THE REFORM OF DIRECTORS' DUTIES

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I. INTRODUCTION

This article examines the adventure in reform of the law on directors' duties set in motion with the exposure draft of the *Corporate Law Reform Bill* 1992 ("the Exposure Draft") by the Commonwealth Government in February 1992. This initiative foreshadows the most significant attempt at statutory renewal of standards of director conduct undertaken in this country. The scale and terms of the initiative have attracted a hostile response of unusual dimensions. The Government's present intention is to introduce the *Bill*, as revised in the light of comments received during the exposure period, during the Budget sittings so that it can be passed before the end of this year.[1] Because of this present uncertainty attaching to the *Bill*, this discussion is directed at the principles upon which the *Bill* is founded and the response which it has evoked.[2] Particular attention is paid to the proposals with respect to directors' duties of care.

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1 See Commonwealth Attorney-General's Department 1(2) *Corporate Law Newsletter* (July 1992) pp 1-2.

2 The Government received around 200 written submissions upon the Exposure Draft. In addition, a parliamentary committee conducted public hearings in several capital cities at which it solicited community and professional responses to the draft: see Joint Statutory Committee on Corporations and Securities *Summary of Evidence Presented to the Committee on the Draft Corporate Law Reform Bill 1992* (June 1992).

The reforms proposed with respect to directors in the Exposure Draft are a response to sustained criticism of transactions and conduct evident during the past decade.[3] To many commentators the scale of business failure following the stock market break of October 1987 marks a conspicuous failure of the accountability mechanisms of Australian corporate law. It is not helpful to identify particular names, nor fair since few have been fully investigated. But neither is it possible to ignore evidence in particular instances of:

(i) the breakdown of monitoring or other oversight of senior management by non-executive directors;

(ii) conspicuous indifference to fiduciary ideology among many who are its primary subject;

(iii) corporate control transactions marked by transparent conflicts of interest among management participants;

(iv) related party transaction entered into by directors to the apparent disadvantage of their company;

(v) asset transfers made within corporate groups without regard to the particular commercial and creditor interests of each company;

(vi) cash and other asset stripping of once prosperous companies under new control;

(vii) directors' remuneration arrangements which bear little obvious relation to their company's fortunes or to the market for executive services;

(viii) the use of put and call options to conceal obligations with respect to corporate assets and

(ix) misleading and manipulated company accounts, especially consolidated accounts.

Some reflection and shrivening are unavoidable. The delinquency of those who abuse the stewardship of other people's money is a species of deviance which is arguably as socially corrosive as the street offences which preoccupy the criminal justice system. The public interest in the integrity of Australian securities markets is no less crucial because it is remote from the direct experience of many. It rests upon two principal foundations. First, on many estimates, over one half of the equity in Australian listed companies is held by financial institutions.[4] This intermediated investment represents the occupational pension funds, retirement investments and other household savings of all social groups. Second, the securities markets are no less important as a source of long term finance for the commercial investment upon which economic growth and job creation depends.

3 See Attorney-General's Department (Cth) *Corporate Law Reform Bill* 1992, *Draft Legislation and Explanatory Paper* (1992) p 3 (the "Explanatory Paper"). The Exposure Draft represents the third general amending bill introduced in the Commonwealth Government's corporate law reform program since commencement of national scheme legislation on 1 January 1991.

4 Some figures are collected in P Redmond *Companies and Securities Law* (2nd ed, 1992) pp 83-5; United Kingdom estimates put the figure at over two thirds of listed equity: P Davies "Institutional Investors: A UK View" (1991) 57 *Brooklyn L Rev* 129 at 131.

These events provide the legal and social context for introduction of the Exposure Draft reforms. The provisions of the Exposure Draft also deal with matters other than directors' duties, including provisions relating to corporate insolvency law[5] and the settlement procedures for stock exchange transactions. The focus of this paper, however, is upon the proposals to strengthen legal standards of director conduct. These comprise measures relating to the director's duty of care and diligence, the partial decriminalisation of directors' statutory obligations, the disclosure by directors of conflicts of interests in transactions or arrangements involving their company, the disclosure of benefits given to a director, his or her spouse or relatives and associated entities, and loans to directors and financial transactions with other related parties. In light of the substantial revision which is currently underway in respect of the loan to directors and related party transactions provisions, they are excluded from the present treatment.

II. THE RANGE OF REFORM PROPOSALS WITH RESPECT TO DIRECTORS

The proposals with respect to the duty of care and diligence and the use of civil penalties in place of criminal sanctions derive from recommendations of the Senate Standing Committee on Legal and Constitutional Affairs (the "Cooney Committee").[6] The proposals relating to disclosure of directors' conflicts give effect to recommendations made by the Companies and Securities Law Review Committee in 1989[7] and those relating to disclosure of benefits given to directors and directors' loans and related party transactions derive from proposals developed by the Companies and Securities Advisory Committee.[8]

These proposals do not exhaust reform initiative with respect to directors. Three further categories of proposals may be identified. The first relates to proposals which the Commonwealth Government has indicated will be included within its corporate law reform program.[9] These comprise reforms concerning insurance and indemnification of directors with respect to their personal liabilities, a statutory derivative action to facilitate enforcement of directors' duties, and other matters recommended in the recent report of the House of Representatives Standing Committee on Legal and Constitutional Affairs (the

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5 These provisions are based upon proposals contained in Law Reform Commission Report No 45 *General Insolvency Inquiry* (1988). They have attracted general support from specialist groups of insolvency practitioners. The insolvency provisions of the Exposure Draft which modify directors' liabilities for insolvent and fraudulent trading are outside the scope of this article.

6 Senate Standing Committee on Legal and Constitutional Affairs *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989).

7 Companies and Securities Law Review Committee Report No 9 *Directors' Statutory Duty to Disclose Interest (Companies Act s 225) and Loans to Directors (Companies Act s 230)* (1989).

8 Companies and Securities Advisory Committee *Report on Reform of the Law Governing Corporate Financial Transactions* (1991).

9 Explanatory Paper p 7.

"Lavarch Committee").[10] The second category comprises those reforms proposed by the Cooney Committee but which have been rejected by the Commonwealth Government in its formal response to the Committee's report.[11] This is not an inconsiderable list which includes proposals for a statutory business judgement rule[12] and for a statutory provision permitting directors to take into account the interests of a company's employees in administering their company.[13] As for the former, the Government simply stated that it "is not at this stage convinced that it is appropriate to introduce in isolation this one aspect of American jurisprudence into the Australian law on directors' duties"[14]; as for the latter, the Government's response was to draw back from a statutory enhancement of employee claims in general management decision-making in favour of providing special priorities for employees in winding up.[15]

The third category concerns other proposals concerning directors made by law reform agencies apart from the Cooney and Lavarch Committees which have not yet been explicitly adopted in or rejected from the Government's law reform program. Principal among these are the proposals made by the Companies and Securities Law Review Committee with respect to:

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10 See House of Representatives Standing Committee on Legal and Constitutional Affairs *Corporate Practices and the Rights of Shareholders* (November 1991). The proposals with respect to director indemnification and insurance and the statutory derivative action are the subject of reports by the Companies and Securities Law Review Committee: see Report No 10 *Company Directors and Officers: Indemnification, Relief and Insurance* (1990) and Report No 12 *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (1990). The proposals for a statutory derivative action are discussed elsewhere in this volume: see IM Ramsay "Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action" (1992) 15 *UNSWLJ* 149. The Lavarch Committee made numerous recommendations concerning directors which include proposals to subject directors of companies which fail to comply with stock exchange listing rules to personal liability. Many of the Lavarch committee recommendations were, however, implicitly rejected in the Government's response to the Cooney Committee.

11 See *Government Response to the Senate Standing Committee on Legal and Constitutional Affairs on "The Social and Fiduciary Duties and Obligations of Company Directors"* Senate Hansard (28 November 1991) p 3611.

12 The proposal was for a statutory rule corresponding to doctrines developed in United States case law which provides a safe harbour from liability for directors' business judgments which are made in good faith and a proper purpose, where the director has no personal interest in the subject of the decision, is adequately informed about the subject of the decision and rationally believes that the business judgement is in the best interests of the company: American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (Proposed Final Draft) s 4.01; see generally DJ Block, NE Barton and SA Radin *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (3rd ed, 1989). Proposals for a statutory business judgment rule are discussed below in part IV.

13 The proposal was intended to follow English companies legislation which adopted a like provision in 1980 (now *Companies Act* 1985 (UK) s 309(1)) to displace the decision in *Parke v Daily News Ltd* [1962] 1 Ch 92: see Senate Standing Committee on Legal and Constitutional Affairs note 5 *supra* at [6.23]. The measure, it was said, was necessary to bring company law into step with prevailing community attitudes: [6.24].

14 Note 11 *supra* at [18].

15 *Ibid* at [63]. This proposal is contained in the Exposure Draft as cl 556.

(i) the rights and duties of nominee and alternate directors;[16]
(ii) the general meeting's power to ratify breaches of directors' duties or to give advance authority for directors to engage in specific conduct (other than conduct which involves an intent to deceive or defraud);[17] and
(iii) directors' rights of access to information concerning corporate affairs.[18]

III. THE FUNCTIONS OF DIRECTORS' DUTIES

A. MANAGERIALISM AND DIRECTORS' DUTIES

What functions are served by the imposition of legal duties upon directors and senior management? The answer depends in part from the conception or theory of the corporation underlying the response. Under managerialist theories of the corporation, the prescription of legal standards protects against hazards inherent in a firm structure that has one group managing the funds of another - the dual dangers of self-dealing and shirking by the managers.[19] These dangers are the more egregious where the funds are contributed by numerous dispersed investors whose individual stakes are insufficient to justify close monitoring of the common fund, even if that lay within their capacities as holders. Protection against management self-dealing is afforded by fiduciary duties of loyalty which impose obligations of good faith and conflict avoidance upon directors and senior officers. Duties of care and diligence are directed towards the problem of shirking. In relation to both species of duty, the general law obligation is reinforced by a statutory duty in similar terms but with wider sanctions and remedies.

Under managerialist theories therefore, legal duties, serve to insinuate an accountability mechanism to constrain management power and to strengthen shareholder controls. This strategy of strengthening shareholder influence and establishing appropriate modalities for management accountability has been the *leitmotif* of corporate law reform in North America, the United Kingdom and Australia during the past half century. Its influence is apparent in the provisions of the Exposure Draft touching directors' duties.

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16 See Companies and Securities Law Review Committee Report 10 *Nominee Directors and Alternate Directors* (1989).

17 Companies and Securities Law Review Committee Report No 10 note 10 *supra* pp 31-3.

18 *Ibid* pp 41-2.

19 See, eg AA Alchian and H Demsetz "Production, Information Costs and Economic Organisation" (1972) 62 *American Economic Rev* 777. Managerialist theories view the firm essentially as hierarchy and senior management, at the apex of the hierarchy, as the principal subject of legal regulation. The manageralist conception of the firm was stimulated by the empirical study by Berle and Means in 1932 disclosing the extent of the separation between ownership and control in the large United States corporations: see AA Berle and GC Means *The Modern Corporation and Private Property* (1932). The evolution of managerialist theories of the corporation, and of complementary economic legal doctrines, is traced in WW Bratton "The New Economic Theory of the Firm: Critical Perspectives from History" (1989) 41 *Stanford L Rev* 1471 at 1475-6, 1482-1501; see also P Redmond note 4 *supra* at 80-9, 95-6.

B. THE DIMINISHED ROLE OF LEGAL STANDARDS UNDER CONTRACT THEORY

A second body of theory of the corporation has gained considerable influence in policy discussion during the past decade and a half, particularly in the United States. Contract based theories were stimulated by economic writing in the 1970s developing Coase's conception of the firm as an alternative to contracting for production through the market.[20] Under this theory the corporation is deconstructed to reveal no more than a "nexus of contracting relationships" between (inter alia) shareholders and managers.[21] The corporate firm is contract, not hierarchy, and does not differ in the slightest degree from ordinary market contracting between any two people. The firm is simply a "highly specialised surrogate market."[22]

Under contract theory, since the firm is no more than a web of contracts drawn from these markets, the view of the corporation as hierarchy disappears and with it the problem of management accountability and legitimacy. The optimal form of agency cost[23] reduction is that determined by market exchanges between corporate issuers and investors. The role of corporate law and state regulation also declines since the contracting parties as rational utilitarians are entitled to structure their relations as they wish. The corporation being contract and not state concession, disciplinary constraints upon management should be left to the invisible hand of market forces although corporate law is useful to catch the non-repeat instances of self-dealing and as a standard form contract which reduces the transaction costs of negotiating a fresh contract for each incorporation. In consequence, under contract theory corporate law is permissive and supplementary. It should not prevail over actual bargains and parties to the corporate contract should be entitled to opt out of the standard form contract, including that portion imposing civil duties upon management.[24]

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20 See RH Coase "The Nature of the Firm" (1937) 4 *Economica NS* 388.

21 MC Jensen and WH Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305 at 310-11.

22 AA Alchian and H Demsetz note 19 *supra* at 777-8.

23 The concept of agency costs reflects the underlying hypothesis that if agents (such as corporate managers) are utility maximisers "there is good reason to believe that the agent will not always act in the best interests of the principal [viz, the shareholder]": MC Jensen and WH Meckling note 21 *supra* at 308. Agency costs represent the losses resulting from the divergence between the agents' decisions and those which would maximise their principals' welfare (net of expenditures incurred by the parties to align the utilities and interests of both groups): see P Redmond note 4 *supra* p 97.

24 The role and character of legal rules under contract theory are examined in the symposium on Contractual Freedom in Corporate Law in (1989) 89 *Columbia L Rev* 1395-1774. For a earlier influential analyses applying contract theory to the function of legal duties imposed upon management see DR Fischel "The Corporate Governance Movement" (1982) 35 *Vanderbilt L Rev* 1259 and FH Easterbrook and DR Fischel "Corporate Control Transactions" (1982) 91 *Yale LJ* 698. The premises and utility of contract theory (with particular reference to the role of legal rules imposing directors' duties are critically analysed in MA Eisenberg "The Structure of Corporation Law" (1989) 89 *Columbia L Rev* 1461; JC Coffee "No exit?: Opting out, the Contractual Theory of the Corporation and the Special Case of Remedies" (1988) 53 *Brooklyn L Rev* 919; V Brudney "Corporate Governance, Agency Costs and the Rhetoric of Contract" (1985) 85 *Columbia L Rev* 1403; RC Clark, "Agency Costs Versus Fiduciary

C. OTHER DISCIPLINARY CONSTRAINTS

The imposition of legal duties upon directors serves as but one device to reduce the agency costs which result from the divergent interests of principal and agent. They take their place along with bonding expenditures voluntarily incurred by managers to demonstrate their fidelity to shareholder welfare (such as the adoption of audit committees and the appointment of directors independent of management), shareholder monitoring to detect self-dealing or shirking and the discipline of markets to which the corporation is subject. A brief review of these non-legal mechanisms indicates the significance of legal rules as a management accountability mechanism.

There are substantial limits upon the effectiveness of shareholder monitoring and enforcement as a constraint upon management. For a dissatisfied shareholder exit through the stock market will usually be far easier than exercising the protective remedies of company law. The logic of individual utility is sometimes expressed in the Wall Street rule under which it is assumed that a shareholder who is unhappy with a company's performance will simply sell the shares. Its logic arises since the gains from shareholder monitoring and agitation will be public goods, accruing to all shareholders. The indivdual shareholder derives benefits from expenditures on monitoring and enforcement only rateably in proportion to his or her interest in the capital fund. Other shareholders who bear none of the costs of agitation also reap the benefits.[25]

The dominance of institutional share-ownership, however, carries the prospect that the investment institutions will monitor management to the advantage of the general body of shareholders. The calculus of advantage under the Wall Street rule appears profoundly different since the costs of organising collective action by institutional shareholders should be lower (bigger holdings and fewer holders with greater monitoring skills) and the benefits of exit appear diminished (institutions' holdings are often large in a relatively thin market).

In practice, however, institutional shareholders have shown little inclination to monitor for the general body of shareholders. Indeed, several factors discourage them from closely monitoring portfolio companies, even in their individual interest. First, investment institutions are under intense performance review pressure from those (such as trustees of pension funds) who have committed funds to their management. Short term performance is, therefore, continuously on the line. Second, in a small investment community such as Australia there are numerous financial relationships with fund sponsors, clients and portfolio companies which may inhibit direct intervention or too close an

Duties" in JW Pratt and RJ Zeckhauser (eds), *Principals and Agents: The Structure of Business* (1985), ch 3; RM Buxbaum "Corporate Legitimacy, Economic Theory and Legal Doctrine" (1984) 45 *Ohio State Law Journal* 515; JL Howard "Fiduciary Relations in Corporate Law" (1991) 19 *Canadian Business Law Journal* 1.

25 This construction of the collective action problem is not without its critics: see for example, BS Black "Shareholder Passivity Reexamined" (1990) 89 *Michigan L Rev* 520. In private companies, where shareholders do not have such an exit, the protective structures and remedies of company law may assume far greater significance.

examination of portfolio company management.[26] Third, there are numerous potential conflicts between the interests of the general body of shareholders and those of the fund beneficiaries.

Trends in institutions' investment theories also militate against the ownership impulse to monitor individual portfolio companies. As in the United States, the efficient capital markets hypothesis has considerable influence among Australian fund managers. This hypothesis assumes that stock markets work efficiently to quickly impound into the price of a security all available information affecting its value[27]. The logic of the hypothesis is that over the medium and long term fund managers cannot 'beat' the market by active trading and that comparable returns can be achieved at lower cost by simply 'holding' the market, that is, by holding an investment portfolio whose composition matches that of the stock market as a whole. Monitoring individual companies within such a broadly diversified portfolio, even if feasible, would squander the transaction cost savings of indexed investing. Hence, in the United States collective action by institutional investors has largely been directed towards improving the corporate governance system generally, rather than monitoring and intervention in the affairs of individual companies.[28]

There are also substantial limitations upon market mechanisms as governance mechanisms. Thus, it is argued that if corporate managers pursue their own interests or act inefficiently or incompetently, the markets to which the corporation is subject will exact a corrective discipline. For example, the market for corporate control will provide an incentive for third parties to acquire control of an ill-managed company for a price less than its value under superior management. Further, such a company will need to bid a higher price for new capital by reason of its inferior management and will suffer in its product markets. Further, the reputational capital of its executive will be diminished in the wider market for managerial services. The theoretical force of each of these market disciplines is impaired, however, by a range of factors. Thus, the discipline of the market for corporate capital is diminished by corporate reliance upon internally generated funds as a substantial source of finance. The market

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26 For United States analogues see MA Eisenberg note 24 *supra* at 1476.

27 See RJ Gilson and RH Kraakman "The Mechanisms of Market Efficiency" (1984) 70 *Virginia L Rev* 549.

28 Thus, institutions have been active in opposing the introduction into corporate constitutions of poison pills and other impediments to hostile takeovers (which threaten performance gains) and have proposed measures to improve the general structure of company boards (such as such as mandatory requirements for outside directors and shareholder advisory committees): see RJ Gilson and RH Kraakman "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 *Stan L Rev* 863 at 867-76. See further on the general capacity and disposition of financial institutions for monitoring management of portfolio companies JC Coffee "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 *Columbia L Rev* 1277; BS Black "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 *UCLA L Rev* 811; EB Rock "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 *Georgetown LJ* 445; RM Buxbaum "Institutional Owners and Corporate Managers: A Comparative Perspective" (1991) 57 *Brooklyn L Rev* 1; JW Barnard "Institutional Investors and the New Corporate Governance" (1991) 69 *North Carolina L Rev* 1135.

for corporate control is at best a blunt and expensive instrument for management accountability.[29] The markets for the corporation's products and executive services generally appear to assure only limited disciplinary force.[30]

D. EMPIRICAL EVIDENCE

There is however, some United States evidence, demonstrating the importance of liability rules for efficient corporate governance. Effective from 1 July 1986, the Delaware legislature permitted corporations to opt out of the strengthened duty of care established in recent decisions and to amend their articles of incorporation to eliminate directors' financial liability for breach of the duty of care.[31] A study of stock prices both prior and subsequent to the amendment disclosed that both the enactment of the provision and the announcement that individual Delaware corporation had adopted the liability restriction served to reduce the value of stockholdings in the firms.[32] The finding is consistent with an earlier study indicating shareholder wealth increases when derivative actions for enforcement of directors' duties are permitted to proceed and correspondingly decreases when the actions are terminated.[33] By such measures - the imposition of duties and facilitation of their enforcement - the agency costs of the corporate form are reduced.

Legal rules, therefore, serve to fix standards of conduct for those managing the capital fund. A particular difficulty in formulating the terms of legal duties is to strike an appropriate balance between the disciplinary function of the rules and the reality that (unlike, for example, trustees) the directors' mandate requires them to make business judgements involving commercial risk taking, sometimes in circumstances of limited information and constrained opportunity for deliberation. The prescription of standards, accordingly, needs to protect directors' business judgements from hindsight review by risk averse tribunals. Striking a balance between management accountability and initiative lies at the core of the corporate law enterprise[34].

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29 JC Coffee "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 *Columbia L Rev* 1145. In view of the high transaction costs and empirical observation suggesting that hostile takeover activity is directed to corporations in cyclically depressed industries, including well managed corporations, Coffee concludes that the disciplinary effect of the market for corporate control "is likely to be limited to instances of gross managerial failure" (at 1200).

30 See MA Eisenberg note 24 *supra* at 1488-97.

31 M Bradley and CA Schipani "The Relevance of the Duty of Care Standard in Corporate Governance" (1990) 75 *Iowa L Rev* 1 at 7.

32 *Ibid* at 69-70.

33 DR Fischel and M Bradley "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis" (1986) 71 *Cornell L Rev* 261 at 277-83; see also R Romano "The Shareholder Suit: Litigation Without Foundation?" (1991) 7 *Journal of Law, Economics & Organization* 55 (data supports conclusion that shareholder litigation is "a weak, if not ineffective, instrument of corporate governance").

34 RC Clark *Corporate Law* (1986) p xxiii

The Exposure Draft does not propose any reforms to directors' duties of loyalty beyond the partial decriminalisation of their statutory formulations: see part VI below. Our present concern therefore is with the proposals for amendment of the statutory duty of care and diligence together with disclosure obligations applying to conflicts of interest and benefits.

IV. THE DIRECTOR'S DUTY OF CARE AND DILIGENCE

A. THE STATE OF ENFORCEMENT AND ITS SIGNIFICANCE FOR LEGAL AND BEHAVIOURAL STANDARDS

Under the general law, directors owe to their company a duty of care in relation to the performance of their office. The general law duty is reinforced by s 232(4) which requires a director (and other officers within the definition in s 232(1)) to exercise a reasonable degree of care and diligence in the exercise of powers and the discharge of their duties. The *Corporations Law* provides two distinct species of civil recovery for the company.[35] The first is an order for compensation for loss suffered by a company which may be made by a court which has found a person guilty of an offence under the section: s 232(7). The second species of recovery is for direct action by the company against a person who contravenes the subsection for an amount equal to (i) the profit made by the contravenor or another person or (ii) the loss or damage suffered by the corporation: s 232(8). These statutory civil recovery remedies are in addition to other duties and obligations arising out of corporate office or employment and do not impair independent remedies (such as those for relief under equitable doctrines or statutory recovery under s 1324): s 232(11).

The duties imposed upon directors depend for their efficacy upon the mechanisms for their enforcement. It is a striking feature of Australian company law that there appear to be no modern reported decisions in which a solvent company has brought proceedings against current or former directors for breach of general law or statutory duties of care and diligence. This inactivity undoubtedly reflects the utilitarian considerations outlined above militating against shareholder enforcement. They are compounded, however, by the curious paradox that responsibility for enforcement is confided to the class of the potential defendants. Thus, under standard constitutional provisions the authority to commence such proceedings rests with the directors, probably exclusively.[36] Criminal prosecution for breach of the statutory duty of care is

35 Both modes apply also to breaches of other statutory duties under the section, namely, the duty to act honestly and to avoid improper use of information or position; s 232(2), (5) and (6).

36 Some dicta support a dual initiative resting with the general meeting to litigate in the company's name if the directors will not do so: see eg *Alexander Ward & Co Ltd v Samyang Navigation Co Ltd* [1975] 1 WLR 673 at 679. There is, however, more explicit authority rejecting such a dual initiative: see *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113 at 134 per Greer LJ and at 143 per Slesser LJ and *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* [1989] BCLC 100. There are seemingly impenetrable legal obstacles to a minority shareholder suit for breach of directors' duties of

rare.[37] In the United Kingdom, the leading decision remains that in *Re City Equitable Fire Insurance Co Ltd*[38] handed down in 1925; indeed, it appears that since then there have been only two reported civil decisions in the United Kingdom based solely upon the director's duty of care and diligence in relation to a company not under external administration.[39] Despite the wider availability of the shareholder's derivative suit and some recent developments, the position does not appear to be radically different in the United States:

> The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self dealing is a search for a very small number of needles in a very large haystack.[40]

Two consequences principally flow from this enforcement inactivity. The first is a relatively undeveloped sphere of legal liability rules, together with rules which themselves express a rather lax liability standard particularly in comparison with the generally rigorous fiduciary standards exacted under the director's duty of loyalty and the more exacting standards of care applied to professional groups. The second consequence is that civil enforcement is largely confined to action taken on the company's behalf by its liquidator, usually in the form of misfeasance proceedings under s 598. Alternatively, action may be taken against directors by a creditor where the company has gone into external administration seeking to impose personal liability for individual debts.[41] For all practical purposes, legal sanctions against shirking apply only when the company has collapsed financially and is under the control of an external administrator. For those companies for which financial collapse is not

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care where self-dealing is not also alleged: *Pavlides v Jensen* [1956] Ch 565. The Australian Securities Commission ("ASC") may, however, commence civil recovery proceedings in the name of a company (without its consent) or an individual where, as a result of an investigation or record of examination, it considers to be in the public interest to do so: *Australian Securities Commission Act* 1989 (Cth) s 50(1). Litigation commenced by the ASC in 1992 against the directors of companies in the former Compass Airlines group will test the reach of this provision to enable the ASC to launch recovery actions under s 232(7) and (8) with respect to alleged breaches of the duty of care and diligence under s 232(4).

37 See *infra* p 119 (Table 1).

38 [1925] Ch 407. This litigation arose out of misfeasance proceedings and concerned the effect of an indemnification provision in company articles.

39 *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 (decided in 1977); *Norman v Theodore Goddard* [1992] BCC 14; (1992) 10 ACLC 3016. The director's duty of care to the company is in addition to any duty to other parties arising out of particular financing arrangements or other transactions attracting liability under general law principles. See for example *Deloitte Haskins and Sells v National Mutual Life Nominees* (1991) 5 NZCLC 67,418.

40 J Bishop "Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers" (1968) 77 *Yale LJ* 1078 at 1099. The statement may require qualification in relation to the application of the duty of care to directors of financial corporations: see WL Cary and MA Eisenberg *Cases and Materials on Corporations* (6th ed, 1988), pp 516-17. The volume of United States litigation is still, however, much greater than the Anglo-Australian. Thus, it is estimated that there have been around forty appellate decisions this century where directors or officers have been found to have violated duty of care obligations: American Law Institute note 12 *supra* at 203.

41 Action may be taken under s 593 by a liquidator but only following criminal prosecution of the directors for fraudulent trading. Individual creditors may also bring civil suit under s 592 against directors and managers of failed companies selling to impose personal liability for particular debts incurred in conditions of actual or threatened insolvency.

a practically foreseeable contingency, the function of legal rules in setting standards of management conduct is severely impaired by weakness in the system for their enforcement.

B. TRADITIONAL LIABILITY STANDARDS[42]

The general law imposes upon directors a duty to their company to take reasonable care in the performance of their functions as a director. It has recently been held that this duty of care arises in tort and exposes directors to liability in damages for breach of duty.[43] The standard is said "to be measured by the care that an ordinary man might be expected to take in the circumstances upon his own behalf".[44] It is helpful to isolate three distinct elements of the general law duty of care. Each is identified in "general propositions" articulated by Romer J in *Re City Equitable Fire Insurance Co Ltd.*[45] They relate respectively to (1) the standard of skill against which a director's performance is measured; (2) a duty of diligent participation in board affairs and (3) the right of directors to delegate the discharge of duties to company officials and to assume reliable performance.

(i) Standards of skill and competence

The first proposition concerns the standard of skill and competence by reference to which the discharge of the duty of care is measured. In *Re City Equitable Fire Insurance Co Ltd* Romer J said (at 428-429):

> A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.

Similarly, fourteen years earlier, in *Re Brazilian Rubber Plantations and Estates Ltd* Neville J observed:

> A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete

42 See further V Finch "Company Directors: Who Cares About Skill and Care?" (1992) 55 *Mod L Rev* 179; LA Warnick The Liabilities of the Inattentive Company Officer" (1988) 18 *Uni Western Australia L Rev* 91; MJ Trebilcock "The Liability of Company Directors for Negligence" (1969) 32 *Mod L Rev* 499; AL Mackenzie "A Company Director's Obligations of Care and Skill" [1982] *Journal of Business Law* 460; J Birds "Directors' Duties of Care and Liability Insurance" in BAK Rider (ed) *The Regulation of the British Securities Industry* (1979) ch 7; RP Austin "Company Directors and Officers: Setting and Enforcing New Standards of Care, Diligence and Skill" (1980) 12 *Commercial Law Association Bulletin* 109; RK Paterson "Reformulating the Standard of Care of Company Directors" (1975) 8 *Victoria University Wellington Law Review* 1.

43 *AWA Ltd v Daniels* (1992) 10 ACLC 933 at 1019.

44 *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 at 437; see also *Re City Equitable Fire Insurance Co Ltd* note 38 *supra* at 428; *Overend & Gurney v Gibb* (1872) LR 5 HL 480 at 486-7. Other formulations of duty stress that the director is liable only for "gross negligence": see for example *Lagunas Nitrate Co v Lagunas Sydnicate* [1899] 2 Ch 392 at 435. Nothing appears to turn, however, upon the difference in formulation.

> ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance: while if he is acquainted with the rubber business he must give the company the advantage of his knowledge when transacting the company's business.[46]

The rigour of this standard is the more apparent when the skill levels of individual directors (all of whom escaped liability for negligence) are revealed:

> Sir Arthur Aylmer was absolutely ignorant of business. He only consented to act because he was told the office would give him a little pleasant employment without incurring any responsiblity. H W Tugwell was a partner in a firm of bankers in a good position in Bath; he was seventy-five years of age and very deaf. .... Barber 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. Hancock was a man of business who said he was induced to join by seeing the names of Tugwell and Barber, whom he considered good men.[47]

It has been said, without unfairness, that all that this doctrine asks of a director is that "he do only as much as one might fairly expect of someone as stupid and as incompetent as the director happens to be."[48] Early justifications stressed shareholder responsibility for the competency of those they appoint to the directorate.[49] A more modern, and compelling, explanation was given one year before the *Re City Equitable* decision by a distinguished American judge:

> I cannot.... agree that in effect [a director gives] an implied warranty of any special fitness. Directors are not specialists, like lawyers or doctors. They must have good sense, perhaps they must have an acquaintance with affairs; but they need not - indeed perhaps they should not - have any technical talent. They are the general advisers of the business, and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable.[50]

Of course, executive directors, especially those with service contracts, may be held to a higher, and objective, standard of care, diligence and skill. Often formal service contracts will contain covenants on the director's part to meet performance standards appropriate to professional managers. Even where no such express provision is made, however, it may well be an implied term of the contract that executive directors will perform duties to objective professional standards of care and diligence.[51]

The dearth of litigation and the consequent lack of doctrinal development has given this doctrine a somewhat dated quality especially in the light of the general professionalisation of corporate management and the objective

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45 *Ibid.*

46 *Re Brazilian* note 44 *supra* at 437; see also *Lagunas Nitrate Co v Lagunas Syndicate* note 44 *supra* at 435.

47 *Re Brazilian ibid* at 427.

48 RW Parsons "The Director's Duty of Good Faith" (1967) 5 *MULR* 395 at 395; but see the mixture of objective and subjective elements applied in *Norman v Theodore Goddard* note 39 *supra* at 3,017.

49 *Turquand v Marshall*(1869) LR 4 Ch App 376 at 386 per Lord Hatherley LC; *Lagunas Nitrate* note 44 *supra* at 426 per Lindley MR.

50 *Barnes v Andrews* 298 Fed 614 (1924) at 618 per Learned Hand J; see also *AWA Ltd v Daniels* note 43 *supra* at 1015 ("[t]he very diversity of companies and the variety of business endeavours do not allow of a uniform standard").

51 *AWA Ltd v Daniels ibid* at 1014-5; *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555.

competence standards since applied to many occupational groups.[52] Thus, in 1959 Sir Douglas Menzies, then a member of the High Court of Australia, speaking extra-curially, referred to the "classical description" of the director's duty by Romer J. Nonetheless, he thought that "[d]irectors are not now appointed on the premise that a directorship is a sinecure in which reasonable competence is a desirable but not a necessary qualification and.... what is expected of directors will tend to become the measure of what is required of them".[53] In *Commonwealth Bank of Australia v Friedrich*,[54] Tadgell J referred to the suggestion by Sir Douglas Menzies that legal standards would follow wider expectations:

> That has surely been borne out over the succeeding years. As the complexity of commerce has gradually intensified (for better or for worse) the community has of necessity come to expect more than formerly from directors whose task it is to govern the affairs of companies to which large sums of money are committed by way of equity capital or loan. In response, the parliaments and the courts have found it necessary in legislation and litigation to refer to the demands made on directors in more exacting terms than formerly; and the standard of capability required of them has correspondingly increased. In particular, the stage has been reached when a director is expected to be capable of understanding his company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity. Moreover, he is under a statutory obligation to express such an opinion annually. I think it follows that he is required by law to be capable of keeping abreast of the company's affairs, and sufficiently abreast of them to act appropriately if there are reasonable grounds to expect that the company will not be able to pay all its debts in due course and he has reasonable cause to expect it.[55]

The statement was made, however, in the context of exploring distinct statutory liabilities for insolvent trading under s 592. It is not clear that they have any significance for standards under the general law or statutory duties of care under s 232(4).

(ii) Diligent participation in board affairs

The second element of duty concerns director diligence. The duty to exercise reasonable diligence in the execution of corporate office has early antecedants.[56] The duty will require a director to acquaint him or herself with the details of the business.[57] It is clear, however, that the obligation of diligent participation is highly qualified, at least for non-executive directors. Thus, in *Re City Equitable* Romer J said (at 429):

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52 The subjective elements of the standard of care applicable to directors were recently reaffirmed in *AWA Ltd v Daniels ibid*; see further *infra* p 101.

53 D Menzies "Company Directors" (1959) 33 *ALJ* 156 at 163.

54 (1991) 5 ACSR 115 at 126.

55 For observations to similar effect, and in a similar context, see *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405 at 432, discussed by the writer in *Australian Corporation Law* at [5.8.0085]

56 *Charitable Corp v Sutton* (1742) 2 Atk 400 at 406; 26 ER 642 at 644.

57 *Re Australasian Venezolana Pty Ltd* (1962) 4 FLR 60.

> A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.

While this standard is more exacting than that expressed in some earlier decisions,[58] it does not entirely dispel the advantages of absenting oneself from board participation during periods of difficulty.[59] A director who attends a board meeting is under a duty 'to be awake' at the meeting,[60] and attentive since it is no excuse to plead that "[a]t that moment my thoughts were elsewhere."[61]

(iii) Reliance upon company officials

As Trebilcock observes, such accommodating qualification and attendance requirements make it inevitable that directors will be permitted to rely upon the information, advice and conduct of company officials.[62] Thus, the third proposition expressed by Romer J relates to the assumptions arising from delegation to company officials. He said (at 429):

> In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

Trebilcock has assembled decisions indicating that the right of delegation and reliance extends not only to company officials[63] but to committees and to the chairman of the board[64] and to external advisers such as the company solicitor or auditor.[65] The right of reliance has been extended beyond ministerial acts executing board decisions to matters of policy formation.[66] The principal instance in which the right of reliance has been withheld as excessive appears to concern directors who have signed blank cheques and entrusted them to an official without proper inquiry as to their application.[67] The right of reliance is displaced if there are grounds for suspicion concerning the reliability of the officer etc entrusted with a particular function.

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58 See for example *Re Cardiff Savings Bank; Marquis of Bute's Case* [1892] 2 Ch 100 at 109; *Re Denham & Co* (1883) 25 Ch D 752.

59 See D Menzies note 53 *supra* at 156.

60 *Land Credit Co of Ireland v Lord Fermoy* (1870) LR 5 Ch App 763 at 770 per Lord Hatherley LC.

61 *Ashurst v Mason* (1875) LR 20 Eq 225 at 234 per Bacon V-C.

62 MJ Trebilcock note 42 *supra* at 506.

63 *Dovey v Cory* [1901] AC 477 at 486, 492; *Re Denham & Co* note 58 *supra* at 766; *Huckerby v Elliott* [1970] 1 All ER 189 at 193, 195.

64 Note 60 *supra*.

65 *Norman v Theodore Goddard* note 39 *supra*; *Re New Mashonaland Exploration Co* [1892] 3 Ch 577.

66 *Lucas v Fitzgerald* (1903) 20 TLR 16; *Sheffield & South Yorkshire Building Society v Aizlewood* (1890) 44 Ch D 412; see MJ Trebilcock note 42 *supra* at 506-8.

67 *Dorchester Finance Co Ltd v Stebbing* note 38 *supra*; *Gould v Mt Oxide Mines Ltd (in liq)* (1916) 22 CLR 490 at 530.

The scope of the right of reliance was recently reviewed in *AWA Ltd v Daniels*.[68] The plaintiff company sued its former auditors for negligence in not bringing to the board's attention the extent of the company's foreign exchange hedging exposure and the inadequacy of its internal accounting controls. The auditors cross-claimed against the former directors of the plaintiff holding office at the relevant time, claiming that their neglect contributed to the plaintiff's loss. The auditors sought contribution from the directors in respect of any judgement made against them. Under the contribution legislation, the auditors were entitled to stand in the company's shoes in relation to any concurrent liability in tort by the directors in relation to the events.

Liability in negligence was found against the auditors who established contributory negligence against senior management of the plaintiff for their failure of foreign exchange supervision and to establish adequate internal accounting controls. As regards the alleged neglect of duty by the non-executive directors Rogers CJ (Commercial Division) found that, in the context of the division of functions within the plaintiff company (which was listed upon the Australian Stock Exchange), the directors relied upon management to manage the corporation and did not expect to be informed of the details of that management. Specifically, the non-executive directors relied upon management to:

> (a) carry out the day to day control of the corporation's business affairs,
>
> (b) establish proper internal controls, management information systems and accounting records,
>
> (c) reduce to writing if appropriate and communicate policies and strategies adopted by the Board,
>
> (d) implement the policies and strategies adopted by the Board,
>
> (e) have a knowledge of and review detailed figures, contracts and other information about the corporation's affairs and financial position and summarise such information for the Board where appropriate,
>
> (f) prepare proposals and submission for consideration by the Board,
>
> (g) prepare a budget,
>
> (h) attend to personnel matters including hiring and firing of staff and their terms of employment.[69]

It was held that such reliance would be unreasonable only where the director was aware of:

> circumstances of such a character, so plain, so manifest and so simple of appreciation that no person, with any degree of prudence acting on his behalf, would have relied on the particular judgment, information and advice of the officers.[70]

The non-executive directors were found not to be in breach of their duty of care in the absence of evidence suggesting that they were aware, or should have

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68 Note 43 *supra*.

69 *Ibid* at 1015.

70 *Id*.

been aware, of deficiencies in accounting controls and supervision of foreign exchange operations. In both respects they relied, and were held to be entitled to rely, upon management to supervise operations and to implement such policies as the board had formulated.[71] The managing director (who was also chairman of directors) was in a different position. Concerns conveyed to him from external as well as internal sources about the company's foreign exchange risk exposure should have prompted investigation as to the adequacy of supervisory controls and their operation. That the managing director was anxious not to alienate a key employee who was producing apparently spectacular foreign exchange profits did not justify a "kid gloves" treatment.[72] The managing director's neglect of duty was held attributable to the plaintiff company so that this contributory negligence reduced the extent of the auditors' liability in damages for the plaintiff's loss.[73]

C. EARLIER REFORM INITIATIVES

As early as 1895 reform agencies have sought to strengthen the standards of care and skill fashioned judicially for directors. The Davey Committee then proposed that the statute be amended to require directors to use reasonable care and prudence in the exercise of powers and to give the company a cause of action for neglect to do so. The committee acknowledged that its proposal "goes beyond any actual decision of the courts. But your committee thinks it right in principle".[74] The proposal was not accepted. In 1978 the United Kingdom government brought forward proposals for a statutory provision requiring directors to exercise "such care and diligence as could reasonably be expected of a reasonably prudent person in circumstances of that description and to exercise such skill as may reasonably be expected of a person of his knowledge and experience".[75] Again the proposal came to naught.

Reform proposals have prospered a little better in Australia. In 1958 the Victorian companies statute was amended to require directors "at all times.... [to] use reasonable diligence in the discharge of the duties of [their] office".[76] The provision was incorporated into the *Uniform Companies Act*. The first exposure draft of the companies legislation under the co-operative scheme proposed more radical changes. It introduced a clause requiring company officers (broadly defined) to exercise "a degree of care, diligence and skill that is not less than the degree of care, diligence and skill that a reasonably prudent

71 *Ibid* at 1020.

72 *Ibid* at 1021-2.

73 It is not clear that, had the failure of management supervision occurred at a level below that of the managing director, it would have been attributable to the company so as to reduce the auditors' liability: *ibid* at 1023.

74 *Report of the Departmental Committee Appointed by the Board of Trade* (C7779, 1895) at [21], [30], [32] quoted in PL Cottrell *Industrial Finance 1830-1914* (1980) p 70.

75 Department of Trade (UK) *Changes in Company Law* (Cmnd 7291, 1978) p 53 (cl 45(1)). The proposed statutory duty was intended to displace the general law standards: cl 45(2).

76 *Companies Act* 1958 (Vic) s 107.

person would exercise in relation to his own business or affairs in comparable circumstances". The clause attracted enormous criticism (particularly from representatives of senior management) for exacting an impossible standard or one that was inappropriate to a body obliged to act collectively. The clause was deleted shortly after and replaced with the provision expressed in s 232(4) which merely requires directors to exercise a reasonable degree of care and diligence.

In 1989 the Cooney Committee brought forward recommendations with respect to each of the three propositions expressed by Romer J. As to the first, the recommendation was somewhat ambiguously framed, viz, "that an objective duty of care for directors be provided in the companies legislation".[77] Although Romer J referred to duties of 'skill' rather than of 'care' it appears that the Cooney Committee may have used the concepts either interchangeably or with the concept of skill embraced within that of care.[78] It appears therefore that its recommendation should be interpreted as one calling for an objective standard of skill, not one determined by reference to the particular qualifications of training and experience which the individual director brings to the office. Thus, the Committee argued:[79]

> 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.

The Committee did not specify a particular standard. Rather, it suggested that the required standard of care 'will inevitably be affected by the particular circumstances' of the individual company, including its size, structure, sphere of operation, board composition and distribution of responsibility among directors.[80]

D. THE EXPOSURE DRAFT PROPOSALS

The Exposure Draft's proposals ("*ED*") follow the Cooney recommendations. For subsection 232(4) it proposes to substitute:

> (4) In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person would exercise in exercising those powers, and discharging those duties, as an officer of a corporation in the corporation's circumstances.

The Exposure Draft also lists a number of factors relevant to the determination of the appropriate standard of care and diligence under *ED* s 232(4). The

77 Note 6 *supra* at [3.20].

78 See [3.6], [3.19], [3.25] and [3.26]. In *Byrne v Baker* [1964] VR 443 at 450 it was accepted by the Full Court of the Supreme Court of Victoria that the requirement of skill "forms part of the concept of reasonable care".

79 Note 6 *supra* at [3.25].

80 *Ibid* at [3.26].

factors are intended not merely as a guide to the courts but as an indication to directors of the factors and matters by reference to which their performance will be assessed.[81] These factors are specified in *ED* s 232(4AA):

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

The duty is reinforced by a requirement in *ED* cl 307(2) applying to directors of public companies which are not wholly-owned subsidiaries of another company requiring disclosure in their annual report to members under Pt 3.3 Div 6 of the number of meetings of directors (including meetings of committees of directors) convened that year and the number of such meetings attended by each director. The Explanatory Paper anticipates that this information will be relevant to members' decisions with respect to approval of directors' remuneration and the appointment of directors.[82]

Subsection 232(11) expresses the duties imposed by the section, including that under s 232(4), to be in addition to and not in derogation from, other duties and liabilities applying to corporate officers. The proposed amendment does not, therefore, affect the general law duties of directors (and other company officers) to meet approriate standards of care, skill and diligence in the discharge of their office.

81 Explanatory Paper note 3 *supra* at [99].

82 *Ibid* at [139].

E. EVALUATION OF THE EXPOSURE DRAFT

How adequate is the Exposure Draft's reformulation of the duty of care as a measure to ensure that liability rules serve the function of setting standards of conduct among directors and other senior management to whom they are expressed to apply?[83] One limitation is upon their reach since the proposed provisions are expressed not to affect general law duties. This is reform at the margins of civil enforcement[84] and arguably at the margins of corporate governance.[85] If the scope of the reform was extended to renewal of the general law duty of care, it might achieve gains of substance.

(i) Specificity of legal standards

The Exposure Draft is concerned to offer a more 'useful description' of the required standard of care and diligence than is provided by concepts of the 'ordinary', 'reasonable' or 'average director'.[86] It seeks to do so by two measures - through the concluding words of *ED* cl 232(4) which fix the standard by reference to an officer of a corporation "in the corporation's circumstances" and through the specification of criteria in *ED* cl 232(4AA) for the guidance of directors and the courts. (The second measure is examined below.) The first provision - the reference to the particular circumstances of *the* corporation - is curiously expressed.[87] The Explanatory Paper offers this interpretation:

> The subsection will oblige the courts to compare what the reasonable person would have done in relation to the matter complained of, with what was actually done by the director the subject of the complaint. The Court will not be required to consider whether the director was an executive or non-executive director, or a paid or honorary director. Whilst these matters are relevant to the director's circumstances, they are not relevant to the company's circumstances.[88]

This would be an extraordinary standard. The distinction between executive and non-executive directors and the differences in function and responsibility between each is fundamental. Distinct standards reflecting their different role and responsibilities are crucial. While courts have long refused to distinguish between the duties of directors by reference to whether the particular office is honorary or remunerated,[89] the fundamentally different character of the responsibilities and functions of executive and non-executive directors is essential to rational definition of the duties of each. The American Law

83 The range of officers within the reach of the statutory duty is specified in s 232(1).

84 Reported litigation under s 232(7) and (8) founded upon the contravention of s 232(4) (a presumed index of remedy selection) is extremely rare.

85 See S Bottomley "Shareholder Derivative Actions and Public Interest Suits" (1992) 15 *UNSWLJ* 127; IM Ramsay note 10 *supra*.

86 Explanatory Paper note 3 *supra* at [98].

87 The Explanatory Paper suggests at [97] and [100] that the provision was fashioned in response to comments by Tadgell J in *Commonwealth Bank of Australia v Friedrich* note 54 *supra* at 955. The directors in that case (which concerned liability for insolvent trading) were honorary.

88 *Ibid* at [101].

89 See *Charitable Corp v Sutton* note 56 *supra* at 406.

Institute's recently adopted formulation concisely tailors the general standard of care to the circumstances of the individual director as well as of the corporation:

> the care that an ordinarily prudent person would reasonably be expected to exercise *in a like position* and under similar circumstances.[90]

The second measure - the specification of criteria in *ED* cl 232(4AA) - lists some of the elements of sound management process which characterise compliance systems responsive to broadly framed corporate responsibilities in the spheres of trade practices and environmental and consumer protection.[91] The list of criteria is not expressed to be prescriptive since only such of the criteria as are relevant to a particular transaction are attracted. Neither is the list expressed to be exhaustive. Further, it serves the dual purpose of fixing the criteria of liability as well as securing educational gains for directors by outlining elements of a desirable general decision-making process.

The specification of criteria in *ED* cl 232(4AA) has been criticised for its failure to attach particular weight to each of its elements, thereby adding further confusion to standard setting.[92] It is not clear, however, that such precise specification is feasible, or desirable given the variety of corporate types and organisational structures.

A more telling criticism, it is suggested, is that the subsection does not spell out, except by oblique implication, the elements of responsibility attaching to directors. Of course, any attempt to do so confronts two principal obstacles. The first is simply the diversity of corporate types, ranging from the incorporated sole partnership or quasi-partnership, which comprise the overwhelming bulk of Australia's 900,000 company registrations,[93] to the 1,150 companies listed upon the Australian Stock Exchange.[94] The second obstacle surrounds the scope of the responsibilities formally assigned to directors under standard constitutional provisions such as those in Table A of Schedule 1 to the *Corporations Law*. Under reg 66 the directors are charged with the function of managing the business of the company, a function which under available

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90 Note 12 *supra* at s 4.01(a) (emphasis added).

91 B Fisse "Corporate Compliance Programme: The Trade Practices Act and Beyond" (1989) 17 *Australian Business L Rev* 356.

92 Australian Institute of Company Directors *Submission to the Attorney-General of the Commonwealth of Australia on the Exposure Draft (February 1992) of the Corporate Law Reform Bill 1992* (May 1992) pp 19-22. The Institute was also concerned that *ED* cl 232(4) would operate to establish a checklist which might put pressure upon directors to lay a 'paper trail' to ensure compliance. It argued that the pursuit of compliance may be at odds with good business practice and a distraction from the directors' principal responsibilities: see Joint Statutory Committee on Corporations and Securities note 2 *supra* at 15. The Business Council of Australia also criticised the clause claiming that many parts "address issues of form and procedure rather than substance. The better approach is to leave the law as it presently stands so that the appropriate issues which are relevant in a particular case will be identified having regard to the facts of that case": *ibid.*

93 See P Redmond note 4 *supra* at 111 and 120-1, 126.

94 Even this global figure obscures profound differences between the largest 25-50 listed companies and the balance of listed companies. These differences relate to market capitalisation and turnover, concentration of ownership and analyst research interest; see TE Headrick "The A to B of Our Two Stockmarkets" [1992] (1) *Journal of the Securities Institute of Australia* 2.

empirical analyses lies comfortably beyond the capacity of the boards of large and, perhaps, most medium sized corporations.[95] Thus in *AWA Ltd v Daniels*,[96] Rogers CJ asserted that:

> [t]he Board of a large public corporation cannot manage the corporation's day to day business. That function must by business necessity be left to the corporation's executives.

The Exposure Draft reforms take their place within a tradition of universalism which addresses all corporate types within its prescriptions. Further, they do not attempt to effect any division of responsibility or function between shareholders, directors and senior management. These tenets restrict the norms to undifferentiated generality.

An alternative approach is to propose a distinct legal standard for directors of publicly held corporations which is responsive to the realities of their feasible role relative to management and which fixes liability rules by reference to that role. A model for such a standard is contained in the American Law Institute's ("ALI's") *Principles of Corporate Governance* which declares that, except as provided by statute, the board of directors of a publicly held corporation[97] should perform the following functions:

(1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives.

(2) Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed.

(3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions.

(4) Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements.

(5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.[98]

This formulation casts directors in the role not of managers but of monitors with an obligation to oversee the conduct of the corporation's business and, for that purpose, to take reasonable steps to keep abreast of the information that flows to the board as a result of monitoring procedures and techniques:

> Typically, the duty to monitor is satisfied not, or not primarily, by direct observation, but by installing or reviewing the adequacy of information systems by which salient information concerning the conduct of a corporation's business will flow to the board, or to reliable executives or third-party professionals acting

95 See the discussion in P Redmond note 4 *supra* at 293-9.

96 Note 43 *supra* at 1013.

97 Note 12 *supra*; defined as a corporation with more than 500 shareholders or assets exceeding $5 million in value: at [1.31].

98 *Ibid* s 3.02.

> on the corporation's behalf and subject to the ultimate responsibility of the board.[99]

The duty to monitor, rather than to manage, becomes part of the general duty of care applicable to different corporate types and distinct director and officer roles. Thus, in *Francis v United Jersey Bank*[100] the New Jersey Supreme Court imposed negligence liability upon a non-executive director in a family company who had taken no steps to oversee the management by active directors who had comprehensively misappropriated moneys belonging to clients of the corporation. The court held:[101]

> Directors are under a continuing obligation to keep informed about the activities of the corporation. .... Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies.... While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements.... Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. Thus, if Mrs Pritchard had read the financial statements, she would have known that her sons were converting trust funds. When financial statements demonstrate that insiders are bleeding a corporation to death, a director should notice and try to staunch the flow of blood.

The second specific element of the duty of care under the American Law Institute formulation is a duty to follow up reasonably on information that has been acquired and which should raise cause for concern.[102] This obligation (the duty of inquiry) is in addition to the oversight obligation. Unlike that obligation, however, it is engaged only by some information or event triggering the obligation. It arises thus:

> The duty [of care] includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.[103]

This duty of inquiry will in the ordinary instance be triggered by information acquired under procedures and systems established to ensure compliance with the directors' oversight obligation.

It is suggested that any attempt to give more definite content to the directors' duty of care ought to incorporate reference to - indeed be built upon the foundation of - these two core elements of the director's role. While the content

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99 MA Eisenberg "The Duty of Care of Corporate Directors and Officers" (1990) 51 *Univ of Pittsburgh L Rev* 945 at 952.

100 87 NJ 15; 432 A2d 814 (1981). For a fuller account of this decision and of the scope and foundation of the duty to monitor see MA Eisenberg *ibid.* Some earlier decisions assume a more passive role for directors, at least with respect to trade practices and like compliance programs: see, eg *Graham v Allis-Chalmers Manufacturing Co* 41 Del Ch 78, 188 A2d 125 (1963) (in supervising officers, directors had no duty to create "a system of watchfulness.... unless something occurs to put them on suspicion that something is wrong" (at 130)).

101 *Ibid* at 822.

102 MA Eisenberg note 99 *supra* at 956.

103 American Law Institute note 12 *supra* s 4.01(a)(i).

of those elements of role will vary with corporate type and with the particular director or officer role, they provide the central principle whose application may be aided by more specific criteria of the type contained in *ED* cl 232(4AA). Without such a guiding principle, however, discrete criteria give no clear guidance to director or court.

Both elements of the duty are complemented by a specific right of delegation to committees or other members of the board, officers, employees, experts or other persons[104] and a right to rely upon such persons where the director reasonably believes that such reliance is warranted and that the person relied upon merits confidence.[105] Whatever view is taken of the merits of differentiated director function by reference to corporate type, the expression of a formal right of delegation and reliance would be a welcome addition to the Exposure Draft provisions. It may be argued, however, that the right is implicit in the statutory duty by reason of its general law counterpart in the third proposition expressed by Romer J in *Re City Equitable.* For educational purposes, as well as for the reassurance of directors subject to the statutory duty, its explicit restatement would be advantageous.

(ii) Standards of director skill and competence

Two questions arise with respect to the standard of director skill and competence - does the reference to care and diligence in *ED* cl 232(4) impose an objective standard of skill and competency, and should it do so? As to the first question, the Cooney Committee apparently intended to include skill in its reference to an objective standard of care: *supra* pp 102-3. What then are the standards of competence (or skill levels) required of directors under *ED* cl 232(4) and, in particular, do subjective characteristics of the individual director take their place along with corporation-specific characteristics in determining the applicable liability standard? The apparent objective of implementing the Cooney recommendation suggests that the formulation of cl 232(4) is intended to comprehend an objective standard of skill and competency, and not one varying with the knowledge and experience of each director. On the other hand, since the excision of the reference to "skill" in the August 1980 draft of the bill which became the *Companies Code*, it has been widely assumed by Australian textbook writers that the statutory reference to care in the current s 232(4) is to be interpreted in terms of the general law standard.[106] It is disconcerting that the answer to so fundamental a question remains unclear.

A more difficult question is whether an objective standard of skill should be imposed. To accept a subjective standard, determined by the particular competencies, qualifications and experience which the individual director brings to the office, places the office of director outside the mainstream movement towards objective standards of competence for professional groups.

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104 *Ibid* s 4.01(b).

105 *Ibid* ss 4.01(a)(2), 4.02, 4.03.

106 See for example HAJ Ford and RP Austin *Ford's Principles of Corporations Law* (6th ed, 1992) p 530.

Further, it is paradoxical that objective standards of skill are imposed upon employees at many levels in the corporate hierarchy but not for those at its commanding heights. On the other hand, to impose a purely objective standard (even if it were feasible) is to deny the representative rather than the occupational elements of the director's office and discourages appointments of those with specialised skills and perspectives (whether in industrial relations, finance, geology etc), but who do not possess the general range of financial and management skills. It has also been said that an objective standard denies the diversity of corporate types and the right of companies to choose directors with the skill levels they require and that it blurs the important difference in function and informational access between executive and non-executive directors.[107] These arguments have been foreign to United States debates on corporate governance where the judicial standard of an "ordinarily prudent person" imports an objective standard of minimum general competence which may be enhanced by reference to the particular specialist skills which a director brings to the office of director.[108]

The writer suggests that it would be beneficial to include explicit reference to skill in the statutory duty proposed by *ED* cl 232(4) and to leave to judicial determination the content of standards of skill and care in particular circumstances. These circumstances will include corporation-specific characteristics invoked by the closing words of *ED* cl 232(4), including presumably the size and organisational structure of the company and, perhaps, whether it is the subject of public investment. The standard of knowledge, experience and competence may be expected to vary between stock exchange listed companies and those which clothe a sole trader in small business. It has also been suggested above (at pp 105-6) that the circumstances of the particular director's role should be relevant to the applicable standard of care. Further, if a director, executive or non-executive, brings specialist qualifications to the role, there appears to be no substantial reason why these should not also be relevant to the duty standard in the absence, at least, of any disclaimer as to their application.

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107 Australian Institute of Company Directors note 92 *supra* at 8-11.

108 See for example *Francis v United Jersey Bank* note 100 *supra* at 832 ("[i]f one 'feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act"); American Law Institute note 12 *supra* at 194, 199, 200; SS Arsht and J Hinsey "Codified Standard - Same Harbor But Charted Channel: A Response" (1980) 35 *Business Lawyer* ix at xiv-xv.

V. A STATUTORY BUSINESS JUDGEMENT RULE?

A. THE UNITED STATES RULE AND ITS AUSTRALIAN ADVOCATES

The Cooney Committee,[109] the Companies and Securities Law Review Committee[110] and the Lavarch Committee[111] have each recommended the introduction of a statutory business judgement rule along the lines of judicial doctrines developed in the United States. The United States case law provides a 'safe harbour' from liability for directors' business judgements which are made in good faith by directors with no personal interest in the transaction and who are adequately informed about the subject of the decision.[112] The Companies and Securities Law Review Committee would include within the rule all lawful judgements made for the conduct of the company's business operations including judgements as to the company's goals, planning and budgeting, acquisition and disposal of assets, capital raising and trading. The rule would not protect, however, judgements taken with respect to matters relating principally to the company's constitution or the conduct of meetings within the company, the appointment of executive officers or the company's solvency.[113] The Commonwealth Government initially rejected this element of the Cooney Report (refer *supra* p 89) although it has encouraged submissions upon the question whether such a rule should be included in the forthcoming *Bill*.

The ALI's *Principles of Corporate Governance* express the duty of care of directors and officers in s 4.01(a) (refer *supra* pp 105-6) to be subject to the business judgement rule contained in s 4.01(c) where applicable. The formulation of the rule adopted by the ALI is in these terms:

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

The complainant has the burden of proving a breach of the duty of care and also of demonstrating that the safe harbour defence of s 4.01(c) is inapplicable.[114]

The basic policy underlying the business judgement rule is said to be that "corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation, and other creative

109 Note 6 *supra* at [3.35].

110 Companies and Securities Law Review Committee Report No 10 note 10 *supra* at [75].

111 House of Representatives Standing Committee on Legal and Constitutional Affairs note 10 *supra* at [5.4.30].

112 See generally DJ Block note 12 *supra*.

113 Companies and Securities Law Review Committee Report No 10 note 10 *supra* at [81].

114 American Law Institute note 12 *supra* at s 4.01(d).

entrepreneurial activities".[115] The rule serves as a barrier to shareholder suit for breach of the duties of care or loyalty. If, however, a shareholder can sustain the burden of demonstrating that the director was not acting in good faith or that one of the three prerequisites to the rule was not satisfied, the safe harbour from liability disappears and the director's conduct is judged by the criteria applicable to breach of directors' duties generally.[116] By its terms the rule only protects business judgements and not omissions to act such as failure in oversight or monitoring; it protects judgements which are informed, the standard varying to reflect the time and information available for the particular decision as well as the value of the transaction.[117]

B. THE MERITS OF A STATUTORY BUSINESS JUDGEMENT RULE

(i) The case for a statutory business judgement rule

The Companies and Securities Law Review Committee thought that a business judgement rule would "encourage business endeavour by assuring people who embark on business enterprises by specfic legislation that if, acting honestly, they take risks there is some safeguard against personal liability flowing from tribunals reviewing with hindsight the merits of bona fide business decisions".[118] Further, the Australian Institute of Company Directors has argued that such a rule is necessary "in order to give directors certainty, *at the time when they take their decisions*, that if specified prerequisites are met their decisions will be beyond challenge. ... [I]t is of the utmost importance to balance the statutory standard of care (whatever its content may be, and whether or not criminal sanctions are attached to its breach) by a protective 'safe harbour' which will give directors the confidence to take commercial decisions on their true merits. The business judgement rule is designed to serve this function".[119] Despite the force of these arguments, the following paragraphs outline some considerations militating against adoption of a statutory business judgement rule.

(ii) Some concerns

First, despite the claims of its advocates, a statutory business judgement rule expressed in terms similar to s 4.01(c) of the ALI's *Principles of Corporate Governance* will not protect a director against the possibility of legal challenge to decisions involving business judgement. A plaintiff may still seek to establish that any of the three prerequisites for the rule's operation, in the ALI's formulation, have not been satisfied. Indeed, while the third prerequisite merely

115 *Ibid* p 176.

116 *Ibid* pp 185-6.

117 *Ibid* pp 229-30.

118 Companies and Securities Law Review Committee Report No 10 note 10 *supra* at 36. (It is not clear, however, that any legal authority supports judicial review of directors' decisions upon their merits as distinct from the directors' bona fides and the propriety of purpose for which their powers are exercised).

119 Australia Institute of Company Directors note 92 *supra* pp 24-5.

requires that the business judgement be rational and need not be reasonable, the second prerequisite - that the director be informed to an extent that he or she *reasonably* believes to be appropriate in the circumstances - is susceptible to easier challenge. The terms of this prerequisite offer a safe but, by no means, assured harbour. Any weakening of the terms of these prerequisites would impair the protection offered to investors by the imposition of directors' duties.

Second, it must be doubted whether the threat of litigation faced by directors of Australian corporations is such as to require protection through a statutory rule of this character. The dearth of litigation with respect to directors' duties of care in respect of solvent corporations has been noted: refer *supra* pp 95-6. Shareholder litigation is more common against directors for breach of their fiduciary duties although even here the reported case law principally deals with the exercise of directors' powers in takeover situations where tactical considerations assume some importance. It has been submitted above (at pp 95-6) that the inadequate state of shareholder remedies for enforcement of directors' duties is a serious obstacle to their function of setting standards of conduct. The creation of further barriers to shareholder suit require formidable justification.

Third, judicial development of directors' duties has created a body of case law principle which in function, if not name, embodies such a business judgement rule. Thus, the general law concedes to directors "the right and duty of deciding where the company's interests lie [and]... their judgment, if exercised in good faith and not for irrelevant purposes is not open to review by the court".[120] Similar statements may be found with respect to the director's duty of care, evidencing a judicial reluctance to 'second guess' business judgements taken without suggestion of bad faith and, indeed, a judicial deference to such judgements. They indicate that the standard applied is not that of a risk averse tribunal exploiting the benefits of hindsight. Thus, for example, in *Overend & Gurney Co v Gibb*[121] Lord Hatherley LC said in a suit against directors alleging negligence in the purchase of a business:

> I think it extremely likely that many a judge, or many a person versed by long experience in the affairs of mankind, as conducted in the mercantile world, will know that there is a great deal more trust, a great deal more speculation, and a great deal more readiness to confide in the probabilities of things, with regard to success in mercantile transactions, than there is on the part of those whose habits of life are entirely of a different character. *It would be extremely wrong to import into the consideration of the case of a person acting as a mercantile agent in the purchase of a business concern, those principles of extreme caution which might dictate the course of one who is not at all inclined to invest his property in any ventures of such a hazardous character. ... Men were chosen by the company as their directors, to act on their behalf in the same manner as they would have acted*

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120 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493; see also *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 835.

121 (1872) LR 5 HL 480 at 495. See also *Turquand v Marshall* (1869) LR 4 Ch App 376 at 386; *Dovey v Cory* note 63 *supra* at 488; *Pavlides v Jensen* note 36 *supra* at 576. Of course, the dearth of modern reported decisions on the duty of care impedes mass citation of authority.

> *in their own behalf as men of the world, and accustomed to business, and accustomed to speculation, and having a knowledge of business of this character.* (emphasis added)

It is not clear, therefore, that the general law deference to directors' business judgement is so deficient as to require statutory revision or that directors are exposed to hindsight review of business judgements by a risk averse tribunal. Neither is it clear that any gains from a comprehensive statutory restatement of these rules would outweigh the loss of flexibility assured by reliance upon the courts for the development of legal principle. Indeed, there is evidence, however tentative and faltering, of movement towards an inquiry into the reasonableness of the directors' processes of decison-making and the care they have brought to that decision-making as factors relevant to judicial review upon fiduciary grounds.[122] These concerns with the processes rather than the substance of directors' decisions characterise many formulations of the United States business judgement rule. Indeed, many of the considerations listed in *ED* cl 232(4AA) bear precisely upon these processes.

Fourth, it is not clear that a formal statutory harbour from liability for directors can be achieved without weakening the legal standard of care. The argument has been put on behalf of the Attorney-General's Department that a statutory business judgement rule is either unnecessary (because it merely reflects the current standard of care and diligence required of directors) or is designed to lower that standard (in which case it is inappropriate).[123] To this argument the Australian Institute of Company Directors makes the following response:[124]

> It is evident from the remarks already made that the business judgment rule does not merely reflect the current standard of care. It does not, in terms, lower the standard of care, but it qualifies the duty in circumstances where liability would arise if the ingredients of the rule were not present. In that sense, it lowers the risk of liability. ....
>
> The rule is intended to articulate the circumstances in which the courts will enquire no further into the nature and quality of a decision made by directors. The precise intention is to define a safe harbour which directors can reach by meeting the prescribed criteria. It is necessary because, at the moment, directors cannot know with any certainty, at the point of decision-making, whether they have fulfilled all that is required of them.

It has been argued above that the rule does not assure any such certainty. But assume that it does and consider the merits of the claim. First, does any other professional or occupational group enjoy a legally ordained right to such certainty? Is the case of directors so special and the quality of the general law deference so deficient as to require this unusual protection? Second, can the risk of director liability be lowered without compromising the standards of

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122 See *Darwall v North Sydney Brick & Tile Co Ltd* (1989) 15 ACLR 230 at 251-3 per Kirby P (dissenting) and 284-5 per Mahoney JA.

123 See A Rose "Directors' Duties" National Practitioner's Forum on the *Corporate Law Reform Bill* (April 1992).

124 Note 92 *supra* p 32.

care? What is claimed for the rule by the Institute is that "[i]t does not, in terms, lower the standard of care, but it qualifies the duty in circumstances where liability would arise if the ingredients of the rule were not present"? Is it not implicit in this statement that the substantial, if not the formal, effect of a statutory rule is to suspend the operation of the duty of care and therefore compromise its function in establishing standards of director conduct? How else can the rule work to protect directors from suit? It is suggested that such a statutory rule is unnecessary and undesirable when the general law presently accords a respect bordering upon deference for directors' business judgements.

VI. THE PARTIAL DECRIMINALISATION OF DIRECTORS' DUTIES

The role of the criminal sanction in relation to management misconduct raises particular difficulties. On the one hand the perception is widely held, especially among prosecutors, that the threat of a custodial sentence is the most efficacious sanction against business and professional groups.[125] On the other hand, however, criminal proceedings may sit uncomfortably with the more urgent need for civil recovery and preservation action. Further, corporate prosecutions are frequently very complex and protracted in their investigation and assessment stages. The offences themselves are sometimes cast in terms of unusual generality and uncertain criminality. The balance between civil sanctions and deterrence under the criminal law is in flux and some innovative sanctions are being pursued. The re-thinking of criminal sanctions in the Exposure Draft is a response to these developments.[126]

The Cooney Committee recommended that the statutory duties imposed upon directors should be expressed so that "criminal liability.... only applies where conduct is genuinely criminal in nature".[127] The Committee's recommendation was made specifically with respect to the duty of care and diligence in s 232(4) although its implementation in the Exposure Draft extends to several other duties which the *Corporations Law* imposes upon directors. The recommendation is implemented in proposed Pt 9.4AA. The general scheme of the Part is to define particular statutory provisions which impose duties upon directors (and other officers) as a civil penalty provision whose contravention may sound in disqualification from management or a civil penalty (or both) but not criminal liability in the absence of dishonest intent. Compensation may be awarded to the company which may bring independent proceedings for

125 See for example M Rozenes QC "Prosecuting Regulatory Offenders" paper presented at The Future of Regulatory Enforcement in Australia Conference (3-5 March 1992).

126 See further R Tomasic "Sanctioning Corporate Crime and Misconduct: Beyond Draconian And Decriminalization Solutions" (1992) 2 *Australian Journal of Corporate Law* 82.

127 Note 6 *supra* at [13.12].

disgorgement of profits, or compensation for loss, resulting from the contravention.

A. THE CIVIL PENALTY SCHEME

The jurisdiction and remedies proposed by Exposure Draft Pt 9.4AA apply in relation to those who contravene a "civil penalty provision" or who are involved in such a contravention.[128] Specific provisions are defined as civil penalty provisions: *ED* cl 1317AA. Persons who contravene any of these provisions - as director, other officer or ancillary participant - will commit an offence only if they act with the dishonest intent discussed below. (Contravention of a civil penalty provision with dishonest intent, as defined, will therefore sound in criminal liability. The term "civil penalty provision" is therefore apt to mislead.) The principal provisions are the statutory duties of honesty, care and diligence and which enjoin improper use of corporate information or office (s 232(2), (4), (5) and (6)), the duty imposed upon directors to ensure that proper accounting records are maintained and financial statements prepared (s 318(1)) and the duty to prevent the company from incurring debts while insolvent (*ED* cl 588G, to replace s 592).

A court may make a civil penalty order against a person who contravenes a civil penalty provision, prohibiting the person from managing a corporation for a specified period or imposing a pecuniary penalty payable to the Commonwealth not exceeding $200,000, or both: *ED* cl 1317AJ. An application for a civil penalty order may be made only by the ASC, its delegate or a person authorised by the Minister: *ED* cl 1317AL.[129] The application is to be determined in accordance with rules of evidence and procedure applicable to civil proceedings: *ED* cl 1317AP. Proceedings under *ED* cl 1317AJ are to be determined on the balance of probabilities: *CL* s 1323.

A court which is satisfied that a civil penalty provision has been contravened may make a disqualification order or a pecuniary penalty or both. It may not, however make a disqualification order against a person if it is satisfied that he or she is a fit and proper person to manage a corporation: *ED* cl 1317AJ(3). A person against whom a civil penalty disqualification order is made must not manage a corporation (within the meaning of *CL* s 91A)[130] except with the

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128 *Exposure Draft* cl 1317AC. Ancillary participants - who aid or abet, induce, conspire in or are otherwise concerned in the contravention - are defined exhaustively in s 79.

129 The ASC may require any person (other than the alleged contravenor and his or her lawyer) to give all reasonable assistance in connection with the application: *ED* cl 1317AS(1)-(3). The ASC may also draw upon like general powers under s 1317 and *Australian Securities Commission Act* s 49: *ED* cl 1317AS(5).

130 The central mystery here concerns the scope of the prohibition upon "being concerned in or taking part in the management of a corporation". See *Commissioner for Corporate Affairs v Bracht* (1989) 7 ACLC 40.

leave of the court: *ED* cl 1317AQ(1). Leave may be granted subject to conditions or restrictions: *ED* cl 1317AQ(3).[131]

B. CRIMINAL PROCEEDINGS

A person who contravenes a civil penalty provision with dishonest intent is guilty of an offence.[132] That intent will be satisfied where the contravention was made (a) knowingly, intentionally or recklessly; and (b) either: (i) dishonestly and intending to gain, whether directly or indirectly, an advantage for that or any other person; or (ii) intending to deceive or defraud someone *ED* cl 1317AT.

If civil penalty proceedings are commenced under *ED* cl 1317AJ, criminal proceedings may not be brought in relation to the same contravention whatever the outcome of the civil proceedings: *ED* cl 1317AU.[133] Where criminal proceedings are begun in relation to contravention of a civil penalty provision, an application may be made for a civil penalty order in relation to the same contravention but this application is stayed until the conclusion of the criminal proceedings: *ED* cl 1317AV(1)-(3). By this measure the right to seek a civil penalty order is preserved against the risk that criminal proceedings might not be disposed of within the six year limitation period. If the criminal proceedings result in a conviction, no civil application may be commenced and any already begun under cl (3) is deemed to be dismissed: *ED* cl 1317AV(4). If the criminal proceedings are unsuccessful, an application for a civil penalty order in respect of the alleged contravention may proceed: *ED* cl 1317AV(5).

C. CIVIL RECOVERY BY THE CORPORATION

The Exposure Draft proposes a civil recovery scheme in Pt 9.4AA Div 4 which largely replicates the provisions of *CL* s 232(7)-(10), providing two distinct species of recovery with respect to contravention of the duties imposed upon directors under s 232(2), (4) and (6); (refer *supra* pp 95-6). The first is an order for compensation for loss suffered by a corporation which is made by a court hearing an application for a civil penalty order or which has found a person guilty of an offence constituted by contravention of a civil penalty provision. Where the court hearing an application for a civil penalty order finds the contravention established it may (whether or not it makes a civil penalty order) order the defendant to pay compensation to the corporation: *ED* cl 1317AW(1). The corporation may intervene in the application but is entitled to be heard only if the court is satisfied that the contravention has been established

131 This ground of disqualification is in addition to existing grounds of disqualification under the *Corporations Law*.

132 The distinction is similar to that drawn in s 232(2) between species of breach of the statutory duty of honesty.

133 The bar is said to be necessary because of the lower civil standard of proof and the more liberal discovery rules applicable to the civil penalty proceedings which "could significantly disadvantage" a defendant in the criminal prosecution: Explanatory Paper note 3 *supra* at [195].

and only then upon the question whether a compensation order should be made under the section: *ED* cl 1317AW(3). The Explanatory Paper (at [201]) notes that these restrictions ensure that the ASC:

> retains carriage of the civil penalty application, and the presentation to the Court of material concerning the civil penalty order that the Court should make.

An award of compensation may also be made by a court which finds a person guilty of an offence constituted by a contravention of a civil penalty provision, whether or not it proceeds to conviction: *ED* cl 1317AX(1). There is no provision for the company to intervene in the criminal proceedings.

The second species of recovery under proposed Pt 9.4AA Div 4 is for direct action by the corporation against a person who contravenes a civil penalty provision of an amount equal to:

(i) the profit made by the contravenor or another person or
(ii) the loss or damage suffered by the corporation: *ED* cl 1317AZ(1)

The remedy exists irrespective of whether an application has been made for a civil penalty order or a criminal conviction obtained in relation to the contravention: *ED* cl 1317AZ(1)(c), (d).

The civil recovery remedies under Pt 9.4AA Div 4 are in addition to other duties and obligations arising out of corporate office or employment and do not impair independent remedies (such as those for relief under equitable doctrines or statutory recovery under *CL* s 1324): *ED* cl 1317AZA.

The court exercising civil jurisdiction with respect to contravention of a civil penalty provision[134] may relieve a person from liability upon grounds which parallel the long standing judicial relief provisions contained in s 1318: *ED* cl 1317AZC(1). In an application with respect to a contravention of *ED* cl 588G the court must have regard to (inter alia) any action the person took with a view to appointing an administrator of the corporation and the results of that action: *ED* cl 1317AZC(3). Anticipatory application for relief may be made by a person who fears that proceedings for contravention will or may be begun against him or her: *ED* cl 1317AZC(4).

D. TENTATIVE RESPONSES

There is a great deal to commend the withdrawal of criminal sanctions from conduct which is not morally repugnant, such as the offences under s 232(4). Indeed, it is not easy to imagine conduct which offends the statutory duty of care and diligence, and does not simultaneously offend s 232(2), which might attract criminal liability under *ED* cl 1317AT. Its inclusion in the group of civil penalty provisions is, however, useful for the application of civil sanctions.

The Exposure Draft vests enforcement initiative with the ASC exclusively. Some indication of the probable impact of the proposals may be derived from knowledge about enforcement activity under the present *Law*. The ASC (like

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134 Including proceedings for direct corporate recovery under *ED* cl 1317AZ or under *ED* cll 588M and 588Y.

its predecessor) does not include detailed figures on prosecution and civil enforcement activity in its annual report. However, a national litigation report prepared by the ASC for the Economic Planning Advisory Committee ("EPAC") summarises all litigation matters commenced, pending, concluded or on appeal in Australian courts in the period from January 1 to June 21, 1991 to which the ASC was a party or an intervener.[135] The figures appearing in Table 1 below were collated by the author from the summaries of current litigation listed for each defendant. They report discrete sets of proceedings and ignore multiple charges brought in a single prosecution. The national report from which the figures are taken comprises a series of State and Territory reports prepared by each regional office of the ASC.

The table reports the incidence of prosecutions by reference to their *Corporations Law* counterpart. The great bulk were taken with respect to *Companies Code* provisions. Of course, the limited span of the reporting period and the size of the ASC's inherited litigation limit the inferences which may be drawn from the table. It has all the limitations of a snapshot of a fast moving subject.

Table 1

Corporations Law provision	Number of prosecutions
Subsection 232 (3)(b) (failing to act honestly but without intent to deceive or defraud)	1
Subsection 232(3)(a) (failing to act honestly with intent to deceive or defraud)	5[136]
Further proceedings under s 232(3) undifferentiated with respect to paragraph (a) and (b)	6[137]
Subsection 232 (4) (failure to exercise reasonable care and diligence)	5[138]
Subsection 232 (5) (improper use of information)	1
Subsection 232(6) (improper use of position)	22

135 See Australian Securities Commission "Companies and Securities Regulation in Australia: The Regulator's Perspective" in *Prudential Regulation in Australia: Recent Developments* Economic Planning Advisory Committee Discussion paper 91/05 (1991) appendix B (pp 30-80). See also R Tomasic "Corporate Crime: Making the Law More Credible" (1990) 8 *Co & Sec LJ* 369 at 372-4.

136 One of these prosecutions contained 30 separate charges.

137 The failure to differentiate between the two species of offence reflects the discrete sources from which these aggregate national figures are derived.

138 One of these five prosecutions involved proceedings brought against four defendants. Considered separately some interesting difference emerge between the States. All the prosecutions for breach of the statutory duty of care and diligence under s 232(4) were reported by the Western Australian Regional Office.

The ASC commenced its operations on 1 January 1991 with an announced preference for instituting civil proceedings at the earliest possible opportunity in order to protect shareholders, creditors or the company itself. The reports make only one reference to proceedings for compensation under the equivalent of s 232(7).[139] Of course, a civil order may be made under this subsection only after a criminal conviction. It would be helpful in considering the wisdom of leaving civil enforcement initiative in relation to these management provisions to the ASC to know the incidence of such proceedings and orders in the following seven months. Given the obstacles to shareholder enforcement in relation to breaches of the general law duty of care and diligence, there is something to be said for opening these civil penalty procedures (especially in their compensation aspect) to other initiatives including that of shareholders. The ASC presently receives about 3,000 complaints per year warranting investigation under its statutory powers.[140] Its attention must necessarily be confined to the most serious cases, and especially those involving the interim preservation of assets rather than the *ex post* pursuit of penalties and compensation.

Some particular comments may also be made. The Explanatory Paper anticipates that a disqualification order will be the primary order to which courts will resort under *ED* cl 1317AJ, and that a pecuniary penalty will be imposed only if the disqualification order provides an inadequate or inappropriate penalty.[141] That is, perhaps, problematic, especially in view of the requirement that a disqualification order not be made if the court is satisfied that the defendant is a fit and proper person to manage a corporation: *ED* cl 1317AJ(3). That is a not inconsiderable bar. It is a concept new to the *Corporations Law*, drawn from the sphere of professional regulation (particularly of lawyers) where it has posed problems of indeterminant standards. Its adoption here, particularly if the disqualification order is the principal remedy, suggests that the civil penalty procedure may be limited in its operation to quite egregious (but not dishonest) conduct.

VII. DISCLOSURE OF CONFLICTS OF INTERESTS BY DIRECTORS

A. PERCEIVED DEFICIENCIES IN CURRENT REGULATION

One element of the director's fiduciary obligation is the duty to avoid situations where, without the consent of the company, the director's personal interest (or another interest which the director is bound to protect) conflicts or may possibly conflict with her or his duty to the company. This conflict

139 One further (but exiguous) reference may be consistent with proceedings leading to a compensation order under the subsection. In addition, several civil matters were commenced by the ASC during this period seeking protective orders under s 1323 or its *Code* equivalents.

140 S Menzies "The Investigative Powers of the ASC" *ASC Digest* (1991) Reports and Speeches 106.

141 Explanatory Paper note 3 *supra* at [178].

avoidance obligation is expressed in a number of specific rules touching directors' dealings with their company. One application is to contracts between a director and her or his company and to other contracts with the company in which the director has a less direct interest. Three tiers of legal rules interact here - the equitable principle enjoining conflict avoidance, provisions in company articles modifying the equitable duty or its consequences and the statutory duty of disclosure under s 231. The Exposure Draft is concerned only with the latter duty. Its concern is to repair deficiencies identified by the Companies and Securities Law Review Committee. These include:

(i) the narrow reach of the section which is limited to interests in contracts or proposed contracts with the company, and possibly only those with which came before the board;

(ii) the failure of the section to require disclosure of interests arising out of business or family relationships;

(iii) the absence of any requirement for a register of directors' interests; and

(iv) the failure to address voting restrictions and quorum requirements arising where directors are interested.[142]

There are other problems under existing law, not least the uncertainty as to the effect upon the equitable principle, as modified in the articles, of non-compliance with the statutory disclosure obligation.[143]

B. THE EXPOSURE DRAFT PROVISIONS

Under the Exposure Draft a director who has an *interest* in a *matter with which the company is concerned* must, as soon as practicable, and in any event within five business days after becoming aware of the relevant facts, give written notice to the company setting out particulars of the interest: *ED* cl 243LA(1). Matters with which the company is concerned are defined to include any act that the company has done or is proposing to do, including transactions that the company has entered into or is proposing to enter into, and extends to any matter whether or not it has been considered by the directors: *ED* cl 243KA. The term "transaction" is defined to include a contract or arrangement and also includes a unilateral act: *ED* cl 243AA (definition). A director has an interest in the matter if as a direct or indirect result of the matter a benefit (whether financial or otherwise) will, or is likely to, accrue to the director, a relative of the director or a relative of the director's spouse: *ED* cl 243KB(1)(a). A director does not have an interest in a matter involving another corporation merely by virtue of an employment relationship with that corporation: *ED* cl 243KB(1)(b). The term "benefit" used in this Division (in contrast to its use in Divisions 4 and 5, as to which see *ED* cl 243AA) is not specifically defined although it is expressed to include a benefit accruing indirectly through

142 See note 7 *supra.*

143 *Hely-Hutchinson v Brayhead Ltd* [1967] 1 QB 549; *Guiness Plc v Saunders* [1990] AC 663.

interposed corporations, trusts or partnerships: *ED* cl 243KB(2). The concept of benefit is, therefore, left relatively 'fuzzy'.

The director must disclose particulars of the nature and extent of the interest and such other particulars as are necessary to enable the fellow directors to decide what action should be taken in the company's interests: *ED* cl 243LA(2). Disclosure is also required of the cessation of the interest or of changes in its nature or extent: *ED* cl 243LA(3). A director who becomes aware that another director has failed to give proper notice of interest is obliged to notify the company: *ED* cl 243LA(4). There is provision for general notices of interest as director, other officer or member of another entity, renewable annually: *ED* cl 243LB. Directors may require further information in respect of an interest notified under the division: *ED* cl 243LD. The division introduces a requirement for a register of directors' interests, open for inspection by any member or director free of charge but not to members of the public: *ED* cl 243MA. Minor interests (as defined in *ED* cl 243KC) need not be included.

Subdivision D introduces restrictions upon voting by a director interested in a matter before the board. The restrictions are, however, subject to provisions contained in the articles of association of a company having no more than 15 members: *ED* cl 243NA(1). It is immaterial whether the company is public or proprietary. A director who has a minor interest in a matter is entitled to vote on the matter at a directors' meeting unless a majority of disinterested directors has resolved that the interest is a material interest (this latter term is not defined): *ED* cl 243NA(2). If the director's interest is not minor, he or she is excluded from board deliberations and voting on the matter unless a disinterested majority of directors resolves that the interest is not a material interest: *ED* cl 243NA(3). A quorum of two directors is required for consideration of every matter at a directors' meeting, being directors who are entitled to vote on any motion that may be moved in relation to the matter: *ED* cl 243NA(5). This restriction appears to exclude from the quorum a director with an interest which is not a minor interest since the director's right to participate in discussion and to vote is contingent upon a resolution that the interest is not material: *ED* cl 243NA(3). Whether a resolution to this effect at a prior meeting will permit the director to be included in a quorum with respect to the matter at subsequent directors' meetings is not clear. Neither is it entirely clear whether, if the director's interest is a minor interest, the prospect that fellow directors might resolve that the interest is material and so exclude the director from participation and voting under *ED* cl 243NA(2), would disqualify the director from inclusion in the quorum ab initio under *ED* cl 243NA(5). The Explanatory Paper appears to assume that such exclusion applies only where the interest is material.[144]

The voting and quorum restrictions under subclauses (2), (3) and (5) do not apply, however, to directors' resolutions to convene a general meeting to deal with a matter in which directors are interested: *ED* cll 243NA (6) and (7).

144 Explanatory Paper note 3 *supra* at [429].

Neither do they apply to transactions between related parties in respect to which *ED* Pt 3.2A requires board authorisation and shareholder approval. Where shareholder approval is to be sought, the voting restrictions and quorum requirements do not apply in relation to the directors' meeting: *ED* cl 243NB.

Directors who contravene the notification of interest requirement of *ED* cl 243LA are jointly and severally liable for any resulting loss sustained by the company or any other person: *ED* cl 243PA. Contravention of Division 3 does not, however, affect the validity of the transaction or act: *ED* cl 243PB(1). The powers of a court with respect to the transaction or act arising independently of the Division are expressly preserved: *ED* cl 243PB(2). These powers might include a declaration that the transaction is voidable, and has been avoided, under equitable principles.[145] By these measures is a balance struck between the interests of third parties and the company.

C. RESPONSE TO THE EXPOSURE DRAFT

The Explanatory Paper (at [415]) itself flags one of the principal questions arising out of this scheme. While an expansive conception of benefits is adopted, the obligation to notify interests is limited to matters with which *the company* is concerned: *ED* cll 243LA (1) and 243KA. Semble, the obligation does not apply, for example, in relation to an interest in a transaction which a wholly-owned subsidiary has entered or may enter into unless the influence of the director upon the directors of that subsidiary is such as to engage the shadow director provisions of s 60.

Second, it is not clear why the exemption from voting restrictions should be accorded to all companies with 15 or less shareholders: *ED* cl 243NA(1). The presumed rationale of close shareholder monitoring may apply to exempt proprietary companies with small membership. The exemption offers rich avoidance opportunities through complex corporate structures which take double advantage of the atomistic conception of the company's concern expressed in *ED* cl 243KA.

VIII. DISCLOSURE OF BENEFITS GIVEN TO DIRECTORS

A. PRESENT OBLIGATIONS

At general law the directors' claims to remuneration were settled by reference to that analogous class of fiduciaries - trustees, whose functions were treated as purely honorary. Thus, in *Hutton v West Cork Ry Co*,[146] Bowen LJ said:

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145 See for example *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488.

146 (1883) 23 Ch D 654 at 672. See also *Re George Newman & Co Ltd* [1895] 1 Ch 674 at 686; *Guinness* note 143 *supra*; *Woolworths Ltd v Kelly* (1991) 4 ACSR 431; *Sali v SPC Ltd* (1991) 9 ACLC 1511; Z Adenwala (1991) 3 *Bond L Rev* 25.

> But what is the remuneration of directors?.... It is gratuity.... In some companies there is a special provision for the way in which the director should be paid, in others there is not. If there is a special provision.... you must look to the special provision to see how to deal with it. But if there is no special provision their payment is in the nature of a gratuity.

Directors' rights to remuneration therefore arise only from express provisions in company articles. Table A, reg 63 is a widely adopted form. It provides that directors shall be paid such remuneration as is from time to time determined by the company in general meeting. In companies in which ownership is divorced from control this legal form may serve merely to conceal the reality of the process by which directors' remuneration is determined.

In consequence, perhaps, the *Corporations Law* imposes three sets of disclosure obligation with respect to officers' remuneration. First, the *Corporations Law* requires disclosure in company financial statements of the remuneration paid to directors and executive officers although amounts are required to be shown only in aggregate and in bands.[147] Secondly, the directors' report under Pt 3.6, Div 6 requires disclosure of other benefits received by directors under contracts with the company or a related company: s 309. Thirdly, the *Corporations Law* requires disclosure of benefits given to directors in a statement to members issued in response to a request for such particulars from a specified proportion of members: s 239. The Exposure Draft proposes that this third provision be repealed and replaced by proposed Pt 3.2A Div 4.

B. THE EXPOSURE DRAFT PROPOSALS

The proposed Division 4 provisions derive from concerns expressed by the Advisory Committee that s 239 is deficient in that:

(i) it relies solely on shareholder initiative to request disclosure of the benefits, and does not provide for continuous disclosure; and

(ii) it is open to avoidance through the use of intermediaries such as management companies or consultancies.[148]

The Exposure Draft's provisions follow reforms proposed by the Advisory Committee. It is proposed that the disclosure of benefits provisions apply to all companies other than exempt proprietary companies. Disclosure is required of benefits given to all persons "relevantly connected" with the company. This term is the subject of a complex definition in *ED* cl 243AT. Briefly, it includes a director of the company or of a related company, a relative of the director or his or her spouse, and companies and trustees whose connection with the director is such that the director might be the ultimate beneficiary of benefits given to the company or trustee[149]. The term "benefit" is defined for purposes of Divisions 4 and 5 to mean "money, any other consideration or any other

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147 See s 297(1) and *Corporations Regulations* sch 5, cll 25 and 29; exempt proprietary companies are excluded from these disclosure obligations: cl 8(2).

148 Note 8 *supra* p 15. These concerns are repeated in the Explanatory Paper note 3 *supra* at [241]-[242].

149 Explanatory Paper *ibid* at [241].

benefit (whether or not having a monetary value" and includes fringe benefits and superannuation contributions; particular exceptions are specified including, for purposes of Division 4, salary and wages: *ED* cl 243AA. Salary and wages are excluded from disclosure under Division 4 since they are subject to aggregate and banded disclosure in the *Corporations Regulations*.

Under the Exposure Draft the disclosure obligation will apply where:

(i) a resolution is passed by the directors, or a decision is made by an officer, of a company a purpose or effect of which is to give a benefit to a person who is relevantly connected with the company; and

(ii) the benefit, either alone or taken together with like benefits given to *that person* within the preceding 12 months exceeds $50,000: *ED* cl 243QA(1).

The company is required to lodge with the ASC, within ten business days of the resolution or decision, prescribed particulars of the benefit and of the like benefits given in the previous 12 months whose aggregate now reaches the threshold of $50,000: *ED* cl 243QA(2). Regulations will provide for disclosure in bands of $25,000.[150] The prescribed particulars are to be defined in the regulations which must not, however, require the particulars to name the persons to whom the benefits are given: *ED* cl 243AN(1). This is subject, however, to retention of a provision broadly drawn from s 239 which would permit individual members comprising either 10 per cent by number of the total membership or holding together 5 per cent of issued capital to require disclosure to all members in an audited statement of emoluments and benefits received by each person relevantly connected with the company, including any amount paid by way of salary (wages are not specified), for the preceding 12 months: *ED* cl 243AN(2).

The directors are required to disclose the prescribed particulars in a note to the company's accounts for the financial year and to draw attention to the note in their report under Pt 3.6A Div 6: *ED* cl 243QA(3). Disclosure is not required under *ED* cl 243QA where it has already been made under the proposed Pt 3.2 Div 2 or under an applicable accounting standard: *ED* cl 243QA(4).

Contravention of the disclosure obligation will expose directors and other persons involved in the contravention to criminal liability: *ED* cl 243QB. The company itself is not guilty of an offence. As with Division 3, contravention of Division 4 does not affect the validity of the resolution or decision: *ED* cl 243QC(1). The powers of a court with respect to the resolution or decision arising independently of the Division are expressly preserved: *ED* cl 243QC(2). These powers might include a declaration that the transaction is voidable, and has been avoided, under equitable principles.

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150 *Ibid* at [435].

C. WEAKNESSES IN THE DISCLOSURE REGIME

Potential grounds exist for avoidance of the Division 5 obligations. Disclosure applies only in relation to benefits having a monetary value. Secondly, the disclosure threshold has been set at $50,000, as a *de minimis* level below which disclosure is considered not to be warranted either in terms of the value of the benefit or the administrative burden.[151] This level is perhaps supportable with respect to stock exchange listed companies but is tendentious as regards non-exempt proprietary companies, other non-listed proprietary companies and non-listed public companies where the position of minority interests in subsidiaries is a delicate one. Thirdly, the disclosure obligation only applies in relation to a benefit below $50,000 given to a relevantly connected person which when aggregated with like benefits to *that person* engages the threshold: *ED* cl 243QA(1)(b)(ii). Would a series of benefits each of $40,000 paid to the spouse and several relatives (or associated companies etc) of a director require disclosure under *ED* cl 243QA? Semble, no. The concept of the relevantly connected person may require unbundling or reference to "that person" to be broadened.

The regulations may not require disclosure of the name of connected persons to whom benefits are given. It is not clear, however, why the regulations should not require disclosure of aggregate benefits given to individual directors and their affinity groups. More extensive disclosure than this may be exacted under s 239 and its proposed substitute in *ED* cl 243AN(2). Current disclosure of benefits in annual statements is often achieved with such verbal economy as to effectively conceal complex associations. Notwithstanding the more exacting conflict disclosure obligations in Division 3, there is much to be said for expressing more clearly the ideology which exacts full disclosure as the price of profit-taking by fiduciaries.

Finally, there is much to be said for vesting in courts a jurisdiction to review director remuneration and other benefits upon grounds of fairness or conscionability. United States law adopts such a principle in relation to directors' interests in company contracts, imposing upon directors the burden of demonstrating fairness as a condition of validity. It is not clear that the proposed disclosure rules would sufficiently flag some of the more egregious management benefits arrangements whose notoriety impelled the Advisory Committee along the path to these reforms. Until we know more about the mechanisms of stock market efficiency in Australia and the capacity and disposition of our investment institutions to monitor management conduct among portfolio companies, more interventionist responses may be needed to bolster investment confidence, especially among households. This is a worthy objective.

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151 *Ibid* at [438].