in terms of the general law, the director had acted for an improper purpose. There would, in terms of *Marchesi's* case be no 'awareness' on the part of the director that he or she was not acting in the interests of the company.

(2) If the court concluded that the director did not act in what he or she considered to be the interests of the company, but in some other interest, there would be criminal liability. That would be based on the 'awareness' of the director that he or she was not acting in the interests of the company. As a result, the motives of the director, however 'good', 'honest' or 'altruistic' they may have seemed to the director to be, would be irrelevant.

(3) If the court concluded that the director did not act in what he or she considered to be the interests of the company, and with intent to deceive or defraud, there would be liability to a higher penalty.

(4) Because the statutory duty was not being treated as co-extensive with the general law duty, the fact that, considered objectively, the director's actions were not in the interests of the company, or, which might be the same thing, that the law would categorise the director's purpose as improper, would only be relevant to support an inference that the director did not, in spite of his or her assertions, in fact act in what he or she considered to be the interests of the company.

Such an approach would bring within the area of criminal liability most cases where a breach of fiduciary duty would be found to have occurred under the general law. However, it would leave outside that area those cases in which a director acted in what he or she genuinely thought to be the interests of the company, but for what the law characterises as an improper purpose. In other words, directors would only be criminally liable for committing a "fraud on the power" where they were aware that they were doing so.

Section 232(2) of the Corporations Law, which is in substantially similar terms to s 229(1), provides as follows:

> An officer of a corporation shall at all times act honestly in the exercise of his or her powers and the discharge of his or her duties of his office.

It is, within the terms of the Corporations Law, a "civil penalty provision". As a result, a director in breach of s 232(2) will not be guilty of an offence unless he or she contravenes the provision:

(1) knowingly, intentionally or recklessly; and
(2) either:
(a) dishonestly and intending to gain, whether directly or indirectly, an advantage for that or any other person; or
(b) intending to deceive or defraud someone.[141]

In so far as a director would appear to be liable not only for consciously and deliberately acting contrary to the interests of the company, but also for being reckless as to whether he or she was acting contrary to the interests of the company, the potential area of criminal liability seems to have been expanded. However, in so far as a director would not appear to be liable except where he or she acts contrary to the interests of the company when intending to dishonestly gain a private advantage or deceive and defraud someone, the potential area of criminal liability seems to have been reduced.

It would seem that a court could now conclude that a director did not act in what he or she considered to be in the interests of the company, but not impose criminal liability except where there was an intent to defraud, deceive or gain private advantage. In other words, to knowingly pursue an improper purpose will not attract criminal liability in the absence of an improper motive. It will no longer be sufficient that a director has knowingly committed a 'fraud on the power' in the absence of a fraudulent intent.

In these changed circumstances, the courts may be inclined to reconsider whether the approach in *van Reesema's* case, of regarding the fiduciary and statutory duties as co-extensive, has some validity. With criminal sanctions removed from "honest" breaches of s 232(2), the case for a restrictive interpretation of the provision loses some force. In that context, it is interesting to note that in October 1995, the Simplification Task Force published, as part of the Corporations Law Simplification Program, a proposal that s 232(2) "...be rewritten, without changing its meaning, to reflect the fiduciary concept of honesty."[142] The proposed new s 232(2) would read:

> An officer of a corporation shall at all times act in good faith in the best interests of the company and for a proper purpose in the exercise of their powers and the discharge of the duties of their office.[143]

This was thought to be consistent with the approach taken in the cases.[144] It is apparent that if s 232(2) were amended in this way the link between the fiduciary duty and the statutory duty would be made explicit. The co-extensive nature of the duties would, for the purposes of at least civil penalties, be put beyond doubt.

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141 Corporations Law, s 1317FA (1) and (2).
142 Corporations Law Simplification Program, *Proposal – Officers and Related Party Transactions* (1995) at 10.
143 Ibid at 4.
144 Ibid at 10-11. This proposal to amend s 232(2) has been endorsed in the Federal Government's Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance*, Paper No 3 (1997) at 48-49.

The duty of care and diligence

Section 124(1) of the Companies Act 1961, the terms of which I set out earlier, prescribed a statutory duty to "use reasonable diligence". *In Byrne v Baker*,[145] the Full Court of the Supreme Court of Victoria considered that this statutory duty was, subject to the omission of any reference to the element of 'skill', co-extensive with the general law duty of care.[146] Therefore, in the view of the Full Court, it merely required a director to exhibit the degree of diligence that "...may reasonably be expected of the director in the circumstances."[147] What might be expected would depend, as at general law, on such things as "...the nature and size of the company's business and the way in which the work of the company is distributed between the board of directors and the staff of the company, due regard...being paid to what is practicable, to what is reasonable in the circumstances and to what is laid down in the articles of association."[148]

It would also, thought that Full Court, be of "some significance" that a director was not, as at general law "...bound to give continuous attention to the affairs of the company."[149]

In *AWA Ltd v Daniels,*[150] Rogers CJ Comm Div suggested that "more recent wisdom" demonstrated that the degree of diligence now required of directors was greater than that which *Byrne's* case might indicate. It seems clear that he regarded this change as simply being a function of the fact 'reasonable expectations' of those to whom directors should consider themselves answerable had changed. As he observed:

> Of necessity, as the complexities of commercial life have intensified the community has come to expect more than formerly from directors whose task is to govern the affairs of companies to which large sums of money are committed by way of equity capital or loan. The affairs of a company with a large annual turnover, large stake in assets and liabilities, the use of very substantial resources and hundreds, if not thousands of employees demands an appreciable degree of diligent application by its directors if they are to attempt to do their duty.[151]

Therefore, directors were at least required to take reasonable steps to place themselves in a position to "...bring an informed and independent judgment to bear on the various matters that come to the Board for decision."[152] On appeal, Clarke and Sheller JA agreed, noting that:

> ...ignorance is no longer necessarily a defence to proceedings brought against a director. In some respects, at least, the director must inform himself or herself about the affairs of the company...That duty involves becoming familiar with the business of the company and how it is run and ensuring that the board has available means to audit the management of the company so that it can satisfy

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145 [1964] VR 443.
146 Ibid at 450. See also *Vrisakis v ASC* (1993) 11 ACSR 162 at 185 per Rowland J.
147 Supra n 145 at 450 per Herring CJ, Smith and Adam JJ.
148 Ibid at 450.
149 Ibid at 451.
150 (1992) 7 ACSR 759.
151 Ibid at 865.
152 Ibid at 864-865.
153 *Daniels v Anderson* (1995) 16 ACSR 607 at 664.

> itself that the company is being properly run.[153]

In that context, in *Vrisakis v ASC*,[154] I noted that "modern expectations" dictated that "...a director...attend all [board] meetings unless exceptional circumstances such as illness or absence from the State prevent him or her from doing so."[155]

In the *AWA* case, Rogers CJ Comm Div was dealing with s 229(2) of the Companies Code which provided as follows:

> An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties.

Because of the "diversity of companies and the variety of business endeavours", it was not, in his view, possible for the courts to set an objective "reasonably competent company director" standard. As Ipp J later put it in *Vrisakis v ASC* "...the ambit of the duty and the standard of care required (ie, the specific functions with which particular directors are charged, and what is required to be done so that those functions are properly carried out) depend on the particular circumstances."[156]

Therefore, Rogers CJ Comm Div thought that in order to apply the provision to the facts of a case, it would first be necessary to determine "the proper division of functions between the board and management", something upon which the legislation itself was silent.[157] In his view, the board's role is generally to set corporate goals, and oversee and review the implementation of those corporate goals.[158] Directors are entitled to rely on managers to "carry out the day to day control of the corporation's business affairs"[159] and "go carefully through relevant financial and other information of the corporation and draw to the board's attention any matter requiring the board's consideration."[160] They are also entitled to rely on the chairman to discharge "the primary responsibility of selecting matters...to be brought to the board's attention"[161] and on the skill, judgment and advice of properly appointed auditors.[162] Absent any reason for suspecting differently the directors are "...entitled to rely without verification on the judgment, information and advice of the officers so entrusted."[163]

However, in *Cummings v Claremont Petroleum*,[164] where both directors were regarded as "experienced commercial solicitors" and one as an "experienced director", the Full Federal Court made it clear that for the purpose of assessing whether a director had exercised a "reasonable degree of care" for the purposes of s 229(2), the actual knowledge and experience of the directors would be taken into account. Again, it is a question of what those affected by the decisions of the directors can reasonably expect in the cir-

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154 Supra n 146.
155 Ibid at 170.
156 Ibid at 213.
157 Supra n 150 at 865.
158 Ibid at 865-866.
159 Ibid at 867.
160 Ibid at 868.
161 Ibid at 867.
162 Ibid at 868.
163 Ibid at 868.
164 (1992) 9 ACSR 583.
165 (1995) 16 ACSR 607.

cumstances. If directors have a particular expertise, it is not unreasonable to expect them to apply it in discharging their duties of office. As Clarke and Sheller JJA observed in *Daniels v Anderson*,[165] the scope of a director's duty "...will vary according to...the experience or skills that the director held himself or herself out to have in support of appointment to the office...[That] turns on the natural expectations and reliance placed by shareholders on the experience and skill of a particular director."[166]

In *ASC v Gallagher*,[167] Pidgeon J noted that where a breach of s 229(2) was alleged, liability was "basically a question of fact" and for this reason "previous decisions [would only be] of importance in determining general principles and the principles to apply in determining what are the actual duties of the director in a particular case."[168] In *Vrisakis v ASC*,[169] Ipp J made a similar point when he pointed out that the remarks in the *AWA* case should be regarded as "...statements of broad principle alone [which] act as signposts in the search for the determination of the ambit of the duties imposed on a particular director and the particular standard of care required to be met."[170]

On the basis of the general law authorities, Pidgeon J, in *Gallagher's* case stated the test to be "...what an ordinary person, with the knowledge and experience of the defendant, might be expected to have done in the circumstances if he was acting on his own behalf."[171] Pidgeon J agreed with the view of Rogers CJ Comm Div that this would now include a director taking reasonable steps to place himself or herself in a position to guide and monitor the company.[172] In his view, it would be possible for a director to breach s 229(2) by failure to obtain a sufficient degree of knowledge about a company's affairs, and in these circumstances "...loss would not have to be proved in order to establish the offence nor would it have to be shown that there was something positive the director could have done if he had that knowledge."[173]

In *Vrisakis v ASC*,[174] Ipp J noted that it did not follow as a matter of course from the adoption by the courts of elements of the general law duty of care in interpreting s 229(2) that "the duty imposed on a director under [the provision] is entirely equivalent to the common law duty" or the "...test for an offence under [the provision] is precisely the same as for a breach of the common law duty."[175] In Ipp J's view the basis of the duty of care was a foreseeable risk of harm to the corporation.[176] On the other hand, it was "inherent in the life of industry and commerce" that company management "...involve[s] taking decisions and embarking upon actions which may promise much, on the one hand, but which are, at the same time, fraught with risk on the other."[177] It followed from this, in his view, that:

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166 Ibid at 668.
167 (1993) 10 ACSR 43.
168 Ibid at 52.
169 (1993) 11 ACSR 162.
170 Ibid at 215.
171 Supra n 167 at 53.
172 Ibid at 53.
173 Ibid at 54.
174 Supra n 146.
175 Ibid at 211.
176 Ibid at 212.
177 Ibid at 212.
178 Ibid at 212.

> ...the question whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably be expected to accrue to the company from the conduct in question.[178]

In other words, it is again a question of 'reasonable expectations'. Would those who rely on the directors reasonably expect them to pursue a course of action given the risk of harm on the one hand, and the potential benefit on the other?

Prior to the enactment of the Corporate Law Reform Act 1992 (Cth), s 232(4) was in substantially identical terms to s 229(2) of the Companies Code. Since the enactment of the Corporate Law Reform Act 1992 (Cth), s 232(4) of the Corporations Law provides as follows:

> In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances.

It may be that s 232(4) of the Corporations Law, in setting the applicable standard by reference to a person in "a like position" in a corporation, now gives some support to the distinctions such as those drawn in the *AWA* case between the duties of executive and non-executive directors, managers and chairmen.[179] Decisions such as that in *ASC v Gallagher*[180] have been criticised as setting an "absurdly low" standard of care for non-executive directors.[181] It has also been suggested that "...it is unacceptable, particularly in light of changing commercial attitudes, that directors not be held to an objective standard of competence."[182] However, in my view the courts do respond, and have responded, to the actual commercial expectations applicable in a particular case and to general changes in commercial expectations over time. As has been pointed out in the cases, there is no magic form of words which will capture for every case the precise scope of a particular director's duty of care. There is no doubt that the bar has been raised in accordance with changing expectations, both in the community and in the commercial world. However, it remains the fact that the question of liability can only continue to be worked out on a case by case basis.

The duty to refrain from making improper use of position

Section 229(4) of the Companies Code provided as follows:

> An officer or employee of a corporation shall not make improper use of his position as such an officer or employee, to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation.

In *Chew v The Queen,*[183] a question arose as to whether this provision prescribed an offence of 'specific intent'. In other words, was it an element of the offence that a director make improper use of his or her position with the purpose of either gaining the rele-

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179 See J Cassidy, "An Evaluation of Section 232 (4) of the Corporations Law and the Directors' Duty of Due Care, Skill and Diligence" (1995) 23 *Australian Business Law Review* 184 at 200.
180 Supra n 167.
181 Supra n 179 at 199.
182 Ibid at 188.
183 (1992) 7 ACSR 481.
184 Ibid at 484.

vant advantage or causing the relevant detriment? Mason CJ, Brennan, Gaudron and McHugh JJ concluded that "to" meant "in order to" and therefore that "...s 229(4) expressly declares purpose to be an element of the offence."[184] As a result, it was not sufficient to simply show that a director had on the one hand committed a deliberate act which the court could categorise as improper, and that the act in fact gained a relevant advantage or caused a relevant detriment.[185] On the other hand, provided that an improper act with the relevant purpose could be shown, it was not necessary to show that a relevant advantage had accrued or that a relevant detriment had been suffered. As a result "...an officer who makes improper use of his or her office in order to gain an advantage is guilty of an offence, even if his or her purpose be thwarted."[186]

A question which was left open was whether the fact that a director had a reasonable but mistaken belief that his or her conduct was for the benefit of the company, might "...in an appropriate case, be material in determining whether the [director] can be held criminally responsible for using his or her position in a manner which would objectively be seen to be improper."[187] This is an issue of some significance in the context of reconciling the emphasis on the objective test of purpose adopted in a civil context in *Whitehouse v Carlton Pty Ltd,*[188] and the recognition in *Chew v The Queen*,[189] that as purpose was an element of the offence, it was the equivalent of an offence of specific intent. Their Honours said that in terms of s 23 of the Criminal Code (WA) "... the intention to cause a particular result is expressly declared [by s 229(4)] to be an element of the offence constituted...by an act or omission."[190]

In other words, s 229(4) contained the two elements of making improper use of position and gaining an advantage or causing detriment. There had to be a specific intent to bring about the second element. However, the question of whether the first element actually involved an improper use of position was to be determined by an objective test, although the subjective belief of the officer might be relevant in determining, in a case where the impropriety lay in the exercise of a power, whether that power was exercised for what the court would regard as an impermissible purpose.

In *ASC v Matthews*,[191] the Full Court of the Supreme Court of Western Australia held that the test for impropriety should be regarded as essentially an objective one, while noting that a person's subjective belief could also be considered in determining whether improper use was made of their position. As Steytler J put it:

> ...the test for impropriety under s 229(4) is objective, although the subjective belief or state of mind of the officer or employee concerned will, in appropriate cases, be a factor which should be taken into account in the course of the objective determination of the question whether or not the use made of the position held by the officer or employee was, or was not, improper.[192]

In that case, Steytler J concluded that subjective belief was a relevant consideration,

185 Ibid at 484.
186 Ibid at 484.
187 Ibid at 485 per Mason CJ, Brennan, Gaudron and McHugh JJ.
188 Supra n 23.
189 Supra n 183.
190 Ibid at 484 per Mason CJ, Brennan, Gaudron and McHugh JJ.
191 (1995) 16 ACSR 313.
192 Ibid at 317.
193 Ibid at 318.

given that there was nothing which would make the impugned conduct "...inherently improper regardless of whether or not the respondent held a bona fide belief that it was such as would benefit [the company]."[193]

In *R v Byrnes*,[194] the High Court had an opportunity to clarify the relevance of subjective belief to s 229(4) of the Companies Code. The essentially 'objective' nature of the test was confirmed, Brennan, Deane, Toohey and Gaudron JJ observing that:

> Impropriety does not depend on an alleged offender's consciousness of impropriety. Impropriety consists in a breach of the standards of conduct that would be expected of a person in the position of the alleged offender by reasonable persons with knowledge of the duties, powers and authority of the position and the circumstances of the case."[195]

In their view, an offender's state of mind would become relevant when an abuse of power had been alleged, because "...the alleged offender's knowledge or means of knowledge of the circumstances in which the power is exercised and his purpose or intention in exercising the power are important factors in determining the question whether the power was abused."[196] In other words, the High Court has confirmed that where the propriety of the use of a power depends on the state of mind of the offender, it will be a relevant consideration. As McHugh J observed "...Many uses of an office or employment will be proper if done for one purpose and improper if done for another purpose."[197]

Conclusion

In conclusion, I think it is apparent from a consideration of the approach of the courts to directors' duties that they have not only adhered, where possible, to the traditional principles of non-interference and non-prescription, but have also increasingly taken account of the principle of commercial reality, in so far as that has been reflected in the changing 'reasonable expectations' both of those in the corporate world and of society in general. The temptation to lay down detailed general rules or principles has been strenuously avoided. This is an approach which should continue to be followed.

194 (1995) 17 ACSR 551.
195 Ibid at 560.
196 Ibid at 560-561 per Brennan, Deane, Toohey and Gaudron JJ.
197 Ibid at 566.

Chapter 6

The Duty of Care of Company Directors in Australia and New Zealand

John H Farrar*

Australia and New Zealand share the confused inheritance of English Law with regard to the duty and standard of care of company directors.[1] However, unlike the United Kingdom, both have now opted for clarification of the basic duties by statutory restatement and in doing so have considered the enactment of a United States style of Business Judgment Rule which immunises directors from negligence liability for business decisions taken in good faith and without self interest.[2] Australia was the first in the British Commonwealth to enact a statutory duty in s 107 of the Victoria Companies Act 1958.[3] This provided quite simply that a 'director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office'. This section was the basis for the equivalent provision in the Uniform Companies Acts 1961 – 1962.

By the time of the Corporations Act 1989 the wording of the provision read 'An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his or her powers or the discharge of his or her duties'. In 1992 this was amended to require the officer to exercise a degree of care and diligence 'that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances'.[4] The New Zealand Law Commission's draft section was influenced by the Canada Business Corporations Act s 117(1)(b) which provides: 'Every director and officer of a corporation in exercising his powers and discharging his duties shall exercise the care, diligence and skill that a reasonable prudent person would exercise in comparable circumstances'.[5] However, the final version of s 137 of the New Zealand Companies Act 1993 has been influenced by both the latest version of the Australian legislation and the Canadian section. Section 137 now provides:

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1 As to Australia see H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (8th ed, 1997) at para 8.330; S Sievers, "Farewell to the Sleeping Director" (1993) 21 *Australian Business Law Review* 111; J H Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors (1993) 6 *Corporate and Business Law Journal* 1. As to New Zealand, see J H Farrar and M Russell, *Company Law and Securities Regulation in New Zealand* (1985) at 233 et seq.; D O Jones, *Company Law in New Zealand: A Guide to the Companies Act* (1993) at 108 et seq.; The Hon Justice Tompkins, "Directing the Directors: The Duties of Directors under the Companies Act 1993" (1995) 2 *Waikato Law Review* 13. See also *CCH New Zealand Company Law and Practice Commentary*, Vol 1 at para 10-835. For a useful review of English law, see V Finch "Company Directors: Who Cares About Skill and Care?" (1992) 55 *Modern Law Review* 179.

2 See J H Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 *Corporate and Business Law Journal* 1.

3 Ibid at 11-12.

4 Ibid at 23.

5 On which, see F Iacobucci, M Pilkington, J R Prichard, *Canadian Business Corporations* (1977) at 287 et seq.

> A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,
>
> (a) the nature of the company; and
>
> (b) the nature of the decision; and
>
> (c) the position of the director and the nature of the responsibilities undertaken by him or her.[6]

The purpose of this chapter is to look in detail at the Australian and New Zealand sections and to compare and contrast them. I will then deal with six outstanding issues.

The Australian Section

The Explanatory Memorandum to the Corporate Law Reform Bill 1992 paragraph 83 stated that the government considered that the new section did not change the law but merely confirmed the present position expounded in recent decisions such as *Hussein v Good*,[7] *Heide Pty Ltd v Lester*,[8] *Statewide Tobacco Services Ltd v Morley*,[9] *Commonwealth Bank of Australia v Friedrich*[10] and *AWA Ltd v Daniels*.[11] The reference to 'reasonable person' was intended to confirm that the required standard of care and diligence was to be determined objectively. It should be noted that the basic duty extends to officers, unlike the New Zealand provision, which is limited to directors. Also the obligation is expressed in terms of a duty of care and diligence, not a duty of care, skill and diligence. In relation to the latter it is worth bearing in mind the comment in *Byrne v Baker*[12] in 1964 in relation to the original provision: 'The legislature, though it has omitted the requirement of skill, which forms part of the concept of 'reasonable care', has clearly enough followed Romer J by limiting the requirement of diligence which it imposes to what may reasonably be expected of the director in the circumstances'.

It is arguable that the omission of the reference to skill may be important as we will see in relation to its inclusion in the New Zealand section. The new wording of the Australian legislation is similar to that of para 8.30(a)(2) of the Model Business Corporation Act (US) which refers to 'the degree an ordinarily prudent person in a like position would exercise under similar circumstances'. The commentary to the Model Business Corporation Act states that the phrase 'in a like position' recognises that the care under consideration is that which would be shown by the ordinarily prudent person if they were a director of the particular corporation. The combined phrase 'in a like position...under similar circumstances' is intended to recognise that the nature and extent of the responsibilities will vary, depending upon such factors as the size, complexity, urgency and location of activities carried on by the particular corporation; that decisions must be made on the basis of the information known to the directors without the benefit

6 See Jones, supra n 1 at 108 et seq.
7 (1990) 1 ACSR 710.
8 (1990) 3 ACSR 159.
9 (1990) 2 ACSR 405.
10 (1991) 5 ACSR 115.
11 (1992) 7 ACSR 463. On appeal (1995) 16 ACSR 607; 13 ACLC 614.
12 [1964] VR 443 at 450.

of hindsight; and that the special background, qualifications and management responsibilities of a particular director may be relevant in evaluating his or her compliance with the standard of care. Even though the phrase takes into account the special background, qualifications and management responsibilities of a particular director, it does not excuse a director lacking business experience or particular expertise from exercising the common sense, practical wisdom, and informed judgment of an ordinary prudent person.

The Explanatory Memorandum stated that Australian law recognises that a special background, qualifications and management responsibilities of the particular director may be relevant in evaluating the director's compliance with the standard of care. At the same time, Australian law also recognises that decisions must be made on the basis of the circumstances at the time and without benefit of hindsight. This mirrors the United States commentary. Likewise the Explanatory Memorandum stated that the new subsection recognises that what constitutes the proper performance of the duties of the director of a particular corporation will be influenced by matters such as the state of the corporation's financial affairs, the size and nature of the corporation, the urgency and magnitude of any problem, the provisions of the corporation's constitution and the composition of its board.

The Explanatory Memorandum stated that in the case of a business corporation, the standard reflects the fact that corporate decisions involve risk taking. In a report which the author prepared for the Business Council of Australia and the Australian Institute of Company Directors in 1992[13] the significance of risk taking in entrepreneurism and the diversity of business enterprise were emphasised. The government considered this report in the context of criticism of an earlier draft bill and the pressure by the business community for a United States Business Judgment Rule. The Commonwealth government gave some recognition to risk taking. In the Explanatory Memorandum reference was made to the fact that directors or officers are not liable for honest errors of judgment and the courts have shown a reluctance to review business judgments made in good faith. In addition, the courts have exercised their discretion under s 1318 of the Corporations Law to excuse directors who have acted honestly and fairly. The government endorsed this approach and did not intend any change in the law by the revised wording of s 232(4). However, at the end of the day no attempt was made to enact a United States style of Business Judgment Rule. The reason given was that at that time no state in the United States of America had adopted a legislative statement of the rule but had left the matter to the courts to develop. Likewise the Explanatory Memorandum stated that the government considered that the development of such principles in Australia was better left to the courts.[14]

The standard of care is now clearly objective.[15] The personal characteristics of the particular officer are less significant although the Explanatory Memorandum states that the new provision did not change the law. The reason for this apparent contradiction was that there have been changes in Australian case law particularly in the insolvent trading cases,[16] which now predicate a basic competence in relation to accounts and the moni-

13 J H Farrar, *Report on Modernising Australian Corporations Law*, Australian Institute of Company Directors and the Business Council of Australia, August 1992. See *Company Director*, November 1992 at 19.

14 Corporation Law Reform Bill 1992, Explanatory Memorandum at para 89.

15 Farrar, supra n 2 at 25.

16 See supra nn 7-10.

toring of solvency. The new wording reinforces these changes. Secondly, the new wording supports the distinction between executive and non-executive directors recognised in recent case law. However, this distinction has been somewhat undermined by subsequent case law as I shall discuss later. Thirdly, although there is no statutory Business Judgment Rule there is a reinforcement in the Explanatory Memorandum of a Business Judgment Doctrine, that is, a judicial policy of unwillingness to second guess good business decisions which turn out badly, given basic honesty and competence, as opposed to decisions which are simply bad or self interested.[17]

The New Zealand Section

As we have seen, this is contained in s 137 of the Companies Act 1993 which must now be read in conjunction with ss 135 and 136.[18] Section 135 deals with reckless trading and s 136 deals with the duty in relation to incurring obligations in general. The latter provisions have no counterpart in the Australian legislation with the exception of s 588G of the Corporations Law which deals with preventing insolvent trading. All are limited to directors and do not apply to officers unless they behave as directors. Justice Tomkins[19] in a valuable lecture given in 1994 at the University of Waikato said that the test is an objective test of a reasonable director judged in the same circumstances. The new section states expressly that there is to be taken into account the nature of the company, the nature of the decision, the position of the director and the nature of the responsibilities undertaken by him or her.

His Honour referred to a change which had occurred in the Select Committee hearings.[20] The Law Reform Division had inserted into the Bill a considerably higher standard of care by requiring that a director in a professional occupation or possessing special skills or knowledge must exercise the care, diligence and skill that a reasonable director 'in that profession or occupation or possessing those special skills or knowledge would exercise in the same circumstances'. This requirement has been deleted. In its place there is to be taken into account the particular matters which have been referred to above. The nature of the company allows one to consider factors such as the size and status of the company, whether it is a publicly listed company or a small incorporated firm. The nature of the decision allows one to consider the importance and significance of the decision or its routine nature. Clearly the greater the significance the greater the need for care. The reference to the position of the director and the nature of the responsibilities undertaken by him or her allows one to consider the executive or non-executive nature of the appointment although this will not necessarily be conclusive on the standard of care.

The relationship of s 137 to the earlier sections seems somewhat problematic because of the degree of overlap and the reforms to the reckless trading provisions seem to render what was a reasonably clear and graduated law in the old s 320 of the Companies Act

17 Farrar, supra n 2 at 25-26.
18 See Jones, supra n 1 and Tompkins, supra n 1.
19 Tomkin, supra n 1 at 28.
20 Ibid at 29.
21 On which see J H Farrar, "The Responsibility of Directors and Shareholders for Company Debts" (1989) 4 *Canterbury Law Review* 12.

1955[21] now rather obscure. At the same time one welcomes the additional provisions relating to delegation and advice which are contained in ss 130 and 138 and again which have no counterpart in the Australian statute law.

Section 130 expressly permits the board to delegate its powers to a committee of directors, a director, an employee or other person subject to certain exceptions. No liability will be incurred in respect of improper acts provided the board believed on reasonable grounds that the delegate would exercise the powers properly and the board monitored the delegate's performance by means of reasonable methods. Section 138 expressly deals with reliance provided the reliance is in good faith, after proper enquiry and there is no knowledge that reliance is unwarranted. Section 138 is based on the American Law Institute's *Principles of Corporate Governance* and has counterparts in state laws in the USA.

Outstanding Issues

The objective/subjective distinction

In the past there has been much confusion on this point. It has often been said that the case law duty and standard are to some extent subjective.[22] This has always been an incorrect view. The standard is an objective standard but the question is the extent to which the particular characteristics of the director in question can be taken into account in formulating the characteristics of the class to which he or she belongs. Both the Australian and the New Zealand provisions now make it quite clear that the standard is objective but set out the particular factors that have to be taken into account in assessing the objective standard.[23] The factors are similar but not identical. The Australian section does not expressly refer to the nature of the decision but this is almost certainly implicit in the new wording as the Explanatory Memorandum indicates.

Executive/non-executive director distinction

The old English case law as demonstrated by the judgment of Romer J in *Re City Equitable Fire Insurance Co Ltd*[24] did not recognise any distinction between executive and non-executive directors. In 1991 Tadgell J in *Commonwealth Bank v Friedrich*[25]said that the Australian Companies Code (as it then was):

> does not in terms distinguish between executive and non-executive directors or between paid and honorary directors...There is nothing in the Code to suggest that the standard to be expected of a part-time non-executive director of a company not for profit is different from the standard expected of any other director of a profit making company; both are required...to exercise a reasonable degree of care and diligence in the exercise of their powers and discharge of their duties.

His Honour added that in considering the availability of relief under the legislation it may be relevant to take into account the non-executive part-time nature of a particular direc-

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22 Cf L C B Gower, *Principles of Modern Company Law* (5th ed, 1992) at 587.

23 On this question see Australian Senate, *Company Directors' Duties*, Report by the Senate Standing Committee on Legal and Constitutional Affairs on the Social and Fiduciary Duties and Obligations of Company Directors (1987) Chapter 3.

24 [1925] 1 Ch 407.

25 (1991) 9 ACLC 946 at 1011.

tor's position.

In the *AWA*[26] decision Rogers CJ at first instance dealt directly with the role of non-executive directors. In that case AWA sued its auditors for negligence following the discovery of substantial losses from various transactions conducted by a manager. AWA alleged that the auditors had failed to draw to the board's attention serious inadequacies in the company's system of internal control and accounting records. The auditors counter claimed against AWA and its directors alleging contributory negligence. His Honour said that in relation to non-executive directors that they were not bound to give continuous attention to the affairs of the company. Their duties are of an intermittent nature to be performed at periodic board meetings and meetings of any committees on which they happen to be placed. Notwithstanding a small number of professional company directors there is no objective standard of the reasonably competent company director to which they may aspire. The very diversity of companies and the variety of business endeavours do not allow of a uniform standard. In the absence of any evidence to suggest that the non-executive directors ever became aware of the serious deficiencies in the internal controls and accounts of AWA the non-executive directors were entitled to rely on management and the auditors. His Honour held that not only did the non-executive directors not breach their statutory duty they had not been negligent at common law.

The judgment of Rogers CJ influenced the drafting of the 1992 amendments to s 232(4). This was made clear in the Explanatory Memorandum.[27] The decision of Rogers CJ was referred to with approval in a number of subsequent Australian cases[28] but in the New South Wales Court of Appeal the majority (Clarke and Sheller JJA)[29] implied that the standard required of non-executive directors was higher than the standard which had been set by Rogers CJ. They referred to his Honour's statement that a non-executive director did not have to turn himself into an auditor, managing director, chairman or other officer to discover whether management was deceiving him and they said 'in our respectful opinion it does not accurately state the extent of the duty of directors whether non-executive or not in modern company law'.[30] Their Honours held that in accepting the office, directors assume the responsibility for exercising a reasonable degree of care and diligence in the performance of the office. More was required than 'supine indifference'.[31] Both diligence and action was required.

Looking at the responsibilities of non-executive directors, they stated that the relevant question was what in the particular circumstances are the duties and responsibilities of directors and then what time is required of them as a board to carry out these duties and responsibilities. It was not a matter of tailoring the extent of the duty or function to fixed intervals between board meetings.[32] In the end they agreed that the non-executive directors were entitled to rely on the information they honestly believed the auditors were providing and on their own management.

An interesting question of statutory construction is the extent to which the Court of

26 (1992) 7 ACSR 463; 10 ACLC 933.
27 Supra n 14 at para 83.
28 *ASC v Gallagher* (1993) 11 ACLC 286; *Vrisakis v ASC* (1993) 11 ACLC 763; *Permanent Building Society v Wheeler* (1994) 12 ACLC 674.
29 (1995) 13 ACLC 614.
30 Ibid at 663.
31 Ibid at 656.
32 Ibid at 662.

Appeal judgments are relevant to the interpretation of the present wording of s 232 (4). The judgments were based on the earlier wording and the revisions were based on the first instance judgment of Rogers CJ. It is arguable, therefore, that his Honour's judgment carries more weight than the judgments of the Court of Appeal in the interpretation of the new wording of s 232(4).

In New Zealand Henry J in *Fletcher v National Mutual Nominees Ltd*[33] said that the standard of care to be exercised by directors 'is to be assessed by also having regard to the circumstances pertaining to the responsibilities which the directors have undertaken'. On appeal[34] Gault J, with whom McGechan J agreed, rejected the argument that a lower standard of care should be applied to a non-executive director but this was on the basis of the old case law. Henry J's dictum is consistent with the wording of s 137, particularly when read in conjunction with s 138. Thus New Zealand and Australia seem to face the same problem of statutory interpretation. Is the case law on the old law a sure guide to the interpretation of the new wording? It is submitted that the approach of Rogers CJ in *AWA* and Henry J in *Fletcher v National Mutual Nominees* represent a more realistic approach to the interpretation of the new sections. There is a need to be selective in the use of earlier dicta.

The wording of s 138 of the New Zealand Act justifies reliance on management but the board as a whole is only excused from responsibility if the delegate has been monitored. The belief that the delegate will exercise the powers properly must be based on reasonable grounds. Similarly a director relying on reports must make proper enquiry where indicated by the circumstances. A director will not be excused unless the director can show that he or she acted in good faith, made proper enquiry and did not know the reliance was unwarranted. Tomkins J in his Waikato lecture[35] said he saw no difficulty with these provisions. If a director suspects an employee may not be completely reliable there is nothing unreasonable in requiring the director to monitor the performance of the employee or to treat any advice or information received with care and caution. The overall consequence is that no longer would directors be able, in respect to actions or decisions which are or should be those of the board, to evade responsibility simply because those actions or decisions were left to others.

A degree of skill?

As we have seen the Australian section does not refer to skill but the New Zealand and Canadian sections do. It has been assumed in Australia that the omission of skill is significant.[36] A more relevant question in both jurisdictions is perhaps the appropriate degree of diligence. There are no common standards for company directors and the sections recognise that the ultimate standard is a matter of relativities. The specific proposal of the Law Reform Division to impose a higher standard of care on a professional person was deleted as we have seen from the New Zealand section. Conversely, a director, whatever his or her background, has a duty greater than that of simply representing a partic-

33 [1990] 3 NZLR 641 at 661.
34 *Deloitte, Haskins & Sells v National Mutual Life Nominees* (1991) 5 NZCLC 67, 418 at 67, 442-443 and 67, 446.
35 Supra n 1 at 31.
36 See *Byrne v Baker* [1964] VR 443 at 450. Cf *Norman v Theodore Goddard* [1991] BCLC 1028.

ular field of expertise. This was recognised by the majority in the New South Wales Court of Appeal in *Daniels v AWA Ltd*. They said that a director has a duty to become familiar with the business of the company and how it is run and to ensure that the board has available means to audit the management of the company so that it can satisfy itself that the company is being properly run.

The responsibilities of directors require that they take reasonable steps to place themselves in a position to guide and monitor the management of the company.[37] They are not, however, expected to exercise the degree of skill of a professional accountant and even in the case of a non-accountant member of the board, he or she is only expected to demonstrate care as a member of the board, not as an accountant. The responsibilities of an executive director who is an accountant would normally be defined by his or her service contract.

The juridical nature of the duty and its significance

Under both Australian and New Zealand law the present duty is statutory. The question is whether the case law duty which still coexists[38] is a common law or equitable duty. The correct position seems to be that it is equitable but not fiduciary and this now overlaps with common law negligence. The English decision of Romer J in *Re City Equitable Fire Insurance Co Ltd*[39]recognised the equitable origins of the duty. This was not a common law situation and indeed *Re City Equitable* preceded the formulation of a general duty of care in *Donoghue v Stevenson*[40] which was decided seven years later. The duty is an incident of an equitable relationship but the content of the duty is not fiduciary. This has been clearly recognised by the Full Court of the Western Australia Supreme Court in *Permanent Building Society v Wheeler*.[41] More sweeping statements about the common law nature of the duty were made by Clarke and Sheller JJA in the New South Wales Court of Appeal in *Daniels v AWA Ltd*[42] but their statements are unhistorical and too wide.

More correct analysis is to be found in the dissenting judgment of Powell JA.[43] The analysis of Clarke and Sheller JJA causes them to engage in a discussion of all the paraphernalia to be found in the common law duty of care. Such analysis was in fact irrelevant as there was no need to establish matters such as proximity since the duty already exists in equity and discussion of such matters are redundant. This view, however, still leaves open the question of whether an *additional* duty at common law can subsist with the statutory duties. Powell J thought that, although directors may in certain circumstances be liable to third parties for common law negligence, given the nature and extent of the duties imposed upon directors by both the general law and the statute, no sufficient case had been made out for imposing an additional duty of care at common law.[44]

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37 (1995) 13 ACLC 614 at 665-666.
38 See Corporations Law, s 232 (11). The New Zealand Act is less explicit. Cf Jones, supra n 1 at 113.
39 [1925] 1 Ch 407. See also *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 at 435, per Lindley MR.
40 [1932] AC 562.
41 (1994) 12 ACLC 674.
42 (1995) 13 ACLC 614.
43 Ibid at 727 et seq.
44 Ibid at 744.
45 (1994) 12 ACLC 674.

The question arises as to why any of this is still relevant in the modern law. The judgment in *Permanent Building Society v Wheeler*[45] shows that these questions are still relevant because that case showed a distinction between the common law and equity on the question of causation in the case of breach of fiduciary duty. Strict liability ensues from breach of a fiduciary duty in equity. This is not so at common law nor in respect of an equitable duty which is non-fiduciary. Other possible significances of the distinction are the impact of equitable delay, limitation and waiver. The question of whether equitable negligence is covered by contributory negligence legislation is also problematic although the modern tendency in the cases is to assume that it is covered.[46] Clearly it should be even if it is not.

Consequences of a breach

Recent cases have shown that if directors are negligent this will enable the company to sue them for breach and their breach may constitute the company's breach for the purpose of contributory negligence.[47] This is of particular significance with regard to claims against auditors. There are, however, additional and different consequences which can result in Australia. The original legislation in 1958 not only codified the duty of care but criminalised breach of the duty. The 1992 amendments removed criminality in the absence of mens rea but retained the concept of civil penalties.[48] Breach of the section can result in imposition of a civil penalty.[49] This can lead to disqualification and/or a fine.

Do we need a Business Judgment Rule?

In the lead up to the Australia reforms of 1992 and the enactment of the New Zealand Companies Act 1993 there were calls by the business community in both countries for the enactment of a United States style of Business Judgment Rule.[50] There was considerable confusion as to what exactly was the nature of such a rule but the work of the American Law Institute[51] in its *Principles of Corporate Governance* provided some clarification of the concept. The Institute formulated the basic Business Judgment Rule as follows:

> A director or officer who makes a business judgment in good faith fulfils the duty under this section if the director or officer (1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent to which the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation.

Such a rule exists under the case law of the various United States jurisdictions and

46 See, for example, *Daniels v AWA Ltd* (1995) 13 ACLC 614.
47 Ibid.
48 See Corporations Law, Part 9.4B. For criticism, see Farrar, supra n 13, but contrast M Gething, "Do We Really Need Criminal and Civil Penalties for Contraventions of Directors' Duties?" (1996) 24 *Australian Business Law Review* 375.
49 Corporations Law, s 1317 DA.
50 See Farrar, supra n 2. See also chapter 3 of the Senate Standing Committee on Legal and Constitutional Affairs Report, supra n 23 and the Companies and Securities Law Review Committee, Report No 10, *Company Directors and Officers: Indemnification, Relief and Insurance (*1990) at para [75].
51 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations, Final Report* (1994) Part IV.

now has been codified to some extent in the Virginia Stock Corporations Act, s 13.1-690A which provides that 'A director shall discharge his duties as a director...in accordance with his good faith business judgment of the best interests of the corporation'.[52] In the American Law Institute formulation the rule gives an immunity from liability for negligence to directors who satisfy the three prerequisites. Neither the Australian Federal Parliament nor the New Zealand Parliament decided to enact a Business Judgment Rule. We have seen above how the Australian Parliament dealt with the matter by adopting amendments which clarify the law and including material in the Explanatory Memorandum which gave a green light to the courts to develop a case law Business Judgment Rule in Australia. At the same time there was a tightening up of related party transactions in the new Part 3.2A of the Corporations Law.[53]

In New Zealand the approach was different. The only reference to a Business Judgment Rule in the 1993 Act is in the long title in paragraph (d) which provides that an object of the Act is 'to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power'. New Zealand opted for the rather loosely worded Canadian model on self interested transactions in s 141 which turns ultimately on fair value. In both Australia and New Zealand there have been increasing pressures on the courts to expect more of company directors. At the same time the Australian courts have begun to recognise the legitimacy of some degree of risk taking in business judgment. In the words of the majority in *Daniels v AWA Ltd*:[54]

> The courts have recognised that directors must be allowed to make business judgments and business decisions in the spirit of enterprise untrammelled by the concerns of a conservative investment trustee. Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate but ephemeral, political insights, a feel for future economic trends, trust in the capacity of other human beings. Great risks may be taken in the hope of commensurate rewards. If such ventures fail, how is the undertaking of it to be judged against an allegation of negligence by the entrepreneur?

Consistent with their view of the duty as a common law duty their Honours thought that the law of negligence could accommodate differing degrees of duty subject to the ultimate test resting 'upon a general public sentiment of moral wrong doing for which the offender must pay'.

The recent trend in Antipodean case law in general insolvent trading cases has been increasingly rigorous and many of the cases have contained general statements which have been used by the courts in tightening the law on the duty of care.[55] Such rigour is in fact potentially inconsistent with an increased recognition of the legitimacy of risk taking and a United States style of Business Judgment Rule. On the other hand, judging by

52 On the interpretation of which see *WLR Foods Inc v Tyson Foods Inc,* 869 F Supp 419 (WD Va 1994). This case went on appeal to the Supreme Court, sub nom *Tyson Foods Inc v WLR Foods Inc,* 116 S Ct 921 (1996) where a constitutional challenge to the Virginian legislation failed.

53 See generally Farrar, supra n 2.

54 (1995) 13 ACLC 614 at 664-665.

55 See Sievers, supra n 1.

the United States experience, the introduction of a Business Judgment Rule, without tightening up on disclosure requirements and the effective policing of self-interested transactions, could be disastrous for investors.[56] The United States pursues more coherent corporate law policies of latitude for business error balanced by rigorous policing of self-interested transactions. In Australia and New Zealand the matter of business judgment has now been left to the courts to strike the appropriate balance against a background of differing approaches to the regulation of self-interested transactions. This is not an easy task for the courts and there is the risk that, like the old English War Office, they will always be busy preparing for the previous war. Society has constantly to balance the demands of efficiency and fairness in its corporate law. Efficiency is predicated because companies operate in various markets in an increasingly competitive international environment and fairness is predicated because of the public interest in the goals of investor and creditor protection and the integrity of the capital markets.[57]

56 D A DeMott, "Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices" (1992) 4 *Bond Law Review* 133; M I Steinberg, "The Corporate Law Reform Act 1992: A View from Abroad" (1993) 3 *Australian Journal of Corporate Law* 154; Farrar, supra n 2.

57 Farrar, supra n 2.

Chapter 7

The Duty of Care of Directors – Does it Depend on the Swing Of the Pendulum?

Robert Baxt*

Introduction

The title to this chapter would probably come as a surprise to lawyers who may have been examining the position facing a director say ten years ago and taken a break from this area of the law. In the last ten years, in particular, there has been a significant shift in the attitude of the courts towards the liability of directors and the evaluation of their duties of care and diligence. This has been accompanied by a continued battle on the part of the business community (in particular) to have inserted into our legislation (the Corporations Law[1]) what is known as a statutory business judgment rule – or a safe harbour for directors who act honestly. In this chapter I wish to examine how the recent intervention of the courts in the interpretation of the duties of care and diligence in particular (but with some discussion of the duty not to allow a conflict of duty and interest) has been accompanied by a shift in emphasis not unlike the swing of a pendulum.

This changed attitude towards directors and their role is illustrated by the following quote from the judgment of Rogers CJ in the Commercial Division of the Supreme Court of New South Wales in what is still regarded by most practitioners (if not academics) in Australia as the leading case on the duties of care and diligence – the *AWA* case (at first instance).[2]

> Of necessity, as the complexities of commercial life have intensified the community has come to expect more than formerly from directors whose task is to indeed govern the affairs of companies to which large sums of money are committed by way of equity, capital or loan. The affairs of the company with a large annual turnover, large stake in assets and liabilities, the use of very substantial resources and hundreds, if not thousands of employees demand an appreciable degree of diligent application by its directors if they are to attempt to do their duty. To some extent this has been recognised by the fact that the compensation paid to non-executive directors has changed from a modest honorarium to a sum which bears a measurable relationship to the work expected of the director. Indeed it has led to a number of professional non-executive directors.

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1 Referred to hereafter as CL.

2 *AWA Limited v Daniel (trading as Deloitte Haskins & Sells)* (1992) 10 ACLC 933; 7 ACSR 759.

> One of the most striking features of the law concerning directors' 'duties' is the insistence that directors accept more and more responsibility for the oversight of the company's affairs at the same time as the affairs of the company become more and more complex and diverse.[3]

The pendulum theory is not unique to corporate law – indeed it might be seen as more adequately addressed to the area of income tax. For many years the Australian courts (especially during the time when Sir Garfield Barwick was Chief Justice of the High Court) seemed unwilling to apply the anti-avoidance provision of the Australian Income Tax Assessment Act – then s 260 – to certain artificial transactions which were clearly structured to minimise tax but in a way that bordered on tax evasion.[4] The very strict black letter law approach of the High Court to these transactions led to a considerable amount of frustration on the part of the Australian Taxation Office, the Government and the community. This build up of community agitation eventually resulted in the courts going the other way – adopting a far more broad brush approach to the interpretation of tax schemes. But more importantly the previous legislative approach led to the introduction of sweeping black letter law changes to the taxation law which have been almost impossible to interpret as has been recently recognised by the High Court of Australia.[5]

I believe a similar pattern to that illustrating the interpretation of our income tax law has occurred in corporate law cases in recent years and in particular the last ten years. For a number of years in the 1970s and 1980s various Supreme Courts took what can be described as a fairly "laid back" attitude towards the duties of directors, especially in the context of duties of care and diligence expected of directors. There was also a perception that the law and the courts were soft on directors who were either "asleep on the job" or who engaged in what we may describe as self dealing (to nominate two relevant areas). Decisions such as those of the New South Wales Court of Appeal in both *Metal Manufacturers v Lewis*,[6] and *North Sydney Brick & Tile Company v Darvall*,[7] to name two of the higher profile cases, were characterised by strong dissenting judgments in these cases delivered by Kirby P. These cases were succeeded by some sweeping judgments of the Victorian Supreme Court in *Statewide Tobacco Company v Morley*[8] and in the *Friedrich*[9] case.

The shift in the interpretation of the insolvent trading provisions, and more particularly a re-evaluation of the role of the "sleeping director" led to a strong movement for the introduction of what is called in the USA a business judgment rule. Directors were concerned that the very strong statements made by some of the courts dealing with the sleeping director might be applied to non-executive directors in particular, in ways that would cause considerable difficulty for them. At the time that s 232(4) of the CL was being amended in 1992, there was pressure to introduce some signposts or guiding prin-

3 (1992) 10 ACLC 933 at 1013. This comment reflects similar views expressed by Sir Douglas Menzies in 1961 and more recently by Tadgell J in *Commonwealth Bank Limited v Friedrich* (1991) 5 ACSR 115; 9 ACLC 946. Referred to hereafter as the *Friedrich* case.

4 See, in particular, *Curran v FCT* (1994) 5 ATR 166; *W P Keighery Pty Ltd v FCT* (1957) 100 CLR 66; and *Slutzkin v FCT* (1977) 7 ATR 166 – but these are just some of the large number of cases.

5 *Hepples v FCT* (1991) 65 ALJR 650. This case more than any other has led to the Tax Simplification Program.

6 (1988) 13 NSWLR 315.

7 (1989) 7 ACLC 659.

8 (1992) 10 ACLC 1233. Referred to hereafter as the *Morley* case.

9 Supra n 3. For a discussion of these cases see S Sievers, "Farewell to the Sleeping Director" (1993) 21 *Australian Business Law Review* 111.

ciples which could be used by the courts to determine how the duties of care and diligence in the CL would be interpreted. That push was blunted – indeed it almost disappeared – as a result of the landmark decision, and helpful statements of Rogers CJ in the *AWA* case. Following that decision, the then Attorney-General, Michael Duffy, through the Explanatory Memorandum accompanying the Corporate Law Reform Bill 1992, indicated that there was no need for a business judgment rule in Australia – the courts generally would not second guess decisions of directors where the directors had acted reasonably and honestly. The Memorandum noted:[10]

> In the case of a business corporation, the standard would reflect the fact that corporate decisions involve risk-taking. The courts have in the past recognised that directors and officers are not liable for honest errors of judgment: *Ford's Principles of Company Law* (6th ed., 1992) at pp 528-9. They have also shown a reluctance to review business judgments taken in good faith. Thus, in *Harlowe's Nominees Pty Limited v Woodside* (1968) 121 CLR 483 at 493 the High Court said: "Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes is not open to review in the courts."
>
> In addition, the courts have exercised their discretion to excuse directors who have acted honestly and who ought fairly to be excused: *Re Claridge's Patent Asphalte Company Limited* [1921] 1 Ch 543. The Corporations Law already contains a provision of this nature (section 1318) and the application of that section is effectively being extended by clause 17 of this Bill.[11]
>
> The Government endorses this approach and does not intend any change in the law by the revised wording of subsection 232(4). No attempt has been made in the Bill to enact a U.S. style of Business Judgment Rule since no State in the USA has adopted a legislative statement of the Rule. Instead the matter has been left to the courts to develop. Similarly the government considers that the development of similar principles in Australia is better left to the courts.

Following the *AWA* case there was a series of important cases (some of which I will discuss briefly in this chapter) which confirmed what many lawyers and members of the business community saw as a common sense approach to an evaluation of directors' duties of care and diligence.

However 1995 was a momentous year for company directors. A series of decisions dealing not only with the duty of care, but also the problems faced by directors where there was a conflict of duty and interest, laid down some fairly demanding "standards" for directors. These decisions were instrumental in reviving the push for a statutory business judgment rule. A number of other cases, not directly linked to the duties of care and diligence but exposing directors to a number of problem areas – for example in relation to their ability to obtain documents to support any defence that they might have in a case where they were sued by a company[12] – have also been influential in strengthening the push for a business judgment rule.

This chapter will first examine the decision in the *AWA* case both at first instance and on appeal. It will then review some of the more important cases which embraced the

10 Explanatory Memorandum, The Corporate Law Reform Bill 1992 at para 101.

11 That is what is now section 1317JA of the CL.

12 *State of South Australia & State Bank of South Australia v Barrett* (1995) 13 ACLC 1365; *Kriewaldt v Independent Direction Ltd* (1996) 14 ACLC 73.

approach adopted – included are cases where there is an indication that the courts will adopt a harder line when the duty of care is mixed with an evaluation of whether the directors had allowed there to be a conflict of duty and interest. This section will also include the recent *Marcus Clark*[13] case. The chapter will then discuss the *Dairy Containers*[14] case. I conclude by examining whether there is need for a statutory business judgment rule in the light of these decisions.

The AWA Case[15]

The facts

AWA Limited (AWA) manufactured electronic and electrical products. AWA conducted foreign exchange operations to cover foreign currency fluctuations arising from its imports of large quantities of components from Japan and other countries. From late 1985, AWA began to make forward purchases of foreign currency against existing or anticipated contracts for imported goods. In December 1985, Koval a young energetic but not very experienced dealer, was appointed foreign exchange manager of AWA. Initially, Koval made significant profits on foreign exchange dealings. However, it was alleged by AWA that by early July 1987, Koval had lost A$49.8 million. Koval sought to conceal these losses by rolling over loss-making contracts and by borrowings from banks. AWA had no internal controls in respect of its foreign exchange operation and no books of account were maintained.

In 1986 and for the first half of 1987, Deloitte Haskins & Sells ("DHS or the auditors") were the auditors to AWA. DHS reported on the deficiencies in AWA's internal controls to AWA's management, but the management did nothing about these. It was not until the middle of 1987 that the board of directors of AWA discovered the true position regarding the losses the company had incurred as a result of the foreign exchange dealings.

On 28 October 1988 AWA brought proceedings against DHS to recover damages for breach of contract and negligence. In their defence, DHS alleged that AWA's loss was caused or materially contributed to by its own fault. DHS cross-claimed to recover indemnity or contribution against four of the directors – Hooke, the chairman and chief executive officer, and the three non- executive directors, Finley, Anderson and Campbell. The banks with whom AWA conducted these activities were also sued. The auditors alleged they had allowed dealings on the foreign exchange markets when they knew or ought to have known that Koval had no authority to obtain loans to fund those dealings. They also claimed that the banks had failed to disclose these loans to the auditors when they were carrying out their audit. These claims failed at first instance. They were not raised on appeal.

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13 *State of South Australia v Marcus Clark* (1996) 19 ACSR 606.

14 *Dairy Containers Limited v NZI Bank Limited* (1995) 7 NZCLC 96-669.

15 This part of the chapter is based in part on an earlier article by the writer in "One AWA Case is not Enough – The Turning of the Screws for Directors" (1995) 13 *Company and Securities Law Journal* 414.

A number of separate judgments were delivered by Rogers CJ in this litigation. These included the major judgment on the liability of directors,[16] a later judgment on the calculation of damages following the initial judgment, and a third judgment which addressed certain other unrelated (to this chapter) issues.[17] These judgments were to the effect that:

1. DHS was liable in contract and tort for AWA's losses. DHS had a duty to report the deficiencies to the board of directors of AWA once it was aware of inactivity on the part of the management.
2. AWA was contributorily negligent with liability to be apportioned at 20 per cent to AWA and 80 per cent to DHS.
3. Hooke and the management of AWA, including Hooke as chief executive, were also negligent.
4. However, because of the appropriate steps taken to delegate responsibilities to management, the non-executive directors were not negligent.
5. DHS was entitled to a contribution from Hooke of 10 per cent of the 80 per cent paid by it.

DHS was ordered to pay AWA A$13.6 million plus approximately A$13.039 million interest. Hooke was ordered to pay DHS A$1.36 million plus approximately A$1.3 million interest.

Issues on appeal in the AWA case[18]

A number of issues arose on appeal. Some, apart from the duties of directors, were:

1. AWA and its directors alleged that it was for AWA's management to put in place all necessary accounting records and controls. Any deficiency in those records or absence of controls was the fault of management and DHS should have discovered those deficiencies and reported on them. Hooke considered that he could safely leave it to management to ensure that the policies of the board were implemented and that he could rely unquestioningly on information supplied to him by senior executives.
2. DHS argued the deficiencies in the records and the absence of internal controls, of which it was aware, required no action by it. DHS alleged that it was for management to correct those faults or to report them to the board.
3. If it was the case that both the board of directors and the auditors failed promptly and diligently to perform their respective functions, which failures contributed to AWA's loss, then reconsideration should be given to the apportionment of liability for such loss.

Two judgments were delivered. In a lengthy judgment Clarke and Sheller JJA upheld a number of the holdings of Rogers CJ on questions such as the liability of directors, the negligence of Hooke and the negligence of the auditors. They reached the conclusion that the auditors could recover from the company on the basis of contributory negligence but by a different route to that taken by Rogers CJ, and I will not discuss this

16 Supra n 2.
17 (1992) 7 ACSR 463.
18 (1995) 16 ACSR 607; 13 ACLC 614.

issue in this chapter. On the duties of directors, whilst reaching the same conclusions as Rogers CJ (other than the personal liability of Hooke as to which see below), they were prepared to impose a harsher standard than I believe was the view of Rogers CJ. They have "muddied the waters" in the distinction between executive and non-executive directors. Powell JA, in a much shorter judgment, whilst agreeing with the majority's findings on the negligence of the auditors, upheld Hooke's appeal. More importantly, however, he disagreed with the majority in their views relating to the liability of directors for common law negligence.

Negligence of the auditors

At the trial Rogers CJ held that the auditors were liable in negligence. In his view they had not carried out their duties properly. They had failed to draw appropriate attention to the absence of the internal controls by AWA, or at least had failed to impress on the board the inadequacies in those internal controls and in the records and accounts systems. He also held that the relevant partner responsible for the audit had recognised that there were inadequate internal controls (at best) or at worst that there were no internal controls. The failure to bring this to the attention of the board of directors and to follow up on these matters was evidence of negligence.Whilst not differing from the decision of Rogers CJ on the vital question of contributory negligence, the majority in the Court of Appeal were not prepared to rely so heavily on the US and other authorities. Rogers CJ had found these useful in breaking with tradition and distinguishing a number of earlier cases, in particular the decision of the New South Wales Court of Appeal in *Simonius Vischer & Co v Holt & Thompson*[19]in which contribution had been denied.[20] It is not intended to discuss this particular issue in this chapter. The issues are of course very important for auditors.

Negligence of management and liability of directors

There was no dispute that senior management were negligent and no arguments were advanced to the contrary. Their conduct was referred to as "grossly negligent". The auditors alleged that AWA's management conducted the foreign exchange operations without proper records and internal controls, either not apparently knowing or caring about the way in which Koval was operating and either accidentally or deliberately not bringing these matters to the attention of the board. The Court of Appeal upheld the judgment of Rogers CJ.

Liability of directors for common law negligence

Both at the trial, and in their appeal, DHS' cross-claim for indemnity or contribution against the directors depended upon establishing that Hooke and the non-executive directors were tortfeasors "liable in respect of the same damage" suffered by AWA as that for

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19 [1979] 2 NSWLR 322.

20 That decision had been followed in later cases such as *Arthur Young & Co v WA Chip & Pulp Co Pty Ltd* [1989] WAR 100. See G Stapledon, "The AWA Case and the Availability to Auditors of the "Defence" of Contributory Negligence" (1995) 13 *Company and Securities Law Journal* 513.

which DHS was also liable, pursuant to s 5(1)(c) of the Law Reform (Miscellaneous Provisions) Act 1946 ("the 1946 Act"). The auditors alleged that, in contravention of s 229(2) of the Companies Code,[21] Hooke and the non-executive directors collectively or severally failed to exercise a reasonable degree of care and diligence in the exercise of their powers and in the discharge of their duties. Alternatively, they alleged that they were negligent in failing to discharge the duty of care they owed to AWA. Notably, the auditors did not rely upon a breach of any equitable or fiduciary duty but claimed common law damages.

Hooke and the non-executive directors denied that they owed any duty to AWA, breach of which would make any of them tortfeasors for the purposes of s 5 of the 1946 Act. In addition, they claimed to be entitled to be relieved from liability under s 1318 of the CL. After reviewing the law, Rogers CJ held that the directors, if guilty of negligence, could be described as "tortfeasors" within the meaning of s 5 of the 1946 Act. Hooke and the non-executive directors challenged this finding.

The Appeal Court was divided on this question and it is my view that the majority's acceptance of the principle that directors could be liable for common law negligence poses potentially significant concerns for directors. In his landmark decision at first instance, Rogers CJ held that, whilst actions had been brought against directors for negligence in the context of an equitable duty of care, there had been a distinct lack of success in actions based on tort against directors. He put forward two reasons for this reluctance to seek remedies on that basis:

> Until recently, it was not recognised that an action for damages for negligence may be brought for purely economic loss..., equitable damages are generally a more complete compensation and breach of fiduciary duty more easily established than negligence at common law. The only reason why...[there is a claim in the present case based on common law negligence] is because of the unfortunate choice of language in the [relevant legislation] dealing with contribution — The Law Reform (Miscellaneous Provisions) Act 1946.[22]

Rogers CJ then went on to analyse the law and suggested that given the way in which the law had developed, the common law obligation "though sounding in common law damages, will not call for any different duty from that which the law already requires [of directors]. The legal label may change but the contents of the bottle will remain the same".[23] He therefore held that the objection raised against the possibility of holding directors guilty of negligence as "tortfeasors" within the relevant legislation failed. However, he did not go on to consider whether the claims against Hooke should be based on notions of common law negligence in evaluating liability. Had he been forced to do so he probably would have reached a not- dissimilar result from that reached by the Court of Appeal. Be that as it may, it is the finding of the majority in the Court of Appeal that creates significant pressure, in my view, on the liabilities of directors in the future.

On the question of whether common law negligence can be claimed against directors it is interesting to note that Ipp J in the Full Court of the Supreme Court of Western Australia in the *Permanent Building Society*[24] case referred to earlier reached a similar

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21 See now s 232(4) of the CL.
22 Supra n 2 at 1018.
23 Ibid at 1019.
24 *Permanent Building Society (In Liquidation) v Wheeler* (1994) 14 ACSR 109.

decision to that of Rogers CJ and of the majority in the AWA case. I will return to that case later.

The Court of Appeal majority view on negligence

Clarke and Sheller JJA canvassed at some length the earlier cases dealing with directors' duties. They referred to the statement in *Ford's Principles of Corporations Law* (6th ed, 1992) that there was as yet "no judicial acceptance...that the common law tortious duty of care involved in the tort of negligence applies to directors".[25] Other writers however, have suggested that directors did owe a common law duty of care to the company.[26]

The majority in AWA emphasised that directors are no longer properly regarded as trustees – there might have been "some flirting" with this idea until the 1950s, but for quite some time the law has had rules that directors could not be treated as trustees. More importantly they recognised, as Ipp J had recognised in the *Vrisakis*[27] case which is discussed briefly later, that directors are entitled, indeed almost expected, to make business decisions and judgments in the spirit of enterprise untroubled by concerns which may restrict the decisions of a conservative investment trustee.

The majority (Clarke and Sheller JJA) then went on to make these comments about the role of directors as "risk takers":

> Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate, but ephemeral, political insights, a feel for future economic trends, trust in the capacity of other human beings. Great risks may be taken in the hope of commensurate rewards. If such ventures fail how is the undertaking of it to be judged against an allegation of negligence by the entrepreneur? In our opinion the concept of negligence which depends ultimately 'upon a general public sentiment of moral wrongdoing for which the offender must pay'...can adapt to measure appropriately in the given case whether the acts or omissions of an entrepreneur are negligent. Indeed, were a company not involved, an investor whose property or money had been lost can call the entrepreneur to account for a breach of duty of care owed in the circumstances to the investor. We are not impressed by this perceived barrier against imposing on directors a duty of care at common law. Nor do we think that the fact that directors come to the task with different backgrounds in terms of training and experience presents any problem.[28]

These comments can be compared with the remarks of Ipp J in the earlier *Vrisakis* case:[29]

> [The] mere fact that a director participates in conduct that carries with it a foreseeable risk of harm to the interests of the company will not necessarily mean that he has failed to exercise a reasonable degree of care and diligence in the discharge of his duties. The management and direction of companies involve taking decisions and embarking upon actions which may promise much, on the one hand, but which are, at the same time, fraught with risk on the other. That is inherent in the life of industry and commerce. The legislature undoubtedly did not intend by [the equivalent of section 232(4) of the Corporations Law] to dampen business enterprise and penalise legitimate but unsuccessful entrepreneurial activity. Accordingly, the question whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of

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25 (1995) 16 ACSR 607 at 653.
26 See, for example, *Gower's Principles of Modern Company Law* (5th ed, 1992) at 550-551; *Pennington's Company Law* (6th ed, 1990) at 600.
27 *Vrisakis v The Australian Securities Commission* (1993) 11 ACSR 162.
28 Supra n 25 at 664-665.
29 Supra n 27 at 212.

> harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.

Clarke and Sheller JJA ruled that the directors could be held liable for common law negligence and added:

> We are of opinion that a director owes to the company a duty to take reasonable care in the performance of the office. As the law of negligence has developed no satisfactory policy grounds survive for excluding directors from the general requirement that they exercise reasonable care in the performance of their office. A director's fiduciary obligations do not preclude the common law duty of care. Modern statutory company law points to the existence of the duty. In some circumstances the duty will require action. The concept of a sleeping or passive director has not survived and is not consistent with the requirements of current [legislation]. ...
>
> A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of a particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by shareholders on the experience and skill of a particular director. The duty is a common law duty to take care owed severally by persons who are fiduciary agents bound not to exercise the powers conferred upon them for private purpose or for any purpose foreign to the power and placed...at the apex of the structure of direction and management.[30]

Ironically, the finding by both the majority in the *AWA* case and by Ipp J in the *Permanent Building Society* case had no financial implications for either Mr Hooke or Mr Hamilton. In both cases no damages were awarded against them. I should also note that Powell JA, the third member of the New South Wales Court of Appeal, strongly disagreed with his majority colleagues on this question. He felt that the existing rules which subjected directors to liabilities under the equivalent of s 232(4) of the CL and the common law were more than enough to discipline the actions of directors.

The majority, whilst upholding the holding of Rogers CJ on the liability of the non-executive directors, nevertheless felt that his evaluation of what standard the law should apply was probably not in line with modern trends. They suggested that he might have relied too much on the 19th century case *Overend & Gurney Co v Gibb*.[31] In their view a conservative analysis of that decision and what it stood for was no longer relevant. They suggested that the duties of directors, whether executive or non-executive, had to be reviewed in the context of the company they served, their professional background, and a number of other matters. With none of this can I quibble. They prefaced their judicial analysis with these comments:

> In our opinion the responsibilities of directors require that they take reasonable steps to place themselves in a position to guide and monitor the management of the company. The board of AWA met only once a month for half a day. But to our mind the board should meet as often as it deems necessary to carry out its functions properly. The question is what in the particular case are the duties and responsibilities of the directors and then what time is required of them as a board to carry out these duties and responsibilities. It is not a matter of tailoring the extent of the duty or function to pre-fixed intervals between board meetings.

30 Supra n 25 at 668.
31 [1872] LR HL 480; it should be noted that Ipp J also relied on that decision in the *Permanent Building Society* case discussed below.

> To be balanced against calls that the modern public company director has acquired and now asserts a professional status together with the professional skills (which should carry a requirement that the director conform to professional standards and the imposition of an objective standard of care which would not yield to considerations such as lack of knowledge or lack of experience) are the difficulties deriving from the variety of businesses with which companies may be concerned and from the highly diversified activities of a large and complex company. In such circumstances it would be unreasonable to expect every director to have equal knowledge and experience of every aspect of the company's activities.[32]

It was in their implied emphasis on the application of this approach irrespective of whether the directors were executive or non-executive that calls into question the utility of the "division" outlined by Rogers CJ at first instance.

The Court of Appeal view on the ability of non-executive directors to delegate

Having recognised that directors could be sued at common law for negligence, and that the law of negligence was flexible enough to deal with these issues, the majority then translated their overall evaluation to the question of how the directors could delegate. They considered again the particular arguments raised in this case by the non-executive directors to escape liability. The arguments had been accepted by Rogers CJ and were challenged by the auditors. Clarke and Sheller JJA inferred from their summary of the views of Rogers CJ that he was probably "too soft". They turned to United States authorities which they suggested required a harsher standard to be applied in delegating.[33] In reviewing the duties of directors in the context of these United States authorities, they made no distinction between non-executive and executive directors, a feature of the decision of Rogers CJ. Indeed, I find it rather disturbing that they chose not to maintain that distinction for it is extremely helpful in the context of an evaluation of this kind. Also, in dealing with the United States authorities they made no allowance for the fact that there is included in US corporate law a Business Judgment Rule which adds a considerable amount of protection for directors in the way in which the courts evaluate their particular decision-making.[34]

Clarke and Sheller JJA commenced with reference to the well known case of *Barnes v Andrews*.[35] They then examined a series of cases concentrating on two – *Francis v United Jersey Bank*[36] and *Federal Deposit Insurance Corporation v Bierman*.[37] In the *Francis* case Pollock J made a number of fascinating comments about directors and their duties. I shall quote a couple of them. In the first place Pollock J held that a director must acquire:

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32 Supra n 25 at 664.
33 These cases and the United States statutes they were considering implied a higher standard on directors and therefore should be evaluated in that context.
34 For an interesting review of the Business Judgment Rule in US cases and the possible adoption of such a rule for Australia, see D DeMott, "Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices" (1992) 4 *Bond Law Review* 1; J H Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 *Corporate and Business Law Journal* 1.
35 298 F 614 (SDNY) (1924).
36 432A 2d 814 (1981).
37 2 F 3d 1424 (1993).

> at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. ...If [a director] feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act...[38]

Pollock J noted that directorial management does not require detailed inspection of day-to-day activities, but a general monitoring of corporate affairs. Directors are not expected to audit corporate books, but they should at least maintain familiarity with the financial position of their company. Pollock J then added these rather colourful words:

> A director is not an ornament, but an essential component of corporate governance. Consequently, a director cannot protect himself behind a paper shield bearing the motto 'dummy director'. The *New Jersey Business Corporations Act,* in imposing a standard of ordinary care on all directors, confirms that dummy, figurehead and accommodation directors are anachronisms...[39]

Indeed the majority noted that Pollock J's judgment had been followed in a number of cases in the United States, the most recent being *Federal Deposit Insurance Corporation v Stanley*[40] where the relevant judge held that:

> all directors of a bank have a duty to be generally familiar with the business and financial conditions of the bank, and to devote a sufficient amount of time and energy to overseeing the affairs of the bank to allow them to discharge their responsibilities....A director's duty to exercise due care, skill and diligence in overseeing the affairs of the bank cannot be met solely by relying on other persons...[41]

Bierman's case in 1993 also contains a strong statement of principle in relation to this topic. In that case Ripple J observed:[42]

> Directors are charged with keeping abreast of the bank's business and exercising reasonable supervision and control over the activities of the bank... A director may not rely on the judgment of others, especially when there is a notice of mismanagement. Certainly, when an investment poses an obvious risk, a director cannot blindly rely on the judgment of others...

After reviewing these and other cases, Clarke and Sheller JJA commented on the developments in Australian cases which have shown that the community expects higher standards of care and diligence – they referred in particular to the insolvent trading cases such as *Metal Manufacturers Ltd v Lewis*,[43] especially the judgment of Kirby P; *Statewide Tobacco Services Ltd v Morley*[44] and *Commonwealth Bank of Australia v Friedrich*,[45] some of which I have referred to earlier in this chapter. They concluded their views on the general duty of care with the following summary:

> A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns upon the natural expectations and reliance placed by share-

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38 Supra n 36 at 822, quoted by Clarke and Sheller JJA in *AWA* on appeal, supra n 25 at 666.
39 Supra n 36 at 823, quoted by Clarke and Sheller JJA in *AWA* on appeal, supra n 25 at 667.
40 770 F Supp 1281 (1991).
41 770 F Sup 1310, quoted by Clarke and Sheller JJA in *AWA* on appeal, supra n 25 at 667.
42 Supra n 37 at 1432-1433, quoted by Clarke and Sheller JJA in *AWA* on appeal, supra n 25 at 666.
43 (1988) 13 NSWLR 315.
44 (1992) 10 ACLC 1233.
45 (1991) 5 ACSR 115. See also the article by Sievers, supra n 9.

> holders on the experience and skill of a particular director. The duty is a common law duty to take reasonable care owed severally by persons who are fiduciary agents bound not to exercise the powers conferred upon them for private purpose or for any purpose foreign to the power and placed,...at the apex of the structure of direction and management.[46]

Negligence of the Chief Executive Officer – Hooke

Rogers CJ had found that Hooke had been in breach of his duty to act with care and diligence. Hooke was ordered to pay to DHS 10 per cent of the damages awarded against it. Hooke argued on appeal that he should not be liable at all – he had taken all necessary steps to ensure that the foreign exchange dealings were carried out by appropriately qualified persons who were responsible for these operations. Having delegated responsibility it was only up to him to step in if it was clear that particular difficulties were raised for his attention and that in all of the circumstances he should be held not liable. Furthermore, he argued that as the company had been held partially responsible for the relevant loss, and that finding was based on his own actions and those of management, he should not be made personally liable, as it were, in this particular context.

In the alternative he renewed his claim that the court should excuse him from responsibility under the terms of s 1318 of the CL.[47] The purpose of this provision is to allow the court to excuse directors (and other officers) from liability in situations where they have acted reasonably and the court believes that in all the circumstances they should be excused from liability. This section is likely to be particularly relevant in the context of the suggestions made by the majority of the Court of Appeal that directors should take a more pro-active role in decision making – even extending to risk taking. Hooke argued that he had acted honestly and had not benefited personally from the course of conduct engaged in. Even if he had been negligent his action could be and should be excused by the court.

Rogers CJ had rejected Hooke's claim for relief under s 1318. The majority ruled that as the company's contribution to the loss could be attributed to the actions of Hooke and management he should not be held liable for damages in these particular circumstances. Whilst they held that he was in breach of his duty to act with reasonable care and diligence, as no monetary damages were awarded against him in the event, there was no need to consider the application of s 1318 to these facts. Powell JA disagreed on the question of negligence so there was no need for him to consider s 1318.

Causation

The Court of Appeal (by majority) held that the auditors were negligent and that the non-executive directors were not. It also held that Hooke was guilty of negligence. It was then necessary to consider the extent to which the damages sustained by the company were attributable to the negligence of the auditors. The majority held (and this part of their judgment was supported by Powell JA) that the failure of the auditors to alert the

46 Supra n 25 at 668.

47 An alternative claim for relief in cases of this kind may in future also be made under s 1317JA as the court can now relieve directors for breaches of statutory duties where these result in a civil penalty. The terms of the section are substantively identical to s 1318.

board to the inadequate internal controls and records denied the company the opportunity to take steps to avoid, or at least minimise, the loss arising from the foreign exchange operations. The majority did not accept the auditors' submission that the information having been made available to management broke the chain of causation. In the view of the majority, whatever view one took of the conduct of management, the negligence of the auditors resulted in the non-executive directors in particular remaining uninformed. The auditors knew that this was the case. Accordingly, at the very least, the auditors' negligence constituted the cause of the loss.

Post AWA Cases

There have been a number of cases since the first instance *AWA* decision which have highlighted a willingness on the part of the courts to adopt a "generous" evaluation of the ability of directors to delegate, and their right to rely upon the work of the delegatees, leading to what some would regard as a benign approach by some courts in evaluating the duties of care and diligence of directors. There are some cases which are more important than others and I will not deal with all of them in this part of the chapter. I will concentrate on four cases but I will also briefly discuss some others. The cases I wish to discuss are *Vrisakis,*[48] the *Biala/Mallina* decision,[49] the *Permanent Building Society*[50]case and finally the *Marcus Clark*[51] case. I will mention briefly some other cases as well at the end of this part of the chapter.

Vrisakis

Vrisakis, who had been appointed as a non-executive chairman as part of the Western Australian Government and National Companies and Securities Commission ("NCSC") sponsored rescue package of the Rothwells Merchant Banking Company, had been charged with various breaches of the Western Australian equivalent of s 232(4) of the CL. At the time of the rescue package a policy committee was appointed to assist him and the board of directors in their attempt to rescue the company and hopefully many of its investors. There were serious doubts expressed about how that policy committee was functioning, whether it met regularly enough, how it interacted with the board of the company and various other matters. Part of the package included the implementation of a business plan for the company.

In fact, eight complaints were brought against Vrisakis alleging offences against the Companies Code. He had been convicted on the first count of a breach of his duty to act with care and diligence. It was alleged that "he had failed to exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties as a director of Rothwells Limited in that he failed to take reasonable steps to ensure that effect was given to the terms of [the business plan] and management restructure which were contained in the paper prepared by him and adopted by resolution of the directors of Rothwells Limited at a meeting held on 2 December 1987". The Australian Securities

48 Supra n 27.
49 (1995) 15 ASCR 1 affirming the decision of Ipp J (1993) 11 ACSR 785; 11 ACLC 1082.
50 Supra n 24 affirming the decision of Anderson J (1993) 11 ACSR 260.
51 Supra n 13.

Commission ("ASC") had set out in the charge various aspects of the business plan which it was alleged Vrisakis had failed to have implemented. However, it had apparently refused to give further particulars of what it believed Vrisakis should have done. He appealed against the conviction not only on the merits but also that there was a miscarriage of justice because the charge was duplicitous in its form in that proper particulars had not been provided.

A majority of the Western Australian Full Court (Malcolm CJ and Ipp J) upheld the appeal and substituted the verdict of not-guilty. In doing so they held that the charges were duplicitous. Rowland J dissented on this aspect and also on the substantive finding.

On the question of the duty of care, Ipp J agreed that Vrisakis could not be regarded as "an ordinary non-executive director". He added however, that "he certainly was a non-executive director in the sense that he was not given responsibility for any part of the day to day operations of the company. He had been made aware, of serious allegations...by the NCSC concerning the management of Rothwells, particularly Connell."[52]. He was a person of "vast experience in commercial matters, with the specialised knowledge, skill and ability necessary to influence the affairs of a company which had previously been conducted in a way which many regarded as being entirely inappropriate. Above all he was regarded as a person of integrity who would, as a director, maintain a careful watch over the company."[53]

In these circumstances it was not surprising that his particular conduct would be viewed under perhaps a sharper microscope than would be applied to others. But, despite this, it was important to evaluate what would be expected of a director in the position of Vrisakis.

> The question is merely whether the defendant director has exercised a reasonable degree of care and diligence in the exercise of his powers in the discharge of his duties. Nevertheless, a criminal offence will not have been committed if an omission to take care did not carry with it a foreseeable risk of harm to the company. No act of commission or omission is capable of constituting a failure to exercise care and diligence under s 229(2) unless at the time thereof it was reasonably foreseeable that harm to the interests of the company might be caused thereby. That is because the duty of a director to exercise a reasonable degree of care and diligence cannot be defined without reference to the nature and extent of the foreseeable risk of harm to the company that would otherwise arise.[54]

Recognising the importance of the role played by directors, especially directors such as Vrisakis, Ipp J nevertheless gave this important qualification which had directors (especially non-executive directors) cheering quite enthusiastically:

> [T]he mere fact that a director participates in conduct that carries with it a foreseeable risk of harm to the interests of the company will not necessarily mean that he has failed to exercise a reasonable degree of care and diligence in the discharge of his duties. The management and direction of companies involve taking decisions and embarking upon actions which may promise much, on the one hand, but which are, at the same time, fraught with risk on the other. That is inherent in the life of industry and commerce. The legislature undoubtedly did not intend by s 229(2) to dampen busi-

52 Supra n 27 at 217.
53 Ibid.
54 Ibid at 212. Compare the remarks of the majority in the *AWA* appeal decision, supra n 25 at 664-665.

> ness enterprise and penalise legitimate but unsuccessful entrepreneurial activity. Accordingly, the question whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.[55]

How much stronger would have been his views in the face of the new statutory duty in s 232(4)?

His conclusion on the question of the duty of care was agreed to in broad terms by Malcolm CJ who, however, refrained from such generous language. Malcolm CJ endorsed the broad description of the duty of care in the judgment of Rogers CJ and in the classic decision of *Re City Equitable Fire Insurance Co Ltd*[56] but recognised, in the context of that earlier decision that standards had risen.[57] He was particularly critical of the prosecution's rather loose pleadings and endorsed the stricter line taken by the Victorian Full Supreme Court in *Byrne v Baker*.[58]

The language of Ipp J became the rallying call for the entrepreneurial spirit to be reinstated as we have seen in the *AWA* decision. Clarke and Sheller JJA highlighted that as part of the duties of directors – in the appeal decision in that case.

The Biala/Mallina case[59]

These facts are taken from the CCH report of the judgment of first instance by Ipp J.[60] Dempster (D) was chairman and managing director of Mallina Holdings Limited ('Mallina') as well as a substantial shareholder. D was also the chairman and managing director of Dempster Nominees Pty Ltd ('Dempster Nominees') and related companies. D determined that Mallina and Dempster Nominees should jointly develop a petrochemical project. It was D's intention to obtain an 'exclusive mandate' from the State government to carry out a feasibility study into such a project. D took charge of the project on behalf of both companies. Rakich, Mallina's chief executive, and a director, was also involved with the project but D made all necessary decisions in relation to both companies. Mallina's non-executive directors had virtually no involvement with the joint venture.

To secure a[n] 'exclusive mandate' for the joint venturers D engaged in substantial lobbying with relevant Western Australian government bodies and Parker (P), the Minister for Minerals and Energy. There was no other party seriously pursuing the development of a petrochemical project in the State, although some other parties had expressed interest. During this lobbying period media reports appeared which suggested that Mallina was suffering financial difficulties. At all times, however, Mallina had adequate resources to fund its involvement in any feasibility study.

In early September 1986 the lobbying process culminated in P deciding to recommend to Cabinet that the exclusive mandate be granted to Mallina/Dempster Nominees. Rather than immediate Cabinet consideration, however, discussions between P and the

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55 Supra n 27 at 212.
56 [1925] 1 Ch 407.
57 Supra n 27 at 170.
58 [1964] VR 443.
59 Supra n 49.
60 (1993) 11 ACLC 1082.

Premier of Western Australia resulted in submissions being sought from other departments regarding the project and a call being made to all interested parties for submissions. D had resigned as a director of Mallina in August 1986. He still, however, had carriage of the petrochemical project on Mallina's behalf.

On the day of the discussion between P and the Premier, D received information that P was embarrassed about the publicity concerning Mallina and that expressions of interest would be called for. D contacted Connell (C) about the possibility of him becoming a joint venture partner with D or Dempster Nominees. D then had discussions with Rakich indicating that the government would never approve a bid which included Mallina. D then outlined that he would be attempting a joint application with C and that they would meet Mallina's costs to date and offer Mallina equity participation in any entity established by D and C to pursue the project. Rakich discussed this with the Mallina directors and they accepted D's proposals and accepted $150,000 (Mallina's expenditure had been assessed at about $75,000). Dempster Nominees received $250,000 from C. Rakich informed P that Petrochemical Industries Company Ltd ('PICL'), a company jointly owned by interests controlled by D and C, would carry out any mandate. Subsequently, PICL made a proposal in respect to the call for submissions and was granted an exclusive mandate in early 1987. PICL submitted its study. D and C's interests in the project were subsequently sold for $50 million and $350 million respectively.

Two Mallina shareholders commenced derivative actions against Dempster Nominees for breach of its fiduciary duties as joint venturer and D's knowing participation in those breaches. A derivative action was also commenced against D, as a de facto director of Mallina, for breaches of fiduciary duties in relation to his conduct in early September 1986. Similar derivative claims were made against Rakich and another Mallina director, Griffin (G). Personal claims, based upon s 574(8) of the Companies (Western Australia) Code[61] were also made against Rakich and G alleging breaches of s 229(1).[62] A claim against all the directors of Mallina for failure to exercise reasonable care and diligence in considering D's proposals, as relayed by Rakich (as required under s 229(2))[63] were also made.

The defendants raised the argument that the derivative actions were improperly brought – the plaintiffs had not come within exceptions to the rule in *Foss v Harbottle*.[64] Ipp J had originally ruled that the action could proceed and that he would hear the substantive arguments based on *Foss v Harbottle* at this trial. In a lengthy judgment he ruled that the action was within one of the exceptions to the rule in *Foss v Harbottle*; the exception being that justice should allow litigation to proceed in certain cases even where the company is not the plaintiff. His judgment is important for that particular purpose.

Turning to the specific question – whether the directors should be liable – the report of the decision is fairly short. Let me quote from Ipp J's judgment: "In essence, the case regarding negligence against the directors depends upon whether it was indeed negligent

61 See now s 1324(10) of the CL.
62 See now s 232(2) of the CL.
63 See now s 232(4) of the CL.
64 (1843) 2 Hare 461.

for each to trust Dempster and make no independent inquiries themselves".[65] He relied on the *AWA* case and the comments made by Rogers CJ, which I have quoted earlier, to excuse G and two other directors who were non-executive directors in finding that they were not negligent. As Dempster Nominees owed fiduciary duties to Mallina, and as they were entitled to assume that Rakich, the chief executive director, was reporting accurately to them about the affairs of the company "they were entitled to rely on his judgment and if he was satisfied that that information was correct they were entitled to accept that".[66]

Ipp J agreed that there was greater responsibility on the part of Rakich as chief executive officer to be satisfied that what Dempster told him was in fact accurate. Again applying the tests in the *AWA* case he noted that:

> whilst Rakich was guilty of an error of judgment in trusting Dempster on so important an issue without attempting to verify what he had been told, his conduct was not negligent. In coming to this conclusion I had regard to the long relationship that existed between Rakich and Dempster and the fact that Rakich had for a long period relied on and trusted Dempster. I also have regard to the fact that the way that the information was conveyed, coupled as it was with the incentive that Mallina would make 100 per cent over its expenses, was calculated to allay any suspicions. In the circumstances in my view, Rakich was not negligent in trusting Dempster.[67]

These are indeed robust remarks and will again add to the enthusiasm that directors, especially non-executive directors, will have for having cases involving breaches of duties of care heard in the Western Australian Supreme Court.

The Full Court of the Western Australian Supreme Court confirmed many of the holdings of Ipp J.[68] On the question of liability for negligence Rowland J on behalf of the Full Court, relying on the evaluation of the witnesses by Ipp J and the evidence before Ipp J, confirmed his ruling that Rakich could rely on Dempster and escape any liability. Rowland J added these words in his concluding remarks:

> In the end, the issue is relatively simple. The learned trial judge had assessed Rakich as being naive, but not in any way concerned with the misrepresentation which lead to Mallina's quitting the joint venture. Biala had accepted the learned trial judge's findings that Dempster misrepresented the position to Rakich and, in turn, the other directors, and that they relied upon that misrepresentation. Absent any complaint now that Rakich had knowledge of the true position, the case is simply one of negligence and, as his honour pointed out, the case regarding negligence against the director depends upon whether he was negligent to trust Dempster and make no independent enquiries himself....This was a case where it was found by the learned trial judge, and the evidence amply supports the finding, that Dempster was the person mainly involved in controlling the project generally. It may be that Rakich was naive, but his Honour in fact accepted that Rakich did trust Dempster and simply did not find it necessary to check that Dempster was telling him the truth.
>
> One can note many strange and perhaps unsatisfactory aspects of the conduct of Rakich and, in fact, all of the directors; but, with respect, I accept that the issue is as simple as that outlined by the learned trial judge and, accepting his Honour's assessment of the witnesses, I agree with him that it is not a breach of duty to accept and not check a statement by a person in charge of the operation

65 Supra n 60 at 1108.
66 Ibid at 1109.
67 Ibid at 1109-1110.
68 (1994) 15 ACSR 1.

> at its face value, notwithstanding the consequences, and especially so in the context of a case where the company's main objective was mining, the project in question was at that stage no more than a project with good possibilities for the future and where the company was handsomely compensated for its endeavours to that date.[69]

Permanent Building Society case[70]

I mentioned earlier the importance of the *Permanent Building Society* case – it concerns both questions of delegation and conflict of interest. Briefly that case concerned the collapse of a building society which had gone into a property investment without the benefit of the advice of Hamilton who was the chief executive officer but who alleged that he could not participate in a particular major decision because he had a conflict of interest. The Full Western Australian Supreme Court held that various other directors were liable and also held that Hamilton, apart from being in breach of his fiduciary duties, also was guilty of negligence at common law. However, because the liquidator could not show causation between the negligence and the damage, Hamilton was able to escape the award of damages against him.

Hamilton, because of his conflict of interest, felt that it was inappropriate for him to participate in decisions of the board of directors on this particular investment transaction. But this was a most important transaction as far as the building society was concerned. A significant question for the Full Court, was whether Hamilton, by not participating in the board decisions had been in breach of his duty of care and diligence. Did this also amount to a breach of a common law duty of care?

Ipp J, on behalf of the Full Court, reviewed these issues not only in the context of the equivalent of s 232(4) of the CL, but also in the context of common law duties of care and diligence. As noted earlier he held that directors could be liable for common law negligence thus supporting the suggestions made by Rogers CJ in the *AWA* case. Did Hamilton exercise a reasonable degree of care and skill (and diligence) in this particular situation? Ipp J's starting point on this question was to turn to the views he had expressed in the *Vrisakis* case. In that case he said:

> [T]he question whether a director has exercised a reasonable degree of care and diligence [note that we are moving here from skill to diligence without explanation] can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.
>
> The proper test to be applied in determining whether directors have exercised a reasonable degree of care and diligence in accordance with the requisite standard is that laid down more than a century ago by Lord Hatherley LC in *Overend & Gurney Co v Gibbs* (1872) LR 5 EL 480 at 486-487...'they [that is, the directors] were cognisant of circumstances of such a character so plain, so manifest, and so simple of appreciation, that no men with ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into.[71]

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69 Ibid at 62.
70 Supra n 24.
71 Supra n 27 at 212; quoted in supra n 24 at 159.

Having established the parameters of the duty of care and skill (and diligence) – and I remind you that Ipp J in *Vrisakis* had also recognised that directors could be entrepreneurial in their activities in the appropriate circumstances – he turned to consider whether Hamilton had in fact satisfied his obligations. He noted:

> In my opinion [his duty] was not affected by the fact that Hamilton believed that he had a conflict of interest and accordingly did not vote when the resolutions in question were taken. It was manifest that the transaction was capable of causing PBS serious harm. In those circumstances, in my opinion, Hamilton could not avoid his duties as chief executive and managing director by asserting his perceived conflict of interest. It may be that, because of conflict, he should not have spoken or voted in favour of the resolution. But as chief executive and managing director there was a responsibility on him to ensure that the other directors appreciated the potential harm inherent in the transaction, and to point out steps that could be taken to reduce the possibility of that harm. Hamilton could not avoid that duty by, metaphorically speaking, burying his head in the sand while his co-directors discussed whether PBS should enter into such a potentially detrimental transaction.[72]

Reviewing the facts in this case Ipp J held that the relevant duty:

> ...could not be delegated either to subordinate officers of [the building society] or even to individual directors. Hamilton either failed to make enquiries which he should have made or was satisfied with superficial and inadequate answers in circumstances requiring further investigation. Applying the test [in the *ASC v Gallagher* case], an ordinary person with the knowledge and experience of Hamilton would be expected to have made the enquiries to which I have referred if he was acting on his own behalf. Accordingly, I am satisfied that Hamilton breached his duty to exercise skill and care as a director of [the building society].[73]

As noted earlier, the victory of the liquidator was certainly a pyrrhic one. Hamilton, although held to be in breach of his various duties, was not found to be liable at all for any damages.

How should a director who is faced with such a conflict act? Clearly the director needs to provide full disclosure to the board but should he or she then also participate in the decision making? Recently the South Australian Full Supreme Court evaluated the obligations of a director faced by such a conflict in *Centofanti v Eekimitor Pty Ltd*.[74]That decision accepts that directors have certain obligations to disclose information. But how much further they need to go in ensuring that the company pursues a course of action (taking extra advice etc) is not clear. The South Australian court recognised this was a very important and difficult question. I will discuss this aspect of the decision later in this chapter. In my view, the Western Australian Full Supreme Court was too demanding in its conclusions in the *Permanent Building Society* case. If this is the relevant standard there will need to be some appropriate guarantee to directors that they will not be liable for breaches of s 232(6) in such circumstances.

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72 Supra n 24 at 161.
73 Ibid at 162.
74 (1995) 13 ACLC 315; see also text at n 105 below.

Marcus Clark[75]

The dispute in this case revolved around a transaction between the State Bank of South Australia (the Bank) and APA Holdings Limited (APA) and whether the Bank should buy the whole of the issued share capital of Oceanic Capital Corporation (Oceanic) which was a wholly owned subsidiary of APA. At the time of the sale, APA was suffering liquidity problems and was in fact indebted to a subsidiary of Equiticorp Holdings Limited (Equiticorp), Equiticorp Australia Ltd, for the sum of \$27m. Repayment was secured by a charge over APA's shareholding in Oceanic.

Marcus Clark (Clark) was both the managing director and chief executive officer of the Bank and a director and substantial shareholder of Equiticorp, a position which some may have thought was too far removed from the main transaction between the Bank and APA to constitute a conflict of interest. The Supreme Court of South Australia, however, held otherwise. The potential position of conflict in which Perry J held Clark was placed can be summarised as follows: as a director and shareholder of Equiticorp, and knowing, as he did, that APA had liquidity problems, he had a duty to ensure that APA repaid the \$27m owed to Equiticorp Australia Ltd before the Bank purchased the relevant interests. His duty as a director of the Bank was to ensure that the acquisition proceeded "at a price which was not excessive after a proper valuation could be made and considered".[76]

These potentially conflicting duties meant that there was a risk that Clark would encourage the proposed transaction, not because it was in the Bank's interests, but rather because it was in Equiticorp's interest, in that the transaction would put APA in funds to repay the debt to Equiticorp. In the opinion of Perry J, Clark did act in Equiticorp's interests at the expense of the duties he owed to the Bank. His Honour pointed to a number of factors to support this conclusion, including the fact that the Bank ended up buying Oceanic at a significant overvalue – for \$59m when a fair value of the shares was put at no more than \$21m – a circumstance which was clearly not in its best interests. Perry J also focused on the following points:

- Clark deliberately sought to conceal the conflict from the Bank.
- Clark not only attended but also voted at meetings at which the sale was discussed.
- Clark actually pressured his advisers to complete the deal.
- Finally, Clark obtained no independent valuation of APA.

A number of breaches of duty arose out of the conflict. In particular, Perry J held Clark to be in breach of his duty to act with care, skill and diligence by failing to obtain an independent valuation of Oceanic. His reasoning was that, as chief executive officer and managing director of a large bank, Clark "must unquestionably be regarded as responsible for the overall control of the operations of the Bank both in a day to day sense and in giving effect to the broader policies spelt out in the Act and by the board of directors".[77] In addition, it was clear that the board relied on him to provide full and accurate information on all matters the board had to consider and to see to it that the Bank was

75 Supra n 13. My treatment of the *Marcus Clark* case has been considerably assisted by work done by Kristin Giles, an Articled Clerk at Arthur Robinson & Hedderwicks.

76 Supra n 13 at 632.

77 Ibid at 629.

not exposed to any unnecessary risk. Thus, the requirements of his office imposed a duty to act in accordance with the highest standard of competence and integrity in the banking industry. The factors which formed the basis for the finding that Clark had breached this high standard were the magnitude of the share acquisition, the defendant's supervision of, and personal involvement in, the transaction and his responsibility for placing material relating to it before the board of the Bank.

Other cases

A number of other cases examine the liability of directors for negligence and for failing to meet the required standard of care and diligence. These cases have also illustrated the willingness of the courts to recognise the validity of delegation and to excuse directors who have not second guessed the actions of those with appropriate responsibility. Alternatively, the cases show how unwilling the courts are to impose liability on directors where they have been in a position which meant that they were unable to challenge the actions of those in control.

In the first category is the interesting decision of the Queensland Supreme Court in *Re Property Force Consultants Pty Ltd*.[78] In this case, Derrington J made it clear that the defendant (one of two directors in the company) whose responsibility was to look after the public relations and other areas of the company activities, did not check the steps taken by his co-director (who was also the founder of the company and who was concerned with the financial affairs of the company) in dealing with the funds of the company. The founder had apparently misappropriated funds invested with the company which was later placed into liquidation. The court was not prepared to find the defendant liable in circumstances where it was clear that the two directors had established a division of labour. It was not appropriate for the defendant to second guess the actions being taken by his colleague in the absence of any "warning signs" that might have forced him to ascertain whether the funds invested had been properly dealt with by him.

The second set of cases involved "prosecutions" of directors who had a minor role to play on the board of the relevant company and who could not force those in control (whether management or directors) to undertake certain tasks. Two of the cases involved the failed Rothwells Banking Company – *Australian Securities Commission v Gallagher*[79] and *Hurley v National Companies and Securities Commission*.[80] In both

78 (1995) 13 ACLC 1051.
79 (1993) 11 ACLC 286.
80 (1993) 11 ACLC 443 at first instance, upheld on appeal (1995) 13 ACLC 1365. It is interesting to note in the context of the obligation of directors to act as "whistle blowers" or as agitators in trying to force their colleagues to do more, or in some cases to do something, the remarks of White J in the first instance decision in *Hurley*. In that case in reversing the Magistrate's finding that Hurley was in breach of the relevant duty to act with care and diligence, White J noted that Hurley had been placed in such a position that no matter what steps he could have reasonably taken, his attempts to stop the relevant transaction would have been totally ineffective. Indeed any action that might have been proposed by Hurley would have been no more than "beating the air" (11 ACLC 443 at 452). White J distinguished between the situation where a director allowed something to happen, consequent on his or her obligations to act with reasonable care and diligence, and the situation where the director was in such a position that he could not have stopped the particular action being taken. "I do not think that section 229 (see now section 232) of the [Companies Code] imposes upon a director the obligation to take action which is doomed to failure. The obligation under that section was to exercise a reasonable degree of care and diligence in the exercise of a director's powers and the discharge of his duties as such director" (11 ACLC 443 at 451). See also the position of the "hapless" director discussed by Hodgson J in *Standard Chartered Bank of Australia v Antico* (1995) 18 ACSR 1 and the remarks of Simos AJA in *Byron v Southern Star Group Pty Ltd* (1997) 15 ACLC 191 at 198-199.

cases the Western Australian Full Supreme Court excused the relevant "junior" director from liability although in the second case, *Hurley,* whilst the court did excuse the director, it sounded a warning that the set of facts was "fairly borderline". In *McQuestin v Australian Securities Commission*[81] the court made it clear that the managing director of the company was very much controlled by the owner of the company and therefore could not be held liable for the relevant "negligence".

The Dairy Containers Case

The New Zealand decision *Dairy Containers Limited v NZI Bank Limited*[82] presents not only an interesting endorsement of the view of Rogers CJ in the *AWA* case (the judgment in the *Dairy Containers* case was given before the Court of Appeal judgment in *AWA*), it also raises further questions of directors' liability and potential liability in the context of principles of modern corporate governance. Whilst it is "a little bit off the beaten track" it illustrates the fact that judges are prepared, in appropriate cases, to drive home liability against those who bear the burden of the particular decision although the ultimate decision was that the holding company was not liable as a shadow director. The decision of Hodgson J in the *Standard Chartered Bank* case[83] is a clear illustration of the courts' willingness to find liability against shadow directors. I will not deal with those particular issues in this chapter but mention them as an indication of the direction the courts are prepared to take in this area.

Dairy Containers Limited (referred to as the company) was a wholly-owned subsidiary of the New Zealand Dairy Board (Dairy Board) which treated it as a division rather than a subsidiary. It was incorporated under the New Zealand Companies Act 1955; its primary task was to manufacture cans for dairy products for the Dairy Board. The Dairy Board provided a captive market for the product. However, the company later became a substantial investment company. Investment accounts were opened with a number of banks including the Australia & New Zealand Banking Group Limited which was the company's banker. The New Zealand Auditor-General (Auditor-General) was engaged as the auditor of both the company and the Dairy Board.

All members of the company's board of directors were senior Dairy Board executives. The company was managed by Messrs Watson (the Chief Executive), and Rose and Joyce (referred to as the managers). The Dairy Board had a very strong hands on role viz-a-viz the company and the general understanding was that the investments of the company would be in the short term money market and restricted to approved trustee investments.

The history of the company's investments in the short term money market and elsewhere was disastrous. Part of this was due to the fact that the three managers committed a diverse range of frauds on the company, including the abuse of company credit cards, diverting company funds into their own accounts and other matters. In August 1989 they were prosecuted and sent to jail. Civil proceedings were then brought by the company against the Auditor-General for losses incurred through the misappropriations,

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81 (1993) 12 ACSR 279.

82 (1995) 7 NZCLC 96-669. This case is discussed by Justice Thomas in Chapter 9 of this book and by Robyn Carroll in Chapter 10.

83 (1995) 18 ACSR 1; see also *Australian Securities Commission v AS Nominees Ltd* (1995) 18 ACSR 459.

and on the ground that the audit conducted on behalf of the company was deficient. The Auditor-General counter-claimed against the company and the directors for contributory negligence. Actions were also brought against some of the banks – these are not relevant to this discussion.

In a lengthy judgment (over 250 pages – most of which has not been reported in the CCH New Zealand Company Law Cases which report is the basis for my discussion), Thomas J followed closely the decision-making pattern enunciated by Rogers CJ in the first instance decision in the *AWA* case. The decision of Thomas J was delivered before the appeal decision in the *AWA* case. His Honour confirmed that New Zealand courts should follow the decision reached by Rogers CJ and by US and other authorities that there could be contributory negligence sought by accountants and auditors from companies and their directors in the factual context that we are considering. The first part of his reported decision contains a fairly detailed discussion of these issues.

In discussing the role of the directors and their failure to perform their fundamental duties, apart from referring to the *AWA* case, Thomas J made some rather interesting observations on the *Principles of Corporate Governance* adopted by the American Law Institute. This is relevant in the context of increasing emphasis on corporate governance. Indeed, the Australian Stock Exchange has recently issued a new listing rule[84] which places an obligation on companies to identify the steps they have taken on corporate governance. The comments of Thomas J on this and related matters are quite similar to statements made in the *AWA* case.

This case also raised the question of whether the nominating company – in this case the Dairy Board – was responsible for the actions of its nominees (who were also employees) and who had failed to carry out their duties appropriately. The counterclaim by the Auditor General was based not only on the question of potential vicarious liability but also on the basis that the Dairy Board was a shadow director – relying on a provision not unlike that in s 60(1)(b) of the CL. Because the Dairy Board had not issued instructions to the relevant nominees in relation to their duties as directors, Thomas J was prepared to find that the Dairy Board was not a shadow director.

He then turned to the question of vicarious liability. Were it not for the Privy Council decision in *Kuwait Asia Bank EC v National Mutual Life Nominees Limited*[85] he would have reached a different view to the one that he finally delivered. Because of that decision (and of course, New Zealand still has the Privy Council as its final "Court of Appeal") he felt that he could not hold the Dairy Board liable. But in doing so, he criticised the decision both directly and indirectly and his criticism may well give Australian courts greater courage to depart from following it. Some of his comments are very interesting indeed.[86]

> The decision does not appear to address important issues which require consideration before it is held that employers cannot be liable for the acts of their employee- directors. Yet these issues are fundamental to our law. One is the common law doctrine that employers are liable for the torts that their employees have committed in the course of their employment...Another issue necessarily stems from the relationship between employers and their employee-directors. The commercial

84 Listing Rule 4.10.3.
85 [1991] 1 AC 187.
86 Supra n 82 at 260,812.

> reality of that relationship was recognised by all expert witnesses in the present case. One can accept the force of Lord Wilberforce's observation that the common law should take a 'practical approach according with commercial reality' (see *New Zealand Shipping Company Limited v A M Satterthwaite & Co Ltd* [1974] 1 NZLR 505 at 510).

In his view the courts should, wherever possible, attach liability to the more appropriate party. In the case of master and servant that usually should be the master. In these circumstances, in his view, whilst recognising that the Privy Council decision was binding on him it was desirable to review the law. He added:

> Recognising the economic reality of employee-directors and their employers requires that those who employ employees as directors to represent their interests accept responsibility for their resulting conduct. Liability can be determined in accordance with the established law of employer and employee and principal and agent. There is no reason in principle why employers should be exempt from liability for the negligent acts of their employees whom they have required to act as directors to protect and promote their interests. The measure of real control exercised by the employer should be recognised in law. It carries with it responsibility and that responsibility should, in the event of the default on the part of the company they control through their employees, be exposed to the potential of vicarious liability.[87]

Since the decision by Thomas J in the *Dairy Containers* case the Privy Council has itself qualified its own decision in the *Kuwait* case. In *New Zealand Guardian Trust Co Ltd v Brooks*[88] the Privy Council indicated that in a situation where directors of a company are negligent the company itself may be vicariously liable although in this case the facts did not deal with the position of nominee directors. One suspects there will be further qualifications of the *Kuwait* decision in the not too distant future.[89]

Thomas J also held that the nature of the circumstances surrounding the appointment of nominee directors adds a further dimension to the problem. It is difficult to attribute to them true independence if they are to be looking over their shoulders all the time to assess the instructions of their nominators. He wanted to adopt what turned out to be quite a commercial approach in evaluating the responsibilities of nominee directors in their capacity as such directors. In that regard, he turned to earlier decisions of Australian courts in which Jacobs J (then in the New South Wales Supreme Court) had emphasised commercial reality when dealing with these matters. These cases, such as *Levin v Clarke*[90] and *Re Broadcasting Station 2GB Pty Ltd,*[91] had been followed by Mahon J in *Berlie Hestia (NZ) Limited v Fernyhough*.[92] However, in later Australian decisions, there has been a tendency to require nominee directors to be more cautious in the way in which they pursue their tasks. In particular Young J adopted a very strict approach to the responsibilities of nominee directors in *Harkness v Commonwealth Bank of Australia Limited*.[93] Thomas J felt that the decisions that he referred to allowed nominee directors to approach company problems:

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87 Ibid at 260,817.
88 [1995] 1 WLR 96.
89 See also J Pizer, "Holding an Appointor Vicariously Liable for its Nominee Director's Wrongdoing – An Australian Roadmap" (1997) 15 *Company and Securities Law Journal* 81.
90 [1962] NSWLR 686.
91 [1964-65] NSWLR 1648.
92 [1990] 2 NZLR 150.
93 (1993) 12 ACSR 165 at 177.

> ...with an open mind and [with the freedom to] pursue their appointers' interests provided that, in the event of a conflict, they prefer the interests of the company. In such circumstances the breadth of the fiduciary duty has been narrowed by agreement amongst the body of shareholders. In other words, the incorporators have agreed upon an adjusted form of fiduciary obligation. This approach has now been incorporated in New Zealand Companies legislation. Section 131(2) of the Companies Act 1993 provides that a director of a company, which is a wholly owned subsidiary may, when exercising powers or performing duties as a director, and if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company, even though it may not be in the best interests of the company.[94]

Conflict, Self Dealing and Care and Diligence

When the courts are faced with scenarios where the directors are not only challenged with respect to their decisions on the basis of good business judgment, but also where the directors may be gaining some sort of benefit from the transaction, then the courts are prepared to shift into a different gear. Here, the courts have taken a very harsh (some would suggest too harsh) approach. In particular the decision in the *Permanent Building Society* case which I have discussed above is seen by some as perhaps going too far. The pendulum has certainly not swung back much in favour of directors in this area. Indeed, if anything, the decisions such as the Full Federal Court in *Cummings and Fuller v Claremont Petroleum NL*,[95] the High Court judgments in *R v Byrnes*[96] and the *Marcus Clark*[97] case discussed earlier have emphasised that perhaps we were not in need of such sweeping law reforms resulting in the related party transaction legislation introduced in the earlier 1990s. Many of these cases are discussed in the excellent chapter by Chief Justice David Malcolm of the Western Australian Supreme Court published in this book.

To what extent the approach taken by the High Court in *Byrnes* can be said to sit comfortably with earlier judgments such as *Mills v Mills*,[98] is an interesting question and one that will no doubt exercise the minds of writers in the future. In a sense it underpins the tension in the cases relating to nominee directors – although in those cases the directors did not benefit personally. I have discussed this subject briefly earlier. I will not deal in any detail with these decisions. But I wish to comment on aspects of the *Marcus Clark* and *Permanent Building Society* decisions which highlight the need for full disclosure by directors of conflicts.

In *Marcus Clark*, as I have shown earlier, there was a concern that the assets being purchased by the State Bank of South Australia were over priced and that there was a conflict of interest. Perry J, in dealing with this second issue, began by noting that the traditional formulation of the rule governing the conduct of fiduciaries was to the effect that the fiduciary may not place himself or herself in a situation where his or her duty and interest conflict.[99] He also noted that there may be, as in this case, conflicting fiduciary duties where the director is a director of more than one company. At this point

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94 Supra n 82 at 260,816.
95 (1992) 9 ACSR 583.
96 (1995) 17 ACSR 551.
97 Supra n 13. There were many others but these seem to have captured the imagination more than others.
98 (1938) 60 CLR 150.
99 See also the comments of Mason J in *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41.

Perry J quoted the court in the *Byrnes* case that in such cases the director of the first company must disclose his or her interest to the second company and obtain that company's consent before exercising his or her powers for the benefit of the first company.

As was the case in the *Byrnes* decision, this combination of circumstances obliged Marcus Clark to disclose his conflict to the bank's board and, in particular, the fact that Equiticorp stood to gain from any payment to APA. In addition, it obliged him to refrain from voting at board meetings at which the matter was considered. Since he did neither of these things, he was held to be in breach of this duty. The *Marcus Clark* decision (together with others such as *Byrnes*) demonstrate the importance of directors disclosing personal interests in transactions in which their company is concerned. The fact that in neither case were the directors involved accused of actual dishonesty shows just how stringently courts are prepared to interpret the duty to avoid conflicts of duty and interest. Even if directors believe they are acting in the interests of their company and even if the conflict involved seems remote, directors who fail to disclose their interest, it seems, do so at their peril.

On a related point, Perry J's discussion of the meaning of 'pecuniary interest' is also indicative of the 'hard line' courts are now taking on directors' conflicts of interest. His Honour's consideration of the term arose in the context of s 11 of the State Bank of South Australia Act. This section, which is in some ways similar to s 232A(1) of the CL, provides that directors who have a 'direct or indirect pecuniary interest' must disclose the nature of the interest to the board and must not take part in any deliberations or decisions of the board with respect to that proposal.

It was argued on behalf of Marcus Clark that the fee of NZ$20,000, which he received as a director of Equiticorp Holdings, was so nominal that it did not give him a pecuniary interest in the proposed transaction. However, Perry J dismissed this line of argument. His Honour held that the size of the pecuniary interest taken in comparison with the scope of the trading operations of Equiticorp was not relevant. Rather, whether or not a particular sum is an insignificant amount must be looked at from the position of the director to whom the section applies. Examined from this point of view, then, the director's fee he received was not so small as to fall short of constituting a 'pecuniary interest' for the purposes of s 11(1) of the relevant legislation.

These cases illustrate that courts can handle such issues. In the 1980s we saw an overreaction, in my view, from the legislature (in enacting legislation) to a perception that the courts were unwilling or unable to deal with the problems of directors' self dealing, and the fact that the corporate regulator was similarly unwilling or unable to tackle these matters in an appropriate fashion. The enactment of the related party transactions legislation and other legislation, which has added considerably to the cost of doing business without necessarily improving the standard of business behaviour, was unnecessary.

I suspect that part of the reason for the rather tougher line that has been adopted in cases where there has been a conflict of duty and interest (although in some of the cases the result could not have come as much of a surprise to directors) is a reaction to the suggestion that the courts would not be able to deal with these matters without help. I refer in particular to cases such as the litigation against Cummings and Fuller in *Claremont,*[100]

100 (1992) 9 ACSR 583.

the strong South Australian Full Supreme Court decision in the *Gemstone*[101] litigation, and of course the very firm views taken in *Chew v R*,[102] *R v Byrnes* and a number of other cases.[103]

The difficulties faced by the courts in dealing with many of these situations have been exacerbated by the high mortality rate amongst some of Australia's high flying companies, and the rather strident reaction of the press and the community in relation to the high profile collapses that have been involved. This in turn led to the enactment of the related party transactions legislation to which I have referred earlier. However, when we have cases where we can identify directors who have made no personal gain where a corporation has relied on high flying management (for example as in the *Friedrich*[104]case), we might be surprised by some of the court decisions, although the profile of the companies and the loss sustained may well lead to a contrary view. That is certainly true in situations where directors have allowed, whether purposely or not, a conflict of interest to cloud their assessment of the steps that need to be taken, as clearly occurred in the *Marcus Clark* litigation.

How Much Disclosure is Necessary?

I have commented previously about problems arising where a director has a position of conflict and a duty to act with care and diligence. As I mentioned, I think that the Western Australian Supreme Court went too far in the *Permanent Building Society* case. What should Hamilton have done in that case? If he had a dominant personality how could he have dealt with the issues at a board meeting that he would have been asked to attend to explain the transaction to his co-directors? Perhaps we can find some guidance from the interesting South Australian Full Supreme Court decision in *Centofanti v Eekimitor Pty Ltd*.[105]

In this case the relevant director had a potential conflict which he disclosed to the board and the question arose as to what else he should have done or could have done in the context of an allegation that he was still gaining a benefit as a result of the relevant transactions that were involved. King CJ adopted a pragmatic and sensible approach. He noted:

> Having made proper disclosure to the [board of directors] was the plaintiff under any further fiduciary obligation? The nature and extent of any obligation remaining on an interested director after making disclosure, must depend upon the circumstances. If he votes, he must exercise his vote with due regard to his obligation to exercise his powers for the benefit of the Company. If he does not vote, the circumstances may be such that he can deal at arm's length with the Company, consulting his own interests and leaving to the other, apparently competent and fully informed directors, the assessment of any risks and the merits of the proposal from the standpoint of the Company. Where, however, the director conducts the day to day operations of the Company or is otherwise possessed with knowledge relevant to the decision, which his co-directors do not possess, he may not be free

101 *Gemstone Corporation of Australia Limited v Grasso* (1994) 12 ACLC 653.
102 (1992) 7 ACSR 481.
103 See, for example, *Re Cook* (1996) 20 ACSR 618. Many of these cases (but not Cook) are discussed in Chief Justice David Malcolm's chapter in this book.
104 Supra n 3.
105 Supra n 74.

> to act in that way but may be obligated to act in a way which protects the interests of the Company.[106]

Olsson J went even further in holding that the appellant director (Centofanti) was only under limited obligations:

> In my view the sole obligation of [Centofanti]...was to make proper disclosure of the nature and extent of his interest only to the Board and it seems to me that the evidence indicated that he in fact probably did so...[... It was not his obligation], at least in the particular circumstances of this case, to act as 'devil's advocate' to propound a need for alternative transactions to be explored by the board.[107]

Indeed, as Samuels JA noted in the important decision of *Woolworths Limited v Kelly*,[108] the requirement for disclosure by directors is "not to protect the company against bad bargains or the consequence of arrangements into which they enter as a result of the partisan interest of a director, but simply to ensure the honesty and integrity which should inform corporate dealings and, in particular, the internal management of the corporations is scrupulously observed."[109] Of course if the director finds that this is not possible, or tantamount to whistling in the wind, as observed by White J in *Hurley*,[110] the director may only have one real option – to resign; or in an extreme case report the matter to the ASC.

It is difficult to be conclusive on the strategy and steps that must be taken by a director in the position that Hamilton found himself in in the *Permanent Building Society* case. To impose the harsh standard that Ipp J imposed, in contrast to the approach adopted by Samuels JA and Olsson J in the *Kelly* and *Centofanti* cases respectively, is not an appropriate solution in my view. If the courts are not prepared to adopt a softer approach as suggested here then directors will need some form of immunity in those cases where, as with Hamilton, there is a dominant personality, and they pursue a course of conduct which may benefit themselves even though they have disclosed their conflict.

Do We Need a Restatement of the Duty of Care or Alternatively a Statutory Business Judgment Rule?

Corporate lawyers are usually the first port of call when a question arises in relation to some of the various issues under consideration in this chapter. The recent spate of litigation against directors, amongst others, no doubt has caused them to consider just what division or line can be drawn between the role of the executive and non-executive directors or directors and managers. Are the views put forward by Rogers CJ in the *AWA* case still valid? Have we moved so far away from this decision even though the bulk of his judgment was upheld by the New South Wales Court of Appeal? Furthermore, the New South Wales Court of Appeal has confirmed the proposition of Rogers CJ (and endorsed by the Full Court of the Western Australian Supreme Court in the *Permanent Building Society* case) that directors owe a duty of care at common law in addition to their equitable duty of care and diligence. This came as a great shock to all concerned but was

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106 Ibid at 317.
107 Ibid at 326.
108 (1991) 9 ACLC 539 at 556.
109 Ibid at 556, quoted by Olsson J in the *Centofanti* case, supra n 74 at 327.
110 See discussion of this case at n 80.

seen as a natural development pursuant to the changes in corporate law culture and of course the statutory provisions of the CL. As a result of the *AWA* appeal judgment is there also a duty of skill expected of directors? How far do we need to go in ensuring that delegation is recognised as an appropriate function of the actions by directors?

These have been important issues for directors for a number of years. To assist directors in determining just what was expected of them in 1992 the Federal Attorney-General proposed an amendment to the CL. Clause 232 (4AA) read:

> In determining whether or not an officer of a corporation has contravened subsection (4), regard must be had to such of the following as are relevant in the particular case:
>
> (a) what information the officer acquired, and what inquiries the officer made, about the corporation's affairs;
>
> (b) what meetings the officer attended;
>
> (c) how far the officer exercised an active discretion in the matters concerned;
>
> (d) what the officer did to ensure that the corporation made adequate arrangements:
>
> (i) to ensure that people who prepared reports, or gave advice or opinions, on which officers or employees of the corporation relied were honest, competent and reliable, and were in other respects such as to inspire confidence in their reports, advice or opinions; and
>
> (ii) to monitor and ensure compliance with the law, and with the corporation's constitution, by the corporation and its officers and employees; and
>
> (iii) to ensure that persons who took part in the corporation's management did whatever was necessary to avoid a conflict of their pecuniary or other interests with the proper performance and exercise of their functions and powers; and
>
> (iv) to ensure that decisions made by persons on the corporation's behalf were adequately monitored; and
>
> (v) to ensure that persons who made decisions on the corporation's behalf had adequate information about the subject matter of the decisions;
>
> (e) what the officer did to ensure that arrangements of the kind referred to in paragraph (d) were given effect to;
>
> and any other relevant matter.

As noted earlier in this chapter, the decision in *AWA* by Rogers CJ persuaded the Attorney-General that there was no need for this type of guidance or a statutory business judgment rule.[111] Perhaps the time has come for this to be re-assessed. Maybe there is a need to have inserted, at the least, a clause replicating the intent behind s 588H(3) of the CL which protects directors in the context of insolvent trading. This could be very useful. The Delaware Corporations Law in the USA provides for delegation in a very simple and clear statement as does the New Zealand Companies Act 1993. The New Zealand Act provides:

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111 See text at n 10.

> **130(1) [Power to delegate]** Subject to any restrictions in the constitution of the company, the board of a company may delegate to a committee of directors, a director or employee of the company, or any other person, any one or more of its powers other than its powers under any of the sections of this Act set out in the Second Schedule to this Act.
>
> **130(2) [Board's responsibility]** A board that delegates a power under subsection (1) of this section is responsible for the exercise of the power by the delegate as if the power had been exercised by the board, unless the board -
>
> (a) Believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise the power in conformity with the duties imposed on directors of the company by this Act and the company's constitution; and
>
> (b) Has monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.

There could be comfort gained by some directors from such a rule because, as explained earlier, some of the judgments may have gone too far in dealing with these matters – in particular I contrast the approach of the South Australian Full Supreme Court in *Centofanti* and the Western Australian Full Supreme Court in *Permanent Building Society.*

A Statutory Business Judgment Rule or a Strong "Forgiving" Clause

Would a statutory business judgment rule really help very much? As indicated earlier, this matter was addressed by the Attorney-General of the day, Michael Duffy, when the Corporate Law Reform Bill 1992 was being considered. At that time, the view of the Attorney-General was that a statutory business judgment rule was not needed. I have referred to the language of the Attorney General earlier in this chapter and it is unnecessary to repeat those words and his strong reliance on cases such as *Harlowe's Nominees Pty Ltd v Woodside*.[112] However, the Federal Government, as part of its Corporate Law Economic Reform Program, has now proposed the introduction of a statutory business judgment rule.[113]

One reason why we may not need to include a specific statutory business judgment rule (although I would have no objection to it being included if I was confident it would not "muddy the waters") is the fact that the courts already have the power, in appropriate cases, to relieve directors of liability: s 1318. This section gives a discretion to the court to relieve a director if the director has acted honestly and reasonably. Also s 1317JA is in similar terms but applies to the new statutory civil breaches of the CL. The fact that the relevant directors were unable to obtain relief in *Freidrich*,[114] or in the *AWA* first instance case (where Rogers CJ felt that the relevant director had not made the case for relief) should not be seen as a rejection of the possible use of these provisions.

More recently, in the *Marcus Clark*[115] case Perry J considered the application of a similar "relieving clause" in the context of the South Australian State Bank legislation.

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112 (1968) 121 CLR 483 at 493. See text at n 10.
113 Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance,* Paper No 3 (1997).
114 Supra n 3.
115 Supra n 13.

The terms of the South Australian legislation (s 29) are similar to s 1318 of the CL. Section 29 provides:

> (1) No liability attaches to a Director or other officer of the Bank for an act or omission done or made, in good faith, and in carrying out, or purporting to carry out, the duties of his office.
>
> (2) Any liability that would, but for subsection (1), attach to a Director or other officer of the Bank shall attach instead to the Bank.

The concept of good faith referred to in that section is not dissimilar to the language of "acting honestly and reasonably" in s 1318 of the CL. Perry J examined the way in which the expression "good faith" has been interpreted in various cases including the important Federal Court decision in *Mid Density Developments Pty Ltd v Rockdale Municipal Council*.[116] Perry J noted that the existence of a provision like s 29 was very useful – "one purpose sought to be achieved by [such a section] is to avoid persons of appropriate experience and ability being deterred from taking up positions with the [Bank], particularly as a director, by reason of any resultant exposure to a liability in circumstances when they have acted in good faith".[117]

Perry J would not be drawn on what good faith stood for "absolutely" – it was clear in his view that the reason for having a provision such as s 29 was similar to the reason for including s 1318 in the CL. He noted that this type of provision was a recognition by the legislature "that in certain circumstances an officer of a company...may be guilty of negligence, breach of trust or other breach of duty which, having regard to the circumstances, ought to be excused". Whilst he did not believe that interpreting the CL provision would help him in any special way in interpreting s 29, as noted earlier, he felt that such a provision did operate to achieve the same general purpose – to provide some comfort to directors who have acted reasonably or in this case in good faith. In any event, he felt that in the circumstances of the case before him Marcus Clark had not satisfied the onus under the provision. He added:

> I am of the view that irrespective of what other circumstances may give rise to a situation in which a director can no longer claim the benefit of a protection otherwise afforded by section 29, a director who, as I have held, is in breach of his or her fiduciary relationship to the bank by deliberately failing to make the disclosures which I found it was incumbent upon Mr Marcus Clark to make, and in taking part in the decision of the [board] with respect to the transaction, could not be said to be acting in 'good faith' in the meaning of the section.[118]

In other words, whilst Perry J was not prepared to state that the absence of good faith was equivalent to gross negligence, that was, in effect the thrust of his remarks (although he may have found that a lower threshhold might also apply). In his view, Marcus Clark had not made a genuine attempt to discharge his obligations as a director. This did not mean that he necessarily acted "dishonestly". But Perry J felt that having regard to his background and experience, and the fact that an independent valuation of the shares in Oceanic was essential, it was surprising that Marcus Clark did not undertake such a valuation.

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116 (1993) 116 ALR 460.
117 Supra n 13 at 643.
118 Ibid at 641.

I have put forward these further observations about the *Marcus Clark* case to illustrate the point that the courts will not lightly apply a provision such as s 29 of the South Australian legislation, or of course s 1318 of the CL. However, the court does have the discretion to do so in appropriate circumstances. If that is the case, why do we need a further statutory guideline?

Perhaps the answer lies in language of the provisions that are relevant. Some are arguing that a section somewhat along the lines of the Delaware Corporations Law s 102(b)(7) should be inserted into the CL. Companies in Delaware can limit the personal liability of directors but are limited by the terms of s 102(b)(7) which provides that a company's constitution may contain:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director provided that such provision shall not eliminate or limit the liability of the director:
>
> (1) for any breach of the director's duty of loyalty to the corporation or its stockholders;
>
> (2) for acts or omissions not in good faith or which involve intentional misconduct of a knowing violation of law; or
>
> (3) for any transaction from which the director derived an improper personal benefit.
>
> No such provision shall eliminate or limit the liability of the director for any act or omission occurring prior to the date when such provision become effective.

Such a provision is of course quite different to one which depends on the exercise of a particular discretion by a judge. It is "self fulfilling" in that the board of a company and its shareholders will be the "assessor" of liability of directors. I suspect that many directors would want something a little more authoritative in addition to this. Perhaps they would like a section in the CL along these lines:[119]

> A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
>
> (1) is not interested in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.

or a section along the lines of that proposed as part of the Federal Government's Corporate Law Economic Reform Program:[120]

> (1) An officer of a corporation is taken to meet the requirements of sub- section 232(4) and the general law duty of care and diligence in respect of a business judgment made by them if the officer:
>
> (a) exercises their business judgment in good faith for a proper purpose;
>
> (b) does not have a material personal interest in the subject-matter of the business judgment;
>
> (c) informs themselves about the subject-matter of the business judgment to the extent the officer reasonably believes to be appropriate; and

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119 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994), s 4.01(c).
120 Supra n 113 at 28.

(d) rationally believes that the business judgment is in the best interests of the corporation.

(2) In this section "business judgment" includes any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation.

(3) Sub-section (1) does not operate in relation to any other provision of this Law or any other Act or any Regulation under which an officer may be liable to make payment in relation to any of their acts or omissions as an officer.

The existence of such provisions would arguably make directors more comfortable in approaching their tasks. I would have no difficulty, in principle, in including such provisions in our law. The danger of course always lies in the fact that the courts will see these as new provisions and may interpret them in a way that may turn out to be quite strange. It is not unusual for hiccups of this kind to occur.

Maybe all we need, as noted earlier, is statutory recognition of the right to delegate together with clear guidelines on reliance, such as that contained in s 138 of the New Zealand Companies Act 1993. This section provides:

138(1) [Power to rely on certain persons] Subject to subsection (2) of this section, a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:

(a) An employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;

(b) A professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence;

(c) Any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.

138(2) [Good faith, etc] Subsection (1) of this section applies to a director only if the director:

(a) Acts in good faith; and

(b) Makes proper inquiry where the need for inquiry is indicated by the circumstances; and

(c) Has no knowledge that such reliance is unwarranted.

Some directors want a more revolutionary approach. They want to see a removal of the personal liability of directors for breaches of a range of statutes such as the Trade Practices Act, Occupational Health and Safety legislation, the Environment Protection Act and similar legislation. To adopt this approach would, in effect, be to turn upside down a number of provisions which have been part of our law for a number of years. Furthermore, this approach would signal a reversal of trends which Australia has adopted in line with its obligations under a number of International Treaties. I do not believe such a move has much political, let alone legal, support.

The price we pay for introducing regular changes to our law is that the courts are continually being asked to reflect on these in the context of a well understood set of principles that have been generally adopted and applied with consistency by the courts over a number of years. That is a price that may be worth paying if the pendulum is "judged" to have swung too far!

Chapter 8

Directors' Statutory Duties of Honesty and Propriety

Michael J Whincop*

Introduction

Section 232 of the Corporations Law states four duties to which corporate officers are subject. Section 232(4), the duty of care, is not a central focus of this chapter, but overlaps with the subject matter of the other duties in an important respect and is discussed below.[1] The other duties of honesty and propriety, contained in s 232(2), (5) and (6) are superimposed on a background where directors and senior corporate officers owe duties that are fiduciary in character. The view is often expressed that these statutory duties have the same content as fiduciary duties.[2] The premise of this chapter is that this uncritical assimilation of the statutory duties with fiduciary doctrine is the source of problematic legal and policy issues.[3] The source of problems is that unlike fiduciary duties, the statutory duties perform "triple" duty. First, the duties are the basis of criminal penalties. Second, the duties are the basis of civil penalties. While there are additional requirements for the criminal penalty, a necessary element of both penalties is a breach of the (same) statutory duty.[4] Third, they confer on the corporation a cause of action against the officer contravening the section. Fiduciary duties, by contrast, serve only the third purpose.

While such drafting might satisfy one's preference for economy in a particularly prolix statute, it creates a difficulty. The High Court has indicated that where a statute provides that breach of its provisions is an occasion both for a penalty and a remedy, that

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* Lecturer, Faculty of Law, Griffith University. I wish to thank Sharon Erbacher for helpful comments, and Thomas Kennedy and Lucille Scomazzon for research assistance. This chapter is an updated revision of my article, "Developments in Directors' Statutory Duties of Honesty and Propriety" (1996) 14 *Company and Securities Law Journal* 157. It appears by kind permission of LBC Information Services.

1 See text accompanying nn 150-168.

2 See, for example, *Cummings v Claremont Petroleum NL* (1993) 11 ACLC 125 at 135; R P Austin, "Fiduciary Accountability for Business Opportunities in P D Finn (ed), *Equity and Commercial Relationships* (1987) at 159.

3 This chapter deals primarily with the legal issues; issues of policy are addressed in other works of the author: M J Whincop, "An Economic Analysis of the Criminalisation and Content of Directors' Duties" (1996) 24 *Australian Business Law Review* 273; M J Whincop and M E Keyes, "Corporation, Contract, Community: An Analysis of Governance in the Privatisation of Public Enterprise and the Publicisation of Private Corporate Law" (1997) 25 *Federal Law Review* 51.

4 While the civil penalty provisions "decriminalized" directors' duties, their major effect was to place the officer in a position where it was easier, because of the lower standard of proof, for him or her to become subject to a penalty. The civil penalty varies from the criminal penalty only to the extent that imprisonment cannot be ordered and the banning of the officer from managing a corporation is discretionary rather than mandatory. Maximum fines are identical. In short, it became much easier to become subject to a penalty which only differs marginally in severity: J H Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 *Corporate and Business Law Journal* 1 at 26.

provision must be interpreted consistently in both types of case.[5] Two issues arise. First, a single interpretation of each provision must be chosen for their triple penal-criminal-remedial application. Second, do the linguistic and contextual similarities between the fiduciary and the statutory duties, and the fact that both forms of duty confer a cause of action on the corporation against the guilty officer, make it desirable that the chosen interpretation replicates the content of the fiduciary duties?

One of the problems with applying the fiduciary principle to directors is that the significance of honest intentions varies. As Carroll demonstrates,[6] the director's apprehension of what is in the best interests of the corporation sometimes is dispositive,[7] sometimes not.[8] There is an apparent tendency for differentiation to relate to the aspect of the fiduciary duty under consideration. Thus, the conflict rule seems to assess objectively whether a real, sensible possibility of conflict exists.[9] However, courts considering the obligation to act for proper purposes frequently consider directors' (reasonable) opinions of what is necessary in the management of the corporation.[10] Equal difficulty is caused by the traditional disregard in Anglo-Australian law of the results or substance of a transaction alleged to breach fiduciary duty – its fairness and favourability have never been material issues.

Therefore, if one interprets the statutory duties in a way that gives them the same content as fiduciary duties, we must accept the irrelevance of result and the variable quality of subjective intention. It is trite to point out that harm and intention are basic concepts in criminal and penal law. A further consequence is one of remedial redundance, given that fiduciary duties already provide for flexible compensation and restitution in almost as many cases as the statutory duties would (if analogously interpreted).[11]

This chapter critically examines the judicial exegeses of the duties of honesty and propriety. By examining both duties, it is possible to contrast their different development. The chapter focuses on how courts have relied on the fiduciary principle to give content to these statutory duties and the analytical problems that have arisen. The analysis presented in this chapter demonstrates that recent interpretations of "impropriety", in

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5 *Waugh v Kippen* (1986) 160 CLR 156.

6 R Carroll, "The Test of Honesty in Civil Proceedings under s 232(2) Corporations Law" (1995) 5 *Australian Journal of Corporate Law* 214 at 221-228.

7 See, for example, *Re Smith and Fawcett Ltd* [1942] Ch 304.

8 See, for example, *Advance Bank of Australia v FAI* (1987) 12 ACLR 118.

9 A*berdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 473.

10 *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 137.

11 There are two exceptions. First, statutory duties apply to officers, and s 232(5) and (6) also apply to employees, which may be wider in extent than persons subject to fiduciary duties: however cf *Green v Bestobell Industries Pty Ltd* (1982) 1 ACLC 1. However, in most cases, the ability to inflict serious loss on the company will make a fiduciary relationship more likely to be implied ex post. Second, breach of the statutory duties has long been thought to allow a shareholder to enjoin the conduct under s 1324, avoiding the consequences of the rule in *Foss v Harbottle*: R Baxt, "Will Section 574 of the Companies Code Please Stand Up (And will Section 1324 of the Corporations Act Follow Suit" (1989) 7 *Company and Securities Law Journal* 388. Cf J Kluver, "Derivative Actions and the Rule in Foss v Harbottle: Do We Need a Statutory Remedy?" (1993) 11 *Company and Securities Law Journal* 7 at 11-12; I Ramsay, "Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action" (1992) 15 *University of New South Wales Law Journal* 149 at 150. However, the decision of Young J in *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 19 ACSR 483 seems to set that difference at naught. The decision has been criticised as incorrect: H Bird, "A Spanner in the Works: The Impact of Mesenberg v Cord Industrial Recruiters Pty Ltd on Enforcement Rights under the Corporations Law" (1997) 25 *Australian Business Law Review* 129. In *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 15 ACLC 715, Einfeld J of the Federal Court disagreed with the judgment in *Mesenberg*..

particular the recent High Court decision in *R v Byrnes,*[12] are seriously problematic. I also argue that a focus on the abuse of a fiduciary office, which involves some substantive detriment to the interests of shareholders is preferable as a test of impropriety, and as a complement to the accepted interpretation of s 232(2).

The Duty of Honesty

Section 232(2) provides that "An officer of a corporation shall at all times act honestly in the exercise of his or her powers and the discharge of the duties of his or her office." The duty of honesty first appeared in s 107 of the Companies Act 1958 (Victoria) and afterwards, in s 124 of the so-called uniform companies legislation. Unlike the duties of propriety, s 232(2) does not require any express connection between the dishonest behaviour and the gaining of advantage or the causing of detriment.[13] Section 232(2) applies only to officers, not also to employees.

The most significant issue that the section raises is the meaning of acting "honestly", the subject of judicial and scholarly commentary.[14] The analysis here will be confined to points that form important contrasts to the duties of propriety. *Marchesi v Barnes*[15] is frequently cited as an authoritative analysis of what acting honestly means. Gowans J said that the section would be contravened if a director deliberately acts in a way that he or she knew was not in the interests of the corporation.[16] This interpretation involves a subjective understanding by the officer that he or she is in breach of fiduciary duty.

The South Australian Supreme Court has at times advocated a different approach. Although in *Morgan v Flavel*[17] *Marchesi v Barnes* was applied, in *Australian Growth Resources Corporation Pty Ltd v van Reesema*[18] a different principle was advocated. King CJ, with whom Cox J concurred, held that the section could be violated even though a director was acting honestly "by his own lights".[19] It sufficed that the director exercised a power for an improper purpose.[20] Of course, this would also breach the director's fiduciary duty. It is not clear from the judgment whether action inconsistent with other fiduciary prohibitions, such as a conflict with a personal interest, would also violate the statutory duty. Johnston J dissented from the principle that fiduciary breach was coextensive with a breach of the duty of honesty.[21]

Van Reesema's case was considered in *Residues Treatment & Trading Co Ltd v Southern Resources Ltd (No 2)*.[22] It was alleged there that a board decision to make a takeover bid was for an improper purpose and was not in the best interests of the corpo-

12 (1995) 17 ACSR 551.
13 Such a connection is relevant to penalty – see text accompanying nn 34-39 infra.
14 See Carroll, supra n 6; B Fisse, "The Criminal Liability of Directors: Honesty and Dishonesty in Law and Corporate Law Reform" (1992) *Journal of Banking and Finance Law and Practice* 151; V Mitchell, "The Concept of Honesty under Section 232(2) of the Corporations Law" (1994) 12 *Company and Securities Law Journal* 231.
15 [1970] VR 434.
16 Ibid at 438.
17 (1983) 1 ACLC 831.
18 (1988) 6 ACLC 529 (hereafter "*van Reesema's* case").
19 Ibid at 539. This approach is objective, although perhaps not entirely so: see ibid at 537 and text accompanying n 10 supra.
20 Ibid. Fisse (supra n 14 at 157) and Carroll (supra n 6 at 223) endorse this test for civil remedies but Fisse criticises it as a test for penalties.
21 (1988) 6 ACLC 529 at 541.
22 (1989) 7 ACLC 1130.

ration. This conduct was alleged to breach fiduciary duties, and provisions equivalent to s 232(2) and (6).[23] While bound to follow it, Perry J criticised the principle in *van Reesema's* case equating the statutory duty of honesty with fiduciary duty. The statute did not include the phrase conventionally used to express fiduciary duties, "in the interests of the company as a whole".[24] When a court considers an allegation of fiduciary breach, it is possible for breach to be established even though a director acted honestly.[25] Perry J expressed difficulty in seeing how an officer, admittedly in breach of fiduciary duty, could contravene the formula used by s 232(2) when acting honestly.[26]

On appeal,[27] Jacobs ACJ, Prior and Mullighan JJ also regarded *van Reesema's* case as binding but considered its principles to be too widely stated. A fiduciary duty could be breached without dishonesty.[28] The court upheld the convictions of two directors for their failure to disclose a benefit that they must have been conscious they would receive. There was a clear conflict of interest, which "[e]quity cannot regard...as acting honestly'.[29] This recourse to fiduciary duty is surprising given the court criticised the reliance on fiduciary duties in *van Reesema's* case. The difference presumably lies in the fact the directors were consciously conferring a benefit on themselves.

In a matter under the Companies Code,[30] von Doussa J applied *van Reesema's* case.[31] However, the case would easily have been caught by the rule in *Marchesi v Barnes* given the finding that the directors entered into transactions knowing that they would defraud their corporation.[32] Other courts have affirmed *Marchesi v Barmes*.[33] The balance of authority seems to favour it.

Since February 1993, breach of s 232(2) contravenes a civil penalty provision.[34] An officer commits an offence if the provision is contravened:

> (a) knowingly, intentionally or recklessly; and
>
> (b) either:
>
> > (i) dishonestly and intending to gain, whether directly or indirectly, an advantage for [the officer] or any other person; or
> >
> > (ii) intending to deceive or defraud someone.[35]

Ignoring the different onus of proof that applies to civil penalty orders, it is difficult to envisage how s 232(2) could be breached without these circumstances of aggravation being present. The requirement in s 1317FA(1)(a) of a "knowing" contravention will

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23 The analysis of s 232(6) is discussed in text accompanying nn 94-96 infra.
24 (1989) 7 ACLC 1130 at 1152.
25 *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n was cited as an example (ibid at 1147).
26 (1989) 7 ACLC 1130 at 1152.
27 (1990) 8 ACLC 1151.
28 Ibid at 1167-1168. The court did not agree with *Marchesi v Barnes*, either. Fisse (supra n 14 at 155) suggests that these doubts of both lines of authority might imply the advocacy of a middle way: a "reckless" act in disregard of the company's interests would breach the section.
29 Ibid at 1168.
30 *Beach Petroleum NL v Johnson* (1993) 11 ACSR 103.
31 Ibid at 108.
32 Ibid.
33 *Flavel v Roget* (1990) 8 ACLC 237 at 247; *Corporate Affairs Commission v Papoulias* (1990) 8 ACLC 849 at 851; *Feil v Corporate Affairs Commission* (1991) 9 ACLC 811 at 817. See also *Chew v R* (1992) 10 ACLC 816 at 825, per Dawson J.
34 Section 1317DA
35 Section 1317FA(1).

probably be established because dishonesty, according to the interpretation in *Marchesi v Barnes*, means that the director *knows* that the action is not in the corporation's best interests. The requirement of dishonesty is s 1317FA(1)(a)(i) must necessarily be established by a breach of a duty of honesty.[36] Only the requirement that the officer intended to gain an advantage for herself or some other person seems not to be a de facto element of the basic contravention. However, if the officer is rational and consciously acts otherwise than in the interests of the corporation, it seems reasonable to predict that the officer will be acting either in self interest or somebody else's interests.[37] This is implicit in the notion of there being a conflict of interests or duties. If so, it will be a short step to find that the officer acted intending to gain an advantage for herself or another person. Of the cases cited that applied *Marchesi v Barnes*, and held s232(2) to be contravened,[38] all exhibit the "criminal" circumstances of aggravation. For instance, in *Morgan v Flavel*,[39] the director acted to gain an advantage for himself.

While few breaches of s 232(2) will support only a civil penalty when applying the *Marchesi* test, the civil penalty regime is useful to the prosecutor, because the elements of the contravention only have to be proved on balance of probabilities.[40] Also, one of the purposes of the civil penalty regime was to partially decriminalise directors' duties.[41] The prosecuting authority can opt to bring civil or criminal proceedings so as to invoke the sanctions it considers to be appropriate to the impugned conduct. Finally, acting in a way the officer knows not to be in the interests of the corporation can uncontroversially be stated to be a serious wrong to the shareholders, which justifies a criminal penalty.

The Duty of Propriety of Use of Corporate Information

Section 232(5) provides that:

> "An officer or employee of a corporation, or a former officer or employee of a corporation, must not...make improper use of information acquired by virtue of his or her position as such an officer or employee to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation."

Section 232(6) prohibits an officer or employee making "improper use of his or her position as such an officer or employee" and is otherwise in similar terms to s 232(5).

The duties of propriety in s 232(5) and (6) naturally have much in common. Both depend on conduct that is "improper", a word that according to the High Court is indefinite in content and not commonly used in criminal law.[42] The term has moralistic and conclusive overtones rather than substantive ones. Both duties require a connection between the conduct and the gaining of some advantage or the infliction of some detriment to the corporation.[43] Arguably, improper use of information is a specific type of

36 Cf Perry J in *Residues Treatment & Trading Company Ltd v Southern Resources Ltd (No 2)* (1989) 7 ACLC 1130 at 1152, see text accompanying n 24 supra. See also Mitchell, supra n 14 at 232-233. Fisse has suggested, but doubted that the word may differ in its meaning here: supra n 14 at 155.

37 Cf Fisse, supra n 14 at 157. See text accompanying n 92 infra.

38 *Morgan v Flavel* (1983) 1 ACLC 831: *Feil v Corporate Affairs Commission* (1991) 9 ACLC 811: *Marson Pty Ltd v Pressbank Pty Ltd* (1987) 12 ACLR 465.

39 (1983) 1 ACLC 831.

40 Corporations Law, s 1332.

41 Corporate Law Reform Bill 1992 – Explanatory Memorandum, para 114. Cf n 4 supra.

42 *R v Byrnes* (1995) 17 ACSR 551 at 559.

43 See text accompanying nn 80-86 infra.

improper use of position.[44] This would hold if "improper use of information acquired by virtue of [the officer's] position" constitutes improper use of the position. Thus, a person who acquires information by virtue of position and puts it to an improper use may also be improperly using his or her position. The existence of separate duties may be inconsistent with this reasoning.

On the other hand, s 232(5) seems to be directed to various types of insider trading conduct.[45] Thus, the difficult policy issues associated with insider trading apply to it.[46]How does one reconcile s 232(5) with the prohibitions of insider trading in s 1002G of Pt 7.11 Div 2A?[47] First, s 232(5) is not restricted to particular uses of information, such as dealing in securities,[48] provided the use is improper. Second, s 1002G generally makes the source of the information irrelevant, whereas s 232(5) is predicated on the information being acquired by virtue of position. It may also follow that an officer who makes use of information that the insider trading provisions would regard as "generally available",[49] and therefore fair game for trading, may still be subject to s 232(5). Third, the cause of action under s 232(5) is only conferred on the corporation, whereas any person suffering loss as a result of conduct contravening s 1002G can sue in respect of it,[50]sometimes with the assistance of loss-deeming provisions.[51] Finally, the normative aspects of impropriety are irrelevant to Pt 7.11 Div 2A.

Es-me Pty Ltd v Parker[52] was the first reported case to consider the information within the scope of the section. In that case, the defendant was employed as an engineer by a corporation that designed electrical systems. He later became a director. During negotiations with a client, the defendant was asked to act as a consulting engineer in a private capacity. Burt J considered that information comes within the section without being secret, provided it is confidential.[53] Use of confidential information by the director would therefore breach the director's fiduciary duty and the statutory duty. The information in this case was held not to be of this character, being acquired by the defendant in his capacity as an employee, not as a director. At the time, the duty did not cover employees.[54] This approach emphasises a nexus between the information that comes within the section and fiduciary breach.[55] Subsequent cases developed a nexus between "improper use" and fiduciary breach.

Some of the cases considering the application of s 232(5) involved officers taking action for personal benefit after learning of some action to be taken by, or some fate to

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44 Cf *Southern Resources Ltd v Residues Treatment & Trading Company Ltd* (1990) 8 ACLC 1151 at 1168-1169.
45 In *Keygrowth Ltd v Mitchell* (1991) 9 ACLC 260, both s 232(5) and insider trading provisions were contravened.
46 In *Southern Resources Ltd v Residues Treatment & Trading Company Ltd* (1990) 8 ACLC 1151 at 1168, the court said that insider trading was the typical case to which s 232(6) applied.
47 For an attempt to reconcile the two provisions, see *Rosetex Co Pty Ltd v Licata* (1994) 12 ACSR 779 at 784, discussed in text accompanying nn 68-69 infra.
48 Cf s 1002G(2) and (3).
49 Section 1002B.
50 Section 1005.
51 Section 1013.
52 (1971-1973) CLC ¶40-038.
53 Ibid at 27,310.
54 Note, "The Duties and Liabilities Imposed on Officers of Corporations: Reasonable Degree of Care and Diligence; Improper Use of Information; Improper Use of Position" (1983) 13 *Queensland Law Society Journal* 260 at 262, argues that the conduct would be caught by the present s 232(5).
55 (1971-1973) CLC ¶40-038 at 27,310.

befall, the corporation, which would cause harm to them. In *Waldron v Green,*[56] a director sold shares in which he was interested after learning of adverse insider information. The action failed for insufficient evidence establishing that the sale was motivated by the information. The decision has been criticised.[57]

In *Grove v Flavel,*[58] a director became aware that his corporation had serious solvency problems. The corporation owed debts to him and entities in which he was interested. He arranged for these to be reduced by an arrangement that, in effect, set off moneys owed to the corporation by entities in which he was interested. The director was alleged to contravene the equivalent of s 232(5). In a frequently cited dictum,[59] the court held that impropriety is not referable to an inflexible standard but depends on the existence of conduct inconsistent with the proper discharge of the officer's duties.[60] A director acts improperly if he acquires information that causes him to believe that his corporation faces a real risk of liquidation, and acts to protect himself from those consequences. The impropriety in this case derived from the fact that the director's action disposed of assets (ie, debts owed to the corporation), which would otherwise belong to the fund available to all creditors. In reaching this conclusion, the court relied on authorities concerning the duties of directors of insolvent corporations.[61]

In *McNamara v Flavel*[62] and *Castrisios v McManus,*[63] directors learnt of financial problems in their corporations and diverted resources from the corporations for their personal benefit. Such action harms the corporation's creditors, whose interests the courts require directors to consider when the corporation has solvency problems.[64] In each case, the conclusion that the information was used improperly seems to rely on the benefit to the director and detriment to the corporation and its creditors as much as on breach of directors' duties.[65]

In *McNamara v Flavel*, Millhouse J disagreed with the decision in *Es-me Pty Ltd v Parker*[66] that information needed to be confidential. The important issue is how the information is acquired.[67] The problem may be illusory. Even if information acquired by virtue of position is not confidential, its use could probably be prosecuted under s 232(6). Identical issues appear to arise.

In *Rosetex Co Pty Ltd v Licata,*[68] the information did not comprise the revelation of facts at a discrete point in time. Instead, it comprised knowledge of customers, with

56 (1977-1978) CLC ¶40-381.
57 R Tomasic and S Bottomley, *Corporations Law in Australia* (1995) at 366; R Tomasic and S Bottomley, "Corporate Crime: Making the Law More Credible" (1990) 8 *Company and Securities Law Journal* 369 at 373.
58 (1986) 4 ACLC 654.
59 *McNamara v Flavel* (1988) 6 ACLC 802 at 807; *Jeffree v NCSC* (1989) 7 ACLC 556 at 564- 565; *Southern Resources Ltd v Residues Treatment & Trading Company Ltd* (1990) 8 ACLC 1151 at 1168; *Castrisios v McManus* (1990) 9 ACLC 287 at 293-294; *Chew v R* (1992) 10 ACLC 816 at 823, 827; *R v Yuill* (1994) 15 ACSR 95 at 108; *ASC v Matthews* (1995) 16 ACSR 313 at 317; *R v Byrnes* (1995) 17 ACSR 551 at 560.
60 (1986) 4 ACLC 654 at 659.
61 *Walker v Wimborne* (1975-1976) 137 CLR 1; *Nicholson v Permakraft (NZ) Ltd (in liq)* (1985) 3 ACLC 453; *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 ACLC 215.
62 (1988) 6 ACLC 802.
63 (1990) 9 ACLC 287.
64 See cases in n 61 supra. Cf *Sycotex Pty Ltd v Baseler* (1994) 13 ACSR 766.
65 *McNamara v Flavel* (1988) 6 ACLC 802 at 806-807; *Castrisios v McManus* (1990) 9 ACLC 287 at 294.
66 (1971-1973) CLC ¶40-038. See text accompanying nn 52-55 supra.
67 (1988) 6 ACLC 802 at 807.
68 (1994) 12 ACSR 779.

whom the defendant, the controlling director, had dealt on the corporation's behalf. Second, at the time the information was alleged to have been used, the corporation had entered receivership and had ceased to trade. It was not suggested that the defendant engineered this situation to enable him to use the information. This contrasts with the above cases where the information was used before it became generally known, in order to protect the director's interests. Third, the corporation did not allege any loss caused by the use of the information. This was unlike the "bad news" cases[69] where there was a benefit to the director, mirrored by a loss to the corporation's contracting constituencies. The director had used the information to assist the marketing operations of a business similar to the corporation's that was being carried on by his son. The director had no financial interest in the corporation, and received no benefits from it.

Young J cited the judgment of Cohen J in *Lord Corporation Pty Ltd v Green*[70] to establish that a director's fiduciary duties are coextensive with ability to exercise the powers and discretions of office. Thus, when powers can no longer be exercised, the fiduciary duty ceases. However, Cohen J recognised that even in these cases, a director is not at liberty to take advantage of information acquired during the subsistence of her authority.[71] Young J considered that a director will be restrained by s 232(5) from making improper use of information where equity would restrain its use for personal profit,[72] that is, where the information is confidential, or protected by contract.[73] That was not the case, here.

Young J rejected the expansive approach of Millhouse J in *McNamara v Flavel*,[74] because of the prohibitions on insider trading in s 1002G.[75] He considered that the prohibition of communicating information in that section implies a narrower interpretation of s 232(5). While reconciliation of these provisions is an important (but rarely attempted) task, his Honour's approach has a glaring fault. Section 1002G(3), which prohibits the communication of "insider" information, only applies to information relevant to the price of securities traded on a stock market. Clearly, this provision did not apply because the corporation was a proprietary corporation.

Young J's interpretation of the word, "improper" is ambiguous:

> '[I]nformation' in s 232(5) means the sort of information which equity would protect by injunction if a director used it in breach of his fiduciary duties. "Improper" use of that information is in much the same plight as a breach of fiduciary duty under the general law. It follows that as there is not here any breach of fiduciary duty in the current circumstances there is no infringement of s 232(5).[76]

His Honour may be indicating that fiduciary breach is generally dispositive of impropriety. Alternatively, his Honour may mean that where equity would restrain a director's use of information, s 232(5) will be contravened per se, thus establishing impropriety. That would leave open the question whether a fiduciary breach involving use of infor-

69 *Grove v Flavel* (1986) 4 ACLC 654; *McNamara v Flavel* (1988) 6 ACLC 802; *Castrisios vMcManus* (1990) 9 ACLC 287.
70 (1991) 9 ACLC 1094.
71 Ibid at 1104.
72 (1994) 12 ACSR 779 at 784.
73 *Wright v Gasweld Pty Ltd* (1991) 22 NSWLR 317.
74 See text accompanying nn 66 and 67 supra.
75 (1994) 12 ACSR 779 at 784.
76 Ibid.

mation is equivalent to improper use. It is regrettable that Young J did not deal with the issue at greater length.

These cases demonstrate the breadth of s 232(5)'s application. It has been applied to straightforward insider trades[77] and self-interested disposals of corporate assets.[78] It is easy enough to regard these uses as improper without the need for searching legal analysis of what "impropriety" means. In cases like *Rosetex Co Pty Ltd v Licata*,[79] the outcome of applying the section is less clear. Is "improper" to be interpreted as meaning a mere breach of fiduciary duty, the existence of conduct that is objectively harmful to the corporation, or the existence of conduct from the pursuit of which the officer profits? Cases where impropriety was established under s 232(5) do not specially endorse any of these approaches. On the other hand, the meaning of impropriety has been clarified in cases under s 232(6), to which we now turn.

The Duty of Propriety of Use of Position

The proscribed intentions

We have seen that s 232(6) prohibits an officer or employee of a corporation from making improper use of his or her position as such an officer or employee. In addition, s 232(6) – and also s 232(5) – are not contravened unless the position or information is used "to gain, directly or indirectly, an advantage for himself or herself or for any other person or to cause detriment to the corporation."

This requirement was considered by the High Court in *Edwards v R*[80] and *Chew v R*.[81] In the court below in *Chew's* case,[82] various interpretations were considered. A majority favoured the requirement that the advantage be gained (etc) in fact.[83] In the High Court, a majority supported the view that the officer must make improper use of his or her position *for the purpose* of gaining an advantage or causing a detriment.[84] A consequence of this approach is that when the conduct that constitutes improper use occurs, and the necessary intention is present, the contravention is complete. It is unnecessary to prove that the advantage was gained or the detriment was caused.[85] The High Court considered that this approach should also be taken to s 232(5).[86]

Some problems with this purposive requirement remain. What does it mean to "gain an advantage" for oneself? This phrase was strangely interpreted in *R v Donald*.[87] The court thought that a director who procured payment to a corporation in which he was

77 See, for example, *Keygrowth Ltd v Mitchell* (1991) 9 ACLC 260. To make this statement, *Waldron v Green* must be regarded as the result of a unique set of facts.

78 See, for example, *Grove v Flavel* (1986) 4 ACLC 654; *McNamara v Flavel* (1988) 6 ACLC 802; *Castrisios v McManus* (1990) 9 ACLC 287.

79 (1994) 12 ACSR 779.

80 (1992) 10 ACLC 859.

81 (1992) 10 ACLC 816.

82 (1991) 5 ACSR 473.

83 Ibid at 507 (Malcolm CJ), 562-564 (Murray J).

84 *Chew v R* (1992) 10 ACLC 816 at 819 (Mason CJ, Brennan, Gaudron and McHugh JJ), 823 (Dawson J); applied in *Edwards v R* (1992) 10 ACLC 859 at 861 (Mason CJ, Brennan, Gaudron and McHugh JJ), 863 (Dawson J).

85 Deane J also favoured the purposive approach but considered the section was not contravened unless in addition the advantage had been gained or the detriment caused: ibid at 822.

86 *Chew v R* (1992) 10 ACLC 816 at 818.

87 (1993) 11 ACLC 712.

interested for services performed under contract, intended to gain an advantage for himself. The apparent logic is that it is an advantage for a corporation to be paid what it is entitled to by contract. This is because if the corporation was not paid, it would sustain a loss, and avoidance of a loss is an advantage.[88] This approach is unacceptably circular – it compares what *has occurred* to a hypothetical situation that *never occurred,* so to conclude that the occurrence was an advantage because it did occur. It comes perilously close to tautology by saying that an event is an advantage because the non-occurrence of the event would not be an advantage.

While the purpose of the duties of propriety is an open question, it seems reasonable to suggest that the section seeks to deter officers from abusing their office. Such conduct involves the director seeking an advantage for herself, by making use of her office, at a direct or an opportunity cost to the corporation. This implies that determining the existence of an advantage involves comparison not between the real and the hypothetical, but between the state before the occurrence of the event impugned as improper and the state after that event. If the officer is enriched after and as a result of the event, and the event involves use of the officer's position, then the officer has used his position to gain an advantage. In *Donald's* case, was it an advantage to be paid? It was an advantage, first, because some payments were for services that were never rendered; second, because some of the payments were for sub-contracting services the other "partner" shareholders indicated they would never have sought.[89] In cases for other payments, the existence of advantage must be gauged by comparing the market value of the service rendered with the amount paid: the mere existence of a conflicting transaction does not determine the existence of advantage *a priori*.

A further problem is what "caus[ing] a detriment to the corporation" means. This invokes a familiar problem: who or what is the corporation? Is it the commercial entity, a hypothetical shareholder, shareholders as a collective body or something with a wider "communitarian" embrace? While legal scholars still pore over this question a century after it was first considered in *Salomon v Salomon & Co Ltd*,[90] the answer to it may determine whether the proscribed intention exists. Consider two cases. First, consider a "redistributive" action, that is one which benefits some and disadvantages other shareholders, but that, overall, neither increases nor decreases the value of the corporation.[91] The corporation-as-commercial-entity test would not trigger the proscribed intentions; the other tests might.

Second, a transaction might involve the dissolution of the corporation and transfer of its business to a new corporation to qualify for concessions under an Act. The corporation- as-commercial-entity test might trigger the proscribed intentions; the others probably would not. Some may object that in any event, the alternative "advantage to the officer" intention may be triggered. This, however, is not the easy solution it appears.

88 Ibid at 715.

89 (1993) 11 ACLC 712 at 714.

90 [1897] AC 22.

91 Elsewhere, I have analysed redistributive cases, such as *Peters' American Delicacy Ltd v Heath* (1939) 61 CLR 457, and argued that the test usually applied to alterations of articles – is the alteration bona fide in the interests of the company as a whole – cannot apply in these cases: M J Whincop, "*Gambotto v WCP Ltd*: An Economic Analysis of Alterations to Articles and Expropriation Articles" (1995) 23 *Australian Business Law Review* 276 at 283-284.

Several scholars have commented that very few transactions are not motivated (at least in part) by the officer's advantage.[92] The problem is to identify cases where the advantage the officer seeks is genuinely "improper". This demonstrates the inescapable nexus between the meaning of "improper" and the proscribed intentions.

The meaning of "improper"

It has been shown how fiduciary duties were used to develop principles concerning the information, and manner of use, to which s 232(5) is directed. Other aspects of the fiduciary duty have been analysed in s 232(6) cases. A literal connection can be made between the impropriety of a purpose which renders a decision invalid in equity and the impropriety that contravenes s 232(6).[93]

At first, this approach was resisted. In *Southern Resources Ltd v Residues Treatment & Trading Co Ltd*,[94] it was pleaded that a decision of directors was tainted by an improper purpose and the breach of provisions equivalent to s 232(2) and (6). The Full Court held that the trial judge fell into error by treating breach of fiduciary duty and the statutory duty of honesty as equivalent to a breach of s 232(6).[95] The court considered that the duty was aimed at "serious" misconduct by an officer (qua officer) intended by him to gain a personal advantage.[96]

A different approach was taken in *Jeffree v NCSC*,[97] although it was cited with approval in *Southern Resources Ltd v Residues Treatment & Trading Co Ltd*.[98] This case involved the transfer of a corporation's business undertaking to a new corporation, motivated by the defendant's fear that a large award might be made in arbitration proceedings against the old corporation. The new corporation paid some of an agreed purchase price to the old corporation, enabling the latter to pay creditors. Subsequently, the arbitration proceedings were decided against the old corporation, but the award could not be enforced given the corporation's moribund condition. The defendant was convicted under the equivalent of s 232(6).

According to Wallace J, the defendant's behaviour was improper because in order to protect his business and himself from liquidation, he acted against the interests of the contingent creditor, whose interests the director was obliged to consider.[99] Brinsden J cited *Whitehouse v Carlton Hotel Pty Ltd*,[100] a decision on fiduciary duties, as authority that a purpose can be improper even though officers believe it to be in the corporation's interests. The director's fiduciary duty to the (old) corporation required him to deal with its assets for the benefit of its creditors.[101] Even though the conduct was not intended to

92 P Ezersky, "Intra-Corporate Mail and Wire Fraud: Criminal Liability for Fiduciary Breach" (1985) 94 *Yale Law Journal* 1427 at 1437-1438; J C Coffee, "The Mandatory/Enabling Balance In Corporate Law: An Essay On The Judicial Role" (1989) 89 *Columbia Law Review* 1618 at 1660-1661; Fisse, supra n 14 at 157.

93 See, for example, the citation of *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 in *Jeffree v NCSC* (1989) 7 ACLC 556 at 560, 565 discussed in text accompanying nn 97-102 infra.

94 (1990) 8 ACLC 1151, sub nom *Residues Treatment & Trading Co Ltd v Southern Resources Ltd (No 2)* (1989) 7 ACLC 1130. See text accompanying nn 22-29 supra.

95 (1990) 8 ACLC 1151 at 1168-1169.

96 Ibid. The word "serious" anticipates s 1317EA(5).

97 (1989) 7 ACLC 556.

98 (1990) 8 ACLC 1151 at 1169.

99 (1989) 7 ACLC 556 at 561.

100 (1987) 162 CLR 285.

101 (1989) 7 ACLC 556 at 565. See also Wallace J at 561.

harm the corporation, it was improperly motivated. This approach to s 232(2) is substantially similar to *van Reesema's* case as it equates the fiduciary duty to the duty of propriety. Nonetheless, in this case the corporation's creditors were prejudiced by the transfer, given the evidence that it was not for full value.[102]

Donald's case[103] was considered above. It involved the payment of some false and some genuine accounts by a corporation to two other corporations in which the defendant director was interested. The conflict was not disclosed. The court considered that the defendant breached his fiduciary duty. The court said that it was "a short step" from a finding of breach of fiduciary duty to the conclusion that the defendant had improperly used his position as an officer.[104] At trial, however, the Crown focused on the acts of authorising payment of the contracts. While not the focus the court preferred, it held that authorising the payments was improper as it was done to avoid the normal processes for payment of accounts, and hence scrutiny of the claims.[105] Again, the logic is circular. For avoiding the accounts system to be improper, the claim being paid must itself be improper; otherwise, avoiding the accounts system is merely irregular and difficult to distinguish from everyday innocent occurrences. A preferable approach is to look at the substance of the claim. Were services actually rendered? Were services provided at an overvalue? Were the services ones the shareholders had agreed were not to be solicited? If any of these questions are answered affirmatively, impropriety would be established more strongly than by the circumvention of the accounts system.

Besides establishing the purposive character of s 232(6), *Chew's* case[106] contains important dicta relevant to the meaning of "improper". Dawson J emphasised that impropriety is determined objectively.[107] His Honour expressly equated the exercise of power for an improper purpose with the improper use of an officer's position. Toohey J expressed a similar principle.[108] According to Mason CJ, Brennan, Gaudron and McHugh JJ:

> The accused's state of mind is relevant not only to the requirement of purpose but also to the element of improper use of his or her position. If, for example, an accused person reasonably but mistakenly believed that a particular transaction which he or she authorised was genuinely for the benefit of the corporation, that belief may, in an appropriate case, be material in determining whether the accused person can be held criminally responsible for using his or her position in a manner which would objectively be seen to be improper.[109]

This dicta poses three questions:

(1) Does "objective" impropriety connote that impropriety is established by a

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102 Ibid at 566.

103 (1993) 11 ACLC 712. See nn 87-89 supra. Contrary to the view advanced here, Baxt applauds the decision: R Baxt, "Director's Misuse of Position and the Utility of the Corporations Law" (1993) 11 *Company and Securities Law Journal* 450. Baxt indicates that the primary inquiry should be whether the director has channeled opportunities from the company to himself. However, the nexus between impropriety and advantage to the director also requires consideration of whether the opportunities the director "channels" to himself are of value to, and come at the expense of, the corporation.

104 (1993) 11 ACLC 712 at 714-715.

105 Ibid at 716.

106 (1992) 10 ACLC 816.

107 Ibid at 824-825.

108 Ibid at 827.

109 Ibid at 819-820.

breach of fiduciary duty, determined without considering the officer's conscience?

(2) What is the relevance of a belief that the conduct is reasonably justified in the corporation's interests?

(3) What is the relationship between intention and impropriety, the two elements of s 232(6)?[110]

In respect of the third question, does the existence of the proscribed intention to cause a detriment to the corporation establish the impropriety of the conduct? Given that an officer's intention to gain an advantage is ubiquitous in many (probably all) corporate transactions, and therefore, morally and ethically ambivalent,[111] impropriety might be expected (consistently with the language of objectivity) to require a broad consideration of consequences and harm of the transaction for the corporation.[112] We now turn to cases in which answers to these questions were attempted.

In *R v Yuill*,[113] a director was prosecuted (inter alia) under s 232(6) for providing funds to another corporation for his personal advantage. Relying on the quoted dicta in *Chew's* case, the defendant submitted that when bringing charges under s 232(6), the prosecution had to prove that the defendant engaged in the conduct, being aware of the improper use. The court held that if the officer's conduct was improper by a "purely" objective standard, state of mind is irrelevant, even if the officer thinks that he is acting in the corporation's best interests. The officer's state of mind is relevant only if the behaviour is not improper by a "purely" objective standard.[114] The first and second impropriety questions were answered, but the nature of the inquiry into impropriety was not described. This case involved conduct improper by almost any standard.

In *ASC v Matthews*,[115] two directors were prosecuted in respect of conduct occurring in a corporate reorganization. The directors caused their corporation, Sun Sovereign, to advance about $70,000 to a corporation, Squire Investments, interest being payable at a "commercial" rate. The money was then forwarded through another corporation, to enable yet another corporation to repay a loan connected with the reorganization. All corporations were controlled by a Mr Yap. The defendants expected Squire Investments to repay Sun Sovereign almost immediately after the money was advanced. Because Squire Investments had almost no net assets, this expectation was based on Yap's oral undertakings. The defendants considered that the reorganization was beneficial to the corporation and that the advance would facilitate the reorganization.[116]

The court considered that authority supported the proposition that the test for impropriety is objective, although subjective beliefs could be considered.[117] The defendants' belief that the transaction would benefit Sun Sovereign was relevant, because the conduct was not inherently improper. The loan was small and at a commercial interest rate.

110 These questions are referred to below as the "first", "second" and "third" impropriety questions.
111 See text accompanying n 92 supra.
112 The references herein to harm to the corporation are simply a shorthand for harm to the corporation_s constituencies. It does not imply that the corporation should be reified or treated as anything other than a nexus of contracts: see generally Whincop, supra n 3.
113 (1994) 15 ACSR 95.
114 Ibid at 112-113.
115 (1995) 16 ACSR 313.
116 Ibid at 320.
117 Ibid at 317.

The risk of default was trivial. While the reorganization would transfer Sun Sovereign's business to another corporation, this would occur at full price, without prejudice to shareholders and creditors.[118] The reorganization would permit the corporation to enter the business of securities trading, which appeared to be beneficial. In touching on the third impropriety question, the court impliedly accepted that in assessing impropriety, the benefit that directors anticipate will accrue to the corporation weighs against the advantage another person may gain.[119] This approach takes a more relaxed view of the entitlement of directors to take action which benefits a corporate group, provided it does not harm the corporation itself, than that usually considered to hold in Australia.[120] While there was no breach of fiduciary duty in this case, the case supports the importance of assessing the potential harm of a transaction.

In *R v Byrnes,* the South Australian Court of Criminal Appeal[121] answered the second and third impropriety questions by holding that conduct is only criminally improper if it is objectively improper, *and* the officer is conscious of the impropriety.[122] The courts in *ASC v Matthews*[123] and *R v Yuill*[124] greeted this decision suspiciously, given its unusual interpretation of *Chew's* case. Writing before the High Court decided *R v Byrnes*, Kluver identified three analyses of the relevance of state of mind to impropriety; that is, three answers to the second impropriety question.[125] First, in *Yuill,* state of mind is only relevant if the prosecution cannot establish that the use of position was objectively improper. Second, in *Byrnes,* the offence is constituted only if the officer was conscious that the corporation would suffer a detriment. Both approaches purport to apply the dicta of Mason CJ, Brennan, Gaudron and McHugh JJ in *Chew's* case, described by Kluver as the third approach. These dicta, however, are equivocal and could be consistent with two propositions:

(1) Conduct that appears to be for an improper purpose does not violate the section if the motivating purpose is proper in equity. This approach answers the first impropriety question by holding that impropriety of purpose is dispositive of impropriety of use of position. Dawson and Toohey JJ expressed this view in *Chew's* case.[126] This seems consistent with the decision in *R v Yuill*.

(2) Conduct motivated by what in equity is an improper purpose might be saved if the officer honestly and reasonably believed that the conduct was in the corporation's best interests. Such a rule contemplates a decision to engage in conduct being motivated by two causative purposes: one ("objectively") improper, the other for the benefit of the corporation. There are cases where causative proper

118 Cf *Jeffree v NCSC* (1989) 7 ACLC 1130.

119 (1995) 16 ACSR 313 at 322-323.

120 See *Walker v Wimborne* (1975-1976) 137 CLR 1. A relaxed principle was also demonstrated in *Equiticorp Financial Services Ltd v Equiticorp Financial Services Ltd (NZ)* (1993) 11 ACLC 84. The High Court decision in *Gambotto v WCP Ltd* (1995) 16 ACSR 1, decided after these cases, does not appear to relax the strict view. See Whincop, supra n 91 at 292.

121 (1994) 13 ACSR 219.

122 Ibid at 249. Note the similarity to the approach taken to the duty of honesty in *Marchesi v Barnes*: see text accompanying nn 15-16 supra.

123 (1995) 16 ACSR 313 at 317.

124 (1994) 15 ACSR 95 at 110.

125 J Kluver, "Improper Use of Corporate Position: How Relevant is a Director's State of Mind to Criminal Liability?" (1994) *Butterworths Corporate Law Bulletin* [515].

126 (1992) 10 ACLC 816 at 824-827. See text accompanying nn 107-108 supra.

> and improper purposes coexist. For instance, in *Teck Corporation v Millar,*[127] the directors' action must have been motivated by the need to defeat Teck's takeover, a purpose long reproved by equity. However, the action was upheld because it involved an exercise of managerial judgment that the takeover needed to be defeated in order for the corporation to get the best deal for its assets. Cases where directors honestly take action in a matter involving management considerations might not contravene the section, even though equity normally regards such action as improper. This approach finds some legitimacy in dicta in *Howard Smith v Ampol Petroleum Ltd*[128] and *Cayne v Global Natural Resources Plc*.[129]

The difference between these two propositions is that the former approach rejects the possibility of a valid decision motivated by proper and improper causative purposes.

R v Byrnes: The High Court decision

The High Court decision in *R v Byrnes* resolves the three impropriety questions in an expansive restatement of s 232(6). Jeffcott Investments Ltd ("Jeffcott") owed debts of $6 million. The litigation concerned a sub-underwriting of an issue of convertible notes, the proceeds from which were intended to repay Jeffcott's debt. The defendants were directors of Jeffcott and Magnacrete Ltd ("Magnacrete"), in which Jeffcott held a substantial interest. Magnacrete held cash reserves to which the defendants were attracted. The Magnacrete board considered that for the cash to be put at their disposal, (a) Jeffcott needed to repay its debts from the proceeds of the notes issue, and (b) Magnacrete should acquire Jeffcott.

The underwriter of the issue required Jeffcott to procure a sub-underwriter for 100 per cent of the issue. A corporation, Vicksburg Pty Ltd (Vicksburg), was formed in which Magnacrete held 45 per cent, and a merchant bank, Baron Partners held interests of 55 per cent. Baron Partners would take up notes under the sub-underwriting, using money borrowed by Vicksburg. The notes would be assigned to Vicksburg. Magnacrete would support Vicksburg's bank loan by a guarantee and deposit, and would receive $40,000 for doing this. The scheme was embodied in agreements between the Vicksburg shareholders, and between Vicksburg and Magnacrete. The defendants were responsible for Magnacrete's execution of the agreements and guarantee. They did this without the knowledge or consent of the other directors, expecting another director to challenge the proposals. The defendants expected that any breaches would be ratified after the successful takeover. When the borrowing facility was discovered, the defendants informed the board that it was an arrangement with Baron for the location of opportunities for short term gain. They did not disclose that discharging the sub-underwriting commitment was Vicksburg's sole purpose.

Eventually, the sub-underwriting commitment was discharged as planned but the larger scheme failed. The defendants were charged with improperly using their position as directors of Magnacrete, by causing Magnacrete to enter into the transactions

127 (1973) 33 DLR (3d) 288.
128 [1974] AC 821 at 837.
129 Chancery Division, Megarry V-C. Unreported, 12 August 1982.

described above to gain an advantage for Jeffcott. The defendants were alleged to have used their position improperly in three respects:

(1) Their purpose was not a purpose of Magnacrete's, but was to confer an advantage on Jeffcott.
(2) They put themselves in a position where their interests in, and duties to, Jeffcott conflicted with their duty to Magnacrete.
(3) They acted without the knowledge or authority of the Magnacrete board.

The defendants were convicted at trial. Applying the analysis of impropriety previously described, the South Australian Court of Criminal Appeal quashed the conviction because (1) the trial judge found that the defendants believed, not improbably, that it would be in Magnacrete's interest to enter into the transaction; (2) the scheme was not inherently (ie, "purely objectively") improper;[130] and (3) Hopwood considered the transaction would eventually be ratified.

The High Court held to be erroneous the conclusion that there had not been improper conduct because there was no intention to harm the corporation. That conclusion failed to separate the two elements of the offence: improper use of position and proscribed purpose. Even if an intention to harm the corporation is absent, the officer contravenes the section if his purpose is to gain an advantage for himself or another. According to Brennan, Deane, Toohey and Gaudron JJ:

(1) Impropriety is a wider concept than conscious use of position for a proscribed purpose in a way that disregards corporation interests. Impropriety refers to conduct that objectively is inconsistent with what is proper.[131]
(2) Impropriety does not involve dishonesty or any intention to act otherwise than in the corporation's best interests. Impropriety involves a breach of standards reasonably expected from the office the defendant holds.[132]
(3) Impropriety is found in the abuse of a power, or in acting in a way known to lack authority. The categories of impropriety are not closed.[133]

McHugh J considered that even a defendant who intends to benefit the corporation, could still be acting improperly:

> [O]fficers or employees who act in breach of their fiduciary duties to secure a gain for themselves or others or to cause detriment to the corporation always make improper use of their position unless they are honestly and reasonably mistaken as to the facts which give rise to the duties or their breach. In the absence of a mistake of that kind, it is difficult to see how officers or employees who use their positions in breach of fiduciary duty to secure such a gain or cause such a detriment can escape a finding of improper use of their position. Certainly, they cannot escape a finding of improper use of position merely because they believed that what they were doing was in the interests of the corporation.[134]

The High Court concluded that the defendants improperly used their positions. The defendants caused the corporation to enter transactions without authority, they tried to

130 The trial judge reached this conclusion because the Vicksburg dealing did not violate any sections of the Corporations Law, and could have been used if the boards of Magnacrete and Vicksburg had been aware of the transaction and properly authorised it.
131 (1995) 17 ACSR 551 at 559-560.
132 Ibid at 560.
133 Ibid at 560-561.
134 Ibid at 566.

conceal these transactions from the other directors, and they permitted their fiduciary duty to Magnacrete to conflict with their interests in and duties to Jeffcott. The answer to the first impropriety question is that a breach of fiduciary duty is an improper use of position, as is knowingly acting without authority.

Given that the court below relied on dicta in *Chew v R*, the High Court reconsidered what it had said there. Brennan, Deane, Toohey and Gaudron JJ seem to maintain the first, narrower interpretation discussed above.[135] This can be inferred by their reference to a director voting in favour of a proposal that favours a third party. In this situation, a vote could be proper,[136] but not "if the director fails to consider the interests of the corporation and votes for the proposal merely in order to benefit a third party."[137] In such a case, a causative improper purpose seems not to exist. There is merely the appearance of an improper purpose. However, intentions and appreciation of relevant circumstances of a director can establish *both* impropriety and the proscribed purpose.[138] This answer to the second impropriety question involves a curious double standard. Conduct motivated by an intention to harm the corporation establishes impropriety; but a motivating intention to benefit the corporation cannot affect the conclusion that conduct is improper if it breaches fiduciary duty or is known to lack authority.

McHugh J considered that the troublesome passage in *Chew* meant that conduct would not violate the section if there was an honest, reasonable mistake of fact concerning the commercial effect of the transaction.[139] His Honour's example is where the corporation purchases goods from a director at an over-price to their "current market value," under a fixed term contract, believing that this was necessary to ensure supply. Presumably, this analysis is justified only if the director could demonstrate that a long term contract was not available at the (spot) market price (ie, the "current market value"). How would it be possible to believe – honestly, reasonably but mistakenly[140] – that such a contract was *necessary* unless the contract *could not* be obtained elsewhere at a lower price? Assume this is the state of affairs the learned judge envisages. The analysis is deeply problematic. First, it fails by the standard of Occam's Razor. There is something deficient about a basic rule that needs an exception to uphold a reasonable and fair transaction of the sort McHugh J envisages. The learned judge merely shows the basic, fiduciary-breach-centred rule catches some cases which are proper, and that what is needed is a principle which goes to substantive impropriety. Why not start the analysis with considerations of substance, rather than engraft them onto a rule of questionable merit?

The second problem is one incapable of resolution. As I read the judgment, McHugh J implies, almost unbelievably, that the transaction he refers to (a) is not proper generally, but (b) only where the director believes, reasonably but falsely, that the facts of the transaction exist. It might be thought that to utter such a statement is to demonstrate its

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135 See text accompanying n 126 supra.
136 (1995) 17 ACSR 551 at 558.
137 Ibid.
138 Ibid at 558-559.
139 Ibid at 567.
140 Presumably, for the directors to form a "reasonable" view, they must demonstrate that they have taken all necessary steps, independently of information provided by the interested director, to reach this view: *Daniels v Anderson* (1995) 16 ACSR 607.

folly. Unquestionably the judge does assert part (b),[141] and (a) is part of the passage quoted above: that in the absence of such a mistake, the officer cannot escape a finding of impropriety, "certainly" not even where the officer believes – *correctly* – that the transaction is necessary in the corporation's interests. How a conflicting transaction that is incorrectly thought to be necessary for the corporation can be valid, while a conflicting transaction that is correctly thought to be necessary for the corporation is invalid defies logic and good sense. Is the learned judge encouraging directors to be wrong?

Analytical faults aside, McHugh J's analysis of the dicta in *Chew* seems untenable. In that case, the reference was to a belief that a transaction was genuinely for the benefit of the corporation, which would be material to determining whether the section is violated by seemingly improper conduct. It is hard to read this to refer to a mistake concerning the transaction's commercial effect. That Brennan and Gaudron JJ did not share McHugh J's interpretation of their joint judgment with Mason CJ seems significant.

The judgments also answer the third impropriety question. Brennan, Deane, Toohey and Gaudron JJ consider that the two elements of the section are separate, and that the width of the proscribed intentions does not necessitate a more discriminating test of impropriety; however, an intention to harm the corporation will establish both limbs. McHugh J seems to agree with this principle.

What then is the present state of the law under s 232(6)? First, impropriety must be determined "objectively". One considers the director's conduct in light of her duties, both those imposed by the law and those assumed in the discharge of office. Second, where the facts support a breach of fiduciary duty, impropriety is almost certainly established. Various manifestations of fiduciary duty are relevant: the duty to act in the best interests of the corporation[142] (including due regard for the interests of creditors in insolvency),[143] the duty to avoid a conflict of interests,[144] and the duty to act for proper purposes.[145] Third, impropriety may be established by action which the director knows exceeds the director's actual authority. It does not appear that the director must also breach some other duty.[146] Fourth, and perhaps contrary to what one might expect, objectivity disregards any benefit that use of position creates in fact or in prospect for the corporation,[147] and also the fact that at the time of the transaction, the director formed a reasonable opinion based on objective evidence that benefit was expected or likely for the corporation. Fifth, and in conformity with the fourth principle, a director, damned on the basis of the above principles, cannot be saved by an intention to benefit the corporation.[148] However, a director can be damned by an intention to benefit herself or some third per-

141 (1995) 17 ACSR 551 at 567. See text accompanying n 139 supra.

142 See, for example, *R v Yuill* (1994) 15 ACSR 95.

143 See, for example, *Jeffree v NCSC* (1989) 7 ACLC 556.

144 See, for example, *R v Donald* (1993) 11 ACLC 712.

145 See, for example, *R v Byrnes* (1995) 17 ACSR 551.

146 This seems to be confirmed by the Queensland Full Court decision in *R v Cook ex parte Commonwealth Director of Public Prosecutions* (1996) 20 ACSR 618, in which the court held that s 232(6) could be breached by an action which the accused should have known he had no authority to take, even though the accused seemed to believe that he was acting in the best interests of the corporation.

147 Cf *ASC v Matthews* (1995) 16 ACSR 313 for an approach that does implicitly balance detriment to the corporation with benefit.

148 See the discussion of *R v Cook* in n 146 supra.

son. "Objectivity" is thus asymmetric (or blinkered). Finally, a reasonable but mistaken belief that action is permissible or authorised is irrelevant.[149]

Substantive Impropriety

Despite its problems, McHugh J's judgment in *R v Byrnes* demonstrates that a principle which equates fiduciary breach with improper use of position is flawed, and needs supplementation with a qualification that looks to the substance of conduct. This is because in Australia, a fiduciary duty can be breached by transactions that are contrary to the best interests of the person owed the duty, as well as by transactions that are fair (or even favourable) to those interests. While the decision in *Grove v Flavel*[150] has been cited[151]for its emphasis on the duties and responsibilities of the officer, the relevant dictum also says that impropriety cannot be determined by reference to an "inflexible" standard. Yet, the inflexibility of application of fiduciary duties has traditionally been emphasised as its hallmark.[152]

The private law character of the fiduciary duty filters out litigation concerning neutral or potentially favourable transactions. For example, where fiduciary breach enables a transaction to be rescinded, a rational corporation would incur costs only to set aside substantially disadvantageous transactions. The plaintiff that bears non-trivial costs (even if successful) will litigate only when it estimates that the expected value of doing so is positive. Given that success is uncertain, but some costs are certain (increasing greatly if the action is dismissed), the subject matter of actions reaching trial will inevitably be substantial. It cannot, however, be asserted that prosecutions for civil or criminal penalties for breach of the statutory duties will only be brought in respect of substantial matters. As a regulatory body, the Australian Securities Commission's decisions to refer matters for prosecution are partially motivated by political considerations, such as prosecution priorities, the public profile of the case, and the probability of success. This makes it important (both for the control of the Australian Securities Commission and the reinforcement of corporate governance) that s 232 is interpreted so that breach occurs only where substantive impropriety exists.

What does this substantive requirement involve, and how would it be formulated? The problem is that the conduct belonging to the set called "fiduciary breaches" is very broad in extent and the criteria for inclusion does not relate to the effect or the character of the breach. Nonetheless, there is a subset of unjustifiable conduct which is detrimental to interests of shareholders.[153] The hallmark of this conduct is that it involves *abuse* of the fiduciary office.[154] While impossible to define this concept comprehensively, it

149 See, for example, *R v Towey* (1996) 21 ACSR 46.

150 (1986) 4 ACLC 654.

151 For citations, see n 59 supra.

152 See, for example, *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 473; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n at 144-145; *Chan v Zacharia* (1984) 154 CLR 178 at 204-205; *Warman International Limited v Dwyer* (1995) 128 ALR 201 at 209.

153 It is possible that some unjustifiable conduct is detrimental to shareholders but does not constitute a fiduciary breach. Examples are not easy to find. This is a consequence of the expansiveness of fiduciary obligation. This is the very problem of fiduciary breach being the sole criterion of impropriety. Especially gross breaches of duty of care might be an example, although this could be construed as a failure to act in the best interests of the company. However, s 232(4) could catch this sort of conduct. See *Lagunas Nitrate Company v Lagunas Syndicate* [1899] 2 Ch 392 at 437, per Lindley MR.

involves exercise of the power and potential of office in a way which is antagonistic to the interests of shareholders. This antagonism flows from the fact that substantial harm to shareholders is a necessary consequence or a subjective motivation of the conduct. Care must be taken in referring to harm. Actual harm to the interests of shareholders is not a necessary nor always a sufficient condition of abuse of fiduciary office. It is not a necessary concept because a plan may be forestalled before harm is caused.

Why, however, is actual harm not a sufficient condition? The answer concerns the way corporations allocate business risk.[155] Shareholders bear the risk of the cash flows of the corporation because they do so most efficiently, being able to eliminate risk specific to the corporation by diversification.[156] Because that risk can be eliminated, it is not compensated by an expected return. Directors, especially executive directors, are incapable of diversifying their human capital investment in the corporation because they generally work for one corporation at a time. Hence to bear risk specific to the corporation, they will demand compensation, which shareholders would not. Consider an investment that, according to capital budgeting analysis, has a positive expected value but eventually fails for business reasons. While the decision to invest does substantial harm to shareholders, they should bear its risk, as they contract to do, as it does not involve an abuse of the fiduciary office. Hence, actual harm is not always a sufficient condition for abuse of a fiduciary office.

This focus on risk and diversification suggests why the statutory duties should be directed at abuses of fiduciary office. Coffee[157] and Gordon[158] have used economic analysis to demonstrate why one cannot diversify against abuses of fiduciary office. Such misconduct is in fact a systematic risk which affects all companies to a significant degree because of the extreme uncertainty of assessing the quality and integrity of management. It is impossible to diversify against these (endogenous) risks unless, in effect, shareholders have some "officer's outcomes" in their portfolio. Accordingly mandatory law, and by extension, in Australia, penalties are needed to discipline this conduct. While economic analysis is generally hostile to mandatory terms because they disrupt the formation of governance equilibria,[159] Black has argued that some mandatory terms are market mimicking, in the sense that all contracting parties would agree to them. [160] Clearly, most would agree to proscribe abuse of office, but it is much less clear that the present formulation of fiduciary duties represents a term to which contracting parties would uniformly agree.[161]

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154 This concept is adapted from J C Coffee, "From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics" (1981) 19 *American Criminal Law Review* 117 at 134.

155 Whincop, supra n 3.

156 The risk that cannot be eliminated is "market" risk: the extent to which the return on a security changes with the value of the market overall.

157 J C Coffee, "No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case Of Remedies" (1988) 53 *Brooklyn Law Review* 919 at 941-948.

158 J N Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 *Columbia Law Review* 1549 at 1594-1595.

159 See H D Butler and L E Ribstein, "Opting Out of Fiduciary Duties: A Response to the Anti- Contractarians" (1990) 65 *Washington Law Review* 1.

160 B S Black, "Is Corporate Law Trivial?: A Political and Economic Analysis" (1990) 84 *Northwestern University Law Review* 542.

161 Cf J C Coffee, "The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role" (1989) 89 *Columbia Law Review* 1618 at 1622 n 8.

Courts have formulated a principle for s 232(2) that approximates abuse of fiduciary office. The dominant interpretation of s 232(2) in *Marchesi v Barnes* involves acting in a way that is known to be contrary to the interests of the corporation. There are really two elements, the first substantive, the second purposive. The first is action that is contrary to the corporation's interests. The second element is that the officer engages in this harmful action knowing this to be true. The first element requires a court to weigh the effects of the transaction on shareholders' interests. For reasons explained above, this must be done with reference to information that is available at the time the action is taken, not with reference to ex post effects. However, the s 232(2) test of abuse of fiduciary office is not sufficient by itself because the insistence on such a purposive element narrows its focus and is difficult to prove.

Assuming that the interpretation of "improper" in *R v Byrnes* holds also for s 232(5) cases, these sub-sections catch conduct irrespective of its effect on the corporation. Therefore, their ambit is too broad. If the section is to catch only abuses of fiduciary office, it must incorporate a substantive element that concentrates on the necessary existence of harm to the interests of shareholders. While I suggested above that one of the purposive elements of s 232(5) and (6) – the officer acting in his or her own benefit – is not difficult to satisfy,[162] the recommended substantive element will not be invoked by transactions that do no harm to shareholders.

This approach involves a pleasing symmetry between the duty of honesty and the duties of propriety. Both involve the same substantive element, namely conduct (probably involving a breach of fiduciary duty) that viewed ex ante will harm the interests of shareholders. However, each has a purposive element, the duty of honesty involving knowledge that the action is contrary to the interests of the shareholders, the duties of impropriety involving a self-interested motivation for the conduct.

Advocates of the present formulation of s 232(5) and (6) might object that the recommended approach will rarely lead to different results. In numerical terms, this is probably correct but the significance of the objection depends on the nature of the cases where the two give different results. There is an important category of case where the two produce different results, that of the *Byrnes* approach being unacceptable. This involves situations where ex ante, the transaction, though risky, appears fair or advantageous to the corporation but for business reasons eventually causes significant loss to the corporation. Normally, directors would probably not be liable for negligence provided they discharge their duty to be informed. However, if the transaction involves, say, a conflict, that result could change radically.

Assume the board of a public corporation carrying on a certain type of business decides to acquire a particular business undertaking. The best deal available is to buy a business that one of the directors wants to sell. The transaction is duly scrutinized and the duty to be informed is discharged. The interested director discloses everything he knows about the business, and a committee of disinterested directors determines that the transaction is advantageous to the corporation. Accordingly, the board resolves to acquire the business. Assume the articles do not change the status of this transaction as a fiduciary breach for the interested director, and that if Pt 3.2A of the Corporations Law

162 See text accompanying n 92 supra.

applies, it is not complied with. Subsequently, assume that for reasons that could not reasonably have been detected when the transaction was entered into, the business becomes insolvent, causing significant loss to the shareholders.

When taking the decisions in *R v Byrnes* and *R v Donald* together, the interested director would be in breach of s 232(6); this conclusion may extend to the disinterested directors also for conferring a benefit on that director. The court might impose a pecuniary penalty on the directors, and might order the directors to compensate the corporation for the loss. Applying the reasoning in this chapter, such an order is misconceived. One must look at the transaction on the basis of information that was or should have been available ex ante. If that information does not reveal an abuse of the fiduciary office, the subsequent failure of the transaction does not either. This approach merely imposes the business risk of the transaction on the directors, who are the least efficient bearers of this risk.

It is unclear whether if the corporation had sued for breach of fiduciary duty, it could in these circumstances recover equitable compensation. The better answer is that the corporation could recover, because concepts of remoteness have not been affirmed to apply to awards of equitable compensation,[163] although they clearly do apply to breaches of a duty of care.[164] However, in other jurisdictions, particularly Canada, there are signs that remoteness can apply to some situations of fiduciary breach.[165] In the hypothetical case, excluding remoteness limitations from the calculation of compensation for fiduciary breach leads to inefficient results where the fiduciary breach itself does not cause the loss.

In the context of the statutory duties, these sorts of situations can be dealt with by interpreting "improper" in the manner advocated in this chapter.[166] In applying the compensation provisions in Pt 9.4B Div 5 of the Corporations Law, courts should read into the words "the corporation...has suffered loss or damage as a result of the act or omission constituting the contravention" a remoteness rule. An appropriately formulated business judgment rule would be desirable in these sorts of situations; however, American courts do not allow that rule to apply in cases of conflicts, where an entire fairness standard applies.[167] Neither concept is embedded in Australian law.[168]

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163 *Nocton v Lord Ashburton* [1914] AC 932; *Re Dawson* [1966] 2 NSWR 211; *Hill v Rose* [1990] VLR 129; *Gemstone Corporation of Australia Ltd v Grasso* (1994) 13 ACSR 695.

164 *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 162-167. This case shows the dramatic difference between liability for damages for breach of duty of care and compensation for loss caused by fiduciary breach.

165 *Canson Enterprises Ltd v Boughton & Co* (1991) 85 DLR (4th) 129; *Simms v Hodgkinson* (1994) 117 DLR (4th) 161.

166 An alternative would be to interpret the word "serious", which s 1317EA(5) requires as a precondition of imposing a pecuniary penalty, to mean cases of abuse of fiduciary office.

167 D Block, M Maimone and S Ross, "The Duty of Loyalty and the Evolution of the Scope of Judicial Review" (1993) 59 *Brooklyn Law Review* 65 at 69-70.

168 Whincop, supra n 3 at 285-286.

Conclusions

In this chapter, the present formulations of the duties of propriety have been demonstrated to be misspecified, from doctrinal and analytical perspectives. The same conclusion can be derived from applying economic analysis.[169] Each of these perspectives supports an interpretation of impropriety directed to those fiduciary breaches that involve harm to shareholders' interests as a necessary consequence or subjective motivation. At present, s 232(2) catches only a limited range of abuses of fiduciary office because of its restrictive purposive element (which suits a provision directed at dishonesty). On the other hand, s 232(5) and (6) are excessively broad. They capture abuses of fiduciary office as well as transactions that are ex ante advantageous or substantively neutral to shareholders. This scope needs to be narrowed, as is indicated in the strained quality of the principles articulated in *R v Byrnes*.

Perhaps the time has also come to review the application of the fiduciary principle to directors in publicly listed corporations. The ability of shareholders to diversify, their ability to enter and exit corporations quickly and inexpensively, the reductionist paradigm viewing corporations as merely a set of risk-return substitutes and the (admittedly imperfect) disciplinary and informational functions served by capital markets suggest that the present formulation of fiduciary duties are questionable in these circumstances. The purpose of a rule which ignores the substance of transactions, and which displays an unprincipled attitude to allocating risk, founders in the corporate environment. The present corporate law reform initiatives could be re-directed to scrapping, rather than simplifying, Pt 3.2A and replacing it with rules that express a duty of loyalty, with an exception in cases of entire fairness, a balanced rule for corporate group problems and a business judgment rule that protects directors whose actions are motivated by maximising value for shareholders. In a time when litigation against directors is expanding, with expanded derivative action rights in prospect, and signs of fight in the Australian Securities Commission, the foundations of the substantive law are due for re-examination.

169 Whincop, supra n 3; Whincop and Keyes, supra n 3.

Chapter 9

The Role of Nominee Directors and the Liability of their Appointors

Justice E W Thomas*

Introduction

Nominee directors are a fact of commercial life and cannot be ignored. I propose to focus sharply on the position of nominee directors and the liability of those who appoint them. In doing so, I will proceed on the basis of what I hold to be a major canon of the common law; that commercial law should, to adopt the words of Lord Wilberforce, take "a practical approach according with commercial reality".[1]

In commercial practice, the relationship of the appointors and the nominee directors whom they have appointed is almost invariably that of principal and agent or employer and employee. Yet, acting as an agent or employee results in the nominee director being, to a greater or lesser extent, in breach of the recognised fiduciary duties of a director. This should be acknowledged and consideration given to relieving nominee directors of the full force of these obligations when they are representing the interests of their appointor. At the same time, consistency with principle and deference to commercial realities point to the need to enlarge the liability of the appointors for the actions of those whom they have appointed and who act under their control or in their interests.

Employees representing their employer on a board of directors are the most obvious example of nominee directors who are answerable to their appointor, and a particularly strong case can be made out for holding employers of employees serving as nominee directors vicariously liable for their actions. Such a case, however, would run counter to the decision of the Privy Council in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*.[2] That decision must therefore be reviewed. But there need be no reluctance to undertake such a review. The *Kuwait Asia Bank* case is highly unsatisfactory.

I propose, however, to focus on the wider question of the liability of appointors for nominee directors generally and not just employees. I will suggest that liability should arise where the nominee directors are expected to act in accordance with some understanding or arrangement which creates an obligation or expectation of loyalty to the appointors. In such circumstances the appointors effectively control the directors or are the effective cause of what they do on the board. I accept that the mere fact of nomina-

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1 *New Zealand Shipping Co Ltd v A M Satherwaite* & Co Ltd [1974] NZLR 505 at 510.

2 [1991] AC 187; [1990] NZLR 513.

tion is not in itself enough.

It is true that over the years the strict application of the directors' fiduciary obligations has been relaxed in respect of all directors. Rather than relaxing the obligation on directors generally, however, it would be preferable to openly recognise the true nature of the nominee directors' relationship with their appointors and adjust the law to deal distinctively with that relationship. Thus, nominee directors (subject to the matters to which I will refer later) should be permitted to have direct regard to the interests of the appointors whom they represent. The traditional obligation of directors to dedicate their exclusive attention to the interests of the company in the sense of its members as a whole will, in such circumstances, need to be adjusted accordingly. The fiduciary obligations of directors to their companies will vary according to the constitution or structure of the company.

At the same time it is essential that the potential liability of the appointors for the actions of their nominees be enlarged if the interests of minority shareholders are to be fully protected. Such a development is the logical corollary of accepting that in some circumstances nominee directors may properly act in the interests of their sponsors. When they do so, those appointing them should be prepared to accept legal responsibility for the actions of their representatives.

There are two main ways in which the potential liability of the appointors could be expanded. The first is to simply apply the law of principal and agent. In no other area of the law do principals enjoy such wide immunity from liability for the default of their agents. Particular consideration is required in respect of major shareholders who effectively control the company through their nominated representatives. The second method by which the interests of minority shareholders could be protected is by further developing the "oppression" remedy. This remedy is sufficiently flexible to prevent any oppressive or prejudicial action on the part of directors who have sought to unfairly advance their appointor's interests.

The Reality of Nominee Directors

Having sounded a call to heed the requirements of commercial reality I must, to be consistent, at once acknowledge that in commercial practice the term "nominee directors" has no clear meaning. Broadly speaking, the phrase is used to embrace appointments ranging from directors of a company which is the vehicle for a joint venture, to directors who represent a specific interest, such as the interests of the debenture holder or major lender. More often, nominee directors represent the interests of the major shareholder or class of shareholders. The common denominator is the fact that, irrespective of their method of appointment, nominee directors are frequently expected to act in accordance with some understanding or arrangement which creates an obligation or expectation of loyalty to a person or persons other than the company as a whole.

The commercial reality underlying the loyalty of nominee directors to their appointors is all too often understated. Typically, nominee directors have been appointed with a clear mandate; a mandate to protect and promote their appointors' interests. They owe their selection to their appointors. They may be co-directors or co-entrepreneurs in the parent company. They may, as in the *Kuwait Asia Bank* case, be employees carrying out the directors' task in their employers' time and at their employers' expense. They probably enjoy the advantage of an indemnity from their appointors. They are expected to report back to their principal. The extent to which they do so will vary with the circumstances; nominee directors representing a major lender will report on the financial well-being of the company generally and, most certainly, on specific proposals likely to affect the appointors' security; nominee directors appointed by a controlling shareholder or joint venture participants are more likely to report in detail, appropriating without thought such of the company's information as might be thought desirable in the interests of their sponsor.

Loyalty inspired by selection, and confirmed by the confidence which the appointors repose in their nominees, is reinforced by the appointor's power of dismissal. If the appointor is a majority shareholder, a large interest group or an employer, directors face the possibility of removal if their loyalty should be seen to waver or lapse. I am not suggesting that nominee directors are servile. Far from it. In directing their loyalty to their appointors they are responding, perhaps unconsciously, to the commercial imperative summed up in the maxim; "He who pays the piper calls the tune". For that reason alone, most nominee directors would feel less than conscientious if they did not diligently pursue their appointor's interests.

Various arrangements often complete the allegiance of nominee directors to their appointors. Joint venture companies are, in reality, partnership ventures utilising the corporate structure, and a joint venture board meeting is, in effect, a meeting of partners. In these circumstances, a dispersal of responsibility and information to those funding the enterprise is to be expected. Then, the constitution of a board to include representatives of a major supplier or consumer probably reflects an underlying arrangement which may inhibit the freedom of directors in reaching decisions affecting the company. Common proprietorship in a group of companies rationally organised to undertake the group business, and sharing group strategy and budgeting, similarly allows little, if any, scope for true independence at the subsidiary level. Shareholder agreements governing the administration of a company have much the same effect.

I therefore observe that, in reality, the primary or ultimate loyalty of most nominee directors is reserved for their appointors and not the company to which they have been appointed. Nominees of a lending bank sitting at the board table would be severely embarrassed if they were required to subvert the interests of their bank to that of the borrowing company. Similarly, the directors of a subsidiary company representing a controlling shareholder would feel uncomfortable if called upon to suppress their commercial instinct to protect the investment or goodwill which the parent company has placed at risk in that company – the residual risk.

The fact that nominee directors may not ordinarily feel compromised in practice is because either the interests of the company and the major shareholder or financier more often than not coincide or the ability of the human mind, perhaps prompted by commercial considerations, to rationalise an identity of interest when in fact there is little or none. But this factor should not detract from the fact that in practice nominee directors are appointed to represent the interests of their appointors and that they function accordingly. In any other circumstances, the nominee directors would be quickly perceived for what they are; the agents of the principals.

The Fundamental Conflict in the Nominee Director's Loyalty

The conflict between nominee directors' loyalty to the company in company law theory and their loyalty to the appointor in commercial practice is readily apparent. In truth, the nominee directors' position is a negation of the fiduciary obligation and its concomitant requirement of undivided loyalty. Their ability to carry out their duties as a director in good faith, and in the interests of the company as a whole, is at once compromised by their divided loyalty. Indeed, it is largely undermined if, as I suggest, their ultimate allegiance is in fact reserved for their appointors.

In the first place, the nominee directors certainly breach the rule proposed by Lord Cranworth in *Aberdeen Railway Co v Blaikie Bros,*[3] which requires directors to avoid situations of actual or possible conflict. Secondly, directors are required to bring an independent judgment to bear in the exercise of their powers. Yet the very nature of the arrangement or understanding which brings directors within the definition of "nominee directors" means that they have fettered their discretion to act independently. Thirdly, directors are obliged to shun extraneous ends, but the nominees' dutiful regard to the interests of their sponsors is collateral to the interests of the company (even where the interests coincide). In essence, good faith predicates the absence of a collateral purpose.

Finally, the duty of directors not to disclose company information or use confidential information without the consent of the company is incompatible with the nominee directors' position. Indeed, in many cases, reporting back to their appointors may be their primary function. It is certainly essential to the control or supervision which the major shareholder or lender will wish to exercise.

It is for these reasons that the rule proposed by Lord Cranworth in *Aberdeen Railway Co* requiring directors to avoid situations of actual or possible conflict has always posed problems for nominee and employee-directors: see, for example, *Scottish Co-operative Wholesale Society Ltd v Meyer.*[4] The employment contract or the nature or understanding of the arrangement by which they were appointed congests their independence. Lord Denning MR recognised this difficulty in *Boulting v Association of Cinematograph, Television and Allied Technicians*.[5] The learned Master at the Rolls said that there is nothing wrong in the director of a company nominated by a large shareholder representing that shareholder's interests, and he acknowledged that it is done every day. He added, of course, that there is nothing wrong with that course so long as the directors are left free to exercise their best judgment in the interests of the company which they serve, a qualification which at once diminishes the concession.

The Courts in Australia and New Zealand have adopted a less uncompromising approach in an effort to recognise the reality of commercial activity. The first case was *Levin v Clark*.[6] In that case, the governing directors acted primarily in the interests of the mortgagee of the shares in the company. Jacobs J did not deny the general requirement that directors must act in the best interests of the company, but he decided, nevertheless, that the scope of their fiduciary duty to the company may be modified by its constituent documents and the wishes of those to whom the fiduciary duty is owed. *Re Broadcasting*

3 (1854) 1 Macq 461 at 471-472; [1843-1860] All ER Rep 249 at 252.
4 [1959] AC 324 at 366-367, per Lord Denning.
5 [1963] 2 QB 606 at 626-627.
6 [1962] NSWR 686.

Station 2GB Pty Ltd,[7] also a decision of Jacobs J, followed shortly afterwards. The majority shareholder (being the Fairfax Group) was challenged by the minority directors, who claimed that the company's affairs were being conducted in an oppressive manner. Jacobs J accepted that the directors would be likely to follow Fairfax's wishes "without a close analysis of the issues" and denied any right in the company to have every director approach each company problem with a completely open mind. To require that of each director of a company, he said, would be to ignore the realities of company organisation.[8]

In New Zealand, Mahon J endorsed the move towards recognising the commercial reality of nominee directors in *Berlei Hestia (NZ) Ltd v Fernyhough*.[9] New Zealand directors, representing a group of shareholders holding 60 per cent of the shareholding, sought to exclude the Australian directors appointed by an Australian company holding the remaining 40 per cent of the shares from having access to information relating to the competitive operation of the New Zealand company. Mahon J referred to attempts to bring the theoretical doctrine of undivided responsibility into harmony with commercial reality on the basis that, when articles are agreed upon in which a specified shareholder is empowered to nominate its own directors, there may be grounds for saying that, in addition to the responsibility which such directors have to all shareholders as represented by the corporate entity, they may have a special responsibility towards those who nominated them.

On the basis of these decisions, nominee directors need not necessarily approach company problems with an open mind and may pursue their appointors' interests provided that, in the event of a conflict, they prefer the interests of the company of which they are a director. In such circumstances, the breadth of the fiduciary duty has been narrowed by agreement amongst the body of shareholders. In other words, the corporators have agreed upon an adjusted form of fiduciary obligation.

This approach has been taken further in New Zealand's recently enacted companies legislation. Section 131(2) of the Companies Act 1993 provides that a director of a company which is a wholly owned subsidiary may, when exercising powers or performing duties as a director, and if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company, even though it may not be in the best interests of the subsidiary company. The same principle applies where the company is incorporated to carry out a joint venture. A director of a subsidiary which is not wholly owned may, under subsection (3), if again expressly permitted to do so by the constitution of the company, act in the same manner, but only with the prior agreement of the other shareholders.

7 [1964-65] NSWR 1648.
8 Ibid at 1663.
9 [1980] 2 NZLR 150.

The Adjustment of the Fiduciary Obligation

The precept underlying these developments is that the fiduciary obligations of directors to their company are not necessarily uniform or constant. Depending on the constitution and structure of the company and, in particular, the source of the directors' appointment, the nature of the obligation may vary. But this notion that the established fiduciary obligations of directors can vary is also apparent in other areas of the law relevant to directors' responsibilities. It is, for example, implicit in the growing numbers of cases in which the courts, particularly in Australia and New Zealand, have held that a company owes a duty to creditors, at least where the company is insolvent or nearly so. See for example *Walker v Wimbourne,*[10] *In re Horsley & Weight Ltd*,[11] *Nicholson v Permakraft (NZ) Ltd,*[12] *Kinsela v Russell Kinslea Pty Ltd,*[13] and *Brady v Brady.*[14]

Reference to this category of directors' liability is extremely helpful, for in no other area of company activity is the apparent conflict between the interests of the shareholders as a whole and the interests of another group likely to be so acute. Facing insolvency, the company may well seek to sell or charge the assets of the company or to distribute the company's resources by way of dividend in the interests of its shareholders. It may seek to incur additional liabilities, restructure the company, or arrange the payment of existing and accruing debts in such a way as to diminish the assets or security available to creditors.

Directors acting in accordance with the traditional notion of pursuing the collective interest of shareholders in this way will be likely to find themselves in direct conflict with nominee directors representing a major creditor or creditors. In reality, the latter will have little or no doubt as to the course the company should adopt; the interest of the shareholders will openly be required to take second place to those of the creditors. Because of the almost certain ability of the creditors in such circumstances to liquidate the company at any time, the creditors' nominees on the board are in a position to insist upon the pursuit of this course even if it is to the clear detriment of the shareholders as a whole. In a very real sense, the directors appointed to represent creditors epitomise the single-minded nominee director.

In such circumstances it is patent that the law cannot neglect the commercial reality and, and in cases like *Walker v Wimbourne* and *Nicholson v Permakraft*, the courts have recognised that reality by expanding the perception of the company beyond the concept of the shareholders as a whole. The rationale is that the interests of the company facing insolvency are in reality the interests of the existing creditors and the assets of the company have, for all practical purposes, ceased to be the assets of the shareholders collectively and become the assets of the existing creditors. The directors must therefore manage those assets for the benefit of the creditors. In short, the residual risk has shifted from the shareholders to the creditors.

For the purpose of determining the legal responsibility of the nominee directors, these developments have particular significance. In the first place, the notion that "the

10 (1976) 137 CLR 1.
11 [1982] Ch 442.
12 [1985] 1 NZLR 242.
13 [1986] 4 NSWLR 722.
14 [1988] BCLC 20 (reversed in the House of Lords largely on factual grounds, [1989] AC 755).

company" is to be equated with the collective shareholders or enterprise itself is no longer invincible. "The company" where, for example, the company is a subsidiary company, need not necessarily be perceived as the entity pursuing the enterprise of an amorphous and indivisible group – "the shareholders collectively". The shareholders can be seen for what they are, and the dominance of a major shareholder fully recognised. Such recognition is consistent with the fact that the shareholder will effectively control the company and almost certainly bear a substantial measure of the residual risk. The interests of the company may, depending on the facts, be properly equated with the interests of the group, be it creditor or shareholder, which assert that control or carry that risk.

If notions of "the company" or the "interests of the company" are to have this more flexible content, it will need to be accepted that the nature of the directors' fiduciary duty to the company will vary accordingly. Thus, where the company is insolvent or close to insolvency, the directors' duty is shaped by that circumstance and the directors are required to have regard to the interests of the existing creditors. The extent to which those interests will predominate will no doubt depend on a number of factors so that, for example, in the case of a company which is financially unsound but not insolvent, the interests of both the members of the company and the creditors will need to be balanced. This is to recognise that the company is a collection or community of interests, creditors as well as shareholders.

A More Realistic Approach to the Liability of Nominee Directors

These brief observations on the developments in the law provide the springboard for approaching the obligation of nominee directors in a more realistic fashion. In particular, the cases which recognise that there is an obligation on directors of an insolvent or near insolvent company to have regard to the interests of creditors recognise that a director's fiduciary duty to the company is shaped by the company's structure. Even without reference to creditors, however, the company is to be seen as a collection or community of interests, and the interests of its various shareholders will or may vary significantly. The nature of the directors' fiduciary obligation is to be defined having regard to that variation in interest. Thus, the fiduciary obligation of a director in a company where there are three equal shareholders need not be the same as the obligation of a director in a company which is wholly or two-thirds owned by one shareholder. Again, no more is being done than accord recognition to the extent of the residual risk undertaken by the various shareholders. For directors, the incidence of the residual risk is the fundamental commercial reality of the company's organisation, and it should inform the law accordingly.

It is a mistake, therefore, to regard the directors' fiduciary duty in company law as fixed and static. It is an obligation which should not be determined in the abstract. As with fiduciary obligations generally, its content must vary with the circumstances, and it is artificial not to include the structure of the company among those circumstances. As demonstrated, the fiduciary obligation of a director in a company with a multiplicity of shareholders may be different from that of a director of a company nominated by one shareholder or class of shareholders and those obligations may, again, vary depending on the company's financial security. In all cases, it is the circumstances which will shape the fiduciary duty. Consistent with this approach, the fiduciary obligation of directors in the one company may properly be permitted to vary. In the example given above, the duty of the directors appointed by the shareholders at large, while not excluding regard for the company structure, may in certain circumstances differ from the obligation of the directors nominated to represent the two-thirds shareholder or class of shareholders. Again, this is to do no more than recognise the attitude which directors in such situation adopt in practice.

Accepting that different directors may have different fiduciary obligations from company to company and within the one company does not mean that the interests of the company will be subverted. Jacobs J noted in *Levin v Clark* that it may be in the interests of the company to have a director on the board who will act solely in the interests of a particular shareholder, mortgagee or other trader. The board as a whole then arrives at decisions which may be said to be in the company's interests because of and not despite the recognition of the disparate interests involved. In a real sense, the board may operate more openly and more democratically without the artificial pretence that there is some ostensible corporate interest separate and abstract from those of the shareholders whose investment, assets or goodwill are at risk.

Maximisation of profit is likely to remain the dominant concern of the company, if only because maximising return on investment is the dominant concern of the shareholders. We do not need, however, to enter upon the debate which waxes and wanes as to the company's true economic function in a free economy. Certainly, whether or not the free market is better served by a corporate system in which the interests of shareholders are subverted to the interests of the company as a whole is open to question. Overall, the community may benefit from the rationalisation of resources and any efficiencies which eventuate, with a realistic recognition of the major shareholder's interest. Nor is the economic goal of profit maximisation eliminated. That goal remains, but it may manifest itself in the interests of the parent company rather than that of the subsidiary. This overt recognition of the owner's or risk-taker's self-interest within the company structure is probably more in keeping with the current perception of the operation of the free market and modern day corporate organisation and activity than the traditional approach.

Permitting nominee directors to have regard to the interests of their appointors will, of course, have a direct impact on their liability apart from any proceeding by the company, or a third party, alleging a breach of fiduciary duty. Their liability in any claim founded in contract or tort would fall to be judged in accordance with their modified fiduciary obligation. Similarly, the adjustment in their legal responsibility would be of direct relevance to an examination of the conduct of a nominee director pursuant to the fraudulent or wrongful conduct provisions in the companies legislation.

Minority shareholders or small investors are not unfairly disadvantaged by this approach. Regard must still be had to their interests as part-owners of the company. But their interests need not be equated with the interests of a majority shareholder, and their interests can be ascertained without mounting a search for the interests of the company as a whole or the enterprise itself. Furthermore, it is to be remembered that, in the operation of the share market, they have subscribed for the capital of the company knowing of the company's constitution and structure and may, if they do not approve of any change in that structure, generally dispose of their shares. Where nominee directors have been appointed to the board, therefore, investors invest in the company in the knowledge of that fact and its possible consequences. Indeed, it may be assumed that they have consciously and rationally decided to invest in the subsidiary in preference to the parent company. The risk of the investment is no different in kind from any other commercial risk.

Apart from these considerations, however, minority shareholders would, on the basis of the proposal in this chapter, be able to hold the appointor who exerts control over the nominee director liable as principal for any loss suffered as a result of a wrong committed by the nominee directors. Further, they would have the added remedy of a more responsive "oppression" suit.

It remains to state two requirements which are important concomitants of a modification to the nominee directors' fiduciary obligation. The first is that the appointment of nominee directors should be provided for in the articles of the company or in the terms of a separate shareholders' agreement. When such provision is made it can be said, in line with the thinking evident in the New Zealand and Australian cases and in the New Zealand companies legislation, that the fiduciary obligation has been modified by the members of the company. The scope and content of the nominee's fiduciary obligation can then be determined in the context of any problem arising in the affairs of the company without destroying the integrity of the general principles governing the liability of directors generally. In the second place, particulars of the nominee's appointment and the extent of the interests of the appointor should be publicly disclosed. Such disclosure is required for the benefit of other directors, for shareholders trading in the company's shares and for creditors and other persons dealing with the company. Such disclosure can be achieved by a simple statutory requirement to the effect that the information be entered in an interests register.[15]

The *Kuwait Asia Bank* Decision

It remains to examine the *Kuwait Asia Bank* case.[16] I had cause to do so at the conclusion of a four and a half month trial late in 1995. In *Dairy Containers Ltd v The Auditor General*[17] all the directors of a subsidiary company were senior employees of a parent company and appointed by it. The liability of the parent company for the negligence of the employee-directors was squarely in issue. While respectfully asserting that the *Kuwait Asia Bank* decision was wrongly decided I held that, as a Judge at first instance, I was bound by it, and the parent company, whose responsibility as the employer was manifest, escaped liability. What follows is largely taken from that case.

The Privy Council's decision in the *Kuwait* case was bound to be contentious. It is undoubtedly the leading Commonwealth authority relating to the applicability of the doctrine of vicarious liability to an employer. The situation of an employee-director was specifically discussed by the Committee,[18] and their Lordships' finding that an employer is not liable for the acts of an employee-director clearly forms part of the ratio of the decision.

15 See s 140 of the New Zealand Companies Act 1993.
16 [1991] AC 187; [1990] NZLR 513.
17 [1995] 2 NZLR 30.
18 [1990] NZLR 513 at 532-533.

It is possible that, as the appeal in the *Kuwait* case came before the Privy Council at an interlocutory stage of the proceeding, the issues were not fully canvassed in argument. In any event, the decision does not appear to address important issues which require consideration before it is held that employers cannot be liable for the acts of their employee- directors. Yet these issues are fundamental to our law. Apart from the need for the law to take "a practical approach according with commercial reality", it is a fundamental doctrine of the common law that employers are liable for the torts of their employees committed in the course of their employment. As Lord Simonds has said, this doctrine is justified by social necessity: see *Mersey Docks and Harbour Board v Coggins & Griffith (Liverpool) Ltd*.[19] Some explanation would seem to be required to explain why the acts of employee- directors performed in the course of their employment are exempt from that doctrine.

Underlying and reinforcing these major canons of the common law is, no doubt, the court's concern to ensure that liability attaches to the appropriate party. In a corporate and impersonal world that party will not be, and cannot always be, the wrongdoer in person. Those on whose behalf they are authorised to act, whether described as employers or principals, must accept responsibility for their employees' or agents' authorised actions. To quote Lord Simonds again, "...if the question is where the responsibility should lie, the answer should surely point to that master in whose acts some degree of fault, though remote, may be found".[20]

The Kuwait Asia Bank owned 40 per cent of the shares in a money-broking firm in New Zealand, AIC Securities Ltd. By agreement, the other major shareholder appointed three directors and the Bank appointed two directors to the five member board of AIC Securities. Both of the directors appointed by the Bank were full-time employees of the Bank. The actual extent to which the Bank exerted control over its employee-directors is not known, as the issue was never litigated following the Privy Council's decision.

AIC Securities borrowed money from depositors for whom the defendant, National Mutual Nominees Ltd, was the trustee under a trust deed. Under the deed, AIC Securities was required to provide National Mutual with quarterly certificates, each to be certified as being true and correct by two directors of the company. The company collapsed and National Mutual sued the directors and the company's auditors for the shortfall of $14.5 million, alleging that the certificates had been given negligently. At the same time it sued the Bank as the employer or principal vicariously responsible for the negligence of the two directors. The validity of the cause of action against the Bank was called in question in the course of an interlocutory application seeking leave to serve the Bank outside New Zealand.

The Privy Council described the duties of the directors as being three-fold; they owed a duty to perform their duties as directors without gross negligence to AIC Securities; they owed a duty to National Mutual to use reasonable care to see that the certificates complied with the requirements of the trust deed; and they owed a duty to their employer, the Bank, to exercise reasonable diligence and skill in the performance of their duties as directors of AIC Securities. The Bank was not, however, responsible for a

19 [1947] AC 1 at 18.
20 Ibid.

breach of the duties owed by the employee-directors to AIC Securities or National Mutual, any more than those companies were responsible for a breach of duty by the directors. If the directors committed a breach of duty owed to National Mutual by virtue of the trust deed, they did so as individuals and as directors of AIC Securities, and not as employees of the Bank. Neither they nor the Bank were parties to the trust deed. In the performance of the duties imposed by the trust deed they were "bound to ignore the interests and wishes of their employer".[21]

The cases referred to by the Judicial Committee do not touch upon the question of the vicarious liability of an employer of nominee directors. On that issue no authority is mentioned in the Privy Council's judgment, although several authorities are cited for the different and well-settled proposition that majority or other shareholders are not, as such, accountable to creditors. The question of the vicarious liability of an employer is treated by their Lordships as simply one of principle. I also regard the question as one of principle; why is it that the doctrine of vicarious liability can have no application to the torts of the employees appointed as directors of a subsidiary company when acting in the course of their employment?

With its origins dating back to early medieval law, the doctrine of vicarious liability is not only an elemental principle of the common law, but is also ingrained in the social consciousness of the community. It has contributed to shaping the social and economic pattern and functioning of society itself. The notion expressed by Holt CJ in *Boston v Sandford*[22] "...whoever employs another is answerable for him, and undertakes for his care to all that make use of him", possesses the force of a social injunction. Before any inroad is made into this basic canon of the common law, the reason for that inroad needs to be clearly spelt out. What is it that sets the relationship of employers and their employee- directors apart from this fundamental doctrine of the common law?

It would seem that the Privy Council regarded the employee-director's duty to the company of which he or she is a director as sovereign and indivisible, not just to the exclusion of any other duty, but to the exclusion of the consequences of the employer-employee relationship. As a director the employee ceases to act as an employee. Yet, directors are at any given time subject to numerous other duties imposed by the law. An employee driver, or a ship's captain, or an employed doctor, or a staff solicitor, are all bound to comply with the law and have responsibilities overriding any that they may owe to their employer, but that does not take them out of the course of their employment.

It could not possibly be suggested that the nominee directors in the *Kuwait Asia Bank* case were on a frolic of their own. In acting as directors they engaged in the very work which the Kuwait Asia Bank employed them to perform. Nor could it plausibly be suggested that in some way they changed intermittently from being the Bank's employees to being its independent contractors. The relationship with their employer remained constant. Although it is not strictly in point, simply because the issue is not whether they were employees or independent contractors, it may be added that the control test is now generally regarded as inadequate to resolve that issue. As Dixon CJ has said: "What matters is lawful authority to command so far as there is scope for it. And there must

21 [1990] NZLR 513 at 533.
22 [1690] 2 Salk 440; 91 ER 382.

always be some room for it, if only in incidental or collateral matters".[23] However limited the Bank's right to influence the decisions made by its employees as directors of AIC Securities, the Bank could certainly have insisted on them attending directors' meetings. In incidental or collateral matters its control over them was complete.

Why should the existence of the directors' fundamental duty to have regard to the interests of the company negate the employer-employee relationship when the employee- director is doing precisely what he has been engaged to do, is instructed to do, and is paid to do – and is liable to be dismissed for not doing? As I have said, the fact that the directors must observe numerous other duties as directors, some of them mandatory obligations, does not serve to terminate or exclude the operation of the ordinary principles of master and servant. In accordance with long-standing principle, recognised in numerous cases and by the highest authority, the employer simply stands in their shoes.

What then went wrong? I believe that their Lordships may have been persuaded to approach the issue as if it were a conflict of interest question. Any duty or interest which employee-directors might have as employees to their employers was perceived to be in conflict with their fundamental duty to the company. But the issue is not one of conflict of interest at all. If the interests of the company come into conflict with the interests of a shareholder or employer, or any third party, or indeed the personal interests of the directors themselves, the law can simply provide that the director's duty to the company must prevail. It does not necessitate the exclusion of the employer-employee relationship or place the employee-directors outside the scope of their employment. Possibly the answer has something to do with the difference between Chancery and common law starting points. A Chancery lawyer may be inclined to think in terms of the duties of persons in trust or fiduciary positions, and to see the problem as concerned with conflicts of interest. A common lawyer thinks rather of employment, essentially a common law concept.

Another possible explanation for rejecting the doctrine of vicarious liability out of hand is, perhaps, a tendency to view the parent company exclusively as the shareholder and disregard its capacity as an employer. Thus, it could be contended that, to the extent that a shareholder has a right to direct or control an employee-director, that right derives from that person's status as a shareholder and not from its status as employer. On this basis, it could be argued, the notion of recognising the employer-employee relationship where an employee has been appointed a director is inconsistent with the fundamental principles of the common law relating to the company's corporate identity and the separation of the company from its shareholders.

But none of this reasoning is relevant. The contention which has to be met is that employee-directors are acting in the course of their employment with the parent company. It does not matter that an employer's power to appoint an employee as director may derive from its status as a shareholder any more than it would be relevant if a nominee director was appointed by a bank or a creditor pursuant to their rights as financier or creditor. The essential point is that the relationship of employer and employee clearly exists. This is not to fail to recognise that the employer is also the shareholder. Dual capacities of this kind abound in the law. Fastening upon the employer's other capacity as a shareholder, even if it confers the right to appoint the director, does not assist the

23 *Zuijs v Wirth Brothers Pty Ltd* (1955) 93 CLR 561 at 571

argument. The fact remains that the shareholder has appointed persons whom he or she employs, and who then act in the course of their employment.

Ultimately, resistance to the proposition that the appointors of nominee directors should be able to be held vicariously liable for the actions of their agents or employees appears to stem from an ill-defined belief that it would undermine the concept of limited liability. Undoubtedly, in practice, a company wishing to undertake a venture in a way which will limit its potential liability will perceive a subsidiary company with a board manned by nominee directors as the obvious arrangement. In this manner it will exert a maximum of control in reality and a minimum of responsibility in law. If the appointing company could be held liable in damages for the negligence or any other breach of duty of its nominees, however, it would no longer be immune from liability.

This perception is misplaced on two counts. First, where nominee directors are negligent or in breach of some other legal duty their appointors will be directly liable for the ensuing damages. The capital of the subsidiary company will remain intact. The damages will be payable from the coffers of the appointing company in discharging its vicarious liability, not from the resources of the subsidiary. Other creditors of the company will not be prejudiced.

Secondly, the argument is a misuse of the concept of limited liability. Under the corporate structure, the shareholders delegate the management of the company to the directors. Such control as they exert is exercised though the medium of shareholders' meetings. But that is not the control which is in issue in this context. Rather, the control is the direction exercised over the directors by the third party, not as a shareholder, but as the principal or employee of those directors. In such circumstances, the basis of the concept of limited liability has been displaced. Appointors are seeking to have it both ways; on the one hand they wish to exert control; on the other, they do not wish to accept responsibility for the consequences of that control. But control without responsibility is essentially contrary to the policy of the law.

Conclusion

In this chapter I have questioned the wisdom of exempting company law from fundamental canons of the common law and stressed the need for the law to accord with commercial reality. Underlying my concern is a desire to ensure that the law is both consistent and relevant. The law can be measured against many criteria, but few would quibble with the assertion that it should strive to achieve those cardinal objectives. Consistency and relevance are imperative if the law is to command respect and remain durable. A redirection of the law in the area which I have discussed is therefore essential if it is to do so.

To be consistent with the law's commitment to commercial reality, and relevant to the needs and expectations of the commercial community, the loyalty of the nominee directors to their appointing principals or employers cannot be neglected in company law. Whenever nominee directors are expected to act in accordance with some understanding or arrangement which creates an obligation or expectation of loyalty to the appointors, the law should pragmatically redefine their legal obligation. The nature of their fiduciary obligation to the company will need to be adjusted, and a more flexible approach to the imposition of liability on nominee directors who hold steadfast to their appointors' interests is required.

Consistency also suggests that employers who are otherwise vicariously liable for the actions of their employees should be no less liable for their actions when they are performed at a board table. At least, it is a proposition worth serious consideration. Similarly, appointors who effectively control the conduct of nominee directors on a board should be held responsible for that conduct as a principal. The status of nominee directors who are agents, and who act as agents, should be more positively recognised.

The nominee director's separate duty to the company exists, and will continue to exist, but it does not in logic alter the basic relationship of the parties. The appointor remains a principal or employer and the nominee director remains an agent or employee. It is therefore fallacious to argue that, because nominee directors owe a duty to the company, they cannot be regarded as the agent or employee of their sponsors, or that their relationship with their appointors, whether principals or employers, may be disregarded as legally irrelevant. The problem cannot be seen solely in terms of a conflict of interest issue. It is not an answer to simply say that it is for the law to determine the duties of nominee directors and their relationship with their appointors, and for the directors and their appointors to conform to those duties. The recognised relationships of employee and employer and principal and agent exist and, if logical consistency is valued, must attract the legal principles which the courts have forged over centuries to determine and control the consequences of those relationships.

Nor does it accord with commercial reality to ignore the existence, or the consequences, of the relationship between an appointor who is a principal or employer, and a nominee director who is an agent or employee. My short survey of the commercial realities of the position of both appointors and appointed, and the economic unity of the two, demonstrates the futility of denying that reality. Neither in law nor in practice, therefore, is there any sound justification for carving out an immunity for appointors which is based on ignoring a relationship which exists in fact, or for imposing some artificial prescription which stipulates that the relationship between principals and agents and employers and employees is not what the law would otherwise decree it to be.

Chapter 10

Shadow Director and Other Third Party Liability for Corporate Activity

Robyn Carroll*

Introduction

Company directors and other members of the commercial community are well aware that in recent years a great deal of attention has been given to the standard of care expected of directors. The expanded liability of directors for the activities of their companies under the Corporations Law and other legislation, for example the Trade Practices Act 1974 and environmental legislation, raises obvious concerns for them.

It is important to appreciate though that concerns about exposure to directorial liability should not be monopolised by properly appointed directors. Parties closely associated with a company need to be aware of the various legal rules which may attribute liability for a company's activities to them. The extended definition of director in s 60 of the Corporations Law, in particular the reference to shadow directors in s 60(1)(b), has an important role to play in this regard. The issues surrounding third party liability for corporate activity, including the application of s 60(1)(b), have been raised by a number of important recent Australian and overseas cases which are analysed in this chapter. These cases are *Standard Chartered Bank v Antico*;[1] *ASC v AS Nominees Ltd*;[2] *Dairy Containers Ltd v NZI Bank Ltd*;[3] and *Re Hydrodam (Corby) Ltd*.[4]

The wrongful conduct which will give rise to the search for additional and alternative defendants typically is breach of the duty of care owed by directors to their company, and the insolvent trading provisions. As we will see, however, the issue can arise in other ways. I will not discuss allocation of contractual liability in this chapter. The voluntary assumption of responsibility does not give rise to the same difficulties associated with involuntary allocation of responsibilities by operation of legal principle. I will focus on the three areas of liability which were the subject of consideration in the cases referred to above. Those areas are tort, breach of fiduciary obligation and the Corporations Law. Discussion of liability for torts and breach of fiduciary obligations will be confined to causes of action which do not arise under statute.

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1 (1995) 13 ACLC 1,381.

2 (1995) 13 ACLC 1,822.

3 (1995) 7 NZCLC 96-669, 13 ACLC 3,211.

4 [1994] 2 BCLC 180.

Who Can be Fixed with Liability?

Third parties who will be most concerned about being fixed with director liability are professional and business experts and advisers; banks and other financial institutions; holding companies; controlling shareholders; and other third parties with an interest in directing the company's actions, for example, management consultants and directors of corporate shareholders.

It has been suggested that following *Re Hydrodam (Corby) Ltd* bankers and financiers need not be too concerned about being found to be shadow directors.[5] That is an arguable conclusion.[6] The position of the professional adviser remains even less certain.[7] These questions will not be pursued in this chapter. The focus here is on the latter three types of third party. These were considered in *Dairy Containers, Standard Chartered Bank, AS Nominees* and *Re Hydrodam*. Discussion of these cases also provides an opportunity to reflect on some fundamental corporate law issues, namely the implications of third party liability for the separate entity doctrine in Australia and the consequences of common and nominee directorships.

Legal Grounds for Fixing Liability on Third Parties

Tort

The principal means in tort of fixing liability on a person other than the company is to establish that a duty of care was owed by that person. The separate entity doctrine has been a powerful barrier to extending tort liability to parties other than the tortious company. The view that a duty of care can be owed by director or a shareholder for a tort committed by a company has received only tentative support in Australia[8] and has attracted considerable debate when it has been considered elsewhere.[9] The expansion of tort liability arguably is at loggerheads with the strict approach taken by the High Court to date to the separate entity doctrine.[10] It remains to be seen whether s 60(1) of the Corporations Law, coupled with s 232(4), provides additional scope for extension of liability.[11]

A significant development for corporate governance in Australia has been the recognition that apportionment of liability for negligence is available in actions brought by companies. In this case the liability rule works against the company. Essentially the company itself becomes fixed with liability for the negligence of its board and/or employees. This rule is likely to be argued in combination with other arguments intended to deflect some of the liability away from defendants in negligence claims brought by

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5 P M C Koh, "Shadow Director, Shadow Director, Who Art Thou?" (1996) 14 *Company and Securities Law Journal* 340; S Girvin, "Statutory Liability of Shadow Directors" [1995] *Juridical Review* 414.

6 N R Campbell, "Liability as a Shadow Director" [1994] *Journal of Business Law* 609.

7 Despite the protection provided by s 60(2) the fine line which divides an adviser and a shadow director can be difficult to draw. For discussion, see G Syrota, "Insolvent Trading: Hidden Risks for Accountants and Banks Participating in Work-Outs" (1993) 23 *University of Western Australia Law Review* 329; J O'Donovan, "Banks as Shadow Directors" (1995) 25 *Victoria University of Wellington Law Review* 283.

8 *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 481.

9 For example, see the academic commentaries on *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517.

10 *Walker v Wimborne* (1976) 137 CLR 1; *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567.

11 See nn 66-89 and accompanying text.

companies, for example against their auditors.[12] As we will see, this was the case in *Dairy Containers Ltd v NZI Bank Ltd*.[13]

Another important issue which Australian courts have not addressed directly but which has been considered by the Privy Council[14] and by the New Zealand High Court[15] is the application of vicarious liability to employers of nominee directors, such as holding companies. This has the potential in suitable cases to push aside the barrier presently imposed by the separate entity doctrine.

1. *Dairy Containers Ltd v NZI Bank*

Dairy Containers Ltd (DCL) was a wholly owned subsidiary of the New Zealand Dairy Board (NZDB). The auditor of DCL and NZDB was the Auditor General (Auditor-General). Three managers of DCL committed a number of frauds on the company. They were prosecuted and convicted of several offences.

DCL brought civil proceedings against the Auditor-General, amongst others, to recover $11.8 million lost through the misappropriation of its funds. It argued that the Auditor-General's audit was deficient and in breach of its contract. The Auditor-General claimed that DCL, DCL's managers and DCL's directors were contributorily negligent. DCL admitted contributory negligence only in respect of the directors' failure to monitor the company's investment policy. The Auditor-General argued that DCL's contributory negligence included failure to look after its own interests. The Auditor-General successfully applied to join NZDB to the proceedings on the basis that it was liable as a joint tortfeasor.[16] His Honour held that damages were recoverable by DCL from the Auditor-General for the negligent audit, but that the damages were reduced by 40 per cent on the ground of contributory negligence.[17] NZDB was held not liable to the Auditor-General.

2. *The relationship between DCL and NZDB*

DCL was a wholly owned subsidairy of NZDB. Their relationship was described by Thomas J as "symbiotic".[18] DCL produced cans to NZDB's order, and NZDB provided a captive market for DCL's product. NZDB instructed DCL as to the type, size and quantity of cans to be required and other production details, determined the raw material requierments and wholly financed the purchase of the tinplate for DCL. NZDB also provided all market data. DCL was not included in discussions relating to the market. As Thomas J concluded "NZDB knew more about DCL's future financial well-being, direction and requirements than the company itself."[19] Any profit that was made by DCL

12 *Daniels v Anderson* (1995) 13 ACLC 614; for the same approach in New Zealand see *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211.

13 (1995) 13 ACLC 3,211.

14 *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1990] 3 WLR 297; [1990] 3 All ER 404.

15 *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211.

16 The joinder was permitted under s 17(1)(c) of the Law Reform Act 1936 (see *ANZ Banking Group Ltd v Dairy Containers Ltd*, unreported, CA 156/92; CA 164/92 and CA 169/92, 17 December, 1992).

17 Thomas J preferred a broad approach to the question of what can constitute contributory negligence by a company. His judgment provides a valuable discussion of the principles to be applied in a claim for apportionment by negligent auditors.

18 (1995) 13 ACLC 3, 211 at 3,232.

19 Ibid.

flowed back to NZDB. The board of DCL met between four and six times a year. A large amount of the material required for DCL's board papers came from NZBD or a related company. His Honour concluded that:

> [I]n truth, DCL's operation was an integral part of NZDB's overall operation of making, processing and selling dairy products. The directors appreciated this, and approached the company as the "tinplate division" of the company.[20]

3. The claim for contribution against NZDB

The Auditor-General sought to reduce the damages payable by it on the basis of DCL's contributory negligence and to hold NZDB accountable as a joint tortfeasor based on the same conduct as was alleged to constitute negligence by the plaintiff. Thomas J rejected the notion that the defendant had a right to "elect" whether to rely on the plaintiff's conduct or the parent's conduct. His reasons for doing so reflect legal and practical concerns about the nature of contribution and the corporate realities of this case.[21]

His Honour reasoned that in the circumstances of this case, it would be artificial and unnecessarily complicated to permit contribution from the parent where the negligence of the directors of the subsidiary more appropriately falls to be considered as contributory negligence. Further artificiality arises in a case like this where the alleged joint tortfeasor is not willing to sue its subsidiary. But for their corporate relationship, NZDB would be expected to seek contribution from DCL in respect of the claim for contribution against it by the Auditor-General. As Thomas J remarked, "[I]t would then become apparent that the damage was not so much being apportioned as being moved in a circle from one party to another."[22]

In conclusion, his Honour disallowed the Auditor-General's purported election to recover its losses by way of contribution. Nevertheless, he proceeded to comment on each of the grounds on which the Auditor-General had based his claim. It is the claims by the Auditor-General against NZDB that are of interest to the discussion in this chapter. The claim against NZDB for contribution as joint tortfeasor was brought on the grounds that NZDB was in breach of a duty of care owed directly to DCL; that it had breached a duty of care owed directly to the Auditor-General; and that it was vicariously liable for the acts and omissions of its senior executives whom it had nominated to DCL's board.

(a) Duty of care to DCL

The duty of care alleged to be owed directly to DCL was said to arise in two ways. First, on the basis of the level of control and intervention, and "interference", by NZDB in the affairs of DCL; and second, on the basis that NZDB was a director of DCL under s 2 of the Companies Act 1955 (NZ) because DCL's directors were accustomed to act in accordance with the instructions and directions of NZDB. Essentially the Auditor-General sought to establish that an alternative cause of the loss suffered by DCL was the conduct

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20 Ibid at 3,233.
21 Ibid at 3,234-3,235.
22 Ibid at 3,234.

of NZDB.

Thomas J did not reject the possibility that interference by a parent may be sufficient to give rise to a direct duty of care. He referred as an example to a breach of duty which might occur if a shareholder were to direct its nominee directors to act in a manner which was not in the best interests of the company on whose board they sit as nominees, in circumstances where the shareholder owed a duty to the company as a joint venture partner. Nevertheless, the situations in which a duty is found to exist at all are likely to be few. For, as Thomas J pointed out, the obligation to ensure that the subsidiary's accounts are being properly kept falls on the directors and management of the subsidiary itself, not on the holding company.[23]

The Auditor-General relied on the almost total control exerted by NZDB over its subsidiary. Consistent with the views expressed by Rogers ACJ in *Briggs v James Hardie & Co Pty Ltd*[24] his Honour correctly concluded that:

> [C]ontrol of this kind, exercised through employees who have been appointed directors to the subsidiary's board, does not negate the duty of those directors to the company. The interference, and the action on the part of NZDB which would give rise to the duty, is not its ability to control the company, but the actual act or acts which override the directors' duty to their company so that the parent can be said to have interfered in the affairs of the company.
>
> I do not consider, therefore, that the general or usual control exerted by a parent company over its subsidiary can be the basis for a duty of care to the subsidiary relating to the way in which the company conducts its business . To my mind , not even total control of NZDB over its subsidiary could give rise to that duty. The parent may hold its subsidiary accountable if it does not perform as required, but it is going too far to suggest that it must undertake the monitoring functions reposed in the directors of DCL which it has appointed to look after its interests.[25]

I suggest this is also an accurate account of the circumstances in which a common law duty of care between parent and subsidiary can be found to exist in Australia. That is not to say that interference cannot constitute other grounds for impugning the parent's actions. For example, the issue of vicarious liability may still arise. There may also be grounds for redress under s 260 of the Corporations Law and s 588V of the Corporations Law may apply on the facts. In addition, there may be an argument on the facts that the parent was a "director" within the meaning of s 60 of the Corporations Law. This was the second ground relied upon by the Attorney-General to establish that NZDB owed DCL a duty of care. This ground will be discussed later in this chapter.

(b) Duty of care to Auditor-General

The Auditor-General also claimed that NZDB had breached a duty of care owed directly to it, based on the same facts said to give rise to the duty of care by NZDB to DCL. At the trial this argument was "pursued so faintly" that Thomas J did not proceed to consider all the difficulties that the Auditor-General would have to overcome to succeed even if it were able to establish a duty of care. Although a duty of care cannot be ruled out as a possibility, there being no legal impediment to a duty being found to exist in an

23 Ibid at 3,236. His Honour is referring here to the common law position. The group accounting requirements in the Corporations Law impose a separate legal obligation on holding companies.

24 (1989) 7 ACLC 481.

25 (1995) 13 ACLC 3, 211 at 3,237.

appropriate case, it is difficult to see a duty arising between a parent or other shareholder in the absence of a close relationship between the parent and the auditor (or any other joint tortfeasor or other third party).

(c) Vicarious liability of NZDB

The Auditor-General also argued that NZDB was vicariously liable for the acts and omissions of its senior executives whom it had nominated to DCL's board. This principle, however, was held not to apply to the acts of an employee-director by the Privy Council in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*.[26] In that case, in proceedings to join the Kuwait Asia Bank as a defendant in a claim against a number of parties, it was argued that an action in negligence lay against two directors of a company, AIC Securities Ltd (AICS) and their employer, the Kuwait Asia Bank. The causes of action relied upon were that the Bank was; first, vicariously liable for the negligence of the two directors employed by the Bank and nominated to the board of AICS; second, liable as principal for its agents, the two directors of AICS; third, liable for breach of a duty of care owed to the unsecured depositors of AICS; and fourth, a shadow director (through its two nominee directors) within the meaning of s 2 of the Companies Act 1955 (NZ).[27]

All four arguments against the Bank failed. On the argument that the Bank was vicariously liable, the Privy Council stated:

> In the absence of fraud or bad faith (which are not alleged here) a shareholder or other person who controls the appointment of a director owes no duty to creditors of the company to take reasonable care to see that directors so appointed discharge their duties as directors with due diligence and competence. One shareholder may lock away his paid-up shares and go to sleep. Another shareholder may take an active interest in the company, insist on detailed information, and deluge the directors with advice. The active shareholder is no more liable than the sleeping director.[28]

Lord Lowry, delivering the judgment for the Judicial Committee, reflected that the liability of a shareholder would be unlimited if he were accountable to a creditor for the exercise of his power to appoint a director and for the conduct of the director so appointed. The concern not to erode the benefits of limited liability has been expressed by the courts on many occasions, and extends to corporate shareholders.[29]

In *Dairy Containers* Thomas J accepted that the decision of the Privy Council was binding upon him and held that NZDB was not vicariously liable for the negligence of its employee-directors.[30] In his judgment however, his Honour mounted a strenuous attack on the notion that employee-directors are to be treated differently from other employees and called for a re-examination of the *Kuwait Asia Bank* approach.[31] He referred to another fundamental legal principle, namely "the common law doctrine that

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26 [1990] 3 NZLR 513; (1990) 5 NZCLC 66,509; [1990] 3 WLR 297; [1990] 3 All ER 404.

27 [1990] 3 All ER 404 at 409.

28 Ibid at 423.

29 See, for example, *Maclaine Watson & Co Ltd v Dept of Trade and Industry* [1989] 3 All ER 523; [1989] 3 WLR 971.

30 Thomas J noted that in *Kuwait Asia Bank*, the actual extent to which the Bank exerted control over its employee-directors was not known as the issue was never litigated following the Privy Council decision: see (1995) 13 ACLC 3,211 at 3,240.

31 Ibid at 3,239-3,244 especially at 3,244.

employers are liable for the torts of their employees committed in the course of their employment."[32] His Honour's arguments for the application of vicarious liability can be summarised as the social necessity of the doctrine, the commercial reality of the relationship between employers and their employee-directors and the court's concern to ensure that liability attaches to the appropriate party.[33]

Thomas J discussed a number of possible explanations for the approach of the Privy Council. Of particular interest here is the argument, made by counsel for the NZDB, that recognising the employer-employee relationship where an employee has been appointed a director, is inconsistent with the fundamental principles of the common law relating to the company's corporate identity and the separation of the company from its shareholders.[34] This argument was rejected by Thomas J as irrelevant. In his view there should be no difficulty recognising the dual capacity of a shareholder-employer. It is evident though that there is a tension between limited liability of shareholders for loss resulting from a company's activities and the social desirability of imposing liability on a shareholder who has appointed to the company's board persons whom he or she employs for their acts in the course of their employment.

Thomas J referred to the Australian and New Zealand cases which recognise that nominee directors owe loyalty to their nominator as well as their company.[35] In his Honour's view, this practical reality in turn supports imposing vicarious liability on the nominator. The importance of the nominee director cases and the compromise inherent in them, in his view:

> [I]s that it demonstrates the commercial futility of endeavouring to construct a company structure divorced from the underlying economic reality of nominee or employee-directors and their principals or employers. Recognising the economic reality of employee-directors and their employers requires that those who employ employees as directors to represent their interests accept responsibility for their resulting conduct. The measure of real control exercised by the employer should be recognised in law.[36]

Applied to NZDB, Thomas J would have found that the Dairy Board was liable for the negligence of the three senior executives it appointed as directors of its wholly owned subsidiary, DCL.

A final remark of his Honour, equally applicable to Australia, is that if a body corporate was qualified to be a company director, NZDB could have been a director, and as such would have owed a duty of care to DCL. It might be argued then "in principle, it should make no difference that NZDB was represented by its employees."[37]

The obvious question for Australian courts, which are not bound by decisions of the Privy Council, is whether the view expressed in *Kuwait Asia Bank* or the view expressed by Thomas J in *Dairy Containers* is to be preferred. The attraction of vicarious liability is that it applies consistently the principle that responsibility for tortious conduct should

32 Ibid at 3,239.
33 His Honour has also expressed his views on the issue of vicarious liability for nominee directors in Chapter 9 of this book.
34 [1995] 13 ACLC 3,211 at 3,241.
35 *Levin v Clark* [1962] NSWR 686; *Re Broadcasting Station 2GB Pty Ltd* [1964-1965] NSWR 1,648; and *Berlei Hestia* (NZ) *Ltd v Fernyhough* [1980] 2 NZLR 150.
36 (1995) 13 ACLC 3,211 at 3,244.
37 Ibid.

lie with the principal, not the agent. Given that the law recognises that nominee directors can maintain loyalty to their company and their nominator, it can be argued that some responsibilty for directors' conduct should lie with the nominator.[38]

On the other hand, application of the vicarious liability principle in these circumstances runs contrary to the separate entity doctrine as it is currently applied and to established corporate law principles. Australian courts have been reluctant to apply case law principles to extend corporate liablity to company shareholders on other occasions[39] and are likely to wait for legislative guidance on this matter. The dual loyalty of a nominee director, and the fact that the director has effectively two principals is one of the many difficulties associated with imposing vicarious liability.

I suggest that the appointment alone of a director who subsequently is negligent should not suffice to attract liability. Consideration could be given to imposing vicarious liability where it is established that the nominating company instructed its nominee directors how to vote or required them to act in breach of the fiduciary duties they owe to the company of which they are director. In either event, the extent to which vicarious liability should be applied, if at all, needs to be considered in conjunction with section 60 of the Corporations Law, which is discussed below.

4. Summary of tort liability developments

The circumstances in which a duty of care for corporate activity will be imposed on a person other than the company itself are limited, as in every tort case, by facts and policy considerations. This point is illustrated by *Dairy Containers*. That case also illustrates the futility of arguing for joint tort liability of a shareholder on the basis of the same conduct which is said to constitute contributory negligence by the company itself. The question whether employers of nominee directors should be vicariously liable for negligence by their employee directors requires further careful consideration before it is answered by an Australian court.

Breach of fiduciary obligation

When a company's directors breach their fiduciary obligations to the company, third parties may become implicated to the extent that they are unable to enforce obligations ostensibly entered into by the company, by being required to account for property to which the company is beneficially entitled or by having to compensate the company for loss it has suffered. The equitable principles by which a third party will be found to have "knowingly assisted", (or "dishonestly assisted" according to the Privy Council), in the breach of fiduciary obligation have been the subject of much debate, and I do not propose to discuss them here.[40] As the application of these principles can result in the imposition on a third party of the "same range of potential remedies (personal and proprietary)

38 See Thomas, supra n 33.

39 See, for example, *Qintex Australia Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267.

40 For discussion of the relevant principles by the Privy Council, see *Royal Brunei Airlines v Tan* (1995) 3 WLR 64; and for commentary, see R Nolan, "From Knowing Assistance to Dishonest Facilitation" [1995] *Cambridge Law Journal* 505.

as are made available against a misbehaving fiduciary",[41] they are obviously very important.[42] There clearly is a difference, however, between these remedial principles and the principles by which a third party can be fixed with direct liability as a fiduciary. As Finn J notes, the remedial principles appear to be settling on a form of fault based liability.[43] Of course, whether liability is imposed on a third party directly or as accessory will make little difference to a third party defendant if the effect is the same. *ASC v AS Nominees Ltd*[44] is a potent reminder of the particular vulnerability to suit of directors of trustee companies through accessorial principles.

It is generally accepted that a director does not owe fiduciary duties to the shareholders of his or her company.[45] One would expect courts to have a keen reluctance to depart from the general rule in most cases where directors are alleged to have breached the fiduciary obligations owed by them to their company. Nevertheless, an independent fiduciary duty to a person other than the company may be shown to arise, though only in exceptional circumstances.[46] The basis for this duty will be the facts surrounding the relationship between the director and that person, for example, a shareholder.

1. ASC v AS Nominees Ltd

Those exceptional circumstances were found to exist in *ASC v AS Nominees Ltd*,[47] a decision of Finn J in the Federal Court. The case involved a group of companies, founded by a Mr Windsor. AS Nominees (ASN) was the trustee of superannuation trusts and Ample Funds Ltd (Ample) was the trustee of unit trusts. The two companies had common boards of directors for all practical purposes, consisting of Mr Cahill, Mr Napper and Mr Sutherland. AS Securities Pty Ltd (Securities) acted as manager of ASN and Ample. The directors of Securities were Mr and Mrs Windsor. The only shareholders in Securities were Mr Windsor and another company whose directors were also Mr and Mrs Windsor. Securities was the ultimate beneficiary of all management and trustee funds paid by the trusts of ASN and Ample.

The proceedings were brought by the Australian Securities Commission (ASC) to remove the trustees and managers of a number of superannuation and unit trusts, either through an order for the winding up of ASN, Ample and Securities or for the appointment of a receiver and manager of all the property of the three companies and over certain property of Mr Windsor.

The facts of the case testified to the abuse of both the corporate form and the duties of office of director.[48] The trustee companies were run largely at the direction of, and largely for the benefit of, Windsor and his interests and the directors repeatedly breached

41 P Finn, "The Liability of Third Parties for Knowing Receipt or Assistance" in D Waters (ed), *Equity, Fiduciaries and Trusts* (1993) at 198.

42 A parallel concern about what knowledge should be attributed to a person dealing with a company for remedial purposes is reflected in s 164(4) of the Corporations Law and the case law interpretation of that section.

43 *ASC v AS Nominees Ltd* (1995) 13 ACLC 1,822 at 1,836.

44 Ibid.

45 *Percival v Wright* [1902] 2 Ch 421; *Esplanade Developments Ltd v Divine Holdings Pty Ltd* [1980] WAR 151; *Glandon Pty Ltd v Strata Consolidated Pty Ltd* (1993) 11 ACLC 895; *Centofanti v Eekimitor Pty Ltd* (1996) 13 ACLR 315.

46 See, for example, *Glavanics v Brunninghausen* (1996) 19 ACSR 204; *Coleman v Myers* [1977] NZLR 225.

47 Supra n 43.

48 Ibid at 1,825.

s 232 of the Corporations Law and their duties as trustees. Trust funds were invested recklessly and improvidently, in circumstances often involving a clear conflict of interest or other partiality; and in one instance fraud of some magnitude was perpetrated on investor-beneficiaries of the superannuation trusts. ASN and Ample conducted their affairs as if they were a single entity, to the extent that they had a common bank account for all their various trusts; and defective and deficient record keeping for the companies and the trusts shrouded much of the group's activities.

To support its application for the appointment of a receiver or a liquidator, the ASC argued that Mr Windsor was a director of Ample and ASN within the meaning of s 60 of the Corporations Law. They made this argument to support the allegations of conflicts of interest in dealings between the companies. This is discussed below.

Justice Finn found the grounds for relief were made out and made an order for the winding up of the companies. The facts of the case raise numerous trust law and corporate law issues, not all of which Finn J needed to determine conclusively. A number of observations are made in his judgment which are important to the question of third party liability and these will now be discussed.

2. *Fiduciary duties*

Numerous fiduciary relationships were alleged to exist.

(a) ASN and Ample as trustees

As would be expected, ASN and Ample were held to be in fiduciary relationships with the beneficiaries of the trusts of which they were trustees.

(b) Ample as fiduciary for investors in ASN trusts

Some of the trust funds held by ASN were invested in Ample trusts. While formally therefore the only beneficiary of those Ample trusts was ASN, Finn J rejected this conclusion as dependent upon artificiality of form. The true character of the relationship between Ample and the investors in the ASN trusts required a conclusion that the relationship between them was a direct fiduciary one.[49] While not suggesting that a direct fiduciary relationship necessarily arises between the trustees of trust A and the beneficiaries of trust B whenever trust B invests in trust A, Finn J determined that this is a justifiable conclusion where trust B is the exclusive investor in trust A and where the trustees themselves have common directors.

(c) Securities as fiduciary for beneficiaries of ASN and Ample trusts

Although as a matter of construction it may have been possible to conclude that Securities was the fiduciary of certain of the investor-beneficiaries of certain of the trusts, Finn J chose not to justify his finding of a fiduciary relationship on this basis. Instead he based his conclusion that for certain purposes Securities clearly was a fiduciary on the

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49 Ibid at 1,833.

functions performed for the trusts by Windsor, Securities' alter ego; the level of responsibility for identifying and securing trust investments conceded to Windsor by the boards of Ample and ASN; with respect to certain trusts, the terms of the trust deeds; the appreciation Windsor must have had[50] of the vulnerability of the trusts to Securities' actions; and the awareness Windsor must be taken to have had of the function that Securities was performing for the benefit of the trust beneficiaries.[51]

(d) The directors of ASN and Ample as fiduciaries for the beneficiaries of the trusts of their respective companies

Justice Finn pointed to three possible arguments that might be made to attribute liability as director to persons other than the company of which they are a director. First, that the actual relationship between the parties warrants the finding of a fiduciary relationship, as in *Coleman v Myers*,[52] as discussed in *Glandon Pty Ltd v Strata Consolidated Pty Ltd*.[53] The trust company director-trust beneficiary relationship does not of itself warrant the finding of a fiduciary relationship.[54] Second, that the duty owed by directors to their company incorporates some level of direct fiduciary responsibility to the beneficiaries of a trust of which their company is a trustee, as for example in *Hurley v BGH Nominees Pty Ltd (No 2)*[55] and *Inge v Inge*.[56] Finn J questioned the desirability of advancing this approach given the ability to protect beneficiaries from misuse by directors of their company's trustee powers by a more orthodox and extensive way.[57] The more orthodox way and third argument relied upon was the accessory liability rule, which is discussed below.

(e) Windsor as fiduciary for investor-beneficiaries

This argument was not made, presumably because of the reliance placed on s 60 and the accessory liability principle. Interestingly, Finn J's remarks suggest that he considered this route may have been preferable in order to "bring home liability to Windsor".[58] For corporate law purposes I consider it preferable to rely on the extended definition in s 60 of director in a case like this. Someone like Mr Windor is more likely to understand what it means to be held to be a "director" of the companies within his group than to be labelled a "fiduciary".

3. Accessory liability for breach of fiduciary duty

This liability rule is "one which exposes a third party to the full range of equitable remed[ies] available against a trustee if that person knowingly or recklessly assists in or

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50 Windsor, incidentally, did not give evidence in the proceedings.
51 Supra n 43 at 1,834.
52 [1977] 2 NZLR 225.
53 (1993) 11 ACLC 866; (1993) 11 ACSR 543.
54 Supra n 43 at 1,835.
55 (1984) 2 ACLC 497; (1984) 10 ACLR 197.
56 (1990) 8 ACLC 943; (1990) 3 ACSR 63.
57 Supra n 43 at 1,835. A similar reluctance to follow the approach of the Supreme Court of South Australia in *Hurley v BGH Nominees Pty Ltd (No 2)* (1984) 2 ACLC 497, was expressed recently by Acting Master Johnson in *Cope v Stardust Investments Pty Ltd* (1995) 14 ACLC 626.
58 Supra n 43 at 1,838.

procures a breach of trust or of fiduciary duty by a trustee."[59] This form of liability is "one of no little consequence" to the directors of a trust company, because, as his Honour points out, often it is the conduct of the directors of the trustee company in exercising their powers which causes the company to commit the breach of trust.[60] The knowledge which fixes liability on directors in these circumstances is not confined to breach of trust by their company, but extends to other companies in the group. Hence the reference by Finn J in his judgment to the "extensive" reach of this remedial principle.

The decision in *ASC v AS Nominees* is a clear example of where accessorial liability for breach of fiduciary duty was made out and warranted remedial action. The liability attaching to persons who knowingly assist in a breach of fiduciary duty should be of particular concern to companies where their directors are capable of being attributed with knowledge about the affairs of one company by virtue of their directorship in another company; that is, their common directorship.[61]

4. Summary of developments in fiduciary obligations

The facts and decision in *ASC v AS Nominees* illustrate the danger of directors of trustee companies becoming personally accountable for activities of their company which are not in the best interests of the trust beneficiaries. It cannot be assumed that the separate entity principle will restrict a director's accountability to the trustee company only. The potential for information acquired as director of one company to be attributed to a person as director of another company makes liability as an accessory to a breach of fiduciary duty a real possibility for directors.

Corporations Law

> It is of paramount importance to the community for its members to know when a person is a director; the duties imposed by the Act on directors are many and, in some respects, onerous.[62]

There are numerous ways in which third parties can become implicated in corporate activities which the Corporations Law does not permit. A notable example is the undue preference provisions in Part 5.7B, Division 2.[63] Another way that third parties might be implicated is as an accessory to a contravention of the Law. Section 79 sets out the circumstances in which a person will be found to be "involved in a contravention". As this part of the chapter is concerned with primary liability, I will not discuss the undue preference provisions or statutory accessory liability.

There are two circumstances where it is most likely that attempts will be made to fix

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59 Ibid at 1,836. For a thorough revision of the principles underlying the accessorial liability rule for breach of trust, see the decision of the Privy Council in *Royal Brunei Airlines v Tan* [1995] 3 WLR 64.

60 Ibid at 1,836. Similarly, there are numerous examples where equitable remedies have been awarded against directors or controlling shareholders who knowingly assist in a breach of fiduciary duty by their company. See, for example, *Green & Clara Pty Ltd v Bestobell Industries Pty Ltd* [1982] WAR 1.

61 See, for example, *Belmont Finance Corp v Williams Furniture (No 2)* [1980] 1 All ER 393; *ZBB (Australia) Ltd v Allen* (1991) 4 ACSR 495. See also *Kratowski v Eurolynx Properties Ltd* (1995) 130 ALR 1.

62 *Harris v S* (1976) 2 ACLR 51 at 56, per Wells J.

63 A further example of where a third party's involvement with a company will affect their legal position is s 164(4) of the Corporations Law, where knowledge of a lack of authority of a company's agents will preclude reliance on the statutory assumptions in s 164(3).

primary liability on third parties via the Corporations Law. The first of these is where it is argued that the third person is liable as a director within the meaning of s 60(1) of the Law for breach of statutory duties, including the general duties in s 232 and the duty to prevent insolvent trading in s 588G. The second likely circumstance is under s 588V which imposes liability on a holding company for insolvent trading by its subsidiary. These will be discussed in turn below.

1. Section 60

Section 60(1) as relevant to this discussion, provides as follows:

> (1) Subject to subsection (2), a reference to a director, in relation to a body, includes a reference to:
>
> (a) a person occupying or acting in the position of director of the body, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position;
>
> (b) a person in accordance with whose directions or instructions the directors of the body are accustomed to act.

Clearly s 60(1) is not intended to be an exhaustive definition of "director" for purposes of the Corporations Law. At the same time, the extended definition of director will not apply to every section of the Corporations Law in which reference is made to directors. Section 6(1) of the Corporations Law has the effect that "director" in s 60(1) will not apply where the substantive provision to which it is sought to be applied shows a contrary intention. So for example, s 60 has no application to s 221(1) and (2) which specify the minimum number of directors that a company must have. Nor is a director under the extended definition in s 60 expected to meet the disclosure requirements in the Corporations Law.

2. Section 60(1)(a) – the de facto director

In *Harris v S*[64] the Full Court of the Supreme Court of South Australia interpreted the words in s 5 of the Companies Act 1961 (SA) "any person occupying the position of director of a corporation by whatever name called" to mean those persons within a corporation who govern the corporation but who go under some other title, for example, "governor" or "president". The issue arose shortly afterwards for consideration in *Corporate Affairs Commission v Drysdale*.[65] In this case the High Court had to decide whether a person who had been a director, but whose term of office had expired, could be held liable for his actions as a director during the period in which he continued to act de facto as a director. The court did not agree that the only possible interpretation of "director" was that given to the words in s 5 in *Harris v S*. The court held the term "director" in s 124 of the Companies Act (NSW), which imposed duties on a director, should be interpreted as including reference to a person who was previously a validly appointed director but whose term of office had expired.

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64 (1976) 2 ACLR 51.
65 (1979) 53 ALJR 144.

Amendment of s 5 following *Corporate Affairs Commission v Drysdale*, reflected in the existing wording of s 60(1)(a), places beyond doubt that "director" is to include a person who has not been validly appointed or authorised to occupy the position. Following the legislature's response to *Corporate Affairs Commission v Drysdale*, it is clear that persons will be deemed to be directors if they act in the position of director, regardless of the name by which they are called and whether or not their appointment is valid. In my view, s 60(1)(a) should be seen as referring to persons intended by the company to be directors, as distinct from the category of directors described in s 60(1)(b).

3. Section 60(1)(b) – the shadow director

This subparagraph refers to "a person in accordance with whose directions or instructions the directors of the body are accustomed to act". This person is called a "shadow director". As the metaphor suggests, the section applies to a person who is neither intended to be appointed as director, nor intends to attract to himself or herself the duties and responsibilities incumbent upon an appointed director.[66] It is clear from the cases that corporate bodies fall within the definition of shadow director in appropriate circumstances.[67] At first glance this seems curious given that corporate bodies are disqualified from being appointed as directors.[68]

There are a limited number of reported decisions in which the meaning of this limb of the definition of director has been considered. In *Harris v S* the court interpreted the definition as applying to the real controller of the company. "[I]t must be shown that it was his will, and not the independent will of the appointed directors, which determined the resolutions of the board of directors."[69]

The court also held that not only must it be shown that the directors are acting as directed or instructed by a person dehors the board, but that the directors must "perform positive acts, not forbear to act or desist from acting".[70] Wells J considered that if the directors simply stand aside – either voluntarily or under compulsion – and allow the company's affairs to be run by another, as was the situation in this case, it cannot be said of them that they are accustomed to act on the directions or instructions of their usurper.[71] The statutory reach of the section does not extend to the situation where a person, by virtue of control or influence exercised over the board, completely usurps the board and acts for the company.

The statutory definition of director was considered in *Kuwait Asia Bank* where an attempt was made to attribute liability to the Bank as employer and nominator of two of the five directors of a company's board. It is clear from the brief remarks in the judgment that the Privy Council would not have regarded evidence that two of the directors of a company were accustomed to act on the direction or instruction of the Bank as sufficient to fix liability on the Bank unless it was clear that the remaining directors were also accustomed so to act.[72] No such allegation had been made.

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66 For clarification of the distinction between de facto and shadow directors, see the discussion by Millett J in *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180.

67 *See Harris v S* (1976) 2 ACLR 51; *Standand Chartered Bank v Antico* (1995) 13 ACLC 1,378.

68 Section 221(3) Corporations Law.

69 (1976) 2 ACLR 51 at 72, per Sangster J.

70 Ibid at 64, per Wells J.

71 Ibid.

72 [1990] 3 All ER 404 at 425, per Lord Lowry.

Two obvious and related questions following *Kuwait Asia Bank* are whether the extended definition of "director" would apply (without more) if all the directors were nominees of the Bank, and whether it is necessary to show that all, rather than a majority, of the directors are accustomed to act in accordance with the directions or instructions of the third party. The first question is addressed expressly in the *Dairy Containers* case which I will now discuss. I suggest the answer to the second question should be no. To the extent that the board can act by majority, it should be effective control over that majority which attracts the operation of s 60(1)(b).

(a) Dairy Containers Ltd v NZI Bank Ltd

It will be recalled that the Auditor-General sought to fix liability on NZDB as a "director" of DCL. The provision relied upon by the Auditor-General is very similar in wording to s 60(1) of the Corporations Law. Subsection 2(1) of the Companies Act 1955 (NZ) provides that a director includes: "A person in accordance with whose directions or instructions the persons occupying the position of directors of a company are accustomed to act."

The decision of Thomas J on this issue was determined as a question of fact: "[W]ere the directors of DCL accustomed to act in accordance with the directions or the instructions of another person?"[73] He concluded that the directors of DCL did not fall within the statutory definition and therefore NZDB was not a director within the extended meaning of director. His Honour concluded:

> As employees they were accustomed to act in accordance with their employer's directions or instructions, but as directors of DCL they did not as a matter of fact receive directions or instructions from the parent company. They were, as directors of DCL, standing (or sitting) in the shoes of NZDB at the board table, but they had not and did not receive directions or instructions from their employer. Even when a firm instruction from NZDB was made, it was directed at the company, not at the directors.[74]

Consequently, the fact that the directors of DCL were employees of NZDB acting in the course of their employment was held not in itself to mean that in carrying out their duties as directors of DCL they were acting on the directions or instructions of NZDB as contemplated in the statutory definition. Thomas J was concerned that for the directors of DCL to be "accustomed to act" in accordance with the instructions or directions of NZDB, DCL's directors would, "in their capacity as employees of NZDB, need to give themselves directions or instructions in their capacity as directors of DCL and then, still in that capacity, be accustomed to carry them out."[75] It was this "artificiality" which his Honour was at pains to avoid.

It is not difficult to agree that merely appointing employees as directors of a company should not render the employer a shadow director. There is a danger, however, that reluctance to identify the employee-directors as conduits for directions or instructions to pass from a holding company to the subsidiary will not allow due weight to be given to the control actually exercised in any particular fact situation. Distinguishing between directors receiving directions or instructions as *employees* rather than as *directors* may

73 (1995) 13 ACLC 3,211 at 3,328.
74 Ibid.
75 Ibid.

be helpful to analyse the facts of a given case but there is a danger of further artificiality if the potential for control is thereby ruled out.

As we have seen, Thomas J preferred to impose vicarious liability on NZDB for the negligence of DCL's directors, rather than characterise NZDB as a director. On his Honour's reasoning, for the statutory definition to apply, it must be shown that the employer retained the responsibility of running the company, rather than delegating the responsibility to its employee-directors, and that the employer gave identifiable directions or instructions to the employee-directors as directors, rather than as employees. This approach is stricter than the approach taken in the following case.

(b) ASC v AS Nominees Ltd

The issue in this case was whether Windsor was a person on whose instructions or directions the directors of ASN and Ample were accustomed to act. The ASC sought to have their application for relief dealt with in the light of Windsor's true relationship with those companies, not simply based on his role as an accessory of the companies and their directors. In effect it was sought to show him as the "moving force" behind the companies.

The respondents argued that Windsor was a person on whose advice the directors acted, and that the "advice [was] given by [him] in the proper performance of the functions attaching to [his] business relationship with the directors" within the terms of s 60(2), (the professional adviser exception), and therefore he was not a director within s 60(1). This argument failed because Finn J found that "it cannot be said that in those matters in which Windsor intruded, the boards of either company exercised an independent role at all."[76] In finding Windsor was a director of both ASN and Ample his Honour noted:

> What so often was asked of, and conceded by, the boards was either to act partially towards Windsor or to act in ways which, in furthering his designs, required the dereliction of their own, and of their trust company's duties.[77]

Finn J concluded that the reference in s 60(1) to a person in accordance with whose directions or instructions the directors are "accustomed to act" does not require that there be directions or instructions embracing all matters involving the board: "Rather it only requires that, as and when the directors are directed or instructed, they are accustomed to act as the section requires."[78] The essential question the section poses was expressed in the following terms by Finn J:

> Where, for some or all purposes, is the locus of effective decision making? If it resides in a third party such as Windsor, and if that person cannot secure the "advisor" protection of s 60(2), then it is open to find that person a director for the purposes of the Corporations Law.

Windsor was potentially liable therefore under s 232(4) of the Corporations Law. I would comment, however, that where liability for loss resulting from a particular act or omission is sought to be fixed on a third party it will be necessary, as a matter of causation, to establish that the loss was caused by an act or omission resulting from the direc-

76 (1995) 13 ACLC 1,822 at 1,838.
77 Ibid.
78 Ibid.

tions or instructions of that third party. Even though s 60(1)(a) refers to the directors of a company being "accustomed" to act, it is implicit that this will not overcome the need to show a causal connection between the shadow director's instruction or direction and the breach of duty occasioning the loss. Otherwise, a third party might be held liable as shadow director for all actions of the directors of a company, based on a pattern of conduct, regardless of actual interference in the circumstances for which s 60(1) is being relied upon. The following case suggests that the situation is somewhat different where the liability is for insolvent trading.

(c) Standard Chartered Bank v Antico[79]

This case involved a claim against a company, Pioneer International Ltd and three of its nominee directors for insolvent trading under s 556 of the Companies Code. The facts were as follows. Pioneer owned 42 per cent of Giant Resources Ltd. Three of Giant's directors, Mr Antico, Mr Quirk and Mr Gardiner, were nominees of Pioneer. The claim arose out of an overdraft facility entered into between Standard Chartered Bank and Giant. Standard had earlier granted a bill acceptance/discount facility of $30 million to Giant, and subsequently extended that facility. When Standard made available the overdraft facility it did not know certain facts, including that Pioneer had decided to take security over some of Giant's assets in order to secure advances that it had made to Giant. Giant failed to repay the money it owed to Standard before being wound up.

The case raised numerous legal questions about the application of s 556 of the Companies Code.[80] The question considered by the court that concerns us here is whether Pioneer had been a director of Giant (under s 5 of the Companies Code which is identical to s 60 of the Corporations Law) or had taken part in its management. The case was heard by Hodgson J who awarded Standard an amount equal to the interest on the overdraft for a period of time before the beginning of the winding up. Hodgson J found on the facts that Pioneer was a director of Giant or was a person who took part in the management of Giant. On the view taken by Hodgson J, in line with previous authorities, the question whether Pioneer was a person who took "part in the management" of Giant was to be determined by identifying whether Pioneer was a person whose management role in the company could be likened to that of a director.[81]

In February 1989, the Giant board consisted of five executive directors and the three nominees of Pioneer, who were non-executive directors. The board of Pioneer consisted of the latter three, Antico as Chairman of Pioneer, Quirk as Managing Director of Pioneer and Gardiner who subsequently became Deputy Managing Director and Finance Director of Pioneer. It appears that in June 1989 the board of Giant was reconstructed, with Antico becoming Chairman and three representatives of Giant management asked to resign.

The usual position where a shareholder appoints nominees to the board was stated by Hodgson J as follows:

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79 (1995) 13 ACLC 1,378.

80 For discussion, see R Baxt, "Liability of Shadow Directors for Insolvent Trading – Australian Authorities Start to Bite" (1996) 14 *Company and Securities Law Journal* 121.

81 Supra n 79 at 1,436. And see *Holpitt Pty Ltd v Swaab* (1992) 10 ACLC 64; *Taylor v Darke* (1992) 10 ACLC 1,516; *Sycotex Pty Ltd v Baseler* (1994) 12 ACLC 494.

> It is clear that the mere fact that Pioneer owned indirectly 42% of the shares of Giant, and had three nominees on its board, is insufficient to make Pioneer either a director or a person who took part in the management of Giant. Furthermore, in general, in the absence of evidence to the contrary, the Court would take it that actions performed by Antico, Quirk and Gardiner, as directors of Giant, were actions taken by them on behalf of Giant, and not as officers or agents of Pioneer.[82]

The court also acknowledged that a holding company is not to be treated as a director of its subsidiaries merely because it has control of how the boards of its subsidiaries are constituted.[83]

Hodgson J then referred to relevant circumstances which led him to conclude that the usual position did not hold in this case. An important factor was that Pioneer had effective control of Giant by virtue of its 42 per cent shareholding where the only other significant shareholders held about 10 per cent, 6 per cent, 6 per cent and 3 per cent of the shares.[84] Effective control alone though would not be sufficient to make a shareholder a director in the absence of evidence, found to exist in this case, that the control was actually exercised. Another relevant circumstance was that Pioneer imposed on Giant requirements for reporting consistent with the financial reporting required for the Pioneer group. Giant's management was directed by the Pioneer Board to ensure there was proper financial reporting by Giant and that there was full access to all financial records by Pioneer.[85]

Of further significance was that three major strategic decisions concerning Giant were effectively made by Pioneer during the period during which it was alleged that Pioneer was a "director" of Giant. In one instance, a decision was taken by Antico, Quirk and Gardiner that Giant should not proceed with an acquisition of one of Pioneer's mineral assets. This recommendation went before the Pioneer board but not the Giant board. The Pioneer board resolved that it was not in the best interest of either company to proceed, which as vendor effectively precluded Giant from deciding whether to buy. The matter was not referred for consideration to the Giant board. Another instance concerned the decision as to how Giant was to be funded by Pioneer and the taking of security. This decision was never the subject of careful consideration by the Giant board, but was accepted by that board as "a fait accompli".[86]

The three nominee directors maintained that they were well aware of their duty, as directors of Giant, to act in the interest of all Giant's shareholders, and that they did not act on instructions from Pioneer as to how they should act in their capacity as directors of Giant. In this case though, it appears that Pioneer was found to be a shadow director because its nominee directors failed to pay sufficient attention to the separate interests of both companies. Hodgson J was not satisfied that the three, having carefully considered in their capacity as directors of Pioneer important strategic decisions concerning Giant, gave separate consideration to the decisions in their capacity as directors of Giant. They "simply accepted the decisions which had effectively been made by Pioneer".[87]

Hodgson J did not address directly the way in which Pioneer was a "person in accor-

82 Supra n 79 at 1,436.
83 Ibid at 1,439.
84 Ibid at 1,437.
85 Ibid at 1,437.
86 Ibid at 1,439.
87 Ibid at 1,440.

dance with whose directions or instructions the directors of Giant were accustomed to act". It is to be inferred that his conclusion that the Giant board accepted certain decisions made by the Pioneer board, such as the decision to fund Giant and the basis of security provided by Giant, as evidence that the Giant board was "accustomed" to act on the directions or instructions of the Pioneer board. Neither did his Honour expressly address the question whether it is necessary to show that all, rather than a majority, of the directors are accustomed to act in accordance with the directions or instructions of the third party. It is to be assumed that in the absence of evidence that a majority of the members of the board acted for reasons unrelated to the intervention of the third party that it is not necessary to show that each director was "accustomed to act on the directions or instructions".

Hodgson J clearly found that the directors of Giant were accustomed to do as directed by Pioneer. He also clearly found that directions and instructions were given. An interesting aspect of the case is how Pioneer's directions or instructions were given to the Giant board. It appears that the nominee directors were at the one time involved in giving the directions and instructions, wearing their Pioneer hats, and at the same time receiving and acting on those instructions, wearing their Giant hats. It was not suggested though that Antico, Quirk or Gardiner were also shadow directors.

Contrast this with the approach taken in *Dairy Containers*. The decision in *Dairy Containers* might be explained on the basis that there was no evidence that any formal directions or instructions were given to the DCL board (although as we have seen, Finn J in *ASC v AS Nominees* was of the view that this is not always necessary). Thomas J's refusal to use the nominees as the conduit for NZDB's directions or instructions might also be supported on the ground that the nominees were "mere employees" of NZDB, not directors of that company, as was the case with the three nominee directors in *Standard Chartered Bank*.

(d) Re Hydrodam (Corby) Ltd

Another recent decision which throws light on how s 60(1)(b) is likely to be applied to holding companies, other controlling shareholders and their directors is the decision of Millett J in *Re Hydrodam (Corby) Ltd*.[88] In that case, Eagle Trust Pty Ltd had a wholly owned subsidiary, Midland City Partnerships Ltd (MCP), which in turn had a wholly owned subsidiary, Landsaver MCP Ltd (Landsaver 19). Hydrodam (Corby) Ltd was a wholly owned subsidiary of Landsaver 19. Hydrodam, which had two corporate directors, (two Channel Island companies that were directed by Eagle Trust), went into liquidation. The liquidator commenced proceedings against two of the directors of Eagle Trust alleging that they were liable for wrongful trading under s 214 of the Insolvency Act 1986 as defacto or shadow directors in connection with the affairs of Hydrodam.

The directors applied to have the liquidator's application against them struck out but their application was dismissed. The matter came before Millett J on appeal from that decision. Millett J allowed the appeal, concluding that the liquidator had not adduced evidence that either of the two directors were at material times directors of Hydrodam.

88 [1994] 2 BCLC 180.

Millett J did not have to decide for purposes of the appeal whether Eagle Trust was a shadow director of Hydrodam but he was prepared to draw that inference.[89] He was not prepared, however, to agree that where a body corporate was a director of a company that its own directors must therefore be shadow directors of that company. As his Honour correctly reasoned, it does not follow from the appointment of a director to the board of a company, that he or she also acts as a director of a subsidiary company.

The following passage from the judgment provides a useful guide for the application of s 60(1)(b):

> It is possible (although it is not so alleged) that the directors of Eagle Trust as a collective body gave directions to the directors of the company and that the directors of the company were accustomed to act in accordance with such directions. But if they did give such directions as directors of Eagle Trust, acting as the board of Eagle Trust, they did so as agents for Eagle Trust (or more accurately as the appropriate organ of Eagle Trust) and the result is to constitute Eagle Trust, but not themselves, shadow directors of the company.

In practice, in a case of the present kind, it is much more likely that it will be found that the executive directors of the ultimate parent company (or some of them) have from time to time individually and personally given directions to the directors of the subsidiary and thereby rendered themselves personally liable as shadow directors of the subsidiary. But if all they have done is to act in their capacity as directors of the ultimate holding company, in passing resolutions at board meetings, then in my judgment the holding company is the shadow director of the subsidiary, and they are not. This decision is consistent with the approach taken in *Standard Chartered Bank*, and it is the holding company to which one will usually look to find the shadow director, rather than to the directors of the holding company.

4. Summary of the shadow director developments

The cases discussed in the preceding section provide some guidance on the following elements which are necessary to prove a shadow directorship. These are summarised below. They also leave many questions unresolved.

(a) Directions or instructions must be given by the third party

Although Millett J in *Re Hydrodam* did not have to decide whether it had been proved that directions or instructions had been given his Honour appears to assume that express directions would be given. The need for directions to be express, or "formal", however, was not accepted by Finn J of the Federal Court in *ASC v AS Nominees Ltd*.[90] In his view "[t]he formal command is by no means always necessary to secure as of course compliance with what is sought."[91] Obviously it will be more difficult to establish that the board acted on the directions or instructions of the shadow director in the absence of evidence of formal commands. In my view, Finn J's interpretation is consistent with the intent of the section which is to have regard to substance rather than form. There are dangers with this approach though. As one commentator has remarked:

89 Ibid at 183.
90 (1995) 13 ACLC 1,822.
91 Ibid at 1,838.

> One can easily imagine a situation in which a board, for reasons known only to itself, acts on its own accord only to advance the interests of an influential and substantial shareholder without formal instructions from the shareholders or the shareholder's representatives.[92]

I agree that it is important to prove that the element of command was present, even if the evidence of command is found in actions taken by the "shadow" rather than in formal commands.

(b) The directions or instructions must be given to the board

An obvious question is whether the reference to "the board" in s 60(1)(b) means all the members of the board. It has not been necessary to decide this question in the cases to date. In my view, where it is possible for a majority to act for the company, it need only be a majority who act on the directions or instructions. Will it be sufficient if the instructions are given to an individual director (or other person with influence over the board) on whose directions or instructions the directors are accustomed to act? On the reasoning in *Re Hydrodam* the person instructing the individual director would be a shadow director. The individual director would only be a shadow director if he or she was not acting as an agent when giving the directions or instructions.

Is it possible to be a shadow director if the directions or instructions are given to a person who exercises board powers that have been delegated to the person by the board? I suggest that it must be. Section 60(1)(b) is concerned with the question: "Who is exercising the board of directors' powers?" Powers which have properly been delegated to individual directors should be capable of being exercised by a shadow director.

It need not be proved that a person *intended* to control the company. There is no requirement of a conscious effort to exercise directorial powers. This is evident from *Standard Chartered Bank*. It is also consistent with the approach taken in *Re Tasbian Ltd (No 3)*[93] where the issue was whether a chartered accountant had, by his conduct, become a shadow director. The court held that the accountant's motive for acting as he did was irrelevant. It is the effect of conduct and not the motive for that conduct that is the deciding factor. The *Dairy Containers* case suggests that the directions or instructions must be given to the board or some of the board in their capacity as directors and not in any other capacity, for example, as employee. I suggest that if this is a requirement, it is unduly restrictive and should not be applied in Australia.

(c) The board must be accustomed to act on the directions or instructions

There is no discussion in the cases of the meaning to be given to "accustomed". The ordinary meaning of this word suggests a course of conduct. One would not expect it to be possible to fix liability on a third party where directions or instructions were given to a board and acted upon only once. In *Re Hydrodam* Millett J considered that to constitute a shadow directorship there needs to be a "pattern of behaviour in which the board did not exercise any discretion or judgment of its own but it acted in accordance with

92 Koh, supra n 5 at 345.
93 [1992] BCC 358.
94 Supra n 88 at 183.

directions of others".[94] This raises an obvious question of degree. What if the directors act in accordance with the directions or instructions of another in respect of a major decision like disposing of key assets but exercise independent judgment on minor day to day matters? One would expect that a pattern of compliance, albeit interrupted by the occasional exercise of independent judgment, could suffice. Decisions involving questions like these will depend heavily on the facts of the particular case.

Millett J went even further and suggested that the board of directors must not have exercised any discretion of its own. While a case would be stronger where the board had exercised no discretion of its own, in my view it is unduly restrictive of the section to confine it to this situation. Based on *ASC v AS Nominees* the Australian position is that a board can be found to be "accustomed to act" even though the directors occasionally exercise independent judgment. In that case Finn J found that the relationship between Mr Windsor and the directors was not one in which the directors could be said at all times and for all purposes to have acted entirely as his puppets without exercising any discretion at all in their companies' affairs, nor was it one in which his influence extended to all board decisions. Nonetheless his Honour was satisfied that Mr Windsor was a shadow director because, when asked, the board had often acted with partiality towards Mr Windsor or in ways which in furthering his designs required a dereliction of their own, and their trust company's, duties.

In *Harris v S* it was held that the directors must perform "positive acts, not forbear to act or desist from acting" for the subparagraph to apply.[95] This is true in the sense that there must be puppets for there to be a puppeteer. One would expect though that the subparagraph would apply to directions or instructions on which the board were accustomed to act which were directions or instructions to *desist* from specified acts. A contrary view would be unduly restrictive of the provision.

5. Liability of holding companies for insolvent trading by their subsidiaries under s 588V

The decision in the *Standard Chartered Bank* case demonstrates that actual control of a company, as distinct from legal control, can lead to a finding that the control has been exercised to the extent that the board of the controlled company acted in accordance with the directions or instructions of the controlling shareholder. Despite the removal of the words "or take part in the management of the company" which formed part of s 592 (see now s 588G) and which could be used to fix liability on parties other than "directors", there remains considerable scope to fix liability on third parties via s 60.

The result is that third parties who exercise actual control over a company may become liable in appropriate circumstances for insolvent trading under s 588G if they are found to be a shadow director under s 60. The closer the relationship between the company and degree of control exercised the less likely it will be that the defences in s 588H will be available.

Section 588V, which also operates to fix liability on a person other than the company that has engaged in insolvent trading, operates in more limited circumstances than s

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95 (1976) 2 ACLR 51 at 64, per Wells J.

588G. Legal control as defined in s 46 of the Corporations Law must be proved before a holding company can be held accountable for debts incurred by its subsidiary.[96] A holding company, legally defined, can be liable for insolvent trading by its subsidiary even where there is no case for arguing that the holding company is a shadow director. The actual influence of the holding company need not be shown, although facts establishing independence of the subsidiary may be relevant to s 588V and the defences in s 588X.

Conclusion

The equitable principles which provide relief against third parties for breach of fiduciary obligations or for knowingly assisting in the breach of fiduciary obligations have long been recognised as forming part of corporate law. The decision in *ASC v AS Nominees* does not create any new principles but it does serve as a reminder to directors of trustee companies that they cannot always hide from trust beneficiaries behind the trustee company. The level at which tort principles have been recognised as applying to corporate activity has traditionally been much lower than fiduciary principles, but I suggest that, as in *Dairy Containers*, this is likely to be placed increasingly under scrutiny.

In *Standard Chartered Bank* the court was willing to recognise effective control of a company as grounds for holding a shareholder to be a director, with the resultant exposure to liability by that shareholder for insolvent trading. In effect this expands the circumstances in which controlling shareholders may be liable beyond s 588V which imposes liability on holding companies. Application of the extended definition of "director" in s 60 is not always required to fix liablity on third parties for corporate activities. As recent cases demonstrate, however, the section has an important part to play in allocating responsibility in a range of situations.

96 On the control required for purposes of s 46, see *Mount Edon Gold Mines (Aust) Ltd v Burmine Ltd* (1994) 12 ACLC 176; *Bluebird Investments Pty Ltd v Graf* (1994) 12 ACLC 724.

Chapter 11

Safe Harbours or Sleepy Hollows: Does Australia Need a Statutory Business Judgment Rule?

Paul Redmond*

Introduction

The business judgment rule carries a variety of meanings across corporate law jurisdictions. In the United States it refers to judicial doctrines which establish a "safe harbour" from liability for breaches of the duties of care owed to their corporation by directors and officers for business judgments taken in good faith, untainted by interest and after adequate decision-making process. In Australia the term is sometimes applied to case law doctrines which establish a presumption of validity of directors' decisions and a judicial disposition against review of their business judgments. An alternate modern Australian usage refers to a statutory rule to give effect to the safe harbour doctrine created by judicial decision in the United States.

This chapter is in three parts. The first looks at the context of the recent advocacy of a statutory business judgment rule in Australia and its connection with developments in the statutory and general law duty of care of directors and officers. The second part examines the principal elements of the United States doctrine and suggested Australian formulations of a statutory expression. The third reviews some arguments touching the introduction of such a statutory rule.

It is the broad thesis of this chapter that the case has not been made by those who propose the introduction of a statutory business judgment rule. First, such a rule is largely irrelevant to the principal difficulties facing company directors and officers under the modern corporate law formulations of their duties, namely, the uncertain and indeterminately expanded tortious duty of care and the imposition of civil and criminal liabilities upon them under myriad statutes by virtue of their office, subject to particular defences. To these latter obligations a statutory business judgment rule, as it is commonly understood, would have no application. Further, within its sphere of operation, it is argued that there is no reason to believe that a statutory business judgment rule would offer superior protection to that provided by long established general law doctrines of directors' duties which protect business judgments from inappropriate hindsight review, including review of the merits of the business judgment.

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Recent Advocacy of a Statutory Business Judgment Rule and its Relation to Development of the Director's Duty of Care

The focus of this chapter is the question whether Australian corporate law requires a *statutory* business judgment rule. This question was placed firmly upon the corporate law agenda in mid 1996 by Senator Brian Gibson, the then Parliamentary Secretary to the Treasurer,[1] the Australian Institute of Company Directors and some commentators.[2] In March 1997, the Treasurer, announcing his Corporate Law Economic Reform Program, specifically included within its remit a review of "whether the current rules regulating company directors' conduct inhibit sound business judgment". Since then, the Federal Government, as part of this Program, has proposed that there be a statutory business judgment rule.[3]

Genesis of the 1992 advocacy in concerns about the reformulation of the statutory duty of care

The arguments for a statutory business judgment rule were considered in 1992 in the context of changes proposed to the statutory duties of care and diligence of company directors and officers by the Exposure Draft of the Corporate Law Reform Bill 1992. The Exposure Draft was released in February 1992. It had proposed that the statutory duty of care of corporate officers contained in s 232(4) be redrafted in the following, more objective, terms:

> In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person would exercise in exercising those powers, and discharging those duties, as an officer of a corporation in the corporation's circumstances.

The reference to the "corporation's circumstances" was intended as excluding from relevance questions going to the nature of the individual director's office as executive or non- executive, paid or honorary.[4] Further, the Exposure Draft proposed the addition of cl 232(4AA) containing a list of matters to which reference might be had in determining whether an officer had complied with the duty of care provision:

> In determining whether or not an officer of a corporation has contravened subsection (4), regard must be had to such of the following as are relevant in the particular case:
>
> (a) what information the officer acquired, and what inquiries the officer made, about the corporation's affairs;
>
> (b) what meetings the officer attended;
>
> (c) how far the officer exercised an active discretion in the matters concerned;
>
> (d) what the officer did to ensure that the corporation made adequate arrangements:

1 See "Corporations Law: The View from Canberra," *Butterworths Corporation Law Bulletin* 1996, No 12, para 218.
2 See, for example, R Baxt, "Do we Need a Business Judgment Rule for Company Directors?" (1995) 69 *Australian Law Journal* 571.
3 Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance*, Paper No 3 (1997).
4 Attorney-General's Department (Cth), *Corporate Law Reform Bill 1992, Draft Legislation and Explanatory Paper* (1992) at para 101 ("Whilst these matters are relevant to the director's circumstances, they are not relevant to the company's circumstances.")

(i) to ensure that people who prepared reports, or gave advice or opinions, on which officers or employees of the corporation relied were honest, competent and reliable, and were in other respects such as to inspire confidence in their reports, advice or opinions; and

(ii) to monitor and ensure compliance with the law, and with the corporation's constitution, by the corporation and its officers and employees; and

(iii) to ensure that persons who took part in the corporation's management did whatever was necessary to avoid a conflict of their pecuniary or other interests with the proper performance and exercise of their functions and powers; and

(iv) to ensure that decisions made by persons on the corporation's behalf were adequately monitored; and

(v) to ensure that persons who made decisions on the corporation's behalf had adequate information about the subject matter of the decisions;

(e) what the officer did to ensure that arrangements of the kind referred to in paragraph (d) were given effect to:

and to any other relevant matter.

In May 1992 the Joint Statutory Committee on Corporations and Securities held public hearings upon the Exposure Draft. The Australian Institute of Company Directors and the Business Council of Australia made submissions which argued against amendments to the duty of care and in favour of a statutory business judgment rule.[5] The Committee's report simply outlined the submissions which it had received and evidence taken at the hearing without making recommendations with respect to matters put to it.[6]

On 3 July 1992, Rogers CJ in the Commercial Division of the Supreme Court of New South Wales handed down judgment in the AWA litigation, exculpating the non-executive directors from claims of negligence.[7] The non-executive directors of AWA were held to be under no obligation of inquiry with respect to defects in the company's foreign exchange operations since they possessed no knowledge displacing their right to rely upon management supervision. (The chairman and chief executive, of course, was not so fortunate.) Rogers CJ was prepared to allow a generous scope for reliance by non-executive directors upon senior management. The judge said that such reliance would be unreasonable, and the right of reliance displaced, only where an individual director was aware of circumstances of such a character, so plain, so manifest and so simple of appreciation that no person, with any degree of prudence acting on his behalf, would have relied on the particular judgment, information and advice of the officers.[8]

This formulation would appear to allow a more generous right of reliance and, correspondingly, a narrower scope for operation of the duty of inquiry, than under the formulation in *Re City Equitable* which permits reliance "in the absence of grounds for suspicion".[9]

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5 Australian Institute of Company Directors, *Submission to the Attorney-General of the Commonwealth of Australia on the Exposure Draft (February 1992) of the Corporate Law Reform Bill 1992* (May 1992) at 23-32; Business Council of Australia, *Draft Response to the Corporate Law Reform Bill 1992* (May 1992) at 3-4.

6 Joint Statutory Committee on Corporations and Securities, *Summary of Evidence Presented to the Committee on the Draft Corporate Law Reform Bill 1992* (June 1992).

7 *AWA Ltd v Daniels* (1992) 7 ACSR 759.

8 Ibid at 868.

9 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 429.

The realistic view taken elsewhere in the judgment of Rogers CJ of the realities of board role and director function, particularly in the large public company, encouraged those who were particularly concerned that legal standards serve accountability functions. On the other hand, the legal formulation of the right of delegation and reliance reassured directors. Judicial development of doctrine seemed to many to offer the prospect of a way to defensible liability standards.

The compact on the statutory formulation of the duty of care

In the latter months of 1992, a meeting was held between the Business Council of Australia and the Attorney-General, the outcome of which was said by one participant to be a decision to reformulate the statutory duty of care, to delete the proposed cl 232 (4AA) with its list of factors by reference to which compliance might be tested, and to reject proposals for a business judgment rule to be included in the redrafted Bill. It was, however, agreed that reference would be made in the Explanatory Memorandum to the role of risk taking and to the judicial developments of the business judgment doctrine, with an endorsement by the Government of those developments.[10]

The Corporate Law Reform Bill 1992 introduced into Parliament on 3 November 1992 by the Attorney-General was consistent with such an agreement. First, the terms of the duty of care were recast to articulate the duty not only to the corporation's circumstances but to the position occupied by the individual director. Thus, the present s 232(4) provides:

> In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person *in a like position in a corporation* would exercise in the corporation's circumstances [emphasis added].

Second, cl 232 (4AA) was excluded from the Bill. Third, the Explanatory Memorandum stated apropos the revised duty of care to be expressed in s 232(4):

> In the case of a business corporation, the standard would reflect the fact that corporate decisions involve risk-taking. The courts have in the past recognised that directors and officers are not liable for honest errors of judgment: *Ford's Principles of Company Law* (6th ed., 1992) at pp 528-9. They have also shown a reluctance to review business judgments taken in good faith. Thus, in *Harlowe's Nominees Pty Limited v Woodside* (1968) 121 CLR 483 at 493, the High Court said:
>
>> Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.
>
> In addition, the courts have exercised their discretion to excuse directors who have acted honestly and who ought fairly to be excused: *Re Claridge's Patent Asphalte Company Limited* [1921] 1 Ch 543. The Corporations Law already contains a provision of this nature (section 1318) and the application of that section is effectively being extended by clause 17 of this Bill.
>
> The Government endorses this approach and does not intend any change in the law by the revised wording of subsection 232(4). No attempt has been made in the Bill to enact a US style of Business Judgment Rule since no State in the USA has adopted a legislative statement of the Rule. Instead the matter has been left to the courts to develop. Similarly the Government considers that the development of similar principles in Australia is better left to the courts.

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10 JH Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 *Corporate and Business Law Journal* 1 at 23.

The AWA appeal judgments

In May 1995 the New South Wales Court of Appeal delivered its judgments in the AWA appeal. The cross-appeal against the trial judge's exculpation of the non-executive directors was dismissed. However, by majority, the court held that directors owe a common law duty to their company to take reasonable care in the performance of their office, actionable by suit in negligence by the company.[11] That duty of care is not "merely subjective, limited by the director's knowledge and experience or ignorance or inaction".[12] The leading decision of the Supreme Court of New Jersey in *Francis v United Jersey Bank* was extensively quoted for its statements of "what is generally expected of directors not only in the United States but in Australia and elsewhere. In our opinion, this has become what the law requires of directors."[13]

The *Francis* formulation obliges directors to meet a minimum objective skill standard, and to have a continuing obligation to keep informed about corporate activities, a general obligation to monitor corporate affairs and policies, and a duty of inquiry arising in particular circumstances.[14] The majority rejected the formulation of the duty of inquiry applied by the trial judge, by implication, on the basis that it set too low a standard.

The Corporate Law Economic Reform Program Proposal

In October 1997, the Federal Government announced, as part of its Corporate Law Economic Reform Program, that the Corporations Law should be amended to include a statutory business judgment rule. The following form of the rule was proposed:

> (1) An officer of a corporation is taken to meet the requirements of sub-section 232(4) and the general law duty of care and diligence in respect of a business judgment made by them if the officer:
>
> (a) exercises their business judgment in good faith for a proper purpose;
>
> (b) does not have a material personal interest in the subject-matter of the business judgment;
>
> (c) informs themselves about the subject-matter of the business judgment to the extent the officer reasonably believes to be appropriate; and
>
> (d) rationally believes that the business judgment is in the best interests of the corporation.
>
> (2) In this section "business judgment" includes any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation.
>
> (3) Sub-section (1) does not operate in relation to any other provision of this Law or any other Act or any Regulation under which an officer may be liable to make payment in relation to any of their acts or omissions as an officer.[15]

It is not fanciful to attribute renewed advocacy for a business judgment rule to concerns about the general law duty of care expressed in the AWA appeal decision. If so, there is a certain irony in view of the earlier phase of that debate since the AWA decision did not raise any issues concerning the interpretation of s 232(4). The action was founded wholly upon alleged beaches of general law duties of directors.

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11 *Daniels v Anderson* (1995) 16 ACSR 607 at 668.
12 Ibid at 666.
13 Ibid at 666 citing *Francis v United Jersey Bank* 432 A2d 814 (1981) at 821-823.
14 Supra n 11 at 667.
15 Corporate Law Economic Reform Program, supra n 3 at 28.

The Nature and Elements of the Business Judgment Rule

As noted, there is no single conception of what is meant by a business judgment rule. The United States case law establishes a rule which provides a safe harbour from liability for directors' business judgments which are made in good faith by directors with no personal interest in the transaction and who are adequately informed about the subject of the decision.[16] On the other there is a clear line of Australian and United Kingdom authority in which courts have eschewed ex post review of directors' business judgments taken in good faith.[17] Another proposed alternative is a statutory provision which might complement general law and statutory duties by providing a safe harbour from liability for business judgments made by disinterested directors in good faith with adequate information.

Australian formulations of a statutory business judgment rule

We have seen that a formulation of a statutory business judgment rule was proposed by the Federal Government as part of its Corporate Law Economic Reform Program in October 1997. Another formulation was proposed by the Companies and Securities Law Review Committee (CSLRC) in 1990, expressly not as a final draft "but only to bear out the considerations that have seemed to the Committee to be relevant".[18]

> (1) A director or officer shall not be liable to pay compensation to a company by reason of section 229 [see now section 232] or under the general law in respect of his or her business judgment unless it is made to appear to the relevant court that at the relevant time the director or officer -
>
> (a) had an unauthorised interest in the transaction of the company to which the judgment relates;
>
> (b) had not informed himself or herself to an appropriate extent about the subject of the judgment;
>
> (c) did not act in good faith for a proper purpose; or
>
> (d) acted in a manner that a reasonable director with his or her training and experience could not possibly regard as being for the benefit of the company.
>
> (2) In this section "business judgment" means a lawful judgment made for the conduct of the company's business operations and, without affecting the generality of the expression, includes a judgment as to -
>
> (e) the company's goals;
>
> (f) plans and budgeting;
>
> (g) promotion of the company's business;

16 See generally DJ Block, NE Barton and SA Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (4th ed, 1993) (hereafter Block et al).

17 See, for example, *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 835; *Turquand v Marshall* (1869) LR 4 Ch App 376 at 386; *Dovey v Cory* [1901] AC 477 at 488; the disposition against judicial intervention precedes the inception of the registered company: see *Carlen v Drury* (1812) 1 V & B 154; 35 ER 61. It is expressed also in the statutory presumption of validity of directors' decisions contained in s 164(3) (f).

18 Companies and Securities Law Review Committee, *Company Directors and Officers: Indemnification, Relief and Insurance,* Report No 10 (1990) at para 81.

(h) acquiring assets and disposing of assets;

(i) raising or altering capital;

(j) obtaining or giving credit;

(k) deploying the company's personnel; or

(l) trading

but does not include a judgment as to -

(m) matters relating principally to the constitution of the company or the conduct of meetings within the company;

(n) appointment of executive officers; or

(o) the company's solvency.

(3) Sub-section (1) does not operate in relation to any other provision of this Act or any other Act or any Regulation under which a director or officer may be liable to make a payment in relation to any of his or her acts or omissions as a director or officer.

(4) In circumstances where, in the absence of this provision, a director or officer would not be liable to pay compensation to the company this provision does not operate to impose any such liability.

United States formulations of the rule

The United States business judgment rule is essentially a creature of the courts of Delaware, although its judicial popularity has spread beyond that State.[19] A doctrine in similar terms has been adopted in many other US jurisdictions although not by statute. The rule has been invoked by the Delaware Court of Chancery on several occasions, most specifically in the area of challenges to defensive measures taken by boards faced with hostile takeovers, although this has not been the sole operation of the rule.

On the simplest level, the business judgment rule is an aspect of judicial doctrine that states that courts will not substitute their own opinion of the wisdom of a business decision for that of the director who originally made it. Judges are not directors, and should not try to be. At the more practical level, the rule is said to operate as a presumption, or a burden of proof issue. In one of the most comprehensive and authoritative commentaries on the business judgment rule, Block et al describe its operation thus:

> Should the directors be sued by shareholders because of their decision, the court will examine the decision only to the extent necessary to verify the presence of a business decision [ie a positive act], disinterestedness and independence, due care, good faith, and the absence of an abuse of discretion. If these elements are present – and they are presumed to be present – and the case does not involve fraud, illegality, ultra vires conduct or waste, then the court will not second guess the merits of the decision.[20]

The American Law Institute ("ALI"), in its detailed report on corporate governance issues, states that its model formulation of the business judgment rule [outlined below] operates consistently with the common law of Delaware, in that under it "[a] person chal-

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19 "Because over 40 percent of the corporations listed on the New York Stock Exchange and over 50 percent of Fortune 500 companies are incorporated in Delaware, the Delaware Court system is often viewed as 'the Mother Court of corporate law'": Block et al, supra n 16 at 2.

20 Ibid at 3.

lenging the conduct of a director or officer has the burden of proving the failure of the director or officer to comply with duty of care obligations...and the inapplicability of [a defined set of criteria for judging whether a director has complied with his or her duty of care]".[21] The ALI formulation is declared to be consistent with that articulated in most US jurisdictions; indeed, as the Australian Institute of Company Directors has noted, there is "simply no controversy about the formulation of the business judgment rule".[22] The ALI formulation places the business judgment rule in the context of the duty of care imposed upon directors and officers. It might be helpful if the full statement of that duty of care, including its obligations of inquiry and rights of delegation and reliance upon subordinate officers, were set out. Sections 4.01–4.03 of the ALI Principles provide as follows:

Section 4.01– Duty of care of directors and officers; the business judgment rule

(a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable.

(1) The duty in Subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.

(2) In performing any of his or her functions (including oversight functions), a director or officer is entitled to rely on materials and persons in accordance with ss 4.02 and 4.03.

(b) Except as otherwise provided by statute or by a standard of the corporation [s 1.36] and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling the duty under this Section with respect to any delegated function if the reliance is in accordance with ss 4.02 and 4.03.

(c) A director or officer who makes a business judgment in good faith fulfils the duty under this Section if the director or officer:

(1) is not interested [s 1.23] in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the corporation.

(d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfilment of duty under Subsection (b) or (c), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.

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21 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994) at 187 (hereafter ALI Principles).

22 Australian Institute of Company Directors, *Submission to the Attorney-General of the Commonwealth of Australia on the Exposure Draft (February 1992) of the Corporate Law Reform Bill 1992* (May 1992) at 29.

Section 4.02– Reliance on directors, officers, employees, experts, and other persons

In performing his or her duties and functions, a director or officer who acts in good faith, and reasonably believes that reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), decisions, judgments, and performance (including decisions, judgments, and performance within the scope of s 4.01(b)) prepared, presented, made, or performed by:

(a) One or more directors, officers, or employees of the corporation, or of a business organization [s 1.04] under joint control or common control [s 1.08] with the corporation, who the director or officer reasonably believes merit confidence; or

(b) Legal counsel, public accountants, engineers, or other persons who the director or officer reasonably believes merit confidence.

Section 4.03– Reliance on a committee of the board

In performing his or her duties and functions, a director who acts in good faith, and reasonably believes that reliance is warranted, is entitled to rely on:

(a) The decisions, judgments, and performance (including decisions, judgments, and performance within the scope of s 4.01(b)), of a duly authorized committee of the board upon which the director does not serve, with respect to matters delegated to that committee, provided that the director reasonably believes the committee merits confidence.

(b) Information, opinions, reports, and statements (including financial statements and other financial data), prepared or presented by a duly authorized committee of the board upon which the director does not serve, provided that the director reasonably believes the committee merits confidence.

The business judgment rule operates upon the duty of care. The ALI Commentary describes the interaction between the rule and the duty of care in these terms:

> If a director or officer has complied with the business judgment criteria set forth in s 4.01(c) with respect to any business judgment, he will be free of liability under s 4.01(a). If, however, a challenging party can sustain the burden of proving that a director or officer was not acting in good faith or with disinterest (in accordance with the standard of s 4.01(c)(1)) or was not informed (in accordance with the standard of s 4.01(c)(2)) with respect to a business judgment, then the safe harbor provided by s 4.01(c) will not be available, and the director or officer will be judged under the duty of care standards set forth in s 4.01(a) or the standards set forth in Part V. For example, the liability of an interested [s 1.23] director or officer in connection with a transaction entered into with the corporation will be judged under the standards [applicable to self-dealing transactions]...Finally, if a challenging party can sustain the burden of proving that a director or officer did not actually believe, or did not rationally believe, that a business judgment was in the best interests of the corporation (s 4.01(c)(3)), then the protection provided by s 4.01(c) would again not be available. A director or officer who has made a decision with a belief that lacks rationality will have failed to meet the higher standard set forth in the first paragraph of s 4.01(a), namely, the obligation to make a decision in a "manner that he or she reasonably believes to be in the best interests of the corporation". Thus, the director's or officer's duty of care will not have been met. This follows from the fact...that the "rationally believes" test is intended to provide a significantly wider range of discretion than the "reasonably believes" test.

Of course, director liability is dependent upon proof not merely of breach of duty but of loss or damage to the corporation caused by that breach.

The elements of a business judgment rule

In Block et al's analysis, the business judgment rule in Delaware law operates as a double-hurdle for the disgruntled shareholder or other person seeking to challenge directors' business decisions. At the first stage, the presumption created by the rule places a "heavy burden"[23] on the challenger to prove that the decision did not satisfy one of five criteria. Block et al have distilled the reasoning of the Delaware courts to provide five criteria which will be examined when deciding whether to open up the decision for examination on its merits. A court will only open up the decision if the challenger can prove that:

- no positive exercise of judgment was in fact made;
- the director had a personal interest in the decision, or was in some other way influenced by factors external to the interests of the company;
- the decision was not made in good faith;
- the director failed to exercise due care in making the decision; or
- there has been some abuse of discretion by the director.[24]

These requirements will be examined serially.

1. The requirement of a positive business judgment

The business judgment rule only protects judgments made by directors and officers, that is, decisions which are consciously made and involve the exercise of judgment. Failure to act is not protected unless it is a decision taken by exercise of judgment. Accordingly, the rule does not protect omissions to act such as failure in oversight or monitoring. Thus, where directors have failed to exercise any financial oversight functions, and the lack of any such system has enabled fraud by a subordinate official to occur, the rule's protection is unavailable and their conduct would be judged by reference to the duty of care standard in s 4.01(a) of the ALI Principles.[25] The ALI Commentary acknowledges the evidentiary difficulty in particular instances of distinguishing a conscious decision from inexcusable inattentiveness.[26]

The CSLRC would include within the rule lawful judgments made for the conduct of the company's business operations including judgments as to the company's goals, planning and budgeting, acquisition and disposal of assets, capital raising and trading. The rule would not protect, however, judgments taken with respect to:

- matters relating principally to the company's constitution or the conduct of meetings within the company;
- the appointment of executive officers; or
- the company's solvency.[27]

The first exception is justified on the basis that this decision is not of a business character, the second on the ground that it can properly be reviewed as to merits and the third on the ground that decisions as to solvency are expressed to be so important that they "should be made without the comfort" given by the rule.[28]

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23 Block et al, supra n 16 at 14, citing *Lewis v SL & E Inc* 629 F2d 764 at 768 (2d Cir 1980).
24 Ibid at 21-33.
25 American Law Institute, supra n 21 at 175.
26 Ibid at 231.
27 Companies and Securities Law Review Committee, supra n 18 at para 81.
28 Ibid at para 87.

In contrast, the ALI formulation does not define the term business judgment. In the US, the rule undoubtedly extends, however, to decisions preparatory to the making of a business decision.[29] The ALI Commentary notes that while most business judgment cases deal with "risky" or "economic" decisions, there is clear authority that the rule applies to decisions relating to corporate personnel, the termination of litigation and other less explicitly business decisions. Accordingly, the ALI formulation is intended to embrace those and like decisions including the setting of policy goals and the apportionment of responsibilities between the board and senior management.[30]

2. The requirements of good faith and disinterestedness

The business judgment rule is inapplicable where an officer has a interest in the subject matter or outcome of the business judgment. Where directors stand to benefit personally from a decision as director, the risk that business judgment will be compromised by interest displaces the protective operation of the rule. Courts' general "unwillingness to assess the merits (or fairness) of business decisions of necessity ends when a transaction is one involving a predominantly interested board with a financial interest in the transaction adverse to the corporation".[31] The term "interested" in s 4.01(c)(1) of the ALI Principles is broadly defined to include interests arising from associate, financial or familial relationships. The disqualifying effect of this requirement operates upon directors as individuals. Accordingly, its impact upon a decision or set of liability exposures will vary with the particular constellation of individual director interests.

3. The requirement of an informed decision

The CSLRC formulation would require the director to be informed "to an adequate extent" about the subject of the decision. This formulation suggests an exclusively objective assessment of preparedness. In contrast, the ALI formulation applies only where the director or officer is informed with respect to the subject of the business judgment to the extent that he or she reasonably believes to be appropriate under the circumstances. This standard mixes objective and subjective characteristics. The focus of each formulation is upon the preparedness of the director in reaching a particular decision as opposed to the quality of the decision itself.[32] The ALI Commentary concedes that there is "no precise way" of measuring what information is required for a particular decision. It lists the following as matters that may be relevant to an assessment of the "appropriateness" of the information before a board:

> (i) the importance of the business judgment to be made; (ii) the time available for obtaining information; (iii) the costs related to obtaining information; (iv) the director's confidence in those who explored a matter and those making presentations; and (v) the state of the corporation's business at the time and the nature of competing demands for the board's attention.

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29 American Law Institute, supra n 21 at 174.
30 Ibid at 173-174.
31 *AC Acquisitions Corp v Anderson, Clayton & Co* 519 A2d 103 at 114 (Del Ch 1986), quoted in Block et al, supra n 16 at 22.
32 American Law Institute, supra n 21 at 177.

The ALI Commentary notes that the "different backgrounds of individual directors, the distinct role each plays in the corporation, and the general value of maintaining board cohesiveness may all be relevant when determining whether a director acted 'reasonably' in believing that the information before him or her was appropriate under the circumstances".[33]

4. *Judicial applications of the informed decision requirement*

There is US case authority supporting the determination of informational adequacy by reference to a "gross negligence" test[34] in the sense of "reckless indifference to or a deliberate disregard of the whole body of shareholders" or conduct "without the bounds of reason".[35] The amount of information required for a decision to ensure the protection of the business judgment rule is itself a business judgment which attracts the protection of the rule if it itself satisfies the informed decision prerequisite.[36] Despite the apparently self- referential nature of this element, the strength of its exactions is revealed in two well known decisions of the mid 1980s.

In *Smith v Van Gorkom*[37] the Delaware Supreme Court held that the board of Trans Union Corporation was not adequately informed with respect to their decision to approve a cash out merger for the company. The directors approved the merger on the basis of a 20 minute presentation by the chief executive, Van Gorkom, without sighting the merger documents or receiving any valuation of the stock. The principal deficiencies which disentitled the directors to the protection of the rule – and which were characterised as grossly negligent – were that the directors:

- did not adequately inform themselves as to the role of Van Gorkom in "forcing" the merger and establishing the cashout price;
- were uninformed as to the intrinsic value of the company; and
- approved the merger upon a mere two hours consideration, without prior notice, and without the exigency of a crisis or emergency.[38]

In *Smith v Van Gorkom* the board did not seek any valuation or other justification for the "sale" price and no inquiry was made as to the basis for Van Gorkom's assertions as to the fairness of the negotiated price he brought to the board for approval. In *Hanson Trust PLC v ML SCM Acquisition Inc*,[39] directors granted a lock-up option by a target company over its most valuable assets to one of two rival bidders. The directors in a three hour meeting late at night apparently relied upon a conclusory opinion provided by their independent financial advisor that the option prices "were within the range of fair value". If they had inquired, however, they would have discovered that no range of fairness had been established. The Second Circuit held that the directors had "some oversight obligations to become reasonably familiar with an opinion, report, or other source

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33 Ibid at 177.
34 See, for example, *Smith v Van Gorkom* 488 A 2d 858 at 872-873 (1985); *Aronson v Lewis* 473 A 2d 805 at 812 (1984) (quoted in Block et al, supra n 16 at 32-33).
35 *Tomczak v Morton Thiokol Inc* [1990 Transfer Binder] Fed Sec L Rep (CCH) 95,327 at 96,585 (quoted in Block et al, supra n 16 at 33).
36 *In Re RJR Nabisco, Inc Shareholders Litigation* [1988-1989 Transfer Binder] Fed Sec L Rep (CCH) 94,194 at 91,713 (cited in Block et al, supra n 16 at 49).
37 488 A2d 858 (Del 1985).
38 Ibid at 874.
39 781 F2d 264 (2d Cir 1986).

of advice before becoming entitled to rely upon it".[40] Had they done so, they would have asked some obviously relevant questions.

These two decisions are, however, described by Block et al as the exception rather than the rule. The authors point to a body of other decisions in which the business judgment rule has been invoked by reference to such factors as:

- a majority of outside directors or the creation of a special committee consisting solely of outside directors;
- consultation with financial advisors and legal counsel retained either by the board as a whole or separately by the outside directors acting as a group (but not by management acting on its own);
- questioning by outside directors of management representatives and financial and legal advisors rather than reliance on conclusory statements by these advisors;
- meetings including only outside directors;
- pre-meeting distribution of relevant documentation, including summaries of the transaction to be discussed and/or copies of agreements to be executed;
- the directors' reading and careful review of this documentation;
- counsel's review of documentation with the directors;
- discussion of the proposed transaction at a lengthy rather than a short (perhaps late night and/or telephonic) meeting and/or at more than one meeting;
- use of the time the directors have in which to act;
- previous consideration of similar or related transactions;
- discussion of the proposed transaction's likely effect upon the corporation; and
- the existence, duration and other bona fides of arm's-length negotiations with third parties with whom the corporation is entering into the transaction, and the extent of outside director involvement in those negotiations.[41]

The authors observe that the courts look at the record as a whole, and the presence or absence of one or even a majority of the factors listed above is not in and of itself dispositive.[42] These factors were mostly absent in *Smith v Van Gorkom, Hansen v SCM* and other decisions denying protection on this ground.

5. The requirement of rationality of the business judgment

The final prerequisite to the protection of the rule relates to the rationality of, or some measure of reasonableness attaching to, the challenged business judgment. It is in this prerequisite that the business judgment rule delivers its benefits, the so-called safe harbour from external ex post judicial review. Those benefits take the form of a less exacting standard of scrutiny of the decision and its determination than under the duty of care. If the prerequisite is not satisfied, the liability of directors is determined under the substantive duty doctrines.

The CSLRC formulation is expressed in terms of directors not acting in a manner that a reasonable director invested with the training and experience of the particular director

40 Ibid at 275.
41 Block et al, supra n 16 at 61-66.
42 Ibid at 66.

could not possibly regard as being for the benefit of the company. This expression combines the distinctive, individuated general law skill standard for directors expressed in *Re City Equitable Fire Insurance Co Ltd*[43] and the realm of reasonableness test by reference to which shareholder decisions were assessed in *Shuttleworth v Cox*[44] under the fraud upon the minority doctrine.

The ALI formulation, on the other hand, merely requires a rational belief on the part of each director that the business judgment is in the best interests of the corporation. The actual belief requirement is purely subjective; the rationality standard is objective, and pitched below a requirement that the decision be reasonable. Some judicial formulations are expressed in terms of the business judgment not being "egregious[45] or unsupported by "any rational business purpose".[46] There is, however, a body of US authority which denies any scope for review based upon the inherent rationality of the business judgment as a precondition to the protection of the rule.[47]

An Australian Statutory Business Judgment Rule: Some Costs and Benefits

This part of the chapter examines arguments pro and contra the adoption of a statutory business judgment rule in Australia. Before doing so, it is necessary to review the scope of protection for business judgments under general law doctrines in this country.

Australian case law doctrines respecting directors' business judgments

We have seen that Australian and United Kingdom courts have eschewed ex post review of directors' business judgments taken in good faith.[48] Judicial development of directors' duties has created a body of case law principle which in function, if not name, embodies such a business judgment rule. Thus, the general law concedes to directors "the right and duty of deciding where the company's interests lie [and]... their judgment, if exercised in good faith and not for irrelevant purposes is not open to review by the court".[49]

Similar statements may be found with respect to the director's duty of care, evidencing a judicial reluctance to "second guess" business judgments taken without suggestion of bad faith and, indeed, a judicial deference to such judgments. They indicate that the standard applied is not that of a risk averse tribunal exploiting the benefits of hindsight. Thus, for example, in *Overend & Gurney Co v Gibb*[50] Lord Hatherley LC said in a suit against directors alleging negligence in the purchase of a business:

> I think it extremely likely that many a judge, or many a person versed by long experience in the affairs of mankind, as conducted in the mercantile world, will know that there is a great deal more trust, a great deal more speculation, and a great deal more readiness to confide in the probabilities

43 [1925] Ch 407 at 428-429.
44 [1927] 2 KB 9.
45 *Aronson v Lewis* 473 A2d 805 at 815 (Del 1984).
46 *Panter v Marshall Field & Co* 646 F2d 271 at 293 (cited in American Law Institute, supra n 21 at 236).
47 See Block et al, supra n 16 at 39-41.
48 Supra n 17.
49 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493; see also *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 835.
50 (1872) LR 5 HL 480 at 495. See also *Turquand v Marshall* (1869) LR 4 Ch App 376 at 386; *Dovey v Cory* [1901] AC 477 at 488; *Pavlides v Jensen* [1956] Ch 565 at 576. Of course, the dearth of modern reported decisions on the duty of care precludes mass citation of authority.

> of things, with regard to success in mercantile transactions, than there is on the part of those whose habits of life are entirely of a different character. It would be extremely wrong to import into the consideration of the case of a person acting as a mercantile agent in the purchase of a business concern, those principles of extreme caution which might dictate the course of one who is not at all inclined to invest his property in any ventures of such a hazardous character...Men were chosen by the company as their directors, to act on their behalf in the same manner as they would have acted in their own behalf as men of the world, and accustomed to business, and accustomed to speculation, and having a knowledge of business of this character.

As noted above, this body of principle was formally cited in the Explanatory Memorandum to the Corporate Law Reform Bill 1992 which contained a statement rejecting the need for a statutory business judgment rule on the basis that the general law provided adequate protection to directors against hindsight review by courts and tribunals. This position was, however, at odds with that earlier taken by several Australian law review committees, including the CSLRC,[51] the Cooney Committee[52] and the Lavarch Committee,[53] which recommended the introduction of a statutory business judgment rule along the lines of judicial doctrines developed in the United States.[54]

Some arguments for a statutory business judgment rule

1. Encouragement of risk taking

The traditional rationale for the business judgment rule in the United States is the stimulus which it is said to provide for "risktaking, innovation, and other creative entrepreneurial activities"; the rule is also justified on the basis of "a desire to limit delegation and judicial intrusiveness with respect to private-sector business decisionmaking".[55] The CSLRC thought that a business judgment rule would "encourage business endeavour by assuring people who embark on business enterprises by specific legislation that if, acting honestly, they take risks there is some safeguard against personal liability flowing from tribunals reviewing with hindsight the merits of bona fide business decisions".[56] It is not clear, however, that any legal authority supports judicial review of directors' decisions upon their merits.

2. The need for protection at the moment when directors take business judgments

The Australian Institute of Company Directors has argued that such a rule is necessary:

> in order to give directors certainty, *at the time when they take their decisions*, that if specified prerequisites are met their decisions will be beyond challenge...[I]t is of the utmost importance to balance the statutory standard of care...by a protective 'safe harbour' which will give directors the confidence to take commercial decisions on their true merits. The business judgment rule is designed

51 Companies and Securities Law Review Committee, supra n 18 at para 75.

52 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989) at para 3.35.

53 House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (1991) at para 5.4.30.

54 The Commonwealth Government initially rejected this element of the Cooney Report: see Government Response to the Senate Standing Committee on Legal and Constitutional Affairs Report on "The Social and Fiduciary Duties and Obligations of Company Directors", Senate Hansard (1991) at 3611.

55 American Law Institute, supra n 21 at 176.

56 Companies and Securities Law Review Committee, supra n 18 at para 76.

57 Australian Institute of Company Directors, supra n 22 at 24-25.

> to serve this function.[57]

As a preliminary point, it is clear that a statutory business judgment rule will not satisfy the Institute's desire for certainty for directors at the time when they take this decision since the decision remains vulnerable to challenge if the plaintiff can establish that one or more of the preconditions to its operation are not satisfied. A more substantial concern, however, is precisely why such a rule, creating an obstacle to shareholder suit, sets a superior balance than does the general law between the antinomic values of stimulating innovation and insinuating accountability for the exercise of discretionary powers and delegated functions. Where that balance should be struck is always going to be difficult. The superior claims of the business judgment rule in this balance are not, with respect, self-evident. The general law's presumption of validity of directors' decisions (expressed in Corporations Law s 164(3)(f)), coupled with the longstanding judicial tradition of non-intervention in the merits of directors' business judgments, strikes a particular balance between the competing values of risk encouragement and accountability which has not been suggested to subject directors and officers to inappropriate hindsight review, much less to merits review of their business judgments.

3. Arguments from fairness and expediency

It has been argued that the business judgment rule's special protection for directors is justified on the twin bases of fairness and expediency:

> The fairness justification focuses on the difference between good decisions which turn out badly and bad decisions. All professionals are liable for the latter. However, in the case of most professionals there is a body of practice against which one can judge what is acceptable conduct. This is not the case with company directors. Many of the decisions taken are complex decisions made on the basis of incomplete information and necessarily involve risk. The expediency reason recognises that shareholders' welfare may be better advanced by encouraging rather than restricting risk taking. Making directors liable for mere errors of judgment will promote risk averse behaviour which will stifle economic growth.[58]

A cavilling answer to the expediency justification is that directors are not made liable under their duty of care, much less their duty of good faith, for mere errors of judgment. The expediency argument rests upon no more than the assertion that shareholder utility will be better served by the absence of legal accountability for directors' decisions. The argument runs counter to legal policy in other spheres. Until its proponents substitute evidence for mere assertion, this counter-intuitive argument ought not frame an anomalous liability regime in relation to one group of potential defendants.

The force of the fairness argument – in the alleged distinctive absence of a body of practice against which the acceptability of a business judgment can be assessed – may not appear self-evident to many professional groups, including those in finance and investment, who might legitimately argue that there is no body of standard practice against which particular decisions might be tested. Further, for professionals in these areas, as in most others, complex decisions must necessarily be made on the basis of incomplete information and involve risk. There is no obvious foundation for a special

58 Farrar, supra n 10 at 23-24.

enclave for directors and officers, and none is offered by those who advance this argument.

It is no answer to add that it is unfair to treat directors as professionals and to apply to them standards of care applicable to professionals generally. Company directors need to apply professional standards for the security of the underlying investment responsibilities reposed in them. Of course, the standard of care and of judicial review to which they are presently held in making their business judgments is responsive to the particular nature of their office and its character of vicarious acquisitiveness. If it were not so, the case for a statutory business judgment rule under this fairness justification would be stronger.

4. The importation of United States liability standards

There is a substantial argument for the statutory introduction of the United States business judgment rule if, as the majority judges in AWA have apparently decided, United States doctrines with respect to the director's duty of care have either been incorporated by reference or used as a model for the development of general law duties in this country.[59] The *Francis* standard, declared to have become what is required of Australian directors, requires directors to:

- possess a minimum objective standard of competency, including a rudimentary understanding of the business and its financial statements;
- keep informed of their company's activities and to engage in "a general monitoring of corporate affairs and policies";
- attend board meetings regularly;
- regularly review the company's financial statements;
- inquire further in matters of concern revealed by those statements; and
- if a director discovers an illegal course of action, to object and, if the company does not correct the conduct, to resign.

This statement of the duty of care marks an undoubted enhancement of the late Victorian standard expressed in the *Re City Equitable case*.[60] There is not inconsiderable force in the argument that it is unwise to import – if that is what has been done – one element of United States doctrine without its complementary element.

Before acceding on this argument, however, two caveats are necessary. First, it would be important to determine to what extent the business judgment rule is properly characterised as a necessary complement to the United States duty of care and to what extent it is a response to other institutional features of the United States shareholder litigation regime, including contingent fee practices, which have no Australian counterpart. Second, it would be unwise to proceed to import the United States business judgment rule, on this ground alone, until any doubts as to the interpretation and status of the *AWA* decision in its duty of care aspects are resolved.

59 See n 13 and accompanying text.
60 [1925] Ch 407.

Some arguments against a statutory business judgment rule

1. The existence of adequate protection under the general law

We have seen that there is a well established body of legal principle which in function, if not in fact, embodies a business judgment rule. It is not clear why the general law deference to directors' business judgments is so deficient as to require statutory revision or that directors are exposed to hindsight review of business judgments by a risk averse tribunal. Neither is it clear that any gains from a comprehensive statutory restatement of these rules would outweigh the loss of flexibility assured by reliance upon the courts for the development of legal principle. It must be doubted that a statutory business judgment rule would offer superior protection to that provided by long established general law doctrines. The case for change needs to be made by those who propose it.

2. Fundamental irrelevance of a statutory business judgment rule to problems of director and officer liability standards

The existence of a statutory business judgment rule appears to be largely irrelevant to the principal difficulties facing company directors and officers under the modern corporate law formulations of their duties; namely, the uncertain and indeterminately expanded tortious duty of care and the imposition of civil and criminal liabilities upon them under myriad statutes by virtue of their office, subject to particular defences. To these latter obligations a statutory business judgment rule, as it is commonly understood, would have no possible application.

3. The conditional nature of the rule's protection

It is important to bear in mind the limitations inherent in the business judgment rule's protection. The first relates to its limited coverage. The CSLRC recommendation acknowledges that it only protects directors and officers against compensation liability, and not against the possibility of injunctive relief, an account of profits or declaration of a constructive trust.[61] The CSLRC would also deny the rule's protection to business judgments vitiated by the exercise of corporate powers for an improper purpose. While such decisions often result in injunctive relief and a declaration of invalidity, rather than an order for compensation against directors, that latter possibility was not thought to be included within the rule since "there should not be any legislative relaxation which would allow directors to make their own assessment of the purposes for which powers were conferred".[62] Accordingly, the CSLRC formulation would limit the parties' application to compensation liability for breach of the duty of care and diligence and that element of the director's duty of good faith severable from the propose purposes doctrine.

A second limitation of the business judgment rule's protection arises from the preconditions to its application. Despite the claims of its advocates, a statutory business

61 Companies and Securities Law Review Committee, supra n 18 at para 84.
62 Ibid at para 86.

judgment rule expressed in terms similar to s 4.01(c) of the ALI's *Principles of Corporate Governance* would not protect a director against the possibility of legal challenge to decisions involving business judgment. A plaintiff may still seek to establish that any of the prerequisites for the rule's operation have not been satisfied. Indeed, while the final prerequisite merely requires that the business judgment be rational and need not be reasonable, the prerequisite that the director be informed to an extent that he or she *reasonably* believes to be appropriate in the circumstances is susceptible to easier challenge. The terms of this prerequisite offer a safe but, by no means, assured harbour. Any weakening of the terms of these prerequisites would impair the protection offered to investors by the imposition of directors' duties.

4. Some realism about shareholder litigation risk

It must be doubted whether the threat of litigation faced by directors of Australian companies is such as to require protection through a statutory rule of this character. The duties imposed upon directors depend for their efficacy upon the mechanisms for their enforcement. It is a striking feature of Australian company law that, until very recently, there were no modern reported decisions in which a solvent company has brought proceedings against current or former directors for breach of general law or statutory duties of care and diligence. This inactivity undoubtedly reflects the utilitarian considerations militating against shareholder enforcement. They are compounded, however, by the curious paradox that responsibility for enforcement is confided to potential defendants. Thus, under standard constitutional provisions the authority to commence such proceedings rests with the directors, probably exclusively.

Shareholder litigation is more common against directors for breach of their fiduciary duties although even here the reported case law principally deals with the exercise of directors' powers in takeover situations where tactical considerations assume some importance. There is a strong argument that the inadequate state of shareholder remedies for enforcement of directors' duties is a serious obstacle to their function of setting standards of conduct. The creation of further barriers to shareholder suit requires formidable justification.

5. Effect of a statutory rule upon the content of the duty of care

It is not clear that a formal statutory harbour from liability for directors can be achieved without weakening the legal standard of care. The argument was put on behalf of the Attorney-General's Department in 1992 that a statutory business judgment rule is either unnecessary (because it merely reflects the current standard of care and diligence required of directors) or is designed to lower that standard (in which case it is inappropriate).[63] To this argument the Australian Institute of Company Directors made the following response:[64]

> [T]he business judgment rule does not merely reflect the current standard of care. It does not, in terms, lower the standard of care, but it qualifies the duty in circumstances where liability would

63 See A Rose, "Directors' Duties", National Practitioners Forum on the Corporate Law Reform Bill (April 1992).
64 Australian Institute of Company Directors, supra n 22 at 32.

> arise if the ingredients of the rule were not present. In that sense, it lowers the risk of liability...
>
> The rule is intended to articulate the circumstances in which the courts will enquire no further into the nature and quality of a decision made by directors. The precise intention is to define a safe harbour which directors can reach by meeting the prescribed criteria. It is necessary because, at the moment, directors cannot know with any certainty, at the point of decisionmaking, whether they have fulfilled all that is required of them.

It has been argued above that the rule does not assure any such certainty. But let us assume that it does, and consider the merits of the claim. First, does any other professional or occupational group enjoy a legally ordained right to such certainty? Is the case of directors so special, and the quality of the general law deference so deficient, as to require this unusual protection? These questions are similar to those posed above.

Second, can the risk of director liability be lowered without compromising the standard of care and the load which it bears of setting or reinforcing standards of conduct? What is claimed for the rule by the Institute is that "[i]t does not in terms, lower the standard of care, but it qualifies the duty in circumstances where liability would arise if the ingredients of the rule were not present".[65] Is it not implicit in this statement that the substantial, if not the formal, effect of a statutory rule is to suspend the operation of the duty of care and therefore compromise its function in establishing standards of director conduct? How else can the rule work to protect directors from suit?

It is suggested that such a statutory rule is unnecessary and undesirable when the general law presently accords a respect bordering upon deference for directors' business judgments and the financial obstacles to shareholder suit are so formidable and their incidence so rare.

65 Ibid at 32.

Chapter 12

The Perspective of the Australian Securities Commission on the Enforcement of Directors' Duties and the Role of the Courts: A Comment

Alan Cameron AM*

I propose to concentrate in this brief comment mainly on the experiences of the Australian Securities Commission ("ASC"), as a regulator and a professional litigant, in the courts of Australia. I shall start, however, by saying something about the recent history of the consideration of the business judgment rule in Australia, and then I shall speak specifically about some of our experiences in civil and criminal matters in Australia.

In April 1993, I spoke on the subject of the business judgment rule at a luncheon in Sydney, and explained the background to the amendments[1] with respect to directors' duties which had become law on 1 February that year. In the Explanatory Memorandum which had accompanied those amendments, it was explained that the Federal Government had decided not to provide a statutory formulation of the business judgment rule, on the basis that no state in the United States of America had adopted a legislative statement of that rule, but that the courts had been left to develop the rule in individual cases. The Australian government felt that a business judgment rule should be allowed to develop in Australia, and invited Australian courts to do so both in the Explanatory Memorandum and in the second reading speech.

I said in my talk in 1993 that the issue appeared to be somewhat like the debate about whether our civil liberties are better protected by the common law, or by a bill of rights. I suggested that it was a bit hard both to oppose a bill of rights, and yet advocate a statutory business judgment rule. Well, all of us can change our minds about each of these matters.

My starting point is that there is a continuing need to encourage risk taking in our commercial community. I can even claim distinguished judicial support for this proposition, in the remarks of Kirby P, to the National Corporate Law Teachers Conference in Melbourne on 6 February 1995:[2]

> ...no participant in the delicate work of corporate law should forget the essential character of the trading corporation as a risk taker and the inevitable consequence that some risks, honestly, diligently and carefully assumed, will sometimes not come off. To forbid this by law might save a few investors from unexpected losses. But it would be to destroy the brilliant idea of the corporation

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* Chairman, Australian Securities Commission. An earlier version of this chapter was presented at the conference *The Courts and Corporate Law* held at The University of Melbourne on 31 October 1996 and hosted by the Centre for Corporate Law and Securities Regulation, the Australian Institute of Company Directors, the Australian Institute of Judicial Administration and the Business Law Section of the Law Council of Australia.

1 The Corporate Law Reform Act 1992.

2 The Hon Justice Michael Kirby, "Rethinking Company Law and Practice" (1995) 5 *Australian Journal of Corporate Law* 176 at 181.

> which remains one of the few truly creative contributions of the law to the economic well being of the world and the economic liberty of its people.

In the Explanatory Memorandum itself there is acknowledgment that "corporate decisions involve risk-taking"; and that "the courts have in the past recognised that directors and officers are not liable for honest errors of judgment". With that distinguished legal support, I scarcely needed the change in portfolio of the ASC from the Attorney-General's Department to the Treasury, to emphasise that the ASC as corporate regulator is expected to administer the law in such a way as will encourage company directors to take on the risks of corporate enterprise. The difficulty is that many of them will be reluctant to do so if the goal posts keep moving after the whistle. If corporate law keeps being seen to change significantly by case law, discouragement of enterprise will be the effect. We lawyers all know that case law operates retrospectively; indeed, I think we enjoy that aspect of it, but it drives business crazy. The judicial history of *AWA v Daniels*[3] emphasises this.

After all, that case involved a single judge sitting in 1992, deciding what directors' duties were in 1986. His judgment appears to have surprised some people, but not the Government which then decided not to rewrite the law of directors' duties, but to endorse explicitly his view of the law, and to suggest that the law is heading in just the right direction. In those circumstances, therefore, there is something curious about the subsequent decision of the Court of Appeal, in disagreeing with significant aspects of his Honour's decision at first instance, and in setting what appears to be a higher standard of care than that espoused by Rogers CJ at first instance. The average business person could be forgiven for thinking that the Federal Government may have spoken too soon, in assuming that the law had settled in a satisfactory spot.

This untidiness demonstrates some of the vagaries of reliance on case law to determine the content of corporate law. Whether decisions at first instance or even by the courts of appeal within the several states, amount in practice to final decisions, too often depends on whether a litigant has the stomach, or the cash, to keep appealing. Indeed, in *AWA v Daniels* itself, Rogers CJ points to significant decisions not to call apparently critical witnesses as decisions which may well have affected the judgment in his case, and may well, by inference, therefore have affected the development of the law.

Consider then the position of the regulator. It too might consider the law has gone astray in a particular case, but may have to drag a private party through several layers of the judicial system on some subsequent occasion in order to have the matter revisited. The regulator is then at risk of being accused by an ombudsman or the like, of harassment, and acting unreasonably, by reason of failing to consider itself bound by the earlier decision, even if that was a decision to which it had not been a party and on a matter on which it had not been heard.

For my part therefore, I must say that I am now persuaded that there is a strong case for the introduction of a statutory business judgment rule into Australia. I do not pretend for one moment that this would be sufficient in itself; it would still remain to look again at the content of directors' duties. And I am doing so on the same basis that the former government ultimately rejected the argument for the statutory formulation of the rule,

3 (1992) 10 ACLC 933; on appeal, *Daniels v Anderson* (1995) 16 ACSR 607.

namely that it would not change the substantive law at all. I believe that it will send the necessary message both to the business community and to the judiciary, and to the regulator, that risk taking is the role of company directors, and while there will continue to be a need for strong and effective regulation, including vigorous attempts to enforce the law against those who favour their own interests over those of the companies of which they are directors and managers, there is also a strong community interest in encouraging a spirit of entrepreneurism in our society.

Even a professional litigant can find the judicial process frustrating, especially when it is combined for a governmental body like mine, with judicial review. The full federal court recently delivered judgment in *ASC v Deloitte Touche Tohmatsu*[4]. There were four earlier judgments in this matter,[5] without any opening address or evidence heard. The case relates to the interpretation of s 50 of the ASC Law, which relevantly provides that the ASC, if a person is a company, may cause a proceeding to be begun and carried on in the person's name or, otherwise, may with the person's written consent, cause a proceeding to be begun and carried on in the person's name.

It is inappropriate to discuss the merits of the case, because it is possible that the matter will come before the High Court. But it is appropriate to note that the proceedings were for judicial review of a decision taken in April 1994, to commence without its consent but after much correspondence and discussion, federal court proceedings in the name of a company generally known as Adsteam, against its former directors and auditors. The proceedings were then commenced and set down for a specially fixed and lengthy hearing, on days which have long since passed. The decision was challenged by the auditors, not the company or the directors. When the appeal proceedings relating simply to the way in which the proceedings were commenced finally are resolved, a further attempt will have to be made to find a lengthy block of court time to hear the matter itself. Less willing plaintiffs than the ASC could be forgiven for being discouraged by such convoluted proceedings, which have so far caused four federal court judges to consider whether a fifth judge of the same court should be able to commence hearing the substance of the claim.

So even professional litigants turn their minds to alternative ways of resolving matters. The ASC has some experience, including some very recent experience, of mediation with respect to major claims, and regards the experience as worthwhile. Rather than rehearsing some of that familiar material about alternative dispute resolution, I propose to mention some other aspects of alternatives to the judicial system.

The first is the Corporations and Securities Panel, perhaps better known colloquially as the Takeovers Panel, and with its own small degree of notoriety derived from the fact that it has only ever had three references from the ASC in something over six years of existence. Several points should be made about the Panel:

(a) Because the Panel is not a court, it cannot deal with matters which involve illegality which ought to be punished as such. Therefore, the ASC is restricted in practice to referring to the Panel those takeovers which it believes involve conduct which is unacceptable, as defined in the Corporations Law, but involves

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4 (1996) 21 ACSR 332.

5 21 October 1994 – (1994) 54 FCR 284; 16 January 1995 – (1995) 54 FCR 562; 20 April 1995 – (1995) 13 ACLC 703; 4 April 1996 – (1996) 21 ACSR 332.

either no illegality or such illegality as does not warrant separate prosecution.

(b) Notwithstanding the occasional utterances of takeover practitioners, the fact is that the threat of the Panel has been used from time to time by the ASC quite effectively, which is the one of the significant reasons why there have been few referrals to the Panel.

(c) There is no doubt that the first reference to the Panel was a searing experience both for the ASC and for the other parties. Being taken through all of the levels of the Australian judiciary to the High Court and back again[6] is no fun. The Corporations Law provisions with respect to the Panel have been substantially rewritten since then, to make it clear that what the Panel conducts is an inquiry rather than a hearing. Further, the membership of the Panel has been reconstituted to include several senior former judges, perhaps ironically, in order to ensure that the Panel has sufficient legal fire power to resist those who would wish to impose the full rigour of quasi judicial procedure on the Panel, rather than allowing the Panel to adopt the inquisitorial role which has been designed for it. One could be forgiven for thinking that on the first occasion, lawyers generally ganged up on the Panel to prevent this alternative dispute resolution mechanism, one of the very few instances of innovation in the 1989 Corporations Law, being tested substantively. The ASC is certainly keen to ensure that the Panel eventually gets a fair run at proper cases, in order to establish its credentials in Australian corporate life.

Secondly, it is important to refer to the work of a small committee of accountants called the Urgent Issues Group (“UIG”). This Group has been set up by the professional accounting bodies in conjunction with the Australian Accounting Standards Board and the Public Sector Accounting Standards Board, in order to provide quick authoritative determinations of gaps and uncertainties in Australian accounting standards. The UIG meets in public, makes all its decisions by consensus, and will remove a matter from its agenda if it is not resolved by the third or fourth meeting after the matter is first raised. Australian accounting standards now have the force of law, and the ASC has the role of enforcing the operation of the standards. In practice, that has put the ASC in recent years into the position of being the de facto setter of standards where there was genuine uncertainty or a gap. The UIG has therefore been established by the accounting bodies in order to keep the content of the accounting standards law within the control of accountants, which I am happy to applaud.

Lawyers will immediately ask, what is the status of decisions of the UIG. The answer is that strictly, they have no legal status, but the decisions are binding as a matter of professional practice, upon the members of the Institute of Chartered Accountants and the Society of CPAs; since members of these bodies are invariably the auditors of Australia’s public companies, the effect is to ensure compliance indirectly. What can corporate lawyers learn from this? I think they can learn that a senior group of professionals, motivated to do so, can provide authoritative determinations on genuinely disputed issues, quickly, cheaply, publicly and with the minimum of fuss. Why can’t we do that with some strictly legal issues which are important to our financial markets as well?

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6 *Precision Data Holdings v Wills* (1991) 173 CLR 167; 6 ACSR 269.

Someone has clearly asked that question in London, and answered in the affirmative, as is shown by the establishment of the Financial Law Panel.[7] The Panel was created at the suggestion of the Legal Risk Review Committee, which had in turn been established in the aftermath of the *Hammersmith and Fulham Swaps Case*, in which the House of Lords had held that local authorities had no authority to enter into swaps contracts.[8] Needless to say, this conclusion had the potential to be extremely disruptive to the financial markets. The Financial Law Panel has the function of identifying and addressing areas of legal uncertainty affecting wholesale financial markets, and seeking to resolve the uncertainty, preferably by finding a market based solution. The Panel operates as a company limited by guarantee, and is funded by the institutions and professional firms. It has a retired judge as chairman and 12 other members, mostly without legal qualifications, but drawn from the markets.

Some may ask, just what issues do we have that require such a panel? One example I am aware of is the vexed question of the validity of netting contracts, which are arrangements designed to ensure that, in the event of the insolvency of one party to a financial contract, the other party may terminate the contract, calculate the termination values of the obligations of the parties, and set off those values so as to arrive at a net amount payable by one party to the other. They arise both in bilateral arrangements and under the rules of stock exchanges, futures exchanges and clearing houses. The opinion of a Financial Law Panel with some legal heavyweight members on these matters would be a useful and a cheaper and quicker way of resolving doubts on such issues than litigation or legislation.[9]

Finally, I want to say something in commendation of a legislative initiative in New South Wales which I thought, despite some difficulties in one particular case which it has caused for the ASC,[10] was nevertheless a worthwhile alternative. There is continuing pressure from the media and some politicians to consider the introduction of plea bargaining into Australia. With the growing effectiveness of the ASC as a corporate prosecutor, and in particular the ASC's first conviction for insider trading, admittedly on a plea of guilty, there is perhaps less pressure at present than there has recently been on this subject. However, a strong countervailing pressure is the increasing tendency towards custodial sentences, or longer custodial sentences, for white collar offences, which tend to discourage pleas of guilty.

In this context, the New South Wales Sentence Indication Scheme seemed to me to overcome many of the difficulties traditionally associated with plea bargaining, by the very fact of its involvement of the judge and its openness. In short, the scheme involved a judge of the District Court conducting a sentence indication hearing in order to tell a defendant what sentence the judge might give the person if the person were to plead guilty to the offence with which the person had been charged or to another or a lesser

7 The following description of the Panel is based on the Editorial by the Chief Executive of the Panel, published in (1994) *Journal of International Banking and Financial Law* 475.

8 [1992] 2 AC 1.

9 While writing this chapter, my attention has been drawn to the fact that Santow J of the NSW Supreme Court, has advocated such a panel for Australia in a submission to the Financial System Inquiry, and suggested that it could also provide guidance to the courts on market practice issues.

10 The New South Wales Court of Criminal Appeal allowed an appeal by a defendant who wished to withdraw her plea of guily under the scheme but was not allowed by the trial judge to do so: *R v Boskovitz*, 19 August 1996, unreported.

offence arising out of the same circumstances. The judge is entitled to consider such material as would be available to the judge if the accused person had pleaded guilty and the judge were passing sentence.[11] A suppression order procedure is available to ensure that, until it is clear whether the accused person proposes to accept that sentence and to plead guilty, the proceedings are not reported, since such a report would prejudice any trial if the sentence was not accepted; but otherwise, the proceedings are conducted in public and may subsequently be reported.

Clearly the procedure is not perfect – for example, there has been judicial comment to the effect that there is a risk that the procedure will encourage pleas of guilty from people who really are not guilty, but would rather take that sentence than run the risk of being more severely punished after being convicted on a plea of not guilty.[12] Nevertheless, speaking as a sometime prosecutor, I must say that sentence indication hearings have much to commend them. I am less happy to note in conclusion that the sentence indication scheme expired in 1996 and has not been revived.

11 See P Byrne, "Sentence Indication Hearings in New South Wales" (1995) 19 *Criminal Law Journal* 209.
12 *R v Impiombato* (1995) 35 NSWLR 627