AUSTRALIAN SENATE

COMPANY DIRECTORS' DUTIES

Report on the Social and Fiduciary Duties and Obligations of Company Directors

By the Senate Standing Committee on Legal and Constitutional Affairs

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

COMPANY DIRECTORS' DUTIES

Report by

Senate Standing Committee
on
Legal and Constitutional Affairs

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TERMS OF REFERENCE

The social and fiduciary duties and responsibilities of company directors.

(Journals of the Senate, No 79, 26 May 1988, pp 763-4)

RECOMMENDATIONS

1 An objective duty of care for directors be provided in the companies legislation. (para 3.28)

2 A 'business judgment rule' be introduced into Australian company law. It should include an obligation on directors to inform themselves of matters relevant to the administration of the company. They should be required to exercise an active discretion in the relevant matter or, alternatively, to show a reasonable degree of care in the circumstances. (para 3.35)

3 Directors be required to attend board meetings unless there is a reasonable excuse for non-attendance. (para 3.39)

4 The companies legislation be amended to provide for, and specifically limit, the extent to which company officers may rely on others. (para 3.53)

5 The companies legislation be amended to set out requirements which must be met for exoneration of directors from what would otherwise be breaches of their fiduciary duties. (para 4.65)

6 The companies legislation be amended to permit all creditors to share equally in sums recovered from directors. (para 5.47)

7 Criminal liability under companies legislation not apply in the absence of criminality. (para 5.57)

8 The companies legislation be amended to make it clear that the interests of a company's employees may be taken into account by directors in administering the company. (para 6.24)

9 Matters such as the interests of consumers, or environmental protection, be dealt with not in companies legislation but in legislation aimed specifically at those matters. (para 6.56)

10 The NCSC and the ASC proceed immediately to consult as necessary, in particular with shareholders' groups and others involved in the securities industry, in order to develop a proposal to eliminate the unfair practices relating to small shareholders in renounceable rights issues. (para 7.48)

11

(i) The establishment of an audit committee be made a requirement for public listing of a company;

(ii) the chairperson and a majority, or all, of the members of the audit committee be non-executive directors;

(iii) the audit committee be required to meet regularly and report to the board;

(iv) the audit committee have direct access to the company's auditors (internal and external) and senior managers, and the ability to consult independent experts where necessary; and

(v) as a high but lesser priority, similar requirements be introduced for larger non-listed companies. (para 8.15)

12 Audit committees have the following functions:

(i) reviewing financial information to ensure its accuracy and timeliness and the inclusion of all appropriate disclosures;

(ii) ensuring the existence and effective operation of accounting and financial controls;

(iii) overseeing the audit of the company, including nominating the auditors, approving the scope of the audit and examining the results;

(iv) providing a link between the auditors and the board; and

(v) any other functions allocated to it by the company, provided that the extra functions do not compromise its ability to perform the tasks set out in paragraphs (i)-(iv) above. (para 8.16)

13 Smaller unlisted companies be encouraged to set up audit committees, or, in the absence of an audit committee, have auditors present at board meetings which approve financial statements prior to their distribution to shareholders. (para 8.17)

14 The Company Directors' Association of Australia and the Institute of Directors in Australia:

(i) make an assessment of the courses and programs dealing with the duties and responsibilities of company directors;

(ii) following this assessment, compile an index which sets out information such as the courses available and the cost, duration and location of the courses;

(iii) update the index at regular intervals; and

(iv) distribute the index freely amongst company directors. (para 9.19)

15 The Company Directors' Association of Australia and the Institute of Directors in Australia encourage company directors to participate in the available courses and programs. (para 9.20)

16 The board of a public company state in the company's annual report the particular skills and expertise that each director brings to the company. (para 9.24)

17 A public company include in its annual report a statement of the particular skills and expertise that it considers desirable to be represented on its board. (para 9.24)

18 Company directors' professional associations, such as the Company Directors' Association of Australia and the Institute of Directors in Australia, take steps to develop and promote a code of ethics for company directors. (para 10.11)

19 The NCSC, the ASC and the Corporations and Securities Panel receive the funding necessary for them to be as active, effective and vigilant as possible. (10.39)

20 The law be amended to make a director personally liable for complicity where he or she intentionally or recklessly assists in or encourages an act which constitutes an offence by a company. (para 12.31)

21

(i) The appropriate mix of individual and corporate liability for corporate misconduct be referred to a body such as the Australian Law Reform Commission for detailed investigation and report;

(ii) the matter be investigated and researched in close consultation with all persons and community groups who are willing and able to contribute; and

(iii) the aim of such a review be to develop a theoretical basis to guide the future drafting of legislation and prosecution guidelines. (para 12.46)

22 Section 229(2) of the Companies Code, or its equivalent, be amended so that criminal liability under that section only applies where conduct is genuinely criminal in nature. (para 13.12)

23 Civil penalties be provided in the companies legislation for breaches by directors where no criminality is involved, and, in appropriate circumstances, people suffering loss as a result of a breach be enabled to bring a claim for damages in the proceedings taken to recover the penalty. (para 13.15)

24 A system of on-the-spot fines for minor offences, such as the Victorian PERIN system, be introduced into the administration of company law. (para 13.20)

ABBREVIATIONS

ASC	Australian Securities Commission
AULSA	Australian Universities Law Schools Association
Companies Code	The Companies Act 1981 as it applies in all jurisdictions
Evidence	Transcript of proceedings of the Committee's public hearings
NCSC	The National Companies and Securities Commission
The Committee	The Senate Standing Committee on Legal and Constitutional Affairs

CHAPTER 1

BACKGROUND TO INQUIRY

Terms of reference

1.1 On 26 May 1988, the Senate resolved to refer the following matter to the Standing Committee on Legal and Constitutional Affairs:

> the social and fiduciary duties and responsibilities of company directors.[1]

1.2 The Committee itself sought this reference from the Senate. It did so because it wanted to examine and consider views that had been expressed, for example, by the Hon Jim Kennan MLC, then Attorney-General for Victoria, that the modern company director should be required to take into account not just the shareholders and, at times, the creditors of the company, but also groups such as consumers and employees, and the environment, when making decisions about the operation of the company.[2]

1.3 The Committee deliberately sought broad terms of reference. This was to enable interested persons and groups to bring to the Committee's attention areas of particular concern.

Advertising the inquiry

1.4 Advertisements were placed in major national, State and Territory newspapers on 1 June 1988, seeking submissions from interested persons by 19 August 1988. In addition, the Committee

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1. *Journals of the Senate, No 79, 26 May 1988, pp 763-4.*
2. *see 'Comments on "Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural"', speech given by the Hon Jim Kennan MLC, at AULSA conference, Monash University, 25 August 1987.*

wrote to various individuals and organisations that it considered might be interested in its inquiry. The inquiry also received newspaper and television publicity.

1.5 The Committee received 33 written submissions. The list of people and organisations who made submissions to the Committee is set out in Appendix I to this report.

Focus of the inquiry

1.6 During the course of its inquiry, the Committee was in contact with both the Companies and Securities Law Review Committee and the Law Reform Commission in relation to work being done concerning company directors. The Committee decided not to examine in detail certain issues that were being looked at by other organisations. These areas included, in particular:

* indemnification of directors (see Companies and Securities Law Review Committee, Discussion Paper No 9, Company Directors and Officers: Indemnification, Relief and Insurance, April 1989);

* alternate and nominee directors (see Companies and Securities Law Review Committee, Report No 8, Nominee Directors and Alternate Directors, 2 March 1989);[3] and

* a director's role in insolvency (see Law Reform Commission, Report No 45, General Insolvency Inquiry, especially chapter 7[4]).

1.7 The Committee also held a private meeting with

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3. *Note also other work of the companies and Securities Law Review Committee, eg, Discussion Paper No 8, Director's Statutory Duty to Disclose Interest (Companies Act s.228) and Loans to Directors (Companies Act s.230), August 1988; A Company's Purchase of its Own Shares, September 1987; and Prescribed Interests, August 1988.*
4. *AGPS, Canberra, 1988; see also submission from Law Reform commission.*

Professor Robert Austin in Canberra on 9 November 1988 to discuss its terms of reference.

1.8 The Committee decided to focus on the following broad areas in its inquiry:

* qualifications of directors;

* multiplicity of directorships;

* role of directors and composition of the board, including board committees (especially audit committees;

* the nature of directors' existing duties and responsibilities and the standards required, to whom the duties and responsibilities are owed and whether they should be widened; and

* the enforcement of the law in so far as it concerns directors.

1.9 The Committee decided that, if particular matters of concern were to emerge from this general inquiry, it would consider seeking further, more specific, terms of reference from the Senate. One such matter that has already been referred to the Committee for investigation and report concerns the shield of the Crown.[5] In the course of that inquiry, the Committee will consider issues arising in relation to Commonwealth regulatory systems and government companies.

Public hearings

1.10 The Committee held public hearings in the following places on the dates indicated:

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5. *Journals of the Senate, No 149, 3 May 1989, p 1578.*

Sydney 15 February 1989
Canberra 10 March 1989
Melbourne 22 March 1989

Witnesses who appeared before the Committee at its public hearings are listed in Appendix II to this report.

New corporations legislation

1.11 During the course of the Committee's inquiry, proposed new corporations legislation was referred to a joint select committee of the Parliament for inquiry and report[6] and was subsequently passed by the Parliament.[7] The new legislation, subject to a pending High Court challenge, will be implemented over a period of time and will set up a national companies scheme. The Committee has considered it inappropriate to comment in detail on the new scheme at this stage.

1.12 Throughout this report, where references are made to specific sections of the Companies Code, reference is also made to the equivalent provision of the Corporations Act 1989. The Attorney-General's Department has told the Committee that the new Corporations Act does not purport to alter the law relating to directors' duties as currently found in the Companies Code.[8]

Structure of the report

1.13 In this report, the Committee deals first with the duties and responsibilities that company directors have under the law as it is. Chapter 3 considers the so-called traditional duties on directors of care, skill and diligence, and chapter 4

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6. *Journals of the Senate, No 100, 17 October 1988, pp 1018-21; House of Representatives, Votes and Proceedings, No 83, 19 October 1988, pp 781-3.*
7. *Journals of the Senate, No 155, 11 May 1989, pp 1641-59; House of Representatives, Votes and Proceedings, No 121, 23 May 1989, pp 1230-4, 1234-43.*
8. *Submission, covering letter.*

the fiduciary duties. These duties are owed to the company.

1.14 The report then deals with the duties directors owe, under company law, to entities outside the company. The case law has, in recent times, imposed a duty on directors to creditors, considered in chapter 5. The basis for this development is the closeness of the relationship between a company, at times of insolvency or near insolvency, and its creditors. Often at these times directors will have dealt with the assets of creditors rather than the assets of the company's owners. The courts have decided that, in those circumstances, directors owe duties to creditors.

1.15 In chapter 6, the Committee considers the interests of entities other than the company, the shareholders and creditors, and the extent to which directors are entitled to take account of extrinsic factors in their decision making. They are entitled to do so to the extent that those interests do not conflict with 'the interests of the company'. In most cases, the Committee has concluded that interests extrinsic to corporations should be promoted and protected, where necessary, in legislation dealing specifically with those extrinsic matters rather than in company law.

1.16 The inter-relationship of the board and the general meeting is discussed in chapter 7. Although the legislature has given shareholders various statutory rights, in reality the conduct of the company's affairs is almost exclusively in the hands of its management and its directors. Shareholders have little to do with the administration of companies which is almost wholly carried out by its management. Chapter 8 examines the role of audit committees. Chapter 9 looks at the qualifications company directors are expected to have and considers whether there should be mandatory qualifications of education, skill or expertise.

1.17 Finally the report deals with enforcement of the law relevant to companies. Chapter 10 considers ethics. The legislature need only provide sanctions when ethical standards are too low or when they are not met. Other enforcement issues dealt with are the remedies available to shareholders to enforce duties owed to them (chapter 11), the extent to which directors should be personally liable for acts of the company (chapter 12), and the kinds of sanctions available against directors who breach their duties (chapter 13).

CHAPTER 2

INTRODUCTION

The modern corporate sector

2.1 The corporate culture we know today is not the corporate culture of a century ago. The balance between ownership and the control of companies has shifted towards the controllers. Management has great power over vast assets which it pursues with vigour through takeovers, mergers and buy outs. Technology is a profound influence in the development of the corporate sector. It transforms old industries, engenders new ones and enables securities trading to be world wide and rapid.

2.2 The modern corporate sector has a profound effect on life in Australia. It has achieved a high public profile and, with it, a high level of public scrutiny. The corporate sector is crucial to the creation of the nation's wealth. Society looks to it to produce that wealth in accordance with community values. It wants ethical conduct, with due regard being given to the rights of shareholders, employees, creditors and consumers, and to the environment.

2.3 Directors are the mind and soul of the corporate sector. They are crucial to how it operates and to how its great power is exercised. They determine the character of corporate culture. Their actions can have a profound effect on the lives of a great number of people, be they shareholders, employees, creditors, or the public generally. They can weaken and even suppress market forces. They can disturb and destroy an environment.

2.4 Ideally, company directors' conduct should be informed by high ethical values. Ethics are morals tempered with

experience. Corporate history confirms that, without ethics, self regulation will fail. Courts and legislatures will need to step in when ethical standards are too low or when they are not met.

2.5 A legal framework has developed regulating companies' incorporation and providing a mechanism for their winding up, laying down standards of conduct for their officers, protecting their shareholders, and stating how they might merge and be taken over. This kind of legal framework will be necessary whatever the extent of self regulation. The degree to which the law will need to intervene in the corporate sector beyond the provision of this framework depends on the degree to which the corporate sector can effectively regulate itself.

2.6 Over the years the community has said much about companies, particularly in relation to directors' duties to those who have invested in the company. The laws regulating the director's role have arisen from the intrinsic nature of companies, their purpose, their structure and their history. For the most part, directors are enjoined to act in the best interests of the company. In this way, the board is required first and foremost to give regard to the shareholders' interests.

2.7 The law also deals in some respects with the duties directors have to others such as employees. This law arises largely from the relationship the company has with entities extrinsic to it. The source of these duties lies not in the nature of the corporation itself but in the nature of its traffic with those other entities.

2.8 Should the law, in either of these aspects, be extended? Some people have advocated a positive answer to this question. Some say that companies are now so dominated by directors that their owners, the shareholders, are denied any effective say in their control. They advocate a different balance. Some argue the law should move to meet the reality that the corporate sector is

now central not only to the economic well-being of society but to most dimensions of community life. They advocate the imposition of wider duties on directors.

Where do directors' duties lie?

2.9 In 1932, The Modern Corporation and Private Property[1] was first published. In this book, the authors, Berle and Means, pointed out that companies had developed so that their ownership and management were separated. They saw this separation as growing out of the ever increasing size, scope and complexity of the corporation which took from the shareholders the ability to control it.

2.10 Berle and Means saw the modern corporation as more than a mechanism allowing a number of investors to hold common property. It was a structure giving a comparatively small number of directors control over huge shareholder funds. Because of its vast economic resources and the activities these made possible, the corporate sector had great impact on the community. It had become a major social institution.

Wider duties

2.11 Berle and Means argued that

[n]either the claims of ownership nor those of control can stand against the paramount interests of the community ... It remains only for the claims of the community to be put forward with clarity and force.2

2.12 In this way, the 'control' of the company would become a balancing of a variety of claims by various groups in the community on the basis of public policy.

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1. *See Berle, Adolf A and Means, Gardiner C, Harvest, USA, 1968 (.revised ed).*
2. *Ibid, p 312.*

2.13 There is much law attending to the rights of shareholders. There is much less guiding directors in what obligations, if any, they have to the community. The legal precedents developed over the centuries give a strong basis for developing further safeguards for shareholders but a narrow one for doing the same for others. To require directors to take into account the social impact their decisions might have would be an extension of Australian company law fraught with most important consequences.

2.14 There is support for making this extension. Mr Jim Kennan, formerly Attorney-General for Victoria and Chairman of the Ministerial Council for Companies and Securities, has said:

In my view it is essential that we... consider ways in which the law can respond to the demands of the modern corporation and can allow the interests of those who are affected by the decisions of corporations to be taken into account in the decision making process.[3]

2.15 Mr Graeme Samuel, as Executive Director of the Macquarie Bank Ltd, has said:

I am beginning to question whether changing social attitudes are not now demanding that, consistent with their obligations to take account of shareholders' interests, directors should take a longer term view and act to also protect the interests of other stakeholders who are vital to the future generation of shareholders' wealth - employees, customers, suppliers and the like.[4]

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3. *'Comments on "Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural"', speech given at AULSA conference, Monash University, 25 August 1987. See also 'The Agenda for Corporate and Securities Law ReForm in Australia', Paper delivered by Mr Kennan at the Eighth Annual Conference of the Australian Society of Labor Lawyers, Hobart, 19 October 1986.*
4. *Samuel, Graeme J, 'Regulation and the Vesting of Discretions in the NCSC', Macquarie Bank-, Melbourne, 1986.*

2.16 These views run counter to those of Justice Plowman in Parke v Daily News Ltd.[5] In that case, directors of a company about to be wound up decided to pay compensation and other benefits to employees about to lose their jobs. The court held that according to law the directors were unable to do so.[6] Their primary duty was to the shareholders.

2.17 Mr Kennan has argued that the law should require directors to take into account interests which include 'at the very least' those of the company's employees and creditors. He has said consideration should be given to the exent to which directors should also be required to look to the interests of consumers of the company's products and services and to take into account the environmental impact of decisions, and to how those interests are to be balanced.[7]

2.18 Legislation already imposes on companies duties to look to the welfare of workers,[8] of consumers,[9] of competitors,[10] of the environment.[11] Should these duties be widened? Should they be imposed specifically on individual directors? In this inquiry, it has been the concern of the Committee to look more closely at these questions.

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5. *[1962] 1 Ch 927.*
6. *Ibid at 962-3.*
7. *'Comments on "Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural"', speech given at AULSA conference, Monash University, 25 August 1987.*
8. *Eg Industrial Relations Act 1998 (Cth); Workers Compensation Act 1987 (NSW); Workplace Health and Safety Act 1989 (Qld); Occupational Health, Safety and Welfare Act 1984 (WA); Workers Rehabilitation and Compensation Act 1986 (SA); Occupational Health and Safety Act 1985 (Vic), Accident Compensation Act 1985 (Vic).*
9. *Eg Trade Practices Act 1974 (Cth), Part V, Consumer Protection; Consumer Affairs Act 1970 (Qld); Fair Trading Act 1987 (NSW); Consumer Affairs Act 1972 (Vic); Consumer Protection Act 1978 (NT).*
10. *Eg Trade Practices Act 1974 (Cth), Part IV, Restrictive Trade Practices.*
11. *Eg Noise Control Act 1975 (NSW); Control of Waters Act 1938 (NT); Environment Protection Act 1970 (Vic); Environment Protection Act 1973 (Tas); Clean Air Act 1984 (SA).*

Multiple duties - much conflict?

2.19 To be successful, enterprises need as a rule to take into account their employees, their customers and the community, as well as their shareholders. Evidence before the Committee emphasised this: it was pointed out that, as a matter of reality, directors already take into account the various interests their decisions might affect.[12] It was urged upon the Committee by some that the imposition of wider duties was therefore unwarranted.[13]

2.20 To require directors to take into account the interests of a company's employees, its creditors, its customers, or the environment, as well as its shareholders, would be to require them to balance out what would on occasions be conflicting forces. To make it optional for directors to take into account the interests of a company's employees, its creditors, its customers, or the environment, as well as its shareholders, again would mean that directors would be in the position of weighing up the various factors. It would also limit the enforceability of shareholders' rights if directors were able to argue that, in making a certain decision, they had been exercising their option to prefer other interests.

2.21 If contemporary public policy requires either of these approaches, then a re-think of some of the fundamentals of company law would be required.

Is there need for more regulation?

2.22 The corporate structure is central to the nation's economic activity. Australia looks to companies for the

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12. *Eg Dr Pascoe (Evidence, p 504); Mr Bosch (Evidence, p 574).*
13. *Eg submissions from Company Directors' Association of Australia, p 8 (Evidence, p 87); Business Council of Australia, pp 22-7 (Evidence, pp 468- 73).*

innovation, enterprise and productivity needed to increase its wealth. At the same time, it expects due regard to be given to the values the community places on other matters such as the rights of consumers, workers and the environment. Regulation of directors and companies (and other forms and aspects of business) must aim to secure adherence to what the community considers are reasonable standards in business practice.

2.23 The growth of public companies has placed their control in the hands of directors and managers as distinct from their shareholders. The ability, industry, honesty and sense of fairness of those directors and managers determine the welfare of shareholders and affect many aspects of community life.

2.24 Most directors, and other company officers, properly carry out their functions, not necessarily because of their legal obligations but for reasons such as their sense of responsibility, career and economic incentives, pride and professionalism. In this context, legal standards, not necessarily within the parameters of the Companies Code or the new Corporations Act, are necessary as a fall back. They provide a standard by which the public's legitimate interest in accountability may be achieved.

What sort of regulation?

2.25 Doctors, lawyers, pharmacists and others belong to honourable professions. All are expected to act according to codes of ethics. Ethics are morality tempered with experience. Peers best know what is reasonable to expect from practitioners and strong peer pressure is a powerful force for proper conduct. It is to be hoped that a code of ethics and strong peer pressure will come to guide the conduct of company directors. A corporate culture which promotes one is vital. Self regulation, if it works, in many respects is better than regulation imposed by law.

2.26 During corporate history there have been directors whose actions have drawn community response. It has been necessary to develop laws protecting shareholders, controlling fund raising, requiring the giving of information, disqualifying categories of people from being directors and prescribing the holding of meetings. A great body of corporate law has evolved to meet the failure of company directors and managers to exhibit competence, industry, wisdom and honesty.

2.27 Mr Kennan has said that, given the history of case law in the area, the regulation of companies should not be left to the courts. He has argued for more legislative activity.

2.28 Case law dealing with companies has so far been concerned predominantly with property rights. This does not preclude it from moving into other areas such as the protection of consumer or employee rights or the environment where appropriate. Some steps in this direction have already been taken in relation to creditors but, to date, regulation in those areas has largely come by way of legislation. It is probable that it will continue to do so. The extent to which this occurs will depend on the policy of the legislator.

What is the standard of directors' duties?

2.29 Because the corporate sector has a profound effect on how we live, the individuals who run the corporate sector have a responsibility to the community which sustains them. At a time of increasing deregulation, Australian business enterprises, many of them corporations, are freer than ever before. In these circumstances, the community might legitimately require even higher standards than in the past.

2.30 Doctors, lawyers, engineers, plumbers, electricians, train drivers and others are required by law to carry out their

work with reasonable care and skill. So are directors. Section 229 of the Companies Code (Corporations Act, s232), and the general law, require them to use due care, skill and diligence. What is required of a director to meet the appropriate standards, however, will depend on the circumstances of each case. Can a more objective standard be devised?

2.31 A director of a small private company might satisfy the requirements of the law by keeping accounts of a kind which, if kept by directors of a large public company, would be insufficient to meet the appropriate standard. It may well be that directors of public companies who hold themselves out as worthy of being trusted with other people's investments are obliged to possess judgment, skills and moral qualities not required in those of private companies. On the other hand, directors of all companies should ensure the workplaces in which they operate are safe and that the products they sell are not dangerous.

2.32 A large public company is likely to have a greater impact on society than a small private one. A corporation employing thousands of people and carrying out massive mining operations is a much more powerful force in the community than one with two or three employees engaged in gardening. Directors of the former can be expected to have processes of supervision and control set up within their company of a kind not required of directors of the latter.

2.33 This kind of distinction is not new. In 1925 Judge Romer said:

The position of a director of a company carrying on a small retail business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of an insurance director, and the duties of a director of one insurance company may differ from those of a director of another. In one company, for

instance, matters may normally be attended to by the manager or other members of the staff that in another company are attended to by the directors themselves. The larger the business carried on by the company the more numerous, and the more important, the matters that must of necessity be left to the manager2, the accountants and the rest of the staff.[14]

Close corporations

2.34 The Close Corporations Act 1989 will reduce the need to draw such a distinction in relation to many aspects of company directors' duties and responsibilities in the future. Many of what are now small proprietary companies will in future incorporate under that legislation.

2.35 A close corporation has no directors - all members may participate in the management of its affairs[15] and will, in reality, be like partners in the corporate enterprise. Nevertheless, many of the provisions of the (new) Corporations Act will apply, including the prohibitions which apply to directors.[16] Members of a close corporation will be relieved of various obligations that apply under companies legislation at the expense of limited liability in the event of non-compliance.

Sanctions

2.36 Any regulatory system involves sanctions. Self regulation means wrong doing will be met with peer pressure, for example, through public censure. Regulation by law can be enforced by civil or criminal penalties or both.

2.37 Where people suffer loss through a director's breach of duty they should be able to recover compensation from him or her.

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14. *Re City Equitable Fire Insurance Co Ltd [1925] 1 Ch 407 at 426-7.*
15. *Close Corporations Act 1989, s72.*
16. *Ibid, s63(3).*

The cost of litigation should not be a barrier. Enforcement action initiated by regulatory agencies should target individual directors or corporate bodies on a principled basis rather than on the ad hoc basis that currently appears to prevail. If the breach is criminal in nature, criminal penalties should follow. But it is draconian to apply such penalties in the absence of criminality. This appears to be the case with section 229 of the Companies Code (Corporations Act, s232).

Summary

2.38 Corporate culture is changing. This is in response to a number of forces.

2.39 The more productive the corporate sector, the more secure the economic well-being of Australia. Directors are crucial to its success. To restrict unnecessarily the operation of their skills, their industry, their enterprise, is to threaten unnecessarily a factor vital to economic growth. Any regulation of directors' activities must be warranted and a sensible balance must be found between measures necessary to promote corporate activity in a way which will be of benefit to all, and measures necessary to protect the bona fide shareholder, worker, consumer, financier, and the public at large. Profitability is but one basis for good corporate citizenship.

2.40 The corporate sector possesses most of Australia's assets, employs most of its workers, and is the sector most capable of injuring the environment. Given this, it is of vital concern to the community and the community is entitled to impose appropriate restrictions on it.

2.41 Companies should be run so that the interests of their members are properly attended to. This is particularly so with public companies, the control and management of which are substantially separated from the ownership.

2.42 Company law, as distinct from the law applicable to companies, deals mainly with the intrinsic nature of companies. The Committee considers it should continue to do so. Where there is a need to govern the relationship between companies and things external to them, this is more appropriately done in separate legislation. Usually such legislation will be applicable not only to companies but to all bodies dealing with, or in a way that will affect, those other things. To illustrate, the environment will require protection not only from the corporate sector but from sole traders, partnerships and all individuals whose actions potentially affect it. The environment should be dealt with in legislation that protects it from whoever or whatever may be in a position to harm it.

2.43 An ethical code is the ideal guide for the activity of directors. Peers know best what can reasonably be expected of their fellows. The development of a corporate culture within which adherence to ethical conduct would grow is essential, but corporate history shows that ethics are not sufficient to ensure proper corporate conduct. The way in which company law has developed testifies to that.

2.44 Where directors fail to regulate themselves effectively, the courts and the legislature will be obliged to do so. It will then be up to the courts to interpret the legislation in accordance with the intent of the legislature.

CHAPTER 3

CARE, SKILL AND DILIGENCE

3.1 To put the notion of 'wider' duties in perspective, it is necessary to set out the so-called traditional duties which apply to company directors. Both courts and parliaments have laid down laws relevant to directors' duties. In relation to the traditional duties of company directors, the former have tended to be less venturesome than the latter. In some respects - for example, duties in relation to creditors - it is the courts which have extended the law.

Case law

3.2 The courts have tended to take a gentle view of some of the basic duties of directors. The cases which have developed the law were decided mainly in the late nineteenth and early twentieth centuries and the standards which were set then are not the standards which the community expects of modern business.

3.3 Turquand v Marshall[1] represents the low point. In that case, the board made a loan to a director who died insolvent without repaying the loan. The Lord Chancellor, Lord Hatherley, said:

It was within the powers of the deed to lend to a brother director, and however foolish the loan might have been, so long as it was within the powers of the directors, the Court could not interfere and make them liable ... Whatever may have been the amount lent to anybody, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they chose such unwise directors; but as long as they kept within the

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1. *(1869) LR 4 Ch App 376.*

powers of their deed, the Court could not interfere with the discretion exercised by them.[2]

3.4 In 1884, in Re Denham and Co,[3] the court described a director as a 'country gentleman and not a skilled accountant'.[4] He had neither checked the accounts nor attended board meetings. Although the court found he had been guilty of 'considerable negligence',[5] it did not expect him to realise the significance of certain information in the financial accounts. As a consequence, he was found not to have breached his duty of diligence and care (although he was refused costs because he had attended only a single board meeting in four years and, in this respect, had failed to discharge his duties).

3.5 Re City Equitable Fire Insurance Co Ltd[6] is considered the leading case in the area. In that case, the company sustained heavy losses mainly because of fraud on the part of the managing director. Other directors were sued for negligence. Justice Romer summarised the duties into four propositions:

1. a director must exercise that degree of skill and diligence as would amount to the reasonable care that an ordinary man might be expected to take, in the circumstances, on his own behalf;

2. a director need show no greater degree of skill than may reasonably be expected from a person of his knowledge and experience;

3. a director is not bound to give continuous attention to the affairs of his company;

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2. *(1869) LR 4 Ch App 376 at 386. For similar statements see, eg, Re New Mashonaland Exploration Co [1892] 3 Ch D 577 at 585 per Vaughan Williams J; Re Forest of Dean Coal Mining Co (1878) 10 Ch D 450 at 453 per Jessel MR; Re Faure Electric Accumulator Co (1888) 40 Ch D 141 at 152 Per Kay J.*
3. *(1883) 25 Ch D 752.*
4. *Ibid at 767.*
5. *Ibid at 766.*
6. *[1925] 1 Ch 407.*

4. a director can rely on other officers or experts.[7]

3.6 A director need not show a greater degree of care and skill than would be reasonably expected of a person of the same knowledge and experience. The extent of the duty of care expected is, therefore, measured by reference to the particular director's knowledge and experience. A director is not required to bring any special knowledge or experience to the task,[8] but, if he or she does, then a commensurate degree of skill will have to be shown.

3.7 Compared with the fiduciary duties of loyalty and good faith, the duties of skill, care and diligence which directors owe to a company have been characterised as 'remarkably low'.[9]

3.8 In Principles of Company Law, Professor HAJ Ford summarises:

Thus, there was no common law standard of the reasonably competent company director analogous to the reasonably competent member of a particular profession or trade, such as architect, solicitor, physician or builder, against whom the conduct of a defendant can be measured when determining whether reasonable care was used. A director was not required to bring any particular qualifications to the office. On the other hand if the director possessed special knowledge he or she was expected to use it in the affairs of the company.

Nor at common law was there a burdensome duty to be diligent in attending meetings of the board: failure to attend meetings seldom led to liability.10

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7. *See Corkery, JF, Directors' Powers and Duties, Longman Cheshire Pty Ltd, Melbourne, 1987, pp 133-9.*
8. *Re Brazilian Rubber Plantations and Estates Ltd [1911] 1 Ch 425 at 437.*
9. *Corkery, JF, Directors' Powers and Duties, Longman Cheshire Pty Ltd, Melbourne, 1987, p 131.*
10. *(4th ed) Butterworths, Sydney, 1986, p 417.*

3.9 Professor Ford writes:

However, the community's expectations as to the qualities to be possessed by directors rose.[11]

3.10 To an extent, the courts have moved to meet these rising expectations. Directors have been expected to make reasonable efforts to acquaint themselves with the company's affairs.[12] In complicated situations which require specialist or technical knowledge, directors may be required to seek and take expert or professional advice. Failure to do this could constitute a breach of the duty of care and skill.[13]

3.11 Nevertheless, the general standard is low. It seems to have stemmed largely from a reluctance on the part of courts to pass judgment on the merits of management decisions taken in good faith. Courts have taken the view that they should not be making companies' business decisions for them. Imprudence and errors of judgment will not constitute negligence of a sufficient degree to result in liability. Directors must be culpably or grossly negligent before a court will find them in breach of their duty of care:

Their negligence must be not the omission to take all possible care; it must be much more blameable than that: it must be in a business sense culpable or gross.[14]

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11. *Principles of Company Law (4th ed), Butterworths, Sydney, 1986, p 418.*
12. *Re Australian Venezolana Pty Ltd (1962) 4 FLR 60 at 66.*
13. *In Re Duomatic Ltd [1969] 2 Ch 365.*
14. *Lagunas Nitrate Co v Lagunas Syndicate [1899] 2 Ch 392, per Lindley MR at 435. See also, eg, Overend & Gurney Co v Gibb (1872) LR 5 HL 480 at 487 per Lord Hatherley LC; Re Brazilian Rubber Plantations & Estates Ltd [1911] 1 Ch 425 at 436-7 per Neville J; Re National Bank of Wales Ltd [1899] 2 Ch 629 at 672 per Wright J; Re Faure Electric Accumulator Co (1888) 40 Ch D 141 at 152 per Kay J.*

Legislation

3.12 Legislation imposes a variety of duties on directors over a wide range of issues. The Institute of Directors in Australia referred the Committee to a range of areas in which legislation imposed obligations on directors. At the Commonwealth level these included income tax, company tax, sales tax, trade practices and industrial arbitration. At the State level, legislation concerning, for example, the stock exchange, land tax, payroll tax, workers' compensation, stamp duty, industrial arbitration and conditions of employment applied further impositions.[15]

3.13 Several submissions to the Committee referred to the complexity of the companies legislation and the obligations flowing from it.[16] It was submitted that the complexity meant that often people were unaware of the precise coverage of the law.[17]

3.14 The Company Directors' Association wrote:

This results from the legal complexities of a modern society. It appears that society must be regulated by increasingly detailed legislation, if it is to maintain the standards it requires for the conduct of its activities.[18]

Section 229

3.15 The principal statutory provision which governs the

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15. *Submission from Institute of Directors in Australia, pp 3-5 (Evidence, pp 121-3).*
16. *See, eg, submissions from Company Directors' Association of Australia, p 3 (Evidence, p 82), Institute of Directors in Australia, pp 2-5 (Evidence, pp 120-3).*
17. *See, eg, submission from Company Directors' Association of Australia, pp 2-3 (Evidence, pp 81-2).*
18. *Submission from company Directors' Association Of Australia, p 3 (Evidence, p 82).*

duties and obligations of company 'officers', including directors, is section 229 of the Companies Code (Corporations Act, s232). The precursor of section 229 was introduced into Victorian company law in 1958, and Tasmanian law in 1959. It seems that, before these dates, no corresponding provision had been contained in the company legislation of any other English-speaking country.[19]

3.16 Section 229 says, in part:

(1) An officer [defined to include directors s229(5)] of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties of his office.

(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.

(3) An officer of a corporation shall not make improper use of information acquired by virtue of his position as such an officer to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

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

3.17 Section 229 applies in addition to any other rule of law affecting directors' duties. It does not prevent civil proceedings being brought for breach of any other duties.[20] There

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19. *Brown, SR and Grogan PR, Company Directors (3rd ed), Law Book Co Ltd, Sydney, 1974, p 270.*
20. *Section 229(10) (Corporations Act, s232(11)).*

is no need for harm to be done to bring the section into operation.

3.18 Breaches of the provisions of section 229 involve penalties from $5000 to $20 000 or imprisonment for five years or both.[21] Civil action may be taken to recover profits improperly made or an amount equal to any loss or damage to the corporation as a result of a contravention of the section.[22]

3.19 The statute, on the face of it, seems to impose an objective standard. An objective standard is one that all individuals would be expected to meet, regardless of their particular capacities or circumstances. In Byrne v Baker,[23] however, the Full Court of the Victorian Supreme Court applied in its interpretation of the equivalent of section 229 the subjective standard of the common law. It looked to what could be expected of the particular director in the particular circumstances. The court noted that 'skill' was not referred to in the statute. Thus the equivalent of section 229 was seen to impose an even weaker standard than the common law. Now, section 229 requires that a 'reasonable degree of care and diligence' be exercised.[24] However, the test applied is still a subjective one.

Other specific provisions

3.20 Apart from this general provision, the legislature has seen fit to impose further specific duties on directors. Those included in the companies legislation operate mostly to protect the interests of shareholders, particularly in so far as the provision of information about the company and its activities is necessary to enable them to exercise their rights under the

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21. *Where some form of dishonesty is involved (eg s229(1)(b), (3), (4)) the penalty is $20 000 or imprisonment for five years, or both. Elsewbere (eg s229(1)(a), (2)) the penalty is $5000. A similar regime operates under the Corporations Act: ss232, 1311(3), Schedule 3.*
22. *Section 229(7).*
23. *[1964] VR 443.*
24. *Section 229(2).*

Companies Code and the company's articles. Some examples are:

* a company is required to keep accounting records which can be audited and which allow proper accounts to be drawn up; a director who fails to take all reasonable steps to enable the company to comply with this requirement may be guilty of an offence (Companies Code, s267(11); Corporations Act, s289(11));

* directors must ensure that profit and loss accounts and balance sheets which give a 'true and fair view' of the company's performance are prepared (Code, s269(l), (2); Act, ss292, 293);

* directors must ensure that accounts are audited (Code, s269(4); Act, s296);

* directors must present a report which sets out certain information about the company's activities (Code, s270; Act, Pt 3.6, Div 6);

* various registers must be kept - eg of directors (Code, s238; Act, s242) and their shareholdings (Code, s231; Act, s235), of members (Code, s256; Act, s2O9), of debenture holders (Code, s147; Act, s1047), of charges over company property (Code, s2O9; Act, s271) - and directors, as officers of the company, may be guilty of an offence if they are not kept; and

* directors are required to convene a general meeting within two months of a 'requisition' from the required number of members (Code, s241(l); Act, s246).[25]

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25. *See also list of liabilities attaching to directors Under companies legislation in submission from Mayne Nickless Ltd, pp 10-36 (Evidence, pp 382-408); and Brown, SR and Crogan, PR,* *__Company Directors__* *(3rd ed), Law Book Co Ltd, Sydney, 1974, pp 186-94.*

3.21 The Institute of Directors referred to the 'bewildering' range of laws which govern directors' conduct in certain circumstances.[26] Mayne Nickless Limited submitted that

[t]here does not appear to be any group of people in commercial, professional or public life who have such heavy legal responsibilities imposed upon them.[27]

3.22 Mr Kenneth MacPherson, a commissioner of the NCSC, said at a recent company directors' seminar:

You [ie Directors] today are on the front line. So far as exposure to liability is concerned, the 'exposures' are increasing in both the criminal and the civil areas.

You [ie directors] are being faced with an ever increasing volume of legislation that is applicable to your activities, not merely with respect to company law but with respect to a wide range of matters such as taxation, occupational health and safety, industrial relations and the environment just to name a few.

In addition to these legislative requirements, there is an ever increasing volume in the rules that are being promulgated by statutory authorities and these also create their own difficulties and complexities.[28]

The traditional duties summarised.

3.23 In summary,

the fewer a director's qualifications for office, the less time and attention he devotes

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26. *Submission, p 5 (Evidence, p 123).*
27. *Submission from Mayne Nickless Ltd, p 3 (Evidence, p 375).*
28. *'Directors' responsibilities - a regulator's perspective', address to a company directors' Seminar, Adelaide, 1 June 1989.*

to his office, and the greater the reliance he places on others, legally the less responsible he is.[29]

3.24 The case law has developed the company director's general duty of care in this way because it has recognised that his or her role involves a degree of risk taking and uncertainty. The courts have been concerned to allow for flexibility and not to hamper entrepreneurs unduly. The standards laid down, however, barely meet the requirements of contemporary business and fall far short of the standards required of other professions.

3.25 There is no objective common law standard of the reasonably competent company director, as there are objective standards for other professions. It is not an easy task to determine uniform minimum standards of behaviour for company directors. The activities of companies are diverse and consequently a range of skills and experience is useful on boards, but, if the modern company director wants professional status, then professional standards of care ought to apply.

3.26 It may be easy to require directors of large public companies to show higher standards in their duty of care than directors of the small proprietary company, but what is required will inevitably be affected by the particular circumstances - the size, structure and sphere of operation of the company, the composition of the board and the distribution of responsibility among board members, for example.

3.27 In 1901, Lord Macnaghten said:

I do not think it desirable for any tribunal to do that which Parliament has abstained from doing - that is, to formulate precise rules for the guidance or embarassment of business men in the conduct of business affairs. There never has been, and I think there never will

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29. *Trebilcock, MS, 'The Liability of Company Directors for Negligence' (1969) 32 Mod LR 499 at 508-9.*

be, much difficulty in dealing with any particular case on its own facts and circumstances; I rather doubt the wisdom of attempting to do more.[30]

However, modern business practices seem to have developed to an extent unforeseen by Lord Macnaghten in 1901 and when the community looks to the law for guidance, often it is not there.

3.28 The traditional approach has developed because of the need to allow directors flexibility to carry out their proper role. Nevertheless, the present state of the law is not satisfactory and the Committee recommends that an objective duty of care for directors be provided in the companies legislation.

3.29 Some particular areas of possible reform which have been considered by the Committee are discussed below.

The business judgment rule

3.30 American courts have developed a 'business judgment rule' which provides special protection to directors' informed business decisions. The American Law Institute has devised a relatively precise formulation which is consistent with the rule developed by the courts but which avoids much of the confusion that has arisen from the various ways in which the courts have stated the rule. The main feature of the rule that the American Law Institute proposes is that a 'safe harbour' is created for a director (or officer) who makes a business judgment in good faith if:

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

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

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

c) he or she rationally believes that the business judgment is in the best interests of the company.[31]

3.31 The Companies and Securities Law Review Committee has suggested the following as factors which the law might adopt to absolve directors from liability for ill effects arising from the exercise of business judgment:

a) the director acted in good faith and was not subject to a conflict of interest or duties;

b) the director exercised an active discretion in the matter;

c) the director took reasonable steps to inform him- or herself; and

d) the director acted with a reasonable degree of care in the circumstances, including

(i) any special skill, knowledge or acumen he or she possessed, and

(ii) the degree of risk involved.[32]

3.32 The policy behind the business judgment rule is that informed business judgments should be encouraged in order to stimulate innovation and risk-taking. It seeks to limit judicial intrusiveness in private sector decision making.

3.33 In Australian law, there has been little attention paid to this issue. The Committee considers that, so long as directors

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31. *American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Tentative Draft No 4, April 1985, Part IV, pp 6-7, 58-76.*
32. *Company Directors and Officers: Indemnification, Relief and Insurance, Discussion Paper No 9, April 1989, para 112.*

stay within the bounds of the business judgment rule, they should not be liable for the consequences of their business decisions. In the expectation of profit, shareholders must accept the risk of the directors' business judgments, provided the business judgment is made on a competent basis.

3.34 Directors' business judgments tend to be judgments of the board rather than the individual. In these circumstances, the situations in which individual directors will be liable for matters of business judgment need to be specially considered. Individual liability will depend on a link being made between the individual's acts or omissions and the damage done to the corporation.

3.35 The Committee did not receive any submissions on this point. It has noted developments in the United States and discussion of the issue by the Companies and Securities Law Review Committee,[33] and recommends that **a 'business judgment rule' be introduced into Australian company law. It should include an obligation on directors to inform themselves of matters relevant to the administration of the company. They should be required to exercise an active discretion in the relevant matter or, alternatively, to show a reasonable degree of care in the circumstances.**

Attendance at meetings

3.36 There is little obligation on a director to attend meetings or to take responsibility for decisions made in his or her absence.[34] A classic example of non-attendance is the Marquis of Bute's case.[35] The Marquis became president of the Cardiff Savings Bank when six months old, inheriting the office from his

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33. *Company Directors and Officers: Indemnification Relief and Insurance, Discussion Paper No 9, April 1989, esp at paras 31-44, 112.*
34. *Eg Re City Equitable Fire Insurance Co Ltd [1925] 1 Ch 407 at 429 per Romer J.*
35. *Re Cardiff Savings Bank [1892] 2 Ch 100.*

father. In 38 years, he attended only one board meeting, yet he was held not to be liable for irregularities in the bank's lending operations.

3.37 In Re City Equitable Fire Insurance Co Ltd,[36] one director had not attended a board meeting in five years due to ill health. Another had attended board meetings (in London) only rarely because he lived and worked in Aberdeen. The court considered both had taken as active a part in the business of the board as could be expected in the circumstances.

3.38 If a director does attend a meeting, he or she is required to give proper attention to the matters raised. Corkery comments: 'It is better to stay away from meetings than to attend and be inattentive'.[37] Lord Hatherley said in Land Credit Co of Ireland v Lord Fermoy:

it is their [ie directors'] duty to be awake and their being asleep would not exempt them from the consequences of not attending to the business of the company.[38]

3.39 In the opinion of the Committee, a director who fails to attend board meetings without reasonable excuse is failing to meet an appropriate standard of conduct. Failure to attend board meetings without reasonable excuse should be considered prima facie evidence that a director is not exercising reasonable skill, care and diligence in the discharge of his or her duties as director. The Committee recommends that **directors be required to attend board meetings unless there is a reasonable excuse for non-attendance.**

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36. *[1925] 1 Ch 407.*

37. *Corkery, JF, Company Directors' Powers and Duties, Longman Cheshire, Melbourne, 1987, p 136. Liability will depend on a link being established between a decision in which a director was involved and a loss to the company.*

38. *(1870) LR 5 Ch App 763 at 770-1.*

3.40 This provision should be incorporated in the body of the companies legislation. This would mean that a director would know exactly what was required of him or her in respect of attendance at board meetings when considering an appointment to a board. The provision would lessen the incidence of appointment of directors merely as window dressing, while those who act responsibly would not be affected.

Figurehead directors

3.41 It can be seen that the law does little to encourage conscientious directors and to dissuade the appointment of 'status' directors who might have little to contribute beyond a name, a title or a reputation. This position may be contrasted with US law which requires directors to supervise the conduct of the company's affairs rather than merely be a figurehead.[39]

3.42 The recommendations made in paragraphs 3.28, 3.35, 3.39 and 3.53 will go some way towards eliminating the appointment of figurehead directors.

Delegation

3.43 The law says that 'a director is, in the absence of grounds for suspicion, justified in trusting [an] official to perform duties honestly'.[40] For example, delegation to auditors, accountants, committees of the board, key employees and managers is essential to the conduct of the large modern corporation. The case law gives some indication of the extent to which delegation is permissible.

3.44 The entitlement to rely on others is not set down in the

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39. *Corkery, JF, Directors' Powers and Duties, Longman Cheshire, Melbourne, 1987, p 137.*
40. *Re City Equitable Fire Insurance Co Ltd [1925] 1 Ch 407 at 429 Per Romer J. Also see Huckerby v Elliot [1970] 1 All ER 189 at 194 per Lord Parker CJ.*

companies legislation. The limits of reliance are not firm and are worked out on a case by case basis. There is no requirement that directors actively supervise delegates or positively believe an official, on whom reliance is placed, is trustworthy.[41]

3.45 Professor Baxt was critical of the state of the law relating to delegation.[42] He referred to the recent decision of the NSW Court of Appeal in Metal Manufacturers Pty Ltd v Lewis.[43] In that case, an action was brought by a creditor of the company against Mrs Lewis, one of the directors, pursuant to section 556 of the Companies Code. The object of the exercise was to recover the debt from Mrs Lewis in her capacity as a director, on the basis that, when incurring the debt, there had been reasonable grounds to expect that it would not be paid.

3.46 Mrs Lewis said that she had had little to do with the management of the company. She defended the action on the basis that the debt had been incurred 'without [her] express or implied authority or consent'.[44] The majority of the Court of Appeal accepted Mrs Lewis's defence.

3.47 Justice Kirby, the President of the Court of Appeal, forcefully dissented from the decision of the majority of the court. He referred to the 'reformatory nature' of section 556, in the context of the history of company law.[45] By this, Justice Kirby meant that the section represented a deliberate departure from the protective mechanisms of limited liability.[46] He said that, beyond providing a means of redress to creditors,

[I]t is also aimed, by proper concern lest

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41. *See discussion in Corkery, JF, Directors' Powers and Duties, Longman Cheshire, Melbourne, 1987, pp 137-9.*
42. *Submission, p 3 (Evidence, p 192). Concern about delegation was also expressed by the Australian Shareholders' Association Ltd in its submission, pp 4-5.*
43. *(1988) 13 NSWLR 315.*
44. *Companies Code, s556(2)(a).*
45. *(1988) 13 NSWLR 315 at 317.*
46. *Ibid at 317-18.*

such proceedings subsequently be brought against the directors personally, to instil in them, during times of insolvency or economic difficulty in the corporation, to take particular care in the incurring of debts by the corporation with third parties.[47]

3.48 Justice Kirby continued:

The time has passed when directors and other officers can simply surrender their duties to the public and those with whom the corporation deals by washing their hands, with impunity, leaving it to one director or a cadre of directors or to a general managers to discharge their responsibilities for them.[48]

3.49 Professor Baxt referred to Justice Kirby's dissent in his submission. In the light of the decision in Metal Manufacturers Pty Ltd v Lewis, Professor Baxt submitted that

the time has come, in my view, for this rule [ie regarding delegation] to be reviewed. It is not good enough for persons who wish to occupy the position of director in a company to simply rely on others to ensure that all obligations etc will be simply complied with in the day-to-day running of the company. It would be a sad day if we reached a stage where persons who were appointed to the boards of directors could simply escape liability by relying on this right to delegate.[49]

3.50 Professor Baxt suggested that 'specific statutory provisions' should be considered as a means of addressing this problem. However, he thought that such an exercise should not be undertaken without careful consideration.[50]

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47. *(1988) 13 NSWLR 315 at 318.*
48. *Ibid at 318-9.*
49. *Submission from Professor Baxt, pp 4-5 (Evidence, pp 193-4).*
50. *Ibid, p 5 (Evidence, p 194).*

3.51 He referred the Committee to the work of the American Law Institute which 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:

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

b) 'legal counsel, public accountants, engineers, or other persons whom the director or officer reasonably believes merit confidence'.[51]

3.52 The significant features of the American Law Institute's formulation are the requirement that the director act in good faith, that he or she reasonably believe that reliance is warranted, and that he or she reasonably believe that the person(s) relied upon merit confidence.

3.53 A formulation such as this would assist in defining boundaries which currently are worked out on a case by case basis and which do not clearly specify limits on the delegation of responsibility. The Committee recommends that **the companies legislation be amended to provide for, and specifically limit, the extent to which company officers may rely on others**. The framing of the amendments needs to be considered by a body with sound technical knowledge of company law such as the Companies and Securities Law Review Committee or the Law Reform Commission.

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51. *The American Law Institute Principles Of Corporate Governance: Analysis and Recommendations, Tentative Draft No 4, April 1985, Part IV, pp 76-7.*

CHAPTER 4

DIRECTORS' FIDUCIARY DUTIES

4.1 A company director has a fiduciary relationship with the company. This relationship gives rise to certain legal obligations that are part of the director's so-called traditional duties. The term 'fiduciary' is derived from Roman law and is used to describe a person who has the character of, or similar to, a trustee. The fiduciary's legal obligations stem from his or her position of trust.[1]

4.2 Professor Finn described what fiduciary law entails. It starts off with the notion that one person [the fiduciary] is in a position that gives them a power or capacity to affect the interests of another [the beneficiary] but in circumstances where the other is entitled to expect that that power or capacity will be used in that person's interest. The general object of fiduciary law is to ensure that the power or capacity that that person possesses is not used to further any interest other than the beneficiary's interests - the company's interest.[2]

4.3 The rules which impose fiduciary obligations are rules of equity, developed over time by the Court of Chancery in England and by Australian courts exercising equitable jurisdiction. To some extent the rules of equity have been reproduced as statutory provisions,[3] but they remain judge-made rules capable of judicial development to meet new situations and

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1. *See Black's Law Dictionary (5th ed), West Publishing, St Paul, 1979, p 563; Jowitt's Dictionary of English Law (2nd ed), Sweet & Maxwell, London, 1977, vol 1, p 788.*
2. *Evidence, pp 160-1.*
3. *Companies Code, s229(1),(3),(4) (Corporations Act, s232(2), (5), (6))*

changing mores. They are far wider than the provisions in the Companies Code or the new Corporations Act.[4]

4.4 The relationship of director and company is just one of a number of relationships based on trust in which fiduciary obligations apply. Others include the relationships of solicitor and client, trustee and beneficiary, and executor and beneficiary under a will.[5]

4.5 The fiduciary relationship is reflected in two distinct (but sometimes overlapping) bodies of rules. The first set of rules concerns itself with the manner in which powers and discretions are to be exercised by a fiduciary. [It] is concerned with the manner of decision making, the propriety of decisions. So it is decision orientated.[6]

It is designed to ensure that when the fiduciary exercises a discretion within his or her 'fiduciary powers', he or she does so bona fide and in the beneficiary's interests.

4.6 The second set of rules
is concerned with the standards of conduct to be expected of a fiduciary and with the types of behaviour that will constitute disloyalty. ... The focus ... is not on the propriety of a decision as such but on the propriety of the conduct of the individual.7

it is designed to ensure the fiduciary's loyalty to the beneficiary. The fiduciary must not allow his or her own

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4. *Evidence, p 169 (Professor Finn).*
5. *Finn, PD, Fiduciary Obligations, Law Book Co Ltd, Sydney, 1977, p 3; Evidence, p 160 (Professor Finn).*
6. *Evidence, p 161 (Professor Finn). See also Finn, PD, Fiduciary Obligations, Law Book Co Ltd, Sydney, 1977, p3.*
7. *Evidence, p 161 (Professor Finn).*

interests (or another duty) to conflict with the fiduciary duty, or to use his or her position to gain a personal advantage, without the informed consent of the beneficiary.[8]

4.7 While fiduciary law has two distinct parts directed to two different kinds of phenomena, in practice the parts may often overlap. For example:

An improper decision may be infected by improper conduct.[9]

4.8 The essence of fiduciary law is the notion of faithful and loyal service. Directors are also required to exercise a reasonable degree of care and diligence and not to be negligent, but those requirements go to competence. Competence is not part of fiduciary law.[10]

4.9 As Professor Finn emphasised, fiduciary law is only one of a number of bodies of law that can apply to directors and it is by no means the universal solvent to all the problems that can flow from the actions and activities of company directors.[11]

The fiduciary's powers and discretions

4.10

The general idea of fiduciary law is to contrive how and to what end powers and discretions are to be exercised.[12]

4.11 When applied to a company director, it is

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8. *Finn, PD, <u>Fiduciary Obligations</u>, Law Book Co Ltd, Sydney, 1977, pp3-4.*
9. *Evidence, pp 161-2 (Professor Finn).*
10. *See, eg, Evidence, p 162 (Professor Finn).*
11. *Evidence, p 162 (Professor Finn).*
12. *Evidence, p .162 (Professor Finn).*

commonly put in terms or in a formula such as a director must act bona fide in the interests of the company.[13]

4.12 It is settled law that a director must 'act bona fide for the benefit of the company'.[14] Expressed like this, the duty seems clear enough where the company's interests are considered against those of some outsiders (in the extreme case, a competing company), but when the interests of different classes of shareholders, or of shareholders and the company as an artificial legal person, are concerned, the expression is not helpful.

4.13 Professor Finn pointed out to the Committee that the application of the duty was far from simple because we have no settled understanding as to what is meant by the company's interests.[15]

He suggested that

the statement that the directors owe their fiduciary duty to the company is really no more than a statement about who can complain about a breach.[16]

He put the view that 'the Companies Code maintains an understandable and a commendable silence'[17] on whose interests directors are obliged to serve in the exercise of their powers.

4.14 The courts have interpreted the duty to act in the company's interests in various ways.[18] As a general statement, the board is expected to act in the interests of the company as a

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13. *Evidence, p162 (Professor Finn).*
14. *Eg Mills v Mills (1938) 60 CLR 150 at 158 per Latham CJ.*
15. *Evidence, p 163.*
16. *Evidence, p 163.*
17. *Evidence, p 163.*
18. *Refer generally to Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1986, pp 120-36.*

whole in relation to issues external to the company, and fairly between members in relation to issues internal to the company.

4.15 The general rule is that directors owe their duties to the company and not to the shareholders.[19] In Coleman v Myers[20] directors were held to owe fiduciary duties directly to a group of individual shareholders. This was because of the particular personal relationship between those shareholders and the directors, including their dependence on him for investment advice.[21] The law expounded in that case could have application in the many small to medium-sized companies where directors and shareholders are friends or relatives of each other.

4.16 A court will usually leave decisions about what is in a company's interests to the directors. It will inquire only as to whether a power was exercised for proper purposes,[22] that is, whether the directors exercised their decision making powers in what they believed to be the company's interests. Professor Ford has said 'courts do not hear appeals from the decision of a board but they will control misuse of a discretion'.[23]

4.17 In fiduciary law, there have long been exceptions to this rule where the fiduciary's actions have been 'demonstrably' not in the beneficiary's interests.[24] In company law, there are some activities which will always be deemed to be improper, even where they enhance the prosperity of the company. In several cases directors have been held to be in breach of their fiduciary duties when acting in a way which influenced the balance of power within the company, even though the directors honestly believed

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19. *Percival v Wright [1902] 2 Ch 421.*
20. *[1977] 2 NZLR 225.*
21. *Ibid at 323-4 per Woodbouse J, at 330-1 per Cooke J; at 370-1 per Casey J.*
22. *Eg Mills v Mills (1938) 60 MR 150 at 185-6 per Dixon J.*
23. *Ford, HAJ, Principles of Company Law (4th ed) Butterworths, Sydney, 1986, p 384.*
24. *Finn, PD, Fiduciary Obligations, Law Book Co Ltd, Sydney, 1977, P 41.*

that their efforts to secure control of the company for one faction rather than another were in the company's best interests.

4.18 A director's decision is not unlawful merely because it imposes unequal burdens or confers unequal benefits on different classes of shareholders. However, the directors must not deliberately interfere with shareholders' rights, so as to advantage or disadvantage one group of shareholders, even as a tactic for furthering (as they see it) the company's interests. Put another way, the directors cannot justify a decision by saying that they believed that it was in the company's interests to advantage or disadvantage a particular group.

4.19 Recent examples of this principle at work are:

* use of the power to issue shares for the purpose of destroying an existing majority or preventing a particular group attaining majority status in the future, when the directors believed that the shareholders thereby foiled would have destroyed the company if they had gained control;25 and

* use of company funds to boost the chances of existing directors in a contested election for positions on the board, where the board believed that it would be detrimental to the company if those who opposed the existing directors were elected.[26]

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25. *Whitehouse v Carlton Hotel Pty Ltd (1987) 162 CLR 285. See also Howard Smith v Ampol Petroleum [1974] AC, 821 at 835, discussed in Finn, PD, Fiduciary Obligations, Law Book Co Ltd, Sydney, 1977, p71.*
26. *Advance Bank Australia Ltd v FAI Insurances Ltd (1987) 9 NSWLR 464. It was held by the majority in that case that directors had the power (and possibly the duty) to provide shareholders with any information necessary to make informed voting decisions (even if that information was highly prejudicial to the chances off a candidate) and to solicit proxy votes. However, it was held that the directors' power did not extend to using company funds to run an expensive and emotive election campaign on behalf of their colleagues and ostensibly in the name of the company.*

4.20 What the courts are requiring of directors in these situations is that they act fairly as between shareholders as well as acting in the interests of them all.

Ratification

4.21. As a general rule of fiduciary law, a beneficiary may forgive acts of a fiduciary which are in breach of the fiduciary's duty. Thus the company can ratify an action by a director which was undertaken for an 'improper' purpose.[27]

4.22 Ratification will usually be up to the shareholders in general meeting. Whether the majority of shareholders should be prevented from ratifying decisions which infringe the rights of minority shareholders is discussed in chapter 11.

The interests of the company

4.23 The notion of the interests of the company is not a simple one. Whether particular interests need protection will depend on the situation and the matter to be decided. In some situations the interests of the company will be straightforwardly opposed to those of some other body or group. In others, the directors will need to balance the interests of different classes of shareholders against each other, or the immediate interests of the shareholders against the interests of future shareholders.

4.24 It may be argued that the law is unclear, but the Committee accepts the view of Professor Finn:

The fluidity [in this aspect of fiduciary law as it applies to company directors] in part is a response to the very diverse range of business arrangements that can occur involving companies and the very diverse circumstances in which companies can find themselves: they are big, they are small, they are solvent,

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27. *Eg Hogg v Cramphorn Ltd [1967] Ch 254 at 271*

they are insolvent, they are related, they are unrelated, they discharge different functions. It seems to me to be a hazardous enterprise, to put it moderately, to try simply to reduce this part of the law into a straitjacket - particularly into a legislative straitjacket - unless the terms in which legislation is framed are so broad as to allow the very flexibility that currently exists within the common law[28].

Standards of conduct

4.25 The second part of fiduciary law (see paragraphs 4.5-4.7 above) is designed to secure the fiduciary's loyalty to the beneficiary.

[B]ecause a director's function is to act in the company's interests, to serve the company's interests, the fiduciary law insists on loyalty in that service. The fiduciary is not to use his or her position or the power or opportunity that it gives to advance any interests other than the company's. [29]

4.26 This means, first, the fiduciary must not allow a situation to develop in which the duty owed to the beneficiary conflicts with his or her own interests or with a duty owed to a third person. Secondly, the fiduciary must not make use of his or her position to gain a personal advantage or an advantage for a third person. [30]

4.27 These two broad rules are sometimes confused in the case law.[31] Often both apply to the same set of facts. For example, if a director is buying property from the company, there is clearly a conflict of interests, but if he or she misuses privileged access to information about the true value of the property, the

28. *Evidence, p 168 (Professor Finn). See also pp 170-1.*
29. *Evidence, p .171 (Professor Finn). See also p 172.*
30. *Chan v Zacharia (1984) 154 CLR 178 at 198-9 per Deane J.*
31. *Evidence, pp 171-2 (Professor Finn). See, eg, New Zealand Netherlands Society v Kuys [1973] 1 WLR 1126 at 1129 per Lord Wilberforce.*

director is also abusing his or her position.

4.28 The law in this area covers a wide range of activities including misuse of corporate assets, misuse of confidential information, dealing with the company, and taking for personal gain business opportunities which ought to be taken up on behalf of the company.

4.29 The purpose of the law is to protect people (such as shareholders) who entrust their interests to the care of others (such as directors). It does this not by compensating individual beneficiaries for losses suffered but by imposing standards of conduct the breach of which will always give rise to liability:

The fiduciary's conduct may be condemned, notwithstanding that it has no adverse effect whatever on the beneficiary's interest.[32]

4.30 Powerful remedies may therefore be available to a beneficiary who has suffered no loss. In this way, the available remedies can bring gain to the beneficiary which could be seen as a 'windfall'. [33] This situation is a result of the general principle that the aim of fiduciary law is to prevent improper conduct rather than remedy its consequences.

4.31 This principle can be justified on two grounds. First, where one person trusts another to see to his or her interests, very strict standards are necessary. [34] Secondly, in many situations, proof of harm would depend on facts best known to, or

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32. *Evidence, p 171 (Professor Finn).*
33. *A prime example is Phipps v Boardman [1967] 2 AC 46. In that case the beneficiaries had got all they were entitled to expect, but the fiduciary had made further profits for himself. The House of Lords found that there had been a breach of fiduciary duty; the beneficiaries were therefore entitled to the extra Profits, less an allowance for the fiduciary's 'services'. See also Evidence, p 171 (Professor Finn).*
34. *See, eg, Meinhard v Salmon (1928) 164 NE 545 at 546; 249 NY 458 at 464.*

controlled by, the fiduciary.[35] For example, if a director takes a chance to make a personal profit in breach of duty, a shareholder would have difficulty disproving a claim by the director that the company could not have exploited the opportunity and therefore has not suffered any loss as a result of his or her actions.

Disclosure

4.32 The object of fiduciary law where there is potential conflict is not to prohibit the action but

to compel disclosure of certain types of actions so that consent can be given notwithstanding there is a conflict of interest or a conflict of duty[36]

As with the duty to act in the beneficiary's interests, the beneficiary may consent to, or approve in retrospect, actions by the fiduciary which otherwise would be in breach of duty. There are limits, however, to the breaches of duty which can be ratified in this way (see chapter 11). Acts which would be fraudulent or oppressive if committed by a majority of the shareholders cannot be committed by the directors and ratified by the majority.

4.33 Subject to these limits, in situations of conflict of duty or interest, the director can be immunised from wrongdoing by the free and informed consent of the beneficiary, the company.[37]

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35. *Austin, RP, 'Fiduciary Accountability for Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at 178-9.*
36. *Evidence, p 172 (Professor- Finn).*
37. *Evidence, p 172 (Professor Finn).*

Conflicts of interest and duty

4.34 If, for example, a director buys property from the company, he or she has a personal interest in getting a low price and a duty to secure a higher one. The rule preventing conflicts of duty and interest is

> based on the consideration that, human nature being what it is, there is danger of the person holding a fiduciary position being swayed by interest rather than duty, and thus prejudicing those whom he was bound to protect.[38]

4.35 Similar considerations apply where the problem is an inconsistent duty rather than personal interest. The presence of the inconsistent duty means that the fiduciary cannot be trusted to protect the beneficiary's interests.

Abuse of a position

4.36 Fiduciary law aims to ensure that someone holding a fiduciary position uses it in the interests of the person it is intended to serve and not in his or her own interests, or in the interests of a third party, without the informed consent of the beneficiary. For example, a person who in the course of his or her activities as a company director received information enabling a handsome profit to be made, and used that information for his or her personal gain rather than bringing it to the attention of the company, would be abusing his or her position. A fiduciary must use his or her office in the interests of the beneficiaries for whose benefit it is established.

Multiple directorships

4.37 It is common for people to hold directorships in two or

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38. *Bray v Ford [1896] AC 44 at 51 per Lord Herschell.*

more companies. This is particularly so with non-executive directors. This is widely seen as beneficial. It enables full use of the pool of available talent; it facilitates cross-fertilisation of ideas and experience; it helps companies secure people with specific skills or business connections to serve on their boards.

4.38 [I]f one's purpose in having external directors is to bring to bear a broader perspective, more background, a wider range of skills on a particular issue or indeed on the management of the company, I think to have people who are able to contribute views on that canvas they are advantaged if they have experience in other corporate or similar roles. [39]

4.39 Professor Finn said that 'given the available human resources in our society we accept it is inevitable'[40] that people with the qualities sought by companies will be asked to join the boards of several.

4.40 Holding multiple directorships can give rise to conflicts of interest which would breach fiduciary duties. If two companies are in direct competition, or if one is buying something from the other, a director cannot participate in the management of both without running into a clear conflict of duties. The companies' interests, and the director's duties to the companies, could also clash if their businesses were in related fields, or indeed in any situation where the activities of one company were likely to affect the interests of the other.

4.41 The usual response to this situation is for directors to absent themselves from boardroom discussions of matters in which they have a conflict of interest or a conflicting duty.[41]

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39. *Evidence, p 618 (Mr Loton).*
40. *Evidence, p 173. See also submission from BHP Ltd, para 30 (Evidence, P 611).*
41. *Eg submission from BHP Ltd, para 31 (Evidence, p 612); Evidence, p 618 (Mr Loton).*

(Disclosure of the conflicting duties to both companies, and their consent to the director continuing to participate, may also absolve the director from breaches of duty.[42])

4.42 For the director to leave the boardroom while a particular issue is being dealt with is a partial solution only. Avoidance of conflict in this situation will depend on the vigilance of the individual concerned and of his or her fellow directors.

4.43 A conflict of interest which should disqualify a director from acting might become apparent only after he or she has participated in a discussion and even voted on the issue. In some cases it is doubtful whether a conflict of interest or duty can be avoided by directors simply leaving the boardroom when the relevant matters come up for discussion. They might quite innocently influence their colleagues even though absent.

4.44 These problems raise the issue of what ethics ought to be adopted by directors (see chapter 10). They also raise the issue of what response is called for by the law.

4.45 Despite the dangers, it is unlikely that multiple directorships will become less common, especially given the relatively small pool of corporate 'talent' in Australia. Mr Loton of BHP Limited expressed the view that

the advantages of having people with broadly-based backgrounds perhaps in other industries certainly outweigh the few occasions on which there are conflicts.[43]

4.46 The conflict between the law and practice can only be resolved by accepting some dilution of strict fiduciary

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42. *Finn, PD, Fiduciary Obligations, Law Book Co Ltd, Sydney, 1977, pp 252-3 (esp note 10).*
43. *Evidence, p 618.*

standards. It is clear that some behaviour is unacceptable. For instance, in one recent case, the directors of a company set themselves up as another company and solicited the clients of the first in order to prevent profits of their business going to the heirs of a deceased fellow director and shareholder.[44] In that case, the court had no difficulty in finding the directors' behaviour beyond the pale. But, in situations where a conflict is indirect or not clear, or where the director has made a reasonable effort to minimise its effects, courts should turn a mildly indulgent eye to a director who attempts to serve two or more companies provided he or she does so with care and within reasonable limits.

4.47 Submissions to the Committee dismissed the idea of legislating to set arbitrary limits on the number of directorships a person could hold as a means of minimising the risk of conflict.[45] It was suggested that 'self-policed' limits[46] already operated. Some individuals have a greater capacity than others, and directorships of some companies require more time and energy than directorships of others.[47]

4.48 Directors need to understand the ethical considerations involved in multiple directorships and must embrace them. To this end the Committee urges directors' professional associations to educate directors in ethics and to assist them to make decisions responsibly.

4.49 It is not useful for the law to set limits on the number of directorships a person may hold. The wide differences in the capacity of directors and in the work required to direct different companies make it pointless to do so. The law should clearly set down the required standards of conduct, and directors must then judge for themselves whether their commitments allow

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44. *Mordecai v Mordecai (1988) 12 NSWLR 58.*
45. *Eg Evidence, pp 31 (Mr Richardson), 150 Mr Harper).*
46. *Evidence, p 110 (Mr Peters).*
47. *Evidence, p 150 (Mr Harper).*

them to meet the standards. If ethics cannot deliver proper conduct, the law must. It should be enforced to remedy the harmful consequences of people holding too many directorships.

Business opportunities

4.50 It is settled law that a fiduciary may not take for personal gain a benefit which his or her fiduciary office requires be that of the beneficiary.[48] If the fiduciary is retained to do work of a certain kind, he or she must obtain the beneficiary's informed consent before doing the same kind of work for his or her own gain. The fiduciary must 'account' to the beneficiary for profits made in breach of the rule: that is, the fiduciary must deliver the profits to the beneficiary.

4.51 When a director is found to have exploited for personal gain a business opportunity which should have been offered to or pursued on behalf of the company, it is not relevant that the company would not have been able to pursue or secure the opportunity and has therefore not suffered by the director's actions.[49] The director is always under a duty to offer the opportunity to the company even though he or she might be aware that, for example, the company is unable to raise sufficient funds in time to take up the opportunity.

4.52 The law does not insist that every profit-making idea a director has belongs to the corporation. An engineering company might have a remedy if one of its directors won, on his or her own account, a major construction contract, but it would have no cause for complaint if the same director started dealing in fruit and vegetables. The difficulty lies in determining the area

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48. Finn, PD, Fiduciary Obligations, Law Book Co Ltd, Sydney, 1977, pp 231-3. See also Evidence, pp 171-2 (Professor Finn)
49. Furs Ltd v Tomkies (1936) 54 CLR 583, Austin, RP 'Fiduciary Accountability for Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships Law Book Co Ltd, Sydney, 1987, pp 141-85 at 176 and cases there cited.

within which opportunities taken by a director 'belong' to the company.

'Corporate opportunity' doctrine

4.53 United States courts have developed a 'corporate opportunity' doctrine which provides that a 'corporate fiduciary' may not, without consent, exploit for his or her own benefit 'an opportunity which is properly regarded as a corporate opportunity'.[50] The leading formulation is the 'line of business' test which was used in the case of Guth v Loft, Inc:

The real issue is whether the opportunity was so closely associated with the existing business activities of Loft, and so essential thereto, as to bring the transaction within that class of cases where the acquisitions of the property would throw the corporate officer purchasing it into competition with the company ... Where a corporation is engaged in a certain business, and an opportunity is presented to it embracing an activity as to which it has fundamental knowledge, practical experience and ability to pursue, which, logically and naturally, is adaptable to its business having regard for its financial position, and is one that is consonant with its reasonable needs and aspirations for expansion, it may properly be said that the opportunity is in the line of the corporation's business.[51]

4.54 Some courts have modified this rule to take greater account of the intended future activities of the corporation as well as its current activities.[52]

4.55 The American Law Institute, in its work on reform of

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50. *Austin, RP, 'Fiduciary Accountability For Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at 153.*
51. *23 Del Ch 255, 5 A 2d 503 (1939).*
52. *Austin, RP, 'Fiduciary Accountability For Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at 155-6.*

company law, has used this expanded 'line of business' test to define business opportunities which are not to be taken up by a director unless offered to and declined by the company.[53] Professor Austin has suggested that a doctrine along these lines, applying only to company directors and other 'corporate' fiduciaries (such as very senior managers), might be developed by courts in Australia.[54] The Committee endorses this view. It would welcome the development of a 'line of business' test by the Australian courts.

Disclosure and consent

4.56 The object of fiduciary law is not to prohibit certain conduct but rather to compel disclosure by a fiduciary of his or her activities so that a beneficiary can make an informed decision about them. Professor Finn described the problems which arise in relation to disclosure:

to whom do you disclose in a company context and who can give consent? The law here is a real shambles, there is no doubt about that. The basic rule is that you disclose to the company in general meeting, but let us presume that the directors are shareholders. Can they vote as shareholders to ratify or to approve their conflict of interest as directors?[55]

4.57 Although the point has not been covered in any reported case in Australia, English authority suggests that the director

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53. *Principles of Corporate Governance, Tentative Draft No 7 (December 1985), para 5.05; discussed in Austin, RP, 'Fiduciary Accountability for Business opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at pp 156-8.*

54. *Austin, RP, 'Fiduciary Accountability for Business opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at p 161.*

55. *Evidence, p 175 (Professor Finn). See also cases cited in Austin, RP, 'Fiduciary Accountability for Business opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at p 183.*

may vote as a shareholder to approve his or her own actions.[56] The problem may be magnified if several directors, all shareholders, are involved in the activity which requires consent.

4.58 The requirement of disclosure to a general meeting can be displaced by the company's articles of association. Professor Finn has written that this 'invariably' happens.[57] The requirement may be reduced to disclosure to the board,[58] to the chairperson or, presumably, to no disclosure at all.

4.59 It is doubtful whether most investors in shares are aware that the duties of loyalty owed by directors can be reduced in this way. Section 228 of the Companies Code (Corporations Act, s231) requires a director to declare certain conflicting interests to the board, and requires a record to be kept of such disclosures. Professor Finn pointed out to the Committee[59] that the duty under section 228 does not cover all matters which general fiduciary law (if it is not displaced) requires to be disclosed. In some situations, then, the requirements of section 228 do not protect shareholders from a complete, or almost complete, abrogation of fiduciary duties of loyalty by the company's articles.

4.60 It appears to be normal practice, if not a legal necessity, that a director who needs approval for his or her activities does not vote on the issue when the board considers it. Professor Finn discussed the problems that could arise:

assuming that the majority of your directors have an interest in a particular matter, do

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56. *North West Transportation Co Ltd v Beatty (1887) 12 AC 589 at 593, 601; Burland v Earle [1902] AC 83 at 94. See also Prudential Co Ltd v Newman Industries Ltd [1981] Ch 229.*
57. *Finn, P.0, Fiduciary Obligations, Law Book Co Ltd, Sydney, 1977, p 227; and see Queensland Mines Ltd v Hudson (1978) 18 ALR 1 at 9-10, where approval of the board was considered sufficient.*
58. *Evidence, p 175 (Professor Finn).*
59. *Evidence, p 176.*

you end up with a minority being the only disinterested ones who can give the decision; is this desirable?[60]

4.61 It is a questionable process for a minority of directors to approve on behalf of the company activities of the majority that need to be sanctioned.

4.62 it is difficult to formulate a general rule for disclosure and consent to activities which would otherwise be breaches of fiduciary duty. For some questions the involvement of shareholders is clearly warranted, while for others it would render decision making unnecessarily cumbersome. Different consent regimes may be appropriate for the various fiduciary rules.[61]

4.63 For misappropriation of assets, the unanimous consent of the shareholders would appear to be appropriate; breaches of the general 'conflict' and 'profit' rules could be consented to by an ordinary resolution of the shareholders; and questions of consent arising under a 'business opportunity' doctrine (which are essentially questions of business judgment rather than the standards expected of directors) could be decided by the board but probably should be referred to a general meeting if a majority of the directors have a personal interest in the matter. It would appear to be preferable for the affected directors) to be prevented from voting in these decisions.[62]

4.64 Professor Austin takes a pessimistic view of the prospect of achieving a sensible and simple set of rules in this

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60. *Evidence, pp 175-6. See, also, an example cited by Professor Austin where all but one of a company's directors were involved in activities requiring the board's consent: Austin, RP, 'Fiduciary Accountability for Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at p 184, n 34.*

61. *Austin, RP, 'Fiduciary Accountability for Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at p 183.*

62. *Ibid at pp 183-4.*

area by way of judicial decision.[63] He suggests that perhaps the only solution is to amend the companies legislation to impose general rules for exoneration from breaches of directors' duties of all kinds.

4.65 The Committee agrees with Professor Austin and recommends that **the companies legislation be amended to set out requirements which must be met for exoneration of directors from what would otherwise be breaches of their fiduciary duties.**

A continuing duty

4.66 A former director continues to have a fiduciary duty to the company after his or her term of office has expired.[64] Where a business opportunity would otherwise come to a company it is wrong for a director to resign and take it up on his or her own account. Even where a director has resigned there are times where he or she should decline to take up an opportunity because to do so would breach a duty to the company. However, a retired director must at some time be allowed to act as a person no longer responsible to the company.

4.67 The extent to which a director is in breach of a fiduciary duty by reason of acts committed after resignation will depend on the rule being invoked and the specific circumstances of the case.[65] Confidential information may remain confidential for many years, and a former director could still breach his or her duty by misusing it. Conversely, a former director could cease to have a conflict of interest within a short time after he or she ceases to hold office.

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63. *Austin, RP, 'Fiduciary Accountability for Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at p 184-5.*
64. *Evidence, p 180 (Professor Finn).*
65. *See generally Austin, RP, 'Fiduciary Accountability for Business Opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at pp 180-2; Evidence. Pp 180-1 (Professor Finn).*

4.68 The Canadian and English courts have held that a director could be liable to account for the profits of a business opportunity secured after resignation if: (i) the resignation was prompted by a desire to secure the opportunity for personal gain; or (ii) the opportunity arose from his or her position as a director (although probably not if the only connection is knowledge acquired in the course of the directorship which helps to secure the opportunity).[64]

4.69 Australian law already recognises and deals with some of the problems that can arise in these kinds of situations. There would appear to be scope for expansion to meet new situations where former directors take improper advantage of their relationship with a company.

The relationship of the companies legislation to equity

4.70 Professor Finn drew the Committee's attention to a difficult issue arising from the intersection of directors' fiduciary duties and the duties under section 229 of the Companies Code (Corporations Act, s232).[64] In the recent case of Australian Growth Resources Corp Pty Ltd v van Reesema[68] a director had hived off the company's business in a manner not found to be morally wrong or dishonest but held by the Supreme Court of South Australia to be in breach of his fiduciary duty to the company. By breaching his fiduciary duty, the director was also found to have breached section 229(l) of the Code by failing to 'act honestly in the exercise of his powers and the discharge of the duties of his office'. Breach of section 229 can result in criminal penalties (fine or imprisonment) and an order to pay

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66. *Canadian Aero Services Ltd v O'Malley (1.973) 40 DLR (3d) 371 at 381; note also Island Export Financing Ltd v Umunna (unreported, discussed in Austin, RP, 'Fiduciary Accountability for Business opportunities' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 141-85 at p 181).*
67. *Evidence, pp 168-9.*
68. *(1988) 6 ACLC 525.*

compensation to the company under section 229(6)-(7). In this way, breach of fiduciary duty became a criminal act. The South Australian and Western Australian Supreme Courts have also found breaches of section 229 in conduct which prejudices the interests of creditors (see paragraphs 5.52-5.57).

4.71 This amalgam of equity and common law causes some concern. Rules of law come into being as a means of applying particular remedies to particular situations. The equitable remedies available for breaches of fiduciary duty revolve around the avoidance of transactions which are entered into in breach of duty. Their rationale is not punitive. Fiduciary standards of behaviour reflect these remedies: they are quite high. For a breach of such strict standards of behaviour to result in a criminal conviction and an order to pay compensation (which may be greater than any illicit profit the director has made) would appear to be, as Professor Finn put it, 'pretty rugged'.[69] It is a problem which must now be dealt with by the courts. In the Committee's view, criminal liability should only result from behaviour genuinely of a criminal nature (see paragraphs 5.57, 13.13).

Conclusion

4.72 This chapter has emphasised some of the difficult and unclear areas of the law relating to directors' fiduciary duties. Yet, as Professor Finn told the Committee,

much of [fiduciary law] in its day-to-day application is quite uncontroversial.[70]

4.73 In most situations facing a director, the requirements of fiduciary duty will be more or less identical to what the director will feel ought to be done from the point of view of

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69. *Evidence, p 169.*
70. *Evidence, p 176.*

ethics or good practice. Problems arise where the duty goes beyond the director's perception of what ethics require, and the director is unaware (as it appears many people are[71]) of what fiduciary duties entail.

4.74 Another criticism which can be directed at directors' fiduciary duties is that, like the Anglo-Australian corporate form as a whole, they are a creation of nineteenth century English law and cannot cope with the complexities of the modern corporate world. As Sealy put it,

[t]he take-over bid, the shelf company, the multinational conglomerate, the comfort letter, the offshore nominee, and so on did not complicate the picture in Victorian days, nor did the all-pervasive intricacies of modern tax law.[72]

To this list could be added subsidiary companies, joint venture companies, close corporations and trading trusts. These phenomena create difficulties in the application of fiduciary standards.

4.75 The appointment of nominee directors gives rise to further difficulties: a nominee director is formally bound to act in the interests of the company but is expected to promote the interests of the body that appointed him or her to the board.[73]

4.76 While these problems certainly exist, fiduciary concepts of acting in the beneficiary's interests, and of loyalty and good faith, provide 'quite a powerful array' of weapons for keeping

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71. *Evidence, p 176 (Professor Finn).*
72. *Sealy, LS, 'Directors' "Wider" Duties - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR -164-88 at 169.*
73. *The Committee has not examined this matter in detail: see para 1.6.*

directors' conduct within acceptable bounds.[74] It was not suggested to the Committee that an alternative model existed which would do a better job.[75]

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74. *Sealy, Ls, 'Directors' "Wider" Duties - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164-88 at 169.*
75. *In fact, quite the Contrary - see, eg, Evidence, pp 170, 178-9, 180 (Professor Finn).*

CHAPTER 5

DIRECTORS' WIDER DUTIES - CREDITORS

Introduction

5.1 Berle and Means developed the view that company law does not allow (or require) the interests of all the people affected by directors' decisions to be considered. They said that companies were now so massive that they had a great impact on the community generally.[1] Mr Jim Kennan, formerly Attorney-General for Victoria and Chairman of the Ministerial Council for Companies and Securities, told the AULSA Conference in 1987 that there was a need for law makers and others to consider ways in which the law can respond to 'the demands of the modern corporation':[2]

It is simply not acceptable to argue that because our legal culture is not presently constructed to allow for an extension of directors' duties, we must accept the law as it is.[3]

5.2 Mr Kennan pointed out that although the law as it now stands emphasises the duties directors have to the company and shareholders, the courts have held that they have wider duties, for example, to creditors.[4] This extension has given impetus to suggestions that the scope of directors' duties should be widened to include other groups and interests within the community.

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1. *Berle, Adolf A, and Means, Gardiner C,* *__The Modern Corporation and Private Property__* *(revised ed) Harvest, USA, 1968, p 313.*
2. *Kennan, JH, 'Comments on "Directors' Wider Responsibilities Problems Conceptual, Practical and Procedural"', speech given at AULSA Conference, Monash University 25 August 1987.*
3. *Ibid.*
4. *Ibid.*

5.3 Mr Kennan made these comments following a paper given to the AULSA Conference by Dr LS Sealy.[5] Dr Sealy highlighted legal developments which required directors to take the interests of creditors into account in certain circumstances. Dr Sealy also pointed out that if a director was to be required to take into account groups and interests extrinsic to the company and the shareholders, then logically those other groups and interests should be able to ratify directors' acts, just as shareholders are able to do. If this were to occur, courts would have to adopt a wider reviewing role. Possibly they would become more interventionist in their approach because, in essence, they would be required to review directors' business judgment. As discussed in chapter 3, this kind of development would be undesirable. It is the role of directors, not courts, to make business judgments on behalf of companies.

5.4 Examples of persons connected with the company are the company's employees, its creditors and its regular suppliers. The umbrella can be extended even wider to include the local community (especially if a whole town depends for its livelihood or existence on the company's business) and 'global' interests such as the preservation of the environment.

5.5 Several submissions6 argued that these wider interests were effectively protected by directors' duties to act for the benefit of the company. The directors, the argument runs, must safeguard the long term interests of the company. This entails making the company a good employer, maintaining good relations with creditors, avoiding activities which will harm the company's public image and so on.

5.6 Dr Pascoe, for the Business Council of Australia,

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5. 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural ', reproduced in (1987) 13 Mon LR 164.
6. Eg submissions from the Company Directors' Association of Australia, p 7 (Evidence, p 86) Institute of Directors in Australia, p 7 (.Evidence, p 125); Australian Stock Exchange Ltd, p 1.

illustrated this point of view:

The employees of an Organisation are its most vital asset and if you have bad employment practices and so on, no training, no development, it is bad management - putting aside the law. Similarly if you do not give attention to your customers, the consumers, it is bad management the marketplace itself is a good discipline any board that fails to take into account all the constituencies is not carrying out its responsibilities to its shareholders. Secondly, it is just gross bad management.[7]

Dr Pascoe also referred to the importance of a company's 'reputation'.[8]

5.7 Similarly, BHP Limited submitted:

The duty [of directors] towards the company, properly understood, includes consideration by directors of matters such as the interests of employees, consumers and the environment. It does not call for a single-minded pursuit of profits in the short term regardless of consequences.

In practice, the preservation and advancement of the interests of a company calls for consideration to be given to the interests of employees and other groups or social interests.[9]

5.8 Fiduciary law does not exclude outside interests being taken into account, as long as, in doing so, the interests of the beneficiary are also served.10 Regard to the future will often, but not always, promote responsible behaviour. For example, a company's prosperity might not involve it being a good employer

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7. *Evidence, pp 504-5.*
8. *Evidence, p 504.*
9. Submission, paras 12, 13 (Evidence, p 606).
10. *See, eg, Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at p 135.*

if the labour market condition is such that people have little choice but to work for it. A company might have no incentive to avoid polluting the local environment if there is little chance of it being detected or if the cost of rectifying any resulting 'image problems' would be less than the cost of better waste disposal systems.

5.9 Proper protection of interests outside the company would seem to require something more than the directors' duty to act 'in the interests of the company'. One way of doing this would be to extend directors' fiduciary duties, either by judicial development or legislation, specifically to cover certain interests outside the company. However, the Committee did not find wide support for steps such as this in the submissions and evidence it received.

5.10 The Business Council of Australia submitted that the statement of directors' duties in the Companies Code was 'vague but powerful',[11] and that the duties were 'broadly similar to those in comparable overseas countries'.[12] It submitted that '[i]ncreasing legislative controls on directors will lead to lower not higher corporate performance'[13] and that '[t]here is no basis for widening directors' duties'.[14] The Business Council recommended that 'the burdens of liability for directors under the Companies Act and other legislation' be lightened.[15]

5.11 The NCSC submitted that 'existing statute law provides a reasonable basis for ensuring that directors safeguard non-shareholder interests when exercising their duties to shareholders and creditors'[16] and expressed concern that 'any significant increase in scope of the existing legal duties on

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11. *Submission, p 9 (Evidence, p 455).*
12. *Submission, p 15 (Evidence, p 461).*
13. *Submission, p 20 (,evidence, p 466).*
14. *Submission, p 22 (Evidence, p 468).*
15. *Submission, p 30 (Evidence, p 476).*
16. *Submission, p 5 (.evidence, p 564).*

directors of companies may discourage suitably qualified people from taking up positions as directors'.[17] It suggested that education and policy statements be used to promote the 'social responsibilities' of directors.[18]

5.12 The Chairman of the NCSC, Mr Henry Bosch, urged the Committee to reject the argument that directors' responsibilities be extended by legislation requiring them to have regard to customers, creditors, employees and the environmental.[19] He said there is no clear theoretical basis' for specifying how directors should decide between the conflicting interests.[20]

5.13 Mr Bosch did agree, however, that the common law (that is, judge-made law, developed in the course of adjudicating upon a dispute) was developing in that direction.[21] The advantage of leaving such development to the common law, Mr Bosch said, was that a judge was subject to appeal:

[O]ur elected representatives are restricted to doing these things suddenly, by virtue of the passage of a law, which means that they take large steps which need to be thought out with particular care. If a judge makes a mistake, he is subject to appeal and there is the possibility of other subsequent judgments.[22]

5.14 Mayne Nickless Limited did not agree with the view that 'the law which governs the responsibilities of directors is largely outmoded and does not reflect the realities of the modern Australian corporation'.[23] Mr Ian Webber, Managing Director of Mayne Nickless, said that the 'broad general obligation of

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17. *Submission, pp 5-6 (Evidence, pp 564-5).*
18. *Submission, p 6 (Evidence, p 565).*
19. *Evidence, p 572.*
20. *Evidence, pp 572-3, 577.*
21. *Evidence, p 576.*
22. *Evidence, pp 576-7.*
23. *Submission, p 1 (Evidence, p 373).*

directors is a very powerful one'.[24]

5.15 BHP Limited submitted that, in practice,

the preservation and advancement of the interests of a company calls for consideration to be given to the interests of employees and other groups or social interests.[25]

The imposition by legislation of duties towards particular groups or interests, independent of the duty towards the company considered as the members as a whole, would only serve to confuse.[26]

Duties to creditors

5.16 Company law has developed to the point where directors owe a duty to the company's creditors where the company is insolvent or near-insolvent. The rationale for this is that, at times of insolvency or near-insolvency, it is the funds of the creditors, rather than the shareholders, with which the directors are dealing.

5.17 While the creditors of a company are entitled to expect that the company's capital will not be unlawfully reduced so as to jeopardise their chances of repayment, the traditional view is that there is no separate fiduciary duty owed by the directors to them.[27] If the company becomes insolvent the liquidator may be able to sue the directors (in this way providing some return to the creditors) for breaches of their duty to the company, but the creditors cannot sue in their own right and an action on their behalf cannot succeed unless the directors have breached their

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24. *Evidence, p 425.*
25. *Submission, para 13 (Evidence, p 606).*
26. *Submission, para 14 (Evidence, p 606).*
27. *See, eg, Re Horseley & Weight Ltd [1982] Ch 442 at 453-4 per Buckley LJ, Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd and Others (1983] Ch 258 at 288 per Dillon LJ.*

duty to the company.

5.18 This view has been challenged by a series of cases following the decision of the High Court in Walker v Wimborne and Others.[28] It is generally accepted that the catalyst for extending directors' duties to the company's creditors was the High Court's decision in Walker v Wimborne, particularly the judgment of Justice Mason (as he then was).

Walker y Wimborne

5.19 In Walker v Wimborne the company was one of a collection of companies, with common directors, which was administered as a group. Shortly before the company went into liquidation, various sums of money were paid out by the directors of the company to related companies (of which they were also directors), resulting in a benefit to those companies. There was no benefit to the company making the payments except an implied promise by the related companies to repay the money.

5.20 When the company eventually went into liquidation, the liquidator challenged the payments as having been made in breach of duty or breach of trust within the applicable companies legislation. The High Court essentially agreed, finding against the directors in respect of the majority of the payments. The court also found that the policy the directors had adopted governing the movement of funds between the companies in the group ignored the interests of the company and its creditors. In reaching this conclusion, Justice Mason said:

[I]t should be emphasised that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for

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28. *(1976) 137 CLR 1.*

them. The creditor of a company, whether it be a member of a 'group' of companies in the accepted sense of that term or not, must look to the company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent. [29]

5.21 It is arguable that Justice Mason was, consistently with the orthodox view, referring simply to the directors' duty to keep creditors 'on side' as part of their duty to the company, [30] but several recent cases have developed and refined the proposition in Walker v Wimborne. They have taken these passages as a basis for suggesting that directors in some circumstances owe an independent fiduciary duty to creditors (see below)[31] A similar trend has occurred in English law.[32]

Ring v Sutton

5.22 The rights of creditors were considered by the Supreme Court of New South Wales in the case of Ring v Sutton.[33] In that case the liquidator of a company brought proceedings against a director in relation to loans he had arranged for himself from the company. The loans were at a significantly lower level of interest than the prevailing commercial rate. The Supreme Court found that this amounted to a breach of duty on the part of the director and ordered that the director repay the sum borrowed plus interest calculated at the market rate.

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29. *(1976) 137 CLR .1 at 7.*
30. *This is Heydon's view: see Heydon, JD, 'Directors' Duties and the Company's Interests', in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at pp 124, 134.*
31. *Eg Ring v Sutton (1980) 5 ACLR 546, Kinsela v Russell Kinsela Pty Ltd (in liq) (1986) 4 NSWLR 722; Nicholson v Permakraft (NZ) Ltd [1985] 1 NZLR 242.*
32. *Eg Re Horsley & Weight Ltd [1982] Ch 442 at 455-6 per Cumming-Bruce and Templemann LJJ. (Contra: Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd and Others [1983] Ch 258 at 288 per Dillon LJ.)*
33. *(1980) 5 ACLR 546.*

5.23 The decision in Walker v Wimborne was cited with approval in Ring v Sutton. It was explicitly recognised that the liquidator had a right to challenge the terms of the loans 'in the interests of the creditors [of the company]'.[34]

Nicholson v Permakraft

5.24 The rationale for the doctrine of creditors' rights was discussed by the New Zealand Court of Appeal in Nicholson v Permakraft (NZ) Ltd.[35] This case, once again, involved a company in financial difficulties. Briefly, the company, in the face of the difficulties, was restructured in such a way as to show a capital profit in its favour. The profit was then distributed to the shareholders as a capital dividend. It was accepted that the directors and shareholders were all actively involved in, and in agreement with, the restructuring.

5.25 The company subsequently encountered further difficulties and, eventually, went into receivership. Although the company's secured and preferential creditors were virtually paid in full, there were no funds to meet the company's liability to its unsecured creditors. In an attempt to remedy this deficiency, the company's liquidator attempted to recover the money which had been distributed to shareholders as a result of the restructuring. The court rejected the liquidator's argument, finding that the whole process was within the power of the directors who were found to have acted honestly.

5.26 Despite this finding, Justice Cooke went on to make statements about the directors' obligations to the company's creditors. He said:

The duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider inter

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34. *(1980) 5 ACLR 546 at 547.*
35. *(1985) 1 NZLR 242.*

alia the interests of creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.

... as a matter of business ethics it is appropriate for directors to consider also whether what they do will prejudice their company's practical ability to discharge promptly debts owed to current and likely continuing trade creditors.

To translate this into a legal obligation accords with the now pervasive concepts of duty to a neighbour. and the linking of power with obligation ... In a situation of marginal commercial solvency such creditors may fairly be seen as beneficially interested in the company or contingently so.[36]

The other judges did not disagree with Justice Cooke but did not find it necessary to discuss this point.

5.27 Justice Cooke linked the 'extended' duty to creditors to the privilege of limited liability:

The recognition of duties to creditors, restricted as already outlined, is justified by the concept that limited liability is a privilege. It is a privilege healthy as tending to the expansion of opportunities and commerce; but it is open to abuse.
Irresponsible structural engineering involving the creating, dissolving or transforming of incorporated companies to the prejudice of creditors - is a mischief to which the courts should be alive.[37]

5.28 Justice Cooke limited the protection of the extended duty to existing and 'likely continuing' creditors of the company (including suppliers who had established trading relationships with the company and continued to extend credit to it). He said

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36. *[1985] 1 NZLR 242 at 249.*
37. *Ibid at 250.*

that it would be 'difficult' to make out a case for 'future new creditors':

Those minded to commence trading with and give credit to a limited liability company must normally take the company as it is when they elect to do business with it. Short of fraud they must be the guardians of their own interests.[38]

Kingela v Russell Kinsela Pty Ltd

5.29 Kinsela and Another v Russell Kinsela Pty Ltd (in liq),[39] a decision of the Court of Appeal of New South Wales, endorsed Justice Cooke's approach in Nicholson v Permakraft. In Kinsela v Russell Kinsela, a company in a precarious financial position entered into a lease arrangement (including an option to purchase) with two of the directors in their individual capacity. The prices of the lease and the purchase option, which related to the company's business premises, were significantly less than the commercial rate. The purpose of the transaction was 'to put a valuable asset of the company out of the reach of creditors'.[40]

5.30 Shortly after the lease was executed, the company went into liquidation. The liquidator of the company sought to avoid the lease and recover the property.

5.31 The Court of Appeal upheld the liquidator's claim. Relying on both Walker v Wimborne and Nicholson v Permakraft, (then) Chief Justice Street, with whom the remainder of the court agreed, recognised

[t]he obligation by directors to consider, in appropriate circumstances, the interests of creditors.[41]

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38. [1985] 1 NZLR 242 at 250.
39. (1986) 4 NSWLR 722.
40. Corkery, JF, Directors’ Powers and Duties, Longman Cheshire Pty Ltd, Melbourne, 1987, p 69.
41. (1986) 4 NSWLR 722 at 732.

5.32 Chief Justice Street went on to say that

> the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors.[42]

5.33 Chief Justice Street said it was difficult to formulate any general test as to the degree of financial instability necessary to impose an obligation on the directors to consider the creditors' interests. He observed that the degree of instability and the degree of risk to creditors were 'inter-related'.[43] Relying on Nicholson v Permakraft, he indicated that the existence of the obligation in an insolvency situation was clear,

> in as much as it is the creditors' money which is at risk, in contrast proprietary interests.[44]

The effect of the cases

5.34 Corkery has concluded that the cases discussed above 'firmly establish the principle that the directors of insolvent companies must act in the interests of creditors'.[43] However, he is unsure what the obligation of directors of solvent companies is.[46] He refers to Justice Cooke's suggestion in Nicholson v Permakraft that there may be a direct duty owed by directors to creditors. This would not be a duty imposed by company law but would be a duty of care similar to the 'neighbour principle' in the law of torts.[47]

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42. *(1986) 4 NSWLR 722 at 732.*
43. *Ibid at 733.*
44. *Ibid.*
45. *Corkery, JF, Directors' Powers and Duties, Longman Cheshire Pty Ltd, Melbourne, 1987, p 69.*
46. *Ibid.*
47. *[1985] 1 NZLR 242 at 249.*

5.35 The existence of a positive duty owed by directors to creditors has been recently recognised by the House of Lords. In Winkworth v Edward Baron Development Co, Lord Templeman said:

[A] company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.[48]

5.36 The Winkworth formula is not confined to insolvency, although this extension has been rejected in at least one Australian case.[49] The Winkworth duty also seems to be less demanding than the one imposed by Australian and New Zealand courts.

5.37 In making a decision where the company is insolvent or nearly so, directors are dealing with the assets of people who have given credit to the company. The creditors' interests are already in the directors' hands and, according to Justice Cooke in the Permakraft case, the directors must protect them. On the other hand, in making their decision the directors cannot be expected to look after anyone who might later choose to extend credit to the company:

There is no good reason for cultivating a paternal concern to protect business people perfectly able to look after themselves.[50]

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48. *(1987) 1 All ER 114 at 118.*
49. *Grove v Flavel (1986) 4 ACLC 654.*
50. *Nicholson v Permakraft NZ Ltd [1985] 1 NZLR 242 at 250.*

5.38 Against this view, Sealy[51] points out that in many situations the 'existing creditors' at the time the directors make their decision will eventually be paid. By the time the company goes into liquidation there may well be a new set of creditors, and it will be these creditors who will need to seek a remedy against the directors. Business people rarely have access to current information about the financial affairs of companies with whom they are dealing, and therefore may not be able to look after their own interests in the way Justice Cooke has suggested. A decision which prejudices existing creditors' chances of being paid also prejudices the interests of future creditors, since if the former are ever paid it will probably be at the expense of the company's ability to pay the latter.[52]

5.39 In most situations, a breach of a director's duty to the company can be forgiven, or approved in advance, by the shareholders in general meeting (see paragraphs 4.21, 4.22). However, there are several statements to the effect that a breach of the duty to have regard to creditors' interests cannot be forgiven by the shareholders.[53] As Chief Justice Street said in the Kinsela case, the creditors become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets that are

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51. *Sealy, LS, 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 177, 185.*
52. *Note also Jeffree v National Companies and Securities Commission (1989) 15 ACLR 217, where the Supreme Court of Western Australia held that a director had a duty to protect the interests of a person who, by virtue of a pending arbitration, was likely to become a creditor of the company in the near future. This probably represents an extension of the duty from the position in the Permakraft case.*
53. *Re Horsley & Weight Ltd [1982] Ch 442 at 455-6 per Cumming-Bruce and Templemann LJJ, Nicholson v Permakraft (NZ) Ltd [1985] 1 NZLR 242 at 250 per Cooke J; Rolled Steel Products (Holdings) Ltd v British Steel Corporation and Others [1985] 3 All ER 52 at 86 per Slade LJ.*

under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.[54]

Where the interests at risk are those of the creditors, the Chief Justice saw 'no reason in law or in logic to recognise that the shareholders can authorise the breach'.[55] The creditors have thus "replaced' the shareholders and the directors' duty can be seen as owed to creditors.

Should creditors be able to sue?

5.40 Although the cases have stopped short of describing the duty as one owed to creditors (rather than a duty owed to the company to have regard to the interests of creditors), the duty can in a sense be seen in this light. A logical consequence is that creditors themselves should be able to bring actions against the directors for its breach, but the decided cases are silent on this point and commentators differ.[56] Nevertheless it seems that the existing framework of company law does not allow creditors to seek a direct remedy against directors.[57] Creditors will only look to directors personally when the company cannot pay. In these situations, insolvency law will apply. This means that, in the majority of cases, a liquidator will act on behalf of creditors.

5.41 In the cases discussed above the action has been brought

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54. *(1986) 4 NSWLR 722 at 730. See also Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at pp 129-30.*
55. *(1986) 4 NSWLR 722 at 732.*
56. *See Corkery, JF, Directors' Powers and Duties Longman Cheshire Pty Ltd, Melbourne, 1987, p 69, Heydon, JD, Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 a pp 131-3.*
57. *See Sealy, LS, 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 177, 184. See also Goldberg, AH, 'Who'd be a company director?', address given to Second Business Lawyers' Conference, presented by Business Law Section of the Law Council of Australia, Melbourne, 10 April 1989.*

by a liquidator in the name of the company. This is the usual situation. It ensures that the proceeds, if any, of the action against the directors will be shared by all unsecured creditors (or at least those with respect to whom there has been a breach of duty) rather than accruing only to a creditor with sufficient resources to bring an action.

Statutory provisions

5.42 Mr Alan Goldberg QC has said

the controversy surrounding the issue whether directors have a duty outside the Companies Code to creditors will remain substantially academic because of the specific standing provisions found in sections 556 and 557.[58]

5.43 Section 556(l) of the Companies Code (Corporations Act, s592(l)) makes directors and others involved in the management of a company personally liable for debts incurred when there are no reasonable grounds to expect that they will be paid. Section 556(3) (Corporations Act, s592(2)) provides for proceedings to be brought to recover such debts.[59]

5.44 Section 557(l) (Corporations Act, s593(l)) only gives a remedy to a person to whom a debt is incurred. It gives no rights to pre-existing creditors whose chances of repayment might be prejudiced by the transaction, or to any creditors whose interests are prejudiced by a corporate restructuring. Its scope is therefore in important respects narrower than the duty to creditors developed in the case law.
5.45 In its recent report, General Insolvency Inquiry, the

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58. *Goldberg, AH, 'Who'd be a company director?', address given to Second Business Lawyers' Conference, presented by Business Law Section of the Law Council Of Australia, Melbourne, 10 April 1989.*

59. *See, eg, Watt v 3M Australia Ltd [1984] 3 NSWLR 671; 3M Australia v Kemish (1986) 4 ACLC 185; Metal Manufacturers Pty Ltd v Lewis (1988) 13 NSWLR 315.*

(Australian) Law Reform Commission criticised the operation of section 556 because, inter alia, it:

- gives any benefit of the civil liability to the creditor taking action and thus is only of advantage to a creditor with the resources to take such action

- fails to provide a liquidator with standing to bring an action for the benefit of all creditors

requires a multiplicity of actions if all creditors who have been affected by the behaviour of the directors are to be compensated, with the possible result that the first creditors to take action may exhaust the assets of errant directors.[60]

5.46 Accordingly, the Law Reform Commission recommended the abandonment of the existing s556 and the enactment of a totally restructured provision which is clear, rational and readily enforceable in a manner which permits all creditors to share equally in the sums recovered.[61]

5.47 The Law Reform Commission suggested that this would promote the principle of 'equal sharing in an insolvency'.[62] The Committee endorses this recommendation. The Committee recommends that **the companies legislation be amended to permit all creditors to share equally in sums recovered from directors**.

5.48 Section 229(6) of the Companies Code (Corporations Act,

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60. *The Law Reform Commission, Report No 45, General Insolvency Inquiry, AGPS, Canberra, 1988, vol 1, p 125.*
61. *Ibid. See also Sealy, LS, 'Directors "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 185.*
62. *The Law Reform Commission, Report No 45, General Insolvency Inquiry, AGPS, Canberra, 1988, vol 1, p 125.*

s232(7)) may afford similar opportunities.[63] Under section 229(6), if a person has been convicted of an offence against section 229, and the company has suffered loss or damage as a result, the court can order the convicted person to pay compensation to the company, in addition to any fine or other penalty imposed.

5.49 A recent case illustrates the use of these provisions. In R v Oades,[64] the liquidator of a company, on behalf of the creditors, sought compensation from a former director of the company pursuant to section 229(6). The director had previously been found guilty of acting 'dishonestly' for the purposes of section 229(l), with intent to defraud creditors of the company. He was sentenced to a four and a half year prison term as a result.

5.50 The liquidator's application was successful and the director was ordered to pay almost $6.1 million to two of the company's creditors. The liquidator indicated afterwards that this was the first such order under section 229(6). He also said he found section 229(6) was an easier section under which to obtain compensation than section 556, which liquidators had previously used against directors.[65]

5.51 Creditors would also appear to have standing to seek an injunction or damages against a director under section 574 of the Code (Corporations Act, s1324). This provisions seems to have been virtually unused. (See the discussion of section 574 at paragraphs 11.33, 11.34.)

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63. *See Lampe, A, 'Former director must pay liquidators $6m, judge finds', The Sydney Morning Herald, 20 May 1989, p 39.*
64. *NSW District Court, Sydney, 17 March 1989, per Madgwick DCJ (unreported).*
65. *See Lampe, A, 'Former director must pay Liquidators $6m, judge finds', The Sydney Morning Herald, 20 May 1989, p 39.*

Intersection of fiduciary and statutory duties

5.52 Grove v Flavel,[66] a decision of the Supreme Court of South Australia, involved a company with liquidity problems, one of whose directors arranged a complex series of payments between the company, himself, and several other companies of which he was also a director. The payments did not change the company's overall financial state but had the effect of giving the director and his other companies an advantage over other creditors when the company went into liquidation.

5.53 The court rejected the argument that there was a general duty owed by directors to protect creditors' interests irrespective of the company's financial situation.[67] However, it held that a director who acts to the detriment of creditors, knowing 'that the company faces a risk of liquidation ... which is a real and not a remote risk', is acting 'improperly'.[68]

5.54 The interesting feature of Grove v Flavel is that, unlike the other cases discussed in this chapter, the action was not brought by a liquidator in the name of the company under general fiduciary law. The action was a criminal prosecution brought by the South Australian Corporate Affairs Commissioner. The director was charged with making 'improper use of information' under the equivalent of section 229(3) of the Code (Corporations Act, s232(5)). His failure to protect the interests of creditors in a situation of likely insolvency was what made his use of information about the risk of insolvency 'improper'.

5.55 A similar approach was taken in the recent decision of the Supreme Court of Western Australia, Jeffree v National Companies and Securities Commission.[69] A director was charged under section 229(4) (Corporations Act, s232(6)) with making

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66. *(1986) 4 ACLC 654.*
67. *Ibid at 652.*
68. *Ibid at 662-3.*
69. *(1989) 15 ACLR 217.*

'improper use of his position' as a director. He transferred the company's assets and business to a new corporate structure to put them beyond the reach of a prospective creditor. The court held that the director owed fiduciary duties to present and future creditors of the company.[70] It followed Grove v Flavel in holding that the test of 'improper' conduct depended on the duties of the person whose conduct was in question.[71] Thus breach of the duty t creditors resulted in liability under section 229(4).

5.56 In the absence of statutory definition, terms like 'improper' must be construed by the courts. It is open to them to apply high standards and insist on a standard of conduct in line with the reasonable expectations of modern business. Courts have tended not to impose such high standards on directors in the past.

5.57 However, the Committee recommends that **criminal liability under companies legislation not apply in the absence of criminality**. It considers that, where appropriate, civil penalties should be introduced into company law to cover those cases where it is important to sanction misconduct of directors where the conduct falls short of a criminal offence.

Conclusion

5.58 Despite the existence of statutory provisions covering much of the same ground, the fiduciary duty created by case law continues to attract litigation. This is because it is broader and more flexible than the duties set out in the companies legislation, both in scope and in the remedies for its breach. With a basis in concepts drawn from trust law, fiduciary duties set high standards of probity which would be difficult to set out in a statute.

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70. *(1989) 15 ACLR 217 at 221-2 per Wallace J; at 227 per Brinsden J; Pidgeon J agreed.*
71. *Ibid at 227 per Brinsden J. Wallace J did not refer to Grove v Flavel but took a similar approach (at 221-2); Pidgeon J agreed.*

5.59 Perhaps more importantly, equitable remedies are potentially much more powerful than those available under the companies legislation. Under the Code or the Corporations Act, the following remedies are available to a creditor:

* criminal liability of the director for breach of sections 229 (Act, s232) (see paragraphs 3.18, 5.52-5.57), 556(l) (Act, s592(l)) (see paragraphs 5.42, 5.43, 5.45, 5.46) or 556(5) (Act, s592(6));

* personal liability of the director for debts to the creditor incurred by the company, under section 556(l) (Act, s592(l)) (see paragraph 5.43); and

* an injunction under section 574 (Act, s1324) to prevent conduct which would amount to a breach of the Code, or to enforce conduct required by the Code. Under section 574(8) (Act, sl324(10)) the court may order the director to pay damages as well as, or instead of, issuing an injunction. (See the general discussion of section 574 at paragraphs 11.33, 11.34.)

5.60 Criminal sanctions against a director do not help a creditor recover his or her money. A restraining injunction is useful only if granted before the wrong conduct takes place. Most creditors (and for that matter most shareholders) do not have sufficient knowledge of what the directors are doing to take action in time. An order making a director personally liable to repay a debt or to pay damages is of limited value if the director has few or no assets.

5.61 The equitable remedies available for breaches of fiduciary duty, on the other hand, can enable the successful

plaintiff to recover specific assets or interests in property.[72] Equitable remedies can also reach an asset which is in the hands of a third party who has not paid for it or who knew of the breach of duty, or profits made by a third party who knowingly assisted the breach of duty. For example, if a director, faced with the imminent liquidation of the company, sold the company's assets at a 'bargain basement' price to a friend who knew what was going on, a court could use the mechanism of a constructuve trust to make the friend transfer the assets to the liquidator.[73]

5.62 For these reasons, equitable remedies will often be more attractive to a creditor than proceedings under the companies legislation. This will be so particularly if the director personally has little in the way of assets.

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72. Eg, -in the Kinsela case (discussed above at paras 5.29-5.33), a lease of the company's business premises which had been granted in breach of duty to two of the directors was held to be voidable. In this way, the liquidator was able to sell the premises unencumbered by the lease.
73. See, eg, Austin, RP, 'Constructive Trusts' in Finn, PD (ed), Essays in Equity, Law Book Co Ltd, Sydney, 1985, pp 196-242.

CHAPTER 6

DIRECTORS' WIDER DUTIES - OTHER 'OUTSIDE' INTERESTS

6.1 Both judges and legislators have placed duties on directors, either directly or through laws governing corporations. Where the law specifies what conditions corporations must provide for employees, what safety measures they must take, how they are to treat the environment, within what areas they are to build their factories, directors must accommodate it because they have a duty to act in their companies' interests. They are the mind and will of the company. They must not allow the company to come into conflict with the law. In some instances, legislatures have chosen to make directors themselves subject to penalty for acts of a corporation: for example, section 53 of the Environmentally Hazardous Chemicals Act 1985 (NSW) makes a director personally liable for contraventions by the company, and section 252(l)(j) of the Income Tax Assessment Act 1936 makes a director liable for breaches of that Act in certain circumstances.

6.2 The courts have been mostly concerned with proprietary rights. Company case law provides a slender basis for extending directors' duties to anyone other than the company and those who have proprietary interests in it: the shareholders and, in certain circumstances, creditors.

6.3 The courts have associated directors' duties with the 'interests of the company'. This does not mean that directors must not consider other interests. The 'interests of the company' include the continuing well-being of the company. Directors may not act for motives foreign to the company's interests, but

the law permits many interests and purposes to be advantaged by company directors, as long as

there is a purpose of gaining in that way a
benefit to the company[1]

Employees

6.4 In his 1987 AULSA speech, Mr Kennan referred to the interests of employees. He put employees on the same footing as creditors: 'at the very least the interests of employees and the interests of the company's creditors must be taken into account'.[2]

6.5 The courts have, to date, rejected suggestions that company directors owe the same kind of duty to employees as they owe to shareholders. The English case of Parke v Daily News Ltd[3] concerned 2700 employees of a business who lost their jobs when the employer-companies were sold. The directors planned to distribute proceeds of the sale to the dismissed employees by way of compensation and other benefits. A shareholder alleged that it was not in the power of the company to make such payments and that they would be illegal. An injunction was granted to stop the payments.

6.6 In the course of the judgment, Justice Plowman said:

The view that directors, in having regard to the question what is in the best interests of their company, are entitled to take into account the interests of the employees, irrespective of any consequential benefit to the company, is one which may be widely held. But no authority to support that proposition as a proposition of law was cited to me; I know of none, and in my judgment such is not the law.[4]

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1. *Heydon, JD, 'Directors' Duties and the company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, law Book Co Ltd, Sydney, 1987, pp 120-36 at p 135.*
2. *'Comments on "Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural'", speech given by the Hon Jim Kennan, MLC at AULSA conference, Monash University, 25 August 1987.*
3. [19*62 1 Ch 927.*
4. *Ibid at 962-3.*

6.7 Professor Baxt has made the point that developments in industrial law - for example, workers' compensation, occupational health and safety and anti-discrimination employment practices - make it almost 'farcical' to retain the narrow approach exemplified by Justice Plowman in Parke v Daily News Ltd.[5]

Gratuitous benefits

6.8 In the context of acting in 'the interests of the company' there are situations where gratuitous benefits to employees or contractors, or general charitable gifts, may not amount to a breach of directors' fiduciary duty to the company.

If conferring such a benefit is part of a generally accepted method of doing business, or if the benefit is conferred for the purpose of gaining some benefit for the company, it may be lawful. Examples of lawful gratuitous benefits are those paid to employees for the purpose of improving the company's relations with them and gifts to educational institutions for the training of people with skills needed by the company.[6]

6.9 The capacities in which 'charity may sit at the board,[7] in this way are limited. For example, gratuities to employees are not justified in law where the company's business is being brought to an end or sold off, as occurred in Parke v Daily News (the rationale being that there is little prospect that such action would bring a future benefit to the company).[8]

6.10 American courts have allowed directors to make charitable gifts where the only benefit to the company is a potential strengthening of faith in the 'free enterprise system'

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5. *Submission, para 43 (Evidence, p 205).*
6. *For these examples and more see Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, law Book Co Ltd, Sydney, 1987, pp 120-36 at pp 135-6.*
7. *Hutton v West Cork Railway Co (1883) 23 Ch D 654 at 673.*
8. *Ibid; Parke v Daily News Ltd [1962] 1 Ch 927.*

amongst people who might not be happy with it,[9] but English and Australian courts are yet to approve actions with such a tenuous link to the company's interests.[10] Furthering the interests of the company in a fairly direct way must be the intent behind the directors' actions. Directors' fiduciary duties to the company as currently understood and applied will therefore often prevent directors making decisions on the basis of social responsibility.

The English situation

6.11 When considering the duties of directors it is often useful to compare company law in England with that in Australia. This is less so where employees are concerned than in other matters. Tribunals make laws which set wages and conditions in Australia but not in England. In the United Kingdom, agreements between employers and employees play a much larger part in settling wages and conditions. Because the corporations which they control are bound by comprehensive awards and determinations, Australian company directors are compelled by law, extrinsic to company law, to take into account a wide range of worker entitlements.

6.12 In 1980, the UK Companies Act was amended to require directors to take employees' interests into account in certain circumstances. Section 309(l) of the Companies Act 1985 provides:

The matters to which the directors of a company are to have to regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.

6.13 The duty is expressed as being owed to the company:

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9. *Wedderburn, KW (Lord), 'The Social Responsibility of companies' (1985) 15 MULR 4 at 17 and cases cited at n 86.*
10. *Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at p 136.*

the duty imposed by section [309] on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.[11]

It appears that only the company can enforce the duty. This limits the benefits employees would derive were they able to enforce it.

6.14 In a winding up situation, there might be no such thing as the 'interests of the company'. Section 719 of the UK Companies Act overcomes this. It enables a company to provide for its employees if the company's business is wound up.

6.15 It has been suggested that the English provisions are largely ineffective.[12] The duty is owed to the company, and situations in which the company will enforce it on behalf of the employees may well be limited. It is unclear whether to enforce the duty an employee/shareholder would have to launch a derivative action, and whether a breach of the duty could be ratified by the shareholders. An unenforceable duty is of questionable value.

6.16 Sealy argues that section 309 'is either one of the most incompetent or one of the most cynical pieces of drafting on record'.[13] This is because there is no room within the established framework of company law for employees to seek a direct remedy against directors, and because it is difficult to envisage a suitable kind of relief that the court might make available to employees.

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11. <u>Companies Act</u> *1985 (UK), s3O9(2).*
12. *See, eg, Birds, J, 'Making Directors Do Their Duties' (1980) 1 co Lawyer 67 at 73, and other articles cited in the submission room Professor Baxt, attachment 9 (Evidence, pp 333-4)*
13. *Sealy, LS, 'Directors' "Wider' Responsibilities - Problems Conceptual, Practical and Procedural ' (1987) 13 Mon LR 164 at 177.*

6.17 Nevertheless section 309 has been recognised as a first step.[14] Gower commented that it would be 'anachronistic' to regard the company as consisting solely of its shareholders and to ignore the employees.[15]

6.18 The Australian Companies Code already recognises certain interests of employees - for example, sections 441, 443, 445 and 446 (Corporations Act, ss556, 558, 560, 561) make provision for the payment of debts due to employees in a winding up. Employees' interests generally are not beyond the scope of a director's consideration to the extent that they coincide with the 'interests of the company'. As a matter of practice, directors do concern themselves with such matters.[16] Employees have been described as a company's 'most vital asset'.[17]

6.19 It is difficult to reconcile the narrow approach company law has traditionally taken with contemporary reality. Mr Keith Byles, in a submission entitled 'Company Law and the Corporate "Good Employer": Limitations, Opportunities and Reform', urged that the law should

set out a robust declaration that being a ‘good employer’ is not contrary to the interests of a company.[18]

6.20 Mr Byles argued that the law should not compel directors to take into account the interests of employees. He merely urged that it be made clear within the parameters of company law that taking employees' interests into account was not contrary to 'the

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14. Eg MacKenzie, AL, 'The Employee and the Company Director’ (1982) 132 NLJ 688.
15. Gower, LCB, Final Report of the Commission of Enquiry into the Working and Administration of the Present Company law of Ghana, Appendix I, Draft Companies Bill, 146 - cited in submission from Professor Baxt, attachment 0 (Evidence, p 335).
16. Eg, see Evidence, pp 504 (Dr Pascoe) 574 (Mr Bosch).
17. Evidence, p 504 (Dr Pascoe)
18. Submission, p 14.

interests of the company'.[19]

6.21 Company directors must ensure their companies comply with the law, including the law relating to employees. Beyond that, they should be permitted by legislation to take the interests of the company's employees into account on the basis that there is a special relationship between employer and employee requiring goodwill between the two. In any event, fair treatment by the company of its employees will probably make it a more successful company.

6.22 it may be said that 'extending' the ambit of a director's proper concerns in this way would weaken the director's duty to shareholder s because, when challenged by shareholders, he or she could argue that his or her decision, although disadvantageous to them, had taken into account the interests of the employees and therefore was not assailable. This would appear to be of little practical consequence. Most directors would instinctively look to the interests of shareholders, and shareholders' and employees' interests are not always mutually exclusive. In any event, evidence before the Committee suggests that employees' interests are already taken into account in practice. Permitting directors to do so by law would bring company law into line with a sensible practice.

6.23 The advantage of making it clear that the interests of a company's employees are a legitimate matter for directors to take into account is that it would make it clear that the approach of Justice Plowman in Parke v Daily News Ltd[20] (see paragraphs 6.5, 6-6) was no longer part of company law. In this way, company law would be brought into step with prevailing community values. Even though such a provision might not set out a formula by which directors could resolve any conflicts that might arise between

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19. *Submission, p 14.*
20. *[1962] 1 Ch 927.*

the interests of shareholder and employees,[21] this is a task directors must perform on the basis of their own judgment, as they would resolve any other conflicts between competing considerations.

6.24 The Committee recommends that the **companies legislation be amended to make it clear that the interests of a company's employees may be taken into account by directors in administering the company**.

Environmental issues

6.25 As the law stands, to the extent that a concern for the environment is consistent with 'the interests of the company', it may be taken into account. Mr Kennan suggested that the environmental impact of decisions should be taken into account by company directors. He suggested, however, that such matters might be 'more effectively addressed' in specific environmental legislation.[22]

6.26 In March 1989, the New South Wales Government announced it was considering a proposal to hold directors and senior staff of companies personally liable for the dumping of toxic waste by those companies.[23] The New South Wales Minister for the Environment, the Hon Tim Moore MLA, referred to cases where large quantities of toxic waste had been dumped into Sydney sewers. Mr Moore said that the existing penalties, of between $5000 and $40 000, were 'a Joke'.[24]

6.27 Mr Moore referred to cases where tanker drivers were

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21. *The UK provision also does not resolve this conflict: submission from Mr Byles, p 12.*
22. *'Comments on "Directors' wider Responsibilities - Problems Conceptual, Practical and Procedural", speech given by the Hon Jim Kennan, MLC, at AULSA conference, Monash University, 25 August 1987.*
23. *See Garcia, LM, 'Bosses Face $1m fines and jail for dumping', The Sydney Morning Herald, 11 March 1989, p 4.*
24. *Ibid.*

dumping waste on the express instructions of their employers. He went on to say:

We have a situation now where company directors cannot be touched while the working tanker drivers can be fined thousands of dollars.[25]

6.28 To combat this, Mr Moore proposed to increase the applicable penalties to fines on directors of up to $1 million or seven years gaol.

6.29 Similarly, in May 1989, the South Australian Attorney-General, the Hon Chris Sumner MLC, warned that the South Australian Government was considering holding directors of companies personally liable for environmental damage caused by their companies. Noting similar provisions in the United States, Mr Sumner suggested that further legislation could be expected to increase the obligations on directors. He said:

In order to ensure the deterrents have the maximum effect the environmental legislation may well make directors and company officers liable for a breach.[26]

6.30 Dr Pascoe, speaking on behalf of the Business Council of Australia, told the Committee he had 'no problem' with company directors and senior staff being held directly responsible for the actions of company employees in dumping polluting substances

when it can be demonstrated to the satisfaction of a court, with proper evidence and so on, that this was being done at the express direction of the directors of the company.[27]

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25. *See Garcia, LM, 'Bosses face $1m fines and jail for dumping'* The Sydney Morning Herald*, 11 March 1189, p4.*
26. *Speech to Company Directors' Association of Australia, see submission from Mr Sumner, p 3.*
27. *Evidence, p 493 (Dr Pascoe, Senator Collins).*

6.31 Mayne Nickless Limited considered the 'traditional' duties owed by directors to the company were sufficient to cover wider responsibility, for example, for the environment.[28] Mr Webber, Managing Director of Mayne Nickless Limited, said:

[A]n EPA [Environment Protection Act] violation would reflect badly on the company in the public arena. It would have heavy costs, not only in the fines but in the correction of deficiencies in equipment and so forth, all of which ultimately come back to the fiduciary performance of the company. In other words, if a director is aware of those matters and is not urging action within the company, he is already guilty of not acting in accordance with his obligation. It is not as though that [ie. the environmental legislation] is the only body of legislation against which companies are going to be tried and found wanting.[29]

6.32 The Managing Director of BHP, Mr Brian Loton, told the Committee:

BHP cautions against moves to address, through the medium of directors' duties, wider questions concerning the role and responsibilities of corporate enterprises in the community. In BHP's view, the reformulation of directors' duties in terms of regard to interests other than those of the shareholders would at best achieve no more than is open to directors at present, and at worst would serve to confuse. As a practical matter directors in fulfilling their duties need to have regard to employees, customers and other groups or social interests.[30]

6.33 The environment is important and the community is highly conscious of that fact. Where necessary, measures should be taken to safeguard it. These should be provided in legislation specific

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28. *Evidence, pp 432-3 (Senator Cooney, Mr Webber).*
29. *Evidence, p 432 (Mr Webber).*
30. *Evidence, p 614.*

to the environment. It is its protection that is important, not whether the harm was perpetrated by a company, a partnership or an individual. It is a matter for environmental and not company law to restrain each and all who go beyond reasonable treatment of the environment.

Consumers

6.34 The development of company law to the point where directors are required, in certain circumstances, to take into account the interests of creditors, and the Committee's recommendation that company law be amended to make it clear that the interests of employees are not contrary to the interests of the company, may be explained on the basis of the special relationships between the company and creditors and between the company and its employees. The question then arises whether the consumers of a company's goods and services have such a relationship with the company that the law should make special provision for them.

6.35 Mr Kennan put forward the argument that 'the interests of consumers of the company's products and services' should be taken into account. He acknowledged that this matter may be more effectively addressed in specific consumer legislation.[31] Nevertheless, Mr Kennan said there was 'no harm' in including this matter in any checklist of interests that directors should take into account in their decision making.

6.36 On the one hand, in the market place a consumer can take his or her custom elsewhere, unless a monopoly situation prevails. It will be in the best interests of the company providing goods and services to be seen as a reliable and competitive supplier.

6.37 On the other hand, a consumer cannot be expected to have

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31. *See, eg, Pt V of the Trade Practices Act.*

special knowledge, sufficient to fully inform his or her choice, in relation to every item of consumption. The consumer therefore is entitled to protection, particularly as the consequences of a shoddy or unsafe product or service may be serious.

6.38 The Ford Pinto case in the United States illustrates the serious consequences that can flow from the purchase of a product with alleged safety defects. In that case, three people who had been travelling in a Pinto, a car manufactured by the Ford company, died in a road accident. Serious questions about aspects of the design of the Pinto had arisen prior to the collision and there was widely held concern that the company had sacrificed safety standards in pursuit of profits.[32]

6.39 In the Ford Pinto case, it is possible that even the most thorough and determined researcher would have been unable to bring to light accurate information regarding safety tests of the product. The case illustrates the monopoly that a producer of goods may have over information that might otherwise inform a consumer's choice.

6.40 The traditional role of the company director in furthering the company's interests will ensure that directors do not neglect the interests of consumers in circumstances where serving these interests will bring a benefit to the company. In the interests of the company's reputation, which may be vital to its success, directors will take these interests into account as a matter of practice. Beyond this, it is the role of specialised consumer protection legislation, extraneous to company law and applying irrespective of the form of the producer or supplier, to protect the consumer and to provide remedies when standards are not met.

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32. *See, generally, Cullen, Frances T, Maakestad, William J and Cavander, G, Corporate Crime Under Attack: The Ford Pinto Case and Beyond, Anderson, Cincinatti, 1987.*

Reconciling different duties

6.41 Directors' fiduciary duties might be enlisted in the service of corporate social responsibility by judicial development of the law this has occurred with creditors' interests (see chapter 5) or by the legislature prescribing various duties and declaring them to be fiduciary (thus signalling to the courts the standards of behaviour which should be applied). An example of the latter course is section 309 of the UK Companies Act (see paragraphs 6.12, 6.13).

6.42 Whichever course were to be taken, directors' duties could be 'widened' within the ambit of company law in at least three ways:

(a) Directors could be required to have regard to the interests of certain non-shareholders, but the duty to do so would be owed to the company. This would mean that only the company could sue for breach of the duty. This is the method used by section 309 of the UK Companies Act (see paragraphs 6.12, 6.13).

(b) Directors could be permitted to consider the interests of certain non-shareholders when making decisions. This would amount to a relaxation of the fairly strict rules as to when directors may confer benefits on non-shareholders. It would accord with what (according to some commentators33) directors do in practice and would have a similar effect to widening the notion of 'the company' to encompass what Sealy has called the "corporate enterprise'.34

(c) Directors could be made subject to a duty owed directly

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33. *Sealy, LS, 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 174.*
34. *Ibid.*

to certain non-shareholders said to have an interest in the outcome of the directors' actions. The person suffering harm could sue for breach of the duty.

6.43 The inadequacies of the method outlined in paragraph 6.42(a), are discussed at paragraphs 6.15, 6.16. Conceptual difficulties also arise with the other two methods.

6.44 If directors were permitted to take 'outside' interests

into account (as in paragraph 6.42(b)), and failed to do so, they would be in breach of no duty because the provision was permissive rather than mandatory, and there would therefore be no remedy against them. Meanwhile, shareholders' ability to bring directors to account for failing to act in the interests of the company would be weakened by the directors' legal licence to have regard to the interests of outsiders. These problems would only arise in the event that the interests were in conflict.

6.45 Duties owed to non-shareholders (as in paragraph 6.42(c)) would also create problems. In the case of creditors, if (as has occurred) the duty is confined to periods of insolvency or near-insolvency, it is possible to identify a reasonably coherent set of 'beneficiaries' with similar interests. The same cannot be said where other non-shareholders are made the beneficiaries of the duty. If that were to occur, the people to whom the duties were owed could have diverse and often directly opposed interests. A director cannot meaningfully act 'in the interests' of such a group. All that can be asked is that he or she act 'fairly' as between the various elements.

6.46 To impose a duty to act fairly between entities as diverse as creditors, employees, consumers, the environment, is to impose a broad and potentially complex range of obligations on directors. Such a duty could be vague. Directors are already required to act fairly between competing groups of shareholders, but, in that situation, shareholdings provide a set of similar,

or at least comparable, rights from which criteria for fairness can be developed (for example, that directors may not act with the aim of altering the balance of those rights). This is not the case where-the competing interests are of completely different kinds. With no firm standard by which to judge directors' actions the law 'abandons all effective control over the decision maker'.[35]

6.47 Without a legally-ordered set of priorities between the various groups, it would be difficult for any claim by one group to be upheld, as the directors' action could probably be characterised as being in the interest of some other group or groups. The question of who could enforce the various duties in the courts would also be difficult.

Conclusion

6.48 Mayne Nickless suggested that '[once] you start identifying special interest groups you are creating a conflict in the obligation of directors'.[36]

6.49 Widening directors' fiduciary duties to protect non-shareholders other than creditors could place the directors beyond the effective control of shareholders without significantly enhancing the rights of non-shareholders. It is Sealy's assessment that

company law (at least as it stands, but probably in any form it could potentially take) must acknowledge that it has no mechanism to ensure the fulfilment of obligations of social responsibility.[37]

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35. *Sealy, Ls, 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 175.*
36. *Evidence, p 432 (Mr Webber).*
37. *Sealy, LS, 'Directors' 'Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 176.*

6.50 Mr Kennan echoed Sealy's concerns but called for creative law reform:

It is simply not acceptable to argue that because our legal culture is not presently constructed to allow for an extension of directors' duties, we must accept the law as it is.

(These issues] are not issues which we can allow ourselves to dismiss because they do not fit neatly into accepted ways of thinking about legal problems. The challenges these issues offer us must ... be taken if our laws are to remain responsive to and reflect modern Australian society.

6.51 It is the shareholders' investment that creates the company. Directors' fiduciary duties are premised on this fact and are designed to protect that investment. If company law were to impose new and, at times, contradictory duties (such as looking after interests which may be directly opposed to those of the corporators), directors' fiduciary duties could be weakened, perhaps to the point where they would be essentially meaningless. In general, requirements aimed at securing responsible corporate behaviour are therefore best provided in other than company law.

6.52 The Company Directors' Association told the Committee that

[t]he specific legislation - not the Companies Act law - should have the power to address [the] problem.[38]

6.53 Professor Baxt expressed a similar opinion. He acknowledged that environmental protection was a serious issue, but told the Committee that it should be dealt with as a discrete

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38. *Evidence, p 104 (Mr Peters).*

issue, 'not through the Companies Act'.[39]

6.54 Mr Bosch, chairman of the NCSC, foresaw 'practical difficulties'[40] with imposing further specific duties on directors, but suggested that society had done 'a fairly reasonable job' in legislating generally in relation to consumer protection and employment.[41]

6.55 It is appropriate that matters external to the company be dealt with in separate and specific legislation, as has been suggested recently in New South Wales and South Australia. This is because companies legislation should deal only with corporate structure and Organisation and matters arising as and between the constituents of the corporate body. Whether directors should be personally liable under such legislation for the acts of their companies is another issue which is dealt with elsewhere (see chapter 12).

6.56 The Committee recommends that **matters such as the interests of consumers, or environmental protection, be dealt with not in companies legislation but in legislation aimed specifically at those matters.**

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39. *Evidence, p 358.*
40. *Evidence, p 596.*
41. *Evidence, p 596.*

CHAPTER 7

INTERNAL CONTROLS

The board of directors

7.1 The members in general meeting and the board of directors are the two main components in the structure of a company. The distribution of power between the two is governed by legislation and by the company's articles of association. Usually, the general meeting is given specific powers and the board of directors the residual ones.

7.2 The board is made up of the directors of the company. Under the Companies Code, a public company must have at least three directors and a proprietary company must have at least two.[1] A 1988 survey showed that the average size board among Australia's public listed companies was 9.3. The average board size for proprietary companies was 7.5 (see table 1, page 117).

7.3 Articles of association usually distribute power so that the board of directors rather than the general meeting controls the company. The articles usually confer wide management powers and the powers are conferred on the directors collectively, not individually. The general meeting has the power to appoint and dismiss the board, but in reality this power is limited (see paragraphs 7.38, 7.39). For the most part, the management of the company is firmly in the hands of the board and shareholders must be content to be passive owners.

What is a director?

7.4 The Macquarie Dictionary defines a director as

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1. *Companies Code, s219(1) (Corporations Act, s221(l)).*

one of a body of persons chosen to control or govern the affairs of a company or corporation.

7.5 'Director' is defined in section 5 of the Companies Code as including:

a) any person occupying or acting in the position of director of (a) corporation, by whatever name called and whether or not validly appointed or duly authorised to act in the position; and

b) any person in accordance with whose directions or instructions the directors of [a] corporation are accustomed to act.

7.6 In the Corporations Act 1989,

a reference to a director, in relation to a body corporate, includes a reference to:

(a) a person occupying or acting in the position of director of the body, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position;

(b) a person in accordance with whose directions or instructions the directors of the body are accustomed to act;

(c) in the case of a body corporate incorporated outside Australia:

(i) a member of the body's board;

(ii) a person occupying or acting in the position of member of the body's board, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position; and

(iii) a person in accordance with whose directions or instructions the members of the body's board are accustomed to act; and

(d) in the case of a close corporation - a member of the close corporations

7.7 Professional advisers are specifically excluded from the

definition in the Corporations Act:

A person shall not be regarded as a person in accordance with whose directions or instructions:

(a) a body corporate's directors; or

(b) the members of the board of a body corporate incorporated outside Australia;

are accustomed to act merely because the directors or members act on advice given by the person in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors 3 or the members of the board, or with the body.

7.8 Clearly, the definition is expansive. McMahon suggests that the purpose of such a wide definition is 'obvious':

It is to include within the ambit of the responsibilities that a Director must bear all those persons who really are the heart and soul of the company, by whatever name they may be called.[4]

7.9 In its submission to the Committee, the NCSC suggested that

[r]ecognition has been given in recent years to the considerable power which executive officers can exercise in the management of companies vis-a-vis that of directors.[5]

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2. *Corporations Act 1989, s60(1).*
3. *Ibid, s60(2).*
4. *McMahon, BJ, The Australia Company Director, 1972, Rydge Publications, Sydney, 1972, p9.*
5. *Submission from NCSC, p 3 (Evidence, p 562).*

7.10 The NCSC suggested that the trend toward more powerful executive officers had increased in recent years

> as directors, particularly of large corporations, have become more concerned with broadbrush issues and executives are employed for their expertise in particular areas of management.[6]

7.11 The NCSC said that this situation raises the question whether the legal responsibilities of executive officers are (and, if not, whether they ought to be) commensurate with the fact that the real power to manage the company rests with them.[7] The NCSC referred to the Companies Code's imposition on secretaries and executive officers of the same duties of honesty, care and diligence as it imposes on directors. Similarly, secretaries and executive officers are subject to the same penalties as directors for making improper use of information. (See paragraph 3.16.)

7.12 The NCSC referred the Committee to section 556 of the Companies Code (Corporations Act, s592), which provides for civil and criminal penalties in relation to the incurring of debts or fraudulent conduct.[8] The section explicitly applies to directors and any persons 'who took part in the management of the company'.

7.13 The Institute of Directors was less impressed by the expansive nature of the Companies Code definition and the obligations imposed. It submitted to the Committee:

> While recognising the extraordinary difficulty posed in defining a director we believe that it has become totally inequitable to use the word director without some form of clearer differentiation of [the] position from an

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6. *Submission from NCSC, p 3 (Evidence, p 562).*
7. *Submission from NCSC, p 3 (Evidence, p 562).*
8. *Submission from NCSC, p 3 (Evidence, p 562).*

officer in a company.[9]

7.14 The Institute suggested that the current use of the word in the Companies Code was a drafting convenience

as it relieves the draftsman of thinking about the objectives of the law being drafted.[10]

7.15 The Institute submitted that the enactment of the close corporations legislation would assist.[11] However, it was the Institute's view that

further differentiation needs to be made depending upon the exact nature of the relationship between the directors and the shareholders/proprietor.[12]

7.16 As the NCSC pointed out (see paragraphs 7.9, 7.10), in recent years there has been a trend towards non-director officers becoming increasingly powerful within companies. This is understandable, given the preponderance of non-executive directors in Australia's boardrooms.[13] The expansive definition of 'director' in the companies legislation takes account of this trend and it is appropriate that it does so.

Representative directors

7.17 Directors might be appointed to a board to represent the interests of a particular group - for example, an institutional

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9. *Submission from Institute of Directors in Australia, p 2 (Evidence,p 120).*
10. *Submission from Institute of Directors in Australia, p 2 (Evidence,p 120).*
11. *Submission from Institute of Directors in Australia, p 2 (Evidence,p 120).*
12. *Submission from Institute of Directors in Australia, p 2 (Evidence,p 120).*
13. *Australia's board 'mix' - public companies: Korn Ferry, AGSW survey cited by Kohler, A, Chanticleer' Australian Financial Review, 5 May 1989, p88.*

shareholder, a major creditor of the company, or the company's employees - or to act in accordance with some understanding or arrangement with a person or persons other than the company as a whole. Generally such directors are referred to as 'nominee' directors. The Companies Code recognises nominee directors.[14] Because of their commitment to other interests, there is a risk that nominee directors will be unable to fulfil the usual requirements of a director to act in the best interests of the company as a whole.[15]

Executive vs non-executive directors

7.18 Company directors fall into two basic categories. Executive directors are full-time employees of the company and have a contract of employment with it independent of their position as a director. Non-executive directors are 'outside' directors. They are generally appointed because they bring particular skills to the board and can approach decision making from an independent perspective. Mr Brian Loton, the Managing Director of BHP, suggested that one reason for the appointment of non-executive directors is

to bring to bear a broader perspective, more background, a wider range of skills on a particular issue or indeed on the management of the company.[16]

7.19 Often the company secretary, accountant, solicitor, marketing or personnel manager will, because of his or her working knowledge of the company, be appointed as a director.

7.20 The Institute of Chartered Accountants suggested that

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14. *See S225(l) (Corporations Act, s227(2)).*
15. *see companies and securities Law Review committee, Nominee Directors and Alternate Directors, Reports No 8, 2 March 1989, for a full discussion of these issues.*
16. *Evidence, p 618.*

a board in toto should ideally represent a balance of qualifications and experience. Maybe if you look at the board as a whole, you can see that one person is less qualified formally than another but would make up for that in experience or by some other contribution.[17]

7.21 Non-executive directors are quite common in public companies and relatively rare in small, family-centred, proprietary companies.[18] The absence of non-executive directors in proprietary companies is because those companies are generally based on small enterprises such as a family business. The directors are usually family members. There is little need or scope for the involvement of persons not directly involved in the business.

The composition of the board

7.22 In Australia, the average board has three executive and six non-executive directors (see table 1, page 117). Compared to the United Kingdom, where the ratio is five executive to three non-executive directors, and the United States, where the ratio is 4:10, the mix in Australia has been described as 'about right'.[19]

7.23 Mr John Richardson, of Peat Marwick Hungerfords, told the Committee that

[i]n the public company context, I must admit that I would prefer there to be always a majority of non-executive directors at the board level because the board, to my mind, should be setting overall policy and philosophy, and should be questioning and considering what the entity has done, and

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17. *Evidence, p 55 (Mr Prosser).*
18. *Corkery, JF, Directors' Powers and Duties, Longman Cheshire Pty, Melbourne, 1987, p 3.*
19. *Kohler, A, 'Chanticleer', Australian Financial Review, 5 May 1989, p 88, quoting Mr Guy Pease, former chairman of Korn Ferry International.*

therefore being a sounding-board.[20]

7.24 The need for non-executive directors is increased with the introduction of audit committees. The Institute of Directors told the Committee:

Most commentators who refer to audit committees insist that audit committees must be predominantly made up of non-executive directors ... those who promote audit committees should also be strongly promoting an increase in the use of non-executive directors in all companies because only in that way will you be able to have a sufficient body of directors to be able to conduct audit committees properly. A company which has all executive directors a priori, cannot have an effective audit committee.[21]

The Institute advocated the use of non-executive directors.[22]

7.25 Mayne Nickless Limited said that both the UK Institute of Directors and the London Stock Exchange had endorsed the need to appoint more non-executive directors to the boards of British companies.[23] The Committee notes that, in the United Kingdom, boards tend to be weighted 3:5 against non-executive directors.[24]

7.26 Neither the UK Institute of Directors nor the London Stock Exchange suggest that boards should have a majority of non-executive directors.[25]

7.27 It can be argued that executive directors are the best guarantee of commercial success because they are wholly committed, full-time managers with a significant personal stake

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20. *Evidence, pp -7 7-18.*
21. *Evidence, p 149 (Mr Bartels).*
22. *Evidence, p 149 (Mr Bartels).*
23. *Submission from Mayne Nickless Ltd, p 2 (Evidence, p 374)*
24. *Kohler, A, 'Chanticleer', Australian Financial Review, 5 May 1989, p88 (citing a Korn Ferry, AGSM survey).*
25. *Submission from Mayne Nickless Ltd, p 2 (Evidence, p 374).*

in the success of the company. It can also be argued that the non-executive director, who brings an outside perspective to bear on the company's affairs and whose outlook is not overborne by current projects and problems, is the key to success.

7.28 The optimal number of independent, or non-executive, directors is a matter for each company. It would be incongruous to fix a specific mix of executive and non-executive directors for all boards. Various companies need various blends of talent, skill and personalities. The Committee considers that both executive and non-executive directors should be on the boards of public companies, in proportions best suited to each company.

Charitable and other non-profit companies

7.29 Section 66 of the Companies Code (Corporations Act, s383) provides for the registration of charitable and other non-profit organisations as companies, without the inclusion of 'limited' in their company name eg the National Safety Council of Australia (Victorian Branch). This means that the company is given all the benefits of limited liability without having to reflect this in the company name. It is entitled to certain prescribed exemptions from various lodgement and notification requirements which would otherwise be required pursuant to the Companies Code.[26] The directors of such companies are otherwise subject to the same duties and obligations as company directors generally.

Directors vs auditors

7.30 The Institute of Chartered Accountants contrasted the role of directors with the role of auditors. The Institute told the Committee that while a company's auditors, liquidators or receivers had to be qualified and registered, there were no such requirements for the people responsible for running the company

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26. *Companies Code, s66(5) (Corporations Act, s383(5)).*

in the first place.[27] They noted that in cases of corporate collapse there was an increasing tendency for the media to blame the companies' auditors rather than the directors.[28]

7.31 The media perception is partially attributable to what the Institute called the 'audit expectation gap':

the perception of what an auditor does, versus the reality of what an auditor does.[29]

7.32 Mr Peter Middleton, the National President of the Institute of Chartered Accountants in Australia, told the Committee that the public assumed an auditor had checked every transaction when, in fact, the auditor has only used 'certain tests' and 'certain judgment'.[30] The auditor is not able to adjudge the business decisions taken by management.[31] He or she is simply required to certify that the balance sheet and accounts present a true and fair view of the company's financial activities.

7.33 The question of insurance was raised. Section 237 of the Companies Code (Corporations Act, s241) explicitly prohibits companies from insuring or indemnifying its 'officers' (including directors) or auditors against liability for negligence, default, breach of duty or breach of trust. Auditors independently carry professional indemnity insurance. However, the Institute told the Committee that auditors of companies were

simply unable to obtain insurance cover to the level of their potential exposure.[32]

7.34 The Institute said the difference between the auditor's

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27. *Evidence, p 54 (Mr Middleton).*
28. *Evidence, pp 67-8 (Mr Middleton).*
29. *Evidence, p 69 (Mr Middleton).*
30. *Evidence, p 70 (Mr Middleton).*
31. *Evidence, p 69 (Mr Middleton).*
32. *Evidence, p 64 (Mr Middleton).*

insurance cover and the extent of potential liability was open-ended'.[33] Given a public perception that the auditor's insurance cover is able to meet any potential liability, the Institute conveyed to the Committee a fear of the 'deep pocket syndrome'. This involved aggrieved people deciding to 'go the auditors', on the basis that the auditors were assumed to be more than adequately covered by insurance. Quite apart from the gap between the actual and perceived levels of cover, this would have the effect of deflecting blame from the directors of a company to the auditors. The Institute found this 'extremely worrying'.[34]

7.35 The responsibility to see that a company is honestly, competently and profitably run is first and foremost that of its directors. That must be made clear to all. Auditors have a heavy responsibility to monitor the company's accounts properly.

However, they should not be made scapegoats for the failure of directors to perform their tasks adequately. The law should reflect the community's growing expectation that directors be active, skilful and honest in their administration of the corporate sector. The Committee's recommendation that an objective duty of care be developed for company directors (see paragraph 3.28) will provide for this.

The division of power between directors and shareholders

7.36 Much of the attention given to the role of directors since the stock market collapse of October 1987 has focused on their treatment of investors. In theory, at least, directors administer a company on behalf of its shareholders. The dedication of some to that task has been questioned. The media have given extensive coverage to instances where investors' funds have been lost through ill-management in the corporate sector.

7.37 Shareholders depend on the board of directors for the

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33. *Evidence, p 64 (Mr Middleton)*.
34. *Evidence, p 67 (Mr Middleton)*.

success of their investment. Their ability to influence the board depends upon their relationship with it. This is based on the company's articles of association.[35]

7.38 Although it is possible for a company's articles of association to give expansive powers to the general meeting, for example, by giving it the right to declare dividends, to choose officers and to fix their salaries, and place strict limits on the powers of the board, this is rare. Commonly articles provide that the general meeting can periodically vote to determine the composition of the board but give it little power beyond that. Since the number of votes a person can cast depends on the number of shares the person has, those holding large numbers of shares decide who become directors. It is in those sitting as the board that the usual articles of association place the power to administer the company.[36] Shareholders may be in a position to refuse to re-elect directors of whose actions they disapprove,[37] but usually they will be able to do little. Shareholders as such are divorced from the company's management.

7.39 Legislation has sought to give shareholders a measure of control over their companies. Section 225 of the Companies Code (Corporations Act, s227) empowers a general meeting to remove a director of a public company during the period of his or her office. It is open to a private company to provide for a similar power in its articles.[38] Those who have substantial shareholdings benefit most from this kind of provision which has its own flaws:

It is a double-edged sword which may facilitate the tyranny of the majority over

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35. *Section 76, Companies Code, provides that a company may alter ox, add to its articles by special resolution (Corporations Act, s.176).*
36. *See, eg, Companies Code, Schedule 3, Table A, cl 66 (Corporations Act, Schedule 1, Table A, cl 66).*
37. *see <u>John Shaw & Sons (Salford) Ltd v Shaw</u> [1935] 2 KB 113 at 134 per Greer LJ.*
38. *See, for example, Companies Code, Schedule 3, Table A, cl 62(l) (Corporations Act, Schedule 1, Table A, cl 62(l)).*

minority and special interest groups.[39]

7.40 Even when there is a 'catch-all' provision such as reg 66 (see paragraph 7.38), there are some circumstances where the general meeting may be empowered to act in relation to matters generally within the control of the board. If there is a deadlock on the board or the board lacks a quorum, the general meeting may exercise management powers by ordinary resolution.[40] Similarly, the general meeting may be able to ratify directors' acts which are in abuse or excess of power (see paragraphs 11.48, 11-49), the shareholders may be able to bring an action (see chapter 11), and the 'informal corporate acts' doctrine gives shareholders a degree of control which is particularly relevant to small companies. This doctrine provides that a company is bound, in a matter that is within its power, by the unanimous agreement of its members, whether or not the agreement is given formally or informally.[41]

7.41 Efforts to give shareholders a greater say have had limited success. Following an inquiry into large quoted companies, one commentator painted a forlorn picture of shareholder inactivity. He found that

a self-appointing oligarchy of directors has little difficulty in using the proxy voting device as a rubber stamp for its decisions. relatively few shareholders (generally less than 16 per cent) who have the right to vote make use of the proxy system, even when prepaid cards are supplied, and the proportion of voters opposing any resolution in normal circumstances is very small indeed. A mere quarter of one per cent, on average, of shareholders attended annual general meetings, which averaged less than half an hour in length; and at such meetings it was unusual

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39. *Afterman, Allen B, Company Directors and Controllers, Law Book Co Ltd, Sydney, 1970, p 20.*
40. *Eg Barrow v Potter [1914] 1 Ch 895] Foster v Foster [1916] 1 Ch 532.*
41. *Salomon v Salomon & Co Ltd [1897] AC 22 at 57 per Lord Davey.*

for more than five questions to be asked and not uncommon for there to be no questions at all. The elaborate form of safeguard protection provided by statute - for example, the requisition of a meeting [Companies Code, s 241; Corporations Act, s246] - is also rarely used, and the chances of success for a dissentient shareholder who is prepared to incur the expense would appear to be remote.[42]

7.42 Midgley calls this the 'procedural facade of company control' rather than lack of responsibility in the shareholders. He says 'shareholders are realistic rather than irresponsible about formal company control procedures'.[43]

Shareholders and renounceable rights issues

7.43 Directors should administer companies in the interests of all shareholders. In reality, the present corporate culture militates against small shareholders. One illustration of how this might occur was given to the Committee by Mr Kingsley Allen in Melbourne. He spoke about shareholders and renounceable rights issues at prices that involve the rights selling for a significant value.[44]

7.44 Mr Allen described a situation where shareholders in a company are offered rights to take up a number of new shares in the company, calculated by reference to the number of shares already held by each shareholder. The right to take up the shares often has to be exercised within stringent time limits. The limits do not allow for 'mail delays, holidays, illnesses, deceased estates'.[45] The rights can be traded but this involves stockbroking charges which can be prohibitive in relation to

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42. *Midgley, Kenneth, 'To Whom Should the Board be Accountable and for What?' in Midgley, Kenneth (ed), Management Accountability ad Corporate Governance, MacMillan, London, 1982, pp 61-77 at p 64.*
43. *Ibid.*
44. *Submissions and evidence (Evidence, pp 514-58).*
45. *Supplementary submission, p 3 (Evidence, p 524).*

small parcels of shares.[46] This system works against the small shareholder and in favour of the large one.

7.45 Mr Allen pointed out that not all companies acted in this way when making renounceable rights issues,[47] but when they did, small shareholders could lose the value of the rights because they would be unable to take them up or to trade them.[48] The main argument advanced by companies for acting in this way was that underwriting fees were reduced and the majority of shareholders thereby benefited.[49]

7.46 The Committee was told that Stock Exchange listing rules obliged companies to appoint a nominee to protect certain overseas shareholders.[50] Mr Allen said that 'the appointment of a trustee, nominee or even the underwriter itself' could protect Australian shareholders who fail to accept or sell their entitlements.[51] Otherwise a small minority of shareholders could be disadvantaged to enable savings in underwriting fees that should properly be borne by all shareholders.

7.47 The Committee drew the matter to the attention of the NCSC by letter. The NCSC replied to the Committee indicating that it had undertaken a preliminary study of the problems identified. In view of the complexity of the problem, the NCSC suggested that further consultation with companies and the participants in the securities industry was necessary before any firm proposal could be drawn up.[52]

7.48 The Committee recommends that **the NCSC and the ASC**

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46. *Supplementary submission from Mr Allen, p 3 (Evidence, p 524).*
47. *Evidence, p 551.*
48. *Supplementary submission, p 2 (Evidence, p 523).*
49. *Supplementary submission from Mr Allen, pp 5-6 (Evidence, p 527-8).*
50. *Evidence, p 550-1 (Mr Allen).*
51. *Evidence, p 557.*
52. *Supplementary submission from NCSC, p 2.*

proceed immediately to consult as necessary, In particular with shareholders' groups and others involved in the securities industry, in order to develop a proposal to eliminate the unfair practices relating to small shareholders in renounceable rights issues.

TABLE 1

AVERAGE SIZE AND COMPOSISTION OF BOARDS, 1988

By type of company

Directors	Public Listed	Public Unlisted	Stat Auth	Private*	Overall
Executive	2.9	2.9	1.5	3.1	2.7
Non-Exec	6.4	6.0	6.6	4.4	5.9
Total	9.3	8.9	8.1	7.5	8.6

By size (turnover)

Directors	>$500m	$101-500m	$51-100m	<$50m
Executive	2.3	3.1	3.0	2.6
Non-Exec	7.3	5.9	4.6	3.8
Total	9.6	9.0	7.6	6.4*

* In 1981 the ratio was 5-2 in favour of executive directors.

Supplied by Guy Pease of Pro-NED from Australian Board Study (formerly known as Korn Ferry Board Study).

CHAPTER 8

AUDIT COMITTEES

8.1 One way in which a board of directors can better focus on particular issues is to set up committees of the board to examine them and report back. A committee charged with a specific responsibility can more efficiently deal with an issue than a meeting of the whole board. For example, the board of Mayne Nickless Limited has a superannuation committee, a remuneration committee and a committee responsible for donations, sponsorships and community activities.[1]

8.2 One major task suitable for committee work is the scrutiny of financial matters. Committees constituted for this role are commonly called audit committees.

8.3 Audit committees, like other committees of the board, allow directors to examine particular issues in greater detail than would be possible for the whole board. They are a way of bringing to the board's attention and, possibly, shareholders' attention, details of matters which should be considered by them.[2]

8.4 In 1979, Mr Spender QC wrote that audit committees were 'little heard of in Australia'.[3] The Committee is unable to judge the extent to which audit committees are used by corporate boards in Australia today, although it appears to be less than in the United States and Canada. Mayne Nickless told the Committee that

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1. *Evidence, p 442 (Mr Webber).*
2. *Evidence, pp 148-9 (Mr Harper).*
3. *Corporate Affairs Commission (NSW), Final Report into the Affairs of Gollin Holdings Ld and Gollin Nominees Ltd, Parliamentary Papers (NSW) 1978-79, vol 2, p 1231 (Gollin Report) at p 1255.*

'many companies' now use audit committees.[4]

8.5 The Committee was told that the New York Stock Exchange (which 'essentially sets the rules for the United States listing of companies') requires companies it lists to have audit committees.[5] It was suggested this requirement was introduced to strengthen the role of auditors in a situation where, unlike Australia, companies report financial information pursuant to accepted standards rather than statutory requirements.[6] In Canada, public companies are required by statute to have audit committees.[7]

8.6 There are proposals in the United Kingdom (where, until recently, approximately only 36% of directors were non-executive directors) to require companies with a majority of executive directors to appoint audit committees with at least a majority of non-executive directors.[8]

8.7 An audit committee is normally a standing committee of the board. It usually consists of, or has a majority of, non-executive directors - that is, people not involved in the day-to-day management of the company - and in its deliberations meets with the company's auditors and financial managers. The basic responsibilities of an audit committee might include:

* reviewing financial information to ensure that it is accurate and timely and includes all appropriate disclosures;

* ensuring that effective accounting and financial controls exist and are operating effectively;

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4. *Supplementary submission from Mayne Nickless Ltd, p 3 (Evidence, p 411). Also see Evidence, pp 148 (Mr Harper), 440 (Mr Webber).*
5. *Evidence, p 12 (Mr Richardson); see also submission from Peat Marwick Hungerfords, p 3 (Evidence, p 5), Gollin Report, p 1256.*
6. *Evidence, p .12 (Mr Richardson).*
7. *Canada Business Corporations Act 1975, s 165.*
8. *Submission from the NCSC, p 4 (Evidence, p 563).*

* overseeing the audit of the company (both external and internal, if there is an internal audit programme), including nominating the auditors, approving the scope of the audit and examining the results;

* providing links between the auditors and the board; and

* helping to ensure that decisions are made at appropriate levels in the company.[9]

8.8 An example of an audit committee was provided by BHP:

BHP's Audit Committee is constituted by 4 non-executive directors. The Committee meets as required, usually 6 times a year in advance of scheduled meetings of the Board. The Committee reviews in detail accounting and audit matters which are to go before the Board. It settles the form of a Directors' Questionnaire to Management which is issued each year to managers throughout the Company and it reviews the responses. The questionnaire is directed to facts and issues forming the basis of the annual accounts. The Committee reviews the annual accounts, it periodically reviews the work of the Internal Audit Group and it deals with questions relating to the external auditors. An important feature of the Committee's role is that it has direct access to senior financial executives, the internal auditor and the external auditors. The Executive General Manager Finance (an executive director) and the General Manager Accounting attend the Committee's meetings by invitation, as does the Internal Auditor when required, and other senior executives attend from time to time for items relevant to their responsibilities. The Committee is able to question relevant company executives in detail. The external auditors attend meetings when the annual accounts are being considered and when otherwise appropriate. The non-executive members are able to discuss issues with the auditors, both internal and external, in the absence of the

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9. *These Points are drawn from the submission from Peat Marwick Hungerfords, p 3 (Evidence, p 5), and from the* *Gollin Report**, P1256.*

executive officers.[10]

8.9 It is important to remember that matters examined by an audit committee remain the responsibility of the whole board.[11] However, as BHP pointed out, an audit committee is able to provide the Board with greater assurance about the effectiveness and integrity of accounting systems and performance within the Company.[12]

8.10 Several advantages have been identified as flowing from the use of audit committees.[13]

* The quality of accounting and financial control clearly can be improved.

* The integrity and credibility of financial reports, and thus public confidence in the company, can be enhanced.

* Directors' awareness of their legal responsibilities is increased, and the committee can assist directors in meeting those responsibilities.

* The role of non-executive directors is strengthened by having access to information other than through auditors and financial managers. They no longer have to rely on senior management for this informational.[14]

The position of the auditors is strengthened because better

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10. *Submission, para 27 (Evidence, pp 610-11).*
11. *See, eg, Evidence, p 149 (Mr Harper).*
12. *Submission, para 28 (Evidence, p 611).*
13. *These Points are drawn mainly from submissions by Peat Marwick Hungerfords, p 3 (Evidence, p 5) and Australian Shareholders' Association Ltd, p 41 the Gollin Report, p 1256; and Priddice, JA and Seaman, RF, Corporate Audit Committees; A guide for Directors, CCH Australia Ltd, Sydney, 1981, p 2.*
14. *See eg, Evidence, p 440 (Mr Webber).*

communication between the auditors and the directors is facilitated. (It was suggested to the Committee that auditors' independence is in many cases 'a myth',[15] as the auditors will often belong to a firm which relies on the company for work. If the auditors are able to bring matters which worry them to the attention of the board through an audit committee comprised of non-executive directors, a measure of independence may be restored.)

* The accountability of executives to boards is strengthened.

8.11 Audit committees are not necessarily a panacea for all problems relating to financial scrutiny. An audit committee does not relieve directors of the responsibility of satisfying themselves that the company's accounts are in order. Its effectiveness may be limited by practical factors. The functions an audit committee can perform will depend on the skills of its members and the amount of time they are able to devote to it. In a large corporation with a complex financial structure, thorough scrutiny of the accounts can become an onerous task for a group of non-executive directors whose commitment to the company is a part-time one. Directors will often lack the skills of auditors. They may not be able to ask the appropriate questions in many instances. The audit committee must therefore rely on the company's internal and external auditors to bring problems to its attention.[9]

8.12 An audit committee might even cause problems. Where its functions are ill-defined, it can encroach on areas which are the proper province of management. This may impair efficiency. If the purposes of the audit committee are not properly explained, managers may gain the impression that its existence is a reflection on their competence or integrity.[17]

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15. *Evidence, pp 360-361 (Professor Baxt).*
16. *Evidence, p 149-50 (Mr Head, Mr Harper).*
17. *Gollin Report, p 1257.*

8.13 The NCSC said the need for audit committees in-Australia is 'less compelling' than elsewhere, 'as over 70% of Australian directors are non-executive directors'.[18]

8.14 The Committee considers that the potential drawbacks of audit committees are outweighed by their advantages. Most members of the Committee also see some advantages in legislatively prescribed standards for the establishment and operation of audit committees. Some writers have argued that an audit committee's field of inquiry should be limited to that determined by the board, and that its establishment should be encouraged rather than enforced.[19] The Committee considers that the community will benefit most where corporate audit committees are required to be established by listed companies and if their operations are reasonably uniform.

8.15 The Committee therefore recommends that:

(i) the establishment of an audit committee be made a requirement for public listing of a company;

(ii) the chairperson and a majority, or all, of the members of the audit committee be non-executive directors;

(iii) the audit committee be required to meet regularly and report to the board;

(iv) the audit committee have direct access to the company's auditors (internal and external) and senior managers, and the ability to consult independent experts where

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18. *Submission, p 4 (Evidence, p 563).*
19. *Priddice, JA and Seaman, RF, Corporate Audit Committees; A Guide for Directors, CCH Australia Ltd, Sydney, 1981, p 6, Gollin Street, p 1257 (although Mr Spender did suggest that audit committees should be required by legislation If companies had not adopted them off their own accord within a reasonable time).*

necessary; and

(v) as a high but lesser priority, similar requirements be introduced for larger non-listed companies.

8.16 The Committee recommends that audit committees have the following functions:

(i) reviewing financial information to ensure its accuracy and timeliness and the inclusion of all appropriate disclosures;

(ii) ensuring the existence and effective operation of accounting and financial controls;

(iii) overseeing the audit of the company, including nominating the auditors, approving the scope of the audit and examining the results;

(iv) providing a link between the auditors and the board; and

(v) any other functions allocated to it by the company, provided that the extra functions do not compromise its ability to perform the tasks set out in paragraphs (i)-(iv) above.

8.17 Smaller unlisted companies will in many cases have too few directors for an audit committee to be feasible, or will have accounts which are too simple for one to be necessary. The Committee recommends **that smaller unlisted companies be encouraged to set up audit committees, or, in the absence of an audit committee, have auditors present at board meetings which approve financial statements prior to their distribution to shareholders.**

8.18 In the Committee's view, this encouragement should be

part of the education of company directors. Education should cover the role of audit committees and their advantages, and also the possible disadvantages to which directors must be alert.

8.19 The establishment of audit committees may well encourage the development of a code of ethics for directors. Audit committees are formed by the directors and it is the directors who must see to the proper running of the company. This requires that they take a conscious and active role in the company's affairs. Audit committees will provide one means of playing this role.

Corporate senates

8.20 The question of corporate senates was raised with the Committee by Mr Shann Turnbull.[20] Mr Turnbull said that a corporate senate was 'simply' a committee of company shareholders elected on the basis of one vote per shareholder, rather than one vote per share.[21] Its function would be to resolve all issues where there was a conflict of interest between the directors and the shareholders. The example that Mr Turnbull gave related to takeovers. He said:

The principle of one vote per constituent is a fundamental requirement of political democracies and co-operative enterprises.[22]

8.21 Mr Turnbull suggested the corporate senate as an alternative to an audit committee. He suggested that a corporate senate was preferable because

[a] fundamental flaw in the U.S. concept of an Audit committee is that it is a sub-committee of the Board appointed by the Board of

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20. *Paper entitled 'Self-regulation for Privatised Structures' delivered to a Company Directors' Association of Australia seminar on privatisation, 22 September 1987 (attached to submission from Mr Turnbull).*
21. *Attachment to submission, p 6.*
22. *Attachment to submission, p 6.*

Directors. It is not appointed by the shareholders. U.S. Audit Committees thus do not have an independent bargaining position to control directors who are determined to 'cook the books' or just present financial reports in a way which makes themselves or their deals look better. The Directors are thus both 'players' and controllers of the 'score board?.[23]

8.22 According to Mr Turnbull, audit committees in Australian corporations are even worse off, because Australian directors are not subject to class actions.[24]

8.23 Mr Turnbull suggested that the 'fundamental flaw' he described (see paragraph 8.21) was overcome either by electing the audit committee or by having a corporate senate.[25]

8.24 Mr Turnbull suggested that many of the conflicts of interest between directors were created by the power, prestige and financial rewards available to directors which they seek to increase or just maintain, at the expense of shareholders.[26]

8.25 This conflict was most evident in takeover situations, which Mr Turnbull suggested should be resolved by a corporate senate. He also nominated levels of directors' fees, appointment of auditors, determination of accounting policies and appointment of financial advisers as matters appropriately dealt with by a corporate senate.[27] He suggested that a general requirement to consult the senate should apply to 'any proposals in which the directors have a beneficial interest or which would entrench their position as a director or officer'.[28]

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23. *Attachment to submission, p 6.*
24. *Attachment to submission, p 6.*
25. *Attachment to submission, p 6.*
26. *Attachment to submission, p 7.*
27. *Attachment to submission, p 6.*
28. *Attachment to submission, p 6.*

8.26 Mr Turnbull suggested that the corporate senate would have no management powers and it would not be able to initiate action, except to report to shareholders.[29] He said that the increase in employee participation, through owning shares, was a further reason for such a body, to encourage participation in the company.[30]

8.27 Mr Turnbull saw it as an important factor in the deregulation and privatisation debates. He suggested that the establishment of a self regulatory procedure such as a corporate senate should be a condition precedent to deregulation.[31]

8.28 Mr Turnbull also suggested that by requiring the establishment of a corporate senate as a pre-condition to privatisation

governments could provide leadership to the private sector on initiatives for encouraging greater employee participation and corporate self-regulation.[32]

8.29 Mr Turnbull's criticisms of audit committees, as being merely sub-sets of the people they seek to scrutinise, is understood, but evidence before the Committee shows that audit committees work effectively, both here and overseas. The concept of a corporate senate does not readily fit with the existing law regulating companies, and much more analysis of the proposal would be needed before any final conclusion is reached.

Stakeholder councils

8.30 Mr Turnbull also raised the issue of stakeholder councils. He suggested that a stakeholder council would be

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29. *Attachment to submission, p 7.*
30. *Attachment to submission, p 1.*
31. *Attachment to submission, p 1.*
32. *Attachment to submission, p 8.*

elected by 'suppliers, customers, users, employees and the host community'.[33] It would have the power to nominate individuals for election to the board, but the shareholders would retain the right to appoint or not.[34]

8.31 Mr Turnbull said:

An important consequence of introducing Stakeholder Councils would be in protecting the environment. This would arise from the stakeholders being those people who would be most adversely affected by any environmental degradation created by the company or its products. Indeed, stakeholders could be defined to be anybody on which the enterprise made an impact.[35]

Mr Turnbull suggested that the concept of a stakeholder council, if universally adopted,

would provide the means for de-regulation of government involvement in consumer, creditor, employee and environmental protection.[36]

8.32 In a letter to the Australian Financial Review, Mr Turnbull suggested that the concept of stakeholder councils was developing overseas

with corporations who seek to integrate their operations with their customers to improve their products and after-sales service.[37]

8.33 Mr Turnbull suggested that stakeholder councils were a means of providing expert advice to directors, independent of management.[38]

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33. *Attachment to submission, p 8.*
34. *Attachment to submission, p 8.*
35. *Attachment to submission, p .9.*
36. *Attachment to submission, p 8.*
37. *Australian Financial Review, 17 April 1989, p 15.*
38. *Ibid*

8.34 The Committee expresses no view on this suggestion, noting that there is nothing that would prevent a corporation from adopting such a scheme if it were considered worthwhile. The Committee has not taken the matter further because it does not directly deal with directors' duties.

CHAPTER 9

QUALIFICATIONS OF COMPANY DIRECTORS

9.1 The Companies Code and, similarly, the Corporations Act, says little about what qualifies a person to be a director of a company. Directors must be natural persons.[1] Some directors (at least two in the case of public companies and one in the case of a. proprietary company) must ordinarily reside within Australia'.[2] The articles of a company may require a director to hold a specified share qualification and failure to attain this can lead to disqualification.[3] No person aged 72 or over can be appointed as a director of a public company or a subsidiary of a public company without a resolution of the company.[4] A company may specifically provide for a lower age limit in its memorandum or articles.[5] In all companies, the minimum age of directors is 18.[6] The NCSC can exempt companies limited by guarantee from the provisions relating to the age of directors.[7] Certain persons are prohibited from being directors without leave of the court[8] and the court may make orders that certain persons not manage corporations.[9]

9.2 Neither the Companies Code nor the Corporations Act imposes minimum standards of education, training or competence on directors.

9.3 In 1976, a private member's bill, the Corporations and

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1. *Section 219(2) (Corporations Act, s221(2)).*
2. *Section 219(-?) (Corporations Act, s221(3)).*
3. *Sections 221, 222 (Corporations Act, ss223, 224).*
4. *Section 226(l), (6),(7) (Corporations Act, s228(1),(6),(7)).*
5. *Section 226(11) (Corporations Act, s228(12)).*
6. *Section 226(12) (Corporations Act, s228(13)).*
7. *Section 226(9) (Corporations Act, s228(10)).*
8. *Section 227 (Corporations Act, s229) - insolvents under administration, certain convicted persons.*
9. *Section 227A (Corporations Act, s230).*

Securities Industry Bill, was introduced.[10] It would have allowed positive qualification requirements to be imposed on company directors. It provided that regulations could be made prescribing 'the qualifications and experience to be possessed by directors of corporations'.[11] The Bill did not proceed.

9.4 Traditionally, English law has not required company directors to have special qualifications. The view has been that it is up to the shareholders to choose. For example, in Re Brazilian Rubber Plantations & Estates Ltd,[12] of four directors, one was 'absolutely ignorant of business' who only consented to act because he was told 'the office would give him a little pleasant employment without his incurring any responsibility'. The second, a partner in a reputable firm of bankers, 'was seventy-five years of age and very deaf'. The third 'was a rubber broker and was told that all he would have to do would be to give an opinion as to the value of rubber when it arrived in England'. The fourth was a businessman who said he was 'induced to join' by seeing the names of the other directors whom he considered 'good men'.[13]

9.5 The directors were found not liable for losses incurred in ruinous speculation in rubber plantations. The judge said:

> [A director] is not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance.[14]

9.6 Most submissions to the Committee which addressed this

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10. *Introduced by Mr Lionel Bowen YP (as he then was), on 19 August 1976, House of Representatives, Hansard, 19 August 1976, p 375.*
11. *Clause 284(l)(g).*
12. *[1911] 1 Ch 425.*
13. *Ibid at 427.*
14. *Ibid at 437 per Neville J.*

issue supported this position. The NCSC submitted that it was appropriate that there were no prescribed qualifications:

The background and experience of directors varies according to the needs of particular companies.[15]

9.7 Mayne Nickless Limited submitted that it would be "counter-productive' for the law to impose minimum qualifications of an 'academic or practical type' for directors; to do so 'would disqualify a large number of present and potential directors'.[16] Mayne Nickless said that it was

the proper function of the shareholders or directors of a company to assess the qualifications and ability of those whom they may invite to join, or elect to, the board[17]

9.8 Mayne Nickless said that the standards required by the law were 'the only practicable measure of regulatory control'.[18]

9.9 The contrary view was taken by the Institute of Chartered Accountants. Mr Middleton, National President of the Institute, said 'there needs to be more specific clarification of who should hold office as directors'.[19] The Institute submitted that

a pre-requisite to appointment as a company director should be experience in a successful business.[20]

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15. *Submission from NCSC, p 1 (Evidence, p 560).*
16. *Supplementary submission from Mayne Nickless Ltd, p 1 (Evidence, p 409).*
17. *Supplementary submission from Mayne Nickless Ltd, p 1 (Evidence, p 409).*
18. *Supplementary submission from Mayne Nickless Ltd, p 1 (Evidence, p 409).*
19. *Evidence, p 53 (Mr Middleton).*
20. *Submission from Institute off Chartered Accountants in Australia, p 3 (Evidence, p 35).*

9.10 The Institute referred to the standard of competence, honesty and fair dealing required of directors. It compared what was required of those seeking appointment as company auditors and liquidators with what was required of directors and said:

Auditors and liquidators are said to come ,after the event' so surely the eligibility of a person for appointment as a company director should be similarly controlled.[21]

9.11 Mr Middleton said that, in terms of specifying mandatory qualifications of directors, no distinction should be made between public and proprietary companies because

they are both dealing with the public purse. In one sense, the smaller company is very much dealing with the creditors.[22]

9.12 Mr Middleton estimated that the amount lost by creditors as a result of the failure of proprietary companies would

exceed the amount that is lost in a large company failure when shareholders at the other end are losing considerable amounts.[23]

Horses for courses

9.13 It is appropriate that the companies legislation not require directors to hold specific academic or technical qualifications. The kind and level of knowledge, skill and experience needed of directors varies according to the companies involved.[24]

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21. *Submission from Institute of Chartered Accountants in Australia, p 3 (Evidence, p 35); see also Evidence, p 54 (Mr Middleton).*
22. *Evidence, p 55.*
23. *Evidence, p 55.*
24. *See, eg, Evidence, pp 11 (Mr Richardson), 54-5 (Mr Middleton).*

9.14 Requiring formal qualifications of skill and education is undesirable. Mayne Nickless pointed out that many of today's highly successful company directors would be excluded from directorship if there were such requirements.[25] In addition, certain groups in the community would be discriminated against in an unwarranted fashion. For example, many women who successfully run businesses today[26] do not have formal qualifications. Companies operating successfully in the rural sector have directors who do not have formal qualifications but who have a wealth of knowledge and experience.[27]

9.15 Mr Loton, Managing Director of BHP, conceded it might be possible, although difficult, to draw up guidelines regarding the qualifications of company directors.[28] He told the Committee that not all directors of BHP had tertiary qualifications[29] and said the criterion was 'the best person available'.[30]

9.16 The Committee considers that the test of a good director is the competence, industry and honesty with which he or she carries out his or her tasks. If directors are competent, industrious and honest it matters little what formal qualifications they hold.

Education and training of directors

9.17 The role of education and training was emphasised throughout the course of the Committee's inquiry.[31] The Company

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25. *See supplementary submission from Mayne Nickless Limited, p 1 (Evidence, p 409)*
26. *see Evidence, p 56 (Senator Powell, Mr Midddleton), referring to information from the Victorian Small Business Development Corporation.*
27. *Evidence, pp 16 (Mr Richardson), 56 (Senator Powell, Mr Middleton).*
28. *Evidence, p 632*
29. *Evidence, pp 632-3.*
30. *Evidence, p 633,*
31. *Eg, Evidence, pp 109 (Mr Peters), 344, 364 (Professor Baxt).*

Directors' Association told the Committee it had run a 'company directors' course' for 12 years. The Association said that recently there had been a

dramatically increasing awareness in the business community of directors and of their increasing responsibility.[32]

9.18 This was reflected in a significant increase in enrolments in the course over the past three years. These increases were expected to continue in the future.[33]

9.19 There should be more courses available for directors and directors should attend them. The Committee recommends that **the Company Directors' Association of Australia and the Institute of Directors in Australia:**

(i) make an assessment of the courses and programs dealing with the duties and responsibilities of company directors;

(ii) following this assessment, compile an index which sets out information such as the courses available and the cost, duration and location of the courses;

(iii) update the index at regular intervals; and

(iv) distribute the index freely amongst company directors.

9.20 The Committee recommends that **the Company Directors' Association of Australia and the Institute of Directors in Australia encourage company directors to participate in the available courses and programs.**

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32. *Evidence, p 108 (Mr Peters).*
33. *Evidence, p 108 (Mr Peters).*

Statement of skills

9.21 It was suggested to the Committee that there should be a

proper matching of the responsibility and the environment in which [directors] are holding that position as a director, and their capabilities.[34]

9.22 One way of establishing such a matching process would be for directors to state publicly the particular skills and expertise they bring to the position of director. The statement of skills could be included in the annual report of the company. The shareholders, creditors and public at large would then be entitled to rely on that person to use those skills in the operation of the company.[35] Companies could set out their requirements and, in balance, see them met by the overall composition of the board.

9.23 This kind of matching process would be more appropriate in the case of public companies than proprietary companies. Proprietary companies are usually small enterprises, often family businesses, centred on those who are involved in the business, whose skills and expertise form the basis of the corporate business.

9.24 The Committee recommends that **the board of a public company state in the company's annual report the particular skills and expertise that each director brings to the company.** Further, the Committee recommends that **a public company include in its annual report a statement of the particular skills and expertise that it considers desirable to be represented on its board.**

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34. Evidence, p 53 (Mr Middleton).
35. See Evidence, pp 11-12, 16 (Mr Richardson). Also see Evidence, p 54 (Mr Middleton), where the matching scheme was approved, although qualifications were still considered of primary importance.

CHAPTER 10

ENFORCEMENT - GENERAL

10.1 Ethical conduct is the best guarantee of decent corporate life. Peer pressure makes for proper behaviour. The legislature need only provide criminal and civil sanctions when ethical standards are low or when they are not met.

Ethics

10.2 Ethics are morals tempered with experience. They provide standards by which people in a particular occupation should conduct themselves. They have a high profile in callings such as medicine and law. It is vital they are developed for, and practised by, company directors.

10.3 Directors are expected to make their companies profitable. The community depends upon a successful corporate sector for its well being. Shareholders look to a return on their investments. Creditors want to be paid. Employees depend upon sound enterprises for their livelihood.

10.4 Were a code of ethics to develop for directors it would include a requirement that they use their best endeavours to make their companies profitable. It would also include one that they do so with morality. Moral conduct pays due regard to how it will affect others, whether they be shareholders, employees, creditors, or the community generally.

10.5 Were it possible to build up amongst directors a code of ethics which they faithfully followed, troubles in the corporate sector would be much diminished. Neither case law nor legislation can instil morality, and morality tempered with experience is the

best guarantee of the sort of conduct that the community is entitled to expect of directors.

10.6 Submissions to the Committee recognised this. The Institute of Directors in Australia stated that

[t]he duties of a director in Australia, as spelt out in Section 229 of the Companies Code, are capable of fulfilment only by persons of integrity.[1]

10.7 The Institute said the community wants business to be conducted in an ethical way which recognises that the common good must not be subverted to promote the profit of individuals or enterprises. Business needs to be conducted in a way which will enhance the economy and in so doing enhance the way of life of all associated with it.[2]

The Institute endorsed this attitude.[3]

10.8 The Committee notes a reported comment of Mr Bosch:

In the last few years the competitive pressures generated by deregulation and concurrent social change led to an erosion of values.[4]

10.9 The Committee sees the growth of an ethical code for directors as essential for both the corporate sector and the community. Directors' ethics are bound up with corporate and business ethics in general. Community support is vital for the

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1. *Submission from Institute of Directors in Australia, p 6 (Evidence, 124).*
2. *Submission from Institute of Directors in Australia, p 5 (Evidence, 123).*
3. *Submission from Institute of Directors in Australia, p 5 (Evidence, 123).*
4. *Carew, Edna, 'Search for Skeletons after the Bull's Feast, Triple A, December, 1987-January 1988, p 67.*

successful operation of any company, so companies must conduct themselves in accordance with community attitudes. Increasingly the community is demanding that corporations, and their leaders, look beyond a narrow economic objective.

10.10 Legislation is not an appropriate means of achieving 'morality'. Legislation is results-oriented, is often assessed in terms of increased costs, and tends to encourage a minimal response. For these reasons, a code of ethics for directors should be developed. The increased use of audit committees to scrutinise a company's accounts and financial dealings should assist in deterring unethical conduct.

10.11 The Committee recommends that **company directors' professional associations, such as the Company Directors' Association of Australia and the Institute of Directors in Australia, take steps to develop and promote a code of ethics for company directors.**

Enforcement of the law

10.12 The Committee has emphasised the need for ethical conduct. In addition, laws governing the corporate sector are necessary. Laws are made to be obeyed. To gain obedience they carry sanctions. Submissions received by the Committee suggested that the adequacy of law enforcement is a more important issue than the adequacy of the law itself.[5]

10.13 The aims of law enforcement are many and varied. Not all of them are discussed here. Suffice to say that one obvious aim is to deter conduct which, either inherently or by categorisation, is undesirable.

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5. *Eg submissions from Company Directors’ Association of Australia, p 3 (Evidence, p 82); Mayne Nickless Ltd, p 9 (Evidence, p 381); Professor Fisse, p 13, Evidence, pp 153-6 (Mr Harper, Mr Head).*

10.14 Proper regulation of the corporate sector is best achieved through a range of penalties to meet the range of particular circumstances that might arise. To illustrate, regulatory infringements are appropriately dealt with by pecuniary penalty, fraudulent conduct by criminal penalty. At times, financial compensation will be appropriate; on other occasions, disqualification of directors may be appropriate.

Australia's corporate regulatory system

10.15 Enforcement of the law applicable to the corporate sector is the responsibility of a number of bodies. These include the National Companies and Securities Commission (the NCSC), the Corporate Affairs Commissions in the States, the Trade Practices Commission, occupational health and safety agencies, pollution control agencies, consumer affairs agencies and drug and medical evaluation authorities. Regulatory bodies have both civil and criminal remedies at their disposal. Most rely on civil rather than criminal remedies.[6]

10.16 The NCSC was established as part of the co-operative companies scheme which came into operation in 1980.[7] It is responsible for the policy and administration of the codes which regulate the Australian companies and securities industry pursuant to a formal agreement between the Commonwealth and the States (‘the formal agreement') which established the co-operative companies scheme.[8] It is funded jointly by the Commonwealth and the States.

10.17 The Ministerial Council for Companies and Securities,

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6. *Law Reform Commission, Sentencing: Penalties, Discussion Paper No 30, September 1987, para 286.*
7. *The National Companies and Commission Act 1979 commenced on 1 February 1980 - Gazette, No S7, 1980, p 1. The Companies Act 1981 commenced on 1 July 1982.*
8. *See schedule to the National Companies and Securities Commission Act 1979.*

established under the formal agreement[9] consists of the ministers responsible for administering the law relating to companies and securities in each of the States, the Northern Territory and the Commonwealth. It reviews the operation of the legislation and oversees and controls the implementation of the co-operative scheme.[10]

10.18 Each State or Territory[11] party to the formal agreement has set up its own regulatory body, usually known as a Corporate Affairs Commission. These State and Territory bodies are subject to the direction of the NCSC.[12] Generally, the State and Territory bodies carry out various registration and investigation functions.

National corporations legislation

10.19 Legislation to establish a new national corporations scheme, in place of the co-operative scheme, was passed by the Parliament on 23 May 1989[13] and assented to on 14 July 1989. At the time of writing, the new legislation is under challenge in the High Court. Part of that legislative package, the Austral' Securities Commission Act 1M, sets up the Australian Securities Commission (ASC). The ASC will be responsible for the administration of the new national scheme. The ASC will eventually replace the NCSC although the functions of the ASC will be implemented gradually and the ASC and NCSC will co-exist for some time.

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9. *National Companies and Securities Commission Act 1979, Schedule, Part VII.*
10. *National Companies and Securities Commission Act 1979, Schedule, Part VIII.*
11. *The Northern Territory became a Party to the formal agreement on 28 January 1986. Its Implementing legislation came into operation on 1 July 1986.*
12. *National Companies and Securities Commission Act 1979, Schedule, c137(l).*
13. *House off Representatives, Votes and Proceedings, No 121, 23 May 1989, at pp 1229, 1230-43.*

10.20 The NCSC is empowered to make findings of unacceptable conduct; the ASC is required to submit any conduct it considers unacceptable to the Corporations and Securities Panel for decision. The ASC cannot determine that issue itself. Its powers are accordingly less than those of the NCSC to which it is otherwise comparable.

Adequacy of enforcement

10.21 Mayne Nickless Limited told the Committee that any problems and deficiencies in companies and securities regulation in Australia go to the enforcement of those laws not their adequacy.[14]

This view was endorsed by others who made submissions in similar terms.[15]

10.22 The Company Directors' Association of Australia said that

[s]ome instances of alleged corporate misbehaviour not being prosecuted, are due to lack of will on the part of the authorities or inadequate policing mechanisms, rather than inadequate law[16]

10.23 The Association said further that

some calls for increased liability upon directors might be usefully re-directed towards more[17] effective application of the existing law.

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14. *Submission, p 9 (Evidence, p 381).*
15. *Eg submissions from Mr MacKinnon MLA, para 1.1; Professor Fisse, p 13; Evidence, pp 153-6 (Mr Harper, Mr Head).*
16. *Submission, p 3 (Evidence, p 82).*
17. *Submission, p 3 (Evidence, p 82).*

10.24 It is necessary that laws be complied with if they are to be respected, and new law will be ineffective where compliance is lacking. A survey of major Australian regulatory agencies shows that, for those agencies, trying to achieve compliance with the law is

> fundamentally seen as a matter of persuasion, negotiation, or simply tapping people on the shoulder to remind them to do what they know they should do. Not only the use of enforcement, but even the threatened use of ... enforcement ... is generally viewed as an adversarial breakdown indicative of failure by the regulatory agency. The enforcement tools are seen as important primarily as a background which gives the agency authority; secondly, they are seen as bargaining chips in negotiation for compliance when faced with resistance; thirdly, and least importantly in the eyes of Australian regulatory managers, they are seen as tools to achieve specific or general deterrence.[18]

Actions by the NCSC

10.25 Professor Baxt told the Committee:

> If you want to protect your small investor you have to ensure that the people who administer the law have the resources to deal with these matters. If you look at what the NCSC has been doing over the last few years you will see that they have been spending nearly all their time on takeovers and they have not had time to look at these issues [ie. directors' duties to the shareholders]. They have not had the resources; maybe they have not had the interest; maybe the takeover area is just too interesting. But the fact of the matter is that these areas have been left alone.[19]

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18. *Grabosky, Peter and Braithwaite, John, Of Manners Gentle - Enforcement Strategies of Australian Business Regulatory Agencies, Oxford University Press, in association with Australian Institute of Criminology, Melbourne, 1986, p 191.*

19. *Evidence, pp 352-3.*

10.26 Professor Baxt suggested that one way of ensuring protection of shareholders and others whose interests are affected would be

to set up a stronger authority (either the NCSC or some replacement body with adequate funding to bring litigation.[20]

10.27 He said:

If we go the 'NCSC route' adequate funds must be provided for it or its replacement to administer the law effectively and to pursue breaches vigorously.[21]

10.28 Justice Kirby, President of the New South Wales Court of Appeal, has also seen fit to comment on the role of the NCSC. Justice Kirby pointed out that litigation concerning companies typically involves large financial stakes, the careers and livelihood of officers and employees and the resolution of intricate and novel legislative provisions. He said:

In these circumstances, it might have been expected that, at least in appropriate cases, the court would have the assistance of the Commission appointed to administer the legislation, which has an interest in the uniform and principled interpretation of the Codes.[22]

Justice Kirby acknowledged 'the limits of time and resources' but expressed regret that the NCSC had neither intervened nor agreed to assist the court in the particular instance.[23]

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20. *Submission, para 51 (Evidence, p 207).*
21. *Submission, para 51 (Evidence, p 208).*
22. *North Sydney Brick & Tile Co Ltd v Darvall and Ors (1986) 5 NSWLR 681 at 684.*
23. *Ibid at 684-5. See also Advance Bank Australia Ltd v FAI Insurances Ltd (1987) 9 NSWLR 464 at 470.*

10.29 In a recent New South Wales case in which a shareholder attempting to challenge a decision of the company was not represented on appeal, the NCSC did intervene, after some prompting from the court.[24] Justice Kirby said:

Decisions of this kind may be followed in other States. Because of the cumbersome machinery for amending the Codes, it is difficult to overcome a determination later found to be inconvenient. That is why the intervention of the NCSC was particularly necessary here.[25]

10.30 Justice Rogers agreed with Justice Kirby:

[W]hilst I fully appreciate that the NCSC must keep to its priorities in the allocation of limited resources, it makes the proper development of company law very difficult when on important questions a Court has to reach its conclusion on the basis of argument from one side only.[26]

10.31 The NCSC has said that it intends to adopt a higher profile in future in enforcing directors' duties. The NCSC's Deputy Chairman, Mr Charles Williams, said in May 1989:

In the last few months, revelations of the misdeeds of directors and executives of some companies have been nothing short of horrific. Based on what I have seen so far, directors will be charged with major infringements of all of the four offence provisions in section 229 of the Companies Code. That is, people will be charged with failing to act honestly, failing to exercise a reasonable degree of care and diligence, with making improper use of information acquired from the company and with improperly gaining an advantage for themselves or another person while acting as

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24. *Catto v Ampol Ltd (unreported, NSW Court of Appeal, 28 April 1989).*
25. *Ibid, transcript, Kirby P, p 9.*
26. *Ibid, Rogers A-JA, p 7.*

directors.[27]

10.32 At least one judge, Justice Brooking of the Victorian Supreme Court, has adopted an active role in ensuring that information concerning possible breaches of company law is put before the NCSC. In Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd[28], Justice Brooking said:

While the Court cannot and should not seek to constitute itself a regulatory agency in the interests of shareholders generally and of commercial morality, there will be occasions when some step is appropriate.[29]

He ordered, on his own initiative, that information obtained by a shareholder under section 265B of the Code (Corporations Act, s319) (which allows the court to make information available to a shareholder) be disclosed to the NCSC.[30]

10.33 Justice Brooking said that the NCSC

has many claims on its limited resources. The public interest will be served by requiring the plaintiff to make available to the Commission a convenient summary of the results of the inspection as well as making available upon request the detailed information.[31]

10.34 The Committee endorses and encourages action such as this.

10.35 If the NCSC, or the appropriate regulatory agency, is prepared where necessary to prosecute directors who breach their obligations under the companies legislation, then it will be

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27. *'Directors - How to Sort out the Professionals from the others', speech given to Institute of Directors in Australia, Victorian Branch, by Mr Charles M Williams, Deputy Chairman, NCSC, Melbourne, 31 may 1989.*
28. *(1989) 7 ACLC 536.*
29. *Ibid at 543.*
30. *See s265B(1)(d).*
31. *(1989) 7 ACLC 536 at 543.*

necessary only to set precedents by way of test cases in order for it to be clear to all and sundry that these obligations are to be met. Mr Williams said:

I think there are grounds for believing that some of this year's crop of charges will result in convictions, and hopefully there will be some directors who end up in jail.

It will be the conviction of directors which would bring into sharper focus the current agenda for directors.[32]

10-36 The Company Directors' Association and others[33] specifically addressed the question of the resources available, in particular, to the NCSC and the States' corporate affairs bodies. Mr Williams has also commented on the 'lack of enforcement resources' and has noted the 'difficulty of securing convictions'.[34]

10.37 Professor Baxt told the Committee:

If you did give the regulators - the NCSC the money to run these cases, all they would need is two or three big victories, and I think the message would get through that you really cannot try that tactic.[35]

10.38 Professor Fisse said:

There seems no real solution to this problem [ie. of minimal resources available for investigation and enforcement] other than to provide more resources. In practice the

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32. *'Directors - How to Sort out the Professionals from the others', speech given to Institute of Directors in Australia, Victorian Branch, by Mr Charles M Williams, Deputy Chairman, NCSC, Melbourne, 31 may 1989.*
33. *Eg submissions from Company Directors' Association of Australia, p 3 (Evidence, p 82), Mayne Nickless Ltd, p 9 (Evidence, p 381), Professor Fisse, p 13; Professor Baxt (Evidence, p 344).*
34. *'Directors - How to Sort out the Professionals from the others', speech given to Institute of Directors in Australia, Victorian Branch, by Mr Charles M Williams, Deputy Chairman, NCSC, Melbourne, 31 may 1989.*
35. *Evidence, p 351.*

problem is sometimes alleviated by using the in terrorem effect of news releases or informal publicity as a cheap and fast alternative to prosecuting offenders but this is hardly an acceptable substitute for the administration of justice by due process of law.[36]

10.39 Publicity is not an alternative to proper legal process. The maintenance and protection of a free and competitive market place requires an active NCSC and ASC, vigilant in the interests of the shareholder. A strong NCSC, ASC and Corporations and Securities Panel are essential for the health and vitality of the corporate sector. They must be adequately funded and in a position to appoint staff of the highest quality. The Committee recommends that **the NCSC, the ASC and the Corporations and Securities Panel receive the funding necessary for them to be as active, effective and vigilant as possible.**

10.40 State Corporate Affairs Commissions raise money from fees charged on the lodgment and registration of company instruments. Professor Baxt told the Committee that these State bodies 'have enormous resources and they are not using them'.[37] He said substantial sums were raised on the registration of business names but not applied to the Commissions' investigatory sections.[38] The Committee agrees that funds derived from the corporate sector should be used to achieve compliance with the law as it applies to that sector.

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36. *Submission, p 13.*
37. *Evidence, p 348.*
38. *Evidence, p 348.*

CHAPTER 11

SHAREHOLDER REMEDIES

11.1 The duties of directors are owed to the company rather than to individual shareholders. It is perhaps ironic that the general power to sue in the company's name, whether to enforce directors' duties or otherwise, lies in the first instance with the directors. Where the board declines to sue, the general meeting may be able to do so. In limited circumstances, an individual may take action which will benefit the company.

Minority shareholders

11.2 The company is generally identified with the majority of shareholders measured by value of shareholding. It is the majority which controls the general meeting. Accordingly, the majority will exercise the power vested in the general meeting.

11.3 Shareholders are neither trustees for one another nor in a fiduciary relationship with each other. Any rights, including the right to vote attached to their shares, are for the shareholders' personal advantage.[1]

11.4 The majority's control is not unfettered. It is bound to act bona fide in the interests of the company as a whole. If it does not, it perpetrates 'fraud on the minority'. In relation to an alteration of articles, it was said of the power of the majority that

like all other powers, [it must] be exercised subject to those general principles of law and equity which are applicable to all powers

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1. *Peters' American Delicacy Ltd v Heath (1939) 61 CLR 457 at 504 per Dixon J.*

conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded.[2]

11.5 The nature of the relationship between majority and minority shareholders is different in public and private companies. Shares in a public company can, at least in theory, be readily sold on the stock exchange. This gives a minority shareholder an escape route.

11.6 The marketplace is not available to shareholders in a private company. The companies legislation itself places a restriction on the right to transfer shares in a proprietary company and prohibits invitations to the public to subscribe for shares or debentures. The right to transfer shares may also be restricted.[3]

11.7 The limits to majority power are unclear. The problem lies in distinguishing decisions of the majority which may cause unhappiness or discontent, but which are otherwise legitimate exercises of power, from decisions that are unfair and an abuse of majority power. It is the latter which are of concern here.

11.8 Majorities can exploit minorities in a number of ways, for example, by withholding dividends, by making distributions which are inadequate, by making disproportionate share allotments, by withholding information, or by excluding the minority from management. In these ways, the majority is in a position to stop shareholders participating in companies they partially own.

11.9 The minority can also suffer from inaction of the majority. This may occur where it is within the power of the

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2. *Allen v Gold Reefs of West Africa, Ltd [1900] 1 Ch 656 at 671 per Lindley MR.*

3. *Section 34 (Corporations Act, s116).*

majority to bring a legal action in the name of the company (for example, to redress action taken by a director) but where it refuses to do so. In these circumstances it seems that the members in general meeting can decide to sue[4] as long as the articles do not prevent them from doing so. The clearest case of abuse occurs if the board and/or the majority commits a wrong against the company and refuses to allow the company to sue. The court will permit a derivative action to be brought by a minority shareholder on behalf of the company in these circumstances.[5] (The Foss v Harbottle principle will not apply. See below.)

The rule in Foss y Harbottle

11.10 If a wrong is done to a company, the company is the proper person to sue for the damage. Professor Finn told the Committee that

because the (director's] duty is owed to the company, the company is the complainant. Obviously, because directors control the company and it is their conduct that is in issue, you are looking, practically, to shareholders having to bring an action in the name of the company. So the courts have had to evolve a set of criteria which would indicate when it would be proper for shareholders to be able to bring an action in the name of the company and when it would not be proper. it has been a view that historically the particular categories that the courts have evolved have been much too narrow.[6]

11.11 The 'set of criteria' referred to by Professor Finn is known as the 'rule in Foss v Harbottle'. In Foss v Harbottle,[7] two shareholders in a company sued its directors for fraudulent misapplication of the company's funds, arguing that the directors

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4. *Marshall's Valve Gear Company Ltd v Manning, Wardle & Co, Ltd [1909] 1 Ch 267.*
5. *Dutton v Gorton (1917) 23 CLR 362.*
6. *Evidence, p 170.*
7. *(1843) 2 Hare 461.*

should compensate the company. The suit was brought on behalf of all of the shareholders except the directors. It was held that the shareholders could not succeed, because the proper plaintiff was the company to whom the wrong had been done. This 'proper plaintiff' concept is the first of two recognised aspects of the rule.

11.12 The second aspect is known as the 'internal management' principle. In brief, if the action complained of is something which the majority is entitled to do, then only the majority can complain that it has not been done properly.[8]

11.13 The rule in Foss v Harbottle can impede individual shareholders seeking to enforce their rights against directors. Directors' duties are owed to the company, and a breach of those duties is a wrong against the company for which it alone can sue. In many cases it is lawful for a general meeting to forgive a breach of duty and decide not to sue a director. If a shareholder cannot persuade a general meeting to sue the transgressing director, the rule in Foss v Harbottle will generally prevent the individual shareholder bringing an action, no matter what loss he or she may suffer. It may be difficult for the shareholder to secure the support of a majority, particularly if the directors control most of the voting shares.

11.14 The courts have established exceptions to the rule in Foss v Harbottle. Likewise the legislature has mitigated its effects.

Derivative action (fraud on the minority)

11.15 In Foss v Harbottle, the court recognised that there would have to be exceptions to the 'proper plaintiff' concept in

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8. *MacDougall v Gardiner (1875) 1 Ch D 13 at 25 per Mellish LJ. See also Australian Coal & Shale Employees' Federation v Smith (1937) 38 SR (NSW) 48 at 54-6.*

some cases where an injury to the company would otherwise go unremedied. So, in limited circumstances, where the board and the general meeting decide the company will not sue, individual shareholders have been allowed by the courts to bring an action for a wrong done to the company.[9]

11.16 The shareholder sues on behalf of the company and not in a personal capacity. These suits are called 'derivative suits'. The term emphasises that the individual member is suing on behalf of the company to enforce a right derived from the company.[10] The benefits of a successful suit are entirely those of the corporation[11] and the individual shareholder gains only through any enhancement to his or her shareholding, unless the company is ordered to reimburse the shareholder for any legal costs not otherwise recovered.

11.17 Unless a majority resolution not to sue is unlawful or beyond the power of the majority, two conditions must be present before a shareholder can bring a derivative action. First, the wrongdoers (eg directors in breach of duty) must have been fraudulent, and secondly, they must have had the power to control a general meeting and, in this way, excuse themselves from liability.

11.18 Fraud in this context does not equate with deceit but rather with improper conduct.[12] A clear example of conduct giving rise to a derivative action is appropriation of company property.[13] Other breaches of fiduciary duty may do so if they

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9. *Eg in Prudential Assurance Co Ltd v Newman Industries Ltd [1981] Ch 229 a derivative suit was brought against directors and their companies for damages.*
10. *See Gower, LCB, Gower's Principles of Modern Company Law (4th ed), Stevens & Sons, London, 1979, pp 647-53; Wallersteiner v Moir (No 2) [1975] QB 373 at 391 per Lord Denning MR.*
11. *Spokes v Grosvenor and West End Railway Terminus Hotel Co. Ltd [1897] 2 VB 124.*
12. *See, eg, Ford, HAJ, Principles of Company Law (4th ed), Butterworths, Sydney, 1986, p491.*
13. *Eg Burland v Earle [1902] AC 83 at 93.*

involve an element of bad faith.[14] Mere negligence by directors, even if it is gross, will not normally be sufficient.[15] However, in at least one English case a shareholder has been allowed to bring a derivative action against directors where no fraud on their part was alleged but where the directors had profited from their wrong actions.[16] Justice Templeman said in that case:

To put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit ... at the expense of the company is something entirely different.[17]

11.19 Another English judge has said that the 'fraud' lies not in the wrong to the company but in the majority's use of its voting power to misappropriate a right (the right to sue) which is in a sense the property of the company.[18] If this line of reasoning were followed, the courts would not need to rely on making fine distinctions between categories of breach of duty as they presently do.

11.20 The degree of control needed is not clear. 'Control' does not necessarily entail the wrongdoers being the owners of a majority of the company's shares.[19] It might be enough if, for example, the wrongdoers controlled another company and it owned shares in the company to which the wrong had been done which, combined with shares actually owned by the wrongdoers, amounted to a majority. Another example of de facto control might be where shares are held by nominees of the wrongdoers:

[I]t must be admissible in certain cases to go behind the apparent ownership of shares in order to discover whether a company is in fact

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14. *Cook v Deeks [1916] 1 AC 554.*
15. *Pavlides v Jensen [1956] Ch 565.*
16. *Daniels v Daniels [1978] Ch 406.*
17. *[1978] Ch 406 at 414.*
18. *Prudential Assurance Co Ltd v Newman Industries Ltd [1981] Ch 229 at 307 per Vinelott J.*
19. *Prudential Assurance Co Ltd v Newman Industries Ltd [1981] Ch 229 at 323-4 per Vinelott J.*

controlled by wrongdoers.[20]

11.21 Mr Charles Williams, Deputy Chairman of the NCSC, has suggested that it might be timely to consider examining the scope of the civil law and the availability of the shareholder's derivative action. He referred to legislation in Canada which allows derivative actions and to changes in the United States and New Zealand which recognise the position of shareholders as distinct from, but with interests in, a corporation when there was an issue of insider trading, and said:

These developments are straws in the wind which suggest that a campaign to replace some of the strictures of the criminal law with greater access to civil remedies might well be successful.[21]

11.22 He cautioned that the shareholder's derivative action tended to be used too often in the United States, probably because of the operation of contingency fees in that country.[22]

Personal action

11.23 A shareholder may bring a personal action where the shareholder, personally, rather than the corporate body, has suffered a wrong. The memorandum and articles of a company form a contract between the company and its members, between the company and its officers, and between each and every member of the company. ('Officer' includes directors.)[23] Like any other contract, this arrangement creates individual legal rights in the parties which can be enforced in the courts. A breach of duty by a director which amounts to a breach of the 'statutory contract' constituted by the articles will be actionable by an individual

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20. *Pavlides v Jensen [1956] Ch 565 at 577 per Danckwerts J.*
21. *'Directors - How to Sort Out the Professionals from the Others', speech given to the Institute of Directors in Australia, Victorian Branch, Melbourne, 31 May 1989.*
22. *Ibid.*
23. *Companies Code, s78 (Corporations Act, s180).*

shareholder.[24] Strictly speaking, this is not an exception to the rule in Foss v Harbottle. Rather, the rule has no application in these circumstances. The wrong has been done to the individual and the company is therefore not the 'proper plaintiff'.

Rectification of the register

11.24 Section 259 of the Companies Code (Corporations Act, s212) provides that a person aggrieved by entries in a share register, or any member of the company, may apply to the court for rectification of the register. The court may order the payment by the company of damages sustained by any party to the application for rectification.

11.25 Rectification of the register can provide a remedy for individual shareholders if the directors' power to allot shares has been used improperly, for example, to qualify certain persons as directors[25] or if directors have acted in breach of duty.[26] An improper allotment of shares (and thus potentially of dividends and future voting power) is seen as a wrong against individual shareholders rather than the company.

Restraining acts ultra wires the company

11.26 Any member of a company has a personal right to restrain directors from committing the company to a transaction which is beyond its powers.[27] Section 68 of the Companies Code (Corporations Act, s162) allows a company to restrict its objects or powers. Acting beyond the objects or powers will not necessarily be illegal of itself but can be relied upon by a

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24. *See, generally, Redmond, Paul, Companies and Securities Law - Commentary and Materials, Law Book Co Ltd, Sydney, 1988, pp 468-9, 487-94.*
25. *See Grant v John Grant & Sons Pty Ltd (1950) 82 CLR 1 at 31-2 per Williams J.*
26. *Ngurli Ltd v McCann (1953) 90 CLR 425.*
27. *Eg Simpson v Directors of the Westminster Palace Hotel Co and Wood (1860) 11 ER 608 at 610.*

member of the company taking action against the company's officers.[28]

'Where justice otherwise requires an exception'

11.27 The possibility of an exception to the general rule, where justice requires an exception, was raised in Foss v Harbottle itself:

If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.[29]

This exception does not appear to have been relied on in company law cases to date.[30]

The Australian attitude

11.28 The rule in Foss v Harbottle has not been as great a barrier to shareholder remedies in Australia as might have been expected.[31] Suits contesting directors' decisions have been commenced in non-representative form and the basis of the plaintiffs' standing to sue has gone substantially unquestioned. Australian courts have applied the established exceptions to the rule so as to accommodate a wide range of circumstances.[32]

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28. *Companies Code, s68(6) (Corporations Act, s162(7)).*
29. *(1843) 2 Hare 461 at 492 per Wigram VC.*
30. *Vinelott J referred to a similar notion in the Prudential Assurance case [1981] Ch 229 at 323, but used it as a rationale for relaxing the 'control ' requirement for a derivative action (see above) Father than to establish a separate exception.*
31. *Evidence, pp 348-9 (Professor Baxt).*
32. *Redmond, Paul, Companies and Securities Law - Commentary and Materials, Law Book Co Ltd, Sydney, 1988, p 492.*

Statutory remedies

11.29 Although the common law gives shareholders a range of procedures to enforce directors' duties and obligations, its scope is far from clear. It is aimed at particular transactions rather than patterns of behaviour. Despite a recent tendency towards relaxation, the narrow rules of standing make it difficult for a shareholder to take legal action.[33] Moreover, the cost of litigation is a formidable barrier to shareholders contemplating action.

11.30 The legislature has enacted various provisions designed to facilitate shareholders' access to the courts. The Foss v Harbottle limitations are not relevant to statutory rights to take action. This development reflects an increasing public concern with the internal regulation of companies, an area the courts have been reluctant to enter.

11.31 Section 320 (Corporations Act, s260), 'the oppression remedy', allows a member of a company (or the NCSC) to apply to the court for an order winding the company up, regulating the company's affairs in some way or restraining a person from certain conduct. In general, orders may be applied for where the affairs or an act or omission of the company are being conducted in an oppressive, unfairly prejudicial, or unfairly discriminatory manner against a member, or in a manner that is contrary to the interests of members as a whole.

11.32 Section 574 (Corporations Act, s1324) provides for an injunction to be granted to restrain or prevent a person from engaging in conduct in contravention of the Companies Code or to force action that is required under the Code. Section 574 is couched in very wide terms[34] - the NCSC or 'any person whose interests have been, are or would be affected by the conduct' may

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33. *Evidence, pp 170, 180 (Professor- Finn).*
34. *See Evidence, p 349 (Professor Baxt).*

seek an injunction.[35] This means that, to the extent that section 229 (Corporations Act, s232) covers the same ground as the obligations imposed on directors by the general law,[36] all shareholders have standing to restrain breaches of those duties or to insist that the duties be carried out.[37]

11.33 When the court is empowered to grant an injunction under section 574 to prevent or require certain action, it can order the injuncted person to pay damages to any other person, either in addition to or in substitution for the injunction.[38]

11.34 Where directors have acted in their own interests or in an unfair or unjust way, or where the company's affairs have been conducted in an oppressive or unfairly discriminatory manner, compulsory liquidation under section 364 of the Companies Code (Corporations Act, s461) may be available.[39]

11.35 Mr Charles Williams, Deputy Chairman of the NCSC, has expressed the view that

[s]omeone may once have believed that the remedies against oppression in section 320 and the injunctive procedure in section 574 of the Companies Code were adequate to protect shareholders, but only an inveterate optimist would think so now.[40]

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35. *Companies Code, s574(1)(b) (Corporations Act, s1324(1), (2b)).*
36. *Marchesi v Barnes (1970] VR 434, ruling on the Companies Act 1961 (Vic) equivalent to s229, and Callaway, FH, 'commentary' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 115-19, esp at p 117.*
37. *See Evidence, p 349 (Professor Baxt); Residues Treatment Ltd v Southern Resources Ltd (1988) 6 ACLC 976.*
38. *Companies Code, s574(8) (Corporations Act, sl324(10)).*
39. *Companies Code, s364(l)(f), (fa) (Corporations Act, S461(e), (f)).*
40. *'Directors - How to Sort Out the Professionals from the Others', speech delivered to the Institute of Directors in Australia, Victorian Branch, Melbourne, 31 May 1989.*

11.36 Mr Williams argued that

[t1he fact that shareholders are relatively powerless against entrenched directors is the root cause ... for government having involved itself so much in the policing of directors' conduct by providing criminal sanctions.[41]

The cost of litigating

11.37 The great hurdle for most shareholders seeking remedies against directors is the cost of litigation. The statutory remedies have not overcome this hurdle. Funding problems affect both the NCSC and individuals who wish to bring an action. The corporation as a whole benefits from successful derivative action yet the individual shareholder who brings it is entitled to recoup no more than limited costs from the proceeds of the litigation, and then only upon an order from the court. An unsuccessful litigant will not get costs and may have to carry those of the opposing party. The English courts have approved a procedure of prior indemnification in derivative suits.[42] This has not been the case with personal actions although there appears to be no objection to it in principle where the suit would benefit a majority or a class of members.[43]

11.38 Professor Baxt said to the Committee:

If we are to retain our current system of allowing persons to sue directors for breach of duty, then consideration should be given to providing incentives for persons to bring action against directors who are negligent or who do not carry out their obligations in an appropriate fashion. Consideration should be given to introducing legislation which would allow the award of multiple damages in

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41. *'Directors - How to Sort Out the Professionals from the Others', speech delivered to the Institute Of Directors in Australia, Victorian Branch, Melbourne, 31 May 1989.*
42. *See Wallersteiner v Moir (No 2) [1975] QB 373.*
43. *See Redmond, Paul, Companies and Securities Law - Commentary and Materials, Law Book Co Ltd, Sydney, 1988, p495.*

appropriate circumstances (for example, where directors take advantage of a corporate opportunity, or allow a flagrant conflict of interest situation to arise). However, the more fundamental breaches - where directors make an honest mistake in trying to defeat a takeover - should not carry heavy penalties. The shareholders should be able to reverse the decisions taken by the company in such cases, but the directors should not be heavily penalised unless they have acted fraudulently.[44]

Contingency fees

11.39 Professor Baxt suggested that contingency fees might be a way of enabling shareholders to take action against recalcitrant directors.[45] A contingency fee is a payment for legal services based on results. It gives litigants the ability to take proceedings without the funds they would ordinarily need to do so. Legal representatives accept work on the basis of receiving an agreed fee or proportion of the proceeds where the litigation is successful. This gives them a personal financial stake in the successful outcome of the case.

11.40 Contingency fees are illegal in Australia. They are seen as a means of converting lawyers into entrepreneurs. They are blamed for causing an explosion in litigation and, as a consequence, in insurance costs. It should be noted that the United States, which allows contingency fees and which ha s been criticised for the operation of its contingency fee system, does not have a costs indemnity rule.

11.41 The Committee is presently inquiring into the cost of justice. It will consider the issue of contingency fees as part of that inquiry. It is premature for it to express an opinion at this time. It notes that the Law Institute of Victoria is now looking closely at the feasibility of introducing contingency

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44. *Submission, par 55 (Evidence, p 209).*
45. *Evidence, pp 350-1.*

fees in that State.

11.42 There is a lack of equity where some shareholders can afford to bring legal actions to protect their rights while others cannot. Any entitlement given to a security holder which he or she cannot enforce is a hollow one. These are issues the Committee will address when considering the cost of justice.

11.43 In the meantime it would be for the benefit of the corporate sector generally were the NCSC and the ASC to keep a vigilant watch over such shareholder interests as they are empowered to protect. Whether they should have greater powers to safeguard shareholders is a question to which such bodies could well give priority.

Obtaining information

11.44 Until recently, it has often been difficult for a shareholder to obtain the relevant information to enable him or her to launch legal action.[46] In 1985, amendments to the Companies Code empowered a court to order inspection of the books of a company by a registered auditor or legal practitioner on behalf of a member of the company.[47] This provision, section 265B (Corporations Act, s319), does not give a shareholder immediate access to the books or access as of right. A court order is necessary. The access is actually granted to an auditor or lawyer acting on the shareholder's behalf.

11.45 An inspection order under section 265B will only be granted if the application is made in good faith and inspection is sought for a proper purpose. In Unity APA Ltd v Humes Ltd (No 2),[48] Justice Beach found that it was a proper purpose to ascertain whether directors had breached their duties in relation

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46. *See, eg, Evidence, pp 176-7 (Professor Finn).*
47. *Companies Code, s265B, inserted by Act No 192 of 1985.*
48. *[1987] VR 474.*

to a takeover proposal and to help the shareholder decide whether or not to oppose the proposal.[49] Other proper purposes include ascertaining whether allegations of mismanagement have substance (for example, prior to taking action under section 229) and ascertaining a fair market value for shares in companies whose articles allow for pre-emption rights to share sales.[50]

11.46 Justice Brooking has recently emphasised the positive obligation on the plaintiff to show that he or she is acting in good faith and that the purpose is genuine. It will usually be sufficient if the shareholder shows that something has gone wrong in the company and, in the light of that, he or she wants to find out further facts to enable proceedings to be brought. It will then be up to the defendant to show that the plaintiff is not acting for an appropriate purpose.[51]

Forgiveness of breaches of duty

11.47 As a general rule, shareholders can forgive (or ratify) conduct of directors amounting to a breach of their duty to the company. In effect, this is a decision not to sue the directors.

11.48 It is open to question whether an exercise of the power to forgive a breach of duty can be challenged by a minority shareholder if it is infected with the same improper purposes as the directors' actions.[52] In the context of a shareholder's voting rights being diluted, a recent decision of the South Australian Supreme Court recognised the right of a minority shareholder to challenge a transaction where the action of the

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49. *[1987] VR 474 at 480-1.*
50. *Explanatory Memorandum, Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985, p 107.*
51. *Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd (1987) 7 ACLC 536.*
52. *Ngurli v McCann (1953) 90 CLR 425 at 438; see also Wintrop Investments Ltd v Winns Ltd [1975] 2 NSWLR 666 at 702 per Mahoney JA.*

majority in ratifying it had been questionable.[53] The force of this decision is presently unclear. It would benefit minority shareholders were it to become established law. It is a trend to be encouraged.

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53. *Residues Treatment & Trading Co Ltd & Anor v Southern Resources Limited & Ors* (1988) 6 ACLC 1160.

CHAPTER 12

DIRECTORS' PERSONAL LIABILITY FOR ACTS OF THE COMPANY

12.1 In the preceding chapter, shareholders' remedies against directors were considered. In this chapter, directors' liability is considered in so far as directors are the mind and will of the company and, in that sense, have duties and responsibilities on behalf of the company to the wider community. Ways in which directors can prevent harm or breaches of legislation occurring are also discussed.

12.2 Directors' personal liability can arise under both company law and under a range of laws which affect the conduct of corporations. The 'corporate veil' does not shield them from personal liability in all circumstances.

Corporate personality

12.3 The concept of a corporation having a legal personality, distinct from the personality of each of its members, was affirmed in 1897 by the House of Lords in the case of Salomon v Salomon & Co Ltd.[1] A corporation is liable as a separate entity for its own actions. For example, a company can be liable in tort if it negligently supplies a product which causes damage,[2] it can be vicariously liable for negligent acts by its servants[3] and it can be sued for breach of contract.[4]

12.4 Traditionally, the law has concerned itself with natural

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1. *[1897] AC 22.*
2. *Eg Grant v Australian Knitting Mills Ltd [1932] AC 562.*
3. *Eg Lloyd v Grace, Smith & Co [1912] AC 716.*
4. *Eg Lee v Lee's Air Farming Ltd [1961], AC 12. See also Companies Code, s80 (Corporations Act, s182), and generally, Ford, HAJ, Principles of Company Law (4th ed), Butterworths, Sydney, 1986, chapter 5.*

persons and there were some difficulties in accepting into the criminal law the concept of corporate personality and corporate responsibility for criminal acts. A major problem stemmed from the fact that, despite a legal personality, a corporation is unable to think and act for itself and so it was difficult to attribute to a corporation the mental element necessary to establish certain offences. As well, as a matter of public policy, criminal behaviour must be considered to be beyond the powers of a corporation. Beyond these conceptual difficulties, certain procedural rules, though apposite when applied to natural persons, required adaptation before they were appropriate to corporations.[5]

12.5 Notwithstanding these difficulties, it is now accepted that a corporation can be liable for a wide range of offences. However, differences in the treatment at law of natural persons and companies have been inevitable due to the artificiality of the corporate personality. As was said to the Committee,

the certificate of incorporation cannot get behind the wheel of a car.[6]

12.6 Because a company must act through a natural person, the distinction between what are to be taken as the acts of the company and the acts of the individual can be a nice point.

12.7 Where fault must be proved, it is attributed to a corporation by imputing to the corporation the actions or behaviour of an individual within the corporation:

A living person has a mind which can have knowledge or intention or be negligent and he has hands to carry out his intentions. A corporation has none of these: it must act through living persons, though not always one

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5. *See Welsh, RS, 'The Criminal Liability of Corporations' (1946) 62 Law Quarterly Review 345, also see Law Reform Commission of Canada, Working Paper 16, Criminal Responsibility for Group Action.*
6. *Evidence, p 139 (Mr Harper).*

or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company.[7]

12.8 Identification of the corporation with the individual is made on the basis that the individual whose actions are imputed to the corporation is in a position which allows a degree of control over the relevant corporate behaviour:

A company may in many ways be likened to a human body. It has a brain and nerve centre which controls what it does. It also has hands which hold the tools and act in accordance with directions from the centre. Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.[8]

12.9 It is a question to be decided in each case whether, in doing certain acts, a particular person is to be regarded as the company itself or as its servant or agent. In the latter situation, the liability of the company can only be statutory or vicarious. In the former situation, the person

is not acting as a servant, representative, agent or delegate. He is an embodiment of the company or, one could say, he hears and speaks through the persona of the company, within his appropriate sphere, and his mind is the mind of the company. If it is a guilty mind then that guilt is the guilt of the company.[9]

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7. *Tesco Supermarkets Ltd v Nattras [1972] AC 153 at 170 per Lord Reid.*
8. *HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd [1957] 1 QB 159 at 172 per Denning LJ.*
9. *Tesco Supermarkets Ltd v Nattras [1972] AC 153 at 170 per Lord Reid.*

12.10 Clearly directors will often be in a position where their actions will be taken as those of the corporation. Actions of delegates of the board and other superior officers will also often be identified in that way. Those of subordinate officers, carrying out orders from above, will seldom be of that kind. For the corporation to be liable for the actions of the officer, the officer must be acting within the scope of his or her authority.[10]

Individual liability

12.11 Individuals may be made liable for corporate misconduct under statute or doctrines which impose such liability. This is referred to as lifting or piercing the corporate veil.[11] For example, individual liability may be imposed by statutory provisions such as sections 82, 229A and 556 of the Companies Code (Corporations Act, ss186, 233 and 592 respectively), or provisions in other legislation such as section 53 of the Environmentally Hazardous Chemicals Act 1985 (NSW).

12.12 In relation to cases in which the corporate veil may be lifted, Gower has said:

[T]hey reveal no consistent principle beyond a refusal by the legislature and the judiciary to apply the logic of the principle laid down in Salomon's case where it is too flagrantly opposed to justice, convenience or the interests of the Revenue.[12]

Hamilton v Whitehead

12.13 An example of a statutory provision in the companies

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10. *Moore v I Bresler Ltd [1944] 2 All ER 515.*
11. *See Redmond, Paul, Companies and Securities Law - Commentary and Materials, Law Book Co Ltd, Sydney, 1988, pp 137-51, for discussion off the kinds of cases in which the corporate veil has been lifted.*
12. *Gower, LCB, Gower's Principles of Modern Company Law (4th ed), Stevens & Sons, London, 1979, p112.*

legislation which imposes personal liability on a director, in addition to the liability on a company, is section 38(l) of the Companies and Securities (Interpretation and Miscellaneous Provisions) (Western Australia) Code:[13]

A person who aids, abets, counsels or procures, or by act or omission is in any way directly or indirectly knowingly concerned in or party to, the commission of an offence against any relevant Code shall be deemed to have committed that offence and is punishable accordingly.

This section has the same effect as the general accessory provision in the Crimes Act 1911 (Cth).[14]

12.14 In Hamilton v Whitehead[15] the High Court found that a (managing) director was personally liable for acts of the company. The director had been 'knowingly concerned' in the commission of offences by the company because he had committed the wrong and knew of all the relevant circumstances.

12.15 The company itself had been found liable under section 169 of the Companies Code (Corporations Act, s1064).[16] Section 38(l) of the Companies and Securities (Interpretation and Miscellaneous Provisions) (Western Australia) Code made the director liable in addition to the company.

12.16 The High Court said:

[T]he fundamental purpose of the companies and securities legislation - to ensure the

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13. *This code, and similar codes in each of the States and the Northern Territory, adopted the substantive provisions of the Companies and Securities (Interpretation and Miscellaneous Provisions) Act 1980 (Cth), incorporating minor variations relevant to each particular jurisdiction.*
14. *Section 5.*
15. *(1989) 7 ACLC 34.*
16. *Pursuant to s169, the company was liable in so far as, being unauthorised, it had offered or issued to the public a prescribed interest in a syndicate trust.*

protection of the public - would be seriously undermined if the hands and brains of a company were not answerable personally for breaches of the Code which they themselves have perpetrated.[17]

Allocation of individual and corporate liability

12.17 Making individuals liable for misdeeds of a company is not a novel concept. However, even today it seems to be the exception rather than the rule.[18] One study of the enforcement of corporate law in Australia shows that liability is usually directed at the corporate entity:

Prosecutions are overwhelmingly directed at companies rather than at individuals who acted on behalf of the company. Only twenty [of the 96 regulatory agencies surveyed] had a policy or preference for prosecuting individuals rather than companies, mostly in the mining and marine areas. Mine safety regulation is notable for fostering individual accountability through statutes which nominate in some detail the responsibilities of individuals who fulfil various roles in the organization.[19]

12.18 Individual and corporate liability are not mutually exclusive. The problem is to find the appropriate balance.[20]

Examples from other jurisdictions

12.19 A common theme running through submissions to the Committee was that the duties and obligations (and consequent liability) imposed on company directors in Australia were already sufficient, if not over-burdensome. Anecdotal examples of

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17. *Hamilton v Whitehead (1989) 7 ACLC 34 at 38-9.*
18. *See submission from Professor Fisse, p 24.*
19. *Grabosky, Peter and Braithwaite, John, Of Manners Gentle - Enforcement Strategies of Australian Business Regulatory Agencies, Oxford University Press in association with Australian Institute of Criminology, Melbourne, 1986, p 189.*
20. *See submission from Professor Fisse, pp 17-18.*

individual liability for corporate misconduct in the United States were cited with disapproval.[21]

12.20 The Committee notes reports of one of the first successful prosecutions of a corporate executive for negligent homicide in the United States.[22] When two employees died in Austin, Texas in 1986 as a result of the collapse of a 30 foot trench in which they were working, charges were laid against the company and its president. Neither contested the charges. The company was fined $10 000. The president was sentenced to a six month gaol term, with probation in lieu, together with an additional six months probation and a $2000 fine. Occupational Safety and Health Administration officials found the trench had not met the required standards.[23]

12.21 Recent research supported by the Institute for Civil Justice in the United States shows

a surge of suits against the directors and officers of corporations alleging personal responsibility for such torts as defective products ?r losses arising from merger rejections.[24]

12.22 it quotes an annual survey of US directors' and officers' liability which showed that the percentage of companies with a director against whom a liability claim was brought rose from 7% in 1974 to 18% in 1984. The average cost for a successful claim (excluding legal fees) rose from less than $US900 000 in

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21. *Eg Evidence, pp 105-6 (Mr Peters), 430 (Mr Webber).*
22. *Corporate Crime Reporter, vol 1, no 2, Monday April 20 1987, p 4.*
23. *According to the report, this case was to have been appealed on a technical point regarding the inter-relationship of state and federal legislation - Corporate Crime Reporter, vol 1, no 2, Monday April 20, 1987, p 5.*
24. *Reuter, Peter, The Economic Consequences of Expanded Corporate Liability: An Exploratory Study, RAND Corporation, USA, November 1988, p 28.*

1980 to almost $US2 million in 1986.[25]

12.23 Individual liability for corporate misconduct appears to be a strong tradition in Japan.[26] For example, the Japanese Supreme Court upheld a ruling that the president and a plant director of a company were responsible for deaths caused by contaminated water discharged from the company's plant in the 1950s. The two were sentenced to two years imprisonment and placed on three years probation. It has been estimated that as many as 10 000 people may have been affected, some fatally, by the discharge of methylene chloride mercury-contaminated water. By 1975, the company had paid out an estimated $80 million to 785 victims of mercury poisoning.[27]

12.24 In the USSR, three directors were sentenced to ten years hard labour following the Chernobyl nuclear plant disaster.[28]

12.25 In the United Kingdom, it is reported that three former directors of the P&O shipping group are to be prosecuted for manslaughter following the Zeebrugge ferry disaster in March 1987.[29] In that accident, 193 lives were lost when a ferry sank as it left the port. The bow doors had been left open. Summonses were issued against various officers who were on the ferry at the time and against the ferry company itself. This will be the first time in the United Kingdom that a company has been prosecuted for manslaughter.

12.26 The directors and seamen face a maximum penalty of life

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25. *Reuter, Peter,* *The Economic Consequences of Expanded Corporate Liability: An Exploratory Study*, *RAND Corporation, USA, November 1988, p 28.*
26. *See, eg, Braithwaite, John and Fisse, Brent, 'Varieties of Responsibility and Organizational Crime' (1985) 7* *Law & Policy* *315 at 317.*
27. *Corporate Crime Reporter*, *vol 2, no 20, Monday May 23 1988, p 3.*
28. *Wells, Cellia, 'The Decline and Rise of English Murder: Corporate Crime and Individual Responsibility' [1988] Crim L Rev 788 at 799.*
29. *The Guardian Weekly*, *2 July 1989, p4.*

imprisonment. The ferry company faces an unlimited fine. If the cases against the individuals are successful, there will be ramifications elsewhere, for example, for those involved in the Kings Cross underground disaster where no prosecution has yet been brought against any individual.

Submissions

12.27 BHP Limited expressed concern at '[t]he nature of some of the liabilities imposed upon directors, and the trend to extend them'.[30] It said:

In some instances liabilities appear to be imposed indiscriminately, without regard to principle. The singling out of directors (and in some cases other officers of companies) for this treatment, as compared with the treatment of those who carry responsibility for the affairs of other organisations in the public and private sectors, cannot be justified. While directors cannot avoid bearing responsibilities, and the law must seek to deal with dishonest and fraudulent conduct, there is no good to be gained by subjecting directors as a group to unrealistic personal liability.[31]

12.28 The Company Directors' Association referred to personal responsibility imposed on company directors by State and Commonwealth legislation and said:

As a matter of principle the [Company Directors'] Association believes that imposing such responsibilities has gone beyond bounds. The corporation is the body responsible and the corporate veil should not be lifted just to ensure compliance [with] a statute.[32]

12.29 Professor Fisse saw no reason for changing the law in so

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30. *Submission, para 19 (Evidence, p 608).*
31. *Submission, para 19 (Evidence, p 608).*
32. *Submission, p 13 (Evidence, p 92).*

far as it allowed for a mix of personal and corporate criminal liability. He cautioned, however, that proposals to extend strict liability for company acts which violated statutory requirements to corporate officers were 'highly problematical' because to do so would violate the traditional precept that criminal liability requires blameworthiness on the part of an accused.[33]

12.30 He recommended 'a much less drastic change'. As the law now stands, a director is liable for complicity, or for being knowingly concerned in an offence, where he or she intentionally gives assistance or encouragement to the commission of that offence. Professor Fisse said that a director's liability for complicity should be extended to cover the situation where he or she recklessly assists or encourages the commission of an offence by another. This would be consistent with the English position at common law.[34]

12.31 The Committee recommends that the **law be amended to make a director personally liable for complicity where he or she intentionally or recklessly assists in or encourages an act which constitutes an offence by a company.**

Indemnification

12-32 Many submissions said the indemnification of directors was a difficult issue.[35] It was suggested that an increase in directors' personal liability would reduce the pool of those prepared to take on a directorship.[36] This would be so

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33. *Submission, p 16.*
34. *Submission, p 17.*
35. *See, eg, submissions from Peat Marwick Hungerfords, p 4 (Evidence, p 6); Company Directors' Association of Australia, p 10 (Evidence, p 89); Institute of Directors in Australia, pp 8-12 (Evidence, pp 126-30; Mayne Nickless Ltd, p 2 (Evidence, p 374); BHP Ltd, para 22 (Evidence, p 609); Desane Group Holdings Ltd, p 1; Attorney-General's Department, paras 5.8-11; Evidence, pp 64-5 (Mr Middleton, Mr Prosser); 99-100 (Mr Peters); 635 (Mr Loton).*
36. *Eg, submissions from BHP Ltd, para 19 (Evidence, p 608); NCSC, pp 5-6 (Evidence, pp 564-5).*

particularly if there were difficulties obtaining indemnification. It has been reported that increases in the personal liability of directors in the United States have made it more difficult to obtain outside directors. This means that US boards now face less than the desired ratio of outside to inside directors.[37]

12.33 As the Companies and Securities Law Review Committee has investigated the question of indemnification,[38] the Committee has not pursued this matter.

Individual liability may be appropriate

12.34 Many submissions recognised that there were circumstances where directors should bear personal liability for acts done in the company's name. For example, Dr Pascoe, speaking for the Business Council of Australia, said if directors of a company knew that polluting substances were being dumped in a sensitive area by the company and condoned the action, they should be held responsible for that action.[39]

12.35 Mr Harper, Federal President of the Institute of Directors in Australia, said:

The fact that an anti-social act is committed requires that some action be taken by the community to put that anti-social act right or to prevent it happening again. The fact that a company is responsible for doing an anti-social act means that some officer of the company is responsible for the action being taken. If it is quite clear that any ordinary person with decent feelings would realise that he was committing an anti-social act then

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37. *Reuter, Peter, The Economic Consequences of Expanded Corporate Liability: An Explanatory Study, RAND Corporation, USA, November 1988, p29.*
38. *Companies and Securities Law Review Committee, Discussion Paper No 9, Company Directors and Officers: Indemnification, Relief and Insurance (April 1989).*
39. *Evidence, pp 492-3.*

clearly that person is responsible. That person may or may not be a director of the company. ... The directors as such are paid their modest fees for the purpose of taking responsibility for the actions of the officers of the company, and therefore ultimately in an anti-social act because of the way our system is structured, the directors are responsible.[40]

12.36 Mr Harper emphasised that, in his view, personal liability of a director should depend on the nature of the 'anti-social act' and on whether the director had been criminal or negligent in what he or she did.[41]

Development of policy

12.37 The Company Director's Association, and others, spoke of the trend towards imposing personal liability on directors.[42] It appears that legislators are thinking more and more in these terms.[43] Mr Loton spoke of 'the rather piecemeal approach in legislation to the imposition of specific legal liabilities on directors and the way in which those liabilities are sometimes extended'.[44]

12.38 Professor Fisse wrote that

[t]he present law provides for both individual and corporate liability but makes no attempt to achieve a well-balanced mix; the balance in fact achieved depends on the vicissitudes of

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40. *Evidence, pp 139-40.*
41. *Evidence, p 140.*
42. *Eg, submissions from Company Directors' Association of Australia, p 13 (Evidence, p 92); BHP Ltd, para 19 (Evidence, p 608); Evidence, pp 576 (Mr Bosch, Senator Hill), 614-15 (Mr Loton).*
43. *See, eg, The Sydney Morning Herald, 11 March 1989, p 4, quoting the NSW Minister for the Environment, the Hon Tim Moore MLA, proposing substantial personal liability for company directors for acts of companies in relation to environmental matters. See also submission from Mr Sumner, SA Attorney-General and Minister of Corporate Affairs and Chairman of the Ministerial Council for Companies and Securities.*
44. *Evidence, p 614.*

prosecutorial discretion.[45]

12.39 Where there is a practice of prosecuting corporations rather than individuals, no matter what the circumstances, there is a risk that people within the company who ought be held liable will never be called to account for their actions. This practice is often followed as a matter of convenience and has no policy underpinning it.[46] No proper thought is given to the best means of preventing future misconduct.

12.40 The way corporations are prosecuted and punished provides little incentive for them to use 'their internal disciplinary systems to sheet home individual accountability'.[47] It is often far less disruptive and embarrassing, and indeed cheaper, for the corporation to pay the fine and let the matter rest.[48]

12.41 Whether a company or an individual should be held liable for corporate misconduct in any given circumstances, or whether liability should be apportioned between the two, is an issue properly decided according to principle. It should not be determined according to the 'vicissitudes of prosecutorial discretion'.[49] Regulators should act according to a policy which vindicates the rights of people vulnerable to ill conduct of companies.

Relevant factors

12.42 Factors which ought to be taken into account when formulating such a policy include:

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45. *Submission, pp 18-19.*
46. *See submission from Professor Fisse, p 19.*
47. *Submission from Professor Fisse, p 19. See also Fisse, Brent and Braithwaite, John, 'Accountability and the Social Control off Corporate Crime: Making the Buck Stop' 20(l) Australian Journal of Forensic Sciences, September 1987, p 166.*
48. *Submission from Professor Fisse, pp 19, 22-3.*
49. *Submission from Professor Fisse, p 19.*

* cost - to prosecute a corporation could be more convenient and cheaper than prosecuting a number of individuals;

* establishing liability - it will be easier to establish the requisite mental element in the case of an individual than in that of a corporation. It may be open to prosecute the company in any case where the mental element of the individual can be imputed to the company;

* securing an effective remedy - where it is cheaper for a company to remedy internal controls which may have failed than to pay a fine, potential prosecution of a corporation might be a more effective remedy;

* admissions of guilt - proof of guilt is often based on admissions, and it may be unclear who would have the authority to make admissions on behalf of a company;

* the law as it is - traditionally, the criminal law has dealt with individual rather than corporate offenders, There is much common sense in this because it is actually individuals who commit crimes, rather than corporations. This approach denies, however, the separate legal personality of the corporation. As a legal entity, it should be subject to legal sanctions;

* the nature of sanctions - an individual may have to pay a fine from his or her personal resources; a fine levied against a corporation must be borne by the shareholders and perhaps by the consumers. Individuals or corporations may be injuncted, either to prevent or to force action. A director can be disqualified or sent to gaol. A corporation can be wound up.

12.43 Professor Fisse submitted that one way of achieving accountability for corporate misconduct, and of achieving a better mix of individual and corporate liability,

would be to structure enforcement so as to activate and monitor the private justice systems of corporate defendants.[50]

12.44 In other words, he said it may be more efficient to devise some means of forcing a corporation which has transgressed to conduct its own inquiry as to who was responsible within the Organisation. The corporation could be required to apportion blame and to discipline those responsible, and to design a means of avoiding such transgressions in the future, to the satisfaction of the court. A further advantage of this approach is that taxpayers would not have to bear the burden of costs associated with investigation.[51] Professor Fisse has said this idea requires further development if it is to be implemented successfully.[52] It was not developed in the evidence before the Committee.

12.45 The Committee has elsewhere commented on the need for adequate enforcement of the law (see chapter 10). Enforcement action must be targeted in a principled way. The development of a policy to direct enforcement is a detailed and technical matter which should be addressed urgently. It is not desirable that development continue in its present ad hoc manner. It should take into account corporate organisational culture. All relevant regulatory agencies should play a part in its development. The economic advantages which have flowed to the community as a result of corporate endeavour are great, but the corporate form should not be used as a mask.

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50. *Submission, p 25.*
51. *Submission from Professor Fisse, pp 26-9.*
52. *Submission, p 29.*

12.46 The Committee recommends that

(i) the appropriate mix of individual and corporate liability for corporate misconduct be referred to a body such as the Australian Law Reform Commission for detailed investigation and report;

(ii) the matter be investigated and researched in close consultation with all persons and community groups who are willing and able to contribute; and

(iii) the aim of such a review be to develop a theoretical basis to guide the future drafting of legislation and prosecution guidelines

Legal risk management

12.47 The imposition of legal obligations on corporate activities generates the need for compliance systems in all but the smallest companies. A "compliance system' is an institutionalised method of preventing illegal or unsatisfactory conduct or outcomes.[53]

12.48 A compliance system could involve drawing up guidelines or statements of policy, implementation of certain procedures (eg designed to ensure safety or quality), clear allocation of responsibility, monitoring compliance with statutory requirements, or general educative programs for company personnel.[54] The system required will depend on the circumstances but

in companies of any size, compliance with legal duties is typically not a matter simply of individual choice but depends upon organisational policies and operating

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53. *Fisse, Brent, 'Legal Risk Management and Corporate Strategy', unpublished paper, Sydney, November 1987, p 6.*
54. *Ibid, pp 8-10.*

procedures.[55]

12.49 Professor Fisse said:

It is entirely conceivable that a company director may be held civilly or criminally liable under s.229(2) of the Companies Code (Corporations Act, s232(4)] if a suitable compliance system is not in place in his or her company. There is also the possibility of civil liability for the tort of negligence. Furthermore, criminal or civil liability can arise under a wide variety of statutory provisions requiring the taking of reasonable care.[56]

12.50 Professor Fisse acknowledged

a vast proliferation of rules governing particular facets of company operations (e.g., accounting requirements, occupational health and safety regulations),[57]

but pointed out that generally companies are given the freedom to regulate their own internal affairs. This did not mean, however, that the adequacy or otherwise of compliance systems would be immune from legal scrutiny.[58]

12.51 He gave the following example:

Assume that the board of directors of a merchant bank delegates all tasks of fraud prevention to a compliance manager and then exercises no supervisory role over his or her compliance activities. Assume further that the compliance manager takes an unduly optimistic or casual view of the compliance function delegated and that the company's financial health is jeopardised by a number of middle managers who have engaged in manipulation of

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55. *Fisse, Brent, Legal Risk Management and Corporate Strategy' unpublished paper, Sydney, November 1987, p 5.*
56. *Submission, p 1.*
57. *Submission, p 1.*
58. *Submission, pp 1-2.*

share prices, trading ahead of customers on the futures exchange, and money-laundering. In supposing that the compliance officer would prepare adequate compliance procedures, and in refraining from demanding any assurances of adequacy, have the members of the board violated s. 229(2) of the Companies Code by failing to use reasonable care and diligence in monitoring the company's compliance efforts? Should they have insisted on at least quarterly or half-yearly reports by the product safety officer as to the nature and extent of the company's compliance system?[59]

12.52 Professor Fisse submitted:

It may be argued that, in the absence of any reason to suspect that the compliance officer would not properly discharge the function delegated, there is no liability. Certainly there is some support in the case law for this position [see, eg, Re City and Equitable Fire Insurance Co Ltd [1925] Ch 407 at 429 per Romer J; Graham v Allis Chalmers 188 A 2d 125 (1963)]. On the other hand, it may be argued that prevention of fraud is a matter of such significance for a merchant bank that failure to monitor compliance by requiring periodic reports and assurances may amount to lack of reasonable care by the directors in exercising their power to manage the business of the company. Losses associated with non-compliance may easily be more significant than some of the traditional items of financial business on the agenda of board meetings, and hence it would be unwise to assume that the duty under s.229(2) is confined only to the traditional areas of fiscal command expected of directors in the past.[60]

12.53 Companies' boards should consider legal risk management as it applies to their particular circumstances:

Unsatisfactory compliance policies and procedures can be directly in issue in a

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59. *Submission, p 2.*
60. *Submission, p 3.*

variety of contexts, including the tort of negligence and statutory offences of failing to exercise due diligence to prevent a contravention [eg under s229(2) of the Companies Code].[61]

12.54 Precedents set under the Trade Practices Act indicate that the existence of compliance measures are taken into account in the assessment of penalty.[62] For example, in a recent resale price maintenance case under the Trade Practices Act, Judge Fisher, in assessing penalty, regarded seriously the fact that an officer of the defendant corporation

had not been made aware or fully aware of the company's obligations under the [Trade Practices] Act and its policy of compliance therewith.[63]

This was notwithstanding evidence that the board of directors itself took its obligations seriously. The judge said

its failure to impress upon its employees and its senior management these obligations is particularly culpable.[64]

12.55 In Henderson v Australasian Conference Association Limited,[65] 'informal and slipshod' product recall procedures sounded in penalties although there was 'no moral turpitude, no dishonesty and no profit making involved'.[66] In Trade Practices

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61. *Submission from Professor Fisse, pp 1-2.*
62. *See Frieberg, Aries, 'Monetary Penalties Under the Trade Practices Act 1974 (Cth)' (1983) 11 Australian Business Law Review 4.*
63. *Trade Practices Commission v General Corporation Japan (Aust) Pty Ltd (1989) ATPR 40-922 at p 49,977.*
64. *Ibid.*
65. *(1987) ATPR 40-801.*
66. *Ibid at p 48,710.*

commission v Annand and Thompson Pty Ltd, [67] the penalty was assessed 'towards the lower end of the scale' because it was 'a "one-off" instance, which occurred despite attempts to inform employees of the requirements of the [Trade Practices] Act'.[68] In Dawson v World Travel Headquarters Pty Ltd,[69] the failure of a fail-safe system, in the absence of dishonest or deliberate conduct, was considered a mitigating factor.

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67. (1987) ATPR 40-772.
68. Ibid at p 48, 394.
69. (1981) ATPR 40-193.

CHAPTER 13

SANCTIONS AGAINST DIRECTORS

13.1 Directors are subject to a range of legal sanctions for breaches of the companies legislation. Where they breach their fiduciary duties, they may be subject to equitable remedies. In this chapter, the focus will be on those sanctions contained in the legislation.

13.2 The Companies Code and Corporations Act provide for civil remedies (damages, compensation) and criminal penalties. They provide that a director may be disqualified from office. Legislation in various States[1] allows for community service orders to be made in respect of certain offences against the companies legislation.

13.3 The Companies Code contains many penalty provisions applicable to directors. Recently, the Deputy Chairman of the NCSC, Mr Charles Williams, commented that 'the ... Corporations [Act] includes 154 offences which directors may commit, of which 149 involve criminal sanctions'. He compared this with 148 obligations imposed on directors under the existing Companies Code. He noted that many of the penalties had been increased.[2]

13.4 Professor Baxt made the point that people may feel disinclined to take on directorships because of the penalties to which they would potentially be subject.[3] Concern was also expressed in the course of the Committee's inquiry that the

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1. *See, eg,* *Community Service Orders Act 1979* *(NSW),* *Penalties and Sentences Act 1985* *(Vic),* *Criminal Law (Sentencing) Act 1988* *SA.*
2. *'Directors - How to Sort Out the Professionals from the others', speech given by Mr Charles M Williams to the Institute of Directors in Australia, Victorian branch, Melbourne, 31 May 1989.*
3. *Evidence, p 357 (Professor Baxt).*

penalties provided in the Companies Code demonstrated little consistency.[4] Concern was expressed that many of the penalty provisions were inappropriate.[5]

Criminal sanctions

13.5 Generally the submissions made to the Committee approved of criminal penalties for company directors where they had acted fraudulently or dishonestly but not otherwise.[6] The criminal law will deal with most offences involving fraud and dishonesty.[7] An auditor who gave evidence to the Committee said the criminal penalties helped to 'focus the view of directors', although he also expressed the view that the civil remedies were 'probably more important'.[8]

13.6 Although many sections of the Companies Code and Corporations Act provide for gaol terms, in lieu of or in addition to monetary penalties, it appears that courts are reluctant to impose them.[9] When gaol terms are provided for breach of the law but the courts are disinclined to impose them because they seem too draconian, the law tends to fall into disrepute. The modest fines which are imposed instead cause some discontent in the community.

13.7 On the other hand, the increased risk of going to gaol that comes with being a director is a disincentive to take on that role. People who would otherwise make good directors may decline a directorship because of this risk.

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4. *Evidence, p 421 (Mr Hulett).*
5. *Eg Evidence, p 356 (Professor Baxt).*
6. *Eg, Evidence, pp 357 (Professor Baxt); 421 (Chairman, Mr Webber); 495 (Dr Pascoe); 625 (Mr St John).*
7. *Eg, false accounting Crimes Act 1958 (Vic)), obtaining financial advantage (s82, Crimes Act 1958 (Vic)) or property (s81, Crimes Act 1958 (Vic), by deception, falsifying books of account (s83(1)(a), Crimes Act 1958 (Vic)), theft (s72, Crimes Act 1958 (Vic)), forgery (common law).*
8. *Evidence, p 10 (Mr Richardson).*
9. *Evidence, p 102 (Mr Peters).*

13.8 Professor Fisse said there was no reason to depart from the present approach of the law, that is, 'to use the range of sentences available generally in the criminal law':[10]

For relatively minor offences a fine or probation may be entirely appropriate. For more serious offences community service orders may be warranted ... For the most serious range of offences jail may be necessary to reflect the gravity of the particular offence committed.[11]

13.9 The Committee agrees that a range of criminal sanctions should be available to meet the range of circumstances of a criminal nature that can arise.

Decriminalisation of Company Law

13.10 Professor Baxt, arguing in favour of 'decriminalisation' of company law, said:

If I were rewriting the Companies Act I would decriminalise a lot of it. I think there are far too many criminal penalties in areas where there should not be. Take the duty to act with care, [section] 229; there are criminal penalties there which seem strange. I query just why you want criminal penalties in some of the 'situations where they are not major problems - failure to file accounts, et cetera. Certainly you can penalise them [ie. directors] monetarily but keep the criminal element out of it.[12]

13.11 Professor Fisse said that the proposal to decriminalise company law seemed 'extreme and unfounded'.[13] He presented an alternative position:

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10. *Submission, p 13.*
11. *Submission, p 13.*
12. *Evidence, p 356.*
13. *Submission, p 13.*

The main trouble with the offence under s. 229(2) as it now stands is that it is defined in terms of negligence rather than in terms of subjective blameworthiness. Generally speaking, the approach adopted in our system of criminal justice is to require proof of guilty intention, knowledge or recklessness, especially where the offence carries the possibility of a jail sentence. The sensible course, in my opinion, would be to redefine the offence under s. 229(2) accordingly. Thus, criminal liability for breaches of s. 229(2) could be confined to situations where a corporate officer knows or is aware of the likelihood that his or her conduct falls short of the standard of care expected. This approach would make the offence narrower in scope and yet would retain criminal liability in the worst instances of violation.[14]

13.12 The criminal law is a necessary means of enforcing proper behaviour. Where offences are genuinely criminal in nature, criminal sanctions are appropriate. They are only appropriate in those circumstances. The Committee recommends that **section 229(2) of the Companies Code, or its equivalent, be amended so that criminal liability under that section only applies where conduct is genuinely criminal in nature.**

Civil remedies

13.13 Professor Fisse used the term 'pyramid of enforcement' to describe the present system,

with civil measures at the base of the pyramid for the general run of cases, and criminal liability at the apex for the more exceptional instances of law-breaking.[15]

13.14 Where a breach of the law does not involve criminality,

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14. *Submission, p 14.*
15. *Submission, p is.*

a civil penalty[16] may be appropriate.[17] Proof of the breach would have to be established on the civil onus (that is, on the balance of probabilities) and there would be no stigma of criminal conviction attaching to the director. In appropriate circumstances, people who suffered loss as a result of the breach could simultaneously bring a claim for damages in the proceedings taken to recover the penalty.

13.15 The Committee recommends that **civil penalties be provided in the companies legislation for breaches by directors where no criminality is involved, and, in appropriate circumstances, people suffering loss as a result of a breach be enabled to bring a claim for damages in the proceedings taken to recover the penalty.**

Level of penalties

13.16 Penalties must suit the offence. They will have no

deterrent value if their level is insufficient. Criminal penalties are not appropriate unless criminality is involved. Civil penalties must be commensurate with the wrong done. Damages should reflect the loss suffered.

13.17 The Company Directors' Association said to the Committee:

The annual reports of State [Corporate Affairs] Commissions show a multiplicity of prosecutions of directors of small companies for minor administrative offences. In the great majority of cases, no community disadvantages result from these breaches.[18]

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16. *Such as applies, eg, under s178 of the Industrial Relations Act 1988 - see Gapes v Commercial Bank of Australia Ltd 27 ALR 87 - and the Trade Practices Act 1974, Part IV.*
17. *See submission from Professor Fisse, p 15, who saw some point in the introduction of a 'regime of civil penalties' in certain circumstances as a 'complementary approach'.*
18. *Submission from Company Directors - Association of Australia, p 3 (Evidence, p 82).*

13.18 The argument seems to be that some administrative procedures required by the law are trivial or unnecessary and the failure to carry them out should not attract a penalty. The companies legislation requires a number of administrative procedures. It is proper that these provisions be enforced. The lodging and filing of documents is essential for the shareholders' and the community's proper access to corporate information. Failure to meet necessary requirements should be penalised. Penalties for breaching such requirements, as with all penalties, should be measured to fit the offence. If provisions are not to be enforced, they should be repealed. There is no scope for half measures. An 'on the spot' fining system could account for minor breaches of an administrative nature in a suitable way.

13.19 In April 1986, the PERIN (Penlty Enforcement by Registration of Infringement Notice) system commenced operation in Victoria.[19] This system is a fully computerised method of processing infringement notices. When people have committed relatively minor offences, where there is a fixed penalty, they are able to pay the penalty, or make suitable payment arrangements, without a conviction being recorded against them. A person retains the right to have the matter determined in a court, if he or she chooses.[20]

13.20 The Committee recommends that **a system of on-the-spot fines for minor offences, such as the Victorian PERIN system, be introduced into the administration of company law.**

13.21 The enactment of the close corporations legislation will

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19. See Magistrates (Summary Proceedings) Act 1975, Part VIIA.
20. See, also ‘Directors - How to sort Out the Professionals from the Others’, speech given by Mr Charles M Williams, Deputy Chairman, NCSC, to the Institute of Directors in Australia, Victorian Branch, Melbourne, 31 May 1989. Mr Williams urged support for the introduction of a scheme such as the PERIN scheme and noted developments in various States along these lines.

relieve small organisations of some of the onerous requirements of the companies legislation which are more appropriately aimed at public companies. It may be that the number of breaches of administrative requirements will decrease when small organisations can incorporate under the close corporations legislation. In any event, an on-the-spot fining system is appropriate where minor offences are involved.

Community service orders

13.22 Community service orders are orders by a court to perform designated work with a public purpose within the community. They may be made against company directors in relation to certain offences under the companies legislation. For example, in New South Wales, when an offence is punishable by a gaol sentence, a court may impose a community service order.[21] Community service orders do not appear to apply to bodies corporate.[22]

13.23 Professor Fisse submitted that community service orders are 'less drastic than jail sentences and yet more severe than fines'.[23] They are more severe because the individual involved is required to expend some personal effort in his or her spare time and this cannot readily be indemnified by the company. This contrasts with the imposition of fines which may be met by the company, either directly or indirectly.[24]

13.24 If suitable work were available for community service orders,[25] then community service orders would be appropriate for

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21. *Community Service Orders Act 1979 (NSW) s4. See also, eg, Penalties and Sentences Act 1985 (Vic), Part V, Criminal Law (Sentencing) Act 1998 (SA), Part VI.*
22. *Submission from Professor Fisse, p 3O.*
23. *Submission, p 31.*
24. *Submission from Professor Fisse, p 31.*
25. *Eg, in NSW, the Minister approves the kind of work that may be done as part of a community service order - see Community Service Order Act 1979 (NSW), s3, definition of 'community service work'.*

company directors in certain circumstances. Suitable work could involve devising an accounting system for a charity or helping set up a community Organisation, for example.

Disqualification

13.25 Given the opportunity for error and fraudulent conduct by company directors, and the absence of any requirement for formal qualifications, disqualification or prohibition provisions[26] are of considerable importance in protecting the public interest. Under section 222 of the Companies Code (Corporations Act, s224), the director must vacate his or her office in certain circumstances which include where the person has not obtained or ceases to hold the relevant share qualification, becomes an insolvent under administration, is convicted of certain offences or becomes subject to certain court orders or notices from the NCSC.

13.26 Evidence was given to the Committee that disqualification from office was the greatest threat to directors, notwithstanding possible gaol sentences and financial penalties, and therefore was an effective sanction.[27]

13.27 It is appropriate that there be a range of sanctions

available to enforce company directors' duties and obligations. A range of sanctions provides a means whereby sanctions may be tailored to the circumstances. Disqualification is an appropriate sanction as part of that range.

The Senate Parliament House Canberra	Barney Cooney Chairman Canberra

November 1989

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26. See, eg, Companies Code ss222, 562 (Corporations Act, ss224, 599).
27. Eg, Evidence, pp 103 (Mr Yeomans), 156 (Mr Head).

APPENDIX I

INDIVIDUALS AND ORGANISATIONS WHO MADE WRITTEN SUBMISSIONS TO THE COMMITTEE

ALLEN, Mr K A (2 submissions)	Melbourne, Vic
ATTORNEY-GENERAL'S DEPARTMENT	Canberra, ACT
AUSTRALIAN SHAREHOLDERS' ASSOCIATION	Sydney, NSW
AUSTRALIAN STOCK EXCHANGE	Sydney, NSW
AXTENS, Mr J M (2 submissions)	Lismore, NSW
BAXT, Professor B	Belconnen, ACT
BHP COMPANY LIMITED (2 submissions)	Melbourne, Vic
BUSINESS COUNCIL OF AUSTRALIA	Melbourne, Vic
BYLES, Mr K	Dickson, ACT
CAMPBELL, M/- T W	Wanniassa, ACT
COMPANY DIRECTORS' ASSOCIATION OF AUSTRALIA	Sydney, NSW
DESANE GROUP HOLDINGS LIMITED	Leichhardt, NSW
FISSE, Professor B	Sydney, NSW
INSTITUTE OF CHARTERED ACCOUNTANTS IN AUSTRALIA	Sydney, NSW
INSTITUTE OF DIRECTORS IN AUSTRALIA (2 submissions)	Sydney, NSW
KEOGH, M/- N M J	Boronia, Vic
LAUGHTON, M/- R B	Gilberton, SA
LAW REFORM COMMISSION, AUSTRALIA	Sydney, NSW
MACKINNON, MLA, Mr B J	Willetton, WA
MAYNE NICKLESS LIMITED (2 submissions)	Melbourne, Vic
MULLENS, Mr J	Surrey Hills, Vic
NATIONAL COMPANIES AND SECURITIES	Melbourne, Vic

COMMISSION (2 submissions)

PEAT MARWICK HUNGERFORDS	Sydney, NSW
SUMNER, Mr C J (Minister for Corporate Affairs)	Adelaide, SA
TURNBULL, Mr S	Sydney, NSW
URQUHART, A B & COMPANY	East Melbourne, Vic
WISHART, Mr D A	Kuala Lumpur, Malaysia

APPENDIX II

WITNESSES WHO APPEARED AT PUBLIC HEARINGS

Allen, Mr Kingsley (Kingsley A Allen & Partners, Consultants to Management)

Baxt, Professor Robert

BHP Company Limited

Mr Brian Loton (Managing Director and Chief Executive Officer)
Mr Richard St John (General Counsel)

Business Council of Australia

Dr Timothy Pascoe (Consultant)
Mr Clive Speed (Assistant Director)

Company Directors' Association of Australia

Mr Christopher Peters (Chief Executive)
Mr Athol Yeomans (Editor and Researcher)

Finn, Professor Paul (Faculty of Law, Australian National University)

Institute of Chartered Accountants in Australia

Mr Peter Middleton (President)
Mr Victor Prosser (Executive Director)

Institute of Directors in Australia

Mr Gregory Bartels (Director-General)
Mr Colin Harper (President)
Mr Neville Head (Chairman, NSW Branch Council)

Mayne Nickless Limited
Mr Anthony Hulett (Legal Counsel)
Mr Ian Webber (Managing Director)

National Companies and Securities Commission

Mr Henry Bosch (Chairman)
Mr Ray Schoer (Executive Director)

Peat Marwick Hungerfords

Mr John Richardson (Partner, National Professional Practice Department)