The Federal Attorney-General is moving towards foisting on a protesting business community a package of difficult-to-read, long-winded and regulatory black-letter law in the form of the Corporate Law Reform Bill 1992. The tone of this package is at odds with the basic tenets of the Attorney's parliamentary colleagues on the Lavarch Committee. [The report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, chaired by Michael Lavarch MP, was tabled in Federal Parliament in December 1991.]

In strong contrast to the fat corporate law reform package proposed by the Attorney-General, the Lavarch Committee, in formulating its recommendations for change, was consciously not merely responding to past abuses—which, due to other factors, may not readily re-occur—but saw the importance of not increasing the legislative and regulatory burdens on the corporate sector.

It will be a shame if the Attorney-General pushes on with his current program of highly technical company law reform without pausing to consider the more balanced and sensible approach to be found in the report of the Lavarch Committee.

The committee's 214-page report has much to offer, not only for those who invest in public companies, but also for those who manage such companies. The report made 30 recommendations for change. This article highlights some of those recommendations that are of significance for shareholders, directors and management.

### Listing Rules and the Stock Exchange

The committee recommended that the Australian Stock Exchange (ASX) take a more active role in the enforcement of the Listing Rules and in relation to malpractices in the market for listed securities. To assist the ASX, the committee also recommended that the ASX no longer be required to give an undertaking as to damages when it takes court proceedings to enforce either the ASX business rules or the Listing Rules.

The committee rejected an ASX submission that the ASX be given qualified privilege to protect it where it considers that it has reasonable grounds to publish information or make statements to the market concerning the activities of listed companies.

However, the committee offered some assistance in this area by recommending that the ASX and the ASC form a liaison committee. Under this proposal, the ASC would use its existing powers to obtain testimony and documents where there is a suspected

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breach of the Listing Rules. The ASC would be permitted to pass the information to the enforcement division of the ASX and its legal advisers.

In addition, the ASC, after consulting the ASX, could make announcements to the market concerning suspected market malpractice or breaches of Listing Rules. Those ASC announcements would have the protection of qualified privilege.

A further recommendation of the committee is the re-drafting of the Listing Rules by those versed in statutory drafting. The aim is to have the rules expressed in a language and style which will make them more enforceable in the courts. This should also make the interpretation of the Listing Rules easier.

To ensure that the ASX attends to the re-drafting of the Listing Rules, the committee recommended that the Attorney-General use his existing power to disallow future changes to the Listing Rules if they do not comply with the committee's recommendation on style and drafting.

The enforcement of the Listing Rules against directors needed further strengthening, in the view of the committee. To this end the committee recommended amendment of the Corporations Law to provide that directors are deemed to be under an obligation to procure the company to comply with the Listing Rules.

If trading in a company's shares is suspended because of failure to comply with Listing Rules, a court should be able to fine the directors, the committee said.

Continuous disclosure

The committee was against legislation for continuous disclosure, holding that it was important not to increase the regulatory burden at a time when business enterprises are emerging from the recession.

Continuous disclosure obligations should be imposed only on listed companies and only through the Listing Rules, the committee said. It was unnecessary to introduce further amendments to the Corporations Law.

Protection for directors

The committee made a number of recommendations offering protection to directors.

The enactment of a "business judgment" rule was recommended. This would give a director immunity from liability in respect of his or her business judgment in the conduct of the company's business. That immunity would be lost if at the relevant time, it is shown that the director:

- had not informed himself or herself to an appropriate extent;
- did not act in good faith for a proper purpose; or
- acted in a manner that a reasonable director could not possibly regard as being for the benefit of the company.

Directors should have the benefit of a statutory right to rely on others to act or to provide information, the committee said. That reliance must be reasonably based and the committee sets out various parameters.

The committee recommended statutory recognition of the procedure for both advance and post-event shareholder approval for conduct or transactions which would otherwise involve a breach of duty on the part of a director.

Uncertainty about the scope of a company's ability to indemnify its directors and the extent to which the company can maintain suitable insurance policies for its officers should be resolved in favour of allowing all those things, the committee said. In saying so it endorsed the 1990 recommendations of another law review committee.

Shareholders suing directors

While the committee's recommendations offer some protections for a director, a further proposal would expose the director to direct litigation at the hands of a disgruntled shareholder.

At present, if a director has breached his or her duties and caused damage to the company, a shareholder faces certain legal obstacles in mounting court proceedings directly against the director. Further, the costs of an action may be prohibitive.

To overcome this, the committee has recommended the introduction of the statutory derivative action. This would confer on each shareholder (and certain other categories of persons or entities) the right to apply to the court for permission to take proceedings (in the name of the company) against current or former directors of the company.

The key features of the recommended statutory derivative action are:

- In seeking permission to take proceedings against the director, the shareholder would have to show the court only that there is a prima facie cause of action on the part of the company against its director. Indeed, the shareholder would not possess all the relevant information (which would be held by management of the company) and the shareholder's affidavit material would be likely to be drawn on the basis of his or her "information and belief".

- The court would not give the shareholder permission to take the proceedings against the director unless:
  (i) it is probable that the company will not sue its director;
  (ii) the shareholder is acting in good faith with a view to the best interests of the company; and
  (iii) it appears to be in the best interests of the company that proceedings against the director be taken.

- If the court gives the shareholder permission to go ahead with the action against the director, it will be able to order the company to pay all the legal costs of the shareholder in the action. This is expected to be the major benefit of the statutory derivative action. The company, which has failed to sue its director, will be funding the shareholder's court proceedings (in the name of the company) against the director.

- The Lavarch Committee was concerned that the targeted director should not be disadvantaged in terms of funding for the court action. It recommended that if the shareholder is funded by the company then the defending director should likewise be funded by the company. This would be in the form of an interest-free loan. If the director wins the case, he or she is entitled to be indemnified by the company and hence the loan does not have to be repaid. If the director loses the case he or she will owe the money to the company.

The proposed statutory derivative action has pluses and minuses. On the
positive side, the probable consequences of its implementation include:
- greater compliance by directors with their duties;
- greater likelihood of recovery of compensation for the company where those duties are breached;
- shareholders, particularly the institutional fund manager, will take a more active role in relation to problem stocks. Rather than selling out they will be more likely to stay and fight for restoration of value to the company’s stock; and
- the threat of a derivative action will be used to lever out of office those directors suspected of maladministration.

On the negative side, the probable consequences of the introduction of the statutory derivative action include:
- it may be used in strategies for getting control of companies, in much the same way as litigation has been used in the context of takeovers;
- directors’ and officers’ liability insurance will become either unprocurable (for all but the few who sit on boards of the bluest of the blue-chip companies) or prohibitively expensive;
- many applications to take derivative actions may be granted on the basis that the applicant shareholder only has to establish a prima facie case and that the affidavit material in support is likely to be drawn on the basis of information and belief. However, when the derivative action itself proceeds, it will, all too often, prove to be unjustified. The damage, in terms of reputations of individuals, time, distraction for management of the company, and the financial costs, will be very great.

There will be nothing friendly about the action. The plaintiff shareholder, using the company’s money, will be determined to leave no stone unturned in trying to win or, at the very least, vindicate the action being taken. There may be a very rapid depletion of shareholders’ funds; and
- the courts’ time will be extensively occupied by complex, time-consuming and hard-fought litigation.

One of the fundamental purposes of the ASC is to “take whatever action it can take, and is necessary, in order to enforce and give effect to national scheme laws”. It seems that the ASC welcomes the statutory derivative action as a means of delegating its own statutory responsibility for enforcement. Already, the ASC has stated in its own Policy Statement (No.4, issued 3 June 1991):

The ASC believes that the private plaintiff is best able to assess the costs and benefits of litigation. The ASC is reluctant to undertake civil proceedings, where there is a potential plaintiff with sufficient funds to bring those proceedings, but is not prepared to do so.

With the introduction of the statutory derivative action, the ASC will be even more reluctant to take its own proceedings if instead it can call on a disgruntled shareholder to determine whether the court will allow the action to be taken at the company’s expense.

The consequences are that the enforcement of the law will be less uniform, less impartial and relatively less efficient. Enforcement proceedings by the ASC, when contrasted with a derivative action, have the following benefits:
- the ASC is more objective about whether proceedings are justified;
- the ASC has a far wider range of powers to obtain evidence and prepare the proceedings;
- proceedings are more likely to be taken in a wider range of circumstances where a derivative suit would not be taken; and
- the ASC will be spending general revenue funds rather than the funds of a particular company, with the cost therefore being spread across corporate Australia at large.

It should be noted that the committee’s recommended statutory provision does not limit the derivative action to proceedings against directors and officers. It proposes that if the permission of the court can be obtained, any proceedings at all could be taken in the name of the company, such as:
- taking proceedings (in the name of the company) against a supplier for breach of contract; or
- lodging a defence (in the name of the company) to proceedings initiated against the company by some person.

The statutory derivative action recommended by the Lavarch Committee will dramatically change corporate life. Whenever a shareholder believes that the board is not prepared to take court proceedings (whether against directors or other parties), the shareholder will be able to seek permission to take up the litigation and may well be fully funded by the company.

Likely fate of the recommendations

Whether the Lavarch Committee’s recommendations will be implemented is not easy to predict, but the following is ventured as a possible result:
- The redrafting of the Listing Rules may well be resisted by the ASX, for reasons which it would do well to justify clearly. If they are not redrafted, other recommendations which would have assisted in the enforcement of the Listing Rules would fall by the wayside.
- The recommendation that a continuous disclosure regime be restricted to listed companies and implemented through the Listing Rules (rather than the Corporations Law) will face attack from a number of quarters but the recommendation may well win out at the end of the day.
- The recommendations which give protection to directors are likely to be implemented, but in a piecemeal fashion. That part of the Attorney’s current Corporate Law Reform Bill which deals with directors’ duties should be now recast to take into account the balancing factors recommended by the Lavarch Committee. If the committee’s recommendations are left to a future reform it may be difficult to have this important aspect of the law work in a cohesive manner.
- The statutory derivative action will probably be introduced.
- The other recommendations of the Lavarch Committee (not dealt with in this article, but nevertheless significant) are, in the main, likely to be implemented.