# DIRECTORS FACE A TOUGHER FUTURE

## SAME LAW, BUT IT'S HITTING HARDER

*By RICHARD WARREN*

***The way courts have interpreted corporate law has changed life for company directors. Sitting on company boards is no longer a pastime of the brainless gentry.***

Until, perhaps, the 1970s, one would hardly have concluded from the academic textbooks that the law imposed any particularly serious burden on the directors of Australia's public and private companies. From the lack of prosecutions during the 1980s, too — particularly in the face of what we are now learning about that decade — one might well have fallen into the trap of believing much the same held true.

In the background, however, a chill wind has been blowing with increasing strength. There is good reason to believe that the 1990s will see a remarkable shift in standards, both in the behaviour of those with some respect for the law, and in the life-styles of those who continue to prey on others or ignore their duties. Some of those who, in the past, chose to live a life of affluent exile on the fruits of their behaviour in "designer prisons", in countries which do not have extradition treaties with Australia, may in future find extradition irrelevant and the design of their "prisons" very much less to their liking.

The theme of this paper is that the views expressed in a number of judgments during the 1970s — and even more in the 1980s — suggest that it is unlikely that directors who fail to meet the standards required of them will have the same experience as their predecessors. And that those standards existed, *largely unnoticed and unenforced*, through most of the past 30 years.

Following this theme could be described as trying to dispel the myth of Romer J.'s judgment in the classic case of *City Equitable Fire Insurance Co.*[1] That case has long been regarded as setting out the basic duties of directors, and for a long while the Australian Companies Acts were regarded as adding little to those duties. Romer's summary of the duties of directors was as follows:

- A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.
- A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever in the circumstances he is reasonably able to do so.
- 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

*Richard Warren ASIA is a partner in the Perth law firm Corke & Co. This article is adapted from his address to the Australian Society of CPAs' Management Accounting Specialists Day.*

official to perform such duties honestly.

The case is also authority for the following proposition.

- Directors are not trustees, and there is "little resemblance between the duties of a director and the duties of a trustee . . ." Directors are agents of the company, rather than trustees — but do stand in a "fiduciary relationship" toward the company.[2]

There was not much point in Romer J. adding that last proposition — unless he meant that directors are not to be trusted — since his statement of the duties of a director implies that all the less capable offspring of the English aristocracy need to do is watch the Situations Vacant columns of the London *Times* for an advertisement for company directors who can meet the following demands:

- Skills required — whatever you are able to offer, given that we are seeking a younger man, generally with no prior experience, whose knowledge is somewhat limited as a result of genetic and chromosome displacement engendered by interbreeding.
- Duties occasionally extend to interrupting a busy golfing, tennis, shooting, hunting and fishing schedule — but we try to keep such interruptions to a bare minimum.
- In any case, please remember that we employ competent professionals from the less privileged classes and, broadly speaking, you may rely upon them to do your work on your behalf. Please do not expect the company to impose any unreasonable demands upon you.

Not long after Romer's judgment, the English had the unedifying spectacle in 1932 of Lord Kylsant being prosecuted over his role as chairman of the Royal Mail Steam Packet Company.[3] The defence was conducted at a level which reflected the apparent view of the likes of Romer J., who argue that it is jolly unfair to treat a chap like this when he has taken time off from his golf and his hunting and shooting.

Kylsant's case is authority for the proposition that while you are free to fake your scorecard when you want to revise your golfing handicap, a different morality applies if you are acting as a company director. You must, for example, refrain from telling lies in prospectuses raising funds from gullible members of the public.

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I do not believe Australia has ever espoused such a *laissez-faire* philosophy about directors' duties as existed in Britain in the 1920s and 1930s. If ever it did, the past twenty years seem to have laid to rest the concept of any domestically-spawned "establishment". And the law, I suggest, never allowed such nonsense.

Taking a 35-year leap forward, we find that with the introduction of the Uniform Companies Act in the 1960s, the duties of directors were dealt with in its section 124. The very first sentence said that a director must act honestly in the discharge of duties. Do I still hear the echoes of those of the hunting and shooting brigade who complained: "I say, that's not cricket!"?

## The 1960s to the 1980s

Section 124 proved a rather useless provision. It was before the courts in only two significant decisions — one in 1964[4] and one in 1970[5], both in the Victorian Supreme Court — and the effect was to defuse the section. In the more recent case, the court suggested that the section "is not concerned with the conduct of a director in relation to . . . anybody . . . but the company itself", that the section was concerned only with "the performance of [the director's] fiduciary duty to the company", and, finally, that "to 'act honestly' refers [only] to acting [in good faith] in the interests of the company in the performance of the functions attaching to the office of director".

The court went further, suggesting that, to be "caught" by the section, you would first have to flunk your common law duties, and, second, be caught doing so with the kind of "criminal intent" appropriate to an offence under the Criminal Code.

There was a clear message that the courts were not prepared to turn the thumbscrews any harder. So directors, assuming they lacked the brains to form a criminal intent, were left alone to be incompetent, interrupt their golf as infrequently as possible, and make the company's employees do all their work.

Nothing much more developed until 1974, and the classic Australian case of *Howard Smith vs Ampol Petroleum*.[6] The directors had been confronted with a situation in which R.W. Millers had lost its guiding light, the deceased chairman, and found itself caught in a takeover struggle. It allotted shares in its capital — or rather, the directors purported to exercise their powers under the company's articles to allot shares in the company's capital — to Howard Smith, the party they favoured to win the battle for control.

The case went on appeal to the Privy Council, which held (basically) that the power to allot the shares in question had been improperly exercised, so the shares the directors of R.W. Millers purported to allot to Howard Smith were invalid. The shares did not exist.

The case is remarkable for two other reasons. First, it is the first case I have found in which the court has actually used the word "honestly" in its plain English meaning— admittedly, only in quoting from a Scottish case, which treated doing things in the interests of the company as "honestly" and, by implication, treated doing them for an improper purpose as not acting "honestly". The Scots have apparently had this view since the time of the First World War.

Second, the Privy Council clearly differed from the views in the two earlier Victorian cases of 1964 and

1970 as to what section 124 of the Companies Act required or permitted. Remember that the Victorian Supreme Court was only prepared to recognise a duty to the company, without regard to the creditors or shareholders or anyone else. But the Privy Council held it was "improper" to exercise the power to allot shares to destroy an existing majority holding, or create one where none exists.

However, the outcome remains unsatisfying. The Privy Council held that "improper purpose" invalidated the allotment of the shares in question, but stopped short of holding the directors of R.W. Millers had acted "dishonestly".

I would ask this: If you have a fiduciary power delegated to you, to act as someone's agent in a fiduciary manner, and you are not permitted to exercise this power for an "improper" purpose, how could any reasonable person describe doing so as *not* acting "dishonestly"?

The missing link was coming up fast at that stage. The thumbscrew took another turn in the case of *Walker vs Wimborne* [7] when the High Court decided that the directors "... in discharging their duty to the company *must take account of the interests of its shareholders and creditors*. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company *as well as for them*."[8]

It was on that point that the 1970 decision on section 124 of the Companies Act had ruled that directors had nothing in particular to fear from the section, because acting honestly (within the meaning of the section) meant that directors had only to carry out their common-law duties and could ignore the creditors and shareholders. Their only duty was to the company.

In *Walker vs Wimborne*, the High Court clearly overruled the previous Australian line of authorities on the meaning of section 124 of the Companies Act, and — with it — the line of authorities relying on case law back to the judgment of Romer J. in the *City Equitable Fire Insurance Co.* case and beyond.

Whether they meant to is not the point; they did, and the case law has not turned back from that point. In any case, while the High Court has the power to overrule the Victorian Supreme Court, the opposite is certainly not possible.

Many directors in Australia have therefore been living in a fools' paradise. Many of the events of the 1970s, and certainly the 1980s, have plainly been illegal in the eyes of the judges and, after 15 years, there is no reason to expect any leniency for bad behaviour in the 1990s. And why should there be?

Another event occurred in 1975: the Companies Act was amended, adding to the director's duty to act "honestly" a further duty to "use reasonable diligence in the discharge of the duties of his office". The logic of earlier cases has already argued that, by a facetious interpretation, the duties of a director's office were to interrupt a game of golf at reasonable intervals, simply to instruct the staff to discharge the duties of his office so he could get back to the golf course.

But *Walker vs Wimborne* placed a barrier in the path of that argument, just as it did with the one relating to the duty of honesty. The stage has thus been set, since 1975, for the performance of what I could call *The Rake's Progress — the Rise and Fall of the Corporate Cowboy*.

What we have seen acted out is the longest boom in the history of the Australian Stock Exchange. We have seen the Rake strut the stage, deflowering corporate virgins and swindling shareholders on a scale never before seen and, I hope, never to be repeated.

We have seen the Goodies enter from the wings, too, pushing a wheelbarrow labelled "the ultimate weapon — the NCSC". We've seen numerous Goodies disguised as the wolf, huffing and puffing and trying to blow down the house of all the pink piggies with snouts in the trough.

We have had royal commissions into the rottenness of Australia in practically every state, territory and suburban backyard in the country. We have had reports of the Rake in his hideaway, his "designer prison" in his choice of non-extraditable country.

Meanwhile, the shareholders have had a desperate struggle repaying their "non-performing loans" to the bankers who funded the Rake's trip to Wonderland. The former Federal Treasurer half hinted that Australia's foreign debt and poor balance of payments figures have now been made "structural" by the excessive foreign borrowings by the corporate cowboys to fund endless paper chases and build endless paper empires, through endless successions of takeovers, leaving no assets behind to cover the burden of this debt.

## Modern case law

Since that stage was set in 1975, the development of directors' duties in Australia has been an anti-climax. Very little has happened. However, there have been a small number of prosecutions reported since the 1970s. And if you read between the lines, the pressure in the boiler is rising dramatically. And since the safety valve seems somehow to have become screwed down, expect a veritable explosion, sometime soon.

In *Grove vs Flavel*[9], the South Australian Supreme Court had no difficulty finding that the defendant company director had "made improper use of information" about the company's impending insolvency to shift the burden of the defunct group's debts to creditors outside his family interests.

The court took dramatic leaps forward into the real world, affirming for instance that the word "improper" is to be understood in its normal commercial context to refer to conduct which is not consistent with the "proper" discharge of a director's duties. Henceforth, "improper" actually means "improper". So if you are a director, don't behave "improperly".

The South Australian court also ruled — as *Walker vs Wimborne* already had — that what is "improper" includes disregarding the interests of the company's creditors, again underlining the fact that it is no longer sufficient to see that a director has discharged his duties to the company, without at least taking into consideration the interests of the company's creditors.

The court went further: it accepted that the recognition of duties of directors to the company's creditors is simply part of the price to be paid for the privilege of limited liability. And since there is a duty to creditors, acting in a manner which may possibly be detrimental to their interests is "improper".

In *Jeffree vs NCSC*[10], the Western Australian Supreme Court was prepared to extend this to a duty to act after proper consideration of the interests of creditors, so that directors must take account of creditors both present and future, both actual and contingent — in short, even prospective creditors.

An earlier case, *Kinsela vs Russell Kinsela*[11], makes things even more interesting. It appears not only to recognise (in passing) that the duties of directors to "the company" include a duty to the shareholders — and accordingly, that the directors may very well be unable to act without obtaining prior approval from shareholders, even where the articles do delegate to the directors the power to enter into a particular transaction — it also stands as authority for the proposition that it does not matter whether the shareholders have approved of the transaction before the directors enter into it; the directors are still acting "improperly" if they enter into a transaction which effectively disregards the interests of the creditors.

That the courts still regard directors' actions taken under the prior authority of a meeting of shareholders as illegal, because those actions disregard the interests of creditors, is something of a breakthrough.

Romer J.'s judgment in the supposedly classic statement of directors' duties is therefore becoming increasingly irrelevant — and potentially dangerously misleading. It plainly no longer states the law in Australia.

The duty to act "honestly", too, has been shifting ground.

In *Australian Growth Resources vs van Reesema*[12], the South Australian Supreme Court finally gave form to the missing link in the earlier case of *Howard Smith vs Ampol*, holding — at last — that "improper" means "dishonest". If a director does something which is viewed by the law as "improper", the director has thereby failed to act "honestly" as required by section 232 of the Corporations Law — or rather, in that case, section 229(1) of the Companies Code, which the Corporations Law replaces.

This judgment effectively overruled the earlier 1970 Victorian case on the

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original version of this section (section 124(1) of the Companies Acts of the 1960s), by stating specifically that there is no need for criminal intent for this result to follow. That had been the major blockage put up by the earlier Victorian decision. Apparently it is no longer true.

The meaning of "honesty" has taken a quantum leap forward in the eyes of the judges. The term now encompasses the standard of conduct one ought to expect from a person in a fiduciary or agency role, such as a director: more honest than the man in the street, perhaps, because he is in a trusted position. The man in the street, after all, can be jailed only if he sets out with a criminal motive; the crooked company director is the man who merely acts for a purpose objectively assessed by others as not being a "proper purpose".

And for that, he can be jailed, have civil liability for huge damages for an error of judgment (or an opinion that others do not share), or be disqualified from acting as a director for five years. Or he may be fined a lot of money, publicly disgraced and forced into bankruptcy by the costs of defending a multitude of legal proceedings.

In the same year (1988), in *Darvall vs North Sydney Brick*[13], the New South Wales Supreme Court held that the duty to act honestly extends to a duty to have regard to the interests of present and future members, the company as a commercial entity, and — also — the creditors (which means present and future, actual or contingent creditors).

The court also held that an "improper" purpose in an act by directors did not have to be the dominant one, as the Privy Council had required in *Howard Smith vs Ampol*. It was sufficient if, had the purpose not existed, the directors would not have acted in the manner complained of.

That case was largely reversed on appeal — perhaps the timing was not quite right — but, interestingly, Kirby J. dissented in the appeal judgment. In several instances in recent years, Kirby's dissenting judgments of a year or two ago have found favour in later cases and become the majority view, sometimes only a year or two later. "Kirby watching" has become something of a pastime, for that reason, among informed members of the legal profession.

So there is little comfort for anyone in the fact that the judgment in the lower court in that case was overturned on appeal. In fact, a number of features of the case are clearly in tune with the general drift of decisions in this area, which seem to be trending inexorably towards demanding of directors far higher standards than in the past.

And this is happening without any change to the law. Note that well, because one of the themes of this paper is that the changes to which I am pointing do not require any legislative amendment. All they require is a change in attitude among the judges in the interpretation of the duties of the directors. With no prior warning, but a gentle shift towards a higher standard or a harsher interpretation, the existing law could catch many directors unawares.

It is dangerous, for that reason, to seek advice on a particular transaction and go ahead with it solely on the view of one lawyer that it is not illegal. Directors are hardly likely to consult a lawyer unless they had some doubts about the propriety of the actions contemplated. Because cases do not come before the courts for perhaps years after an event, the reactions of judges in the past are not necessarily relevant.

It is likely that what has been ruled in the past to be quite legal will not, in future cases, be tolerated at all. And it is more a case of "when", rather than "whether", this is so.

In a more recent case, *Blackwell vs Moray*[14], the New South Wales Supreme Court handed down a judgment which may appear harsh. The court found the director in that case may have been "honest" in his actions, in an everyday sense, but still hadn't exercised his powers properly in the interests of the company as a whole, so was in breach of his duties. That judgment is not tied to a specific provision of the legislation; it is speaking generally of the common-law duties of directors.

One can only wonder whether under section 232(2) of the Corporations Law — the section imposing the duty of "honesty" — a director could be told he may have been "honest" in a layman's sense, but not in a way that excused him from the section, because "honesty" within the section demands that he acted also in the interests of the present and prospective future members and creditors. It is entirely possible that the courts are heading in that direction. Most of the more recent case-law would justify and support such a view.

In the *National Safety Council* case[15], Eise (a 75-year-old non-executive director) was told (among other things) that his acceptance of the accounts produced, and his signature to those accounts without checking them out thoroughly ". . . if . . . not dishonest . . . was surely conduct of the utmost folly; and . . . involved clear and flagrant breaches of both the letter and the intent of the [Companies] Code". As a result of that and other similar matters, judgment was awarded against him for $95 million.

In *Feil vs Commissioner for Corporate Affairs*[16], the Supreme Court of Victoria held a director liable for breach of section 229(1) of the Companies Code — now section 232 of the Corporations Law — for banking in his own account cheques payable to the company.

That decision is hardly surprising — except to some extent it eats away at an earlier decision, on vaguely similar

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facts, where the defendant had been excused on the grounds that it was his company. The courts are simply becoming harder on cases involving directors' duties, and less receptive to any defences. And note again that the wording of the legislation is not the reason for the shift; it is the attitude of judges, reflecting a view broadly shared in our society, that directors are expected to be better behaved, far more competent and far more active.

To lay to rest yet another of the so-called duties of directors from the judgment of Romer J. — or, at least, one of the standards Romer was prepared to accept — consider *Heide vs Lester*[17], where a housewife whose husband had appointed her as a director to make up the minimum of two directors required for a proprietary company, was held liable for the debts of the company after it failed. She was told she had impliedly consented to those debts being incurred, that her lack of business acumen or of details about the company's affairs was no excuse, and that she should have informed herself.

She was treated as being as much at fault as she would have been if, armed with an accounting degree and a knowledge of the duties of directors under the Code, she had known the state of the company before the debts were incurred, and had been directly involved in incurring those debts.

Another recent case is the Western Australian Court of Criminal Appeal's judgment in the appeal by Stephen Chew against his conviction for making improper use of his position as a director to gain an advantage for himself and to cause detriment to the company.

The court held that a criminal intent is not a necessary ingredient of the offence. It is sufficient, in the terms of this judgment, to have been a director of a company and to have gained an advantage, or to have caused detriment to the company, as a result of a deliberate act or combination of acts, with the knowledge that what is being done is not for the purpose of furthering any interests of the company, gaining an advantage for the director or some other person, or causing detriment to the company. This is less than a specific intent. In the event, the court found that Chew *did* have the requisite intent.

While criminal intent is not a necessary ingredient of the offence, the court did draw attention to the fact that it is a circumstance of aggravation under section 232(3)(a) of the Corporations Law which — if a person breaches the duty of an officer, to act honestly in the exercise of his powers and the duties of his office — will result in a harsher penalty.

There had been a suggestion in an earlier South Australian case, *Southern Resources Ltd vs Southern Residues*[18], that the decision in *Australian Growth Resources vs van Reesema* had been too widely stated, and the court indicated that it was only reluctantly prepared to follow it. Had the shifting emphasis of judicial interpretation faltered at that point, the trend towards higher duties being imposed through judicial interpretation, which I have been describing, might also have faltered.

However, the decision in Chew's case can now be expected to provide new vigour in the drive towards the establishment of even higher standards for directors of companies in Australia.

The final bullet was fired at Chew by the following question. Did he know he was in a situation of conflict, where he should have subordinated his interests to those of the company and the other shareholders? The answer to that question was "yes", and down he went.

The moral of the story is that a director simply cannot place himself in a position where his interests are in conflict with those of the company or its shareholders or creditors. That alone is now regarded as sufficient to secure a conviction. Far too many directors, I suggest, take a chance at that level.

## Conclusions

The present state of the judicial interpretation of directors' duties, in the context of the duties propounded by Romer J. in the *City Equitable Fire Insurance Co.* case, could be summarised as follows:

- A director needs reasonably advanced commercial skills knowledge and understanding. It is no longer possible (as it was in 1925) for a person to discharge the duties of a director if his skills would not enable him to ensure (for instance) that the accounts and accounting records were properly kept and accurately reflected the state of affairs and results of the company, to give a true and fair view; or would not enable him to ensure that the company was not incurring debts when it had no reasonable prospects of discharging them; or if he could not ensure that transactions were not being entered into for an improper purpose.
- While a director is not bound to give *continuous* attention to the company's affairs, he must exercise a reasonable degree of care and diligence. Merely attending board meetings falls far short of the effort he is required to make. Not only will he have to attend those meetings; he will have to prepare for them. He will also have to give time and attention to ensuring he is aware of what is happening within the company. Even a non-executive director must ensure he keeps abreast of the company's operations.
- While a director may seek to rely on other officers or employees of the company to carry out the tasks assigned to them, a director can no longer keep out of trouble by relying on them to do so. He must inform himself whether or not those tasks have been carried out and ensure that the company is being properly run, that the decisions of the board are being implemented, and that the results are accurately reported back to the board.

This point is emphasised by both the *National Safety Council* case and *Heide vs Lester*. Not only was it considered no defence to suggest that Mr Eise and Mrs Heide had relied on the other directors or the accountant or auditors; Eise was virtually told that his lack of further knowledge, because of this reliance on others, went so far beyond mere neglect that it was either reckless or fraudulent for a person in his position to behave like that.

- While directors are neither guarantors nor trustees for the shareholders and creditors, or for the company itself — and they are entitled, legally, to take commercial risks, on their assessment of what is in the interests of all concerned — they must take careful stock of extensive fiduciary duties, both at common law and under the legislation.

A director with a conflict of interest must disclose it forthwith, and take no part in the decision on whether the transaction proceeds. Many such transactions cannot proceed in any event without shareholder approval or ratification. Without *total disclosure of all relevant information* such approval or ratification is an impossibility.

No improper use can be made of information or opportunities which are obtained as a director, or while acting as a director.

A classic example is the director of not one, but two, mining companies who hears of a gold mine. He is damned if he gives it to A, because of his duties to B, and damned if he gives it to B instead — unless shareholders of the other company give him their express consent.

Some of these duties will haunt him for months after ceasing to hold office, and some continue to apply to him forever. The director who became aware of an invention while an officer of company A can never take that information to any other company of which he may later become a director, even if company A never commercially exploits it.

A director with a commercial background, such as an accountant, a geologist, or a lawyer, might well be advised to bring those skills to the boardroom and accept his fees, and never contemplate acting for the company in his professional capacity. One of the directors of Guinness, the Irish brewer, was jailed for five years because, in his professional capacity as a lawyer, he had overcharged the company for legal work done.

I do not believe there is an absolute bar against acting for the company as well as being a director but it would be prudent to put this potential conflict out of reach and act either as a director or as a professional adviser — but not both.

So the days of the brainless gentry running companies are nearing an end. The courts do not regard it as acceptable, or as a defence to a breach of the judges' interpretation of the law.

I believe the implications of that interpretation have swung heavily against directors over the past 15 years, and that this is continuing. The law used to be clearer, simpler and easier to live with, but it is constantly evolving and changing, and the manner and direction in which it is changing are making it increasingly tough for directors.

## NOTES

1 [1925] Ch. 407.
2 C.f. *Modern Company Law*, Prof. L.C.B. Gower (Stevens), 3rd ed., p. 516.
3 R.vs Kylsant [1932] 1 K.B. 442.
4 Byrne vs Baker [1964] V.R. 443.
5 Marchese vs Barnes [1970] V.R. 434.
6 [1972] 2 NSWLR 850; [1974] 1 NSWLR 68; and [1974] A.C. 821.
7 [1971-1976] ACLC para. 40-251; judgment of the High Court of Australia in March 1976.
8 Ibid; Mason J. at p. 28, 537.
9 [1986] 4 ACLC 645.
10 [1989] 7 ACLC 556.
11 [1986] 4 ACLC 215.
12 [1988] 6 ACLC 528.
13 [1988] 6 ACLC 154.
14 [1991] 9 ACLC 924.
15 Commonwealth Bank of Australia vs Friedrich [1991] 9 ACLC 946.
16 [1991] 9 ACLC 811.
17 [1990] 8 ACLC 958.
18 [1990] 3 ACSR 207 at pp. 226-7.