REPORT OF THE COMPANIES AND SECURITIES LAW REVIEW COMMITTEE ON INDEMNIFICATION, RELIEF AND INSURANCE IN RELATION TO COMPANY DIRECTORS AND OFFICERS

TO: The Ministerial Council for Companies and Securities

The CSLRC presents to the Ministerial Council its Report on indemnification, relief and insurance in relation to company directors and officers. This is the Tenth Report of the Committee, the others being:

* Report on the Takeover Threshold (November 1984)

* Report on Partial Takeover Bids (August 1985)

* Report on Forms of Legal Organisation for Small Business Enterprises (September 1985)

* Report on the Civil Liability of Company Auditors (September 1986)

* Report on the Issue of Shares for Non-Cash Consideration and Treatment of Share Premiums (September 1986)

* Report on a Company's Purchase of its own Shares (September 1987)

* Report on Prescribed Interests (May 1988)

* Report on Nominee Directors and Alternate Directors (March 1989)

* Report on Director's Statutory Duty to Disclose Interest and Loans to Directors (November 1989)

Terms of Reference

The Ministerial Council for Companies and Securities referred to the Committee "for inquiry and review the following questions relating to directors and officers of companies:

(a) standards relating to their conduct and performance"

Background : Discussion Paper No. 9

In April 1989 the Committee published Discussion Paper No. 9: Company Directors and Officers: Indemnification, Relief and Insurance.

A list of respondents to the Discussion Paper is in the Appendix to this report.

INTRODUCTION

This report is about the legal limitations' imposed on companies and others in the matter of protecting directors and officers of a company registered under legislation such as the Companies Act 1981 (Cwlth) against personal liability for their acts and omissions in the course of acting on behalf of the company.

The Committee has prepared this report at a time of uncertainty as to the extent to which the co-operative Commonwealth/State scheme of regulation of companies and securities will continue to operate. Because the Committee operates under the co-operative scheme this report is concerned with the Companies Act 1981 (Cwlth). However, the Committee's recommendations deal with matters which must be legislated for under any system of regulation of companies.

The primary reason for a review of the law about indemnification of directors and officers is uncertainty in the commercial and legal communities about the scope of section 237 of the Companies Act 1981 (Cwlth), a measure that invalidates certain provisions giving protection to directors and officers.[1] The central matter of policy behind section 237 is that shareholders and creditors should not be unfairly prejudiced by directors and officers (among others) being able to insulate themselves from liability for breaches of duty. But there is uncertainty as to the reach of section 237. Discussion of section 237 throws into focus the various ways in which liability of directors and officers for their acts or omissions may be prevented from arising or removed. The report canvasses the conditions under which it is proper for a company to provide indemnification and the processes by which it may properly be provided. Implementation of the Committee's recommendations on those matters should remove much of the uncertainty surrounding section 237.

The existing uncertainty about section 237 extends into the question of insurance in respect of directors' and officers' liability and this report includes consideration of the power of a company to establish and maintain such insurance. The part of this report dealing with insurance should be read with Discussion Paper No. 9 which includes the results of a survey of directors' and officers' insurance in Australia.

1. The equivalent provision in the Corporations Act 1989 (Cwlth) (not yet proclaimed) is section 241.

Whilst this report is concerned with section 237, the Committee has chosen to examine the subject matter of that section from basic principles and makes recommendations which have an impact not only on section 237 but also on other provisions of the Act.[2]

Proposed further report on enforcement of directors' duties. As noted, the future of the Committee is uncertain pending the outcome of the planned assumption by the Commonwealth Government of sole responsibility for companies and securities regulation in Australia. If time is available CSLRC proposes to issue a further discussion paper and report, dealing with methods of enforcement of the duties of directors and officers available to members of a company and others. The areas to be addressed' would be complementary to a number of the matters dealt with in this report, for example the release from liability for breach of duty by way of resolution of a company in general meeting; see below para. [105] ff.

2. In particular, sections 229 and 535. Their respective counterparts in the Corporations Act 1989 (Cwlth) are sections 232 and 1318.

SUMMARY OF RECOMMENDATIONS

the duty by a general provision in a contract between a company and a director or officer or in any other instrument or resolution which purports

to bind the company. It should not be possible for the company's constituent documents, any contract or any other instrument or resolution to contain any provision to reduce or limit liability to the company for breach of the duty of care and diligence as fixed by law. That extends to exclusion of liability, restrictive prescription of causal connection, restrictive prescription of time limits for proceedings, prescription of standard of proof or reduction by .any other means. It also extends to any imposition of a cap on the amount of compensation or damages that maybe recoverable [44] 27

(7) **That the legislation should recognise that there should be scope for a company by its constituent documents to define the limits of the duty of good faith in relation to exercise of discretions by stating the specific purposes for which discretions are conferred. But there should be no possibility of the articles conferring a general power to disregard the duty to consider the benefit of the company as a whole except in the circumstances referred to in the Committee's Report No. 8 on Nominee Directors and Alternate Directors.** [51] 29

(8) **That the Act should allow articles to contain a provision permitting a director to be interested in a transaction of the company so long as the provision will only operate if and when the director has made prior disclosure to the board in compliance with section 228.** [55] 30

Advance authority from general meeting

(9) **That the legislation should recognise the power of the company in general meeting to give advance authority for specific conduct of a director or officer in relation to a specific transaction, other than conduct which involves an intent to deceive or defraud.** [58] 31

(10) **That the legislation should require that the disclosure, for the purposes of the preceding recommendation, should be such as to make members aware of at least:**

(i) material details of the transaction;

(ii) any direct or indirect interest of the directors or officers or their associates or their relatives in the transaction;

(iii) the benefits to the company that it will obtain that could not be obtained by a transaction that did not require the authority of the company in general meeting; and

(iv) the circumstances that indicate that without the authority the director or officer will be in breach of duty and the nature of any liability that could accrue.

In a group of companies it should be a general meeting of the holding company that gives approval for directors in subsidiary companies to be authorised.

In the case of a partly-owned subsidiary the members of both the subsidiary and the holding company should give the approval (as for directors' loans).

Fairness requires that the person who will be relieved should not consent to his or her own wrong. Interested directors, their associates and relatives should not be able to vote. The necessary majority should be that for an ordinary resolution. **[60] 31**

(11) **That the statutory statement of the power of the general meeting to authorise what would otherwise be a breach of duty should be expressed to be subject to section 320 alone.** **[64] 33**

(12) **That if the company goes into liquidation within 12 months after the authority is given and is insolvent, the Court may order that the director or officer in question should be considered to be in the same position as if the authority had not been given.** **[67] 33**

Statutory business judgment rule

(13) **That there be enacted a business judgment rule in terms suggested in para [81].** **[75] 36**

(14) **If the recommendations in para. [99] that conduct not involving intent to deceive or defraud should be taken outside the penal operation of section 229 are not adopted, the Committee recommends that it should be possible to apply the business judgment rule in criminal as well as civil proceedings. In that event the suggested formulation will need to be widened to protect against the imposition** **[90] 40**

of a penalty when the rule applies.

Director's right to information

(15) **That there be enacted legislation under which a director shall be entitled, notwithstanding anything to the**

contrary in the company's constituent documents, to:

(a) notice of all meetings:

(i) of the company or of a class of members, to which any other person is entitled, whether or not the director is a member of the company; and

(ii) Of the board of directors or of committees of the board;

(b) to attend and speak at all such meetings in respect of any item of business whether or not he or she has a right to vote at the meeting;

(c) access at reasonable times to the company's books; and

(d) reasonable facilities (including travel expenses) to enable the director to take reasonable steps to become acquainted with the company's assets and operations. **[96] 42**

Principal executive officer to furnish information

(16) **That the legislation should impose on the principal executive officer of a company an obligation to take reasonable steps to cause each director to be furnished with such information about the company's affairs as is reasonably necessary to enable the director to exercise his or her powers and to discharge the duties of his or her office and to treat each director equally in that respect except where the board (subject to an order of the Court) decides that it is against the interests of the company to do so. The test of what is necessary information for a director should be an objective one and the matter should not rest on the subjective assessment of the principal executive officer. To assist the principal executive officer to perform that duty there should be imposed on each executive officer an obligation to keep the principal executive officer informed of such matters as the principal executive officer; reasonably** **[97] 42**

requires. A suitable penalty needs to be prescribed in support of each duty.

(17) **That there should be an exclusion from penalty under all of section 229 of acts or omissions that do not involve intent to deceive or defraud.** **[99] 43**

Punitive damages

(18)	**That there should be legislation giving Courts a discretion to award the company an amount in the nature of punitive damages in relation to breaches of duty by directors or officers. An alternative course would be to provide for something in the nature of a civil penalty of the kind discussed and recommended by the Senate Standing Committee on Legal and Constitutional Affairs. However, any such penalty should in the Committee's view be recoverable by only the company.**	**[103]**	**43**

Release from liability by general meeting

(19)	**That there should be legislation adopting the same approach for release from liability as the Committee has recommended in relation to specific authority given in advance. The disclosure to members should extend to explaining the circumstances of the breach and the nature of the liability attaching to the director or officer. That if the company goes into liquidation within 12 months after the release and is insolvent, the Court may order that the director or officer in question should be considered to be in the same position as if the release had not been given.**	**[106]**	**44**
(20)	**That the question whether a release should be accompanied by ratification of a transaction which was invalid because the director or officer was in breach of duty should be a matter for decision by disinterested members in general meeting. Ratification should be the subject of a resolution separate from any which releases a director or officer from civil personal liability. The pre-meeting disclosure about the proposed ratification should provide information as to why it will be for the benefit of the company that the transaction should be ratified.**	**[108]**	**44**

Court's power to excuse from liability

(21)	**That the enactment of a business judgment rule should not replace section 535.**	**[111]**	**46**

(22) **That if a suitable drafting opportunity occurs, section 535 should be relocated near section 237. That would be in recognition of not only the relevance of the two sections to each other but also their historical inter-relationship as disclosed by the report by the Greene Committee.** **[112] 46**

(23)	**That in view of the use of the word "honestly" in a broad sense in section 229 there is a need to alter section 535 so that the condition (which must be satisfied before relief can be granted under section 535) requires it to appear to the Court that the person concerned "acted with no intent to deceive or defraud". A similar amendment is required in section 539(6)(b).**	**[114]**	**46**
(24)	**That section 535 be amended so that it should apply in respect of any liability that may be imposed under the Companies Act. In this instance the recommendation relates to all persons who currently can be given relief under section 535.**	**[116]**	**46**
(25)	**That section 535 be amended to authorise the court to take into account efforts made by the person seeking relief to inform himself or herself about the legal responsibilities of his or her office and about the company's business operations.**	**[118]**	**47**

INSURANCE

(26)	**That section 237(1) be amended to make it clear that it is limited to proceedings brought by or on behalf of the company.**	**[122]**	**48**
(27)	**That section 237 should not have the effect of invalidating any contract of insurance taken out by the company in good faith with an outside insurer.**	**[125]**	**48**
(28)	**That a company in exercising its power to obtain insurance in respect of harm caused to third persons by directors in the course of their activities as directors should be at liberty to obtain that insurance on terms which free directors from the possibility of being made liable on subrogated claims where the relevant conduct of the directors has not involved intent to deceive or defraud.**	**[131]**	**52**
(29)	**That a company should also be able to take out and maintain insurance to relieve its directors, officers and employees from liability for loss or damage suffered**		

directly by the company (as distinct from loss which results from the imposition on the company of vicarious liability to a third party) in such a way that the terms of the insurance free directors, officers and employees from the possibility of being made liable on subrogated claims. Hence directors, officers and employees would

not be liable to subrogated claims whether the insurance was in respect of the company's vicarious liability (see para [131]) or in respect of loss suffered directly by the company. In taking that view the Committee needs to recommend, and does recommend, that the restriction on payment of premiums by the company now in section 237(3) should not be maintained. **[134] 52**

(30) **That there should be enacted a provision like section 124(4) of the Canada Business Corporations Act – see para. [137] - (dealing with a company's ability to purchase and maintain insurance covering the liability of a director or officer etc).** **[139] 55**

(31) **That legislation empowering a company to establish and maintain insurance in respect of the liability of a director or officer should require that the insurance should be on reasonable terms and should not involve the company itself carrying to any substantial extent the burden of liability of directors and officers for loss caused to the company by any of those directors or officers. The legislation should provide that regulations may be made prescribing limits within which a policy of insurance in respect of the liability to the company of a director or officer may provide that the risk shall be carried by the company.**

The legislation should further provide that, notwithstanding any other rule of law, the board shall have the power to obtain and maintain the insurance referred to above and that in doing so the board must act in the best interests of the company. There should also be a prohibition on the company obtaining or maintaining the insurance from a company related to or associated with it unless there is re-insurance from an independent re-insurer. **[152] 58**

(32) **That if for any reason the legislature does not see fit to give the power to take out insurance to all companies, the power should at least be given to companies which cannot** **[155] 59**

distribute profits to members.

(33) **That directors, officers and employees of a company be given a statutory right to indemnity for the costs of a successful defence in terms similar to section 124(3) of the Canada Business Corporations Act. The duty to indemnify should extend to the case where a director, officer or employee has incurred costs of being represented in criminal or civil proceedings to which he or she is made a party by reason of being or having been a director, officer or employee of the company.**

The duty to indemnify should also extend to the costs of any administrative proceeding out of which the criminal or civil proceedings arose where the Court concerned with the criminal or civil proceedings is of the opinion that it is just that that duty be imposed. **[161]** **61**

PAYMENT OF FINES ETC.

(34) **That any revision of section 237 should stop short of providing authority for payment by the company of fines imposed upon, or the amount of civil damages or compensation ordered against, directors and officers.** **[168]** **63**

CHAPTER 1

THE CONTEXT OF SECTION 237

[1] Who are directors and officers? The conduct of a company's affairs normally requires the services of:

(i) persons appointed to the office of director so as to be responsible for the direction of the company;

(ii) senior employees responsible for managing the company; and

(iii) other employees not responsible for the direction or management of the company.

Persons in those three categories are referred to respectively as:

(i) director;

(ii) executive officer;[3] and

(iii) employee.

An executive officer or an employee could also be appointed a director and have dual functions. The expression "executive director" used in this report refers to an executive officer who has been appointed to the office of director.

This report is mainly concerned with directors and executive officers to the exclusion of employees not concerned, or taking part, in management.

In the Companies Act 1981 (Cwlth) the word "officer" does not have a uniform definition. The general definition in section 5(1) and the special definition in section 237 include any employee but the special definition in section 229 includes only two types of employee, namely, a secretary and an executive officer.

Later in this report in paras [19], [22], [122], [125] and [134] recommendations are made for the amendment of section 237. One such recommendation is that section 237 should extend not to all employees but only to secretaries and executive officers.

3. Compare the definition of "executive officer" in the Companies Act 1981 (Cwlth) section 5(1):

'"executive officer", in relation to a corporation, means any person, by whatever name called and whether or not he is a director

of the corporation, who is concerned, or takes part, in the management of the corporation;'

The expression "officer" as used in this report refers to secretaries and executive officers. The word "employee" is used to refer to any other employee of the company in question.

[2] This report deals with persons within the company, namely, directors, officers and employees. This report is concerned with the effect of companies legislation on the liability of persons engaged in internal administration of a company in the normal course, namely, directors on the one hand and on the other hand, officers and other employees of the company. Apart from a recommendation in para [116] the report does not primarily relate to the other persons who provide services from outside the company, namely, auditors, receivers, receivers and managers, official managers, deputy official managers, administrators of schemes of arrangement, provisional liquidators and liquidators.

The reason for limiting the report to the position of directors, officers and employees is that many of the matters considered in this report relate to the company providing insurance against liability. External professional contractors will have their own professional liability insurance. The cost of that insurance is an item in the calculation of their fees as contractors; it will not be a distinct cost item of the company. As will be seen later, an important question about section 237 is its effect on the power of the company to take out insurance to cover the liability of directors, officers and employees.

[3] The principal duties of directors and officers from breach of which

personal liability can arise. Directors and officers can be subject to civil or criminal liability under companies and securities legislation and other legislation. For the purposes of this report attention can be focussed on the principal duties of directors that have been established by case law and are now stated in the Companies Act 1981 (Cwlth) section 229. It is not necessary in the present context to provide a full analysis of those duties and the following is only a broad statement.

There are two main duties:

(i) a duty of good faith; and
(ii) a duty to exercise reasonable care and diligence.

[4] Liability for failing to act in good faith. Individual directors and officers of a company owe duties of good faith to the company. Under this heading there are particular duties. The principal duties are:

(a) to avoid unauthorised engagements which would involve the director or officer in a conflict of interest and duty or a conflict of duties; and

(b) not to appropriate or divert company property or use information that is confidential to the company without the authority of the company.

A director, as a member of the board of directors, is under a duty:

(c) not to use directors' powers for a substantial purpose other than the purpose for which they were granted; and

(d) not to hand over discretions to other persons without authority.

[5] The duties involved in the obligation of good faith are subsumed under the rubric that a director and an officer must act honestly. The Companies Act 1981 (Cwlth) section 229(1) does that when it provides:

"229(1). 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."

The provisions in section 229(1) about penalties distinguish between:

(1) an offence involving intent to deceive or defraud the company, members or creditors of the company or creditors of any other person or for any other fraudulent purpose; and

(2) all other failures to act "honestly".

The maximum penalty for the first category of offence (fine of $20,000 or imprisonment for 5 years or both) is much higher than for the maximum penalty for offences in the latter category (fine of $5,000).

The distinction reflects early development in case law which produced a distinction between "actual fraud" and "constructive fraud". "Constructive" or "equitable" fraud can be committed by a person who is quite honest but who fails to act up to the high standard required of a person who owes fiduciary duties. For example, use by a board of directors of a power to issue shares for a purpose outside the range of permitted purposes can attract the epithet "constructive fraud" or "equitable fraud" even though the board members had no intention to deceive or defraud. Such an improper use of power could be within section 229(1) so as to attract a penalty to each director of up to $5,000. Another example could be where a director interested in a transaction of the company fails to make adequate disclosure of the interest, having regard to any relevant articles, but without intending to deceive or defraud.

[6] Liability for failing to exercise reasonable care and diligence. In the case of a director this duty arises from the director's fiduciary relationship to the company and is analogous to the liability of a trustee to a beneficiary. There is an objective standard of care. The director is to take such care as an ordinary person might be expected to take on his or her own behalf.

But the standard of skill expected of a director in relation to a particular matter depends on whether the director is acting on a matter within or outside the director's own expertise. The director is expected to bring to bear any special expertise he or she may possess in relation to the particular matter: **Re City Equitable Fire Insurance Co Ltd.** [1925] Ch 407.

The assessment of whether a director exercised reasonable care and skill could produce different results in relation to different directors and as between executive directors and non-executive directors.

An executive director's closer contact with the affairs of a company could lead to the executive director being held to have failed to exercise reasonable care and skill in circumstances where a non-executive director might not be held to have failed in that way.

[7] The duty to exercise reasonable care and diligence is currently stated in section 229(2) of the Companies Act 1981 (Cwlth):

"229(2). 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.

Penalty: $5,000."

[8] The spelling out of what is involved in the duty to exercise reasonable care and diligence will differ according to the size and nature of the company in question. But there may be some duties that are common to all companies and the time may have arrived for legislation to state more specific duties. One such duty is the duty to make reasonable efforts to become familiar with the company's affairs.[4] There may be others. This is not the place to canvass that question. The matter of what should be the limits of the power of a company and others to indemnify directors and officers can be examined without embarking on a full elucidation of the implied duties of directors and officers.

[9] The remedies for breach of fiduciary duty by a director or officer. Under case law a director or officer who commits a breach of fiduciary duty could be subject to one of a range of remedies depending upon the nature of the breach. For making an unauthorised gain in breach of duty the remedy could be an account of profits or subjection to a constructive trust in respect of specific property gained. Section 229(7) gives a statutory basis for an account of profits. For a breach that causes loss to the company the remedy will be an order that the director or officer pay equitable compensation to the company.[5] Section 229(7) gives a comparable statutory remedy. Equitable compensation is not the same as common law damages. It is only restitutionary and there does not appear to be the same scope as at common law for awarding anything in the nature of punitive damages.

[10] Possible ways in which personal liability to the company or to shareholders could be limited. In the abstract, protection of directors, officers and employees against personal liability could be provided in

4. In Australasian Venezolana Pty Ltd. (1962) 4 FLR 60; V, a director-employee responsible for the books of a proprietary

company, passively followed the directions of the governing director in drawing cheques to make unsecured loans to another company of which the governing director was also a director. V was considered to be in breach of duty in failing to take reasonable steps to acquaint himself with the company's affairs.

5. See generally on equitable compensation, Davidson 'The Equitable Remedy of Compensation' (1982) 13 MULR 349.

various ways:

Prospective protection. Protection in advance of possible breach of duty could be provided by:

(i) narrow formulation of duties by some general provision such as a regulation in articles of association or a term of a contract; or

(ii) specific advance authority in. a particular case from the company to a director, officer or employee to act in a manner which would otherwise be a breach of duty.

Retrospective protection. Protection after a breach of duty could be provided by:

(i) the operation of a provision in the articles or in a contract or in an industrial award operating by way of exculpation of the director, officer or employee from liability either:

(a) absolutely; or

(b) subject to conditions, such as disclosure to the board;

(ii) a release by the company in general meeting (or in certain circumstances by the board) of the director, officer or employee from liability;

(iii) a release or reduction of liability by the court under section 535 of the Companies Act 1981 (Cwlth);[6] or

(iv) insurance taken out by:

(a) directors, officers or employees against their own liability;

(b) the company against loss caused to the company directly by the breach of a duty owed to the company by the director, officer or employee; or

(c) the company against loss caused by the director, officer or employee to a third person where the company, the director, the officer or the employee would be liable to that person.

[11] Insurance of the company against loss caused to it by the director, officer or employee (including its liability to third persons for loss caused by the director, officer or employee) does not insulate the director, officer or employee from personal liability absolutely. At common law the insurer will be entitled to be subrogated to the rights of the company to sue on any cause

of action available to the company against the director, officer or employee.

[12] In the case of an officer or other employee the implied term in a contract of service that an employee will exercise reasonable care and skill up to the standard applicable to his or her calling could provide such a

6. See para. [109].

cause of action: **Lister v Romford Ice and Cold Storage Co Ltd.** [1957] AC 555. In practice that right is often excluded by insurance wording or by employees being included in the class of persons insured. In New South Wales there is legislation taking the right away where the loss is caused by employees to third persons. The Employee's Liability (Indemnification of Employer) Act 1982 (NSW) section 2(3) provides:

"Where:

(a) a person suffers damage as a result of the fault of an employee; and

(b) but for this Act, the employee would be liable to indemnify the employer against whom proceedings for damages may be taken as a result of the fault against any liability of the employer arising out of the proceedings,

the employee is not so liable, whether the cause of action against the employer arose before, or arises after, the commencement of this Act."[7]

"Employee" is not defined in the Act. It seems that the expression could include an officer at least when not acting as a director.

[13] Section 237 of the Companies Act 1981 (Cwlth): a provision cutting across indemnification of directors, officers and employees. The efficacy of some of the above methods of protecting directors and officers is affected by section 237, a broad provision capable of upsetting various indemnifying provisions and susceptible to frustratingly varied interpretations.

[14] Section 237 is aimed at terms in arrangements affecting the conduct of companies which give excessive immunity from liability for wrongs committed by directors, officers and employees and is derived from United Kingdom legislation passed after the Greene Committee in 1926 expressed disquiet about provisions in articles of association under which a director would be relieved from liability for all but dishonesty. Articles of association then and now constituted a contract between the company and the members and between member and member[8] as to how the company should be run. Provisions in articles could also affect legal relations between the company and non-members. Provisions in articles could be expressly or impliedly incorporated by reference in the contract between a company and the persons who agreed to serve as directors or officers. It would be on that basis that a director could claim the benefit of an exculpatory article in any proceedings brought by the company or its liquidator.

7. ***McGrath v Fairfield Municipal Council*** *(1985) 59 ALR 19.*

8. In 1985, an amendment to section 78 of the Companies Act 1981 (Cwlth) had the effect of also making the articles a contract between each officer and the company.

The Greene Committee said[9]:

"We consider that this type of article gives a quite unjustifiable protection to directors. Under it a director may with impunity be guilty of the grossest negligence provided that he does not consciously do anything which he recognises to be improper. The evidence satisfies us that in the great majority of companies in this country directors conscientiously endeavour to do their duty. The public interest excited when exceptions are brought to light is perhaps the best proof of their rarity. But the position is one which in our opinion calls for an alteration of the law. To attempt to define by statute the duties of directors would be a hopeless task and the proper course in our view is to prohibit articles and contracts directed to relieving directors and other officers of a company from their liability under the general law for negligence and breach of duty or breach of trust. We are satisfied that such an enactment would not cause any hardship to a conscientious director or make his position more onerous and, in our view, there is no foundation whatever for the suggestion that it would discourage many otherwise desirable persons from accepting office. A director who accepts office does not do so upon the footing that he may be as negligent as he pleases without incurring liability. It is only when he has been negligent and the company has suffered a loss, that he is content to take shelter behind the article. It is, moreover, in our opinion fallacious to say that the shareholders must be taken to have agreed that their directors should be placed in this remarkable position. The articles are drafted on the instructions of those concerned in the formation of the company, and it is obviously a matter of great difficulty and delicacy for shareholders to attempt to alter such an article as that under consideration.

On the other hand it has been forcibly brought to our notice that under the modern conditions of company administration it is in many cases quite impossible for every director to have an intimate knowledge of or to exercise more than a quite general supervision over the company's business. Moreover, it often happens that a director is appointed owing to some special knowledge of a particular branch or aspect of the company's affairs or because he is in a position to obtain business for the company. It is not to be expected that such a director should be bound to have so close an acquaintance with the general business of the company as other members of the board. We are of the opinion that the general law of negligence is sufficient to deal with such a case but in order to remove any possible hardship we recommend that the Court in exercising its power to grant relief should give attention to considerations of the nature indicated.[10]

The Greene Committee then recommended:

"that any contract or provision (whether contained in the company's

9. Report Cmd 2657 paras 46-47.

10. See later, para. [118].

articles or otherwise) whereby a director, manager or other officer is to be excused from or indemnified against his liability under the general law for negligence or breach of duty or breach of trust should be declared void. This should extend to contracts or provisions existing at the date when the amending Act comes into force, but as regards such contracts or provisions it should not take effect until (say) six months from that date."

It may be noted in passing that the Greene Committee made its recommendation without any reference to insurance against liability.

[15] Legislation enacted in the United Kingdom in implementation of the Greene Committee's recommendation was the model for legislation in the Dominions.

The current provision in the co-operative scheme legislation is section 237 of the Companies Act 1981 (Cwlth). Some of its provisions represent embellishments added over the years to the original measure recommended by the Greene Committee.

Section 237 is as follows:

"237(1) Any provision, whether contained in the articles or in a contract with a company or otherwise, for exempting any officer or auditor of the company from, or indemnifying him against, any liability that by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company is void.

(2) Notwithstanding anything in this section, a company may, pursuant to its articles or otherwise, indemnify an officer or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted or in connection with any application in relation to any such proceedings in which relief is under this Act granted to him by the Court.

(3) Sub-section (1) does not apply in relation to a contract of insurance, not being a contract of insurance the premiums in respect of which are paid by the company or by a related corporation.

(4) For the purposes of this section, "officer", in relation to a company, means:

(a) a director, secretary, executive officer or employee of the company;

(b) a receiver, or receiver and manager, of property of the company;

(c) an official manager or deputy official manager of the company;

(d) a liquidator of the company; and

(e) a trustee or other person administering a compromise or arrangement made between the company and another person or other persons."

[16] For whose protection does section 237 invalidate provisions? It is evident from the extract in para. [14] above that the Greene Committee was concerned that the company should be protected. In protecting the company as a corporate entity the provision indirectly protects creditors and members of the company.

[17] Section 237 is an obscure provision. There are some obscurities in section 237 which deserve legislative attention.

Some of the obscurities in section 237 are:

(i) whether the section extends to wrongs to persons other than the company;

(ii) just which contracts are affected by the section;

(iii) the meaning of the words "or otherwise" and "negligence" appearing in sub-section (1); and

(iv) the effect of the section on contracts of insurance.

The obscurities were discussed in Discussion Paper No. 9 and most submissions received by the Committee expressed dissatisfaction with uncertainties engendered by section 237.

In the United Kingdom the similar provision, section 310 of the Companies Act 1985 (UK), has recently been amended by the Companies Act 1989 section 137. Details of that amendment appear later in this report.[11]

The New Zealand Law Commission in its report of June 1989 on Company Law Reform and Restatement recommended that the New Zealand equivalent of section 237 be replaced by another provision.[12]

The obscurities in section 237 can best be dealt with in this report in the course of considering in chapter 2 each of the ways in which protection of directors and officers may be attempted.

11. See para. [135].

12. Report No. 9 paras 560 - 563.

CHAPTER 2

RECOMMENDATIONS

[18] The need to amend section 237 to remove obscurities. Among the recommendations made later in this chapter are recommendations about the limits within which directors and officers may be benefited by:

(i) a narrow formulation of their duties;

(ii) protection against liability in a particular case, before any breach of duty, by specific advance authority from the company;

(iii) a statutory business judgment rule;

(iv) protection after breach of duty by exculpatory provision in the articles;

(v) protection after breach of duty by release by the company in general meeting;

(vi) protection after breach of duty through the Court excusing the breach under section 535; or

(vii) protection after breach of duty by insurance.

Those recommendations, if adopted, will entail the enactment of provisions which will remove some of the uncertainty as to the operation of section 237. There has been some uncertainty about the phrase "articles, contract or otherwise."

INTRODUCTORY RECOMMENDATIONS ABOUT DEFINITION

[19] **The Committee recommends amendment of section 237 to remove uncertainty about the phrase "articles, contract or otherwise" by making it clear that section 237(1) is concerned with any provision, whether oral or in writing, which purports to bind the company but which is not authorised by the Act. The provisions authorised by the Act would comprise those referred to in later recommendations.**

[20] Company employees who are neither directors nor officers. Section 237 at present precludes a release being given by a company not only in respect of a breach of duty by a director, secretary or executive officer but also any other employee of the company.

[21] It seems to the Committee that it should be open to the board of directors to decide that any of those other employees be

released. It should also be possible for the board to give advance authority in a particular case. If an employee is not involved in management and is not a secretary, there is little scope for that employee being able to bring about a release or a grant of authority.

[22] **The Committee recommends that the definition of "officer" in section 229 should be adopted as the definition of "Officer" in section 237.**

RECOMMENDATIONS ABOUT DUTIES AND POWERS OF DIRECTORS

[23] Minimum responsibility of the board of directors. This matter is related to the formulation in articles of association of the functions of directors. Usually various provisions in the articles confer powers and functions on directors. In the present context attention can be directed to the general management function. There is usually a provision similar to Table A regulation 66(1) which is as follows:

"(1) Subject to the Act and to any other provision of these regulations, the business of the company shall be managed by the directors, who may pay all expenses incurred in promoting and forming the company, and may exercise all such powers of the company as are not, by the Act or by these regulations, required to be exercised by the company in general meeting."

In a large company in which the directors do not themselves manage, a more appropriate formula is that "the business shall be managed under the direction of the directors".

[24] Consideration of formulations which could attenuate duties of directors leads the Committee to the view that there should be a legislative statement of an irreducible responsibility of directors.

[25] **The Committee recommends that the Act should contain a provision that the business and affairs of a company shall be managed by or under the direction of the board of directors of the company.**

[26] One object of such a provision is to disable directors from relinquishing their responsibility by wholesale delegation through a management agreement appointing a person or management company operating as an independent contractor. Management of a company by or under the direction of its board of directors should involve the board having in the last resort power to direct how any person involved in management, whether higher, middle or lower management or any other person shall carry out their duties. In the interests of members it should not be possible for the directors to hand over direction of management to an external independent contractor without an appropriate degree of control and accountability. Directors must retain responsibility for management of the company.

There would need to be exceptions for where a receiver, a receiver and manager, an administrator of a scheme of arrangement, an official manager, a deputy official manager, a provisional liquidator or a liquidator is lawfully appointed.

[27] Right of directors to rely on others : delegation. A legislative statement of the minimum functions of directors needs to be accompanied by a legislative recognition that directors may rely on other persons.

[28] The Senate Standing Committee on Legal and Constitutional Affairs in its report on Directors' Duties recommended[13] that the companies legislation be amended to provide for, and specifically limit, the extent to which company officers may rely on others. The Senate Committee stated that the framing of the amendments needed to be considered by this Committee or the Australian Law Reform Commission. Since the question of reliance is relevant to the other aspects of this report the Committee has taken the matter under consideration.

[29] In most companies there will be a need for directors to enlist' the services of employees of the company or a related corporation and of independent contractors outside the company. But because directors are fiduciaries their discretions incidental to their fiduciary office are not to be delegated without authority in the constituent documents of the company. Moreover, discretions conferred by legislation could not be delegated except under statutory authority.

[30] In preparing themselves to make their decisions members of the board of directors may employ other persons to provide them with information, including advice, on the basis of which the board will make a decision. It is not feasible for board members to check personally all the information supplied to them as the basis for a decision. But even beyond the mere gathering of information there will be a need in the conduct of any sizeable company's affairs for many decisions to be taken at levels below the board. In some companies decisions will be made by management on many matters without the particular decision, as such, coming before the board for decision. Such decisions will be made within the limits of the board's delegation either within specific limits such as monetary approval levels or within broad limits such as approved plans and budgets. Other decisions may fall under the broad mantle of delegating the day-to-day management to the chief executive, the extent of which will depend on the unspoken trust which must necessarily exist between the board and the chief executive, and between the chief executive and subordinates. Often some decisions will fall into the "grey" area of delegation and in such cases, management will have to make decisions identifying matters requiring the attention of the board or at least discussion with the chairman.

[31] The Committee understands that in good current practice regular reporting by the delegate to the board is required. There is also a growing reliance on audit sub-committees.

[32] It is impossible to formulate an all-embracing test by which to distinguish mechanically between discretions which must stay with the board and those that are capable of being delegated. The

category of delegable discretions can differ from company to company depending on the size of the company, the nature of its business operations and theories of management. Any legislative statement of a right of directors to rely on other persons must be qualified by denying to the board the power to delegate those discretions which, in the circumstances of the particular company, should be exercised only by the board but that qualification cannot be expressed in other than general terms.

13. Report on the Social and Fiduciary Duties and Obligations of Company Directors (November 1989) para. 3.53.

A precedent for legislation exists in the American Law Institute's **Principles of Corporate Governance : Analysis and Recommendations** section 4.01(b) providing:

"Except as otherwise provided by statute or by a standard of the corporation 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 ..."[14]

In that statement the phrase "subject to the board's ultimate responsibility for oversight" is another way of saying that there are some responsibilities that no board can shift to other persons such as the responsibility to ensure that there are adequate and proper systems of accountability of the delegate and other checks and balances in the system (for example, audit committees).

[33] **The Committee recommends the enactment in section 229 of a provision similar to the American Law Institute's provision. Instead of the words "a standard" there should be substituted "the articles" and the words "direction and" should be inserted before "oversight". With those changes the American Law Institute's provision indicates the kind of provision that the Committee contemplates.**

[34] Later in this report (see para. [75]) the Committee recommends the enactment of a business judgment rule which would leave to the board the capacity to make decisions on a category of subjects called "business operations" which would not be reviewable on the merits in litigation in which it is sought to make a director personally liable to compensate the company : see para. [68]ff. A decision to delegate in relation to an aspect of the business operations could itself be a business judgment attracting the business judgment rule. As it was put by Romer J. in **Re City Equitable Fire Insurance Co. Ltd.** [1925] Ch 407 at 427:

"The manner in which the work of the company is to be distributed between the board of directors and the staff is in truth a business matter to be decided on business lines."[15]

14. Tentative Draft No. 4. April 12, 1985.

15. Compare law in U.S. jurisdictions under which board decisions to delegate can be within the business judgment rule : Block, Barton and Radin The Business Judgment Rule:Fiduciary Duties of Corporate Directors and Officers (1987) Prentice Hall, pp. 47 - 8.

[35] The matter of reliance has been well described by the American Law Institute[16]:

"For example, in carrying out their oversight obligations directors will almost certainly have to rely on information, reports, and statements from other persons and from committees of the board. Directors who do not serve on a committee (e.g., the audit committee or executive committee) will often have to rely on the committee's work product, its performance (e.g., with respect to its ongoing oversight of particular areas), and its decisions and judgments with respect to procedural and substantive matters. In making business judgments, directors will often have to delegate responsibility with respect to the evaluation of various matters and will almost invariably have to rely on memoranda, documents, and oral statements prepared and presented by other persons."

[36] In the U.S.A. the Model Business Corporation Act section 8.30 contains the following provisions about reliance on information”:

"In discharging his duties a director is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted ... unwarranted."

[37] The American Law Institute has recommended that a director or officer "who acts in good faith, and reasonably believes that reliance is warranted" be entitled to rely on information, opinions, reports, statements, etc from:

(i) (other) directors, officers or employees, under joint or common control, "whom the director or officer reasonably believes merit confidence"; or

16. Principles of Corporate Governance: Analysis and Recommendations Section 4.01(b) Comment at 55 (Tentative Draft No. 4 April 12, 1985).

(ii) "legal counsel, public accountants, engineers, or other persons whom the director or officer reasonably believes merit confidence".[17]

[38] The New Zealand Law Commission has recommended that a new Companies Act should contain the following provision:

"107 Use of information and advice

Every director' of a company, when exercising powers or performing duties as a director, may accept as correct, reports, statements, financial data and other information prepared, and professional or expert advice given, by any of the following persons to the extent only that the director acts in good faith, after reasonable inquiry when the need for inquiry is indicated by the circumstances, and without knowledge that would cause such acceptance to be unwarranted:

(a) any employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;

(b) any professional or expert person 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."

[39] **The Committee recommends that there should be legislation giving directors and officers power to rely, in the performance of their duties, on other persons to act or to provide information. What the Committee recommends is not out of line with the principles that a court would apply as part of the unenacted law.**

Subject to extending its benefit to officers as well as directors, the New Zealand Law Commission's draft set out above exemplifies a suitable provision on the matter of reliance.

[40] Given a legislative statement of minimum functions of a board of directors such as that recommended in para. [25], should it be open to articles of association, a contract, any other arrangement or resolution to relax by general provision the impact of (i)the duty to exercise reasonable care and diligence or (ii) the duty of good faith? (Discussion Paper NO. 9 paragraphs [76] - [78])

17. The American Law Institute Principles of Corporate Governance : Analysis and Recommendations, Tentative Draft No 4, April 1985, Part IV, pp. 16 - 7.

[41] The duty to exercise reasonable care and diligence. In its submission The Institute of Directors in Australia[18] said that companies should not be permitted in their articles to remove entirely the liability of directors for negligent misconduct but that procedural and other qualifications which modify the director's duty or limit the circumstances of its enforceability should be permitted, provided they do not amount in substance to abrogation of liability. The Company Directors' Association of Australia thought that too great a freedom to companies to formulate duties of directors could lead to abuses and that it would be better that the formulation be done by statute if it is thought that there are advantages in formulating duties. The Law Society of South Australia pointed to the prospect of lack of uniformity as to directors' duties.

[42] The Committee believes that the mischief referred to by the Greene Committee in 1926 of exculpatory articles that are too wide (see para. [14]) would still be encountered if section 237(1) were repealed altogether and that there is still a need for regulating exculpatory provisions that could unfairly prejudice creditors and members.

[43] In the Committee's opinion the duty to exercise reasonable care and diligence is so fundamental to the proper administration of companies that in the interests of creditors, if not members, the legislation should make it clear that the duty cannot be cut down by any provision in the company's constituent documents.

[44] **So far as the duty to exercise reasonable care and diligence is concerned, the Committee recommends against making any amendment of the legislation to allow reduction of that duty by the company's constituent documents. That recommendation is made in relation to all companies, both public and proprietary. Nor should it be possible to effect a reduction of the duty by a general provision in a contract between a company and a director or officer or in any other instrument or resolution which purports to bind the company. Later (in para. [.57] ff.) the Committee deals with the circumstances in which protection against liability in a particular case may be given prospectively by antecedent's authority from the company in general meeting.**

The Committee's recommendation is that it should not be possible for the company's constituent documents, any contract or any other instrument or resolution to contain any provision to reduce or limit liability to the company for breach of the duty of care and diligence as fixed by law. That extends to exclusion of liability, restrictive prescription of causal connection, restrictive prescription of time limits for proceedings, prescription of standard of proof or reduction by any other means. It also extends

to any imposition of a cap on the amount of compensation or damages that may be recoverable.

18. Since The Institute of Directors in Australia and The Company Directors' Association of Australia each responded to Discussion Paper No. 9 they have merged as from 1 January 1990 in a new organisation, The Australian Institute of Company Directors.

[45] In Discussion Paper No. 9 the Committee raised the question whether the Companies Act should be amended to authorise a company to provide in its articles that the liability of a non-executive director who has acted honestly but in breach of the duty of care and diligence may be limited to a multiple of the director's annual remuneration over a period. There was a mixed response from respondents. The Institute of Directors in Australia favoured such an amendment but The Company Directors' Association of Australia was of the view that a proposal to cap the liability of directors should hot be considered in isolation from a similar question in relation to members of professions generally. The Association believed that in the absence of a common approach to limitation on professional liability the matter should be dealt with by provision for the company to purchase adequate insurance.

[46] The Committee agrees with the approach advocated by The Company Directors' Association of Australia. There is an additional consideration that to allow members of a company to sanction a provision for a cap on liability could prejudice the company's creditors. Commercial convenience demands that outsiders who deal with a company should not have to inspect the company's constituent documents before they deal. In recent years companies legislation has changed to accord with that view.

[47] The duty of good faith of a director or officer. Attenuation by general provision of the duty of good faith is another matter. Clearly, no article or other provision should be allowed to reduce the duty to be honest in the sense of having no intent to deceive or defraud.

[48] But the duty to exercise a discretion for a proper purpose - the purpose or purposes for which the discretion was conferred - may be thought to be a duty which can be affected by statements in the articles specifying the purposes. Directors who use their powers for an impermissible purpose can be in breach of duty even if they have a bona fide belief that their decision is for a proper purpose. It seems inappropriate for legislation to deny to companies the power to set forth in the articles the purposes for which directors are to be able to use their discretions. For example, a power given to the board of directors to refuse registration of a transfer of shares could be given for many different purposes. Not every company in which directors have that power will confer the power for the same purposes. In a quasi-partnership company the purpose of the power is to reduce the possibility of disharmony among shareholders. In another company the purpose of the power may be to ensure that only Australian nationals come onto the company's register of members. Part of the problem is that the duty to be honest relates to bona fide exercise of discretions. Discretions, like fiduciary powers,

are to be exercised only for the purposes for which they have been conferred. Directors who use their powers for a purpose outside the range of impliedly permitted purposes can be in breach of duty even if they had a bona fide belief that their decision was for a proper purpose. Their duty can be attenuated by the statement in the articles of the purposes for which a use of the power is permitted, at least when the power is one to issue shares. The High Court has recognised that at least in a proprietary company:

"articles of a company may be so framed that they expressly or impliedly authorise the exercise of the power of allotment of

unissued shares for what would otherwise be a vitiating purpose."[19]

[49] Another instance where the duty of good faith in relation to exercise of discretions may be attenuated by the articles is where a director has been appointed by a nominator and the articles indicate that the nominee's primary duty is to protect the interests of the appointor. That such an article is quite proper seems to be implicit in **Levin v Clark** [1962] NSWR 686. See also **Berlei Hestia (NZ) Ltd. v Fernyhough** [1980] 2 NZLR 150 at 165 - 166.

[50] In its Report No. 8 on Nominee Directors and Alternate Directors (2 March 1989) the Committee recommended that there be a modification of section 229 of the Companies Act 1981 (Cwl.th) to the effect that a director will not be in breach of section 229 or be otherwise in breach of duty by reason that his or her main reason or actuating motive for an act or omission was a consideration other than the benefit of the company as a whole in three cases. The three cases were:

(i) where all members have given prior informed consent to the particular exercise of power or performance of duty in that way;

(ii) where the company is being managed in accordance with an agreement or arrangement to which all members are parties and which authorises the director to take into account the interest of one or more of the members in the particular exercise of power or performance of duty; or

(iii) where the company is a wholly-owned subsidiary company and the director took into account the interest of a related corporation that is a holding company in relation to it.

The Committee then recommended, by a majority, that the legislation should indicate that an exempt proprietary company and a non-commercial company should be at liberty to include in their constituent documents provisions which relieve directors of their normal duty to consider the benefit of the company as a whole, so long as the company is solvent.

[51] In the present context the Committee recommends that the legislation should recognise that there should be scope for a company by its constituent documents to define the limits of the duty of good faith in relation to exercise of discretions by stating the specific purposes for which discretions are conferred. But there should be no possibility of the articles conferring a general power to disregard the duty to consider the benefit of the company as a whole except in the circumstances referred to in the

Committee's Report No. 8 on Nominee Directors and Alternate Directors.

19. ***Whitehouse v Carlton Hotel Pty Ltd.*** *(1987) 70 ALR 251 at 255 Mason, Deane and Dawson JJ. Whether there is a wide freedom to define purposes in respect of powers generally is not clear : cf* ***Marson v Pressbank Pty Ltd.*** *(1987) 12 ACLR 465 at 472 on appeal* ***Urban v Pressbank Pty Ltd.*** *(1989) 15 ACLR 466.*

[52] A further aspect of the duty of good faith relates to a director being interested in a transaction of the company, Articles commonly provide that a director may be interested in a transaction with the company provided the director discloses the nature of the interest at a meeting of directors. Subject to that requirement the director will not be accountable for any profit. In a listed company the article cannot effectively go further and allow the interested director to vote on a contract or proposed contract or other arrangement because ASX Listing Rule 3L(6) provides that:

"A director (including an alternate director) shall not vote at a meeting of directors in regard to any contract or proposed contract or arrangement in which he has directly or indirectly a material interest."

[53] In relation to the matter of the interested director there has been uncertainty as to whether section 237 forbids relaxation of the principle that a director shall not derive personal profit from a company transaction without the informed consent of the company in general meeting.[20] There may be room for debate as to whether the interested director who makes no disclosure commits at common law a breach of duty or is merely under a disability as to having a dealing with the company.

[54] The usual provision in articles about interested directors is needed by many companies because it is just not feasible to refer the director's interest to the company in general meeting. Because the concept of a director's interest is necessarily wide[21] many transactions that would be of value to the company can be affected. Time will often be of the essence of a transaction. To require the assent of the company in general meeting would very often mean that transactions will be held up for periods not commercially acceptable.

[55] **The Committee recommends that the Act should allow articles to contain a provision permitting a director to be interested in a transaction of the company so long as the provision will only operate if, and when the director has made prior disclosure to the board in compliance with section 228.[22]**

[56] Appropriate amendments to section 229 to give effect to the above recommendations could take the following form. These examples are not put forward as a draft to be adopted but for the purpose of disclosing to better effect the Committee's recommendations.

*20. **Movitex Ltd. v Bulfield** (1986) 2 BCC 99,403.*

21. In its Report No. 9 on a director's statutory duty to disclose interest the Committee recommended in para [11] that the Act should require directors to provide a board with enough information to enable the board to decide whether the interest may be disregarded as not being material.

22. The reference is to section 228 in the form it would assume if it were to be amended as recommended by the Committee in its report on section 228 (Report No. 9, 22 November 1989).

Add to section 229 the following new sub-sections:

"In determining the duties of an officer in the exercise of discretions regard shall be had to any provision in the constituent documents of the corporation which expressly states particular purposes for which the discretion has been conferred."

"A director or officer does not contravene this section or commit a breach of duty by being interested in a transaction or proposed transaction of the company if there is a provision in the constituent documents of the company which allows him to be so interested provided he complies with section 228 in respect of the transaction, and he does in fact so comply."

Advance authority from general meeting

[57] Protection against liability in a particular case, before any breach of duty, by specific advance authority from the company. Respondents to Discussion Paper No. 9 offered different views on this matter. The Company Directors' Association of Australia thought that existing law is clear enough and the Law Society of South Australia thought legislation would be premature. On the other hand the Law Council of Australia suggested that the Act should make it clear that conduct could be authorised in advance and so as to avoid a breach of section 229 provided the conduct would not constitute or involve moral dishonesty. The Institute of Directors in Australia thought advance authorisation should be possible so long as there was full disclosure and that interested parties did not vote.

It is clear that to the extent that the giving of specific advance authority should be allowable any such authority should come only from the company in general meeting, apart from cases within section 228. Cases within section 228 can be exceptionally approved by an informed board.

[58] **The Committee recommends that the legislation should recognize the power of the company in general meeting to give advance authority for specific conduct of a director or officer in relation to a specific transaction, other than conduct which involves an intent to deceive or defraud.**

[59] The critical requirement is that the general meeting should be adequately informed. There would need to be full, frank and fair disclosure to members in advance of the meeting. The courts have established rules as to the standards of communication. The Committee does not propose that the legislation should re-state those standards.

[60] **But the Committee recommends that the legislation should require that the disclosure (for the purposes of the recommendation in para. [58]) should be such as to make members aware of at least:**

(i) material details of the transaction;

{ii) any direct or indirect interest of the directors or officers or their associates or their relatives in the transaction;

(iii) the benefits to the company that it will obtain that could not be obtained by a transaction that did not require the authority of the company in general meeting; and

(iv) the circumstances that indicate that without the authority the director or officer will be in breach of duty and the nature of any liability that could accrue.

In a group of companies it should be a general meeting of the holding company that gives approval for directors in subsidiary companies to be authorised.

In the case of a partly-owned subsidiary the members of both the subsidiary and the holding company should give the approval (as for directors' loans).

Fairness requires that the person who will be relieved should not consent to his or her own wrong. Interested directors, their associates and relatives should not be able to vote.[23] The necessary majority should be that for an ordinary resolution.

The advance consent of the company in general meeting would be effective not only to protect the director or officer from personal liability but would foreclose any assertion that his or her act was invalid.

[61] If in the general meeting the majority was acting in fraud of the minority or the resolution was passed in circumstances attracting the remedy for oppression under section 320, the consent would be liable to be set aside. If that happened, the personal liability and any invalidity would persist. In other words, a director or officer seeking advance authority from the general meeting would have to assume the risk that the general meeting acted improperly. An innocent third person could be protected by the indoor management rule or section 68A or, in cases under section 320, by the exercise of the court's discretion under section 320(2).

[62] There may be a question as to how it can be within the legal competence of a general meeting to authorise or ratify action of directors which would be in excess of, or an abuse of, their exclusive power in the common case where the board has been given the general powers of the company to be exercised independently of the general meeting. The Committee thinks that this objection should not stand in the way of legislation affirming the

23. As long ago as 1879 Lord Justice James in ***Mason v Harris*** *(1879) 11 Ch D 97 at 109 regretted the absence of power in the Court to order a meeting at which a person in breach would not be able to*

vote. His Lordship said: "It has been suggested that the Court has some means of directing a meeting to be called in which the corrupt shareholder should not be able to vote. If the court had that power that mode of proceeding might furnish the best remedy in cases of this nature, but I cannot see how any directions for holding such a meeting could be given."

power of a general meeting to absolve in advance. The Committee does not propose abolition of all limits under the general law as to the action that a majority in a general meeting can take to bind a minority. The case law doctrine of a majority acting in fraud of a minority treated as now being embodied in section 320 would not be disturbed under the Committee's recommendations. If it be said that the doctrine of fraud on the minority is vague and requires detailed legislative definition, the answer is that there is already relevant legislation in section 320. That section uses broad concepts but it seems to the Committee that any attempt to enact in detail what is conduct unfairly prejudicial to a minority would be a vain endeavour. The wide formulae in section 320 must be left for application by the courts in the exercise of a broad judicial discretion to meet the infinite variety of cases- that can arise. In the interests of certainty it would be advisable to refer in the proposed legislation to the fact that the authority given by members only relates to relief from liability for exceeding or using a power for an improper purpose and not for breach of any other duty. Directors would still have to consider whether the particular transaction was in the interests of the company.

[63] Questions were raised in **Winthrop Investments Ltd. v Winns Ltd.** [1975] 2 NSWLR 666 at 702 as to whether ratification by the general meeting of a decision made by directors for a collateral purpose would be ineffective where the general meeting had the same collateral purpose. Under the Committee's proposals that question would be one to be disposed of in proceedings under section 320. There should be less occasion for concern as to the purpose of the general meeting under the Committee's proposals since interested directors would not be able to vote as shareholders.

[64] **The Committee recommends that the statutory statement of the power of the general meeting to authorise[24] what would otherwise be a breach of duty should be expressed to be subject to section 320 alone.**

[65] An authority given by the company in advance of conduct by directors or officers could go to the definition of powers or duties for the purposes of section 229(1) and 229(2) and to what is improper under section 229(3) or 229(4). Hence conduct in accordance with an authority given in advance would not be a contravention of section 229.

[66] Solvency of the Company. An advance authority to act in breach of duty could adversely affect creditors.

[67] **The Committee recommends that if the company goes into liquidation within 12 months after the authority is given and is**

insolvent, the Court may order that the director or officer in question should be considered to be in the same position as if the authority had not been given.

24. And to ratify retrospectively : see para. [108].

Statutory business judgment rule

[68] Protection by operation of a statutory business judgment rule. The expression "business judgment rule" has been adopted in the U.S.A. to describe a rule which has been operating there for at least a century and a half and which helps to ensure that tribunals before which the conduct of directors and officers is called into question do not second-guess the merits of a business judgment made by directors and officers after reasonable investigation, in good faith without personal interest and in a reasonable belief that they are acting for the benefit of the corporation.[25]

[69] The Committee drew attention in Discussion Paper No. 9 paragraph [37] to a draft by the American Law Institute of a restatement of the rule; that draft refers to a director or officer who makes a business judgment in good faith where:

(i) he or she has no personal interest in the subject of the business judgment;

(ii) he or she is informed to an appropriate extent about the subject of the business judgment; and

(iii) he or she rationally believes that the business judgment is in the best interests of the company.

Many respondents[26] to Discussion Paper No. 9 strongly supported adoption in the Companies Act of a similar provision.

[70] The need for a legislative statement of a business judgment rule may be questioned on the ground that there is already something like the business judgment rule inherent in the law about the liability of a director or officer for breach of the duty of care and diligence. In proceedings against a director for breach of that duty the initiator of the proceedings (whether a plaintiff or a prosecutor) has the burden of persuading the court that the director did not exercise a reasonable degree of care and diligence. In discharging that burden the plaintiff has to adduce evidence showing some act or omission differing from the behaviour to be expected of a reasonable person having the training and experience of the director. Where the alleged default is a matter of business judgment the plaintiff has to show that no reasonable director with equivalent training and experience could have made the judgment in question.

25. See generally, Block, Barton and Radin The Business Judgment Rule Fiduciary Duties of Corporate Directors and Officers (1987) Prentice Hall.

26. Australian Bankers Association; Australian Society of Accountants; CRA Limited; The Company Directors' Association of Australia; Institute of Chartered Accountants in Australia; The Institute of Directors in Australia; Mr. A. P. Kelly; Law Council of Australia; The Broken Hill Proprietary Company Limited; Trustee Companies Association.

[71] Where the validity of a collective decision of a board of directors is brought into question courts will not review the merits of a decision on a matter of business management. The Privy Council said in **Howard Smith Ltd. v Ampol Petroleum Ltd.** [1974] AC 821 at 823:

"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."

See also per Barwick CJ, McTiernan and Kitto JJ in **Harlowe's Nominees Pty Ltd. Woodside (Lakes Entrance) Oil Co NL** (1968) 121 CLR 483 at 493:

"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."

[72] Moreover, it would be wrong to suggest that in cases beyond directors and boards courts never make allowance for the difficulty involved in the making of judgments. Even in applying common law standards to members of a profession courts recognise the special position of an error of judgment. For example, in **Saif Ali v Sydney Mitchell & Co** [1978] 3 All ER 1033 at 1043, [1980] AC 198 at 220 Lord Diplock said:

"No matter what profession it may be, the common law does not impose on those who practise it any liability for damage resulting from what in the result turns out to have been errors of judgment, unless the error was such as no reasonably well informed and competent member of the profession could have made."

There is another example in the field of trusts. It was said in **Bartlett v Barclays Bank Trust Co Ltd.** [1980] Ch 515, [1980] 1 All ER 139, No 2 [1980] 2 All ER 92:

"Nor must the court be astute to fix liability on a trustee who has committed no more than an error of judgment, from which no business man, however prudent, can expect to be immune."

[73] However, there are in the view of the Committee, special reasons why there should be explicit reference in the Companies Act to something in the nature of a business judgment rule.

Since matters of judgment come up for consideration by courts in many contexts not limited to business, it may be asked as to what

is so special about companies legislation and the conduct it regulates that demands a specific legislative statement about the review of business judgments.

The Committee thinks that there are good reasons for the legislation to recognise business judgments made in companies. Those reasons lie in the nature of business enterprise and in the raison d'etre for limited companies.

[74] The review of business judgments needs to be considered in the light of the following arguments:

(i) there is a continuing social need for the encouragement of new business enterprises;

(ii) those new enterprises can include enterprises carrying business risks which only a small minority of the general community would be prepared to accept; and

(iii) there is a danger that when a high-risk enterprise fails, even one floated with full disclosure of the likely risks, the liability of the movers of the enterprise will arise for consideration by persons averse to risk who may apply, in good faith, standards of caution that are inappropriate in the circumstances to a judgment on a matter of business operations.

Enactment of 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.

Enactment of a business judgment rule would also provide legislative recognition of the commercial reality that a limited company is a vehicle for taking commercial risks. Limited companies came into being to provide a legal vehicle for the taking of commercial risks in new enterprises.

[75] **The Committee recommends the enactment of a business judgment rule in terms suggested in para [81].**

[76] The Committee's recommendation of a statutory business judgment rule relates only to the business merits of a business decision. Business decisions would remain reviewable in other respects. A director who made a decision while subject to a conflict of interest would not be relieved by the business judgment rule. Nor would the benefits of the business judgment rule accrue to any director who, in making the decision, abuses his or her power and makes the decision for a purpose not permitted either expressly or impliedly by the terms of the grant of the power to decide. The benefit of the business judgment rule would be available only to a director who first obtains information to an appropriate extent regarding the subject of the business decision. Although one of the aims of stating the rule would be to protect enterprising persons who decide on a high-risk venture, it would still be necessary to exclude decisions which could not possibly on any view be regarded as being for the benefit of the company.

[77] The Committee proposes enactment of a business judgment rule which would be relevant to only the duty of care and diligence and only in relation to judgments about the business operations of a company rather than judgments about constitutional matters arising in the administration of the company. The Committee believes that there is a relevant distinction between judgments on business operations (such as the decision to relocate a retail branch) from judgments on constitutional matters (such as a decision to refuse to accept a nomination of a person for election as a director). In the U.S.A. a business judgment rule developed because courts were thought to have no place substituting their judgment for that of

directors. Originally the rule was intended to apply to decisions of directors on matters arising in the conduct of the company's operations, matters such as deployment of company resources, raising of corporate finance etc. But the rule came to be applied in cases where there was a suspicion that the motive for a board decision was not the advancement of the corporate business but something else, such as where the incumbent board of a target company decided upon a corporate transaction in order to foil a take-over bid.[27] The application of the rule in connection with defensive tactics has been questioned in the U.S.A.[28]

[78] The Committee's recommendation limits the statutory business judgment rule to cases where the issue is whether a director or officer should be declared liable to pay compensation to the company. The benefit of the rule is to prevent personal liability to pay compensation. The statutory statement of the rule is not to be relevant to any question as to the validity of the transaction in respect of which the decision was made. Normally, an innocent third person will be protected by the indoor management rule or section 68A against any attempt by the company to resile from a transaction affected by a breach of duty on the part of a director or officer.

[79] The enactment of a business judgment rule should be addressed to the liability of a director or officer who is in breach of duty to pay compensation for the breach generally, whether by reason of section 229(6), by reason of any breach of statutory duty or otherwise by reason of the case law. Elsewhere in this report the Committee recommends the exclusion from penalty under all of section 229 of acts or omissions that do not involve intent to deceive or defraud : see para. [99].

[80] As part of section 229 the business judgment rule could be applicable to civil proceedings based on any of sub-sections (1), (2), (3) or (4) that did not involve intent to deceive or defraud.

[81] As to the terms of a possible statutory business judgment rule, the following is suggested, not as a final draft, but only to bear out the considerations that have seemed to the Committee to be relevant;

(1) A director or officer shall not be liable to pay compensation to a company by reason of section 229 or under the general law in respect of his or her business judgment unless it is made to appear to the

27. For a comparison in the context of hostile take-overs of the business judgment rule as applied in the U.S.A. and the proper purpose doctrine as applied in the United Kingdom, Australia and

New Zealand, see Farrar J H, 'Business Judgment and Defensive Tactics in Hostile Takeover Bids' (1989) 15 Can. Bus. L. Jnl. 15.

28. For example, in Minstar Acquiring Corp. v AMF Inc. 621 F.Supp. 1252 (1985 US Dist Ct SD New York) per Lowe J : "The rule was developed to protect directors' judgments on questions of corporate governance. Questions like 'should we buy a new truck today?' or 'should we give Joe a raise?' are simplistically, types of business judgments which the rule was developed to protect."

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;

(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.

The intention of the Committee will be made further apparent by the following comments on the above formulation.

[82] Sub-section (1). The benefit of the provision can be obtained by any director or officer. It is the nature of business judgments in a company that calls for the rule not the status of those who have to make the decisions.

[83] The protection is against liability to pay compensation to the company. For example, the provision will not be relevant in proceedings under section 107 for compensation for misstatement in a prospectus. The statutory statement of the rule will not apply where a member or a creditor has a personal right of action against the director or officer. There are provisions in the Companies Act sections 218(3), 556 and 565 under which a director or' officer can be liable to creditors. The rule will not apply in relation to those provisions.

[84] The suggested measure will not protect a director or officer from the possibility of being enjoined. Nor will it give protection against liability to account for profits or to give up property of which the director or officer may be declared to be a constructive trustee.

[85] As to the condition about the director or officer being informed, the field of required information is confined to the particular subject of the decision. The Committee notes that the Senate Standing Committee on Legal and Constitutional Affairs recommended that a business judgment rule be introduced into Australian company law.[29] The Senate Committee thought that the rule should include an obligation on directors to inform themselves of matters relevant to the administration of the company. CSLRC agrees that directors should inform themselves in that way but thinks that effect should be given to that obligation through the court's power to excuse under section 535. Later in this report (see para. [118]) the Committee recommends in relation to the power of the court to exercise its discretion to excuse under section 535 an amendment of section 535 so that one of the matters to be considered by the court is to be the effort made by the director or officer to acquaint himself or herself with the legal responsibilities of his or her office and with the company's business operations. The condition about being informed requires that the director or officer be informed "to an appropriate extent". Among other cases, this will allow for the case where the board is constrained by time limits and must act quickly to seize a business opportunity that is open for only a short time. The condition about the director or officer being informed calls into question the need for an adequate legislative guarantee of adequate and equal access to information about the company's affairs. The Committee deals with that question later in paras. [96] and [97].

[86] The statutory business judgment rule will not be available in respect of that part of the duty of good faith which requires directors to use their powers for proper purposes. Normally questions of misuse of power go not to liability to pay compensation but to the validity of board action. But there can be cases where personal liability to compensate the company arises from a misuse of powers. An example is where, in particular circumstances, directors use company funds to persuade shareholders to vote against
29

29. Report on the Social and Fiduciary Duties and Obligations of Company Directors (November 1989) para. 3.35.

particular persons nominated for election to the board and the directors are acting in the mistaken, but honest, belief that their powers enable them to do so.[30] Even though directors can honestly think that an exercise of power is for a proper purpose, their decision is liable to be set aside if their view of the permissible purposes differs from that of the court. It seems to the Committee that there should not be any legislative relaxation which would allow directors to make their own assessment of the purposes for which powers were conferred.

[87] Sub-section (2). It is necessary to provide some legislative guidance as to the content of the expression "business judgment". The definition uses the expression "business operations". Business operations will, of course, differ from company to company. Some decisions will have both a business and a constitutional significance. For example, a decision to raise more capital by the creation and issue of a new class of shares relates to business operations when seen as a change in financing. But it is also constitutional if it affects relative voting power as between shareholders in different classes. Under the draft such a decision will be a business judgment unless it relates "principally" to the company's constitution. A decision of the board or an officer appointing executive officers (in the usual case, the board appoints only the managing director) is excepted from business judgments because it is a decision which can properly be reviewed as to merits. A decision as to the solvency of the company is so important that it should be made without the comfort given by the business judgment rule.

[88] Sub-section (3). The statutory rule is not intended to be available in respect of a director's liability to pay the company under any other provision of the Companies Act (such as section 129(6) dealing with compensation for loss resulting from contravention of section 129 and section 133QC dealing with indemnity to the company where shares have been bought back and the company later becomes insolvent) or under any other Act or any Regulation.

[89] Sub-section (4). This sub-section is included to prevent any implication being drawn from the statutory statement of the rule that the statutory statement abolishes a common law rule to the same effect.

[90] **If the recommendations in para. [99] that conduct not involving intent to deceive or defraud should be taken outside the penal operation of section 229 are not adopted, the Committee recommends that it should be possible to apply the business judgment rule in criminal as well as civil proceedings. In that**

event the suggested formulation will need to be widened to protect against the imposition of a penalty when the rule applies.

[91] Consideration of whether there should be a legislative statement of a business judgment rule calls into question the existing legislation under which directors and officers who are otherwise liable for a breach of duty may be excused by the court. That provision is section 535 of the Companies Act 1981 (Cwlth) which is reproduced below in para. [109].

30. ***Advance Bank of Australia Ltd. v FAI Insurances Ltd.*** *(1987) 9 NSWLR 464.*

Section 535 has been applied in at least one reported case (**Re Claridge's Patent Asphalte Co Ltd.** [1921] 1 Ch 543) to produce a result very like that which would follow an application of a business judgment rule similar to that proposed by the American Law Institute: see Discussion Paper No. 9 paragraphs [107] and [108]. But section 535 does not operate to prevent a finding of breach of duty whereas the business judgment rule proposed by the Committee would.

[92] The Committee favours the enactment of a provision which would operate before a finding of liability and it is intended that the proposed statutory business judgment rule would have that operation. Later the Committee recommends that even if a statutory business judgment rule is enacted, section 535 should be maintained: see para. [111].

[93] Access by directors and officers to company information. If a statutory business judgment rule is to be enacted in terms which put a premium on each director being informed about the matter to be judged, the rights of directors to access to corporate information come into question. While there is case law on the matter, it seems desirable that the new measure should be accompanied by provisions dealing with a director's right of access to information.

[94] It is important that directors, as members of a board having the function of directing a company, should have equal access to information about the affairs of the company possessed by other directors and the managers of the company. Non-executive directors need the support of legislation guaranteeing that right to enable them to perform their duty to participate fully in the deliberations of the board.[31] It may be that in some circumstances necessary arrangements (such as a Chinese wall of the kind contemplated in section 128 of the Securities Industry Act 1980 (Cwlth)) may require that a director should not be supplied with information on a particular matter but the decision that information not be supplied to a director should be that of the board.

[95] The right of access to company records given to directors by the Companies Act should be more extensive than the right of access of members. Section 265B empowers the Court to order inspection of the "books" of a company on behalf of a member. The Court's power under section 267(8) to order inspection on behalf of a director relates only to "accounting records", an expression narrower than "books". Of course, a director who obtains information will be subject to restraints under general law to use the information only in the interests of the company. The circumstances in which a director should be permitted to use company information for the

benefit of a third person have been considered in an earlier report of the

31. Compare the concern of the City Panel in London that each director of an offeror company and of an offeree company must have full information about a bid rather than leaving the matter to a board committee since each has responsibility to see that the City Code on Takeovers is complied with : Panel Statement on the involvement of the full board of a company in an offer, July 30, 1987 : [1987] Jnl Bus. Law 480.

Committee.[32]

[96] **The Committee recommends legislation under which a director shall be entitled, notwithstanding anything to the contrary in the company's constituent documents, to:**

(a) notice of all meetings:

(i) of the company or of a class of members, to which any other person is entitled, whether or not the director is a member of the company; and

(ii) of the board of directors or of committees of the board;

(b) to attend and speak at all such meetings in respect of any item of business whether or not he or she has a right to vote at the meeting;

(c) access at reasonable times to the company's books; and

(d) reasonable facilities (including travel expenses) to enable the director to take reasonable steps to become acquainted with the company's assets and operations.

[97] **The Committee further recommends that the legislation should impose on the principal executive officer of a company an obligation to take reasonable steps to cause each director to be furnished with such information about the company's affairs as is reasonably necessary to enable the director to exercise his or her powers and to discharge the duties of his or her office and to treat each director equally in that respect except where the board (subject to an order of the Court) decides that it is against the interests of the company to do so. The test of what is necessary information for a director should be an objective one and the matter should not rest on the subjective assessment of the principal executive officer. To assist the principal executive officer to perform that duty there should be imposed on each executive office an obligation to keep the principal executive officer informed of such matters as the principal executive officer reasonably requires. A suitable penalty needs to be prescribed in support of each duty.**

[98] Penal liability under section 229 and punitive awards. The Committee notes that the Senate Standing Committee on Legal and Constitutional Affairs[33] recommended[34] that section 229(2) be amended so that criminal

32. Report No. 8, Nominee Directors and Alternate Directors (March 1989), para. [83].

33. Report on the Social and Fiduciary Duties and Obligations of Company Directors (November 1989).

34. Ibid. para. 13.12.

liability under that provision only applies where conduct is "genuinely criminal in nature". CSLRC concurs and goes further.

[99] **The Committee recommends the exclusion from penalty under all of section 229 of acts or omissions that do not involve intent to deceive or defraud.**

[100] In relation to section 229(1), in particular, one may doubt whether the threat of ignominy of conviction for an offence described as failure to "act honestly" should be visited upon a person who may be acting without any intent to deceive or defraud.

The Committee envisages that even if these recommendations that section 229 be amended to limit criminal sanctions under the section to acts or omissions that involve intent to deceive or defraud are accepted, section 229 will need to continue the statements of duties now in sub-sections (1), (2), (3) and (4) but that sub-section (2) will only be relevant to civil liability.

[101] To meet the case of a breach which although honest is particularly flagrant, as where the director or officer is reckless, courts should be empowered to make an award in the nature of punitive damages. As noted in para. [9] equitable compensation for breach of fiduciary duty is only restitutionary and there is not the same scope as at common law for awarding anything similar to punitive damages.

[102] When a company fails, the level of loss is likely to be so high that an award of punitive damages against an individual will carry little impact. However, there may be the odd case where such an award could have practical significance. The Committee believes that to meet such a case a court dealing with a claim for compensation for breach of fiduciary duty should have power to make in favour of the company an award in the nature of punitive damages.

[103] **The Committee recommends legislation giving Courts a discretion to award the company an amount in the nature of punitive damages in relation to breaches of duty by directors or officers. An alternative course would be to provide for something in the nature of a civil penalty of the kind discussed and recommended by the Senate Standing Committee on Legal and Constitutional Affairs.[35] However, any such penalty should in the Committee's view be recoverable by only the company.**

[104] Protection after breach of duty by exculpatory provision in the articles. This is the central mischief at which section 237 was aimed. Section 237's operation in relation to that mischief should be maintained. The earlier recommendations in paras. [51] and [58] as to legislation sanctioning attenuation of duty, advance

authority by the company in general meeting and later recommendations (see paras. [106] and [125]ff) to be made about release by the company in general meeting and insurance will leave section 237 with this function in relation to directors and officers.

35. Report on the Social and Fiduciary Duties and Obligations of Company Directors (November 1989) paras. 13.13 - 13.15.

[105] Protection after breach of duty by release by the company in general meeting. The recommendations made in para. [58] about the general meeting giving specific authority in advance are relevant here.

[106] **The Committee recommends legislation adopting the same approach for release from liability as the Committee has recommended in relation to specific authority given in advance. The disclosure to members should extend to explaining the circumstances of the breach and the nature of the liability attaching to the director or officer. If the company goes into liquidation within 12 months after the authority is given and is insolvent, the Court may order that the director or officer in question should be considered to be in the same position as if the release had not been given.**

The kind of release in question is only a release from civil personal liability of a director to the company or to members. Post-default absolution by the company should not be able to alter accrued liability to any penalty for a contravention.

[107] Validity of transaction. A breach of duty may make a transaction invalid. However, innocent third persons having dealings with the company will have the benefit of the indoor management rule or section 68A. Such a person will be able to presume that the directors, the principal executive officer, the secretaries, the employees and the agents of the company properly performed their duties. However, there may be cases where neither the indoor management rule nor section 68A applies and the company may wish to validate the transaction.

[108] **The Committee recommends that the question whether a release should be accompanied by ratification of a transaction which was invalid because the director or officer was in breach of duty should be a matter for decision by disinterested members in general meeting. Ratification should be the subject of a resolution separate from any which releases a director or officer from civil personal liability. The pre-meeting disclosure about the proposed ratification should provide information as to why it will be for the benefit of the company that the transaction should be ratified.**

When a member brings proceedings complaining of a breach of duty that is capable of ratification the court may be disposed to refuse relief because of the possibility of ratification. In the present context the Committee sees no reason to recommend any alteration of the legislation which could affect the principles upon which the courts act in the light of possible ratification.

[109] Protection after breach of duty through the court excusing under section 535. There is provision in section 535 for the court having a discretion to relieve a director or officer from liability.

Section 535 provides:

"535(1) If, in any civil proceeding against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity by virtue of which he is such a

person, it appears to the Court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default, or breach but that he has acted honestly and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default or breach, the Court may relieve him either wholly or partly from his liability on such terms as the Court thinks fit.

(2) Where a person to whom this section applies has reason to apprehend that any claim will or might be made against him in respect of any negligence, default, breach of trust or breach of duty in a capacity by virtue of which he is such a person, he may apply to the Court for relief, and the Court has the same power to relieve him as it would have had under sub-section (1) if it had been a Court before which proceedings against the person for negligence, default, breach of trust or breach of duty had been brought.

(3) Where a case to which sub-section (1) applies is being tried by a judge with a jury, the judge after hearing the evidence may, if he is satisfied that the defendant ought pursuant to that sub-section to be relieved either wholly or partly from the liability sought to be enforced against him, withdraw the case in whole or in part from the jury and forthwith direct judgment to be entered for the defendant on such terms as to costs or otherwise as the judge thinks fit and proper.

(4) This section applies to a person who is:

(a) an officer of a corporation;

(b) an auditor of a corporation, whether or not he is an officer of the corporation;

(c) an expert in relation to a matter in relation to which the civil proceeding has been taken or the claim will or might arise; or

(d) a receiver, receiver and manager, liquidator or other person appointed or directed by the Court to carry out any duty under this Act in relation to a corporation.

(5) For the purposes of this section, "officer" in relation to a corporation, means:

(a) a director, secretary, executive officer or employee of the corporation;

(b) a receiver, or receiver and manager, of property of the corporation;

(c) an official manager or deputy official manager of the corporation;

(d) a liquidator of the corporation; and

(e) a trustee or other person administering a compromise or arrangement made between the corporation and another person or other persons."

The origin of section 535 was discussed in Discussion Paper No. 9 (para. 94ff).

[110] If the Committee's recommendation for the enactment of a business judgment rule is adopted, there will still be a need for section 535 even in relation to persons who could have the benefit of the business judgment rule. In the application of the business judgment rule attention is directed to the acts or omissions of the director or officer in relation to the particular transaction or transactions in respect of which liability is alleged. By contrast section 535, if amended in the manner suggested later in para. [118], would allow the court to consider other matters.

[111] **The Committee recommends that the enactment of a business judgment rule should not replace section 535.**

[112] **The Committee also recommends that if a suitable drafting opportunity occurs, section 535 should be re-located near section 237. That would be in recognition of not only the relevance of the two sections to each other but also their historical inter-relationship as disclosed by the report by the Greene Committee.**

[113] One of the conditions of the Court giving relief under section 535 is that it must appear to the Court that the person who would be liable has acted "honestly"

[114] **The Committee recommends that in view of the use of the word "honestly" in a broad sense in section 229 there is a need to alter section 535 so that the condition requires it to appear to the Court that the person concerned "acted with no intent to deceive or defraud". A similar amendment is required in section 539(6) (b).**

[115] Another question about section 535 is whether its present limitation to civil proceedings should be maintained or whether the court's power to relieve should extend to relieving against criminal liability where the breach has not involved any intent to deceive. Before that extension could be made it would be advisable to restore to the section the condition of exercise of the court's power that used to be in predecessors of the section that it should appear to the court that the person concerned acted reasonably as well as honestly; see Discussion Paper No. 9 paragraphs [114] and [115]. Some respondents favoured extension of section 535 to criminal proceedings. However, it seems to the Committee that section 535 should not be extended to criminal

proceedings generally but that it should be applicable in respect of any liability that may be imposed under the Companies Act.

[116] **The Committee recommends amendment of section 535 so that it should apply in respect of any liability that may be imposed under the Companies Act. In this instance the recommendation relates to all persons who currently can be given relief under section 535.**

[117] The Committee has considered a possible provision that when the Court is asked to use its power under section 535 to excuse a director or officer in whole or in part a criterion to be stated in the section should be whether it appears to the Court that the director or officer has made any reasonable attempt to inform himself or herself about the legal responsibilities of his or her office.

It may be said that if the person had made adequate efforts, he or she should not have acted so as to come under liability. However, the intention behind section 535 appears to be to give a very wide discretion and there is a question as to whether there is scope for distinguishing between, on the one hand, a director or officer who approached his or her duties without concern for legal responsibilities of the office and, on the other hand, one who, though at fault, exhibited genuine concern on that score.

From the viewpoint of a company which has suffered loss and to which the erring director or officer is liable to pay compensation for that loss, the fact of efforts having been made by the director or officer would be irrelevant. The suggestion about exercise of discretion under section 535 would be just if a court dealing with a proven breach of duty had power not only to award equitable compensation, a remedy in lieu of specific restitution, but also to award something in the nature of punitive damages. Earlier in this report (see para. [103]) the Committee has recommended that courts be given that power.

Later in para. [139] the Committee recommends that a company be authorised to establish and maintain insurance to cover its directors, executive officers and employees against personal liability to the company. It may be that, given the possibility of punitive damages being remitted in favour of an informed director, executive officer or employee an insurer would be prepared to accept a lower premium from a company which takes steps to ensure that its directors, executive officers and employees obtain independent instruction about their legal responsibilities.

[118] **The Committee recommends that section 535 be amended to authorise the court to take into account efforts made by the person seeking relief to inform himself or herself about the legal responsibilities of his or her office and about the company's business operations.**

[119] The Law Council of Australia suggested that the presence or absence of insurance might be taken into account by the court as a factor in its decision whether to excuse the director or officer. However, the Committee believes that it would be useful to enlist

the insurers in efforts to encourage directors and officers to acquaint themselves with their legal responsibilities. Given the Committee's earlier recommendation linking that objective with the administration of section 535, the Committee is of the view that the presence or absence of insurance should not be expressed to be a factor relevant to the discretion under section 535.

INSURANCE

[120] Protection by insurance after breach of duty. In considering the matter of insurance there is a preliminary question as to the proceedings properly within the scope of a provision like section 237.

[121] Should section 237 be limited to proceedings brought by or on behalf of the company? The Greene Committee's consideration of the mischief needing attention suggests that the Committee was concerned with protection of only the company against loss. Section 237 is concerned with exculpation from liability for negligence etc. of which the relevant person "may be guilty in relation to the company" That language does not clearly confine the section to cases of loss by the company.

In paragraph [60] of Discussion Paper No. 9 this Committee discussed whether section 237, properly interpreted, extended to affect legal proceedings brought otherwise than by the company (or a liquidator) directly or derivative proceedings brought by a member. It was suggested that section 237 was limited to proceedings brought by or on behalf of the company. It is desirable that clarifying legislation should confirm that that is intended.

[122] The Committee recommends that section 237(1) be amended to make it clear that it is limited to proceedings brought by or on behalf of the company.

[123] Contracts of insurance entered by the company. The doubt as to the range of possible claimants whose proceedings could be facilitated by section 237 causes difficulty in the context of insurance. Would section 237 invalidate a provision in a contract of insurance between the company and an insurer that had the effect of saving a director, officer or employee from having to meet a personal liability to a third person caused while acting in the course of the employment? At present section 237(3) declares that sub-section (1) does not apply in relation to a contract of insurance but it is not clear whether that is limited to a contract of insurance taken out by an "officer or auditor".

[124] Section 237 on one interpretation could invalidate a contract of insurance between the company and an insurer providing cover for directors, officers and employees in respect of road collisions while driving a company vehicle on company business. Similarly a contract of insurance covering directors, officers and employees against liability for other torts, such as libel or slander, could be invalidated.

[125] The Committee recommends that section 237 should not have the effect of invalidating any contract of insurance taken out by the company in good faith with an outside insurer.

[126] Existing insurance coverage. In Discussion Paper No. 9 (at paras. [150] to [169]) the Committee summarised aspects of the current market in Australia for Directors' and Officers' ("D&O") Insurance; that summary included the results of a questionnaire

which had been circulated to a number of Australian companies in late 1988. For present purposes, the most important features of current local D&O cover are as follows:

(i) The norm is a "corporate insurance policy" made up of:

(a) a directors' and officers' liability component covering loss arising from acts or omissions of directors or officers for which a company cannot provide indemnity, the premium for which is payable by the directors or officers; and

(b) a company reimbursement component covering reimbursement for indemnity that a company can lawfully grant to its directors and officers, the premium in respect of which is payable by the company.

Having regard to section 237, coverage under the company reimbursement component is necessarily limited to costs incurred by a director or officer in successfully defending civil or criminal proceedings or the costs of a successful application under section 535.

(ii) One premium is payable on the corporate insurance policy, a far greater proportion of which is attributable to the company reimbursement component; it is common for this component to attract 90% of the premium.

(iii) Policies generally exclude liability in certain situations, including:

(a) where loss is based on or attributable to the gaining by any director or officer of any personal profit or advantage or receipt of remuneration to which there is no legal entitlement;

(b) where loss has been brought about or contributed to by any "dishonest, fraudulent, criminal or malicious, willful or reckless" act or omission on the part of a director or officer;

(c) where there has been an attempt by any person to acquire shares in the company against the opposition of the board of directors or where the board has acted to resist such an attempt; and

(d) where proceedings against a director or officer are taken by the company or any other director or officer other than derivative actions by shareholders in the name of the company or actions by employees in certain circumstances including complaints of unfair dismissal (the "insured versus insured" exception).

[127] How do D&O policies work in practice? The Committee has found it difficult to obtain information concerning the practical application of D&O policies to particular types of claims against companies or directors and officers.

This is perhaps understandable in view of the confidentiality which is generally maintained in the insurance industry.

What follows are illustrations of the ways in which the different components of corporate insurance policies should respond to various types of claims, both under the current law and under that which will apply if the recommendations contained in this report are adopted. (For the situation with respect to advance authority

for breach of duty or release from liability from the company in these sorts of cases in the absence of D&O insurance, refer to paras. [58] and [106] of this report).

* Example 1: Successful action by third party against the company for loss caused by the negligence etc of a director or officer.

Current situation. The company would be able to claim from the director or officer the amount of any payment for which the company would be vicariously liable, including costs properly incurred.

Section 237 of the Companies Act could be interpreted to prevent the company from exempting the director or officer or later reimbursing the director or officer for any payment to the company made by the director or officer and seeking to claim on the corporate reimbursement component of the D&O policy.

Situation if CSLRC recommendations adopted. In para. [131] the Committee recommends that a company should have power to obtain insurance in respect of harm caused to third persons by directors or officers where the directors or officers have not intended to deceive or defraud. If this were the case liability for the payment by the company would come under the D&O insurance cover, provided that insurers are prepared to write policies on that basis; it is likely that the terms of policies would require the company to assume liability for an amount by way of excess (see paras. [151] and [152] below). The Committee believes that the insurer should not have a right of subrogation against the director or officer concerned.

* Example 2: Successful action by a company against its directors or officers for loss suffered directly by the company.

Current situation. The liability of the directors or officers would not be covered by the directors' and officers' component of the D&O policy due to the standard "insured versus insured" exception; the only circumstance in which the policy would respond would be a derivative action on behalf of the company so long as that action was not actively encouraged by any other insured party.

Situation if CSLRC recommendations adopted. It is not possible to predict with any certainty the effect that adoption of the recommendations will have on the types of exceptions or exclusions which insurers will require to be written into D&O policies. If the "insured versus insured" exception is retained the result will be the same as under current practice; a claim could not be made by the directors or officers under the directors' and officers' liability component of the policy. The directors or officers would be personally liable to satisfy the judgment in favour of the company.

In the absence of an "insured versus insured" exception the directors' and officers' liability component would cover the

liability in question, other than any amount by way of excess for which the company will be permitted to assume responsibility (see paras. [151] and [152] below).

* Example 3: Successful action by a third party against a director or officer.

This type of action could include civil proceedings for damages or compensation under various legislative provisions, such as those discussed at paras. [143] to [147] of this report, in which ordinarily it would be expected that the company would not be joined as a party.

Current situation. Ordinarily a company would be able, at least by resolution in general meeting, to indemnify a director or officer for the amount of any judgment obtained against him or her by a third party under those legislative provisions. Whether that payment could be overturned upon application by a member of the company under provisions such as Companies Act section 320, on the basis that the payment was not in the interests of the members as a whole, would probably depend on whether the actions of the director or officer giving rise to the liability could be characterized as involving moral turpitude.

In the absence of any decision of the Court overturning such a resolution, a company might claim the amount reimbursed to the director or officer under its D&O policy; such a claim would presumably be resisted if the if insurer considered that the actions of the director or officer justified the invoking of the standard exception relating to loss caused by any dishonest, fraudulent, criminal, malicious, willful or reckless act or omission.

In the absence of any resolution by the company to indemnify, the success of any claim by a director or officer under the directors' and officers' liability component of a D&O policy would depend on whether the insurer was able to rely on the same type of exception.

Situation if CSLRC recommendations adopted. As far as the ability of the company to provide indemnity (other than through maintenance of insurance) in these circumstances is concerned, the Committee's recommendation is the same as that applying to the reimbursement of fines imposed on a director or officer, namely that the legislation should not contain positive authority for the company to make reimbursement; see below paras. [163] to [168]. The outcome of any action under, for example, Companies Act section 320 will still turn on the factors discussed above.

In relation to insurance, the Committee's view is that certain liabilities of directors or officers, for example under Companies Act section 565, should be specifically excepted from the enlargement of a company's ability to take out and maintain insurance for its directors or officers while others, for example liability arising under Companies Act section 218(3), should be able to be insured against by the company; this is discussed in greater detail in paras. [143] to [147].

[128] At one time the argument might have been put that to enable individuals to be covered by insurance to save themselves from being mulcted damages for their own negligence or other wrongdoing would be undesirable because it would remove some of the incentive to take care not to commit the kind of wrong in question. The general

spread of liability insurance represents a social rejection of that argument. There is no reason in public policy why any director, officer or employee should not have the benefit of insurance against wrongdoing short of that in which an intent to deceive or defraud is involved. The common law takes care of deceit or fraud : it is unlawful to attempt to provide insurance cover for the person who intends to deceive or defraud.

[129] Insurance in respect of the company's vicarious liability. The taking out of insurance by an employer to cover its own vicarious liability for loss caused by the wrongs of its work force is a well established practice. For a time it was possible that if an employer were made vicariously liable to a third person for harm caused by the wrong of an

employee and the employee caused that harm through negligence, the employer could sue the employee by way of indemnity for the employee's breach of his or her contractual promise to perform duties with reasonable care and skill : **Lister v Romford Ice and Cold Storage Co Ltd.** [1957] AC 555.

The possibility of the employer suing an employee for indemnification has been removed by statute in New South Wales by the Employee's Liability (Indemnification of Employer) Act 1982 (NSW) section 2(3) : see para. [12] above.

That New South Wales Act suggests the existence of a principle that for non-fraudulent harm caused in the course of carrying on an enterprise, the burden should in the first instance fall on the enterprise rather than the particular person whose fault caused the harm. The existence of a system of insurance provides a means whereby the enterprise can spread the loss over all the persons who pay premiums to insure against the particular risk.

[130] If it is appropriate for a company to be able to take out insurance with respect to harms that may be caused to third persons by the activities of its officers and other employees on terms that relieve them from personal liability, there does not seem to be any reason by a company should not be able to take out similar cover giving similar relief in respect of harm caused to third persons by non-fraudulent activity of directors in the course of their activities as directors.

[131] **The Committee recommends that a company in exercising its power to obtain insurance in respect of harm caused to third persons by directors in the course of their activities as directors should be at liberty to obtain that insurance on terms which free directors from the possibility of being made liable on subrogated claims where the relevant conduct of the directors has not involved intent to deceive or defraud.**

[132] Insurance other than for vicarious liability. In determining the extent to which companies should be permitted to relieve directors or officers from liability by meeting the cost of insurance, there would not appear to be any justification for drawing a distinction between the acts or omissions of directors and officers which lead to the imposition of vicarious liability on a company for loss suffered by a third party and any such acts or omissions which give rise to a direct liability to a company on the part of directors and officers for loss suffered by the company.

[133] The Committee considers that in the absence of such factors as fraud on the part of directors or officers, which in any event

would not be able to be insured against, the central question is how far a company should be able, through taking out insurance, to relieve the directors or officers from liability to make good loss suffered by the company.

[134] **The Committee recommends that a company should also be able to take out and maintain insurance to relieve its directors, officers and employees from liability for loss or damage suffered directly by the company (as distinct from loss which results from the imposition on the company of vicarious liability to a third party) in such a way that the terms of the insurance free directors, officers and employees from the possibility of being made liable on subrogated claims. Hence**

directors, officers and employees would not be liable to subrogated claims whether the insurance was in respect of the company's vicarious liability (see para. [131]) or in respect of loss suffered directly by the company. In taking that view the Committee needs to recommend, and does recommend, that the restriction on payment of premiums by the company now in section 237(3) should not be maintained.

In so recommending, the Committee is influenced by several reasons:

(i) It is desirable that when a loss is caused to a company there should be some insurance proceeds available for the benefit of creditors and members. Allowing the company to insure will reduce the cases in which there is no insurance, individual directors' and officers' insurance having become difficult to obtain in recent years.[36]

(ii) The cost of directors' and officers' insurance is high and a company will usually be in a better position than an individual director or officer to obtain cover on the most economical terms because it will normally have larger insurance needs than an individual.

(iii) Giving companies authority to insure in the way suggested may reduce the reluctance of competent persons to become directors of public companies, a reluctance of which there is anecdotal evidence.[37] A public company would be unlikely to decide not to insure since that would adversely affect its capacity to attract suitable appointees. The problem of reluctance to serve is particularly acute in relation to non-executive directors. There is an influential school of thought that listed public companies should have an adequate number of non-executive directors to provide a check on management. It is desirable that obstacles to recruitment of good non-executive directors should be removed.

(iv) The existing restraint in section 237(3) has not proved effective in ensuring that the company not bear the cost of insurance - there is evidence that companies which have wished to save directors and officers from the cost of taking out insurance have borne the cost indirectly by increasing the remuneration of directors and officers. It seems to the Committee that it would be better to allow companies to take out the insurance directly.

Even though, logically, the policy that requires a company not to indemnify its directors and officers may dictate that a company should not use company resources to obtain insurance to achieve the same result, we consider that the reasons set out above justify allowing expenditure on insurance.

36. As stated in the response of The Institute of Directors in Australia.

37. As stated in the response of The Company Directors' Association of Australia.

[135] Legislation in other countries enlarging the company's power to insure. The Committee notes that in the United Kingdom the Companies Act 1989 section 137 amends section 310 of the Companies Act 1985 (the provision comparable to section 237 of the Companies Act 1981 (Cwlth)) by adding to section 310 a provision:

"(3) This section does not prevent a company:

(a) from purchasing and maintaining for any such officer or auditor insurance against such liability, or

(b) ...."

[136] The kind of provision for authorising companies to purchase and maintain insurance that the Committee envisages is exemplified by section 124(4) of the Canada Business Corporations Act.

Section 124 of the Canada Business Corporations Act regulates indemnification by a company of directors and officers.

[137] Section 124(4) provides:

"A corporation may purchase and maintain insurance for the benefit of any person referred to in sub-section (1) against any liability incurred by him

(a) in his capacity as a director or officer of the corporation, except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the corporation; or

(b) in his capacity as a director or officer of another body corporate where he acts or acted in that capacity at the corporation's request, except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the body corporate."

The persons referred to in sub-section (1) are:

* a director or officer;

* a former director or officer;

* a person who acts or acted at the corporation's request as a director or officer of a body corporate of which the corporation is or was a shareholder or creditor;

* any such person's heirs and legal representatives.

[138] New Zealand has in its Companies Act 1955 a provision in section 204 comparable with section 237 of the Companies Act 1981 (Cwlth). In June 1989 the New Zealand Law Commission recommended the substitution of a new provision as part of a completely re-drafted Companies Act. The proposed provision, section 125 of the Draft Companies Act, is as follows:

"125 Indemnity and insurance

(1) Except as provided in this section, no company may indemnify, or provide insurance for, any director or employee of the company in respect of any liability or costs incurred by him or her in any proceedings, and any indemnity given or insurance provided in breach of the section is void.

(2) A company may, if expressly authorised to do so by its constitution, indemnify or provide insurance for a director or employee of the company in respect of any costs incurred by him or her in any proceedings:

(a) brought by the company against the director or employee in that capacity; and

(b) in which judgment is given in his or her favour, or he or she is acquitted, or relief is granted to him or her under section 137.[38]

(3) A company may indemnify or provide insurance for a director or employee of the company in respect of any liability or costs incurred by him or her in any proceedings:

(a) brought by any person other than the company against the director or employee in that capacity; and

(b) which do not result from a failure by the director or employee to act in good faith in a manner that he or she believes on reasonable grounds to be in the best interests of the company."

The suggested New Zealand provisions, unlike those in the United Kingdom and in the Canada Business Corporations Act, do not allow the company to take out insurance to cover a director's liability to the company.

For reasons stated earlier the Committee believes that a company should be able to establish and maintain insurance in respect of the liability of a director or officer to the company.

[139] **The Committee recommends the enactment of a provision like section 124(4) of the Canada Business Corporations Act - see para. [137].**

[140] The insurance which the company should be empowered to arrange and pay for should be limited to claims against the company or the director or officer arising out of acts or omissions in the course of the activity of the particular director or officer on behalf of the company. There can be occasions on which a person who is a director of a company is liable to pay compensation for

some particular act and one of the elements of liability is that the person liable is director of a particular company. An example is

38. Section 137 in the Draft Companies Act is in substance the same as section 535 of the Companies Act 1981 (Cwlth).

in the Securities Industry Act 1980 (Cwlth) under which a person who is a director of a company could be liable to compensate a purchaser of shares in a transaction which constitutes a contravention of the insider-dealing prohibition in section 128. In such a case the director would be acting for himself or herself rather than the company and the liability could not properly be insurable by the company.

[141] The general law of insurance limits the risks in respect of which it is permissible to recover. Recovery on a contract of insurance will be denied on grounds of public policy where the claim arises out of some, but not all, instances of commission of a crime by the person insured.[39]

[142] It could be as well that the suggested provision based on section 124(4) of the Canada Business Corporations Act should make it clear that the condition that there should be no "failure to act honestly and in good faith with a view to the best interests of the corporation" looks to the subjective belief of the person concerned. Directors may have been objectively unreasonable in believing that they were acting in good faith with a view to the best interests of the corporation but that should not exclude an honest director from the benefit of insurance provided by the company if insurers are prepared to write policies wide enough. Presumably, insurers would cover cases where the director has committed a wrong in the nature of a breach of trust but not with the intention to deceive or defraud. That distinction is found in the wording of policies currently in use.

[143] There are some instances of personal liability under the Companies Act which require special consideration.

[144] Under section 218(3) an officer or person acting on behalf of a company can be liable on certain negotiable instruments and letters of credit. It is problematical whether insurance against that liability is obtainable in the market, but in case it is, the legislation allowing the company to insure should extend to it. Similar considerations apply in respect of section 229A dealing with the liability of directors of trustee-companies where the company lacks a right of indemnity against trust assets.

[145] Under section 556(1) directors who honestly believe that they are acting in the best interests of the company can still be liable to pay a debt of the company. Although section 556(4) shows a legislative intention that the liability imposed on the director or officer should not be shifted to the company, there is a question whether the liability should be capable of being shifted to an insurer who may be willing to insure against the liability where the company pays the premium. It is the Committee's view that in

case it is commercially feasible for a company to obtain insurance covering its directors and officers against the risk of civil liability under section 556(1), the legislation should not allow the company to obtain that insurance at the company's expense.

39. ***Fire and All Risks Insurance Co Ltd. v Powell*** *[1966] VR 513.*

[146] Whether the liability of a director or executive officer under section 565 in respect of an improper dividend raises the same problem depends on the proper interpretation of the condition of liability that the director or executive officer "wilfully pays or permits to be paid" an improper dividend. "Wilfully" can mean no more than deliberately or intentionally or it can imply something more and carry the notion that what is done is done with consciousness of the evil that will result.[4°] If the second meaning is appropriate to section 565, it is probable that the liability cannot be lawfully insured against. The Committee is of the view that in any event it should not be possible for the company to insure against the liability.

[147] It is desirable that the amending legislation should make specific reference to each of these special cases.

[148] Company's power to agree to excess clauses in insurance policies. The assumption by directors and officers and companies of liability to meet an amount by way of excess would appear to be a standard feature of the Australian D&O insurance market. It is common for a small amount of excess (in the range $500 - $1500 per claim) to be applied to the directors' and officers' liability component and a much larger amount (anything from $1000 to $250,000 per claim) to be required in the case of the company reimbursement component.

[149] The company reimbursement component excess is designed to meet costs incurred in the investigation of claims and the obtaining of legal and other specialist advice etc. The amount of this excess is determined by a number of factors including the asset size and nature of operations of the company involved, with the largest amounts apparently being written for the policies of entrepreneurial companies and those with a short history of operations. There is not necessarily any correlation between the quantum of the cover afforded by a policy and the magnitude of the excess.

[150] The amounts applicable to directors' and officers' liability components are kept low to ensure marketability and are said to reflect the experience of insurers with payments under the respective D&O policy components.

[151] It is impossible to foretell what insurance terms as to excess may be developed after implementation of the Committee's recommendations for enlargement of the power of a company to obtain and maintain insurance. The Committee believes that a company which wishes to relieve its directors or officers of the burden of liability, whether a direct liability to the company or that which arises from imposition of vicarious liability on the company as

a result of the actions of directors or officers, should do so by obtaining insurance. But the company should be free to agree to reasonable provisions about excess so that some of the burden stays with the company. In negotiating the terms of insurance on behalf of the company, directors

40. ***Richards v Golden Fleece Petroleum Pty Ltd.*** *(1983) 49 ALR 337 at 345 citing Andrews 'Willfulness, a lesson in ambiguity' in Legal Studies, the Journal of The Society of Public Teachers of Law, Vol. 1, No 3 at p. 303.*

will be subject to their fiduciary duty to act in the interests of the company. Any implementing legislation should require that the insurance to be obtained by the board should be on reasonable terms. To meet the possibility that experience in the insurance market may show that some specific limit should be placed on the excess provisions to which a company may agree, there should be power in the Executive to make regulations prescribing such limits. Since all members of the board will have a personal interest in the negotiations for insurance the legislation should specifically authorise the board .to obtain and maintain insurance on behalf of the company.

[152] **The Committee recommends that legislation empowering a company establish and maintain insurance in respect of the liability of a director or officer should require that the insurance should be on reasonable terms and should not involve the company itself carrying to any substantial extent the burden of liability of directors and officers for loss caused to the company by any of those directors or officers. The legislation should provide that regulations may be made prescribing limits within which a policy of insurance in respect of the liability to the company of a director or officer may provide that the risk shall be carried by the company.**

The legislation should further provide that, notwithstanding any other rule of law, the board shall have the power to obtain and maintain the insurance referred to above and that in doing so the board must act in the best interests of the company. There should also be a prohibition on the company obtaining or maintaining the insurance from a company related to or associated with it unless there is re-insurance from an independent re-insurer.

[153] Compulsory insurance. The Committee raised in Discussion Paper No. 9 the question whether there should be instituted some kind of compulsory directors' and officers' liability insurance fund.

Many respondents opposed compulsory insurance. The Australian Bankers' Association pointed out that there would be an increase in costs for companies which have global groups and which are able to purchase insurance on a global basis. The Law Council of Australia referred to the wide diversity of companies in terms of size, business practice and nature of business.

The Committee has not made a full investigation of the implications of compulsory insurance because it believes that at this stage it will be a sufficient step forward to legislate to allow companies to maintain insurance for indemnification of directors, officers and employees and then to see how the insurance market reacts.

[154] Non-commercial Companies. In Discussion Paper No. 9 the Committee posed the question whether the legislation about indemnification should distinguish between non-commercial companies and others. Some respondents thought that there might be a case for subjecting directors of companies formed for purely social purposes to more lenient principles.

A distinction should not be drawn between companies limited by guarantee and other companies. Nor should any distinction turn on whether a company is prohibited from making distributions of profit among its members. Some companies which are inhibited in that way may incur large liabilities and the interests of creditors require that, in principle, the directors should be in no different position from that of directors of ordinary companies. However, it would be unrealistic to ignore the fact that directors of non-commercial companies are elected from the general membership who may not exhibit a great deal of business expertise.

The submission of The Registered Clubs Association of New South Wales suggested that so far as registered Clubs are concerned, directors should be subject to legislation similar to that in the Canada Business Corporations Act under which a corporation has the right to take out insurance indemnifying directors and officers.

The Committee has recommended in para. [131] that companies generally should be given the power to take out that insurance. Legislation implementing that recommendation should apply to all companies whether commercial or non-commercial.

[155] **The Committee recommends that if for any reason the legislature does not see fit to give the power to take out insurance to all companies, the power should at least be given to companies which cannot distribute profits to members.**

[156] Successful defence indemnity : should there be a right to it? Under section 237(2) the prohibition in section 237(1) is lifted to the extent of allowing a company to indemnify an officer (in the extended sense in section 237(4)) against any liability incurred by him or her

(i) in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted,[41] or

(ii) in connection with any application in relation to any such proceedings in which relief is under the Companies Act granted to him or her by the Court.

The latter is a reference to an application for relief under section 535 : see para. [109].

[157] The indemnity can be given pursuant to the articles or otherwise. If the articles provide for the indemnity, the decision to give it can be made by the board and that would mean, in the case of a director seeking indemnity, the decision would have to be made by disinterested directors. If all the board were seeking

indemnity, the decision would have to be made by the company in general meeting. If the articles do not provide for this indemnity and the person seeking indemnity is a director, the indemnity

41. ***Bendix Consolidated Industries Ltd. v FCT*** *(1982) 82 ATC 4582 indicates that all "types" of criminal conduct may be covered by a permissible indemnification provision covering costs where acquittal is the result.*

could only be given under the authority of a resolution of the company in general meeting.

[158] Since section 237(2) operates by withholding the prohibition in section 237(1) there is an implication that section 237(2) gives authority only in relation to proceedings in respect of any liability that by law would attach to the officer or auditor in respect of any negligence etc of which he or she "may be guilty in relation to the company"

Most companies have an article giving the necessary authority. Table A regulation 98 is such a provision. It benefits officers, auditors and agents of the company.

[159] In some overseas jurisdictions a director or officer who succeeds in defending civil proceedings or who is acquitted in criminal proceedings is given a right as against the company to be indemnified in relation to his or her defence costs and does not have to depend on the company (whether by the board or the general meeting) deciding to provide the indemnity. See, for example, Canada Business Corporations Act section 124(3) which is as follows:

"Sec. 124(3) Indemnity as of right

Notwithstanding anything in this section, a person referred to in sub-section (1)[42] is entitled to indemnity from the corporation in respect of all costs, charges and expenses reasonably incurred by him in connection with the defence of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of the corporation or body corporate, if the person seeking indemnity

(a) was substantially successful on the merits in his defence of the action or proceeding, and

(b) fulfils the conditions set out in paragraphs (1)(a) and (b)."

The conditions set out in paragraphs (1)(a) and (b) are that the person seeking indemnity:

(a) acted honestly and in good faith with a view to the best interests of the corporation; and

(b) in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, had reasonable grounds for believing that his conduct was lawful.

[160] The elevation of the right from a right to be considered to an absolute right rests on the view that the indemnity of an innocent director or officer should not be at the whim of a new board or new controllers of the company. There is an analogy in the law of trusts where trustees who successfully defend proceedings brought against them by beneficiaries are

42. See above para. [137].

entitled to their costs out of the estate.[43]

If the company went into liquidation before the director is paid, the director should not have any priority and should be treated as any other unsecured creditor.

[161] **The Committee recommends that directors, officers and employees of a company be given a statutory right to indemnity for the costs, of a successful defence in terms similar to section 124(3) of the Canada Business Corporations Act. The duty to indemnify should extend to the case where a director, officer or employee has incurred costs of being represented in criminal or civil proceedings to which he or she is made a party by reason of being or having been a director, officer or employee of the company.**

The duty to indemnify should also extend to the costs of any administrative proceeding out of which the criminal or civil proceedings arose where the Court concerned with the criminal or civil proceedings is of the opinion that it is just that that duty be imposed.

[162] In any revision of the legislation it should be made clear that the legislative authority for the company to provide indemnity for defence costs is accompanied by authority for the company to obtain and maintain insurance.

[163] Should companies legislation provide that a company can pay a fine imposed upon a director or officer? Section 237 of the Companies Act 1981 (Cwlth) does not in terms forbid a company from paying a penalty. The tribunal which imposes a fine is not concerned with who pays the fine and has no means of ensuring that the fine be paid by the person convicted. Where an offence carries an alternative punishment of a term of imprisonment or a fine, the choice by the tribunal between them could possibly be influenced by the consideration that there is nothing to stop a person fined from having the benefit of a payment of the fine by another person. Conceivably, where the services of a director, officer or employee are so valuable to a company that if there were some danger of losing them, it would be in the interests of the company that the company should pay the fine. The test of propriety of a company paying a fine would be the same as that applicable where the company wanted to make a payment to the director, officer or employee. Benefits to directors depend upon shareholder approval unless the articles can properly provide for the benefit. At this point section 237 becomes relevant and prevents inclusion in the articles of any authority to the board or otherwise to make a payment from company funds in circumstances where payment of the fine was linked with the payment from the company. If authority cannot be given in the articles, any payment to discharge a fine imposed on a director

would need the authority of a resolution of the company in general meeting. At that point one of the uncertainties about section 237 becomes relevant. Does the expression "or otherwise" extend to a resolution?

43. **Nissen v Grunden** (1912) 14 CLR 297; **National Trustees Executors and Agency Co of Australasia Ltd. v Barnes** (1941) 64 CLR 268.

[164] The recommendation made earlier by the Committee[44] for maintaining the principle of section 237 which prevents a company from providing by general provision in advance of default an indemnity against liability should extend to indemnification in general terms against payment of fines whether by provision in the articles, a contract, a resolution or otherwise.

[165] As to the matter of a resolution approving payment of a particular fine, the committee believes that the question whether a fine imposed on a director should be paid by the company should not be dealt with by specific provision. It should be left to the general law about conferment of benefits by the company on directors, executive officers and employees. Any legislation positively authorising one person to pay another person's fine could be seen to be subversive of legal order. It is one thing for the law to be unable to ensure that persons fined will discharge their own fines, it is quite another thing for the law positively to approve that surrogation.

[166] In case this approach may seem unduly restrictive in some situations where a penalty is imposed, for instance where an offence of strict liability is involved, it is to be remembered that the courts are able to deal with many proven offences without proceeding to a conviction with consequent imposition of a fine; discharge upon the entering into of a recognizance to be of good behaviour for a specified period is an example.[45] Thus the imposition of a fine after conviction would in many cases tend to indicate that the court considered the contravention to be of some seriousness. It would seem inappropriate for companies legislation to authorise the application of a company's resources in reimbursement of a fine.

[167] The Committee believes that the same considerations apply in the case of reimbursement by companies of the amount of any damages or compensation ordered to be paid by a director or officer as a result of civil proceedings. Such proceedings could include actions under various statutory provisions such as sections of the Companies Act in which ordinarily it would be expected the company would not be joined as a party. In paras. [143] to [147] of this report the Committee recommends that companies should not be free to insure their directors or officers for liability arising under some of those provisions; that view has been influenced by the nature of the actions or omissions on the part of a director or officer that must be established before liability is made out.

The Committee believes that in the case of both fines and civil damages or compensation any decision of a company by way of resolution in general meeting, informed as required by para. [106], should be based on the particular facts of each case; there should

be no positive statement of authority in the legislation which might erode the ability of any member to complain, for example by way of an application under Companies Act section 320, that any decision to reimburse is not in the best interests of the members of the company as a whole; see also para. [127].

44. See para. [43].

45. See generally, Bishop J, Criminal Procedure (1983) Butterworths.

[168] **Accordingly, the committee recommends that any revision of section 237 should stop short of providing authority for payment by the company of fines imposed upon, or the amount of civil damages or compensation ordered against, directors and officers.**

[169] Appreciation by directors and officers of their legal responsibilities. In Discussion Paper No. 9 the Committee raised the question whether there should be a legal requirement that before being eligible for appointment as a director a person shall either:

(i) have participated to a significant level in a course of study designed to inform about basic responsibilities involved in directing a company; or

(ii) be a member of a professional body which sets standards for the directing of companies?

Any such requirements were opposed by most respondents. The point was made by the Law Council of Australia that a course of instruction on legal and accounting matters would assist directors only on the periphery of their business concerns. There would be problems in determining criteria for accrediting new professional bodies. There would be difficulties in imposing the requirements on foreign directors.

The Institute of Directors in Australia thought that it would be inappropriate to require professional bodies to be obliged to accept all company directors as members. The Company Directors' Association of Australia thought that a better approach would be education by encouragement rather than coercion.

[170] The Committee acknowledges the point made by several respondents that there have been outstanding directors who have not undergone courses of instruction and that formal education is no guarantee of honesty or directorial skill. The Committee does not recommend the imposition of any requirement for attendance at courses of instruction designed to improve business skills. For one thing, there is so great a variety of companies and businesses that any such requirement would be unlikely to produce worthwhile results. Effective boards are more likely to result from a body of directors working as a team but with each member having the degree of integrity, independence, personality, judgment, capability and experience to equip that person for the role of being an able director for the particular company. The desired personal attributes of directors will vary with the size and nature of the company's enterprise and what is necessary to complement the skills and experience of other members of that company's board. Any course of instruction on the substance of directing companies could only

canvass the varying theories as to proper forms of management. The Committee thinks it would be in appropriate to legislate to require formal study of management as a condition of becoming a director.

[171] The Committee notes that the Senate Standing Committee on Legal and Constitutional Affairs has recommended[46] that The Company Directors' Association of Australia and The Institute of Directors in Australia should encourage directors to participate in the courses and programmes that are available. CSLRC agrees with the Senate Committee's approach.

Nor does the Committee recommend any legislative requirement of membership of any association as a qualification for being a director.

[172] While the Committee accepts that it would not be practicable or worthwhile to require attendance at courses about business skills or membership of associations, the Committee believes that there is still a problem in that the general level of appreciation by directors and executive officers of their fiduciary responsibilities needs to be raised. The problem is particularly acute in relation to the duty of good faith.

It is possible for a person of business to be very skilful in managing a business operation without having any adequate appreciation of what is involved in the duty of good faith.

[173] In particular, the duty to avoid situations in which the director has a conflict of interest is not fully understood. There is sometimes a belief that all that is necessary is that no unfair dealing should be involved. The true position is that a director who receives rewards (not authorised by the company in general meeting or, where the articles allow, by other board members who are disinterested) while in a position of conflict of interest is liable to give up those rewards to the company, however fair to the company the transaction giving rise to the reward may otherwise be thought to be. The mischief is that by being in an unauthorised conflict of interest, directors improperly disable themselves from disinterested performance of the functions of stewardship they have undertaken to perform.

The Committee notes that the Senate Standing Committee on Legal and Constitutional Affairs has recommended that company directors' associations take steps to develop and promote a code of ethics for company directors[47]. CSLRC concurs in this recommendation.

[174] It appears to the Committee that it is possible for companies legislation to play a part in encouraging directors and executive officers to inform themselves as to their legal responsibilities. To that end the Committee has earlier (see para. [118]) recommended that section 535 be amended to authorise the court to consider whether the person seeking to be excused under that section has made efforts to inform himself or herself as to the legal

responsibilities applicable to his or her office and as to the company's operations. That recommendation depends in turn on another

46. Report on the Social and Fiduciary Duties and Obligations of Company Directors (November 1989) para. 9.20.

47. Ibid. para. 10.11

recommendation (see para [103]) that the remedy against a person in breach be extended by adding the possibility of an award in the nature of punitive damages.

H A J FORD (Chairman)
G W CHARLTON
D A CRAWFORD
A B GREENWOOD
D R MAGAREY

21 May 1990

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APPENDIX

LIST OF RESPONDENTS

The Institute of Chartered Secretaries and Administrators

CRA Limited

Insurance and Superannuation Commission (Cwlth)

Australian Bankers' Association

Mr. H E Peterson

Trustee Companies Association of Australia

Mr. C B Penman

Marsh & McLennan Pty Ltd.

Mr. A P Kelly

Law Council of Australia (Companies Committee, Business Law Section)

The Institute of Directors in Australia

Australian Society of Accountants/The Institute of Chartered Accountants in Australia (joint response)

The Company Directors' Association of Australia

The Law Society of Western Australia (Corporate Lawyers Committee)

Octavian Underwriting Limited (UK)

The Broken Hill Proprietary Company Limited

The Law Society of South Australia (Commercial Law Committee)

The Registered Clubs Association of New South Wales

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REFERENCE : **CSLDIR**