

Directors' Duties and Corporate Governance

Facilitating innovation and protecting investors

Corporate Law Economic Reform Program

Proposals for Reform: Paper No. 3

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ISBN 0 642 26117 2

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Printed by the Australian Government Publishing Service

TABLE OF CONTENTS

	Page
Abbreviations	v
PART 1: Reform Proposals	1
PART 2: Introduction.....	5
2.1 Background to review.....	5
2.2 Key economic principles	5
PART 3: Governance Issues Affecting Directors and Shareholders	7
3.1 The significance of the corporate entity and director activity in the economy	7
3.2 Why are corporations a preferred vehicle for business and investment?	8
3.3 Is reform necessary?.....	9
3.4 Objectives of regulation.....	10
PART 4: Survey of Directors' Roles and Duties.....	13
4.1 General principles	13
4.2 Company constitution	14
4.3 General law duties	15
4.4 Corporations Law.....	19
PART 5: Business Judgement Rule — Statutory Derivative Action — New Tools for Corporate Governance	21
5.1 Introduction	21
5.2 Statutory Business Judgement Rule.....	22
5.3 Statutory Derivative Action.....	29
5.4 Conclusion.....	40

PART 6: Other Issues for Directors	43
6.1 Background	43
6.2 Duties of executive and non-executive directors.....	43
6.3 Should directors be able to delegate their responsibilities?	45
6.4 Extent of directors' liability at common law (for negligence).....	47
6.5 Other proposed changes to the Corporations Law	48
6.6 A standard or model <i>due diligence</i> defence for directors	53
PART 7: Corporate Governance — Domestic and International Trends	59
7.1 Introduction	59
7.2 Corporate governance environment	60
7.3 Disclosure of corporate governance practices.....	62
7.4 Role of Government.....	66
7.5 Audit committees	67
7.6 Role of investors	68
7.7 Organisation for Economic Co-operation and Development — international reviews	69
7.8 Conclusion.....	70
Appendix A Business Regulation Advisory Group.....	73
Appendix B Other directors' duties under the Corporations Law that do not give rise to civil penalties	75
Appendix C Summary of reports on the business judgement rule	77
Appendix D Draft derivative action provisions	83
Appendix E New Zealand <i>Companies Act 1993</i> — Sections 130 and 138	91

ABBREVIATIONS

AIMA	Australian Investment Managers' Association
ALI	American Law Institute
ASC	Australian Securities Commission
ASX	Australian Stock Exchange
CASAC	Companies and Securities Advisory Committee
CEOs	Chief Executive Officers
CLERP	Corporate Law Economic Reform Program
CSLRC	Companies and Securities Law Review Committee
GDP	Gross Domestic Product
MINCO	Ministerial Council for Corporations
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development

PART 1: REFORM PROPOSALS

PROPOSAL NO. 1 — A STATUTORY BUSINESS JUDGEMENT RULE AND A STATUTORY DERIVATIVE ACTION SHOULD BE INTRODUCED INTO THE CORPORATIONS LAW

- As a means of facilitating decision-making by directors and promoting investor confidence, the Corporations Law (the Law) should be amended to provide both a statutory form of:
 - business judgement rule, as outlined in Part 5.2.3, which would offer directors a *safe harbour* from personal liability for breaches of the duty of care and diligence in relation to honest, informed and rational business judgements; and
 - derivative action, as outlined in [Appendix D](#), to enable shareholders or directors of a company to bring an action on behalf of the company, for a wrong done to the company where the company is unwilling or unable to do so.

PROPOSAL NO. 2 — AMENDMENTS SHOULD BE MADE TO THE CORPORATIONS LAW TO CLARIFY CERTAIN ASPECTS OF DIRECTORS' OBLIGATIONS

- To provide directors and officers with greater certainty regarding key aspects of their duties to the company, the following amendments to the Corporations Law are proposed:
 - The existing duty to exercise care and diligence in subsection 232(4) should be amended to make it clear that the standard of care required by the duty must be assessed by reference to the particular circumstances of the officer concerned. Under the revised provision a director or other officer of a corporation would be required to exercise

their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- (a) were a director or officer of a corporation in the corporation's circumstances;
 - (b) occupied the office within that corporation held by the director or officer; and
 - (c) had the director or officer's experience, powers and duties.
- The Law should expressly recognise the oversight role played by directors and their reliance on delegates to manage their company's day-to-day affairs. Accordingly, to provide certainty to directors regarding the extent of their ability to delegate functions and to rely on the advice of experts when making decisions, amendments should be made to the Corporations Law along the lines of sections 130 and 138 of the New Zealand *Companies Act 1993* (see [Appendix E](#)).
- The existing duty in subsection 232(2) to act *honestly* should be reformulated to capture the fiduciary principles that a director or other officer of a corporation must exercise their powers and discharge their duties:
- (a) in good faith in the best interests of the corporation; and
 - (b) for a proper purpose.

Breach of the duty to act honestly would continue to have both criminal and civil consequences.

- The Law should be amended so that a breach of the duty of care and diligence in subsection 232(4) would only give rise to civil sanctions and would no longer provide a basis for an offence under section 1317FA. Under subsection 1317FA(1) of the Corporations Law, a breach of the duty of care and diligence in subsection 232(4) undertaken with a dishonest intent currently amounts to an offence punishable by a maximum fine of \$200,000 or five years imprisonment, or both. However, the concept of negligence is inconsistent with dishonesty, in that dishonesty suggests an active awareness of wrongdoing rather than a failure to exercise sufficient care and diligence.

PROPOSAL NO. 3 — A COMPANY’S ABILITY TO INDEMNIFY OFFICERS FOR LEGAL EXPENSES SHOULD BE CLARIFIED

- Different views have been expressed about the extent to which section 241 of the Corporations Law allows a company to indemnify its officers against a liability for legal expenses incurred by them in defending proceedings. It is proposed to amend the Law to allow a company to indemnify an officer for legal expenses where the liability is incurred in:
 - defending or resisting a civil claim or civil penalty that is settled, except in the case of an action brought by the company or a related company;
 - defending a civil claim brought by the company, or a related company, where the director or officer was wholly successful, or substantially successful having regard to all the circumstances;
 - defending or resisting criminal proceedings in which the person is not found guilty; or
 - connection with proceedings in which the Court grants relief to the person under the Law.

PROPOSAL NO. 4 — THE DESIRABILITY OF A STANDARD FORM OF *DUE DILIGENCE* DEFENCE FOR DIRECTORS SHOULD BE PURSUED WITH STATE AND TERRITORY GOVERNMENTS

- The Government will pursue with State and Territory Governments a review of legislation which imposes strict liability on directors for breaches committed by their company.
 - As part of the review, consideration should be given to the desirability of developing a standard, or model, *due diligence* defence for directors in respect of liabilities arising under statutes other than the Corporations Law.

PROPOSAL NO. 5 — CORPORATE GOVERNANCE PRACTICES BY AUSTRALIAN COMPANIES SHOULD BE CONTINUOUSLY MONITORED

- The establishment and maintenance of effective corporate governance practices by Australian companies is essential to Australia's international competitiveness and economic growth.
 - Corporate governance practices should, as far as practicable, be continuously monitored by the Australian Stock Exchange (ASX), relevant industry and professional bodies who promote best practice, investors and Government to maintain investor confidence in Australia's capital markets. The Government will not impose additional mandatory legislative requirements unless there is a failure of the current requirements or these regulatory mechanisms.

PART 2: INTRODUCTION

2.1 BACKGROUND TO REVIEW

On 4 March 1997 the Treasurer announced that, as part of the Government's new Corporate Law Economic Reform Program (CLERP), papers on key areas of corporate law policy which affect business and market activity would be released.

This paper:

- reviews whether the current rules regulating company directors inhibit sound business judgements;
- examines whether shareholders have sufficient opportunity for redress against a corporation;
- explores whether the private sector is adequately addressing the issue of corporate governance in light of the importance of domestic and international confidence in Australia's securities markets; and
- makes specific recommendations for amendment of the Corporations Law.

The proposals contained in this paper have been developed in consultation with the business community, in particular, the Government's Business Regulation Advisory Group, see [Appendix A](#).

2.2 KEY ECONOMIC PRINCIPLES

As with other key corporate law policy areas which the Government has identified in CLERP, the proposed reforms have been assessed against the following key principles:

- cost/benefit of proposals as against the existing law;
- the development of a regulatory and legislative framework that is consistent, flexible, adaptable and cost effective;

- the reduction of transaction costs for firms and market participants; and
- an appropriate balance between government regulation and industry self regulation.

PART 3: GOVERNANCE ISSUES AFFECTING DIRECTORS AND SHAREHOLDERS

3.1 THE SIGNIFICANCE OF THE CORPORATE ENTITY AND DIRECTOR ACTIVITY IN THE ECONOMY

The corporation is a vehicle for the conduct of business activity and the creation of wealth. The corporate form is today the dominant type of structure for business activity.

The significance of corporate activity in the Australian economy is borne out by the following:

- As at 30 June 1997, just over 1 million companies were on the Australian Securities Commission (ASC) companies register and over 17,000 were public companies;¹
- Entities listed on the ASX totalled 1,198 at 30 June 1997;²
- In 1995-96, the top 500 Australian listed companies generated revenue equivalent to 36 per cent of Australia's GDP (approximately \$489 billion), and the top 50 Australian listed companies (by profit) earned \$9.4 billion;³ and
- Company taxes collected in 1995-96 totalled over \$19 billion (or 16.6 per cent of all Commonwealth tax revenue).⁴

The corporation is a relatively efficient organisational means to supervise and direct capital into productive activities within industry. It is also an important vehicle for investment and accumulation of capital. Research conducted by the

1 ASC estimates.

2 ASX, *Monthly Index Analysis*, Issue no. 208, June 1997, p 23.

3 Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product*, Cat 206.0; *Company Profits Australia*, Cat 5651.

4 Australian Bureau of Statistics, *Taxation Revenue Australia*, Cat 5506.0.

ASX shows that total share ownership (direct and indirect) now stands at over one third of the Australian adult population or 4.7 million Australians.⁵

As directors manage a corporation for and on behalf of the shareholders who own it, it is critical that any regulatory and legal requirements placed on directors do not seriously compromise their goal of maximising shareholder wealth.

Directors' behaviour influences the efficient operation of corporations. If directors are subject to undue transaction costs in protecting themselves from personal liability, these costs will ultimately be passed onto, and borne by, the corporation itself.

On the other hand, if directors are permitted to operate completely unfettered by regulation and a degree of shareholder control, investor confidence in the corporate vehicle may potentially be undermined. In this regard, it is clear from past experience, particularly in relation to the corporate collapses of the 1980s, that the conduct of directors through corporations can have a significant impact on public perceptions and market confidence.

3.2 WHY ARE CORPORATIONS A PREFERRED VEHICLE FOR BUSINESS AND INVESTMENT?

A corporation exists independently of its owners, survives their deaths and can enter into binding contracts. Unlike personal proprietorship or partnership, a corporation is not terminated by a change of ownership. Shares in the corporation may be traded, extinguished (reduction of capital) or new shares issued. The market value of shares also, in effect, provides access to future gains of the corporation as the market value of corporate stock reflects gains expected to accrue from current acts. Additionally, by limiting the liability of the owners of the corporation to the value of their shareholding, the corporation limits potential loss and encourages investment in activities which may have the potential for significant gains.

Shares in corporations represent investment opportunities and shareholders have a vested interest in the profitability of the corporation. If future prospects of the corporation look better than previously anticipated, share values will be bid up as investors try to buy a share of the improved prospects. Likewise, if prospects do not meet market expectations, investors will seek to transfer their

⁵ ASX, *Australian Share Ownership Survey*, 1997 p 4.

investment with a view to maximising their gain and minimising any loss. The price of the shares will settle at a market level where it is not to an investor's advantage to transfer their investment.

Certain costs are, however, inherent in the corporate form. The constitution of the modern corporation vests in its management the power to direct the resources provided by members for the members' ultimate benefit. This separation of ownership from control leaves open the possibility that management might divert those resources for its own benefit rather than that of the members, or fail to exercise the appropriate degree of care and diligence in the exercise of its powers. Recognising this possibility, the law seeks to provide members with adequate means of holding management accountable for the improper exercise of its powers.

The overall goal of conferring rights on members is to provide an incentive for boards to exercise their powers appropriately and discharge their functions for the ultimate advantage of the providers of the corporation's capital. However, in many corporations the members are a diffuse group with little or no interest in the entity's day-to-day operations and little or no actual power to control its affairs. The question then arises as to how to maximise incentives for the board to, in turn, maximise the wealth of the company.

Traditionally, these incentives have been imposed on boards in the form of broad fiduciary obligations rather than prescriptive behavioural requirements. Furthermore, rather than the law imposing mandatory professional qualifications on directors or significant limitations on their discretion by, for example, requiring all their substantive decisions to be put to the shareholders in general meeting, directors are largely unfettered in the way they operate. The factors influencing directors' behaviour have come principally from market forces and the interpretation by the Courts of the directors' general law fiduciary and statutory duties to the company. These duties are quite general in nature.

3.3 IS REFORM NECESSARY?

In light of more recent judicial decisions which appear to increase the responsibility of directors and create a degree of uncertainty regarding their potential liability, concerns have been expressed that directors' attentions are increasingly being focussed on compliance issues rather than on wealth creation for shareholders. In particular, concerns have been expressed that the Corporations Law contributes to risk-averse behaviour on the part of directors.

If this is the case, the losers are not only directors personally, but also shareholders, whose returns on company capital will ultimately be diminished. The nation also loses as behaviour that is unnecessarily risk-averse distracts from behaviour that could expand the enterprise and therefore wealth and employment.

At the same time as directors are feeling constrained by the law, shareholders are feeling somewhat frustrated in that the law apparently does not, at present, facilitate them protecting the best interests of the company.

3.4 OBJECTIVES OF REGULATION

While regulatory requirements are usually placed on directors as a means of protecting investors, or the general public, such protection may well be achieved at the expense of investors themselves. Accordingly, it is vitally important that any measures put in place as a means of promoting investor protection are properly assessed from an economic perspective to ensure that they do not ultimately act to the detriment of shareholders as a whole.

To promote investor confidence and thereby facilitate expansion of our capital market, investors need to be satisfied that they have sufficient opportunity for redress against a corporation and its directors in clear cases of negligent, reckless or fraudulent conduct. However, directors who effectively control the corporation, must not feel so over-burdened with a *fear of responsibility* that their decision-making is seriously constrained.

Regulation in the area of directors' duties and shareholders' rights invariably involves a fine balance between maintaining investor confidence and encouraging commercial enterprise.

In the interests of maximising shareholder wealth and economic growth, directors need to be encouraged to take enterprising decisions. However, these decisions must be taken in the interests of the company and be challengeable if they are not bona fides and well informed. If they are not so challengeable, investors may invest outside Australian companies and our capital market will be adversely affected.

Similarly, if Australia's corporate governance structures are not of a standard to inspire investor confidence, and if they lag behind overseas capital markets, investors will invest their money elsewhere, thereby possibly jeopardising economic growth.

Corporations regulation must therefore promote optimal corporate governance structures without compromising flexibility and innovation.

PART 4: SURVEY OF DIRECTORS' ROLES AND DUTIES

4.1 GENERAL PRINCIPLES

At the most general level, the role of the directors of a company is to oversee the management of the company on behalf of its members. That is, directors are responsible for maximising the value of the company for members within the legal framework and economic environment in which the company operates. In doing so, directors are also responsible for ensuring that the company meets its contractual and other obligations, such as in relation to the environment, trade practices, fair trading and occupational health and safety.

Beyond this, the precise role of directors is dependent on the memorandum and articles of association (the constitution) of the particular company. In large public companies directors are likely to have limited involvement in the day-to-day management of the company; their role will thus be more one of providing general direction, oversight and review. In many such companies, the directors will be non-executive directors whose main occupation lies outside the company and whose function is to bring an independent view to, and a broader outlook on, the company's decision-making and to assist company management with specialised expertise or ability.

By contrast, in small and medium sized proprietary companies, the directors may be members of the company whose main occupation is conducting all of the operations of the company. These directors will be involved in the day-to-day management of the company.

Within these two extremes, across companies, there will be a mix of executive and non-executive directors and there will be differences in the extent of directors' involvement in day-to-day management or the more general direction of management.

The Corporations Law does not make any distinction between the types of directors or the degree of their involvement in management. Rather, it establishes general principles which are intended to apply to all directors. The application of those general principles by the Courts to different types of directors is considered later in this paper.

In performing their role, directors are subject to a range of duties and obligations from the following sources:

- the constitution of the company;
- the general law; and
- statute law, including the Corporations Law.

4.2 COMPANY CONSTITUTION

A company's constitution may confer rights, and impose responsibilities, on directors. Those rights and responsibilities are binding in contract on directors and on the company.⁶ It is open to a company's subscribers to determine what provisions should be included in its constitution in relation to directors.

It is also possible for members to alter a company's constitution in certain circumstances. As a general rule, alterations must be agreed to by a special resolution by a majority of at least 75 per cent of members who voted on the resolution.⁷

There are, however, a number of limitations on members' ability to alter a company's constitution. In particular, the Courts may declare invalid an alteration which is passed in fraud on a minority of members.⁸ This general law limitation is reinforced by the Corporations Law under which the Court may make an order preventing an oppressive or discriminatory resolution of a general meeting from operating.⁹ An exercise of power by a majority of members will bind the minority only if exercised bona fide for the purpose for which the power was conferred; it must not be exercised for purposes outside the company's operations, affairs and organisation.

There are also restrictions on alterations which affect the class rights of particular class members and which increase members' liability or place restrictions on the right to transfer shares. There are additional requirements in the Law to effect such changes.¹⁰

6 Corporations Law, section 180.

7 Corporations Law, Division 3, Part 2.3.

8 See, for example, *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457.

9 Corporations Law, section 260.

10 Corporations Law, subsection 180(3).

4.3 GENERAL LAW DUTIES

General law duties of directors fall within three broad categories:

- contractual;
- equitable; and
- tortious.

4.3.1 Contractual

Executive directors are employed by the company under a contract of service. Such a contract will include a range of duties, both express and implied, owed by these directors to the company, including a duty of care in the performance of the contract.¹¹

4.3.2 Equitable

Under general law equitable principles, a director's relationship with the company is regarded as fiduciary in nature.¹² Consequently, directors owe a duty of loyalty and a duty to act with reasonable care, skill and diligence in performing their functions on behalf of the company. These duties are owed to the company and are enforceable by the company, although derivative actions may be brought by a member on behalf of the company in certain limited circumstances. A breach of these equitable obligations gives rise to liability to account for improper profits and to pay equitable compensation for improper loss of company assets.

The broad duty of loyalty may be regarded as encompassing the following more specific duties to:

- act in good faith for the benefit of the company as a whole;
- avoid fettering discretions;
- exercise powers only for a proper purpose; and
- avoid conflicts of interest.

¹¹ *Lister v Romford Ice and Cold Storage Co* [1957] AC 555.

¹² *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461; [1843-60] All ER 249.

Good faith

The duty to act in good faith for the benefit of the company as a whole is primarily a subjective one requiring directors to exercise their powers and discharge their duties in what they believe to be in the company's interests.¹³ However, it also has an objective element in that a Court may intervene if an act is one which no reasonable director could regard as being in the interests of the company. In recent years, the Courts have developed the duty further to require directors to have regard to the interests of creditors in certain circumstances, particularly where a company is nearing insolvency.¹⁴

Proper purpose

Directors must exercise their powers for the purpose for which they were conferred and not for any collateral purpose even if directors may have honestly believed that they were acting in the company's best interests.¹⁵

Fettering discretions

As directors are bound to exercise their functions for the benefit of the company, they may not generally fetter discretions conferred on them by the company's constitution. This means that directors must give adequate consideration in exercising discretions and must not delegate or fetter future exercise of discretions without authority. However, directors may contract to exercise their discretions in the future in a particular way provided that, in deciding to make the contract, they give proper consideration to whether the contract is in the interests of the company as a whole.¹⁶

Conflicts of interest

As fiduciaries, directors have a duty to serve the company. The converse of this duty is that directors must avoid placing themselves in a position in which their own interests or the interests of another may conflict with the interests of the company. However, a director may act notwithstanding a conflict of interest with the fully informed consent of the company.¹⁷ More specifically, the duty to avoid conflicts of interest may be broken down into the following rules:

13 *Re Smith & Fawcett Ltd* [1942] Ch 304.

14 *Walker v Winbourne* (1976) 137 CLR 1; *Kuwait Asia Bank EC v National Mutual Nominees Ltd* [1991] AC 187.

15 See *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187 at 218, per Ipp J.

16 *Thorby v Goldberg* (1964) 112 CLR 597.

17 *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.

- directors, as such, must not have a personal interest in a matter falling within the scope of their service, or enter into an inconsistent obligation with a third party, except with the company's fully informed consent (the conflict rule);
- directors must not misuse their position for their own or a third party's possible advantage, except with the company's fully informed consent (the profit rule); and
- directors must not misappropriate the company's property for their own or a third party's benefit (the misappropriation rule).

Fiduciary duty of care, skill and diligence

Directors, whether executive or non-executive, are also subject to an equitable duty of care, skill and diligence. The classic formulation of what is required of directors under this duty is found in the judgement of Romer J in *Re City Equitable Fire Insurance Co Ltd*¹⁸ as follows:

- the standard of care is that which 'an ordinary man might be expected to take on his own behalf';¹⁹
- a director is not required to exercise a greater skill than may reasonably be expected from a person with their knowledge and experience;
- a director is not bound to give continuous attention to the affairs of a company — the duties of care can be of an intermittent nature to be performed at periodical board meetings which the director is not always bound to attend although the director ought to do so when reasonably able to; and
- in the absence of grounds for suspicion, a director is justified in trusting and expecting other directors and officers to perform their duties diligently and honestly.

This formulation places a fairly low subjective burden of care and diligence on directors. However, in recent years there has been some, although not entirely uniform, indication in judicial consideration of the duty of an increasingly objective standard of care and diligence on directors, particularly in relation to financial matters. For example, in *Commonwealth Bank of Australia v Friedrich*²⁰ Tadgell J took the view that with the increasing complexity of commerce, the obligations of directors had also increased to a level where a director was

18 1925 Ch. 407 at 427-429.

19 *Overend & Gurney v Gibb* 1872 LR 5 HI 480 at 486.

20 (1991) 9 ACLC 946.

expected to be capable of understanding their company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity.

More recently, in the context of discussing directors' liability for a tortious duty of care (see discussion below), the majority of the Court of Appeal in *Daniels v Anderson*²¹ seemed to extend this objective standard beyond the financial sphere by requiring directors to take reasonable steps to place themselves in a position to guide and monitor the company's management. The majority acknowledged, however, that directors would not have equal knowledge and experience of every aspect of a company's activities and thus the duty would vary according to the size and business of the particular company and the experience or skills that the director held themselves out to have in support of appointment to the office.

While the majority in *Daniels* recognised that it was not only appropriate, but desirable, for directors to delegate and rely on others, they challenged the traditional view of the circumstances in which delegation and reliance on the advice of others is appropriate. They indicated that directors could not blindly rely on the judgement of others, particularly when an investment posed an obvious risk or where there was notice of mismanagement. That is, the majority considered that directors must be proactive in overseeing the management of a company.²²

There have also been statutory developments in relation to the standard of care and diligence which are discussed below.

4.3.3 Tortious

The majority of the Court of Appeal in *Daniels* confirmed that directors owe a duty of care and diligence to the company under the general law of negligence, thus agreeing with Rogers C J at first instance.²³ The standard of care and diligence applying to that duty is discussed above. Directors are liable to the company for damages for loss suffered, including economic loss, arising from breach of this tortious duty. The quantum of damages for breach of the equitable and tortious duties arising out of the same facts may differ significantly because conditions such as foreseeability and remoteness, to which damages for negligence are subject, are not relevant for equitable compensation. There is also the possibility of contributory negligence.

21 (1995) 37 NSWLR 438.

22 (1995) 37 NSWLR 438 at 502-504.

23 *AWA Ltd v Daniels* (1992) 10 ACLC 933.

4.4 CORPORATIONS LAW

Under the Law, a 'director' includes a person occupying or acting in the position of director, by whatever name called and whether or not validly appointed or duly authorised to act in the position, as well as a person in accordance with whose directions or instructions the members of the board are accustomed to act.²⁴ In the absence of contrary provisions in a company's constitution, the Law provides that directors are responsible for managing the business of the company and in doing so may exercise all the powers of the company.²⁵

The Corporations Law encapsulates the general law fiduciary duties of directors and requires them (and other company officers) to:

- act honestly;
- exercise reasonable care and diligence;
- not make improper use of the company's information; and
- not make improper use of their position as directors.²⁶

In the past, the statutory duty of care and diligence has been interpreted consistently with the equitable duty. As noted above, however, amendments were made in 1992 to bring some objectivity into the standard of care and diligence.²⁷ The Law now provides that 'in the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances'.²⁸ The Explanatory Memorandum to this amendment indicates an intention that the special background, qualifications and management responsibilities of the particular officer be taken into account in evaluating their compliance with the duty of care and diligence.²⁹

A director of a public company must not be present, or vote, at a board meeting in relation to a matter in which he or she has a material personal interest.³⁰ A director of a proprietary company must disclose any material

24 Corporations Law, section 60.

25 Corporations Law, Schedule 1, Table A, Article 66.

26 Corporations Law, section 232.

27 *Corporate Law Reform Act 1992*, section 11.

28 Corporations Law, subsection 232(4).

29 Explanatory Memorandum to the *Corporate Law Reform Act 1992*, p 25.

30 Corporations Law, sections 232A and 232B. A contravention of these provisions is punishable by a maximum fine of \$500.

interest he or she has in a contract with the company, subject to limited exceptions.³¹

The Law also specifically regulates the giving of financial benefits by public companies to their directors (and other related parties).³²

A contravention of the duties in section 232 or Part 3.2A may have civil or criminal consequences.³³

The ASC may apply to the Court for a declaration that a person has contravened these provisions in relation to a specific corporation. If the contravention is serious, the Court may also order the person to pay a pecuniary penalty to the Commonwealth of up to \$200,000. In addition, the Court may order the person to compensate the corporation for any loss it has suffered as a result of the contravention. Further, the corporation may recover from the person any profit they have made because of the contravention.

Where the Court is satisfied that a person has contravened the provisions, it may also disqualify that person from acting as a director for such period as it thinks fit unless it is satisfied that the person is a fit and proper person to act as a director.

Where dishonest intent is involved in the contravention, a director may be subject to criminal sanctions of a fine of up to \$200,000 or five years imprisonment, or both.

Apart from these duties owed to the company, there are a range of provisions in the Law which impose more specific statutory duties on company directors. These include provisions in relation to insolvent trading liability³⁴ and the obligation to prepare financial statements.³⁵ These duties are also civil penalty provisions under Part 9.4B of the Law. Further statutory duties imposed on directors under the Law, which are not civil penalty provisions, are outlined in Appendix B.

Legislation other than the Corporations Law may also impose duties on directors. For example, environmental control legislation in a number of States and Territories places obligations on directors as well as companies.

31 Corporations Law, section 231. A contravention of this provision is punishable by a maximum fine of \$1000.

32 Corporations Law, Part 3.2A.

33 Corporations Law, Part 9.4B.

34 Corporations Law, section 588G.

35 Corporations Law, section 318.

PART 5: BUSINESS JUDGEMENT RULE — STATUTORY DERIVATIVE ACTION — NEW TOOLS FOR CORPORATE GOVERNANCE

5.1 INTRODUCTION

There has been increasing debate in Australia about the standard of corporate governance, particularly in light of the experiences of the late 1980s.

On the one hand, there have been calls by investor and shareholder groups for greater accountability by directors. On the other hand, directors have been demanding greater certainty in respect of their potential liabilities having regard to notable corporate civil litigation cases.

The question therefore arises as to what should be done to address these concerns — can Government legislation ensure good corporate governance?

It seems clear that any reforms that are introduced in this area should provide an appropriate incentive for directors to behave properly without unduly fettering the exercise of their judgement or their enterprise. What needs to be avoided in this regard is unnecessary, prescriptive legislation imposing additional liabilities on directors that could tip the balance away from economically rational behaviour towards overly legalistic, defensive behaviour.

Recent, but separate, proposals for the introduction of a statutory business judgement *safe harbour* for directors and a statutory form of derivative action for shareholders are particularly relevant to the wider debate on corporate governance. A statutory business judgement rule would, in general terms, offer directors a *safe harbour* from personal liability in relation to honest, informed and rational business judgements. A statutory derivative action would enable a shareholder or director to bring an action on behalf of a company for a wrong done to the company where the company is unable or unwilling to do so itself.

Looked at from both an economic and legal perspective, these proposals would seem attractive as they are potentially able to address concerns about

director liability and accountability at the same time. While the proposals do not seek to impose further prescriptive rules about director behaviour, they provide incentives toward proper behaviour.

5.2 STATUTORY BUSINESS JUDGEMENT RULE

5.2.1 Issues Facing Directors

The business of a corporation is managed by its board of directors which exercises all powers directly conferred on, or implicitly granted to, the corporation. The board makes the broad decisions and designates the officers to execute the decisions. In practice, in the case of large public corporations, the idea that the board of directors actually manages the company is gradually being replaced with the notion that the board's primary function is to monitor management and oversee the operation of the corporation. This is certainly true of non-executive directors.

While the Courts have been reluctant to review judgements of directors exercised in good faith, they have also, on occasion, refused to exercise their discretion to excuse directors from liability where they have acted fairly and honestly.³⁶ This has led to uncertainty in the minds of directors as to the extent of *due diligence* required of them.

In particular, the Court of Appeal decision in *Daniels v Anderson*³⁷ has extended and made more uncertain the accountability and liability of directors. This uncertainty has been heightened in light of Court decisions, both before and after *Daniels*, that are apparently inconsistent with the Court of Appeal decision and with each other.³⁸

While these Court decisions may not have led to a rush of litigation against directors, they have contributed to a climate of uncertainty thereby potentially affecting, whether directly or indirectly, directors' behaviour.

36 *Standard Chartered Bank of Aust Ltd v Antico & Ors* (1995) 38 NSWLR 290; *Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946; *Knightswood Nominees Pty Ltd v Sherwin Pastoral Co Ltd* (1989) 7 ACLC 536; *Chew v R* (1991) 4 WAR 21.

37 (1995) 37 NSWLR 438.

38 *Re Property Force Consultant Pty Ltd* (1995) 13 ACLC 1051; *Dempster v Mallina Holdings Ltd* (1994) 13 WAR 12; *Permanent Building Society (In liq) v Wheeler* (1994) 11 WAR 187; *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395.

Many directors say they are unclear about the extent of their ability to rely on officers of the corporation and experts when making decisions or delegating responsibilities. They are also uncertain about their potential liability at common law for a breach of their duty of care.

It is argued that this lack of certainty regarding the limits of directors' duties is causing directors to be conservative and risk-averse in their approach to carrying out their functions. Shareholders will ultimately suffer the economic consequences of this change in director behaviour.

5.2.2 The Case for a Statutory Business Judgement Rule

The introduction into the Corporations Law of a business judgement rule has been considered and recommended by various Committees.³⁹ The former Government's response to calls for a statutory form of business judgement rule was to make amendments to the Corporations Law in 1992 which left the 'rules relating to the exercise of business judgement' to be developed by the Courts and not be given any explicit statutory foundation.⁴⁰ The history of the consideration of a business judgement rule in Australia is outlined in [Appendix C](#).

The fundamental purpose of a business judgement rule is to protect the authority of directors in the exercise of their duties, not to insulate directors from liability. In the absence of an express statutory acknowledgment of a business judgement rule, companies and their shareholders will inevitably incur costs as a result of the failure by the company and its directors to take advantage of opportunities that involve responsible risk-taking.

While it is accepted that directors should be subject to a high level of accountability, a failure to expressly acknowledge that directors should not be liable for decisions made in good faith and with due care can have the effect of encouraging business behaviour which is risk-averse.

In a corporate context, particularly in the case of large publicly listed companies, there may be a divergence of interests between directors and

39 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties*, November 1989; Companies and Securities Law Review Committee (CSLRC), *Company Directors and Officers: Indemnification, Relief and Insurance*, 1990; House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders*, 1991; CASAC, *Directors' Duty of Care and Consequences of Breaches of Directors' Duties*, September 1991.

40 Explanatory Memorandum to the Corporate Law Reform Act 1992, pp 25 and 26.

shareholders which can give rise to costs to the company sometimes referred to as agency costs.⁴¹ Agency costs are so called because the body of shareholders and the directors are, in a loose non-legal sense, in a principal/agent relationship.

Agency costs can arise because of the disparity between shareholders' desire for the company's directors to maximise company wealth and the directors' lesser incentive to maximise shareholder wealth in circumstances where decision-making may give rise to unquantifiable personal liability. One approach developed by the market to reduce agency costs has been the introduction by companies of various incentive schemes or arrangements, for example, executive performance bonus schemes and executive share schemes. These schemes or arrangements provide directors with a direct interest in the profitability of the company (ie, the agent also takes on the role of a principal).

The codification of a director's duty of care in the Corporations Law,⁴² without a complementary codification of the business judgement doctrine, appears to have overlooked the potential effects this has on agency costs. Certainly, the continued and widespread calls from company directors for the introduction of some form of business judgement rule is indicative of director uncertainty which increases agency costs.

From an economic perspective, a statutory business judgement rule would provide an incentive for boards to adopt effective corporate governance practices that promote transparency, accountability, and consequently investor confidence. A legislative statement of the rule would assist the Courts in striking the right balance between the competing interests of, on the one hand, commercial risk-taking by directors and, on the other hand, their accountability. Such a rule would introduce an element of certainty into the Law which could be expected to reduce company agency costs. This should, in turn, improve corporate financial performance.

The introduction of a statutory form of business judgement rule would effectively be a recognition that prescriptive liability rules do not necessarily guarantee optimal board performance in terms of maximising shareholder wealth. If they are to act as efficient tools of corporate governance, liability rules need to be tempered against the need to ensure that the attention of directors is not significantly diverted from the pursuit of maximising shareholder wealth.

41 See M C Jensen and W H Meckling, 'Theory of the Firm; Managerial Behaviour, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol 3, 1976, pp 305-360.

42 Corporations Law, section 232.

A statutory formulation of the business judgement rule would clarify and confirm the position reached at common law that Courts will rarely review bona fide business decisions.⁴³ However, unlike the common law, it would provide a clear presumption in favour of a director's judgement thereby creating much more certainty for directors. Accordingly, while the substantive duties of directors would remain unchanged, directors would benefit from knowing that if they took decisions in good faith and in the company's interest, they would not be subject to challenge.

Section 1318 of the Law, which provides scope for the Courts to excuse directors from liability where they have acted fairly and honestly, only operates after there is a finding of breach of duty and applies at the discretion of the judge. It therefore does not have the same effect as the business judgement rule, nor does it provide the same element of certainty for directors.

As there is considerable cost in defending actions for breach of duty and loss of reputation after having been found to be in breach, a presumption in a director's favour is a more efficient mechanism for encouraging positive director behaviour.

However, the parameters of a statutory business judgement rule, or director *safe harbour* law, need to be very clearly expressed in legislation. A business judgement rule should not insulate directors from liability for negligent, ill-informed or fraudulent decisions. Rather, the rule should encourage a company to adopt risk-management structures and thereby significantly reduce director uncertainty. While the current law does not prevent the adoption of appropriate risk-management structures, the worth of such structures at present is open to question given the somewhat uncertain application of the common law.⁴⁴

Absent fraud or bad faith, the business judgement rule should allow directors the benefit of a presumption that, in making business decisions, they have acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company. A statutory rule would be weighted in favour of directors who make well informed business decisions

43 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 492; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 2 WLR 689.

44 In *Harlowe's Nominees Pty Ltd v Woodside* (1968) 121 CLR 483 at 493, the High Court stated that 'Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned *with a wide range of practical considerations*, and their judgement, if exercised in good faith and not for an irrelevant purpose, is not open to review by the Courts.' (emphasis added).

and would ideally encourage the active participation and involvement of directors.

In addition, the enactment of a statutory business judgement rule may pre-empt the possibility of future calls, which have already occurred in the United States, for legislation which would enable companies to relax liability for a breach of the duty of care and effectively insulate directors from liability for negligence. Following the decision of the Delaware Supreme Court in *Smith v Van Gorkom*,⁴⁵ which initially strengthened the standard of care and diligence, an amendment was introduced in Delaware some 18 months later enabling shareholders to limit directors' liability, through the company's constitution, for damages where they have acted in good faith.⁴⁶ The amendment followed large increases in the premiums for directors' and officers' liability insurance and the concern of the legislature that qualified people would refuse to serve on boards of directors because of fear of personal monetary liability.

5.2.3 The Form of a Statutory Business Judgement Rule

In Australia and the United States various attempts have been made to formulate a business judgement rule. The underlying policy in each case has been the same: the prevention of judicial review of business decisions made in good faith and with due care. What is needed is a liability rule strict enough to reduce agency costs while encouraging competent persons to serve on corporate boards and take the risks necessary to engage the corporation in profitable projects.

The United States business judgement rule has developed, and received recognition, as a judicial doctrine. It operates as a legal presumption and as a rule of the law. Directors are presumed to have made informed business decisions in good faith and with care. Unless the presumption is rebutted by a plaintiff, a director is not liable to compensate the corporation for loss or damage flowing from the business decision. Although not specifically enacted in the United States, the American Law Institute (ALI) in 1994 produced a draft model provision:

45 (Del Sc 1985) 488 A 2d 858.

46 *Delaware General Corporation Law 1967*, paragraph 102(b)(7).

- ‘ . . . (c) A director or officer who makes a business judgement in good faith fulfils the duty under this Section if the director or officer:
- (1) is not interested in the subject of the business judgement;
 - (2) is informed with respect to the subject of the business judgement to the extent the director or officer reasonably believes to be appropriate in the circumstances; and
 - (3) rationally believes that the business judgement is in the best interests of the corporation.’⁴⁷

In Australia, the rule was given written expression in 1989 by the Companies and Securities Law Review Committee (CSLRC) in its report in favour of an Australian business judgement rule.⁴⁸ In the following year, the CSLRC elaborated on the form of a statutory rule.⁴⁹

The CSLRC formulation was recommended by the House of Representatives Standing Committee on Legal and Constitutional Affairs,⁵⁰ and released for comment as part of the *Corporate Law Reform Bill 1992*. However, it was not ultimately proceeded with essentially because it was considered that the common law as it had developed at that time already effectively meant that the Courts would not second guess bona fide business judgements made by directors.

47 ALI, *Principles of Corporate Governance: Analysis and Recommendations*, Paragraph 4.10(c), proposed final draft, 31 March 1992.

48 CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Discussion Paper No. 9, April 1989. The Committee took the view that the rule ought to be introduced by amending section 535, which dealt with the power of the Court to grant relief to parties before it where they had acted honestly (now section 1318 of the Corporations Law):

‘Section 535 might be supplemented by a provision . . . that a Court shall not hold an officer liable in respect of a matter of business judgement where he has in that matter:

- (1) acted in good faith and without being subject to a conflict of interest or duties;
- (2) exercised an active discretion in the matter;
- (3) taken reasonable steps to inform himself;
- (4) acted with a reasonable degree of care in the circumstances including:
 - (a) any special skill, knowledge or acumen he possesses; and
 - (b) the degree of risk involved.’

49 See [Appendix C](#) for a copy of the rule.

50 House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders*, 1991.

Both the CSLRC's and the ALI's formulation of the business judgement rule have their merits. The following is a proposed provision which seeks to draw on the key features of the two formulations and adapt them to the regime of directors' duties contained in the Corporations Law:

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

The proposed provision would result in the Corporations Law setting out, not only the duty of care and diligence of directors, but also an explicit *safe harbour* for directors, such that they would know with some certainty that, if they fulfilled the requirements of paragraphs (a) to (d), they would effectively be shielded from liability for any breach of their duty of care and diligence.

It is envisaged that the provision would also operate in relation to the general law duty of care and diligence so that the merits of directors' business judgements would not be capable of review by the Courts if the requirements of paragraphs (a) to (d) had been met.

The proposed provision would act as a rebuttable presumption in favour of directors which, if rebutted by a plaintiff, would mean that the plaintiff would

then still have to establish that the officer had breached their duty of care and diligence.

It is not intended that the proposed provision would apply to business judgements made by directors in the context of insolvent trading or in relation to misstatements in a prospectus or takeover document, as these are considered to be discrete areas where it would not be appropriate for the business judgement presumption to operate. In this regard, it is considered desirable to confine the operation of the business judgement rule to cases which involve the taking of decisions involving the ordinary business operations of the company of the type expressly mentioned by the CSLRC in its proposed draft provisions.

5.3 STATUTORY DERIVATIVE ACTION

5.3.1 Issues Facing Shareholders

Inadequacies of Existing Statutory Remedies

As a matter of law, individual shareholders cannot become involved in the management of the companies in which they invest as the principal organs for the management of the company are the directors acting as a board and the members, acting in the general meeting. Shareholders, through the general meeting, are able to take decisions on key matters affecting the company but generally the directors are left with a wide discretion as to how they perform their duties. This is necessary to provide flexibility for the corporation to be managed effectively by, or through, the directors.

In addition to their powers to vote at a general meeting, the Corporations Law confers on company members a number of rights relating to the company's internal management. Some are subject to the company's constitution, while others prevail over the constitution. Under the Law, shareholders' rights include:

- participation in decisions concerning the company's constitution;⁵¹
- approving certain transactions involving directors and other officers;⁵² and

51 Corporations Law, sections 171-174 and 176.

52 Corporations Law, Division 5, Part 3.2A.

- appointing and removing the company's directors in accordance with procedures specified in the Corporations Law.⁵³

The rules in this area of the Law seek to reduce the cost to members and directors of establishing and enforcing their relationship with one another.

Currently, the Law allows investors, in limited ways, to enforce a right belonging to a company by providing a remedy in cases of oppression of minority shareholders, and for the granting of injunctions where there has been a breach of the Corporations Law.⁵⁴ The Companies and Securities Advisory Committee (CASAC), in its July 1993 report on a statutory derivative action, concluded that these remedies were inadequate and inappropriate and that a provision which defined a right of action for shareholders to bring on behalf of their company, with specifically enunciated procedures, was needed.⁵⁵ Since that report a number of cases have created further uncertainty, in particular about the scope of section 1324.⁵⁶

The need for a shareholder to take a derivative action can arise where a board of a company declines to pursue an action against one or more directors of that company for a breach of their common law or statutory duties. The conflict of interest that may arise when directors consider whether the company should commence such litigation is a key reason for enabling the company's members to be able to commence a derivative action.

Inadequacies of Common Law Derivative Action

Although derivative actions are possible at common law, the legal rule that the company is the *proper plaintiff* to enforce rights belonging to that company, commonly known as the rule in *Foss v Harbottle*,⁵⁷ restricts the circumstances in which a derivative action may be taken. An individual shareholder is thus only permitted to bring a derivative action if the case falls within specified and narrowly defined exceptions to the rule.

A key difficulty with the rule lies in the uncertainty whether ratification by some shareholders of a breach of duty by a company's directors has the effect of denying other shareholders the right to bring a derivative action to protect the company as a whole. If effective, the purported ratification by a majority of

53 Corporations Law, Schedule 1, Table A, Articles 57-60.

54 Corporations Law, sections 260 and 1324.

55 Legal Committee of CASAC, *Statutory Derivative Action*, 1993.

56 *Mesenberg v Cord Industrial Recruiters Pty Ltd (No. 2)* (1996) 39 NSWLR 128; cf *Airpeak Pty Ltd v Jetstream Aircraft Ltd* (1997) 23 ACSR 715.

57 (1843) 2 Hare 461; Ch.12 LJ 319.

shareholders could deny the company as a whole, and hence minority shareholders, any right of action against the directors.

Other significant difficulties with the rule relate to the potential liability of a shareholder for the costs of the action although the shareholder has no personal rights to any damages resulting if they are successful. Where a shareholder seeks to enforce a right on behalf of a company, they are likely to be disinclined to risk having costs awarded against them in a case which will ultimately benefit the company as a whole, not just individual shareholders.

A fundamental issue of good corporate governance and the economic merits of the proposal for a statutory derivative action is the concern that it may inhibit boards and corporate managements from their proper decision-making role. It is in this respect that there is a natural connection between a statutory derivative action and a business judgement rule.

5.3.2 The Case for a Statutory Derivative Action

Any enhancement of members' rights must be assessed against the need to encourage managerial risk-taking which is an essential element in the pursuit of profit. The conferral of rights on members should not work against their interests by causing management to avoid commercial risk-taking because of perceptions of risk of personal liability. The overall goal of conferring rights on investors is to provide an incentive for management to exercise its powers appropriately and discharge its functions for the ultimate advantage of the providers of the corporation's capital. The aim should be to enable this to be done without placing unnecessary constraints, or inappropriate incentives, on management in its pursuit of that ultimate advantage.

The existing law is unsatisfactory both on the question of standing of a shareholder to take action and the disincentive to commence proceedings because of the potential costs which might be incurred.

Without the introduction of clear statutory procedures, pursuing derivative actions will continue to be an uncertain enterprise surrounded by confusion.

Although recent Australian cases⁵⁸ have shown that the Courts do not necessarily consider themselves bound by the restrictions imposed by the rule in *Foss v Harbottle*, thus seeming to provide shareholders with greater access to remedies, their decisions have created a degree of uncertainty in themselves. In particular, the increasing reliance upon the so-called *interests of justice* exception effectively means that the question of standing for shareholders is at the discretion of the Courts which do not always apply this exception consistently.

This uncertainty, coupled with the risk of personally having to bear the costs of bringing the action, whether successful or not, provides a strong deterrent to shareholders seeking to take common law derivative actions. In these circumstances, some breaches of duty by directors may not be pursued as neither the company, because it may be controlled by the directors, nor the shareholders are willing to litigate.

A statutory derivative action would not impose a new form of liability on directors but would provide a more effective avenue of enforcement than has previously been available. In the past, relatively few breaches of directors duties have been able to be litigated, other than in the insolvency context, especially where there has been no involvement by the ASC.

A statutory derivative action would provide strong encouragement for company managers to be accountable to shareholders for the decisions they make. However, potential abuse of the statutory right of action needs to be recognised and clear safeguards provided to ensure that company management is not undermined by unjustified litigation. These safeguards should include strict criteria for satisfying the Court that a plaintiff shareholder should be granted leave to bring an action, and should give a Court power to make various orders relating to costs, security for costs and the appointment of an independent investigator to report to the Court on funds expended by both sides during proceedings.

The introduction of clear statutory procedures would remove the uncertainty that surrounds the common law action, particularly in relation to the issue of ratification of management actions with less than unanimous shareholder support, and in relation to the question of costs.

58 *Biala Pty Ltd v Mallina Holdings Ltd* (No. 2) (1993) 2 WAR 381; *Aloridge Pt Ltd v West Australian Gem Explorers Pty Ltd* (1995) 13 ACLC 196; *Mesenberg v Cord Industrial Recruiters Pty Ltd (Nos. 1&2)* (1996) 39 NSWLR 128; *Ruralcorp Consulting Pty Ltd v Pynery Pty Ltd* (1996) 21 ACSR 161; cf *Prudential Assurance Co Ltd v Newman Industries Ltd (No. 2)* [1982] Ch 204; *Eromanga Hydrocarbons NL v Australia Mining NL* (1988) 6 ACLC 906.

A statutory right of action would also remove some of the regulatory burden from the ASC by making it easier for investors themselves to protect the interests of the company.⁵⁹ In this respect, it is appropriate for company members to use their own, or company funds, to protect their investments rather than such actions being taxpayer funded through ASC involvement.

The potential benefits of a statutory derivative action may be particularly relevant in addressing any perceptions, both domestically and internationally, that directors are not accountable to shareholders for their actions. Such a rule would send a strong message not only to company boards in relation to their corporate governance practices but also to investors.

Most importantly, a statutory form of derivative action could potentially be a valuable tool to enhance corporate governance and to maintain investor confidence. In particular, it may have the effect of reducing agency costs between the director/managers of a company and its shareholders. A direct accountability mechanism that can be used by shareholders in an efficient and effective manner provides an added incentive for directors to ensure that they always act in the interests of the company.

5.3.3 The Form of a Statutory Derivative Action

Draft provisions establishing a statutory derivative action were exposed for public comment in September 1995.⁶⁰ The draft provisions essentially implemented recommendations proposing the introduction of a statutory derivative action by several different Committees.⁶¹

The House of Representatives Standing Committee on Legal and Constitutional Affairs considered the introduction of a statutory derivative action to be an important means of overcoming deficiencies within the existing

59 ASC Law, section 50, provides that the ASC may in certain circumstances commence proceedings in another person's name.

60 Attorney-General's Department, *Proceedings on Behalf of a Company (Statutory Derivative Action): Draft provisions and commentary*, September 1995.

61 House of Representatives Standing Committee on Legal and Constitutional Affairs *Corporate Practices and the Rights of Shareholders*, 1991; CSLRC, *Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action*, Report No.12, 1990; Legal Committee of CASAC, *Statutory Derivative Action*, 1993.

law and enhancing shareholders' rights.⁶² This recommendation supported an earlier 1990 report by the CSLRC.⁶³

Subsequently, the Legal Committee of CASAC recommended that a statutory right should be introduced for an individual shareholder to bring an action on behalf of a company where the company is unwilling or unable to do so.⁶⁴

As the 1995 exposure draft provisions were generally supported in terms of their effectiveness in achieving the objectives of a derivative action, there would seem merit in retaining the provisions with some possible exceptions.

The key aspects of the proposed statutory derivative action as contained in the 1995 exposure draft provisions are:

- An application to the Court to commence a statutory derivative action may be made by:
 - members/shareholders (including those with a present entitlement to be registered), former members of a company or a related body corporate;
 - directors, officers, present and former, of the company; and
 - the ASC.
- The Court would need to be satisfied that the following four criteria had been met before it could grant leave to an applicant to pursue a derivative action:
 - inaction by the company;
 - the applicant is acting in good faith;
 - the action appears in the best interests of the company; and
 - there is a serious question at issue.
- Procedures would make a derivative action more feasible and practical than under the common law:

62 *Corporate Practices and the Rights of Shareholders*, 1991.

63 *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action*, Report No.12, 1990.

64 *Statutory Derivative Action*, 1993.

- the Court would have a broad discretion to make orders about the costs of the applicant, the company or any other party to the proceedings or the application;
- ratification by the general meeting of a company of any breach of the law giving rise to the action would not necessarily bar an action;
- the Court would have the power to ensure that an action was conducted in the best interests of a company through supervision by an independent investigator; and
- applicants would be given access to company records.

In light of comments received after public exposure of the draft provisions, it is proposed that three changes be made to the draft provisions:

- removal of the ASC as an eligible applicant;
- addition of provisions clarifying that the Court has a discretion regarding the allocation of responsibility for payment of the fees and costs of an independent investigator; and
- addition of a note to clarify that the provision, although abolishing common law derivative actions, is not intended to affect any personal rights generally attaching at common law.⁶⁵

In relation to the removal of the ASC as an eligible applicant, as the basic policy objective of derivative proceedings is to provide an effective remedy for investors and to overcome the difficulties in *Foss v Harbottle*, there is no proper role for the ASC to bring such proceedings. In particular, the statutory action is not intended to be regulatory in nature but to facilitate private parties to enforce existing rights attaching to the company — in effect, the action is designed to be a self-help measure. In this regard, a statutory derivative action has the potential to remove some of the regulatory burden from the ASC by making it easier for investors themselves to protect the interests of a company.

In any case, where there has been a serious breach of the Corporations Law, the ASC already has all the necessary powers to undertake civil proceedings on behalf of a relevant party, provided the proceedings are in the public interest.⁶⁶

⁶⁵ See [Appendix D](#) for a copy of the revised provisions.

⁶⁶ ASC Law, section 50.

It is notable that overseas jurisdictions with similar legislation, for example New Zealand and Canada, do not specifically provide for participation by the regulator.

Safeguards Against Abuse of the Procedure

The draft provisions at Appendix D include significant safeguards aimed at preventing potentially vexatious or unmeritorious actions that would be detrimental to the company on whose behalf the action was taken. These safeguards are embodied in the criteria that need to be satisfied by the applicant before leave to take a derivative action can be granted by the Court. The criteria are based on recommendations of the CSLRC and were endorsed by CASAC and the House of Representative Standing Committee on Legal and Constitutional Affairs.

The criteria seek to strike a balance between the need to provide a real avenue for applicants to seek redress on behalf of a company where it fails to do so and the need to prevent actions proceeding which have little likelihood of success.

Inaction by the Company

As a practical matter, the company's response to any notice of intention to apply for a grant of leave would provide evidence relevant to this criterion. An applicant might also seek to discharge this criterion by demonstrating that the alleged wrongdoer has a dominant influence on the board of directors.

Ratification by the general meeting of any wrong committed against the company would be a matter for the Court to take into account under this criterion although it would not necessarily be decisive.

Applicant's Good Faith

In assessing whether an applicant is acting in good faith, the Court could be expected to have regard to whether:

- there was any complicity by the applicant in the matters complained of; and
- the application is being made in pursuit of an interest other than that of the company.

The good faith requirement is designed to prevent proceedings being used to further the purposes of the applicant, rather than the company as a whole.

Best Interests of the Company

This criterion would allow the Court to focus on the true nature and purpose of the proceedings. It would recognise that a company might have sound business reasons for not pursuing a cause of action open to it and that its management might legitimately have decided that the best interests of the company would be served by not taking action. For example, a decision may be taken in a case where, although it may be clear that there has been a breach of duty by a director, the loss to the company may only be nominal. In this case, the costs of taking proceedings may outweigh any benefit to the company.

The inclusion of this criterion would allow the Court to refuse to grant leave in these circumstances because the applicant for leave would not be able to show that to do so would be in the best interests of the company.

Serious Question

The *serious question to be tried* test is familiar and regularly employed by the Courts in the context of interim injunction applications. The *serious question to be tried* test was preferred to the alternative of requiring the applicant to show a *prima facie* case. It is important in this regard that the application for leave to take proceedings is not turned into a trial of the substantive issues, without the applicant having the usual plaintiff's right to pre-trial discovery and interrogatories. The applicant is simply required to show that proceedings should be commenced. On the other hand, this criterion would prevent the proceedings being abused to further frivolous or vexatious claims.

It is considered unnecessary as a precondition for relief for a shareholder to have to bring the matter before a general meeting of the company as the exposure draft provisions already require the Court to be satisfied that it is probable that the company would not itself bring the proceedings or take responsibility for them. In any case, this criterion would be difficult to establish without the applicant showing that it had in fact tried to gain the support of the company by at least attempting to convene a general meeting. There are also practical obstacles facing an applicant in requisitioning a general meeting. Unless the articles provide otherwise, the Corporations Law currently requires five per cent of total voting rights of all members to convene a meeting of the company.⁶⁷

Similarly, limiting derivative actions to those cases where a dominant shareholder is affecting the interests of the company could exclude from the

⁶⁷ Corporations Law, section 247.

application of derivative actions cases where directors have acted in breach of their duties to the company, unless those directors were also a dominant shareholder. It would also preclude the situation where several shareholders who held the balance of power acted in concert. In addition, it could be argued that the question of dominance is already addressed in the majority of cases under the oppression remedy, while the statutory derivative action is specifically designed to go beyond instances of strict oppression.

The draft provisions at Appendix D also include other safeguards which apply once leave to take proceedings has been granted.

Leave to Discontinue, Compromise or Settle Derivative Proceedings

A person having charge of the conduct of the proceedings would not be permitted to discontinue, compromise or settle the proceedings without the Court first considering if that was in the best interests of the company.

Independent Investigator

The Court would also be able to make an order appointing an independent person to investigate and report to the Court on the:

- financial affairs of the company;
- facts surrounding the circumstances that gave rise to the cause of action; and
- funds expended by both sides during proceedings.

The draft provision is principally designed to ensure that where an action is being funded by the company, the Court will be able to find out independently of the parties whether shareholders' funds are being expended in a reasonable manner and whether a complaint constitutes a good cause of action.

Costs Orders

Under the draft provisions, the Court would have a broad discretion to make any orders it thinks just about the costs of the applicant, the company or any other party to the proceedings or the application. Orders could be made in respect of the application for leave or the proceedings, and could include a requirement for indemnification for costs.

The Court's discretion regarding the allocation of costs is aimed at providing an additional safeguard in respect of use of company funds. In particular, the Court would be able to protect a bona fide shareholder against liability for costs by indemnifying them out of company funds while at the same time allowing the Court a further means of discouraging unmeritorious or doubtful action. This reflects the position that the company itself is the beneficiary in a successful derivative action.

In addition, if a shareholder was successful in an action, the costs would not necessarily fall on the company but on the defendants to the action. If the action was not successful, the applicant may have costs awarded against them, especially if the action was ultimately considered frivolous. The exercise of the Court's decision in this regard would probably depend on the merits of the case.

Interaction with Business Judgement Rule

The question arises whether a business judgement rule should be capable of operating in the context of decisions made by directors regarding whether or not the company should sue the directors and/or third parties. That is, should the Law provide a direct link between the business judgement rule and a statutory derivative action by:

- first requiring a shareholder wishing to bring a derivative action to request the board of directors to pursue the action on behalf of the company; and
- requiring the Court to refuse an application where the directors have refrained from pursuing an action on behalf of the company based on their business judgement that such an action would not be in the best interests of the company?

If so, should these requirements only apply in cases of third party suits, as opposed to actions against the directors themselves, or only in cases where no conflict of interest has been shown on the part of directors, or where a majority of the directors are not implicated in the wrong doing?

The Courts in some United States jurisdictions may dismiss a derivative action if the directors not involved in the alleged wrong-doing pass a resolution that the action should be dismissed. The resolution must satisfy the business judgement rule. That is, the decision must be bona fide and made at arms length.

A recommendation by independent directors against proceeding with an action on behalf of the company should be a relevant consideration by the

Court in determining whether leave should be granted, however, it should not necessarily be decisive. Rather, the Court should take into account the directors' decision having regard to all the relevant facts.

It is desirable for the Court to have a discretion to override the decision of directors particularly because of the inherent conflict of interest involved when directors, whether independent or not, make decisions about legal actions against themselves. Even where directors have not been involved in the conduct which is the subject matter of the legal proceedings, they may feel constrained about taking decisions against their fellow directors who may well have been instrumental in having them appointed to the board in the first place.

5.4 CONCLUSION

A statutory business judgement rule would not insulate directors from liability. Rather, it would protect the authority of directors to exercise their duties in good faith and with due care. A statutory business judgement *safe harbour* should provide encouragement and certainty to managers that if they behave honestly and reasonably, they will not be questioned.

The introduction of a statutory derivative action is not intended to impose a new form of liability on directors but to provide a new avenue of enforcement where there has previously been a gap. In particular, the objective of a statutory provision is not to provide additional grounds to sue directors but to overcome a number of key procedural difficulties which currently exist. A statutory form of derivative action should provide strong encouragement for company managers to be accountable to shareholders.

The statutory forms of the business judgement rule and derivative action have the potential to facilitate innovative and forward looking decision-making by directors and promote investor confidence.

Proposal No. 1 — A Statutory Business Judgement Rule and a Statutory Derivative Action should be Introduced into the Corporations Law

- As a means of facilitating decision-making by directors and promoting investor confidence, the Corporations Law should be amended to provide both a statutory form of:
 - business judgement rule, as outlined in Part 5.2.3, which would offer directors a *safe harbour* from personal liability for breaches of the duty of care and diligence in relation to honest, informed and rational business judgements; and
 - derivative action, as outlined in [Appendix D](#), to enable shareholders or directors of a company to bring an action on behalf of the company, for a wrong done to the company where the company is unwilling or unable to do so.

PART 6: OTHER ISSUES FOR DIRECTORS

6.1 BACKGROUND

Following the Court of Appeal decision in *Daniels v Anderson*,⁶⁸ and the increasing uncertainty regarding the ambit of directors' liability under the general law, there have been suggestions that the Government should legislate to specifically provide that:

- the duties and standard of care and diligence of executive and non-executive directors be different;
- directors be entitled to delegate responsibility and to rely on information provided to them by experts and company officers as a defence to an action for breach of their duties of care and diligence to the company;
- directors owe their duties to the company only and should not be personally liable in tort for negligence;
- the requirement under the Law for directors to act honestly be reformulated, the extent of directors' right of access to an indemnity in respect of legal expenses be clarified and criminal liability for breach of the duty of care and diligence be removed; and
- a generic or model *due diligence* defence be available to directors in respect of liability under legislation other than the Corporations Law, for example, under environmental legislation.

6.2 DUTIES OF EXECUTIVE AND NON-EXECUTIVE DIRECTORS

Concerns have been expressed in the business community about the implications of the decision of the New South Wales Court of Appeal in *Daniels* for the standard of care and diligence of non-executive directors. As noted in Part 4, while the majority in that case recognised that not every

68 (1995) 37 NSWLR 438.

director can be expected to have equal knowledge and experience of every aspect of their company's activities, they took the view that non-executive directors were subject to the same standard of care and diligence as executive directors and that the standard was an objective one.⁶⁹ This has raised concerns about the likelihood in the future of finding suitably qualified persons prepared to bring the independence that is necessary to Australian company boards.

On its facts, the *Daniels*' decision only deals with the tortious duty of care owed by directors and it is unclear whether it would also have application to the equitable duty of care owed by them. Although Rogers C J at first instance made it clear that he regarded the content of the tortious and equitable duties as the same,⁷⁰ the majority on appeal were not so explicit. Thus, it may be that subsequent Courts will apply a different standard to the equitable duty. However, even prior to the *Daniels*' case, the equitable duty seemed to be approaching a more objective standard for both executive and non-executive directors, particularly in relation to financial matters. Furthermore, amendments to Law in 1992 introduced an objective standard into the statutory duty of care and diligence.⁷¹

The fact that the standards in all the duties are seemingly heading in the same direction, with increasing reliance being placed on an objective standard, is a reflection of the important role that directors, both executive and non-executive, are considered to play in corporate Australia. It is no longer acceptable for a director to take a passive role in company affairs. An individual should not accept a directorship unless they have the appropriate skills and competence to perform the role.

That is not to say that all directors should have the same qualifications and experience; it is clearly important that a board be composed of a mix of skill and experience. The Court of Appeal in *Daniels* recognised that this was consistent with an objective standard of care and diligence and that the duty would vary according to the size and business of the particular company, and the experience or skills that the director held themselves out to have.⁷²

Some concern has been expressed, however, that the statutory formulation of the standard of care and diligence may not sufficiently allow for differences in qualifications and experience of individual directors to be taken into account. Although the Explanatory Memorandum to the 1992 amendments made it

69 (1995) 37 NSWLR 438 at 500-501.

70 (1992) 10 ACLC 933 at 1019.

71 Corporate Law Reform Act 1992, section 11.

72 (1995) 37 NSWLR 438 at 501-502.

clear that this was what was intended by the words ‘a reasonable person in a like position in a corporation . . .’,⁷³ it has been noted by some commentators that the word ‘position’ may connote the particular circumstances of the director’s office, rather than the director’s personal qualities.

Accordingly, to provide greater certainty to directors regarding their responsibilities, it is proposed that subsection 232(4) of the Law be amended to ensure that the intention of the provision, as outlined in the Explanatory Memorandum, is achieved. This could be done by clarifying that a director or other officer of a corporation would be required to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- were a director or officer of a corporation in the corporation’s circumstances;
- occupied the directorship or office within that corporation held by the director or officer; and
- had the director or officer’s experience, powers and duties.

The objective test in subsection 232(4) would effectively remain, but the special background, qualifications and position within the corporation of the particular director could be taken into account in evaluating their compliance with the standard of care, as well as factors such as the size of the company, the composition of the board and the distribution of work between board members. Such an approach would appear to be consistent with the standard of care and diligence enunciated by the majority of the Court of Appeal in *Daniels*.

While the proposal should not result in a lower standard of care applying to non-executive directors in comparison to executive directors, it should address concerns expressed by non-executive directors that their special circumstances should be relevant in determining the standard of care applicable to them.

6.3 SHOULD DIRECTORS BE ABLE TO DELEGATE THEIR RESPONSIBILITIES?

The judgement of the majority of the Court of Appeal in *Daniels* has raised doubts about the extent to which it is permissible for directors, non-executive directors in particular, to delegate functions to, and rely on the judgements of,

73 Explanatory Memorandum to the Corporate Law Reform Act 1992, p 25.

others. The majority indicated that directors cannot blindly rely on the judgements of others. In particular, ignorance, a failure to inquire or blind reliance on the judgement of others will not protect directors from liability for breach of the duty of care and diligence. Furthermore, the majority indicated that all directors must take positive steps to ensure that they are in a position to satisfy themselves that the company is being run properly. To this end they must be reasonably familiar with the business of the company.⁷⁴

This view was in contrast with the approach to delegation and reliance that was reflected in the judgement of Rogers C J at first instance to the effect that a 'director is justified in trusting officers of the corporation to perform all the duties that, having regard to the exigencies of the business, the intelligent devolution of labour and the articles of association, may properly be left to such officers' and may 'rely without verification on the judgements of the officers so entrusted . . . [unless] the director is aware of circumstances of such a character, so plain, so manifest and simple of appreciation that no person, with any degree of prudence, acting on his own behalf, would have relied on . . .'.⁷⁵ Both approaches have been followed by different Courts in subsequent cases.⁷⁶

Uncertainty about the circumstances in which it is appropriate for a director to delegate to, or place reliance on the advice of, others could lead to an overly conservative approach to management and could impede the decision-making processes within a company. This is a less than optimal outcome and is not conducive to the development of sound corporate governance practices such as putting in place appropriate board committee systems. To remedy this, it is proposed to provide specific legislative authority for delegation and reliance by directors along the lines of the New Zealand system.⁷⁷

In New Zealand, express legislative authority is given to the board of directors to delegate their powers, subject to any restrictions in the constitution of the company. However, the board remains responsible for the exercise of any power so delegated unless they:

- believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise the power in conformity with the duties imposed on directors of the company; and

74 (1995) 37 NSWLR 438 at 502-504.

75 (1992) 10 ACLC 933 at 1015.

76 *Re Property Force Consultant Pty Ltd* (1995) 13 ACLC 1051; *Dempster v Mallina Holdings Ltd* (1994) 13 WAR 12; *Permanent Building Society (In liq) v Wheeler* (1994) 11 WAR 187; *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395.

77 *Companies Act 1993*, sections 130 and 138, see [Appendix E](#).

- have monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.⁷⁸

The law in New Zealand further provides that, in the exercise of their powers or performance of their duties, directors may rely on reports, statements, financial data and other information supplied by employees, experts, professional advisers and other directors where the matters fall within their designated field of responsibility. However, reliance is only possible where the director has acted in good faith, made proper inquiry where appropriate and has no knowledge that such reliance was unwarranted.⁷⁹

These provisions would have the advantage of clarifying the ambit of directors' responsibilities without leading to an abdication of them.

6.4 EXTENT OF DIRECTORS' LIABILITY AT COMMON LAW (FOR NEGLIGENCE)

A further concern that has arisen in light of the majority judgement in *Daniels* is that once it is accepted that a director is sufficiently proximate to a company to owe a tortious duty of care, there may be difficulties ensuring that the duty remains one owed to the company alone. As the tortious duty does not have its foundation in the fiduciary relationship between the director and the company, but rather relies on the proximity of the relationship, it is conceivable that a tortious duty of care could be found to be owed by directors to shareholders, creditors or employees. This could significantly widen the potential liability of directors.

At this stage, however, any such development is a matter of speculation. The law of tort has been traditionally slow to develop; it is therefore unlikely that any such dramatic change would occur in the near future and without changes in the business environment which would justify widening directors' liability. The enactment of a derivative action for breaches of directors' duties, as proposed earlier in this paper, may reduce the pressure for a tortious duty of care owed to shareholders.

Flexibility is one of the key themes of corporate regulation. The law needs to be dynamic so that it can adapt to changes in the business environment. Accordingly, it would be inappropriate to legislate any further in this area.

⁷⁸ Companies Act, section 130.

⁷⁹ Companies Act, section 138.

The proposed changes to the Corporations Law outlined above provide an appropriate degree of certainty to directors without diminishing their overall responsibilities and duties. To go further by interfering with the development of the common law could be counterproductive.

6.5 OTHER PROPOSED CHANGES TO THE CORPORATIONS LAW

6.5.1 Content of Duty to Act *Honestly*

Under subsection 1317FA(1) of the Law a contravention of section 232 may constitute an offence if the relevant person acted knowingly, intentionally or recklessly and either:

- dishonestly and intending to gain, whether directly or indirectly, an advantage for that or any other person; or
- intending to deceive or defraud someone.

This offence is punishable by a maximum fine of \$200,000 or five years imprisonment, or both.

Section 1317FA would appear to be unnecessarily complicated. It has been described as ‘extremely complex and arguably unworkable’ by the Model Criminal Code Officers’ Committee of the Standing Committee of Attorneys-General.⁸⁰

The difficulties with subsection 1317FA(1) are most acute in respect of its interaction with the duty to act honestly in subsection 232(2). Read together, these sections establish an offence where an officer of a corporation *dishonestly* and intending to gain an advantage for themselves, knowingly, intentionally or recklessly *fails to act honestly* in the exercise of their powers. The question arises whether the term *dishonestly* in subsection 1317FA(1) is consistent with the meaning of *honestly* in subsection 232(2).

The companies legislation of both New Zealand and Canada contain a provision corresponding to subsection 232(2), though in a different form. In

⁸⁰ Model Criminal Code Officers’ Committee of the Standing Committee of Attorneys-General, *Conspiracy to Defraud Model Criminal Code*, Chapter 3, Discussion Paper, June 1996, p 25.

New Zealand ‘a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company’.⁸¹ A New Zealand director must also ‘exercise a power for a proper purpose’.⁸² In Canada, a director ‘in exercising his powers and discharging his duties shall act honestly and in good faith with a view to the best interests of the corporation’.⁸³

In light of the above, it is proposed that the inconsistent use of *honestly* in subsections 232(2) and 1317FA(1) should be resolved by rewriting subsection 232(2) to capture the fiduciary principle that a director or other officer of a corporation must exercise their powers and discharge their duties:

- in good faith in the best interests of the corporation; and
- for a proper purpose.

Breach of the duty to act honestly would continue to have both criminal and civil consequences.

6.5.2 Liability for Negligence

A contravention of the duty of care and diligence in the Law⁸⁴ may expose an officer to:

- a declaration that they have contravened the duty;⁸⁵
- disqualification from managing corporations;⁸⁶
- a pecuniary penalty;⁸⁷ and
- a compensation order.⁸⁸

The contravention may also constitute an offence if it is undertaken with the mental elements specified in subsection 1317FA(1). These require that the failure to exercise sufficient care and diligence be intentional, knowing or reckless. In addition, the lack of care must be either dishonest or intending to deceive.

81 Companies Act, subsection 131(1).

82 Companies Act, section 133.

83 *Canada Business Corporations Act 1975*, paragraph 122(1)(a).

84 Corporations Law, subsection 232(4).

85 Corporations Law, subsection 1317EA(2).

86 Corporations Law, paragraph 1317EA(3)(a).

87 Corporations Law, paragraph 1317EA(3)(b).

88 Corporations Law, Division 5, Part 9.4B.

Conduct exhibiting intent, knowledge or recklessness on behalf of an officer suggests a lack of good faith rather than a lack of appropriate care and diligence. Similarly, conduct that is dishonest or intended to deceive suggests more than a mere lack of care. In particular, it is difficult to reconcile a lack of care with conduct that is knowing, intentional, reckless, dishonest or deceptive.

As a matter of principle, criminal sanctions on directors should only apply in exceptional circumstances and not from a failure to exercise sufficient care and diligence.

It is therefore proposed that the Law be amended so that only the civil consequences mentioned above may arise from a contravention of subsection 232(4).

6.5.3 Indemnification of Company Officers

A company may not indemnify an officer against a liability incurred by them as an officer of the company.⁸⁹ An exception to this rule allows a company to indemnify an officer against a liability to a person other than the company, unless the liability arose out of conduct involving a lack of good faith.⁹⁰

Another exception applies to a liability for legal costs and expenses incurred by an officer in defending civil or criminal proceedings in which judgement is given in favour of the person, or in which the person is acquitted.⁹¹

However, the ambit of the exceptions is uncertain. For example, subsection 241(2) may be interpreted as allowing a company to indemnify an officer against liability for legal costs incurred in good faith, or, on the other hand, as allowing a company to indemnify an officer for legal costs only under subsection 241(3).

The difference in approach arises, in part, from the narrowness of the exception in subsection 241(3). On the latter view a company may not indemnify its officers in a range of circumstances that one would expect that it could. For example, on this view a company would not be able to indemnify its officers if the action was dismissed by the Court or settled, or if the plaintiff was awarded only nominal damages. In criminal matters it seems

89 Corporations Law, paragraph 241(1)(a).

90 Corporations Law, subsection 241(2).

91 Corporations Law, paragraph 241(3)(a).

unreasonable that a company cannot indemnify its officers for legal costs if the prosecution is withdrawn or fails at the committal stage.

The current position in Australia can be contrasted with that in New Zealand, Canada and Delaware.

In New Zealand, a company may, 'if expressly authorised by its constitution, indemnify a director in respect of liability to any person other than the company . . . for any act or omission in his or her capacity as a director . . . or costs incurred by that director . . . in defending or settling any claim or proceeding relating to any such liability'. However, in the case of a director, this indemnity may not extend to 'criminal liability or liability in respect of a breach of the duty specified in section 131'.⁹² A company may also, 'if expressly authorised by its constitution, indemnify a director . . . for any costs incurred by him or her in any proceeding that relates to liability for any act or omission in his or her capacity as a director . . . and in which judgement is given in his or her favour, or in which he or she is acquitted, or which is discontinued'.⁹³

In Canada, a director is entitled to an indemnity in respect of costs reasonably incurred in defending an action if the director was substantially successful on the merits in their defence of the action, acted honestly and in good faith with a view to the best interests of the corporation, and, in the case of a criminal or administrative matter enforced by a monetary penalty, had reasonable grounds for believing that his or her conduct was lawful.⁹⁴

In Delaware, a company may indemnify its officers against legal expenses reasonably incurred in connection with the defence or settlement of an action if the director acted in good faith and in a manner the director reasonably believed to be in, or not opposed to, the best interests of the corporation. In the case of a criminal action, the company may only provide an indemnity if the director had no reasonable cause to believe their conduct was unlawful. Further, where a director has been found liable in respect of a claim made by the company, the company may give an indemnity only to the extent approved by the Court.⁹⁵

In Australia, an indemnity or the paying of an insurance premium in respect of a liability incurred as a director is counted towards the director's

92 Companies Act, subsection 163(4). Section 131 is the duty to act in good faith in the best interests of the company — see section 6.5.1 above.

93 Companies Act, subsection 162(3).

94 Canada Business Corporations Act, subsection 124(3).

95 Delaware General Corporations Law, section 145.

remuneration for the purposes of the rules concerning related party transactions.⁹⁶ Under these rules a director's remuneration must be approved by the company's shareholders to the extent that the remuneration is not reasonable in all the circumstances.⁹⁷ It has been suggested from time to time that it is not appropriate to count indemnities and insurance premiums towards a director's remuneration for this purpose. Rather, the reasonableness of these benefits should be assessed without regard to other benefits received by the director. Also, it is not clear whether the reasonableness of an indemnity or insurance premium should be assessed when the indemnity agreement is entered into or the premium is paid, or when the director subsequently becomes entitled to a payment under the indemnity or insurance policy.

Directors have argued that the company should be able to advance a director their legal costs in anticipation of being able to rely on an indemnity given by the company when the matter has been concluded. In Delaware, legal costs incurred by a director in defending an action may be paid by the company pending the outcome of the action, provided the director gives an undertaking to repay any amount for which the director is ultimately not entitled to an indemnity.⁹⁸

To provide greater certainty for directors in respect of their access to indemnities for legal costs, and to bring the law more into line with that in New Zealand, Canada and Delaware, it is proposed to amend the Law to allow a company to indemnify an officer for legal expenses where the liability is incurred:

- in defending or resisting a civil claim or civil penalty that is settled, except in the case of an action brought by the company or a related company;
- in defending a civil claim brought by the company, or a related company, where they were wholly successful, or substantially successful having regard to all the circumstances;
- in defending or resisting criminal proceedings in which the person is not found guilty; or
- in connection with proceedings in which the Court grants relief to any person under the Law.

96 Corporations Law, Part 3.2A.

97 Corporations Law, subsections 243K(7A) and (7B).

98 Delaware General Corporations Law, subsection 145(e).

It is also proposed that the related party provisions of the Law⁹⁹ be amended to provide a separate exemption from shareholder approval for reasonable indemnities or insurance premiums paid by a company to, or on behalf of, a director, or for an advance made on reasonable terms given by a company to a director to cover legal costs including an obligation to repay the advance if the director is subsequently not entitled to the indemnity. It is proposed that the amendments should make it clear that the reasonableness of the transaction is to be assessed when the indemnity is entered into, the premium is paid, or the advance is given.

6.5.4 Rewrite of Officers Provisions

The Government has indicated that the program for rewriting the Corporations Law in order to simplify it will be subsumed within its overall corporate law reform program. Bills to rewrite the Law arising from this reform agenda will be prepared in a style which is consistent with the earlier work on simplifying the Corporations Law. In the context of the reforms to the provisions concerning directors addressed in this paper, it is proposed to rewrite without substantial change the provisions concerning officers,¹⁰⁰ related party transactions,¹⁰¹ oppression¹⁰² and civil penalties¹⁰³.

6.6 A STANDARD OR MODEL *DUE DILIGENCE* DEFENCE FOR DIRECTORS

Over the years there has been a growing trend for legislatures to impose strict personal liability upon directors of corporations for breaches of statutory obligations by the corporation. The areas where this is occurring range from environmental protection legislation to occupational health and safety regulation.

The understandable motivation behind the liability regimes in these areas is to provide a significant incentive for directors to put in place effective risk-management arrangements to ensure the corporation complies with its obligations. While the imposition of financial penalties on corporations for

99 Corporations Law, Part 3.2A.

100 Corporations Law, Part 3.2.

101 Corporations Law, Part 3.2A.

102 Corporations Law, Part 3.4.

103 Corporations Law, Part 9.4.

breaches of legislation provides some incentive towards compliance, it is considered that in certain key areas there is a need to place additional personal responsibility on directors who, in contrast with the shareholders who ultimately bear the costs of the financial penalty, have it within their means to seek to ensure compliance.

However, if directors risk personal liability for breaches incurred by the corporation, irrespective of the directors' culpability, they may be increasingly reluctant to serve on boards or may become overly concerned with compliance issues and processes rather than wealth creation. Certainly, it would be an unfair and unnecessary burden on directors if they can potentially be made responsible for breaches by their corporation, even where they have taken all reasonable steps to prevent such breaches.

To overcome the possible negative effects of these liability regimes, it would be desirable to consider the appropriateness of developing a standard, or model, *due diligence* defence for directors in cases where they are effectively subject to strict liability under statutes other than the Corporations Law. The defence could operate where directors are able to demonstrate that they had taken reasonable precautions and exercised *due diligence* in an effort to ensure compliance by the corporation with the statute.

As the relevant legislation imposing strict liability on directors falls within the responsibility of State and Territory Governments, as well as the Commonwealth, any proposals for reform in this area would need to be explored with those Governments. As a first step in any consideration of reform proposals, a stock-take of the relevant legislation imposing liability on directors for breaches committed by their company should be undertaken. Following on from that, consideration could be given to developing a standard defence that could be included in the legislation to address the concerns about strict liability of directors but which would not detract from the need to provide a sufficient incentive for corporations and their directors to ensure compliance with the legislation.

The Ministerial Council for Corporations and Securities (MINCO) is an appropriate forum for consideration of this issue and the Commonwealth will seek to have the matter placed on MINCO's agenda for consideration.

Proposal No. 2 — Amendments should be made to the Corporations Law to Clarify Certain Aspects of Directors' Obligations

- To provide directors and officers with greater certainty regarding key aspects of their duties to the company, the following amendments to the Corporations Law are proposed:
 - The existing duty to exercise care and diligence in subsection 232(4) should be amended to make it clear that the standard of care required by the duty must be assessed by reference to the particular circumstances of the officer concerned. Under the revised provision a director or other officer of a corporation would be required to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
 - (a) were a director or officer of a corporation in the corporation's circumstances;
 - (b) occupied the office within that corporation held by the director or officer; and
 - (c) had the director or other officer's experience, powers and duties.
 - The Law should expressly recognise the oversight role played by directors and their reliance on delegates to manage their company's day-to-day affairs. Accordingly, to provide certainty to directors regarding the extent of their ability to delegate functions and to rely on the advice of experts when making decisions, amendments should be made to the Corporations Law along the lines of sections 130 and 138 of the New Zealand Companies Act (see [Appendix E](#)).
 - The existing duty in subsection 232(2) to act *honestly* should be reformulated to capture the fiduciary principles that a director or other officer of a corporation must exercise their powers and discharge their duties:
 - (a) in good faith in the best interests of the corporation; and
 - (b) for a proper purpose.

Breach of the duty to act honestly would continue to have both criminal and civil consequences.

Continued

- The Law should be amended so that a breach of the duty of care and diligence in subsection 232(4) would only give rise to civil sanctions and would no longer provide a basis for an offence under section 1317FA. Under subsection 1317FA(1) of the Corporations Law, a breach of the duty of care and diligence in subsection 232(4) undertaken with a dishonest intent currently amounts to an offence punishable by a maximum fine of \$200,000 or five years imprisonment, or both. However, the concept of negligence is inconsistent with dishonesty, in that dishonesty suggests an active awareness of wrongdoing rather than a failure to exercise sufficient care and diligence.

Proposal No. 3 — A Company's Ability to Indemnify Officers for Legal Expenses should be Clarified

- Different views have been expressed about the extent to which section 241 of the Corporations Law allows a company to indemnify its officers against a liability for legal expenses incurred by them in defending proceedings. It is proposed to amend the Law to allow a company to indemnify an officer for legal expenses where the liability is incurred in:
 - defending or resisting a civil claim or civil penalty that is settled, except in the case of an action brought by the company or a related company;
 - defending a civil claim brought by the company, or a related company, where the director or officer was wholly successful, or substantially successful having regard to all the circumstances;
 - defending or resisting criminal proceedings in which the person is not found guilty; or
 - connection with proceedings in which the Court grants relief to the person under the Law.

Proposal No. 4 — The Desirability of a Standard Form of *Due Diligence* Defence for Directors should be Pursued with State and Territory Governments

- The Government will pursue with State and Territory Governments a review of legislation which imposes strict liability on directors for breaches committed by their company.
 - As part of the review, consideration should be given to the desirability of developing a standard, or model, *due diligence* defence for directors in respect of liabilities arising under statutes other than the Corporations Law.

PART 7: CORPORATE GOVERNANCE — DOMESTIC AND INTERNATIONAL TRENDS

7.1 INTRODUCTION

The powers of the corporation are vested in its board of directors who are answerable to the owners of the company, the shareholders. The make-up, structure and operation of the board are fundamental to the governance of the corporation. While the Corporations Law does not prescribe corporate governance structures, it does impose a range of requirements on corporations in relation to financial disclosure.

Effective corporate governance is recognised in Australia as essential for economic growth financed by private sector activity. The internationalisation of business and competition for capital has resulted in calls for corporate governance reform in all significant capital markets. This common call for reform and greater accountability has arisen within the context of corporate structures that are fundamentally different. The economic policy debate has been particularly notable in the Organisation for Economic Co-operation and Development (OECD) countries over the last few years. The OECD itself is examining the matter and has issued a number of publications on the topic.¹⁰⁴ Australia's system of corporate governance is broadly comparable to that of the United Kingdom and the United States, but quite distinct from the German or Japanese models.

104 OECD, *The Influence of Corporate Governance and Financing Structures on Economic Performance*, Conference Papers, 23-24 February 1995; C Mayer, *Corporate Governance, Competition and Performance*, Economics Department Working Paper No. 164, OECD/GD(96)99, 1996; OECD, 'Chapter III: Corporate Governance in Italy' and 'Chapter IV: Ownership, Control and Decision Making in German Firms', *Economic Surveys*, 1994-95; OECD, 'Chapter IV: Strengthening the Foundations of Growth', *Economic Surveys*, 1995-96.

7.2 CORPORATE GOVERNANCE ENVIRONMENT

7.2.1 Background

Corporate governance is the term used to describe the rules and practices put in place within a company to manage information and economic incentive problems inherent in the separation of ownership from control in large enterprises. It deals with how, and to what extent, the interests of various agents involved in the company are reconciled and what checks and incentives are put in place to ensure that managers maximise the value of the investment made by shareholders.

The manner in which directors carry out their tasks in a particular corporation may differ significantly depending on the:

- size of the corporation;
- nature of its business;
- distribution of work between the directors and other officers of the corporation; and
- financial position of the corporation.

The corporate governance structures of common law countries such as Australia, the United Kingdom, the United States, Canada and New Zealand are generally based on what is described as a *shareholder approach* or *outsider model* of corporate control. That is, the achievement of corporate goals and profit maximisation is monitored by the owners of the corporation, its shareholders, to whom corporate management is accountable. The focus of the *outsider model* is profit maximisation for the owners of the corporation.

By contrast, the corporate governance structures of civil law countries such as France, Germany, the Netherlands, and Italy are based on what is described as a *stakeholder approach* or *insider model* of corporate control. That is, governance structures reflect a model of corporate control which seeks to align the various interests of multiple stakeholders — workers, managers, creditors, suppliers, customers and other members of the community.¹⁰⁵

105 However, elements of the *stakeholder system* of corporate control are also present in the Australian system. They are essentially reflected in the ability of creditors to initiate the voluntary administration procedures of the Corporations Law and to seek the winding up of a company. Additionally, in the context of superannuation fund governance, industry funds are required to have employee representation on the board of the fund trustee.

The determination of appropriate corporate governance practices is a significant issue around the world. In this regard it would appear that both *shareholder* and *stakeholder models* for corporate control have experienced notable failures in corporate governance in the recent past.¹⁰⁶

It is difficult to assess the relative effectiveness of the competing approaches to corporate governance. Indeed, while a recent economic analysis of laws governing investor protection in 49 countries around the world found that civil law systems appeared to have less efficiency properties from the perspective of corporate governance, the analysis was inconclusive in passing a judgement on a preferred system.¹⁰⁷ By way of a possible explanation for this uncertainty, the proposition was put forward by the researchers that the type of legal system does not in fact matter very much because investors can generally contract around any limitations of a particular legal system.

The globalisation of markets and the trend towards increasing reliance on sources of external equity by companies in civil law jurisdictions tends to favour a movement towards the *shareholder approach* of corporate control. It would appear that the *shareholder approach* may be preferable because of the external accountability involved and having regard to the rising dependence on external equity, particularly institutional equity investment, to finance the operations and expansion of corporations. Moreover, in focusing on maximising shareholder wealth, the *shareholder approach* may make a company more flexible and responsive to change in its environment.

Other factors such as macroeconomic policy, tax policy, market structures and competition in financial sectors, product markets and labour markets also affect corporate performance independently of corporate governance policy regimes.

7.2.2 Development of Corporate Governance Structures

As highlighted in the Australian publication *Corporate Practices and Conduct*, ‘experience, and a great deal of debate in several countries, has produced a considerable consensus on key issues and basic principles that underlie governance’.¹⁰⁸ The basic principles of good corporate governance involve

106 United Kingdom — Barings Bank; Japan — Nomura Securities; United States — Savings and Loans; Australia — Bond Corporation.

107 R La Porta et al, *Law and Finance*, NBER Working Paper 5661, July 1996.

108 Working Group on Corporate Practices and Conduct, *Corporate Practices and Conduct*, Third Edition, p 2. The Working Group (the Bosch Committee) represented the Australian Institute of Company Directors, the Australian Society of Certified Practising Accountants,

appropriate disclosures, the development of codes of conduct for company directors and the development of internal structures which provide for independent review of processes and decision-making within a company.

Although the basic principles of good corporate governance seem clear, even within the *shareholder approach* of many common law countries, there are significant differences in how these principles are implemented. For example, in relation to the composition and structure of boards of directors, the Australian model varies from the practice in the United Kingdom and the United States. The role of Chief Executive Officers (CEOs) and board chairs is usually, although not always, separate in Australia and a majority of the board is comprised of non-executive directors. In contrast, the role of the CEO and the board chair are often combined in the United States and there is also usually a majority of non-executive directors. The situation is different again in the United Kingdom where the role of the CEO and the board chair is usually separate, but there is often not a majority of non-executive directors.

The shift in Australia towards having a majority of non-executives has been in response to perceived problems in having management dominated boards. Nevertheless, the value of having boards dominated by non-executive directors, and having separate CEOs and board chairs, are pivotal issues in corporate governance in Australia. The Working Group on Corporate Practices and Conduct and the Australian Investment Managers' Association (AIMA) have strongly supported both these aspects as being *best practice*, while others instead have focussed on the *stewardship* benefits of management dominated boards which, it is argued, can be weakened by non-executive dominated boards.

7.3 DISCLOSURE OF CORPORATE GOVERNANCE PRACTICES

An important development in the corporate governance practices of Australian listed companies was the June 1994 review by the ASX of corporate governance. In September 1994, the ASX released a discussion paper on *Disclosure of Corporate Governance Practices by Listed Companies*.¹⁰⁹ That review resulted in the introduction by the ASX of a listing rule which requires a listed company to disclose in its annual report the main corporate governance

the Business Council of Australia, the Law Council of Australia, the Institute of Chartered Accountants in Australia and the Securities Institute of Australia.

109 ASX, *Disclosure of Corporate Governance Practices by Listed Companies*, Discussion Paper, September 1994.

practices that it has had in place during the year.¹¹⁰ The rule took effect for annual reporting periods ending on or after 30 June 1996.

The rationale for the rule was that it would result in the release of more information of greater relevance to the market compared with a rule requiring specific corporate governance practices to be adopted by all listed companies. In reviewing the operation of the listing rule, the ASX recently concluded, on the basis of a review of 791 company annual reports for reporting periods ending on or shortly after 30 June 1996, that:

- there has been a high level of compliance with the listing rule; and
- a large proportion of companies have committee structures in place to handle corporate governance issues.¹¹¹

The success of compliance with the requirements of the listing rule has not, however, been without debate. In particular, AIMA, representing institutional investors, has been critical of the general nature of the listing rule and the extent of its positive influence on the development of good corporate governance practices within listed companies. Such debate is a healthy indication of the seriousness with which all stakeholders approach the issue of corporate governance in Australia. It is also indicative of a market perception that companies need to do more in the area of corporate governance to satisfy stakeholders.

While recognising that the adoption of appropriate corporate governance structures is to some extent evolutionary and dependent on the size, nature, and activities of the corporation, there is a need to ensure that the ongoing debate about corporate governance does not distract investors from the progress made by Australian companies in establishing effective systems of governance.

7.3.1 Overseas Comparisons — United Kingdom and United States

The approach taken in the ASX listing rule can be contrasted with that in the United Kingdom where the London Stock Exchange listing rules require listed companies to make a statement in their annual report about compliance with

110 Listing Rule 4.10.3. When Listing Rule 4.10.3 was introduced, an indicative list of corporate governance matters was included in Appendix 4A to the Listing Rules.

111 ASX media release, *Good response to ASX Corporate Governance Disclosure Rule*, 5 March 1997.

the Code of Best Practice (the Code).¹¹² The Code was incorporated into the final report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee).¹¹³

The Cadbury Committee report made recommendations concerning board functions and structure. In terms of functions, the Code requires the board to have a formal schedule of matters specifically reserved to it for decision, to ensure that the direction and control of the company is firmly in its hands. A central recommendation of the Cadbury Committee was that public companies have at least three independent directors and that the boards of companies appoint an audit committee of independent directors. The Code also provides that a board should:

- provide a balanced and understandable assessment of the company's position;
- ensure that an objective and professional relationship is maintained with the auditors of the company; and
- make clear to shareholders their responsibility for the preparation of the financial accounts of the company.

In relation to board structure, the Code also requires that:

- the board should include a sufficient number of non-executive directors to carry significant weight in the board's decisions;
- the majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement;
- the independent element of the board should have a *recognised senior member* if the chairman of the board is also the chief executive;
- non-executive directors should be appointed for specified terms and be selected through a formal process and both the process and appointment should be a matter for the board as a whole;
- there should be an agreed procedure enabling directors, in the performance of their duties, to take independent professional advice at the company's expense;
- all directors should have access to the advice and services of the company secretary; and

112 Code of Best Practice in Corporate Governance.

113 Committee on the Financial Aspects and Code of Best Practice of Corporate Governance, Sir Adrian Cadbury (Chairman), *Report*, December 1992.

- the pay of executive directors should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

The rules of the London Stock Exchange require listed companies to make a statement in their annual report about compliance with the Code. In particular, the company statement must:

- state whether the company has complied with the Code and should identify and give reasons for any areas of non-compliance; and
- be reviewed by its external auditors before publication.

In November 1995 a Committee on Corporate Governance chaired by Sir Ronald Hampel was established to review the implementation of the recommendations of the Cadbury and Greenbury (Directors' Remuneration) Committees.¹¹⁴ In particular, the Hampel Committee is reviewing the implementation of the Cadbury Code to ensure that the original purpose of promoting openness, integrity and accountability is being achieved. The Committee released a preliminary report in August this year¹¹⁵ the broad thrust of which was that in relation to corporate governance in the United Kingdom, accountability had been given too much weight at the expense of business prosperity. The Committee noted that, while the Cadbury Committee had intended their recommendations to be implemented as broad principles that could be applied flexibly, in practice, the Code has been treated as a prescriptive set of rules.

The Hampel Committee recommended that companies should include in their annual reports a narrative account of how they have applied a broad set of corporate governance principles which the Committee outlined in its report, but that this should not be an additional regulatory requirement. Companies, and those concerned with their governance, should apply the principles flexibly, with common sense, and with due regard to companies' individual circumstances. Following a period of public consultation the Committee is expected to release its final report in December this year.

The New York Stock Exchange (NYSE) does not have a disclosure based rule for corporate governance but rather has two fundamental requirements:

114 The Committee was established on the initiative of the Chairman of the Financial Reporting Council, Sir Sydney Lipworth, and is sponsored by the London Stock Exchange, the Confederation of British Industry, the Institute of Directors, the Consultative Committee of Accountancy Bodies, the National Association of Pension Funds and the Association of British Insurers.

115 Committee on Corporate Governance, *Preliminary Report*, August 1997.

- domestic companies must have an audit committee comprising only directors independent of management and free from any relationship that, in the opinion of their board of directors, would interfere with the exercise of independent judgement as a committee member; and
- domestic companies must have at least two *outside* directors on their board.

7.4 ROLE OF GOVERNMENT

The ASX corporate governance requirements, while similar to, are not as prescriptive as those of the London Stock Exchange, nor, like the listing rules of the NYSE, do they require an audit committee or the involvement of independent directors. The issue for Government in this regard is how far it should go in legislating best practices in light of its responsibility to promote and assist in the development of good corporate governance structures for the benefit of the Australian economy as a whole.

The Government has a public policy responsibility to set the parameters within which Australian business operates to encourage economic growth. The Government is mindful in the area of corporate governance that legislative prescription could promote inappropriate structures and lead to rigidity and a lack of responsiveness, potentially resulting in a misallocation of capital resources.

Legislation is appropriate, however, where it delineates broad parameters for the conduct of business, removes uncertainty in the operation of the law and clarifies the rights and responsibilities of stakeholders. Where legislation is enacted for these purposes, it should seek to achieve a balance between mandating certain conduct and allowing boards the freedom to delineate and delegate their responsibilities to best suit their companies.

In the area of corporate governance, it is neither feasible nor appropriate for Government to attempt to strictly prescribe governance structures which are the responsibility of the directors of the corporation and, indirectly, the shareholders. The Hampel Committee review of the Cadbury Code in the United Kingdom confirms this approach.

However, while corporate governance arrangements need to be flexible and dynamic, the Government has noted the more prescriptive requirements of the NYSE and London Stock Exchange, particularly in respect of audit committees. The Government is conscious of the debate surrounding the corporate governance requirements of listed companies and the possible

negative effect that this may have on the success of Australian companies gaining access to global capital.

7.5 AUDIT COMMITTEES

It is notable in this context that the Joint Parliamentary Committee on Corporations and Securities has identified a number of positive benefits in a publicly listed company having an audit committee.¹¹⁶ Those benefits, which are equally, if not more, important today and for the future, are that companies with audit committees:

- take a more active role in assessing the risk of fraudulent or otherwise misleading financial reporting;
- are more active in raising accounting and regulatory issues with both management and external auditors; and
- use the committee to focus on regulatory requirements and internal controls.

In 1992, survey results showed that only 48 per cent of ASX listed companies had audit committees.¹¹⁷ In the 1996-97 financial year, approximately 96 per cent of the Top 150 ASX listed companies had an audit committee.¹¹⁸ While there has been a significant move by Australian listed companies to incorporate audit committees within their governance structures, the level of detail provided by companies on the composition and operation of those committees has varied.

Although the majority of the members of audit committees of ASX listed companies may, in fact, be non-executive directors, the corporate governance statements of the Top 100 ASX listed companies disclosed that only 27 per cent had an audit committee with all non-executive directors, 12 per cent had a majority of non-executive directors, and 61 per cent had no stated policy on the composition of the committee.¹¹⁹ It may therefore be desirable for the indicative list of corporate governance matters in the ASX listing rules to be

116 Joint Parliamentary Committee on Corporations and Securities, *The Role of Audit Committees in Corporate Governance — A Progress Report*, 1993.

117 Arthur Andersen and the Australian Institute of Company Directors, *Audit committees in the 1990s. Results of the 1992 Arthur Andersen Survey of Audit Committees* (2 Volumes), 1993.

118 ASX media release, *Good response to ASX Corporate Governance Disclosure Rule*, 5 March 1997.

119 Corporate Governance International Pty Limited, *Corporate Governance Statements by Major ASX Listed Companies*, report commissioned by AIMA, March 1997, p 40.

appropriately enhanced to facilitate the disclosure by listed companies of their policies on audit committees.

As with other areas of corporate governance, the Government believes a non-prescriptive approach on the question of audit committees is appropriate. Clearly, this is an area where business has the capacity to respond to market needs and the ASX is well placed to determine and encourage best practices in this regard.

7.6 ROLE OF INVESTORS

Government has legislated to require reporting of financial information. In addition, the ASX has an on-going responsibility to ensure that an informed market is maintained. Accordingly, the market itself should be able to judge the worth of a corporation on the basis of an assessment of the corporation's profitability and governance arrangements.

To achieve the right balance between regulation and performance, Government, business and investors must each have an understanding of their role and objectives in what are increasingly competitive domestic and global markets.

Effective corporate governance involves a number of mutual obligations. On the one hand, company directors have an obligation to properly oversee the management of the company. On the other hand, there is a balancing obligation on shareholders to participate in the scrutiny of the methods and results of company management.

There has been debate in a number of countries, in particular Canada and the United States, about whether institutional investors should play a greater role than other shareholders in meeting this obligation. On balance, the view has been that they should; they have greater ability and skill to influence corporate governance through their relative size and sophistication. The issue has also been considered at a preliminary level in Australia by the Joint Parliamentary Committee on Corporations and Securities. The Committee concurred with international examinations of the issue.¹²⁰

Following on from the corporate collapses of the 1980s, there are indications that institutional investors are taking an increasingly active role in relation to

120 Joint Parliamentary Committee on Corporations and Securities, *Inquiry into the Role and Activities of Institutional Investors in Australia*, Issues Paper, November 1994.

corporate governance. While institutional shareholders were, in the early 1990s, less significant players in the Australian corporate sector than institutional shareholders in the United States and United Kingdom,¹²¹ that trend has been changing rapidly as is evidenced by the growing levels of funds which are under management with funds managers. From 1992-93 to 1995-96 the assets of managed funds rose 27 per cent, from \$249 billion to \$317 billion.¹²² This trend is likely to continue as a result of Government initiatives in relation to superannuation. There has also been an increase in the proportion of the assets held by managed funds in equities and unit trusts from 25 per cent in 1992-93 to 28 per cent in 1995-96.¹²³

Furthermore, the establishment of AIMA in 1991 is an indication of the growing activism of institutional investors. The increasing globalisation of Australia's capital markets is likely to provide further impetus to such a role, as foreign institutional investors seek to influence corporate governance practices of Australian companies in the same way as they do in their own domestic markets. This will no doubt lead to greater involvement by domestic institutional investors in corporate governance issues.

Representative groups, such as AIMA, and individual institutions take an active role both in relation to corporate governance issues generally and in relation to the particular companies in which they invest. An active working relationship between corporate managers and shareholders should ensure corporate governance practices that appropriately balance investors' need for confidence against managements' functions of maximising wealth. Institutional investors have a vital role to play in this regard. The Government believes this activity is the most effective way to improve corporate governance practices.

7.7 ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT — INTERNATIONAL REVIEWS

Australian capital markets are reliant on the participation of domestic and foreign institutions. The Government must, therefore, be sensitive to international corporate governance standards in the development of markets policy. The extent to which Australia successfully deals with issues of

121 G P Stapledon, 'Disincentives to Activism by Institutional Investors in Listed Australian Companies', *Sydney Law Review*, vol 18, 1996 p 152.

122 Australian Bureau of Statistics, *Managed Funds Australia*, Cat no. 5655.0.

123 Australian Bureau of Statistics, *Managed Funds Australia*, Cat no. 5655.0.

corporate governance will be reflected in the success or failure of Australian business in attracting capital in a very competitive global capital market.

Having regard to the above, the Government has agreed to corporate governance being the special topic for the next OECD survey of the Australian economy. This survey will evaluate Australia's corporate governance practices against those existing in comparable overseas jurisdictions. The Australian survey is part of a wider OECD project which initially reviewed the main legal, regulatory and behavioural parameters of national governance environments in the United States, Japan, Germany, the United Kingdom, Canada, Finland and Sweden. The review has extended to other OECD member countries and is particularly examining the parameters which have a direct impact on the investment strategies of firms, their competitive behaviour and performance. Those parameters are:

- concentration of ownership and control;
- strategic roles of boards;
- strategic information of owners;
- use of takeovers;
- concentration of creditors;
- mix of equity and credit by *universal* investors;
- use of bankruptcies; and
- financial return expectations of investors.

Australian practices, whether the product of self regulation or legislation, must meet internationally acceptable standards of behaviour and accountability if our companies and the market within which they operate are to be competitive. In this regard, it is important for the international competitiveness of Australian firms that they are seen to have the highest standards of corporate governance. The OECD analysis of Australian corporate governance will provide a useful measure to Government on the efficiency of our regulatory environment and market practices, and their appropriateness in a competitive global environment.

7.8 CONCLUSION

As a fundamental starting point the Government considers that the existence of good corporate governance is a judgement best made by the market. Public corporations need to demonstrate to investors that their governance structures

are appropriate to ensure that the return to investors on their capital will be maximised. While the Government should seek to encourage public corporations to adopt appropriate governance structures, it should avoid unnecessary prescription which could lead to inflexibility and inhibit innovation. In this regard, it is considered preferable for Australian corporate governance practices to develop in response to competitive economic, commercial and international pressures, rather than in response to prescriptive rules mandated by Government. The Government will not impose additional mandatory legislative requirements unless there is a clear failure of these mechanisms to produce appropriate corporate governance practices.

The Government also has a responsibility to ensure that no unnecessary legal impediments operate to restrict companies and their boards from carrying out their responsibilities to investors. The proposals outlined earlier in this paper regarding the introduction of a statutory business judgement rule and a statutory derivative action are consistent with this philosophy as they should enhance the further development of effective corporate governance practices rather than leading to rigid legalistic outcomes.

Proposal No. 5 — Corporate Governance Practices by Australian Companies should be Continuously Monitored

- The establishment and maintenance of effective corporate governance practices by Australian companies is essential to Australia's international competitiveness and economic growth.
 - Corporate governance practices should, as far as practicable, be continuously monitored by the ASX, relevant industry and professional bodies who promote best practice, investors and Government to maintain investor confidence in Australia's capital markets. The Government will not impose additional mandatory legislative requirements unless there is a failure of the current requirements or these regulatory mechanisms.

APPENDIX A: BUSINESS REGULATION ADVISORY GROUP

Mrs Catherine Walter	(Chairman) Australian Institute of Company Directors
Mr Peter Barnett	Business Council of Australia
Mr Leigh Hall	Australian Investment Managers' Association
Mr Rohan Jeffs	Australian Chamber of Commerce and Industry
Mr Jeffrey Lucy	Accounting bodies
Mr John Murray	Small Business Coalition
Mr Robert Nottle	Australian Stock Exchange
Mr Malcolm Starr	Sydney Futures Exchange
Mr Les Taylor	Australian Corporate Lawyers Association

APPENDIX B: OTHER DIRECTORS' DUTIES UNDER THE CORPORATIONS LAW THAT DO NOT GIVE RISE TO CIVIL PENALTIES

- Section 201** A director who willfully pays, or permits to be paid, a dividend out of what he or she knows not to be profits is liable to the creditors for the amount of the debts due by the company to them respectively to the extent by which the dividends so paid have exceeded profits. There is an exception where the payment is made from a share premium account in accordance with paragraph 191(2)(c).
- Subsection 220(4)** A document may be served on a company by delivering a copy of it personally to each of two directors of the company who ordinarily reside in Australia or an external Territory.
- Subsection 231(1)** A director of a proprietary company who is in any way interested in a contract with the company shall as soon as practicable after the relevant facts have come to the director's knowledge, declare the nature of the interest at a meeting of the directors.
- Subsection 231(6)** A director of a proprietary company who holds any office or possesses any property under which the director might have a conflict of interest with his or her duties or interests as a director shall declare at a meeting of the company the fact and nature, character and extent of the conflict.
- Section 232** Subject to exceptions, a director of a public company who has a material personal interest in a matter that is being considered at a meeting of the directors must not vote on the matter or be present while the matter is being considered at the meeting.

- Section 236** A director of a company must give written notice to the company of any interest held by the director in any securities or prescribed interests made available by the company or a body corporate that is related to the company.
- Section 598** Provides the basis for the Court to make orders against a person who is guilty of fraud, negligence, default, breach of trust or breach of duty in relation to the relevant company and the company has suffered or is likely to suffer loss or damage as a result of that particular fraud, default or breach.
- Section 1001A** A listed company must comply with the listing rules of the ASX concerning obligations to disclose information that is not generally available and which a reasonable person would expect, if it were generally available, to have a material effect on the price of the company's securities.

APPENDIX C: SUMMARY OF REPORTS ON THE BUSINESS JUDGEMENT RULE

1. Senate Standing Committee on Legal and Constitutional Affairs, *Report on the Social and Fiduciary Duties and Obligations of Company Directors*, November 1989.
2. CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No. 10, May 1990.
3. House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders*, November 1991.
4. CASAC, *Directors' Duty of Care and Consequences of Breaches of Directors' Duties*, September 1991.

1. REPORT ON THE SOCIAL AND FIDUCIARY DUTIES AND OBLIGATIONS OF COMPANY DIRECTORS

This report traces the development of directors' duties through United Kingdom and Australian case law, and recommends the introduction of a statutory business judgement rule in Australia. It states that 'the community looks to the law for guidance, often it is not there.'

No submissions were received by the Committee regarding the desirability of legislating for a business judgement rule in Australia. Instead, the Committee said that it took note of United States developments and of the views of the CSLRC in its 1989 discussion paper¹²⁴ in which it recommended that a business judgement rule be introduced into Australian company law.

124 CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Discussion Paper No. 9, April 1989. The Committee suggested at pp47-48 that the rule might be introduced by supplementing section 535 (now section 1318), such that a Court would not hold an officer liable in respect of a matter of business judgement where they:

- (1) acted in good faith and without being subject to a conflict of interest or duties;
- (2) exercised an active discretion in the matter;
- (3) took reasonable steps to inform themselves; and
- (4) acted with a reasonable degree of care in the circumstances including:
 - (a) any special skill, knowledge or acumen possessed; and
 - (b) the degree of risk involved.

2. COMPANY DIRECTORS AND OFFICERS: INDEMNIFICATION, RELIEF AND INSURANCE

In line with its earlier discussion paper,¹²⁵ the CSLRC supported the introduction of a business judgement rule into the Corporations Law. The report noted at the outset the strong support for a business judgement rule in Australia amongst Australian business and corporate associations. The Committee considered, 'What is so special about companies legislation and the conduct it regulates that demands a specific legislative statement about the review of business judgements?' To answer this, the Committee stated that:

- '(i) there is a continuing social need for the encouragement of new business enterprises;
- (ii) those new enterprises can include enterprises carrying business risks which only a small minority of the general community would be prepared to accept; and
- (iii) there is a danger that when a high-risk enterprise fails, even one floated with full disclosure of the likely risks, the liability of the movers of the enterprise will arise for consideration by persons averse to risk who may apply, in good faith, standards of caution that are inappropriate in the circumstances to a judgement on a matter of business operations.'¹²⁶

Having regard to the above assumptions, the Committee expressed its support for the business judgement rule in terms of the encouragement of endeavour, by freeing business judgement makers from the fear of review by tribunals of bona fide business decisions. The Committee considered that the:

'[e]nactment of a business judgement rule would provide legislative recognition of the commercial reality that a limited company is a vehicle for taking commercial risks.'¹²⁷

125 CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Discussion Paper No. 9, April 1989.

126 CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No. 10, May 1990, paragraph 74.

127 CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No. 10, May 1990, paragraph 74.

The Committee recommended the enactment of a business judgement rule in the following terms:

- ‘(1) a director or officer shall not be liable to pay compensation to a company by reason of section 229 or under the general law in respect of his or her business judgement unless it is made to appear to the relevant Court that at the relevant time the director or officer:
 - (a) had an unauthorised interest in the transaction of the company to which the judgement relates;
 - (b) had not informed himself or herself to an appropriate extent about the subject of the judgement;
 - (c) did not act in good faith for a proper purpose; or
 - (d) acted in a manner that a reasonable director with his or her training and experience could not possibly regard as being for the benefit of the company.

- (2) In this section “business judgement” means a lawful judgement made for the conduct of the company’s business operations and, without affecting the generality of the expression, includes a judgement as to:
 - (e) the company’s goals;
 - (f) plans and budgeting;
 - (g) promotion of the company’s business
 - (h) acquiring assets and disposing of assets
 - (i) raising or altering capital
 - (j) obtaining or giving credit
 - (k) deploying the company’s personnel; or
 - (l) trading

but does not include a judgement as to:

 - (m) matters relating principally to the constitution of the company or the conduct of meetings within the company;
 - (n) appointment of executive officers; or
 - (o) the company’s solvency.

- (3) Sub-section (1) does not operate in relation to any other provision of the Act or any other Act or any Regulation under which a director or officer may be liable to make a payment in relation to any of his or her acts or omissions as a director or officer.
- (4) In the circumstances where, in the absence of this provision, a director or officer would not be liable to pay compensation to the company this provision does not operate to impose any such liability.¹²⁸

3. *CORPORATE PRACTICES AND THE RIGHTS OF SHAREHOLDERS*

The Committee noted that the Senate Committee endorsed the approach taken by the CSLRC.¹²⁹ It also referred to an ASC submission in favour of introducing a business judgement rule into Australian law. The ASC considered that such a rule would emphasise the need for an orderly and proper decision-making process to be adopted by directors, and would ‘help overcome existing uncertainties in the interpretation of s.232(4) of the Corporations Law and the director’s duty of care . . .’

The ASC further submitted that:

‘. . . the adoption of the business judgement rule should be usefully supplemented by provisions regulating the extent and impact of delegations by the board to company staff and imposing duties on principal executive officers to provide information to board members. This would reduce the scope for directors to plead ignorance or delegation as an excuse for avoiding liability.’¹³⁰

Without going any further, the Committee concluded that the Corporations Law should be amended to implement the recommendations of the 1989 Senate Committee report, including the introduction of the business judgement rule into the Law, along the lines of the phrasing adopted by the CSLRC in its May 1990 report.

128 CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No. 10, May 1990, paragraph 81.

129 CSLRC, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No. 10, May 1990.

130 House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders*, November 1991, paragraph [5.4.27].

4. DIRECTORS' DUTY OF CARE AND CONSEQUENCES OF BREACHES OF DIRECTORS' DUTIES

The former Attorney-General requested advice from CASAC in relation to the six following recommendations of the Senate Committee report:

- an objective duty of care for directors;
- the introduction of a business judgement rule;
- attendance at board meetings;
- delegation by directors;
- criminal liability for breaches of directors' duties; and
- directors' power to take into account the interests of their employees.

In its report, CASAC stated that 'a form of business judgment rule is already recognised by Courts in Australia', citing the High Court's decision in *Harlowe's Nominees*,¹³¹ CASAC noted that the Senate Committee report did not acknowledge developments in Australia.

The position of CASAC is best summarised in its conclusion to the section of the report on the business judgement rule:

'. . . the Advisory Committee strongly believes that it is inappropriate to enact a statutory business judgment rule in Australia. [A]ustralian courts have already developed principles that provide protection for the informed business decisions of directors. The Advisory Committee finds it significant that no body which has recommended a statutory business judgment rule for Australia has apparently undertaken the research which (if it had been undertaken) clearly demonstrates that such attempts have never been successful and in fact have engendered prolonged controversy.'

131 *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493.

APPENDIX D: DRAFT DERIVATIVE ACTION PROVISIONS

MAIN PROVISIONS

Proceedings on behalf of a Company by Members and Others

- 1 *Bringing, or Intervening in, Proceedings on behalf of a Company*
- (1) A person may bring proceedings on behalf of a company, or intervene in any proceedings to which the company is a party for the purpose of taking responsibility on behalf of the company for those proceedings, or for a particular step in those proceedings (for example, compromising or settling them), if:
 - (a) the person is:
 - (i) a member, former member, or person entitled to be registered as a member, of the company or of a related body corporate; or
 - (ii) an officer or former officer of the company; and
 - (b) the person is acting with leave granted under section 2.
 - (2) Proceedings brought on behalf of a company must be brought in the company's name.
 - (3) The right of a person at common law to bring, or intervene in, proceedings on behalf of a company is abolished.

Note 1: For the right to inspect company books, see section 8.

Note 2: For the requirements to disclose proceedings and leave applications in the annual directors' report, see section 9.

Note 3: This section does not prevent a person bringing, or intervening in, proceedings on their own behalf in respect of a personal right.

2 *Applying for and granting leave*

- (1) A person referred to in paragraph 1(1)(a) may apply to the Court for leave to bring, or to intervene in, proceedings.
- (2) The Court must grant the application if it is satisfied that:
 - (a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the step in them; and
 - (b) the applicant is acting in good faith; and
 - (c) it is in the best interests of the company that the applicant be granted leave; and
 - (d) if the applicant is applying for leave to bring proceedings — there is a serious question to be tried; and
 - (e) either:
 - (i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
 - (ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.

3 *Substitution of another person for the person granted leave*

- (1) Any of the following persons may apply to the Court for an order that they be substituted for a person to whom leave has been granted under section 2:
 - (a) a member, former member, or a person entitled to be registered as a member, of the company or of a related body corporate; or
 - (b) an officer, or former officer, of the company.
- (2) The Court may make the order if it is satisfied that:

- (a) the applicant is acting in good faith; and
 - (b) it is appropriate to make the order in all the circumstances.
- (3) An order substituting one person for another has the effect that:
- (a) the grant of leave is taken to have been made in favour of the substituted person; and
 - (b) if the other person has already brought the proceedings or intervened—the substituted person is taken to have brought those proceedings or to have made that intervention.

4 *Effect of ratification by members*

- (1) If the members of a company ratify or approve conduct, the ratification or approval:
- (a) does not prevent a person from bringing or intervening in proceedings with leave under section 2 or from applying for leave under that section; and
 - (b) does not have the effect that proceedings brought or intervened in with leave under section 2 must be determined in favour of the defendant, or that an application for leave under that section must be refused.
- (2) If members of a company ratify or approve conduct, the Court may take the ratification or approval into account in deciding what order or judgment (including as to damages) to make in proceedings brought or intervened in with leave under section 2 or in relation to an application for leave under that section. In doing this, it must have regard to:
- (a) how well-informed about the conduct the members were when deciding whether to ratify or approve the conduct; and
 - (b) whether the members who ratified or approved the conduct were acting for proper purposes.

5 *Leave to discontinue, compromise or settle proceedings brought, or intervened in, with leave*

Proceedings brought or intervened in with leave must not be discontinued, compromised or settled without the leave of the Court.

6 *General powers of the Court*

(1) The Court may make any orders, and give any directions, that it considers appropriate in relation to proceedings brought or intervened in with leave, or an application for leave, including:

- (a) interim orders;
- (b) directions about the conduct of the proceedings, including requiring mediation;
- (c) an order directing the company, or an officer of the company, to do, or not to do, any act; and
- (d) an order appointing an independent person to investigate, and report to the Court on:
 - (i) the financial affairs of the company;
 - (ii) the facts or circumstances which gave rise to the cause of action the subject of the proceedings; or
 - (iii) the costs incurred in the proceedings by the parties to the proceedings and the person granted leave.

(2) A person appointed by the Court under paragraph (1)(d) is entitled, on giving reasonable notice to the company, to inspect any books of the company for any purpose connected with their appointment.

(3) If the Court appoints a person under paragraph (1)(d):

- (a) the Court must also make an order stating who is liable for the remuneration and expenses of the person appointed; and
- (b) the Court may vary the order at any time; and

- (c) the persons who may be made liable under the order, or the order as varied, are:
 - (i) all or any of the parties to the proceedings or application; and
 - (ii) the company; and
 - (d) if the order, or the order as varied, makes 2 or more persons liable, the order may also determine the nature and extent of the liability of each of those persons.
- (4) Subsection (3) does not affect the powers of the Court as to costs.

7 *Power of the Court to make costs orders*

The Court may at any time make any orders it considers appropriate about the costs of the following persons in relation to proceedings brought or intervened in with leave under section 2 or an application for leave under that section:

- (a) the person who applied for or was granted leave;
- (b) the company; and
- (c) any other party to the proceedings or application.

An order under this section may require indemnification for costs.

ADDITION TO THE INSPECTION OF BOOKS PROVISIONS

8 *Order for inspection of books of company—person bringing proceedings on behalf of a company*

- (1) A person who:
 - (a) is granted leave under section 2; or
 - (b) applies for leave under that section; or
 - (c) is eligible to apply for leave under that section;

may apply to the Court for an order under this section.

- (2) On application, the Court may make an order authorising:
 - (a) the applicant to inspect books of the company; or
 - (b) another person to inspect books of the company on the applicant's behalf.
- (3) The Court may make the order only if it is satisfied that:
 - (a) the applicant is acting in good faith; and
 - (b) the inspection is to be made for a purpose connected with:
 - (i) applying for leave under section 2; or
 - (ii) bringing or intervening in proceedings with leave under that section.
- (4) A person authorised to inspect books may make copies of the books unless the Court orders otherwise.

ADDITION TO THE ANNUAL DIRECTORS' REPORTS PROVISION

- 9 *Annual Directors' Report—Specific Information—Proceedings on behalf of a Company*
 - (1) The report for a company must also include the following details of any application for leave under section 2 made in respect of the company:
 - (a) the applicant's name; and
 - (b) a statement whether leave was granted.
 - (2) The report for a company must also include the following details of any proceedings that a person has brought or intervened in on behalf of the company with leave under section 2:
 - (a) the person's name; and
 - (b) the names of the parties to the proceedings; and

- (c) sufficient information to enable members to understand:
 - (i) the nature of the proceedings (including the cause of action and the status of the proceedings); and
 - (ii) the orders (if any) made by the Court (other than orders of a procedural nature); and
 - (iii) the potential impact of the proceedings or orders on the company.

APPENDIX E: NEW ZEALAND COMPANIES ACT 1993— SECTIONS 130 AND 138

Section 130 Delegation of Powers

130(1) [Power to delegate] Subject to any restrictions in the constitution of the company, the board of a company may delegate to a committee of directors, a director or employee of the company, or any other person, any one or more of its powers.

130(2) [Board's responsibility] A board that delegates a power under subsection (1) of this section is responsible for the exercise of the power by the delegate as if the power had been exercised by the board, unless the board:

- (a) Believed on reasonable grounds at all times before the exercise of the power that the delegate would exercise the power in conformity with the duties imposed on directors of the company by this Act and the company's constitution; and
- (b) Has monitored, by means of reasonable methods properly used, the exercise of the power by the delegate.

Section 138 Use of Information and Advice

138(1) [Power to rely on certain persons] Subject to subsection (2) of this section, a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given by any of the following persons:

- (a) An employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;
- (b) A professional adviser or expert in relation to matters which the director believes on reasonable grounds to

be within the person's professional or expert competence; and

- (c) Any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.

138(2) [Good faith, etc] Subsection (1) of this section applies to a director only if the director:

- (a) Acts in good faith;
- (b) Makes proper inquiry where the need for inquiry is indicated by the circumstances; and
- (c) Has no knowledge that such reliance is unwarranted.