

## Chapter 8

# Directors' Duties of Care, Skill and Diligence

As discussed above, directors' duties fall into two categories: first, the fiduciary duties, and second, the duties to exercise care, diligence and skill in discharging their functions. The latter are often simply called the duty of care, although the words 'care', 'skill', and 'diligence' do have different meanings. These duties are owed to the company itself. But they protect present and future shareholders, present and future creditors of the company, employees and even the public at large.

In Australia the director's duties of care, diligence and skill are set down in both common law and statute. Section ~~229(2)~~<sup>232(4)</sup> of the Code lays out the statutory duty of care:

An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties. Penalty: \$5,000.

This formulation differs from s 124(1) of the *UCA* which read:

A director shall at all times . . . use reasonable diligence in the discharge of the duties of his office.

Such provisions to some extent codify the common law duty of care and diligence. Under s 229(10)<sup>1</sup> the provisions apply in addition to and not in derogation of any other rule of law relating to directors' duties. In 1961 the Jenkins Committee noted that the Companies Acts are by no means exhaustive in laying down directors' duties, 'the larger part of their duties and responsibilities having been determined by extensive and complex case law which does not find expression in the Act'.<sup>2</sup> This is still true. The common law and the legislative duties will be considered in turn.

## Duties under common law

Most reported directors' negligence cases were decided in the 19th and early 20th centuries. They set a remarkably low standard of care for directors. Business conditions and expectations have changed since then.

1. Formerly s 124(4) of the *UCA*.  
2. Cmnd 1749, para 86.

Companies are larger, shareholders more numerous, and business more complex. But these cases still provide the bulk of the common law statements on directors' duties.

### *Gross negligence required*

At common law directors must be 'culpably' or 'grossly' negligent before they are in breach of the duty of care and diligence.<sup>3</sup> As Lindley MR put it:

. . . it is plain that directors are not liable for all the mistakes they may make, although if they had taken more care they might have avoided them. . . . Their negligence must be not the omission to take all possible care; it must be much more blamable than that: it must be in a business sense culpable or gross.<sup>4</sup>

While the courts have long been unsure about exactly what 'gross negligence' means, apparently something more than what we may call ordinary negligence is required. In *Wilson v Brett*, Rolfe B concluded: "'gross negligence" is the same thing as "negligence" with the addition of a vituperative epithet'.<sup>5</sup>

### *Low standard of care imposed*

One thing is clear: directors do not presently have to meet a high standard. It is often contrasted with the strict standard of honesty or loyalty demanded from directors under their fiduciary duties.<sup>6</sup> In the United States, by contrast, most jurisdictions have applied an 'ordinary negligence' standard in preference to 'gross negligence'.<sup>7</sup>

A low ebb in the common law standard of care required of directors came with *Turquand v Marshall*.<sup>8</sup> The directors made a loan to one of their fellow directors. He died insolvent and without repaying the loan. The court found that, as it was within the directors' powers to make this loan, the directors were not liable for the loss.

Whatever may have been the amount lent to anybody, however ridiculous and absurd their conduct might seem, it was the misfortune of the company that they chose such unwise directors; but as long as they kept within the powers in their deed, the Court could not interfere with the discretion exercised by them.<sup>9</sup>

In essence, the courts have said that if the shareholders choose to appoint inexperienced, unskilled or witless directors they should bear the conse-

3. See Romer J, Lindley MR and Rigby LJ respectively in *Lagunas Nitrate Co v Lagunas Nitrate Syndicate Ltd* [1899] 2 Ch 392 at 418, 435, 466 (CA).

4. *Ibid* at 435.

5. (1843) 11 M & W 113 at 115–116.

6. See also *Overend, Gurney & Co v Gibb* (1872) LR 5 HL 480 at 494–495.

7. See American Law Institute 1982 document, *Principles of Corporate Governance and Structure: Restatement and Recommendations* at 137, 172–173.

8. (1869) LR 4 Ch App 376.

9. Hatherley LC, *ibid* at 386.

quences of their folly. Judge Learned Hand in 1924 said much the same thing in *Barnes v Andrews*:

True, he was not very well-suited by experience for the job he had undertaken, but I cannot hold him on that account. After all, it is the same corporation that chose him which now seeks to charge him . . . Directors are not specialists, like lawyers or doctors.<sup>10</sup>

Imprudence or errors of judgment do not amount to gross or culpable negligence. In *Re Brazilian Rubber Plantations and Estates Ltd*,<sup>11</sup> the board committed the company to a contract to buy a plantation in Brazil. The board had relied on a fraudulent report prepared by a person who, having sold an option over the estate to the vendors, was not a disinterested party. The vendors, who themselves had bought the plantation for £15,000, sold to the company for £150,000. The directors knew this. They had accepted the report without inquiry and they completed payment under the contract even though a company officer, before completion, reported that the plantation did not live up to the description in the report. When the company was wound up some two years later, the liquidator sought to make the directors liable for what he described as 'gross negligence' in this transaction (it being accepted there was no fraud or dishonesty by the directors). He unsuccessfully alleged they were grossly negligent in entering the contract without proper inquiry and in not repudiating it when errors in the report were exposed before the transfer was completed.

#### *Romer J's summary of the common law*

Neville J's findings<sup>12</sup> foreshadowed the judgment of Romer J in *Re City Equitable Fire Insurance Co Ltd*,<sup>13</sup> the *locus classicus* in this field. There, in the course of winding up an insurance company, the liquidator found a shortage of funds, this loss being largely attributable to the fraud of the managing director. While it was found that the other directors were not implicated in the fraud, the liquidator sought to make them liable for negligence in authorising or making poor and unwise investments and loans and for payment of dividends out of capital. He did not succeed, mainly because the company's articles exempted the directors from liability for any non-wilful loss or damage they might cause. Romer J's judgment, which was affirmed by the English Court of Appeal, summarised the duties of skill, diligence and care into four propositions:

1. *A director must exercise that degree of skill and diligence as would amount to the reasonable care that an ordinary man might be expected to take, in the circumstances, on his own behalf.* This seems to posit an objective, reasonable man test. But this is qualified by Romer J's second point.

10. 298 F 614 at 618 (1924).

11. [1911] 1 Ch 425.

12. *Re Brazilian Rubber Plantations and Estates Ltd*, *ibid*.

13. [1925] Ch 407.

2. A director need show no greater degree of skill 'than may reasonably be expected from a person of his knowledge and experience'. Thus the director's care and diligence must be judged on subjective criteria. Regard must be had to that director's personal qualifications and experience, not to some objective minimum standard. He need bring no special qualifications to the office.<sup>14</sup> Only if he has knowledge and experience appropriate to his tasks will he be expected to demonstrate a commensurate degree of skill.

*Re Denham & Co*<sup>15</sup> offers an example. A director, who infrequently attended general meetings (but who did propose a declaration of a 15% dividend at one of them), was held not to be in breach of his duty of care when it was discovered that for four years dividends had been paid out of capital because of fraudulent manipulations by the chairman and the company's book-keeper. The director was not an experienced businessman — he was described by Chitty J as a 'country gentleman'. He had neither perused the accounts nor attended board meetings. While it was acknowledged that he had been 'guilty of considerable negligence in the discharge of the duties of his office'<sup>16</sup> and that he had 'abstained during the long period of four years from executing in any way the duties of his office',<sup>17</sup> it was held that given his knowledge and experience he could not be expected to realise the significance of the information in the financial statements. Thus he was not in breach of his duty of diligence and care. He could rely on the expertise of duly authorised officers of the company.

Such findings as *Denham* did nothing to discourage the appointment of 'figurehead' directors or to encourage conscientious attention to the affairs of the company.<sup>18</sup> Today, business conditions and expectations have changed a great deal. Yet while business will expect a director to have an objectively reasonable knowledge of the company's financial affairs and to show a reasonable degree of competence, the courts have not yet forthrightly demanded that. As the law stands, some argue, a director can be 'as stupid and incompetent as that director happens to be'.<sup>19</sup>

14. See *Re Brazilian Rubber Plantations and Estates Ltd*, above n 11 at 437.

15. (1884) 25 Ch D 752.

16. *Ibid* at 766.

17. *Ibid* at 768.

18. In *Re Brazilian Rubber Plantations*, above n 11 at 427, for another example, the incompetent defendants were viewed rather sanguinely:

Sir Arthur Aylmer was absolutely ignorant of business. He only consented to act because he was told the office would give him a little pleasant employment without his incurring any responsibility. H W Tugwell was partner in a firm of bankers in a good position in Bath; he was seventy-five years of age and very deaf; he was induced to join the board by representations made to him in January 1906. Barber was a rubber broker and was told that all he would have to do would be to give an opinion as to the value of rubber when it arrived in England. Hancock was a man of business who said he was induced to join by seeing the names of Tugwell and Barber, whom he considered good men.

19. See Parsons, 'The Director's Duty of Good Faith' (1967) 5 MULR 395.

There is, though, evidence of judicial awareness of the need for a minimum standard of competence and skill. A largely ignored 1962 decision signalled a change in attitude. In *Re Australasian Venezolana Pty Ltd*,<sup>20</sup> a director, who had accountancy skills, was held to be negligent in the performance of his duties when his co-director deliberately misapplied company money. The defendant, acting on the instructions of the governing director, drew three cheques on the company's account in favour of another company in which his co-director was also the governing director. The defendant did not inquire as to the reason for these payments. Nor did he take steps to acquaint himself with the company's business to enable him to judge whether or not such payments or 'loans' were warranted. Eggleston J commented:

It is true that [the defendant director] was responsible for the books of the company and was attempting to compile a set of books at the time. But having regard to the short time at his disposal and the fact that his activities were not confined to this one company, he may well have been speaking the truth when he said that he was not aware of the true nature of the transaction.

This conclusion does not, in my opinion, relieve him of responsibility for any loss sustained by the company in respect of the transactions, since as I have said, if [the defendant] had made reasonable efforts to acquaint himself with the affairs of the company he would have known that this money should not have been lent to American Export Corporation. His liability, however, is a liability for failure to perform his duty as a director, and not that of a person who has deliberately misapplied the company's funds.<sup>21</sup>

To require a director to take 'reasonable efforts' is to require more than was asked in most earlier cases.

So too, in *Dorchester Finance Co Ltd v Stebbing*,<sup>22</sup> a higher standard was applied. Three directors of a moneylending company were held liable in damages for negligence. Only one of the directors was involved full-time in the company's affairs. Apparently there were no board meetings. The company made a number of loans at the instigation of the active director, but with the compliance of the other two who signed blank cheques drawn on the company. Because they were not adequately secured, the loans could not be recovered. So the company brought proceedings against all three directors. There was no question that the active director had at least been grossly negligent. However the other two, despite evidence that they had acted bona fide, were also held liable in damages. Foster J stressed the accounting experience of both men, and ruled they could not simply rely on the company's auditors.

20. (1962) 4 FLR 60.

21. *Ibid* at 66. This action against the defendant was brought under s 308(1) of the *Companies Act 1936-1960* (NSW) for misfeasance in relation to the company.

22. Unreported 22 July 1977 in the Chancery Division; noted in (1980) 1 Co Law 38-39.

For a chartered accountant and an experienced accountant to put forward the proposition that a non-executive director has no duties to perform I find quite alarming . . . The signing of blank cheques by Hamilton and Parsons was in my judgment negligent, as it allowed Stebbing to do as he pleased. Apart from that, they not only failed to exhibit the necessary skill and care in the performance of their duties as directors, but also failed to perform any duty at all as directors of Dorchester.

Foster J clearly required active participation by the directors in the company's affairs. This goes further than most older cases<sup>23</sup> and heralds a stricter attitude on directors' negligence.

3. '[A] director is not bound to give "continuous attention to the affairs of his company"'. The duties, Romer J added, are of an intermittent nature, to be performed in the boardroom and on subcommittees. But there is no duty to attend all board meetings or shoulder responsibility for decisions made in his or her absence.<sup>24</sup> This echoes the forthright Bacon VC in *Re Montrotier Asphalte Co* (Perry's case):

It is not part of the duty of a director to take part in every transaction which is conducted at a board meeting. His business or his pleasure may take him elsewhere and it would be a most unheard of thing to say that if anything wrong was done at a board meeting, he being named among the directors but not present, he is liable for what is done in his absence.<sup>25</sup>

Once at a meeting, however, a director should pay attention to proceedings. As Lord Hatherley noted in *Land Credit Co of Ireland v Lord Fermoy*: 'it is their duty to be awake and their being asleep would not exempt them from the consequences of not attending to the business of the company'.<sup>26</sup> It is better to stay away from meetings than to attend and be inattentive.

A good example of this reasoning arose in *Re Cardiff Savings Bank* (the *Marquis of Bute's* case).<sup>27</sup> The Marquis was described in the books and documents of the company, a bank, as its President from the time he inherited the role as an infant barely six months old. He attended but one

23. Cf *Charitable Corporation v Sutton* (1742) 2 Atk 400; 26 ER 642.

24. *Re City and Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 429, per Romer J.

25. (1876) 34 LT 716 at 717.

26. (1870) LR 5 Ch App 763 at 770–771. Cf, though, Lord Hardwicke L C in *The Charitable Corporation v Sutton*, above n 23 at 645: 'If some persons [directors of the corporation] are guilty of gross non-attendance, and leave the management intirely to others, they may be guilty by this means of the breaches of trust that are committed by others. By accepting a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence . . .'. In the past, the weight of authority accepted that the absent or dissenting director was not responsible for the actions or resolutions of the others. Sealy concluded in 'The Director as Trustee' [1967] CLJ 83 at 88: 'Liability therefore today rests on the fault of individual directors being established, and also a causal link between this and the loss suffered.' Foster J's comments in *Dorchester Finance*, above n 22, signal some sympathy for the stricter view offered by Lord Hardwicke L C above.

27. [1892] 2 Ch 100.

board meeting in 38 years. Without the Marquis's knowledge, statutory rules (including audit rules) had not been observed by the company over the years. This had enabled officers of the bank to carry out frauds, and the liquidator sought to make the Marquis liable for neglect. But Stirling J ruled that while there may have been neglect if the Marquis had notice of the irregularities, 'neglect or omission to attend meetings is not . . . the same thing as neglect or omission of a duty which ought to be performed at those meetings'.<sup>28</sup>

The articles of the company<sup>29</sup> or an executive director's contract of service may specifically or impliedly require attendance at meetings. But, in the absence of such requirements, the position arguably remains as set out by Romer J. It encourages, or at least does not discourage, the appointment of 'window-dressing' or 'name' non-executive directors who may make little effort to enhance the company's fortunes beyond lending it the influence of their title, name or reputation. Despite the appearance of the word 'diligence' in the formulation, the weight of authority says that such directors are not liable for whatever happens in board meetings in their absence. The weight of authority says they need not attend meetings or take other steps to discourage improper or negligent decisions by their fellow directors.

Writing in the late 1950s, Sir Douglas Menzies concluded<sup>30</sup> that a director's safest course in the present state of the law may be to stay away from meetings where risky decisions might be discussed and taken. Contrast this with US law. Even at the turn of the century directors had a common law duty to supervise the conduct of the company's affairs by officers. Failure or even inability to attend meetings was no excuse.<sup>31</sup> In *Francis v United Jersey Bank*,<sup>32</sup> the Court commented that 'In legal contemplations there is no such thing as a "figurehead" director'.<sup>33</sup>

4. *A director can rely on other officers or experts.* Modern, large businesses rely on effective delegation by the boards of directors of subordinate and administrative tasks to subordinates or experts. Boards delegate to accountants, auditors, lawyers, executive committees, managers and other company employees and trust in and rely on their advice. Can the directors rely on officials and experts to perform these functions? Romer J in *Re City Equitable Fire Insurance Co Ltd* qualified his affirmative answer:

In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.<sup>34</sup>

28. *Ibid* at 109.

29. See reg 65(e) of Table A.

30. In 'Company Directors' (1959) 33 ALJ 156.

31. *Rankin v Cooper* 149 F 1010 (1907).

32. 162 NJ Super 355; 392 A 2d 1233 (1978).

33. *Ibid* at 1242.

34. Above n 24 at 429. See also *Huckerby v Elliott* [1970] 1 All ER 189 at 194.

Romer J went on to cite a passage from an English Court of Appeal judgment in *Re National Bank of Wales Ltd*.<sup>35</sup> There a director was not expected to have supervised inferior officers or verified the auditor's calculations.

Business cannot be carried on upon principles of distrust. Men in responsible positions must be trusted by those above them, as well as by those below them, until there is reason to distrust them. We agree that care and prudence do not involve distrust; but for a director acting honestly himself to be held legally liable for negligence, in trusting the officers under him not to conceal from him what they ought to report to him, appears to us to be laying too heavy a burden on honest business men.<sup>36</sup>

The limits of reliance are worked out on a case-by-case basis. *Gould v Mount Oxide Mines Ltd*<sup>37</sup> noted that to allow a person who was not a director, company official or even a shareholder to have uncontrolled power to draw cheques on the company's account amounted to actionable negligence. Directors of financial institutions seem to have a higher duty of care than others.<sup>38</sup>

In the older authorities there is no general call for directors to exercise active supervision.<sup>39</sup> Nor do they require directors to have positive grounds for believing an official to be trustworthy. Directors must only avoid negligence on their own part when and if they interact with company officials on whom they rely. Reasonable grounds for suspicion as to an official's honesty or even competence cannot be ignored.<sup>40</sup>

The right to rely is not set out in the Australian Code. Section 35 of the US *Model Business Corporation Act*<sup>41</sup> offers a precedent.

In performing his duties, a director shall be entitled to rely on information, opinion, reports or statements, including financial statements and other financial data, in each case prepared or presented by:

- (a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
- (b) counsel, public accountants or other persons as to matters which the director reasonably believes to be within such person's professional or expert competence; or
- (c) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the articles of incor-

35. Later reported as *Dovey v Cory* in the House of Lords appeal: [1901] AC 477.

36. *Re City Equitable Fire Insurance* [1925] Ch 407 at 429, quoting from *Re National Bank of Wales Ltd* [1899] 2 Ch 629 at 673.

37. (1916) 22 CLR 490 at 530.

38. For the position in the United States see *Bates v Dresser* 251 US 524 (1920); *Gamble v Brown* 179 US 839 (1928).

39. But see unreported decision in *Dorchester's* case discussed above; and cf US law as reflected in *Barnes v Andrews* 298 F 614 (1924).

40. See, generally, Mackenzie, 'A Company Director's Obligations of Care and Skill' (1982) Jo of Bus Law 460 at 461-463.

41. 2nd ed, s 35.

poration [memorandum] or the by-laws [articles], as to matters within its designated authority, which committee the director reasonably believes to merit confidence.

but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted.

This is a useful statutory model and a summary of the common law position.

### *Higher standards for executive directors?*

The standard of care the common law sets for directors falls short of the standard that reasonably prudent business people would today expect of themselves in the office of director. It is certainly below what they would expect their employees to meet, especially in modern business conditions.

In *Lister v Romford Ice and Cold Storage Co Ltd*<sup>42</sup> a company employee, a lorry driver who ran over another employee (his father), was held to be, by the fact of his employment, under an obligation to use all reasonable care in the performance of his duties.<sup>43</sup> Such an implied contractual obligation of reasonable care would also apply to the executive (inside or employee) director. He will be in a contractual relationship with the company as an employee with a service contract. Thus, managing directors and other board members with 'executive' positions in the company are subject to an implied contractual obligation to the company to show due care. The performance of this duty is objectively assessed.<sup>44</sup> An objective duty applicable to *all* directors and written into legislation (or individual service contracts) seems desirable. The *Lister* principle has not been directly applied to the executive director yet, although this must only be a matter of time. Accordingly, should an executive director's lack of reasonable skill and/or care cause loss or damage, the director would be liable to the company, and liable to indemnify the company against any liability to third parties arising out of the director's breach.

## **Duty of care under the Code**

Section 124(1) of the *UCA* (set out above) seemed to impose a reasonable man or objective standard. It required a director to exercise 'reasonable diligence' in the discharge of the duties of his office. However, in one of the very few reported cases on the section — *Byrne v Baker*<sup>45</sup> — the Full Court of the Supreme Court of Victoria gave it a subjective gloss. Reasoning that s 124(1) must have been 'inspired' by Romer J's words in

42. [1957] AC 555 (HL).

43. See Viscount Simonds, *ibid* at 573; Lord Radcliffe, *ibid* at 586–587. Lord Radcliffe, *ibid* at 587, thought the obligation arose and was implied from tort and contractual principles.

44. See also *Gore-Browne On Companies* (44th ed, 1986) at para 27.19.1.

45. [1964] VR 443.

*Re City Equitable*, the Court held that the degree of diligence demanded was what may reasonably be expected of the director in the circumstances.<sup>46</sup> The statute only demanded what was reasonable for that particular director in his particular circumstances. Subjective criteria were to affect the judgment of whether or not a director had carried out his duty. Further, the Court pointed out that the section did not, as Romer J did, call for skill in addition to diligence. This even further undermined the standard — one can be diligent yet deficient in skill.

Under this sort of interpretation, s 124(1) imposed an even less rigorous standard of care on directors than did the common law. Accordingly, the March 1980 Australian draft proposal to replace s 124(1) seemed timely. The draftsmen looked to the Canadian federal statute<sup>47</sup> and to the Ontario code<sup>48</sup> for models. The draft provision said:

An officer of a corporation shall at all times exercise, in relation to the affairs or business of the corporation, a degree of care, diligence and skill that a reasonably prudent person would exercise in relation to his own business or affairs in comparable circumstances.<sup>49</sup>

The Explanatory Paper suggested that this test of diligence was more objective than that in the *UCA*. It further noted that the more objective test applied to both 'care' and 'skill'. The *UCA* provision applied only to the first of these. But in fact this formulation was not too dissimilar to the Full Supreme Court of Victoria's summary of the effect of *Re City Equitable Fire Insurance Co* when it discussed that case and s 124(1) of the *UCA* in *Byrne v Baker*:

... a director in discharging the duties of his office must act honestly and must exercise such degree of both care and skill and diligence as would amount to the reasonable care which an ordinary man might be expected to take in the circumstances on his own behalf: see *Re City Equitable Fire Insurance Co*. . . .<sup>50</sup>

Claims that cl 124(2) of the unsuccessful 1980 draft contained a more objective test than the old *UCA* formulation were too optimistic. Even so, in the face of hostile reaction to the March draft, the legislature trimmed back this provision dramatically for the 1981 Code. In essence the new s 229(2) (see above) differs little from the *UCA* provision.

The maximum penalty for breach was increased to \$5,000. The court may, in the same proceedings, order a person convicted of an offence under the provision to pay compensation to the corporation: s 229(6). A corporation can take civil proceedings against a person who has contravened the section for the amount of profit made by that person or the

46. *Ibid* at 450ff.

47. *Canada Business Corporations Act*, para 117(1)(b).

48. *Ontario Business Corporations Act 1970*, s 144.

49. Clause 124(2) in the March 1980 Bill.

50. Above n 45 at 450. See a similar formulation in *Overend, Gurney & Co v Gibb* (1872) LR 5 HL 480; *Re Dominion Portland Cement Co Ltd* [1921] NZLR 667. 6 *Halsbury's Laws of England* (3d) 309, para 619 used the same wording.

loss suffered by the corporation, this right applying irrespective of whether the person has been convicted of an offence under the section: s 229(7).<sup>51</sup> In the redrafting of s 229 the proposed penalty of up to one year's imprisonment was dropped.

The offence now extends to 'officers' as defined in s 229(4) and does not apply only to directors. 'Officers' applies, inter alia, to directors, secretaries and executive officers. 'Executive officer' is defined in s 5(1) and means a person who is concerned in or takes part in the management of a company. Such a definition is wide and comparatively junior people in a company's hierarchy may be affected.

The section refers to a 'reasonable degree of care' as well as to 'diligence'. The new legislation, like the old, does not require harm to be done to the company or others — just a failure to exercise reasonable care and diligence.

Section 574 allows the Commission or any person whose interests are, have been or would be affected by negligence of directors to bring proceedings for an injunction. This is unlikely to be very useful in this area as the damage caused by the negligence will usually be done by the time one would get around to such proceedings. However, under s 574(8) the court has power to grant damages in substitution for an injunction.

## Reform proposals

Trebilcock noted in 1969:

It is unfortunately the case that the fewer a director's qualifications for office, the less time and attention he devotes to his office, and the greater the reliance he places on others, legally the less responsible he is.<sup>52</sup>

This is arguably still the law.<sup>53</sup>

There have been many calls for legislative intervention to make the director's duties more onerous.<sup>54</sup> The thrust of most of these calls has been to make the director's duties more objective. Most States in the United States of America impose a 'reasonable director' standard of care, although defining who is and what is done by a reasonable director is a formidable task. A few States use the 'care exercised by a prudent person in his own affairs' formula. This is thought to be a higher standard than the 'care that an ordinarily prudent person would exercise under similar circumstances' test. The latter has supporters.<sup>55</sup> Section 1704(g) of the American Law Institute's (ALI) *Federal Securities Code* mixed the two:

51. Cf s 124(3) of the UCA.

52. Trebilcock, 'The Liability of Company Directors for Negligence' (1969) 32 MLR 499 at 508–509.

53. See also Parsons, 'The Director's Duty of Good Faith' (1967) 5 MULR 395.

54. See Trebilcock, 'The Liability of Company Directors for Negligence' (1969) 32 MLR 499 at 508–515.

55. See Mace, 'The President and the Board of Directors' (1972) 50 Harv Bus Rev 37 at 48–49.

'the standard of reasonableness is that required of a prudent man under the circumstances in the conduct of his own affairs'. The ALI in 1982 suggested that the 'business judgment rule', little discussed in Australasian and English courts, should be written into companies legislation. The ALI's draft duty of care provision said:

A corporate director or officer shall not be subject to liability under the duty of care standards . . . with respect to the consequences of a business judgment if he:

- (1) informed himself and made reasonable inquiry with respect to the business judgment;
- (2) acted in good faith and without a disabling conflict of interest; and
- (3) had a rational basis for the business judgment.

This undoubtedly modifies the reasonably prudent director standard. This 'business judgment' gloss on the duty of care arose, the ALI notes, 'because of a desire to protect honest directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and because of a desire to refrain from stifling innovation and venturesome business activity'.<sup>56</sup> There is a distinction between 'rational' as used above and 'reasonable'. As you can be rational and unreasonable, the above drafting may provide a haven for directors.

Some reformers argue that an objective standard of knowledge, experience and thus skill can be imposed, much the same as that demanded of surgeons, dentists, architects and other professional groups.<sup>57</sup> Assuming it is possible, is it fair to impose a uniform requirement of skill or professional competence on the very diverse group of persons which traditionally acts as directors? And is it fair to make it a criminal offence to fail to meet such standards? Hulme had this to say:

. . . breach of s. 124 [UCA] is a crime, for which the director can go to gaol. There is no requirement of wilful harm; no requirement that harm can be done. It is enough, to justify sending a director to gaol, that he has been careless. Not so for a Prime Minister, Premier, Cabinet Minister, President for the A.C.T.U., doctor, lawyer, accountant, or even motor-car driver. Alone in his glory, the director can go to gaol for negligence. May one ask why it is, that this function is singled out for such drastic treatment?<sup>58</sup>

Such arguments convinced legislators to remove the imprisonment penalty from s 229(2) of the Australian Code.

Should there be a distinction in type and severity of penalties between those for acting dishonestly and those for acting without due care and diligence? The ALI noted:

56. *Principles of Corporate Governance and Structure: Restatement and Recommendations* (1982) at 143.

57. See *Saif Ali v Sydney Mitchell & Co* [1978] 3 WLR 849 at 859 (HL).

58. 'The New Duties of Directors and Officers of Companies' (published by the Business Law Education Centre, Melbourne, 1980).

... a recurring theme advanced in Part IV is the necessity of avoiding harsh and unworkable substantive standards and penalty provisions. The willingness of those with vision, ability and expertise to serve corporations must not be unduly chilled. Moreover, unduly harsh standards or disproportionate penalties are likely to lead to judicial nullification.<sup>59</sup>

The multi-faceted nature of company work means that a variety of skills and personalities is useful in boardrooms. One must also bear in mind the difference between the paid, executive directors and the 'outside' or non-executive directors. The latter's objectivity, knowledge and experience may often be highly-prized and they frequently fulfil important functions on boards. But they are not well-versed, full-time employees of the company. Is the same standard to be expected of them? Can an objective standard of care and diligence reasonably be demanded? Can we demand a similar degree or standard of skill?

On the other hand, higher requirements of care, diligence and skill will encourage better appointments. Candidates would have to consider their capabilities and responsibilities more seriously. Companies and investors could only benefit from this. Certainly higher standards would discourage the appointment of 'name' or 'window-dressing' directors. Some argue there is an identifiable profession of company 'directing' and that legislatures can realistically impose an objective 'ordinary skilful and conscientious director' test.<sup>60</sup> Increasing demands by the business community, the judiciary and the legislators could see the enactment of a more stringent test in the future. On balance there is still a need in Australia, as in the United Kingdom, to tighten up the director's duties of care and skill at law.<sup>61</sup>

## Problems of enforcement: standing to sue

### *Enforcing the legislative duty of care*

Criminal proceedings for breach of s 229 may be brought by those who have standing under s 36 of the *Companies and Securities (Interpretation and Miscellaneous Provisions) Act 1980*.<sup>62</sup> Usually proceedings will be taken by the delegates of the NCSC — invariably the corporate affairs administration or an officer of the administration of a State or Territory. In *Marchesi v Barnes and Keogh*,<sup>63</sup> for example, an officer of the Victorian office

59. Above n 56 at 129.

60. Gower, *Final Report on Company Law in Ghana* (1961) at 146 commenting on his draft s 203(2).

61. For challenging comments on these duties see Hulme's paper in the Institute of Chartered Accountants in Australia and the Business Law Education Centre's handbook on *The National Companies Legislation* (November 1981) at 160.

62. See Ch 9 on enforcement of duties generally.

63. [1970] VR 434. See also *Karounos v Flavel* [1984] 2 ACLC 394 at 403ff on what is valid or sufficient Ministerial consent.

of the Registrar of Companies was authorised to take action by a signed consent to the proceedings by the responsible Minister.<sup>64</sup>

Section 574 — the injunction provision — can be a powerful provision for members and creditors seeking to enforce the Code. It could be used in s 229 negligence situations (see discussion later in Chapter 9).

### *Enforcing the common law duty of care*

Directors often control the general meeting, and under the articles they are likely to control the company's litigation. The decision to sue or not is a management decision. Directors are unlikely to sue one of their own number. So most civil actions against directors for common law negligence are brought by liquidators, who on appointment take over the powers of directors including their control over the litigation process. The liquidators can then pursue remedies available to the company and can challenge breaches of duty by directors.

Minority shareholders wishing to have the company sue in respect of negligence by directors have to fit themselves into one of the exceptions to the rule in *Foss v Harbottle*. Even where there is a clear case of breach of duty by management, this is usually difficult, costly and time-consuming.<sup>65</sup> As discussed in a later chapter, it seems action may not be brought by a shareholder when there is simply a breach of the duty of care.<sup>66</sup> The breach must benefit the directors as well as harm the company.<sup>67</sup>

However, boardroom negligence will found successful actions by shareholders for oppression or unfairness under s 320 (also discussed later, in Chapter 12). This course of action is especially useful to disadvantaged members of small or 'close' companies.

Negligent management may also now be removed from office on the application of members, creditors and others under s 227A of the Code. If an officer has 'failed to exercise a reasonable degree of care and diligence, in the performance of his duties as an officer of the corporation', he may be prohibited from corporate management for such period as the court at its discretion directs.<sup>68</sup>

64. Section 381(1) of the *UCA* (equivalent of s 36 of the *Companies and Securities (Interpretation and Miscellaneous Provisions) Act*) was at issue there. *Marchesi* is, with respect, a confusing judgment on the statutory duty of care. Gowans J appears to confuse acting honestly with acting in the company's best interests: see 437–438. Bearing in mind that s 229 imposes criminal sanctions, should not moral culpability be required for a crime and not just the failure to act in the company's best interests (which can be *bona fide*)?

65. See this matter discussed in detail later in Ch 9.

66. *Pavliades v Jensen* [1956] Ch 565.

67. See Templeman J in *Daniels v Daniels* [1978] 1 Ch 406.

68. See s 227A(1)(d). Persons who may apply under the sections are listed in s 227A(7). Section 227A is discussed earlier in Ch 2.