Recent court cases have highlighted the increasingly onerous responsibilities of boards of directors.

Don Harding reviews proposed legislation and the developing judicial interpretation of the duty of care.

Richard Warren's entertaining, if irreverent, piece in the June issue of JASSA ("Same law, but it's hitting harder") may have taken a little poetic licence, but it accurately conveyed the point that the courts are demanding more of directors, particularly in respect of their duties of care.

There have been developments since those covered by Warren. Superficially at least, they seem to send out conflicting messages, as the financial press has noted in contrasting the tenor of Rogers J's decision in the AHEA case (AHEA Limited v Deloitte Haskins & Sells, 3 July 1992) with that of the Victorian Full Court decision in Morley v Statewide Tobacco Services Limited, 24 July 1992. The question is what degree of involvement is now expected of directors, and particularly non-executive directors, if they are to discharge their duty of care.

Certainly, directors have been told in no uncertain terms that courts will not excuse a director's ignorance of matters of which he should be aware.1

Yet directors might be forgiven for saying that it is not very clear what the duty of care demands of them, and particularly how much positive action they must take in setting up internal controls and managing and supervising.

On the one hand, Rogers J, consistent with US commentators, demands involvement in establishing principles and policies but says of a large corporation that it is all right to leave the establishment of controls and their supervision to senior management. On the other, the Morley case raises the spectre of liability of a non-executive director who implicitly authorises a person performing an executive's role to incur debt and holds the person liable on the basis that she has not done all she ought to do.

The reality is that directors are witnessing a classic example of how the common law develops: cases arising from the events of recent years are wrestling with the law's reformulation of the duty of care. This is a response to community expectations that the law should require more of directors. Tadgell J in Commonwealth Bank of Australia v Friedrich2 recognised that when he said: "As the complexity of commerce is gradually intensified . . . the community has of necessity come to expect more than formerly from directors whose task it is to govern the affairs of companies to which large sums of money are committed." The role of community expectations in setting the standards, he noted, was accepted by Sir Douglas Menzies J, speaking off the High Court, in his oft-quoted statement of 30 years ago that "honest and diligent muddling" is not enough.3

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The Morley judgment also contains reference to community expectations. It says that "in this day and age" it does not seem right that a director who wholly ignores the obligations imposed by the Code can escape liability by pleading ignorance of relevant facts, when a director who takes sufficient interest in his duties to be fixed with knowledge can become liable. Ironically, perhaps, the bench quotes an observation of Rogers A J in Naffai v Haines that "the days of the sleeping, or passive, director are well and truly over".

The effort to meet the expectations, however, as Rogers J noted in the AWA judgment, runs into the reality that it occurs at the same time as the job becomes more difficult. "As conglomerates get larger and more complex", he says, it becomes "almost impossible for the non-executive director to discharge directorial duties in any detailed and knowledgeable manner".

Like the judiciary, the Attorney-General also is responding to community expectations, following the reports of the Ford, Lavarch and Cooney committees, by seeking statutory reforms. These would not only restate, in the Corporations Law Reform Bill 1992, the general standard of care and diligence in section 232, but also specify, in a proposed sub-section 232(4AA), the factors to which a court must have regard in deciding whether directors have discharged their duties. This subsection might be taken to imply expectations beyond what Rogers J states for non-executive directors.

Complex as the process of development of the duty of care by the courts may be, it is a widely held view, which the writer shares, that this judicial development should be allowed to proceed, rather than being overlaid prematurely by a detailed statutory standard.

Different legal starting points

The complexity of the task of clarification or restatement has been heightened by the variety of the technical contexts in which cases are brought. The AWA case addressed the question of standards at a fairly general level in dealing with a claim of contributory negligence on the part of AWA due to the negligence of its directors and senior management.

A legal question arose as to whether the duty of care of directors is imposed on directors by reason of their fiduciary position only in equity, or whether it can be treated as a duty to avoid negligence at common law. Rogers J found that a director, in effect, can be liable for contributory negligence at common law and therefore in part must owe a duty under common law as well as equitable principles and under the Corporations Law, section 232.

From the technical legal point of view, this was a significant position to take, the law having been by no means clear on the issue.

From a different starting point, Morleys' case and Commonwealth Bank v Friedrich were concerned with actions to make directors personally liable for a company's debts under section 556 of the Companies Code (now section 592 of the Corporations Law). The section creates liability if the company incurred the debt when there were reasonable grounds to expect that it would not be able to pay its debts as and when they became due.

In Morleys' case, the court dealt with the statutory defence to the action that the director did not have reasonable cause to expect that the company was unable to pay its debts.

Departing from the earlier High Court decision in Shapenoff v Dunn, the Victorian Full Court agreed with the trial judge, Ormiston J, that the director could not rely on ignorance of relevant facts, but must go further and show that he or she made all of the inquiries which he or she ought reasonably to have made, having regard to the general duties of a director.

That view, and the departure from the High Court, was justified in part by slight differences in the wording of the sections before the two courts.

Of course, the Full Court's view begs the question of what the director should have done. The court was assuming a sufficient obligation to take positive actions to support the finding of liability against Mrs Morley.

A notable feature of the judgments has been the way in which they cross-reference to obligations or liabilities imposed on directors in different parts of the law in developing the standard relevant to the claim before them. This is desirable, however. Otherwise, directors might think that they had complied with the general duty in equity or under section 232, but be caught by a provision like that in section 592.

Thus, while Morley turns on a specific statutory standard in section 556 (section 592), the court refers to the general duty of care (stated in section 232) in relation to what can reasonably be expected of the director by way of inquiry into the state of solvency of a company when a debt is being incurred.

In the Friedrich case, Tadgell J, like Ormiston J in Morley, accepted that section 556 was to be interpreted in the light of the obligations placed on directors by the Code, including the
specific obligation that directors cause a statement to be attached to any accounts of the company required to be laid before its annual general meeting.

Ormiston said that a director is therefore obliged to inform himself or herself as to the financial affairs of the company to the extent necessary to form each year the opinion required for the directors' statement. Although that is only an annual obligation, it "presupposes sufficient knowledge and understanding of the company's affairs and its financial records to permit the opinion of solvency to be formed". That is imposing on directors a more specific requirements of knowledge and skill in relation to financial records and affairs that the general law standards stated in 1926 in the City Equitable case.

The factors listed in proposed sub-section (4AA)

The proposed amendments of the Corporations Law Reform Bill No. 3 restate the duty of care in general terms, in sub-section 232(4), so that an officer of a corporation must exercise "the degree of care and diligence" that a "reasonable person would exercise in relation to his or her powers and the discharge of his or her duties as an officer that in the corporation's circumstances". Broadly speaking, as a restatement of the statutory duty of care and diligence, the standard is workable.

The proposed sub-section (4AA) is a different matter. It requires consideration of a number of general matters, which admittedly are factors similar to those being referred to in the recent cases, namely:

- what the officer did to ensure the corporation made adequate arrangements;
- to ensure that people who prepared reports and gave advice or opinions were honest, competent and reliable and such as to inspire confidence;
- to monitor and ensure compliance with the law and the corporations constitution;
- to ensure that persons who took part in management avoided conflicts;
- to ensure that decisions made were adequately monitored;
- to ensure that persons who made decisions had adequate information about the subject matter of those decisions; and what was done by the officer to ensure that the arrangements referred to were given effect to, as well as any other relevant matter.

This might be interpreted to require the officer to become more actively involved than would be regarded by the case law as reasonable, depending on the position which he or she holds. It might alter the law (or simply present the courts with the task of limiting the role of the section to what it would require regardless).

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The proposed amendment has been the subject of many expressions of concern including, according to a recent financial press report, doubts expressed by the Companies & Securities Advisory Committee itself in a report not released at the time of writing.

While the factors proposed in subsection (4AA) find echoes in the case law, their formulation as a statute to which courts must have regard is undesirable. A result could be that directors, including non-executive directors, will be engaged in expensive compliance systems which enable them to avoid liability by going "through the motions".

This makes for inflexibility and an excessive burden on directors and officers, without sufficient allowance for the vast difference in their roles, expertise and reasonable commitment. Moreover, situations are infinitely various and complex. Factors not mentioned at all may be the most important.

A business judgment rule?

In the debate over this amendment it has been suggested by a number of commentators that any statutory standard should include a business judgment rule of the US type. The Commonwealth Attorney-General, in an address on 18 June 1992, rejected the suggestion and sought to distinguish between the Australian and American positions.

However, there is a great deal of similarity in the two jurisdictions in the functional considerations relevant to the development of the standards. The statement of a business judgment rule is at least a reminder of the need to allow directors to make the best rational judgment they can, on the basis that they have attempted reasonably to inform themselves before doing so and that their principal function is to run the business. Rational business judgment is undoubtedly a factor. Courts will be driven by circumstances to allow for it in the formulation of a duty of care or by implication in determining what is reasonable.

What guides are there for directors?

The practical question for directors, in the light of all this activity, is whether there are any specific rules
or guides which tell them what is expected of them. Most directors, particularly of large and sophisticated corporations, simply wish to know what it is that they are supposed to do, so that they can get on with it, while at the same time discharging their responsibilities to guide a business.

None of the activity, however, has changed the basic considerations against which the duty of care has been formulated in the past and which have made it difficult to offer precise rules. The courts are likely to keep coming back to these basics in applying any standards.

From the time of the City Equitable case in 1926 and Re Brazilian Rubber Plantations, it has generally been accepted, as Rogers J reiterates in the AWA decision, that what constitutes the proper performance of the duties of a director of a particular company depends on:

- the actual knowledge and experience of an individual director;
- the nature and extent of the corporation’s business;
- the distribution of responsibilities in the particular corporation.

It is still the case that the range of corporations of which people are directors is vast, as are the circumstances giving rise to loss. It is also true that directors and officers have many different roles—there is no profession of being a "director" or "officer" in the sense that a profession involves an established body of knowledge, an expected level of skill and an established and possibly detailed code of behaviour.

The variety of corporations also means that the depth of responsibility of directors will vary. A small corporation with few executives may present even non-executive directors with greater monitoring responsibility than a large organisation such as AWA, which had a substantial team of senior managers and, as noted by Rogers J, a highly structured and controlled system for operations other than foreign-exchange trading. Even the chief executive officer, it was acknowledged, was entitled initially to have confidence in senior management, although at a certain point he should have realised that something was wrong with management’s performance.

Non-executive directors’ role in a large corporation

Rogers J acknowledged that the board of a public corporation cannot manage the corporation’s day-to-day business. That function must by business necessity be left to the corporation’s executives. Rogers J saw a board’s functions, apart from statutory ones, as being:

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- to set goals for the corporation;
- to appoint the corporation’s chief executive;
- to oversee the plans of managers for acquisitions and the organisation of the corporation’s financial and human resources towards attainment of the goals;
- to review, at reasonable intervals, the corporation’s progress towards obtaining its goals.

As indicated, there may be corporations where less responsibility is delegated than was usual in AWA, so that the role of non-executive directors may be different. Moreover, there can be special limitations in the articles, which require the directors to be concerned with particular matters.

Chief executive officers

The responsibilities of the chief executive officer, too, will depend on the circumstances. Rogers J noted in AWA that generally a chief executive is a director to whom the board of directors has delegated management of the business. Usually, the chief executive is employed under a contract which at least implies that he or she will exercise the care and skill to be expected of a person in that position.

The degree of skill required of an executive director, Rogers J said, is measured objectively. In effect, he probably is required to give continuous attention to the affairs of the corporation. This heavier expectation of the chief executive officer is in line with the approach being taken in the United States and which has been taken there for some time in the case law, for example, on due diligence inquiries in connection with prospectuses.

Senior managers

In the context of the AWA case, directors relied on senior management to:

- carry out the day-to-day control of the corporation’s business affairs;
- establish proper internal controls, management information systems and accounting records;
- reduce to writing if appropriate and communicate policies and strategies adopted by the board;
- implement the policies and strategies adopted by the board;
- have a knowledge of and review detailed figures, contracts and other information where appropriate;
- prepare proposals and submissions for consideration by the board;
- prepare a budget; and
- attend to personnel matters, including hiring and firing of staff and their terms of employment.

Not all of those matters are necessarily the obligations of senior managers, although in the context of a large corporation it may commonly be the case that responsibility is organised in that way and that legal obligations flow accordingly.

It seems to follow that where there is some such devolution of responsibilities to senior managers, section 232, being applicable to all officers and not just directors, will impose a commensurate legal duty on them with consequent criminal and civil liabilities.
A need for law reform?

In the light of his endeavours to allocate responsibilities between directors, non-executive and executive, and senior management, as well as articulating the responsibilities of the auditor, Rogers J at the end of his judgment noted for law reformers that the division of responsibility between the different categories is not sufficiently clear.

The focus has been almost entirely on defining the responsibility of directors. Yet the commercial reality is that, as he says, "in these days of conglomerates and perhaps transnational corporations", the opportunity for non-executive directors to exercise meaningful control over management is as slight as the ability of ministers to control a vast bureaucracy.

He suggested therefore that law reformers should give more attention to the divisions of responsibility. Of course, Rogers J's judgment itself points the way to a refocusing on the responsibilities of these different groups, depending on the circumstances, readjusting the excessive emphasis on directors.

Leaving aside the question of liabilities of auditors, Rogers J's decision indicates that the duty of care needs to be defined according to the division of responsibility in the corporation and its size; then the duties can be articulated in terms of what is reasonable given the corporation's circumstances and the position of the particular officer.

It is appropriate that the general statutory standard in proposed subsection 232(4) refers to the corporation's circumstances; however, it would assist clarity if it also referred to the position of the officer.

In other cases, it has been evident that the expectations of directors depend on the defendant's position in the company. In *Metal Manufacturers v Lewis*9, Hodgson J, with whom the Victorian Full Supreme Court agreed in the *Morley* case, indicated that in determining whether the defendant had made out a defence of reasonable absence of expectation of insolvency, it was said that one considers circumstances actually known to the defendant, but also facts and circumstances which the defendant ought to know, "having regard to the defendant's position in the company and the duties associated with that position". Different judicial views of what was expected of the defendant director in the particular corporation's circumstances is one reason for the difference between such cases as *Morley* and *Friedrich*, on the one hand, and *AWA* on the other.

On the question of non-executive directors, the point has been made that directors are appointed for different reasons, even in the same company. It is accepted that a company is free to appoint "generalist" directors, those with special expertise and those who can bring to the business a general knowledge of the economy or the industry involved, or potential contacts for the corporation.

It would seem appropriate, in line with widespread opinion, to leave the task of delineating directors' duties to the courts.

Specific requirements

In the light of all of these reasons for flexibility, and the difficulty of formulating specific rules, what specific requirements have now been set? Of those that exist, some date back to earlier decisions, but there has been some development:

Duty to use actual knowledge and skill: It is clearly accepted that if a director has special skill or knowledge, he must use it.

Duty to inquire if on notice: Inattention is no excuse. A director must diligently attend to matters which have come to his notice. If put on inquiry, the director must follow up. That requirement has been perhaps the most important single expectation imposed on both executive and non-executive directors in the recent cases. It was crucial in *Commonwealth Bank v Friedrich*.

Clearly, a director cannot ignore "credible signals". He has an obligation, in terms of the American Corporate Governance Code, "to make, or cause to be made, such enquiry as the director or officer reasonably believes to be appropriate under the circumstances". However, the cases indicate that what constitutes "reasonably necessary" inquiry may be judged objectively.

Duty to bring an informed and independent judgment to bear on the subject for decision: This is now being reflected commonly in the formulation that requires a director, before making a decision, to make himself appropriately informed about the matter for decision.

Reliance on experts and officers: Qualifying the above points to some extent is the proposition that the board may delegate (subject to the Corporations Law and the articles) and that the directors may rely on committees, officers and outside experts, whose assistance they are entitled to seek and, in some cases, should seek. Provided they have reasons for confidence in those persons—in their expertise, reliability, and lack of conflicting interest—directors may rely on them. However, directors have to consider whether it is dangerous to rely on others in some situations, such as where a power to draw cheques was entrusted to someone not a director or officer.10

Some statutory due diligence defences confuse this aspect a little. For example, while directors can rely on outside experts in the preparation of prospectuses, the defence for officers (at least in section 1011 of the Corporations Law) is not as clear-cut. Some due-diligence defences may require a more active process of inquiry than is normal.

Duty to have a general understanding of the business: All of the above is consistent with the old cases. The more recent law has moved towards formulating some further obligations of a general kind. One duty articulated by Sir Douglas Menzies and since reaffirmed in the decisions11, has been the obligation of
directors to have a general understanding of their company’s business.

In this respect, if a director feels he does not have sufficient understanding, he should either acquire it by inquiry or refuse the position.

Duty to monitor in the light of that understanding: Rogers J in AWA noted that: “More recent wisdom has suggested that it is of the essence of the responsibilities of directors that they take reasonable steps to place themselves in a position to guide and monitor the management of a company (cf Commonwealth Bank v Friedrich) . . . A director is obliged to obtain at least a general understanding of the business of the company and the effect that a changing economy may have on that business. Directors should bring an informed and independent judgment to bear on the various matters that come to the board for decision.”

As a corollary, the directors must take reasonable steps to keep abreast of the information that flows to the board as a result of monitoring procedures and techniques. While the board must ensure that there is a functioning management and an internal information system to keep management informed, the board of a large corporation is not required to design, install, operate or monitor the operation of such systems, but rather to call for periodic assurances that they are in place and are being maintained.

Duty to be concerned with major staff questions: This was mentioned by Sir Douglas Menzies in his curial statement referred earlier. Rogers J in the AWA case referred to the role of the board in the appointment of the chief executive officer.

Duty to attend meetings whenever reasonably possible: In contrast with the relaxed position of a century ago which, in effect, made it better for a director to fail to attend or to be inattentive at a meeting, there is widespread agreement that a director ought to attend whenever he or she is reasonably able to do so. Perhaps the obligation may be put in stronger terms: that there must be a good excuse not to attend. Absence because of illness is referred to in Metal Manufacturers v Lewis. But the obligation to attend appears to be emerging as an aspect of diligence.

Duty to understand financial affairs and financial statements: The Commonwealth Bank decision appears to establish that directors must have sufficient knowledge and understanding of a company’s affairs and financial records to enable them to form opinions about solvency, which they must do under several provisions. Solvency declarations are becoming a common feature of statutory requirements imposed on them.

The statement in the Friedrich case has been picked up in later cases and appears to express the general standard of skill required. It may no longer be possible for a non-executive director to excuse an ignorance of financial accounts on the ground that he or she was appointed because of an expertise of a kind having nothing to do with finance.

In the 1926 City Equitable case, specific obligations concerning financial matters were stated for someone appointed to the position of finance director, but Friedrich imposes wider expectations. If that is right, it is a significant departure from the 1926 position. Some current litigation is focusing attention on this aspect.

Conclusion

Underlying difficulties remain in the path of efforts to formulate specific rules on the care to be taken by directors and officers—as distinct from a general standard of reasonableness in the corporation’s circumstances and having regard to the individual’s position. The courts have, however, given more specific indications of what they expect in terms of duties to inquire, to monitor, to delegate only to appropriate officers, not to rely on officers who are affected by conflicts and, even more specifically, to attend meetings which they reasonably can attend, to make efforts to become acquainted with the general business of the company, to ensure that there is a sufficient flow of information to themselves and others about it and to exhibit an understanding of financial affairs and records.

The courts are clearly conscious of the community’s expectations that high standards be imposed on directors, while nevertheless appreciating the realities where large corporations are concerned and acknowledging the roles of senior managers as well as those of directors and the auditor.

It would seem appropriate, in line with widespread opinion, to drop the proposed sub-section (4AA) and leave the task of delineating directors’ duties to the courts. Gradually, the strands of the duty will be clarified by the process of litigation, difficult and uncertain as that process may appear. There is, however, an overall thrust emerging from the decisions, which does take into account the actual division of responsibility in the particular corporation and the realities of the situation. Executives and senior managers should be conscious of the responsibilities which are placed on them in the division of responsibilities which is in place within many corporations.

Insofar as the general statement of the statutory standard in proposed sub-section 232(4) is concerned, it is suggested that the wording be amended to include, in addition to a reference to the “corporation’s circumstances”, an additional reference to the “position of the officer”. That would have the advantage of flagging for the court the distinction between the positions of one director and another, between non-executive directors and executive directors, between the chief executive officer and others, and between officers who are not directors and their different positions.

NOTES

2. (1991) 9 ACLC 926 at 956
3. (1959) 33 ALJ 156 at 164
4. unreported, 26 November 1991
5. (1981) 148 CLR 72
6. Re City Equitable Fire Insurance Co Ltd [1925] Ch. 407
8. [1911] 1 Ch.D 425, at 437
9. (1986) 4 ACLC 739
10. Gould v Mt Oxide Mines (1916) 22 CLR 490
11. Re Australian Venezolana Pty Ltd (1962) 4 FLR 60, at 66