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Review of Sanctions for Breaches of Corporate Law
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2770

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Dear Sir or Madam

Review of Sanctions in Corporate Law

We refer to the above discussion paper and are pleased to present detailed comment. The various issues and proposals raised in the discussion paper are highly significant to the efficient operation of Australia's corporate environment in which many of CPA Australia's members play leading roles.

The comments herein are confined to the substantive matters and questions raised in Chapter 3 of the discussion paper. On the key issues of the utility of a general defence CPA Australia concludes that it would add little value to promoting responsible risk-taking, and moreover, could potentially create uncertainty around the present structure of directors' powers and duties, the basis for attracting penalties and the rights and remedies of companies and their members. On the more specific matters raised variously throughout Chapter 3 the following comments, observations and recommendations are made:

- Whilst a number of the proposed elements of the general defence can be found elsewhere in corporate law, significant care would need to be applied to defining their meaning and scope.
- A more certain and effective way forward would be around resolving the absence of symmetry between ss 180 and 181.
- The duties which constitute 'core' duties are sufficiently distinct and specific as to render a general defence either of little value or potentially a source of uncertainty.
- The structure of defences for breach of directors' duties need to be considered in the wider context of other available relief provided in the Corporations Act – particularly that of s 1318 dealing with the courts powers to grant relief.
- The potentially subjective nature of a general defence which looks to subjective intent, runs counter to clear judicial authority as to impropriety extending beyond obvious abuse of power, to include aspects of what the director ought objectively have known with respect to the scope and objectives of his or her power.
- The development of understanding in the use of authorisation (before the conduct) and ratification (after the conduct) could form a measured and cautious basis for excusing directors whilst protecting the paramount interests of the company and its members.

- It is highly undesirable to introduce into the law any mechanism that would derogate against the protection afforded to unsecured creditors by way of the insolvent trading provisions – a general defence presents such risk.
- The potential for encouraging the continuity of trading by chronically insolvent companies contained in a general defence, would weaken the regime’s capacity to protect unsecured creditors.
- Contrary to any view that because the absence of a successful arguing in litigation of the business judgement relief, the outcome of these cases in fact confirms the robustness of the present rule.
- The comparatively targeted basis upon which members’ remedies apply, enable it to be concluded that directors can exercise their powers of management largely unencumbered by the interference of either the courts or members. On this basis a general defence would add little, if anything, to the scope for engaging in sensible risk-taking.
- Any additional general defence or business judgement type remedy would derogate against what has proven in the main to be a highly appropriate mechanism, operating through the insolvent trading defences, for the early intervention in cases of actual or impending corporate insolvency.
- The absence of symmetry between ss 180 and 181 should be resolved through amendment to the latter, but this should not extent to the more distinct duty around proper purpose.
- Section 189(b)(ii) dealing with the basis of reliance should be amended to an ‘after personally assessing’ criteria.
- Consideration should be given to strengthening the interaction between s 286 and s 344. The dishonesty basis of contravention contained in s 344(2) would seems clearly out of step with other provisions related to the obligation to keep financial records; particularly s 588E(4) which establishes a presumption of insolvency in relation to a failure to comply with s 286.

CPA Australia would like to thank Treasury for the opportunity to comment. If you have any queries or wish to discuss any aspects of our submission, these can be directed to Mr John Purcell, CPA Australia’s Policy Advisory Professional Standards on 03 9606 9826.

Yours sincerely



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cc:J Purcell
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Chapter 3: Better defining the contravention

Do you consider that the introduction of a general defence would improve the balance between discouraging undesirable conduct and promoting responsible risk taking?

CPA Australia (CPA) is of the view that a general defence in its suggested form would add little value to promoting responsible risk taking, and moreover, could potentially create uncertainty around:

1. the present structure of directors powers and duties,
2. the basis for attracting penalties, and
3. the rights and remedies of companies and their members.

Our concerns are outlined in the following specific responses. Where appropriate, alternative basis of development are suggested and a number of more specific suggestions for reform are endorsed.

Do you consider that the proposed elements of the general defence are correct?

- **Are there any particular concepts in the general defence that may require further consideration or elaboration?**

Given the absence of precise definition and meaning of the various components that might make up a general defence, it is uncertain as to what useful function such a defence might serve against currently available, though more specifically defined and targeted, defences. Any explanatory memoranda developed around a statutory general relief would need to more fully define the elements and explain the objective. CPA would nonetheless like to make the following observations and suggestions:

- *'in a bona fide manner'*

This phrase in a legal sense is synonymous with obligations of good faith and honest intention. In a corporate law context, it has been interpreted to mean that directors owe their company an equitable duty of good faith. In *Chew v R*¹ it was stated that the duty of good faith had a number of components required of directors; to act honestly, exercise their powers in the interests of the company, avoid misusing their powers and to avoid conflicts of interest. Under s 181(1) meeting the duty of good faith requires more than good intention and an absence of self-interest:

“It is not to the point that a director genuinely considers his purposes to be honest if those purposes are not in the interests of the company. The director must act in a way which he conceives to be for the benefit of the company as a whole, as that concept is understood by the law.”²

Hence, consistent with the more exacting standards of equitable duties, the subjective element of honesty is subservient to the actuality of whether or not the director acted in a way in which the law would regard as being for the benefit of the company as a whole.

¹ (1991) 5 ACSR 473 at 499

² *Australian Growth Resources Corp Pty Ltd v Van Reesema & Ors* (1988) 6 ACLC 529

- *'within the scope of the corporation's business'* and *'reasonably and incidentally to the corporation's business'*

Two observations are made. First, the phrase 'corporation's business' would within a statutory general defence warrant relatively precise definition – presently the interaction of ss 124³ and 125⁴ confirms that since removal of the requirement for an objectives clause, the capacity of a company to pursue any particular type of business is unfettered in a corporation constitutional sense. Secondly, whilst these phrases at an abstract level seem unambiguous, there would likely emerge the type of complexity described below in relation an understanding of the s 182 requirement of propriety.

- *'for the corporation's benefit'*

The practical implications of phrases similar to this⁵ have been subject to extensive analysis both judicially and academically. For example, applied to a reconciling of the interests of present and future members:

“... it is proper to have regard to the interests of present and future members of a company, on the footing that it would be continued as a going concern.”⁶

Similarly, J.D. Heydon in “Directors’ Duties and the Company’s Interests”⁷ offers a series of formulations of duty under the preface statement: “Directors must act bona fide for the benefit of the company as a whole.”⁸ Commenting on the related notion of “best interests of the company” Heydon makes the following remark:

“ - - - [it] does not mean the sectional interests of some, or a majority, or even all the present members, but of present and future members; a long-term view should be balanced against the short-term interest of present members. The ‘future members’ of a company are another reflection of the interests of the company as a distinct corporate entity, separate from the short-term interests of present shareholders.”⁹

Quite clearly there can be observed similarities between the suggested elements of a general defence and the various words and phrases used in s 181(1)(a). On this basis, and because of the various concerns raised elsewhere in our response, CPA’s conclusion is that a more certain and effective way forward would be around resolving the absence of symmetry between ss 180 and 181. (Refer our response to this specific question.)

Should the general defence apply to the ‘core’ duties in sections 180-183 and section 588G?

CPA suggests that an appropriate approach to this question is to determine whether those duties which constitute ‘core’ duties are sufficiently distinct and specific as to render a general defence either of little value or potentially a source of uncertainty.

³ Legal capacity and powers of a company

⁴ Constitution may limit powers and set out objects

⁵ Now embodied in s 181(1)(a) “in good faith in the best interests of the corporation”

⁶ *Darvall v North Sydney Brick & Tile Co. Ltd & Ors* (1987) 12 ACLR 537 at 554 per Hodgson J, (affirmed (1989) 15 ACLR 230).

⁷ *Equity and Commercial Relationships* (edited by P.D. Finn) LBC Sydney 1987 p 120.

⁸ *Mills v Mills* (1938) 60 CLR 150 at 188 per Dixon J.

⁹ *Equity and Commercial Relationships* (edited by P.D. Finn) LBC Sydney 1987 p 123.

Hanrahan, Ramsay & Stapledon¹⁰ draw a broad dichotomy between the duty of care and diligence and the duty of loyalty and good faith; the latter of which can be subdivided into four more specific categories:

- the duty to act in good faith in the interests of the company,
- the duty to act for a proper purpose,
- the duty to retain discretions, and
- the duty to avoid conflicts of interest.

Rather than some haphazard consequence of the historical development of corporate law, these respective categories reflect more enduring and fundamental elements of corporate governance. First, the duty of care diligence aligns the execution of the directors' powers of management so as to protect the interests and promote the objectives of the members. Secondly, the duties of loyalty and good faith seek to ensure that the director does not promote or pursue his or her interest ahead of that of the company. Those duties which are characterised by a duty of care and related obligations at law can more readily accommodate, and indeed should reasonably encourage, elements of measured risk-taking in the company's commercial setting; as Professor Sealy observes "[i]t is not the director's primary role to take care but to take risks. A duty of care and the liberty to take risk are incompatible bedfellows."¹¹ In contrast, those duties characterised as equitable in nature should promote significantly more cautious approaches on the part of directors. Thus, CPA is of the view that the suggested 'blanket' covering of duties by a general defence pays insufficient regard to the distinctive characteristic of the law of directors' duties which have evolved to meet separate, though interrelated, facets of the director / company relationship.

The multi-faceted nature for directors' duties is clearly evident in such high profile decisions as *ASIC v Adler*¹². In this litigation, the directors were found through the same complex series of facts to have contravened each of the ss 180, 181, 182 and 183 core duties, as well as breaching more specific duties - in particular those concerning prejudice to the interests of the company arising out of financial assistance in relation to the acquiring of the company's shares.¹³ Similarly, with the compensation aspects of the insolvent trading provisions¹⁴, the legislation there directly refers to the director's personal liability being additional to, and not in abrogation of, any other breach of duty.¹⁵

Finally in relation to this question, it is stressed that the structure of defences for breach of directors' duties needs to be considered in the wider context of other available relief provided in the Corporations Act – particularly that of s 1318 dealing with the courts' powers to grant relief. CPA maintains that this section operates as a sound basis for the excusing of behaviour¹⁶ which may not come within the strict confines of existing remedies. Hence, it is CPA's view that a general defence would add little value to this existing flexibility.

¹⁰ *Commercial Applications of Company Law* (7th ed., CCH, Australia 2005) p 199.

¹¹ "Directors' "Wider" Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 *Monash University Law Review* 164 at p 176.

¹² (2002) 41 ACSR 72

¹³ s 260A

¹⁴ Pt 5.7B - Division 4 Director liability to compensate company

¹⁵ s 588P

¹⁶ See for example Austin J's analysis in *ASIC v Vines* (2005) 224 ALR 499 where s 1318 was construed to have the effect that: "[a] person may be excused from liability under s 1318 even though the contravening conduct has been found to be unreasonable. 'Reasonableness' is not a black and white concept. It is sensible and relevant to the exercise of the discretion to consider the degree to which a defendant's conduct has fallen short of the statutory standard of reasonable care and diligence. A relevant consideration may be whether competent expert advice was sought or obtained. It appears that unreasonableness in post-contravention conduct may also be taken into account." (at 499 headnote)

Are there any adverse consequences that may result from a general protection applying to the duties of use of position (section 182) and use of information (section 183)?

Sections 182 (Use of position) and 183 (use of information) are sections to which s 185¹⁷ applies. Significantly, the authors of Ford's note that "the conflict, profit and misappropriation rules may be applied to the same facts which attract the statutory provisions."¹⁸ It is thus appropriate to examine both the general law and statutory provisions relating to directors' fiduciary based duties, noting that whilst each might be applicable to a particular fact situation, there are differences in the scope of application. In terms of the introduction of a general defence in relation to the duties it is essential also to determine:

- whether the current differences between the general law and statutory rules create a significant uncertainty that might be alleviated by means other than a general defence;
- whether existing understanding of the rules, both general and statute, achieve desirable outcomes against which a well informed director should reasonably be able to protect him or herself from breach;
- whether the notion of, or the components which make up, the proposed general defence are contradictory to judicially developed understanding of both the general law and statutory rules related conflict, profit and misappropriation; and
- whether there are alternative means of achieving greater certainty in these facets of directors' duties.

The general law rules relating to appropriation of corporate property, information and opportunity have emerged over many decades¹⁹, and indeed, have much of their foundation in the Court of Chancery's development of trust law²⁰, applied either directly or by way of analogy to an emerging understanding of directors' duties. It is impractical here to trace the complex lines of interrelated development.²¹ Instead, it is sufficient to concentrate on relatively more recent High Court authority as these represent clearly established principles governing the loyalty and propriety aspects of the relationship of director to company against which any proposed general defence must be set. Significant in this regard are the statement of the joint decision (Mason CJ, Brennan, Deane, Dawson and Gaudron JJ) in *Warman International Ltd v Dwyer*²²:

"It has been suggested that the liability of the fiduciary to account for a profit made in breach of the fiduciary duty should be determined by reference to the concept of unjust enrichment, namely, whether the profit is made at the expense of the person to whom the fiduciary duty is owed, and to the honesty and bona fides of the fiduciary. **But authorities in Australia and England deny that the liability of a fiduciary to account depends upon detriment to the plaintiff or the dishonesty and lack of bona fides of the fiduciary.**"²³ (Emphasis added)

¹⁷ Interaction of sections 180 to 184 with other law etc.

¹⁸ H.A.J. Ford, R.P. Austin and I.M. Ramsay, *Ford's Principles of Corporations Law* (12th ed., Butterworths, Australia 2005) p 459.

¹⁹ See for example the seminal case *Cook v Deeks* [1916] 1 AC 554

²⁰ See for example *Keech v Sanford* (1726) Sel Cas t King 61; 25 ER 233

²¹ See for example the those cases which determine that a director cannot avoid liability by resigning to do what would have been a breach of duty if the director had not resigned; *Industrial Development Consultants Ltd v Cooley* [1972] 1 WLR 443 and *Canadian Aero Services v O'Malley* (1973) 40 DLR (3d) 371.

²² (1995) 128 ALR 201

²³ *Ibid* at 208

Additionally,

“The stringent rule that the fiduciary cannot profit from his trust is said to have two purposes: (1) that the fiduciary must account for what has been acquired at the expense of the trust, and (2) to ensure that fiduciaries generally conduct themselves ‘at a level higher than that trodden by the crowd’.”²⁴

And that moreover,

“Thus, it is no defence that the plaintiff was unwilling, unlikely or unable to make the profits for which an account is taken or that the fiduciary acted honestly and reasonably.”²⁵

Any overlaying of clear judicial authority which strictly prohibits a director from preferring his interest over his duty with a generalised basis of relief is either superfluous, or at worst, likely to cause uncertainty in areas where resort to subjective aspects of honesty have thus far been excluded.

What flexibility there is, operates around the judicial determination of the scale of the equitable remedy of an account of profits:

“ - - - in conformity with the principle that a fiduciary must not profit from a breach of fiduciary duty, a court will not apportion profits in the absence of an antecedent arrangement for profit-sharing but will make allowance for skill, expertise and other expenses.”²⁶

Again, this limited scope for discretion which is specifically protective of the interests of the corporation and its members, should not be undermined by a possibly vague defence which might derogate against the well established objective in the law of ensuring, on the part of directors, pursuit of corporate interests ahead of any possible personal interests.

The leading authority providing interpretation of the directors’ statutory duty not to act with impropriety is that of the High Court’s decision in *R v Byrnes*.²⁷ The following characteristics of the duty are apparent:

- The proscribed purposes of advantage or detriment need not be proven, there need only be such purpose²⁸,
- improper use can exist without a state of mind towards detriment²⁹, and
- an objective to gain an advantage can also exist without an objective of detriment.³⁰

²⁴ Ibid at 209

²⁵ Ibid at 209

²⁶ Ibid at 212

²⁷ (1995) 17 ACSR 551

²⁸ Ibid at 558 “So construed, s 229(4) [the precursor section to the current s 182] does not require proof that an advantage has in fact been gained by the offender or any other person or that detriment has in fact been caused to the corporation.” And at 559 “Here, the Court of Criminal Appeal appears to have reasoned that the absence of purpose to cause detriment to the corporation meant that the respondents ought not to have been convicted. That was erroneous.”, per Brennan, Deane, Toohey and Gaudron JJ.

²⁹ Ibid at 559 “ - - - improper use and purpose (or intention) are different elements of the offence and may be established by evidence of different circumstances.”, per Brennan etc.

³⁰ Ibid at 559 “The second fallacy is that an absence of purpose to cause detriment to the corporation negates the existence of a purpose to gain an advantage for the alleged offender or another person.” Per Brennan etc.

Cases of this type³¹ often deal with complex situations around conflicting duties where the director is involved in the consideration or advancement of a transaction which affects the interests of two companies of which he or she is a director of both. CPA believes that the overlaying of these statutory rules with a general defence would seem to add little, if any, clarity. CPA further suggests that the risk of in fact adding uncertainty or contradiction is further enforced by reference to the meaning of what is 'improper' in the commercial context against which the directors' obligations and responsibilities to the company are discharged. Again the remarks of the High Court in *R v Byrnes* are significant:

"Impropriety does not depend on an alleged offender's consciousness of impropriety. Impropriety consists in a breach of the standards of conduct that would be expected of a person in the position of the alleged offender **by reasonable persons** with the knowledge of the duties, powers and authority of the position and the circumstances of the case."³² (Emphasis added)

Thus CPA believes that the potentially subjective nature of a general defence which looks to subjective intent, runs counter to clear judicial authority as to impropriety extending beyond obvious abuse of power, to include aspects of what the director ought objectively have known with respect to the scope and objectives of his or her power.

To conclude our consideration of this question, it is worth commenting on possible alternative developments to a general defence that would add more certainty in this area of directors' duties, particularly given evident differences in the scope of the statutory and general law rules.³³ Aside from consideration of possible statutory definition of impropriety that might better clarify the fiduciary basis of the duty, CPA suggests that there should be encouraged a clearer understanding of the scope for authorisation and ratification. The authors of Ford's in considering the development of the principles of ratification in relation to ss 182 and 183 note that:

"If the shareholders authorise directors to engage in conduct which would otherwise be in breach of their fiduciary duty and the statutory provisions, and the authorisation is validly given, it appears that the directors are free to engage in the conduct without breach of their fiduciary duty or statutory provisions."³⁴

The development of understanding in the use of authorisation (before the conduct) and ratification (after the conduct), in CPA's view, could form a measured and cautious basis for excusing directors whilst protecting the paramount interests of the company and its members.

Would an extension of the general defence to the insolvent trading provisions encourage insolvent trading? Would an extension be to the detriment of creditors?
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CPA believes that it is distinctly undesirable to introduce into the law any mechanism that would derogate against the protection afforded to unsecured creditors by way of the insolvent trading provisions – a general defence presents such risk.

³¹ See also *Fitzsimmons v R* (1997) 23 ACSR 355 at 357 – 359 per Owen J.

³² (1995) 17 ACSR 551 at 560.

³³ See H.A.J. Ford, R.P. Austin and I.M. Ramsay, *Ford's Principles of Corporations Law* (12th ed., Butterworths, Australia 2005) p 460 - 461.

³⁴ *Ibid* at p 462. See also more generally the comments of Santow J in *Miller v Miller* (1995) 16 ACSR 73 at 89 "Provided there has been full and frank disclosure of the nature of any particular breach and of the fact that absolution is being sought for that breach, a wide scope remains for valid ratification."

The inappropriateness of a general defence to the duty to prevent insolvent trading applies very much on the same basis as why the business judgement rule does not extend to protect directors in relation to this duty. Avoidance of abuse of the corporate form can be seen as the vital underpinning of the insolvent trading provisions and the rationale for not extending business judgement type protection to the 588G offence. On this specific point, and its contrast to the more general duty of care and diligence, it is worthwhile quoting here the comments of Rosemary Langford:

“ - - - the insolvent trading duty is intended to be a stricter and more specific duty than the duty of care and diligence in order to send a strong deterrent message that insolvent trading will not be tolerated.”³⁵

CPA believes it counterintuitive, and clearly contrary to established policy, to allow a provision such as the business judgement rule, and by inference a general defence, which is designed to encourage entrepreneurial behaviour, to encroach upon another provision of the Corporations Act specifically intended to compel risk-averse actions where the interests of creditors intervene.

From a broader policy perspective it is worth reiterating here the nature of the director / unsecured creditor relationship and why the insolvent trading provisions function as a justifiable form of regulatory interference. A duty owed to creditors in situations of corporate insolvency has amounted only to a ‘take account of’ level. As articulated by Street CJ in *Kinsela v Russell Kinsela Pty Ltd*:

“ - - - the interests of creditors intrude - - - through the mechanism of liquidation, to displace the powers of shareholders and directors to deal with the company assets”.³⁶

This indicates that once a winding up has commenced, the interests of creditors are paramount. However, in the ‘twilight zone’ leading up to insolvency the position of an identifiable duty to creditors has been uncertain. In what has been described as a ‘quiet revolution’ a line of authority has been regarded as suggesting a wider directors’ duty to creditors intervening at a lower threshold. Typical of these cases is *Grove v Flavel* in which the following remark is made:

“ - - - ‘duty’ of a director to have regard to the interests of creditors when the company is known to be insolvent there can be no reason in principle why knowledge of a real risk of insolvency should not attract the same duty”.³⁷

However more recent authority from the High Court concludes that:

“In so far as remarks in *Grove v Flavel* suggest that the directors owe an independent duty to, and enforceable by, the creditors by reason of their position as directors, they are contrary to principle - - - and do not correctly state the law.”³⁸

CPA strongly emphasises the need to recognise that insolvency is a collective procedure under which each unsecured creditor forfeits his or her individual right to take action to enforce the debt owed, and in lieu depends upon the outcome of the collective procedure ranking *pari passu*³⁹ with other creditors of the same class. There should be avoided any change to the law which would encourage behaviour that might further erode the pool of funds to which creditors are collectively entitled.

³⁵ “The New Statutory Business Judgement Rule: Should it Apply to the Duty to Prevent Insolvent Trading?” (1998) 16 C&SLJ 533 at p 557.

³⁶ (1986) 4 NSWLR 722 at 730.

³⁷ (1986) 11 ACLR 161 at 170 per Jacobs J.

³⁸ *Spies v The Queen* (2000) 201 CLR 603 at 636-637.

³⁹ Equally; without preference to one side or another.

Absent the formality of a duty owed to unsecured creditors outside that of contractual obligations, the insolvent trading provisions function as an important buttress against the differential bargaining positions of secured and unsecured creditors. It is CPA's view that the potential contained in a general defence for encouraging the continuity of trading by chronically insolvent companies, would weaken the regime's capacity to protect unsecured creditors, particularly those who are unable to price adjust for risk or protect themselves through quasi-security devices such as retention of title clauses.

If the general defence is applied to the duty to exercise care and diligence (section 180) is there a need to clarify its interaction with the business judgement rule in subsection 180(2)?

Notwithstanding the serious misgivings thus far expressed about the utility of a general defence, were such a defence introduced it would logically have to apply to a broad range of duties. Aside from the insolvent trading defences discussed immediately above, the next most specific defence available to directors is the business judgement rule which operates as a 'safe-harbour' relief specifically in relation to the duty of care and diligence.

CPA is of the view that in addressing this question it is necessary to determine whether a general defence would go any significant way towards achieving desirable outcome not presently achievable, or viewed alternatively, has the business judgement rule fallen short in meeting the objectives of its enactment. To this end it is appropriate to outline the background to the formulation of the existing business judgement rule.

CLERP Proposal Paper No 3 (at 5.2.2) referred to the need to seek a balance between responsible risk-taking, accountability to shareholders and the reluctance of courts to review bona fide business decisions. The latter point is illustrated in judicial comments such as:

" - - - they [their Lordships] accept that it would be wrong for the court to substitute its opinion for that of management - - - . There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at."⁴⁰

This is highly consistent with earlier Australian authority:

"Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are served may be concerned with a wide range of practical considerations, and their judgement, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts."⁴¹

The objective in codifying this general law principle has been to protect legitimate business risk type decisions from judicial scrutiny and thus challenge by shareholders. The statutory form sits appropriately in direct relationship with duties of care and diligence (by inference also skill) as these are the attributes that most directly relate to the management of the company. As such Treasury's view has been that:

"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 agency costs."⁴²

⁴⁰ *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 834 per Lord Wilberforce.

⁴¹ *Harlow's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co. NL* (1968) 121 CLR 483 at 493 per Barwick CJ, McTiernan and Kitto JJ.

⁴² CLERP Proposal for Reform: Paper No. 3 Directors' Duties and Corporate Governance p 24.

Here it is also significant to make some observation as to the court's views on corporate management responsibility which relate directly to the type of decision-making contemplated in a business judgment relief. In *Deputy Commissioner of Taxation v Clark*⁴³;

“For over two decades there has been a symbiotic interaction between legislative change and judicial decision. This interaction has both clarified and intensified the expectation that directors will participate in the management of the corporation. This expectation is reflected in s 198A⁴⁴ of the Corporations Act - - - . This section was inserted - - - as one of the replaceable rules⁴⁵ - - - [and] - - - has been a basal operating assumption of Australian corporation law for many decades that, subject only to express provision to the contrary, directors will participate in the management of the company. That expectation was tested in both insolvent trading cases and director's negligence cases.”

The objective of encouraging sound corporate governance practices is also apparent in the intention that a “statutory rule would be weighted in favour of directors who make informed business decisions and would ideally encourage the active participation and involvement of directors.”⁴⁶ Section 180(2) has since its introduction received only limited judicial consideration, though consistently applying a high threshold of behaviour for the concerned director seeking to avail of the protection. In *Gold Ribbon (Accountants) Pty Ltd (in liq) v Sheers* the following conclusion was drawn by Muir J:

“Subsection (2) of s 180 does not assist Mr Dunn. For the reasons advanced earlier, if Mr Dunn made a judgement to leave matters as they stood, he did not inform himself about the subject matter of it. Mr Dunn did not concern himself at all with the contents of the Austide agreement or with the administrative procedures applicable to the scheme. Nor, which I rather doubt, he made the judgement he alleges, did he turn his mind to whether the ‘judgement’ was in the best interests of the plaintiff. Because CRM was denied the administrative agreement, Mr Dunn washed his hands of responsibilities relating to it and in relation to the affairs of the company generally.”⁴⁷

Further in *ASIC v Adler*, Santow J provides a good analysis of the interaction of the s 180(2) ‘base rule’ and the four qualifiers (a) through (d):

“ - - - Mr Williams simply neglected to deal with proper safeguards, with no evidence that he ever turned his mind to a judgement of what safeguards there should be. Given that the purpose of Mr Adler was to maintain or stabilise the HIH share price and of HIH to make a quick profit, Mr Williams, as a major shareholder in HIH, had a ‘material personal interest’ as would preclude reliance under s 180(2)(b).”⁴⁸

CPA suggests that contrary to any view that because the absence of a successful arguing in litigation of the business judgement relief, the outcome of these cases in fact confirms the robustness of the present rule. The business judgement rule forms part of a wider basis for compelling a director's active engagement in the conduct of the business affairs of their companies – once such threshold of participation is achieved there is, by clear inference, ample scope to take sensible commercial risk within those matters recognised as a part of broad powers of management. It is therefore CPA's view that the introduction of a general defence sitting along side the business judgement rule would add, little if any, guidance to directors as to their scope for the taking of sensible commercial risk.

⁴³ (2003) 45 ACSR 332 at 345 – 346 per Spigelman CJ.

⁴⁴ Powers of Directors

⁴⁵ s 135

⁴⁶ CLERP Proposal for Reform: Paper No. 3 Directors' Duties and Corporate Governance p 25.

⁴⁷ [2005] QSC 198; BC200505054 par. [106]

⁴⁸ (2002) 41 ACSR 72 at 175, the conclusion subsequently approved by Giles JA *Adler v ASIC* (2003) 46 ACSR 504 at 615.

The operation of the business judgement rule ought also, in CPA's view, be considered in the context of 'skill'. Notwithstanding the absence in s 180 of direct reference to 'skill', this attribute of director competency is examined by Clarke and Sheller JJA in *Daniels v Anderson*⁴⁹:

"Skill is that special competence which is not part of the ordinary equipment of the reasonable man but the result of aptitude developed by special training and experience which requires those who undertake work calling for special skill not only to exercise reasonable care but measure up to the standard of proficiency that can be expected from persons undertaking such work."

It seems fair to conjecture that this notion of skill equates well with the reference to 'judgement' used in s 180(2)(a). Thus, if it is within a director's judgement, based on those attributes of skill, that the taking of particular commercial risk is valid, then this action would be protected without the need for a general defence.

CPA further suggests that it is appropriate here to give brief reference to the structure of member remedies and the broader basis of the rules around members' capacity to challenge the decisions of directors made within their powers of management – these rule further confirm by-and-large the adequacy of the present protections afforded to directors, and more broadly, an appropriate structure of checks and balances within the wider scheme of corporate law. Part 2F.1⁵⁰ provides a powerful tool through which members can seek the intervention of the court to compel directors to desist in actions⁵¹ which are either contrary to the interests of the members as a whole⁵² or oppressive, prejudicial, or discriminatory against a member.⁵³ Nonetheless, as indicated by the High Court's decision in *Wayde v New South Wales Rugby League Limited*⁵⁴, a cautious approach is still taken:

"Where the directors of a company are empowered to discriminate among its members and to prejudice the interests of one of them, the adoption of a resolution which is made in good faith and for a purpose within the power is not, without more, oppressive or unfair prejudicial to, or unfairly discriminate against, a member".

Similarly whilst there is afforded to members the opportunity to ask questions and make comment on the management of the company as a whole at annual general meetings⁵⁵:

"It is no part of the function of the members of a company in general meeting by resolution, ie as a formal act of the company, to express an opinion as to how a power vested by the constitution of the company in some other body or person ought to be exercised by that other body or person."⁵⁶

These factors, CPA believes, enable it to be clearly concluded that directors can exercise their powers of management largely unencumbered by the interference of either the courts or members. On this basis a general defence would add little, if anything, to the scope for engaging in sensible risk-taking.

⁴⁹ (1995) 16 ACSR 607 at 667

⁵⁰ Oppressive conduct of affairs

⁵¹ See for example s 233(1)(i) "[the court may make an order] restraining a person from engaging in specified conduct or from doing a specified act".

⁵² s 232(d)

⁵³ s 232(e)

⁵⁴ (1985) 180 CLR 459

⁵⁵ s 250S

⁵⁶ *NRMA v Parker* (1986) 4 ACLC 609 at 614.

If the general defence is applied to the insolvent trading provisions, is there a need to clarify its interaction with the existing defences?

Given the response to the two questions immediately above, it is reiterated that the specific form of defences and their interaction with other statutory provisions (Part 5.3A⁵⁷) should preclude the application of a general defence in relation to the duty to prevent insolvent trading. This aside, any attempt to clarify the interaction of different categories or class of defence potentially causes the type of uncertainty which the development of corporate law has sought to avoid.

It is worth considering here the characteristic of the key insolvent trading defences contained in s 588H as CPA Australia emphasises these as providing a sound basis for guiding directors' behaviour when insolvency either exists or is imminent. The terms and strictness of these defences dovetail the specific nature of offence as part of a regime driven by consideration of creditor protection and compensation. As such, the law's view on the gravity of the offence is reflected, for example, in s 588H(2) which is expressed in terms of 'reasonable grounds to **expect** company solvency' [emphasis added]. Conversely the offence provisions at various points are expressed as 'suspect insolvency'. The combination of expect and suspect, quite reasonably narrows the parameters for risk-taking where the interests of creditors are likely to intrude on the basis of the company's inability to pay debts as and when due. This strictness of approach CPA believes does not 'sit' comfortably with any parallel or blanket defence which might potentially tend towards the subjective views and motivations of the directors.

The implications of insolvent trading's higher threshold of relief, and the consequential requirement of a proactive enquiry as to the state of company finances, are further examined by Mandie J in *ASIC v Plymin*⁵⁸ - there focusing on the s 588H(3) reliance defence.

Additionally, s 588H(5) in particular encourages responsible and pro-active behaviour by directors offering an appropriately targeted means of protection for directors through recognition of 'any action the person took with a view to appointing an administrator of the company' (s 588H(6)(a)). In these terms, CPA believes that any additional general defence or business judgement type remedy would derogate against what has proven in the main to be a highly appropriate mechanism for the early intervention in cases of actual or impending corporate insolvency.

Should the general defence apply to those strict liability offences that are intended to protect shareholder interests?

CPA has no specific comment on this question.

The business judgement rule in subsection 180(2) also applies to equivalent duties at common law and in equity. Should a general defence also apply as a defence to actions brought in relation to equivalent duties at common law or equity?

The terminology in s 180(2) referring to equivalent duties at common law and in equity, most likely reflects the operation of s 185 which preserves equal applicability of the general law and statutory provisions to the same fact situations. Subject to the concerns raise above, the introduction of a general defence would for consistency need to cover both the general as well as the statutory duties.

⁵⁷ Administration of a company's affairs with a view to executing a deed of company arrangement

⁵⁸ (2003) 21 ACLC 700 at 808-810.

Should the lack of symmetry between sections 180 and 181 on what constitutes acting ‘in the best interests of the corporation’ be addressed by introducing the concept of ‘rational belief’ to section 181?

This particular issue was dealt with by CASAC (now CAMAC) in their October 2000 Report to the Minister for Financial Services and Regulation. There they observed that:

“Directors may comply with the business judgement rule requirements of having the appropriate rational belief, yet could still breach the separate duty of good faith by making decisions which, on a purely objective test, are not in the best interests of the corporation.”
(page 2)

The Advisory Committee presented the following possible redrafting of s 181(1)(b):

1. “in good faith in what the director or officer rationally believes to be in the best interests of the corporation” [using the same test of rational belief as in s 180(2)].
2. “in good faith in what a reasonable person in the director’s or officer’s position would believe to be in the interests of the corporation”.

CPA supports either of these approaches, as an alternative to a more expansive general defence, though with a preference for option 2 as this, whilst adding required clarity, would still emphasise the importance of the general law test of acting in the best interests of the company.

CPA further believes that it is important to note that CASAC made no reference the second limb of s 181(1) – that of “for a proper purpose.” This standard in CPA’s view sits quite fairly separate to the more general element of good faith, and as the authors of Ford’s observe in relation to proper purpose, “the courts have been more exacting.”⁵⁹ A significant body of case law dealing with impermissible purposes for the issue and allotment of shares excludes the excusing of directors behaviour based on subjective intent:

“The reason why, as a general rule, it is impermissible for the directors of a company to exercise a fiduciary power to allot shares for the purpose of destroying or creating a majority of voting power was identified by the *Privy Council in Howard Smith v Ampol*. It lies essentially in the distinction between the indirect proprietorship and ultimate control of the shareholders on the one hand and the powers of management entrusted to the directors on the other. It is simply no part of the function of the directors as such to favour one shareholder or group of shareholders by exercising a fiduciary power to allot shares for the purpose of diluting the voting power attaching to the issued shares held by some other shareholder or group of shareholders.”⁶⁰

The strictness of this rule has been subject to criticism⁶¹, particularly in the realm of the validity of the actions of directors of companies subject to what is genuinely perceived as hostile takeover. Nonetheless, CPA believes that consideration of reform of this aspect of the law of directors’ duties is probably beyond the scope of the current Inquiry.

⁵⁹ H.A.J. Ford, R.P. Austin and I.M. Ramsay, *Ford’s Principles of Corporations Law* (12th ed., Butterworths, Australia 2005) p 340.

⁶⁰ *Whitehouse v Carlton Hotels Pty Ltd* (1987) 70 ALR 251 at 254.

⁶¹ See for example N. Roger, “When Can Target Directors Legitimately Frustrate a Takeover Bid?” (1994) 12 C&SLJ 207.

**Does the requirement to make an independent assessment of information or advice received, place too high a burden on directors?
Is the original formulation subparagraph 189(b)(ii) preferable to the current formulation?**

As with the immediately above question, this matter was dealt with by CASAC in their October 2000 Report to the Minister for Financial Services and Regulation in which they concluded that:

“[I]f an opportunity to amend the provision [s 189(b)(ii)] arises, it would be useful to clarify this matter by replacing the phrase ‘after making an independent assessment of’ with the phrase ‘after personally assessing.’” (page 5)

CPA fully endorses this recommendation.

**Does the penalty for breach of section 286 provide an adequate deterrent?
Are there alternatives to pecuniary penalties that could apply to a contravention of section 286?**

Views on similar matters to this were canvassed in the Parliamentary Joint Committee on Corporations and Financial Services (PJC) inquiry into the Corporations Amendment (Insolvency) Bill 2007. Amongst other matters, the PJC sought comment on the present need for legislative response in relation to Recommendation 10 from its 2004 report *Corporate Insolvency Law: a Stocktake*. Recommendation 10 is as follows:

“The Committee recommends that the Government consider amending the law to permit an administrator or a liquidator to recover from directors who fail to ensure that company records are complete and up-to-date, the costs and expense of reconstructing the company’s financial records in order to prepare a full and complete report on the affairs of the company. Directors would be held jointly and severally liable.”

The PJC in its March 2007 report⁶² noted significant support amongst the professional bodies for rigorous enforcement of the financial record keeping obligation, both in general terms and as an important adjunct to the effective operation of external administration. CPA fully endorses the views of PJC on these matters and suggests that their recommendations (numbers 5 and 6) be considered by Treasury in its current deliberations.

One further matter here which CPA urges consideration of is the interaction between s 286 and s 344.⁶³ The dishonesty basis of contravention contained in s 344(2) would seem to be out of step with other provisions related to the obligation to keep financial records; particularly s 588E(4) which establishes a presumption of insolvency in relation to a failure to comply with s 286. Cases dealing with s 588E(4) have taken a quite critical view on the keeping and retaining of financial record obligations - see for example *ASC v Forem-Freeway Enterprises Pty Ltd* (1999) 17 ACLC 511 and *Kenna & Brown Pty Ltd v Kenna* (1999) 17 ACLC 1,183.

⁶² http://www.aph.gov.au/senate/committee/corporations_ctte/insolvency/report/report.pdf

⁶³ Contravention of Part 2M.2 or 2M.3