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INSOLVENCY PRACTITIONERS ASSOCIATION OF AUSTRALIA

NATIONAL CONFERENCE, 2008

Sydney, 21-23 May 2008

Some Remarks on the Launching of the Code of Professional Practice

By Justice RP Austin, Supreme Court of New South Wales

The last time I addressed a conference of this Association was in Brisbane in October 2006, when I spoke about the legal standard of loyalty and professional guidelines. Your president at that time introduced and welcomed my fellow speakers and me. It was an articulate welcoming address except for his closing remarks when, in a rush of slightly tongue-twisted enthusiasm, he told the audience, "I would like to spank the speakers". On that occasion I was able to escape unscathed, clutching my complimentary T-shirt, which was emblazoned, "Insolvency Practitioners Do It With Integrity". I am not sure of the fate of the other speakers.

And so I come before you today with a modicum of apprehension. Forgive me if I occasionally glance over my shoulder.

On the last occasion I made the obvious point, echoing some remarks a few years earlier by Professor Ron Harmer, that the professional association for insolvency practitioners should actively assist its members to appreciate and perform their duties, including in particular their duties of loyalty, impartiality and independence. This was for three reasons. First, the professional body could offer its members the "corporate" wisdom and experience of the profession. Secondly, the development of appropriate standards and guidelines could well influence the regulators and even the courts, who would be prepared, in all probability, to take responsible professional guidelines into account when evaluating a practitioner's conduct in a particular case. Thirdly, if the professional association was perceived not to be establishing adequate standards, faithfully observed by its members, it would be inevitable that additional standards would be enacted by law, probably highly prescriptive, detailed and complex standards which would not necessarily take into account the practicalities of daily insolvency work.

The last point deserves emphasis. The advantages of self-regulation as a regulatory strategy are well documented (see, for example, John Braithwaite, "Enforced Self-Regulation: A New Strategy for Corporate Crime Control," (1982) *Michigan Law Rev* 1466). But as soon as self-regulation is perceived to be ineffective, public opinion turns against it rapidly, for poor self-regulation tends to be equated with self-interest. The United Kingdom experience with self-regulation in the financial services industry in the 1980s is a chilling illustration of what can occur.

The Financial Services Act 1986 was enacted after the Big Bang of the London Stock Exchange and the opening up of the UK financial services industry to foreign

banks. The legislation followed recommendations by Professor LCB Gower, a prominent corporate law expert, who was instructed by the Thatcher Government to avoid the establishment of "yet another quango" (ie, the Government did not want recommendations for a US style Securities and Exchange Commission). So Professor Gower recommended a system in which there were about a dozen self-regulatory bodies supervised by the Securities and Investment Board. But the system was dissolved with the enactment of the Financial Services and Markets Act 1999 because of a series of scandals, including the theft of assets from the Maxwell company pension funds, improper sale of home income plans to elderly investors, some unseemly goings-on at the London Fox futures market, the collapse of Barings Bank, the mis-selling of personal pensions and some irregularities at Morgan Grenfell's European Growth Unit Trusts. Those advising the UK Government took the view that these problems reflected failure of the self-regulatory organisations to discharge their regulatory responsibilities, in circumstances where their members were not adhering to the applicable self-regulatory requirements. Their monitoring had been too mechanistic and they had treated the information that they received uncritically, and had failed to act quickly enough (see House of Commons Research Paper 99/68, 24 June 1999, pages 7-11; Kevin Dowd, *Money and the Market: Essays on Free Banking* (Routledge, 2001), ch 17). In consequence, the legislation of 1999 established a public regulatory body, the Financial Services Authority, and imposed public regulation on the industry. In Australia, failure of self-regulation for the insolvency profession will mean more active and comprehensive regulation by ASIC.

In October 2006 I had some critical remarks to make about the Code of Professional Conduct that had been promulgated by the IPA in May 2001, and the Statements of Best Practice relevant to the duty of loyalty, such as the statement on Independence (July 2003). I urged the adoption of clearer, more principles-oriented guidelines that distinguished between what was desirable and what was obligatory.

Now the IPA has produced a handsome and detailed new Code of Professional Practice, to be launched this morning. It would be inappropriate for me to make an assessment of the content of the new Code, by reference to the criteria established in my 2006 paper or any other criteria. I have to keep in mind the prospect that in some future case I will be asked to rule on the reasonableness or appropriateness of some provision of the Code, and I must preserve the capacity to approach that issue impartially. I can say, however, having had the opportunity to review self-regulatory codes in various professional contexts over the years, that this Code is very impressive for its structure, clarity and practicality.

The Code states principles governing the insolvency profession's work in a straightforward and simple way. The importance of a clear and simple articulation of governing principles must not be underestimated. When you delve into the details of the Code, it will be helpful to refer back to the relevant principle and keep it in front of mind. But life in any profession is not always simple and straightforward, and professionals need guidance as to how to apply the principles of their code of conduct to the complexities of real situations. And so the Code goes beyond the statement of principles and presents detailed guidance and examples, as well as templates and practice notes. That necessarily makes for a long document. The present version runs for over 100 pages. It may be possible further to simplify and

reduce the document in future, but not, I suspect, by much. There is no avoiding the inevitable: insolvency practitioners will have to read and then master this document; indeed it will be a mark of their professional status that they do so.

The range of subjects addressed by the Code appears to me to be comprehensive. For a lawyer, it is impossible to avoid making comparisons with the legal profession. After articulating the principles governing conduct, remuneration and practice management, the Code gives detailed guidance on independence, communication, timeliness, remuneration and other matters. Let me briefly supplement the Code with some lessons from the legal profession.

As to communication, it is essential not only to supply clear and pertinent information, but also to ask the right questions. An English criminal defence solicitor has recorded this interview with a client:
Are you using drugs?
No.
Do you drink alcohol?
Yes.
Have you had a drink today?
Yes.
Do you drink every day?
Yes.
When you drink, do you always become intoxicated?
Yes.
Do you consider yourself to be an alcoholic?
Yes.
Have you sought help with your drinking?
No, I drink it all myself.

As to timeliness, we are all aware of some uncomfortably long liquidations. I have reason to notice these because they corrupt our court statistics on the speed of completion of litigation. But these long liquidations are merely the fluttering of a butterfly's wings compared with legal delays in India. The author Christopher Kremmer reports, in his book *Inhaling the Mahatma*, that India holds the record for the most protracted lawsuit ever adjudicated, a dispute over control of a Hindu temple in Pune that went to court in AD 1205 and was finally concluded in 1966. Even in modern times, on average it takes 10 years for a court case to be completed in India. In October 2004 the Delhi High Court ordered a 55-year-old bank clerk who had been sacked 30 years earlier to be reinstated, enabling him to work for 5 years before his retirement. Hopefully, with the assistance of the Code, the Australian insolvency profession can do much better than this.

As to remuneration, the Code makes many points, one of which is that a practitioner is entitled to remuneration only in respect of work done that was necessary for the administration. Lawyers also pay lip service to this principle, but there might be some debate about what is necessary work. In a recent address to a LawAsia conference, the Chief Justice of Hong Kong gave the instance of a client who asked his lawyer for a breakdown of his bill. The itemised account included a charge for "recognizing you in the street and crossing the busy road to talk to you to discuss your affairs, and re-crossing the road after discovering it was not you."

During my 40 years in the law, the legal profession's work has developed greatly in the commercial area. But I am sure the development of the legal profession has been minor compared with the rapid evolution of the insolvency profession. The Code is expressed to apply to all members of the IPA in so far as they conduct or are involved in the administration of insolvencies, formal and informal. The words "formal and informal" are important. 40 years ago insolvency practitioners were accountants who specialised in bankruptcy or corporate winding up, and in the latter category, included those on the Supreme Court's rotation list. There were some specialist receivers, typically partners in accounting firms. Altogether, it was a small band. During the last 40 years we have seen exceptional growth, not only in specialist insolvency firms and specialist branches of accounting firms, but also in the nature and scope of the work. Most importantly, the profession moved into voluntary administration in the 1990s, opening up not only new work, but also new ways of doing and acquiring business. Now the profession is moving into informal "turnaround" or "workout" assignments, particularly in the corporate area. In offering themselves as experts in turnarounds, insolvency professionals put themselves in competition with a range of financial experts, perhaps most notably investment banks and private equity. In particular, in the current economic circumstances the appetite of private equity for turnaround work is not to be underestimated.

What can insolvency practitioners do to give themselves an edge in competition with others for turnaround work? In my view a substantial part of the answer is this: insolvency practitioners are professionals, and as such they can command a level of confidence from clients and creditors that would not be given to other financial engineers. What is it that makes insolvency practitioners "professionals" deserving of special confidence? The answer, in my view, lies between the covers of the Code of Professional Practice. In the language of the Chief Justice of Hong Kong:
"The virtue of [a] profession, which distinguishes it from a business, is that in its practice, the selfish pursuit of economic success is tempered by adherence to ethical standards and a concern for the public good". These are not mere words of exhortation. Their validity is tested by the presence, amongst practitioners, of sound ethical and professional standards, not only proclaimed but in fact adhered to on a rigorous and daily basis.

In my view the establishment of a comprehensive Code of Professional Practice marks the maturity of the insolvency profession and has the potential to distinguish insolvency practitioners from other operatives in the insolvency area. That potential will be realised if the Code is followed and enforced.

That leads me to a topic of great importance. No matter how elaborate and impressive the text of a code of conduct might be, it is worse than useless if it is filed away and disregarded in everyday practice. Worse than useless because, if the conduct of a practitioner is challenged in court, the practitioner will be cross-examined along these lines:
Have you heard of the IPA Code of Professional Practice?
Do you have a copy of it?
Have you read it recently?
What have you done to ensure that you and your employees comply with it?

If these questions are not answered satisfactorily, the practitioner can only expect the gravest consequences.

What is needed, therefore, is for insolvency practitioners both to master the Code themselves, and to take appropriate steps to ensure that it is a living instrument governing their conduct and the conduct of everyone in their firm. This can only be done if steps are taken, structured around the adoption of the new Code, to inject into the firm a culture of compliance. Those steps would include tuition, discussion, and leading by example. If the firm is of significant size, they would include the establishment of a compliance system, with regularly tested protocols for identifying issues and ensuring they are dealt with at the right level within the organisation.

You might infer, correctly, that the task is large, possibly even daunting. But you can take encouragement from the fact that the principles you are asked to adhere to generally reflect sound common sense and a sense of doing things in the proper way. I wish you well in your endeavours.

Let me conclude by reminding you of one matter of basic common sense. Before you sign off on a document, be it a report to creditors, or financial statements, or the text of a deed of company arrangement, it is a very good idea to read the document yourself. It is depressingly common for judges to find that the contents of such documents have been simply lifted from precedents, without proper review. When, however, you review the document, you must make absolutely sure that it contains clause 10.4. Clause 10.4 is so important that it was recently published in England in the *Times Online*. It is as follows:
"**10.4 End of the world**. Upon the occurrence of the end of the world … the notes and drafts, at the option of the required banks, will become immediately due and payable in full and may be enforced against the company by any available terrestrial, extraterrestrial or spiritual procedure. For remedial purposes … the company, by virtue of its attorneys, will be deemed to be aligned with the forces of light, and the banks and their attorneys will be deemed to be aligned with the forces of darkness, regardless of actual ultimate terrestrial, extraterrestrial or spiritual destinations of the company or the banks or any of their particular officers (including, without limitation, the Treasurer and the Vice President-Finance)."

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Mergers And Acquisitions 2007

University of New South Wales
Faculty of Law
Centre for Continuing Legal Education

MERGERS AND ACQUISITIONS 2007
24 October 2007
Opening Commentary
by Justice RP Austin

With his usual efficiency, Christopher Lemercier has given me access to the papers for this morning's seminar, so far as they have been made available to him. As one would expect, the conference program identifies some critically important issues confronting M & A lawyers today.

In the first session, David Friedlander of Mallesons will consider developments in international mergers and acquisitions, including the prospects for private equity transactions, and global trends in light of the tsunami effects of the US sub-prime mortgage crisis.

Leon Pasternak of Freehills has prepared a wide-ranging paper canvassing the responsibilities of directors and their advisers. Not only does he survey statutory and case law and guidance notes provided by the Takeovers Panel. He also offers some practical steps and tips for managing conflicts of interest.

Leigh Brown of Minter Ellison will speak on developments in mergers by scheme of arrangement, including trusts. Several problems have been identified in recent Federal Court and Supreme Court decisions that will no doubt be canvassed.

Karen Evans-Cullen of Clayton Utz will discuss some developments concerning the Takeovers Panel. She will review the Panel's track record and consider the amendments that took effect earlier this year concerning its powers, in response to the *Glencore* cases ((2005) 54 ACSR 708; (2006) 56 ACSR 753). She will also review the *Alinta* decision in the Full Federal Court ((2007) 62 ACSR 196), from which the High Court has recently heard an appeal, reserving its judgment. She will ask, "where to now for takeover disputes?" She will also consider the Panel's draft Guidance Note on derivatives.

In my opening commentary, I propose to raise some subjects pertinent to the first three papers, offering some necessarily general and tentative observations on each of my selected subjects. I shall talk about:

- the short-term future of private equity transactions;
- executive directors of the target participating in a bidding consortium;
- some current issues in merger schemes.

I then want to make a few remarks about the current state of Australian statutory company law and in particular, what seems to me a deplorable trend in the drafting of legislative amendments. I have decided not to say anything about the subject matter of Karen Evans-Cullen's paper, principally because she addresses issues that have been argued before the High Court but not decided. My views about the *Alinta* case in the Full Federal Court, and the Corporations Law Amendment (Takeovers) Act 2007 enacted in response to the *Glencore* decisions, are set out at length in Chapter 23 of Ford.

The short-term future of private equity transactions

Recently I was responsible for organising the second Supreme Court/Law Society Corporate Law Conference in the Banco Court in Phillip Street. The book containing the edited conference transcript, and an excellent essay on private equity by my young academic colleague, Andrew Tuch, will become

available for conference participants, and for sale to others, from this coming Friday through the Ross Parsons Centre at Sydney Law School. It is called *Private Equity and Corporate Control Transactions*, edited by me and Andrew Tuch.

I mention it here not to promote sales, for the book will sell itself, but rather to tell you something I found striking about the remarks of the speakers. When we decided to hold the conference, private equity was rampant and seemed unstoppable. Myer had fallen, Coles was in negotiation and Qantas was under offer. Internationally, transactions of staggering size were being announced. Globally private equity investment had increased from just under $US200 billion in 2001 to over $US800 billion in 2006. It was party time for M&A lawyers. Then came the US sub-prime mortgage crisis, the collapse of two Bear Stearns funds, and widening ripples in the credit and equity markets. I wondered what our speakers would be able to say about private equity, in the prevailing turbulence as at 28 August 2007.

Strikingly, the unanimous verdict of the speakers was that private equity transactions would continue as a significant force in mergers and acquisitions. Future transactions would be different and in particular, there would be a more commercial approach to the pricing of risk. But private equity would still be there. As David Gonski concluded:

> "For so long as we have extensive disclosure requirements and a great deal of law and market conventions applicable to listed public companies, privately owned businesses will be able to take substantial advantage of the system".

And so the legal issues posed by private equity transactions - for instance, problems relating to whether to prefer schemes to takeover bids, whether to accept no-shop and no-talk clauses and break fees, whether to disclose a private equity approach to the market, and how to deal with participation by management of the target in the buying consortium, issues addressed in the August conference and today, are very much worthy of careful consideration.

Executive directors of the target participating in a bidding consortium

Suppose that a bidder, typically private equity, invites key executive directors, including the chief executive, to join the bidding consortium, with an offer of equity participation as well as greatly enhanced remuneration if the bid succeeds. Is there a legal problem for the executive directors? How should the rest of the target board respond?

These questions have received intense attention in recent times, in light of various transactions that I shall not discuss. Leon Pasternak addresses the issues in his paper for today's conference. Like many other commentators, he speaks of "managing" conflicts of interest and, following the lead given in the Takeovers Panel's Guidance Note, he proposes some protocols and practical advice for conflict management in these situations.

But of course, as Leon is aware, Guidance Notes by the Takeovers Panel, worthy though they are, are of the limited significance. They only assist if the question is whether the Panel will exercise a discretion vested in it under the Corporations Act. They do not purport to affect the content of the statutory and equitable fiduciary duties of executive directors. The Panel itself acknowledges, at [22] of Guidance Note 19, that compliance with its protocols may not be adequate to discharge the duties and responsibilities that apply.

Guidance as to the law is to be obtained from the text of the legislation and the cases. In Australia, unlike the United Kingdom, the statutory provisions are not exclusive, and so the general law of fiduciary duties may have an application where the statute does not.

Recently two leaders of the Australian bar, one a former Federal Court judge, have given presentations as to the content of the duties in issue. They have spoken with substantial but not complete consistency.

The first presentation was a written paper by Neil Young QC, delivered at a Law Council Workshop in South Australia on 21 July 2007. Mr Young carefully reviewed the general case law on fiduciary duties and the various statutory provisions that affect the position of the executive director.

Referring to *Furs v Tomkies* (1936) 54 CLR 583 and other cases, he said (at [56]):

> "When these principles are translated to the private equity context, it becomes plain that senior executives of the target company cannot, consistently with their fiduciary duty, agree to accept substantial incentive or equity packages from a bidder without approval of the target company's shareholders. If they do, they will breach their fiduciary duties and will be bound to account to the target company for any profits they make. Even if executives in this position disclose all of the details of their incentive packages to the target company's board of directors, that would not afford an answer to their breach of fiduciary duty. The fully informed consent of the target company's shareholders would be required to authorise or ratify private incentive or profit arrangements of this kind."

Mr Young also expressed the opinion (at [99]) that, in addition to the general law fiduciary duty, if a senior executive of the target agrees to accept a financial package from the bidding consortium as an inducement for that person to remain on after the acquisition is completed, the case potentially falls within s182, which prevents an officer from improperly using his or her position to gain an advantage or cause detriment to the corporation.

He contrasted Australian law with US law, under which it is thought that directors can usually overcome conflicts by disclosure and abstentions. He said (at [102]):

> "Under Australian law, the true position is that, in some instances, a declaration of the conflict, full disclosure of all relevant circumstances and abstention from discussion and voting may be sufficient for a director to discharge his or her obligations. In other instances, it will not; the approval of the company in general meeting may be required, the director may have to take steps to eliminate the conflict, or special circumstances may require a director to take positive steps to protect the company (e.g. by recommending a particular course of action)."

Tom Bathurst QC addressed these issues in his presentation to the Supreme Court/Law Society Conference on 28 August 2007. He said (at p 79):

> "Members of management who may benefit from the proposal either by incentives to stay on or by encouragement to participate in the bid, are plainly in a position of conflict in making recommendations based on the indicative price, in making recommendations as to whether an exclusivity period is appropriate and, subsequently, recommendations on whether an offer should be accepted, its terms or any break fee. To avoid that conflict arising, it will be necessary, first, for the management concerned to disclose fully and frankly details of the negotiations with the private equity bidder, and thereafter to take no part in the decision-making process on behalf of the company. The negotiations and ultimate decision must be left to an independent board, taking such independent expert advice as it regards as desirable."

The position is different, in his view (at 80), if management actually solicits the private equity bid: "What they cannot do, however, is promote a bid as a means of advancing their own position. … Quite apart from the general law obligations, such conduct could involve an improper use of their position prohibited by s 182 of the Act and an improper use of information prohibited by s 183."

Referring to *Furs v Tomkies* and other cases, he said (at 80): If an existing employee is offered shares or other incentives to participate in the bid or to stay on with the company after the transaction is completed, it seems to me that there is a real prospect that he or she is improperly profiting from his or her position as an officer of the company."

On the question whether conduct of this kind is capable of ratification by an independent board or whether ratification by the shareholders is necessary, he referred to *Queensland Mines v Hudson* and said (at 81):

> "Where an independent board reaches the conclusion that a transaction is in the interests of shareholders, and that a necessary incident of the transaction is that the benefits to be provided to the officer necessary to keep the officer there and to ensure that the bid is made and proceeded with in the best interests of shareholders, then in my opinion (but without any certainty) the board's approval would provide the necessary informed consent of the company. The issue, however, remains controversial."

Presumably the board is "independent" only if the executive who stands to benefit from the bid is not, himself or herself, a director.

There is much common ground in the views presented by Mr Young and Mr Bathurst, both of whom emphasised the strict and inexorable character of fiduciary duties. But there are differences on two matters:

- whether executive officers will ever be sufficiently protected simply by making full disclosure to the board and excluding themselves from further involvement in the negotiations on behalf the company;
- whether, if there is an independent board, the fully informed consent of the company can be given by that board or only by the shareholders in general meeting.

As Mr Bathurst observed on several occasions during his presentation, questions of this kind are tested in the courts not at times of readily available capital and booming markets, when everyone is doing well; they are tested when things are going wrong. Inevitably the courts will be asked to pronounce on these matters, and recent difficulties in the markets suggest that this could be sooner rather than later. It would be premature for a judge to seek to anticipate the outcome of such litigation, especially when so much will depend on the facts of the instant case. But it does seem to me that talk about managing conflicts of interest in this situation is at risk of losing sight of the strict standards set by the law. Some conflicts cannot be "managed"; they must be avoided. As Mr Young emphasised in his paper, courts have frequently said that the law demands undivided loyalty from a fiduciary. The question is not whether there is an actual conflict; the question is whether there is a real sensible possibility of conflict. If there is, either the conflict must be eliminated (for example, by the executive director rejecting the offer of benefits) or the proposal must obtain the fully informed consent of the company. The court will be interested to know whether, and if so why, the instant facts are distinguishable from *Furs v Tomkies*.

Some current Issues in Merger Schemes

The central issues for the court, when it is asked to approve a scheme of arrangement, are constant and readily understandable: does it comply with the law; was it approved on the basis of adequate information by the shareholders acting in good faith; is it sufficiently fair and reasonable that an intelligent and honest shareholder, acting alone, might approve it. Those are always the matters to be addressed by the applicant for approval.

There are, however, some other issues, more or less subsidiary, that attract the attention of counsel and the court, frequently because the issue in question has been raised in a recent decision or line of decisions. In recent cases courts have been concerned with three such issues: credit or performance risk, the acquisition of encumbered shares, and lock-up devices. There is a detailed discussion of these three issues in *Ford's Principles of Corporations Law* at [24.071]. There is not much more to be said about credit or performance risk and lock-up devices, but the acquisition of encumbered shares is a subject warranting further consideration.

The issue of credit or performance risk is relatively straightforward and does not present any insuperable problem, provided that the issue is recognized and addressed by, for example, setting aside the cash portion of the scheme consideration in a trust fund immediately before the vesting of the shares in the acquiring company.

There was some concern about the court's attitude to lock up devices (such as no-shop and no-talk causes and break fees), especially when Lindgren J in the *APN* case ([2007] FCA 770) stated some requirements going beyond the Takeovers Panel's Guidance Note 7. But in the *Investa Property* case the same judge accepted an affidavit to the effect that the arrangements were agreed to by the company following ordinary arm's-length commercial negotiations during which the parties were separately advised by advisers with extensive experience of transactions of that kind.

In my opinion there is still more to be said about the question of acquisition of encumbered shares. In the *Webcentral* case ((2006) 58 ACSR 742) the court decided that a "no encumbrances" clause (that is, a clause in the scheme stating that the scheme shares would be transferred free of encumbrances) was to be excluded by amendment to the scheme after the shareholders had approved the scheme.

The court took the view that the presence of the clause might have given the impression that the interests of holders of security were being adversely affected.

In the *Investa Property* case ([2007] FCA 1104) the court did not object to a similar cause that was expressed to apply "to the extent permitted by law". The court was concerned that there might be some cases, probably rare, where a third party has an equitable interest in shares (typically as a financier) and the acquiring company has notice of that interest. Lindgren J said he saw no reason why the court should do anything that might give the impression that it was supporting the extinguishment of the third party's equitable interest in such (presumably rare) circumstances. He said that at the very least, before approving a scheme containing an unqualified "vesting free of encumbrances" term, the court would require evidence that the acquiring company had no notice of any third party interests.

There is a live issue as to whether this reasoning imposes an unnecessary restriction on the operation of s 411. The issue is canvassed in Ford. The argument is made there that the principal attraction of a scheme of arrangement, when compared with other methods of corporate reconstruction, is that the court's order implementing the scheme achieves certainty of outcome, an achievement that would be compromised in the case of transfer schemes if the court's order were to be subject to the prospect that the holder of an equitable interest over the transferred shares could assert a claim over the shares in the hands of the acquirer. It would be surprising if the scheme procedure could not extinguish security interests over transferred shares, given that other methods of compulsory acquisition of shares apparently do so.

The future of Australian company law

When I began studying company law in 1967, it would have been accurate to say that nothing in the companies legislation was as important, in the life of companies and their officers, as the major general law decisions of the appellate courts, in cases such as *Mills v Mills* (1938) 60 CLR 150, *Ngurli v McCann* (1953) 90 CLR 425 and *Furs v Tomkies* in the High Court, and *Regal (Hastings) v Gulliver* [1942] 1 All ER 378 and *Boardman v Phipps* [1967] 2 AC 46 in the House of Lords. The principles enunciated by the courts in those cases affected day to day management of Australian companies, particularly when management was under stress.

Today it is statutory company law that has the primary day to day impact on corporate activity: statutory formulations of the basic duties of company directors and officers; provisions defining the metes and bounds of corporate fundraising and regulating in detail the provision of financial products and services; prescribing the content of periodic and continuing disclosure including remuneration disclosure; reinforcing accounting and auditing standards and proclaiming rules for auditor independence; regulating corporate acquisitions; creating statutory liability for companies (and ancillary liability for directors and officers) for misleading conduct; and exposing directors to liability for insolvent trading.

The dramatic elevation of the importance of statutory company law carries with it a responsibility for the legislature, the government and its advisers. It is of fundamental importance that statutory laws be clear, simple and knowable. It is strongly desirable, when the law seeks to regulate those commercial activities where time is often of the essence, that the law be understandable in its basic components by business people in their own right, without recourse to lawyers. These things are important because valuable commercial rights are at stake, which can be greatly diminished if the legislature casts a shadow of uncertainty over them.

Admittedly, clarity and simplicity are aspirations that will never be perfectly achieved, because of the complexity of the subject matter and the limits of human ability. But we need to demand, persistently and with force, that modern statutory company law be regularly and systematically reassessed by reference to these benchmarks.

The Corporations Law Simplification Program of the 1990s led to some real achievements in reversing the trend towards longer and more complex legislation. The First Corporate Law Simplification Act 1995 was dramatically successful in reducing the number of registers to be maintained by companies and in slashing through the verbal thicket of the old share buy-back provisions. The Company Law Review Act 1998 (essentially the Second Simplification Act, re-badged after a change of government) was even more dramatic, not merely simplifying language but fundamentally changing the basal concepts in such areas as share capital. But every significant amendment to the corporations legislation since that time (with the single exception of the replacement of the co-operative state system with a national Corporations Act) has added substantially to complexity and, it has to be said,

has created obfuscation.

The very mention of the Financial Services Reform Act 2001 will produce moans of despair. It is not just the excessive detail and complexity of the drafting, the devastatingly comprehensive abandonment of the principles of simplification, that causes difficulties; it is also the extent to which the legislative text is affected by regulations and ASIC modifications, adjustments that evidently became necessary because of flaws in the formulation of policy and legislative text.

Then there is the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 ("CLERP 9 Act"). Most M&A lawyers do not have to grapple with the auditor independence provisions, but rest assured that the drafting is every bit as depressing as the FSR Act. As we point out in Ford (at [10 .455]), the statutory language establishes duties in parallel with but different in content from the general law fiduciary duties of auditors.

The drafting of the Corporations Law Amendment (Takeovers) Act 2007 is problematic in some respects, as pointed out in Ford (at [23.600]). But the legislation is generally acceptable, partly because it is short and partly because there was effective consultation with those primarily affected.

On 28 June 2007 we were given another example of the legislative drafter's delinquencies, when the Corporations Legislation Amendment (Simpler Regulatory System) Act 2007 commenced. The centrepiece of this legislation is an attempt to remove the prospectus requirement for a rights issue. But the drafting displays a peculiarly 19th-century understanding of rights issues, and the legislation does not seem to work when it comes to modern variants such as jumbos and RAPIDS. Not only that, but the purported exemption only works if the issue gives the securities exchange a "cleansing" notice that complies fully with the statutory requirements. If something is left out, the legislation gives protection from contravention of one of its provisions (s 727) but not others (ss 723(1) and 734(2)). These problems are explained in detail in the most recent supplement to Ford. Relying on the exemption will require a measure of courage.

But that is not the only issue with the new legislation. The legislation substantially winds back some of the auditor independence provisions that were enacted to give effect to recommendations of the HIH Royal Commission. To take just one example, the two-year exclusion period during which a former audit partner cannot become an officer of the audited client has been re-calibrated to become far less effective. Before the amendment, the two-year period began when the partner ceased to be a partner in the audit firm. After the amendment, the two years is measured from the date of the last audit or half-yearly report in which the partner participated as a professional member of the audit team for the client. If the partner moves out of the audit team for the client at least two years before retiring from the partnership, there is no longer any restriction on joining the client immediately upon retirement, even though the partner has continued to enjoy profit distributions contributed to by the client right up to retirement and would probably have every incentive to support the firm uncritically in his or her new position.

There are questions about the policy foundations for the changes made by this legislation; there are questions about how important shifts of policy were implemented under the guise of simplifying the regulatory system; there are questions about the adequacy of consultation and public exposure of the proposals; and there are questions about the style and efficacy of the drafting. Underlying these questions there is (or should be) a deep concern as to whether legislative drafting of corporate law reform is in the right hands.

One only has to compare the drafting of any of the samples of corporate law reform offered up since the commencement of the Corporations Act, with the drafting of the UK Companies Act 2006, to realise how much scope there is for improvement here. Some of the provisions of the UK legislation are controversial, especially in the field of corporate social responsibility. I do not wish to fuel the fires of that controversy here. I refer, instead, to the statutory restatement of less controversial directors' duties, which is made in the UK Act with an elegance, clarity and simplicity that we would do well to emulate.

We can and should do a great deal better than we have in the corporate law amendments of the last six years. The legal profession should make it clear that drafting and processes of the kind exemplified in the Simpler Regulatory System Act is not to be tolerated. Those instructing Parliamentary Counsel must lift their game. One wonders whether part of the problem might be the transfer of responsibility for corporations legislation, in the second half of the 1990s, from the Attorney-General's Department to Treasury. Would there be a better understanding that incompletely debated policies, reflected in badly drafted legislation, actually undermine the efficacy of important commercial rights, *and therefore*

economic efficiency, if responsibility for the process is transferred back to the lawyers of Attorney-General's?

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Implications of the Sons of Gwalia Decision

LAW COUNCIL OF AUSTRALIA
BUSINESS LAW SECTION

Corporations Workshop
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Glenelg, South Australia

"Implications of the Sons of Gwalia Decision"
A commentary on the paper by Konrad de Kerloy

Commentator: The Hon Justice Robert Austin, Supreme Court of New South Wales

Introduction

My comment on Mr de Kerloy's paper will focus on the question of scope of the High Court's decision in *Sons of Gwalia*. The ideas I shall put forward are presented more fully in the most recent update to *Ford's Principles of Corporations Law*, especially at [24.501]-[24.510].

To understand the scope and significance of the High Court's decision, it is necessary to proceed step by step, by considering:

- the principle of maintenance of capital;
- the rule in *Houldsworth's* case; and then
- statutory deferral of shareholder claims in liquidation.

The principle of maintenance of capital

The principle of maintenance of capital was one of the three foundational principles of 19th-century British and Australian company law. The other two were the concept of limited liability and the idea that a company had power to act only if the power was conferred upon it by its memorandum of association. The third principle, the doctrine of ultra vires, was abrogated by legislation that reflected an important change of policy. But the other two principles, maintenance of capital and limited liability, have been retained, although both of them have been substantially qualified by statutory reforms.

In the *Sons of Gwalia* case, Gummow and Hayne JJ made the point that there is no common law of companies: the company is a statutory creature and the principles governing it must be derived from statute. The 19th century principles conformed to these propositions. Though the principles were given wide application, each of them was derived from the express provisions of, or by necessary implication from, the terms of the companies legislation.

In the case of maintenance of capital, the statutory reforms now offer simple procedures for share buybacks and reductions of capital. But those statutory provisions reinforce the general principle, because they assume that in the absence of facultative provisions, a reduction of capital or a share buyback would be contrary to the companies legislation and therefore invalid. Thus, s 256B permits the company to reduce its share capital "in a way that is not otherwise authorised by law" in certain circumstances.

The principle of maintenance of capital extends to transactions that have the *indirect* effect of returning paid-up capital to members. That was made clear, in Australia, in *Australasian Oil Exploration Ltd v Lachberg* (1958) 101 CLR 119 and *Davis Investments Pty Ltd v Commissioner of Stamp Duties (NSW)* (1958) 100 CLR 392. The breadth of the implications of that proposition has been demonstrated in later cases (for example, *Jenkins v Harbour View Courts Ltd* [1966] NZLR 1; *Re Archaean Gold NL* (1997) 23 ACSR 143; see Ford [24.360]). Where a transaction constitutes an indirect return of capital to members, not authorised by any provisions of the Corporations Act, the transaction is invalid by application of the maintenance of capital principle. That is why, when *Jenkins v Harbour View Courts*

made it evident that the principle of maintenance of capital would affect the administration of residential home unit companies in a fashion thought to be undesirable in terms of policy, it was necessary to amend the legislation (see now s 258B).

If a subscriber for shares recovers damages from the company for actionable misrepresentations or misleading and deceptive conduct in connection with the offering of the shares for subscription, the damages will normally be measured by the difference between the subscription price and the value of the shares. If the shares are worthless, the shareholder's damages are equivalent to the subscription price (subject to claims for consequential loss or, in the Trade Practices Act context, loss of opportunity). If a shareholder is permitted to recover the subscription price for the shares, while remaining a shareholder, the recovery of damages has the effect, indirectly, of a return of capital. The principle of maintenance of capital appears, therefore, to be an obstacle to a successful action by the shareholder, unless there is a statutory provision that expressly or by necessary implication overrides the application of the general principle. As noted below, it is arguable that ss 553A and 563A have this effect when the company is in liquidation; and that certain statutory causes of action have like effect whether or not the company is in liquidation.

Sometimes judges have described the principle of maintenance of capital by using imprecise language, which appears to reflect a lack of understanding of financial accounting. They refer to paid-up capital as a "fund", as if it were represented by an identifiable asset or assets, to be preserved for the protection of creditors, who are said to rely on the preservation of that fund when deciding to extend credit to the company (for example, *Trevor v Whitworth* (1887) 12 App Cas 409, per Lord Herschell at 414; in the same case Lord Watson said (at 423-4) that persons who deal with the company "are entitled to assume that no part of the capital which has been paid into the coffers of the company has subsequently been paid out, except in the legitimate course of its business").

In the discussion in *Ford's Principles of Corporations Law*, we refer to the idea that paid-up capital is a physical fund as "the supposed capital fund principle". If it were the true basis of the law of maintenance of capital, the supposed principle would suggest that the law of maintenance of capital is engaged in much broader circumstances that have been thought to be the case: for example, a payment of damages to a purchaser of shares would be just as capable of diminishing the "fund" of paid-up capital, to the detriment of creditors, as would the payment of damages to a subscriber.

There are at least three difficulties with the supposed capital fund principle:
(1) the idea that paid-up capital is a "fund" physically preserved in the "coffers" of the company for the protection of creditors does not reflect the way modern corporations manage their assets or account for paid-up capital, as Callinan J (dissenting) clearly explained in *Sons of Gwalia* at [250];
(2) the supposed capital fund principle suggests that creditors are entitled to be protected against any diminution of the "fund" other than by ordinary trading, whether the diminution is by return of capital to members or by payment to some third party;
(3) the supposed capital fund principle would be an ineffective instrument of creditor protection, because in modern commercial conditions credit risk is assessed by reference to such matters as cash flow, liquidity, assets and liabilities, shareholder support and credit history, and the question whether paid-up capital has been preserved does not, as such, play a part in the assessment.

An important aspect of the High Court's decision in *Sons of Gwalia* is the recognition by Gleeson CJ (at [5]) and Gummow J (at [84]-[85]) of the defects in the supposed capital fund principle. Each of their Honours gave voice to one or more of the above three criticisms. Those criticisms are strongly expressed and seem to have the effect that the supposed capital fund principle has been excoriated once and for all (at least in Australia).

In *Ford*, it is suggested that a more accurate formulation of the principle of maintenance of capital ties the principle to the concept of limited liability. In *Ooregum Gold Mining Co of India Ltd v Roper* [1892] AC 125 at 145, Lord Macnaghten, citing *Buckley on the Companies Acts*, said that "the dominant and cardinal principle of these Acts is that the investors shall purchase immunity from liability beyond a certain limit, on the terms that there shall be and remain a liability up to that limit". This characterises the principle of maintenance of capital as a principle relating to members, which does not depend upon the idea that paid-up capital is a physical fund.

Once the proper basis for the principle of maintenance of capital is understood, the force of the policy underlying it can be assessed. Like the other 19th century principles of company law, time has shown that the principle of maintenance of capital is not to be applied with absolute rigour and without exception. It is generally unfair to allow subscribing shareholders to have the benefit of limited liability if they are relieved of their obligation to provide the paid-up capital that they have undertaken to provide when applying for the shares, or the capital is returned to them. But the legislature has decided that

this is not an unfair outcome where, for example, the conditions for a reduction of capital or share buyback are satisfied. In the present context, there is a real question whether the indirect reduction of capital that occurs when a subscriber recovers damages from the company, equivalent to the subscription price, is always so unfair that recovery should be prohibited - especially where the subscriber can show that the company has engaged in fraudulent misrepresentation and there are issues of investor confidence and market integrity at stake.

The rule in Houldsworth's case

It is easy enough to give a textbook formulation of the rule in *Houldsworth's* case. The formulation we give in Ford [24.501] is this:
"a subscriber for shares in a company cannot, while remaining a member of the company, recover damages from the company in that capacity for misrepresentation in connection with the subscription."

It is said that the subscriber's proper remedy is to take proceedings in equity for rescission of the contract of allotment, in which the company will be required to make restitution in integrum by returning the subscription money. But rescission is not available in certain cases, including when the company has gone into liquidation (see Ford at [24.503], noting the discussion of Gummow J's observations on rescission in *Sons of Gwalia* at [59]). As McHugh J observed, dissenting, in the *Webb Distributors* case ((1993) 179 CLR 15 at 39), the rule is a source of injustice where the company is in liquidation, because the defrauded shareholder can neither rescind nor obtain damages.

The principle underlying the so-called rule has been said to be "famously elusive" (*Sons of Gwalia* at [14], per Gleeson CJ) and "of legendary impenetrability" (by counsel in submissions at first instance in *Soden v British & Commonwealth Holdings plc* [1995] BCC 531; see BCC at 537 per Robert Walker J). The *Houldsworth* case gave rise to a celebrated debate between Professors Gower and Hornby: (1956) 19 Mod LR 54; 61; and 185.

A careful reading of the speeches in the House of Lords discloses two rationales for the rule, one of which is now incorrect while the other supports a very narrow principle. One rationale is that the fraudulent conduct which induced the appellant to subscribe for shares should not be attributed to all of the shareholders (treating them as if they were partners) except one, namely the appellant ((1880) 5 App Cas 317 at 329 per Lord Selborne). In *Sons of Gwalia* Gummow J, taking up a theme advanced by Prof Gower, criticised this reasoning on the grounds that it failed to recognise the separate entity of the corporation (at [63], [69]-[70]), and that it has been superseded by later authority (e.g. *New South Wales v Lepore* (2003) 212 CLR 511).

The second line of reasoning discernible in the speeches in the House of Lords is that there is said to be an inherent inconsistency between the claimant's position as a member, liable as such to contribute to meet a shortfall in liquidation up to the limit of his or her liability, and the claimant's position as a creditor, seeking under the contract of allotment to recover at the expense of the body of shareholders including the claimant (*Houldsworth*, at 333 per Lord Hatheley). A member, it is said, should not be permitted to "approbate and reprobate" by maintaining his or her position as member while at the same time recouping in substance the whole or part of the subscription money (Earl Cairns LC at 325). Again the partnership analogy is called in aid, for a partner who is a creditor of a bankrupt firm cannot prove in competition with the firm's external creditors, because that would diminish the partnership assets available to meet the claims of the creditors of the firm, who are also the creditors of each partner.

There are several problems with this reasoning. In *Sons of Gwalia* Gleeson CJ criticised it on the ground that it misuses the partnership analogy (at [3]-[4]). Professor Hornby endeavoured to support the reasoning, but his analysis seems to depend crucially on the idea that on the facts of *Houldsworth*, the shareholders of the company had unlimited liability to pay calls. Where the company is an unlimited liability company (or a company with substantial unpaid calls), and there are insufficient assets to meet a damages claim made by a subscriber, allowing the damages claim would lead to a kind of infinite regression of "interlacing claims" (*Houldsworth* at 333 per Lord Hatheley), in which recoverable damages would rise when the call was made, forcing the company to make another call to meet the additional liability, thereby giving rise to a further increase in recoverable damages, and so on: "something akin to perpetual motion would be involved for the merry carousel would go round till the end of time, the aggrieved shareholder being eventually obliged to pay call after call to meet his own claim in damages" (*Re Dividend Fund Inc (in liq)* [1974] VR 451 at 454 per Anderson J).

In Ford [24.501], it is submitted that no similar "inconsistency" arises in the case of a limited liability company where all shares are fully paid. To the extent that *Houldsworth* is based on the "inconsistency" analysis, it is strongly arguable that the case should be confined to unlimited liability

companies or companies with substantial unpaid calls, in circumstances where there are insufficient assets to meet the damages claim.

If, then, neither of the lines of reasoning actually advanced in the House of Lords to achieve the outcome in *Houldsworth* would support the rule as formulated, does it follow that the rule is without any foundation in principle? No, because later cases have supplied a rationale that their Lordships did not themselves advance. For example, in *Re Addlestone Linoleum Co* (1887) 37 ChD at 191 Lindley LJ said (at 205-6) that *Houldsworth* was authority for the principle that "a shareholder contracts to contribute a certain amount to be applied in payment of the debts and liabilities of the company, and that it is inconsistent with his position as a shareholder, while he remains as such, to claim back any of that money - he must not directly or indirectly received back any part of it". That is an orthodox statement of the principle of maintenance of capital, not corrupted by the supposed capital fund principle. The idea that *Houldsworth's* case is supported by the principle of maintenance of capital was taken up by Prof Gower, and eventually was recognised in the High Court of Australia. In the *Webb Distributors* case the majority (Mason CJ, Deane, Dawson and Toohey JJ, (1993) 179 CLR 15 at 33) concluded that *Houldsworth* supported the proposition that a shareholder may not, directly or indirectly, receive back any part of his or her contribution to the capital of the company, subject to statutory exceptions. Again, that is an orthodox statement of the principle of maintenance of capital. The same idea was reflected in the House of Lords in *Soden v British & Commonwealth Holdings plc* [1998] AC 298 at 326, and then in *Sons of Gwalia* (at [5] and [20] per Gleeson CJ; and at [83]-[86] per Gummow J).

On this approach, now well supported by authority, the rule in *Houldsworth's* case is an application of the principle of maintenance of capital in a case where the payment of damages by a company to its subscribing shareholder would constitute, indirectly, a return of capital not authorised by the statute. If the claimant for damages is not a shareholder, there is no obstacle to recovery, and so a subscriber claimant is required to rescind the contract of allotment as a pre-requisite to recovery. If the claimant for damages is a purchaser of shares, there is likewise no obstacle to recovery (at least, no obstacle under the rule - statutory liquidation provisions are considered below): the claimant's damages will reflect the purchase price paid for the shares to a third party, rather than any subscription of capital to the company. If the supposed capital fund principle were correct, the analysis in the case of a purchaser may be different, but for the reasons stated, that so-called principle has been rejected.

To summarise to this point: case law shows that the principle of maintenance of capital has an application to prevent a shareholder, while remaining as such, from recovering damages from his or her company for actionable misrepresentation measured by reference to the subscription price paid for the shares. That is the rule in *Houldsworth's* case. Note that the rule is expressed to be about misrepresentations actionable at common law. We have yet to consider whether various statutory causes of action, such as those under the Trade Practices Act or the Corporations Act, expressly or impliedly exclude the rule. Note also that the rule prohibits the shareholder from maintaining the cause of action; it does not merely postpone the claim to the claims of creditors. In *Houldsworth's* case itself, Earl Cairns LC rejected a submission that the appellant's claim for damages was viable but in the company's liquidation it was to be deferred in priority to the claims of external creditors (at 323).

Statutory deferral of shareholder claims in liquidation

If the company is in liquidation, the following provisions are relevant to an assessment of whether a shareholder may maintain a claim for damages, and if so, whether the claim is to be postponed to claims by external creditors:

"553(1) Subject to this Division, in every winding up, all debts payable by, and all claims against, the company (present or future, certain or contingent, ascertained or sounding only in damages), being debts or claims the circumstances giving rise to which occurred before the relevant date, are admissible to proof against the company."

"553A A debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is not admissible to proof against the company unless the person has paid to the company or the liquidator all amounts that the person is liable to pay as a member of the company."

"563A Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied."

A claim by a shareholder who has subscribed for or purchased shares in reliance upon misrepresentations by the company is admissible to proof against the company by force of s 553(1), if it is a valid claim. The predecessor of what is now s 553(1) was introduced in 1992, and it changed the law as to the admissibility of proofs of claim. Until then, statutory company law applied the law of bankruptcy to determine what debts and liabilities of a company were provable in its winding up, with the result that claims in the nature of unliquidated damages were not provable unless they arose by reason of contract, promise or breach of trust (*Sons of Gwalia* at [159] per Hayne J). By no stretch of the imagination can s 553(1) be read as overruling the rule in *Houldsworth's* case so as to validate subscriber claims, but if they are validated by some other provisions, then s 553(1) permits the claimant to prove.

Sections 553A and 563A apply only to a "debt" and do not expressly refer to a claim against the company. But it appears from the judgment of Hayne J (and by implication from the judgments of Gleeson CJ and Gummow J), that a claim for damages by a subscriber for or purchaser of shares falls within the description of "debt owed by a company" for the purposes of those two provisions (*Sons of Gwalia* at [166], [193]).

In its terms, s 553A assumes that a claim made by a person in the capacity of member for recovery of a "debt owed by" the company, "whether by way of dividends, profits or otherwise", will be admissible to proof once that person has paid all amounts payable by him or her as a member to the company. Section 563A appears on its face to refer to that same category of claim, and says that the meeting of the claim (that is, payment of the "debt") is to be postponed until all debts owing to or claims made by persons other than as members of the company have been satisfied. Once again, the section assumes that the category of claims that it identifies are valid claims, but it postpones payment of those claims. Should these provisions be construed as having abrogated the rule in *Houldsworth's* case with respect to a company in liquidation, so as to permit the subscriber's claim (as well as the purchaser's claim, to which the rule in *Houldsworth's* case does not apply) to be maintained for the purposes of proof of claim?

Section 563A was not always in its present form. Its predecessor in the Companies Code and in all previous manifestations in Australian legislation said this:
"360(1) On a company being wound up, every present and past member is liable to contribute to the property of the company to an amount sufficient for payment of its debts and liabilities and the costs, charges and expenses of the winding up and for the adjustment of the rights of the contributories among themselves, subject to the following qualifications: …
(k) a sum due to a member in his capacity as a member by way of dividends, profits or otherwise shall not be treated as a debt of the company payable to that member in a case of competition between himself and any other creditor who is not a member, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves."

In the *Webb Distributors* case, the majority in the High Court took the view that s 360(1)(k) amounted to a statutory recognition of the rule in *Houldsworth's* case, rather than the abrogation of the rule. They saw s 360(1)(k) as precluding a shareholder's claim for damages for misrepresentation in relation to the issue of shares (CLR at 34-5), not merely as a provision about priority of claims. Further, they held that the rule in *Houldsworth's* case, as recognised by s 360(1)(k), defeated not only common law claims in deceit but also claims made under the Trade Practices Act, because the Trade Practices Act was not to be seen as eliminating, by a side-wind, "the detailed provisions established for more than a hundred years to govern the winding up of the company" (CLR at 37). McHugh J, dissenting, criticised *Houldsworth's* case as misconceived and a source of injustice but he said that the rule in *Houldsworth* was "too deeply entrenched to be set aside by judicial decision", and that it had been applied on hundreds of occasions in the winding up of companies in Australia, and that the companies legislation had been enacted on the basis that it was an entrenched rule of company law (CLR at 39). But in his dissenting opinion, the rule could not prevail against the manifest width of the provisions of the Trade Practices Act, which should not be subject to an implied limitation in their application to companies in liquidation.

The United Kingdom legislation has, and has always had, a provision indistinguishable from s 360(1)(k) of the Companies Code (see, initially, Companies Act 1862 (UK) s 38(7); now Insolvency Act 1986 (UK), s 74(1)(f)). If the reasoning in *Webb Distributors* were to be applied in the UK, subscriber claims for damages for misrepresentation inducing the subscription would be unavailable against a company in liquidation because of the rule in *Houldsworth's* case, reinforced by the section. But there is another relevant provision in the UK, initially s 111A of the Companies Act 1985 (UK) and now Companies Act 2006 (UK), s 665. According to that provision, a person is not debarred from obtaining compensation from a company by reason only of holding or having held shares. That provision appears to reverse the effect of the rule in *Houldsworth's* case, whether or not the company is in liquidation.

In *Soden's* case, a purchaser of shares claimed damages against a company in liquidation for negligent misrepresentation inducing the share purchase. The issue was whether that claim was to be postponed to the claims of external creditors under the UK equivalent of s 360(1)(k). In contrast with the *Webb Distributors* case, there was no issue as to whether the claim could be maintained at all, presumably for two reasons: properly analysed, the rule in *Houldsworth's* case applies only to prevent a subscriber claim, not a purchaser claim; and in any event, the rule in *Houldsworth's* case had been abrogated by s 111A of the Companies Act 1985 (UK). The House of Lords held, for reasons considered below, that the purchaser's claim was not maintained in the character of member and consequently it could be admitted to proof in competition with external creditors.

Soden's case does not help us to decide whether the current Australian provisions abrogate the rule in *Houldsworth's* case. When the High Court came to consider *Sons of Gwalia*, there was still a live issue as to whether the statutory insolvency provisions (ss 553A and 563A) impliedly exclude the rule.

That issue need not have been decided in *Sons of Gwalia*. The High Court might have said that the rule in *Houldsworth's* case, even if it were preserved under the Corporations Act in respect of a company in liquidation, would have no application to a purchaser claim as opposed to a subscriber claim, for reasons to do with the proper analysis of the foundation of the rule in the principle of maintenance of capital. There are elements of such reasoning, especially in the judgment of Hayne J, who said (at [190]);
"Maintenance of capital may be relevant to a shareholder's entitlement to recover from the company amounts that the shareholder subscribes as capital, but it has no direct relevance to the recovery from a company of damages for loss occasioned by the making of a contract to acquire existing shares in the company from a third party."

However, all members of the majority in *Sons of Gwalia* appear to have based their reasoning primarily on the construction of the statutory provisions. Hayne J noted that s 553A assumes that the member's debt can be admitted to proof (at [163]) and emphasised that s 563A, in contrast with its predecessors, is expressed to be about the postponement of shareholders' claims, with the result that if the claim falls within the statutory description, it is admissible to proof though it is postponed to the claims of external creditors (at [193]-[197]). Gleeson CJ criticised the majority in *Webb Distributors* for finding that the rule in *Houldsworth's* case had received statutory recognition, given that the statute had been enacted (initially in 1862) before the House of Lords delivered its decision (in 1880); and in any case, he said that the section expressly contemplated that the claimant could prove after other claims were satisfied (at [14], [15], [26]). Gummow J discussed the rule in *Houldsworth's* case at length, reaching the conclusion that the rule does not prevent shareholder damages claims in the external administration of a company under liquidation provisions of the Corporations Act (at [84]-[96]).

In light of Sons of Gwalia, the correct conclusions seem to be that:
(i) purchaser claims are available against a company in liquidation, both because the rule in *Houldsworth's* case has no application and because such claims are impliedly recognised by ss 553A and 563A;
(ii) subscriber claims are available against a company in liquidation because, although the rule in *Houldsworth's* case would prevent them from being maintained, its application to a company in liquidation is excluded by ss 553A and 563A;
(iii) semble, although ss 553A and 563A exhibit a legislative intention wholly to exclude the rule in *Houldsworth's* case from the administration of winding up, s 563A does not necessarily postpone shareholder claims in every case, the question being whether the claim is brought by a person in his or her capacity as member of the company by way of dividends profits or otherwise.

Three questions about the viability of shareholder claims after *Sons of Gwalia* remain to be addressed:

- When is a claim postponed under s 563A?
- Are claims available when the company is not in liquidation?
- Are statutory claims available to shareholders?

Postponement under s 563A (see Ford [24.506])

A claim is not automatically postponed in a liquidation merely because the claimant happens to be a member. The question is whether, in the words of s 563A, the claim is for "a debt owed by [the] company to [the] person in the person's capacity as a member of the company, whether by way of

dividends, profits or otherwise".

In *Sons of Gwalia*, Hayne J said that these words require a connection to be shown between the company's alleged obligation and the claimant's membership, and the connection must have its ultimate foundation in the Corporations Act (at [202]).

Thus:
(1) where a holder of partly paid shares makes an interest-bearing advance to the company in anticipation of later calls, interest payable by the company to the shareholder under the arrangement is not owed to the shareholder in the capacity of member (Hayne J at [195]): the claimant had no obligation to advance the money to the company in the capacity of member and has no entitlement to receive the interest as a member, and therefore the right to receive interest is not a right which attaches to membership (at [197]);
(2) a claim for damages by a former member, suffered when the company forfeited his shares without giving notice as required by its constitution, has been held not to be a sum due to the member in his capacity as member (Hayne J at [198]): it is a claim for damages payable under the statutory contract by reason of the claimant having been *deprived* of the rights of membership by an irregular act on the part of the company;
(3) where a company enters into an employment contract with an employee, under which it undertakes that if the employment is terminated it will find a purchaser for the shares issued to the employee when the employment commenced, and the company fails to discharge its obligation, the employee's claim for damages is not a claim for an amount due in his capacity as member (Gleeson CJ at [29]; Hayne J at [199]);
(4) where a company's managing director was obliged by the company's constitution to be a shareholder, his action for arrears of salary and for breach of his contract of employment was held not to be a claim made by him in the character of member (Gleeson CJ at [29]).

In *Soden's* case, the House of Lords linked the statutory wording (not quite identical with s 563A) with the concept of rights conferred by the statutory contract under the UK equivalent of s 140 of the Corporations Act. But Hayne J did not adopt the same test, saying that there may be cases where a claim to enforce a right conferred by the statutory contract is not a claim made in the capacity of member for the purposes of s 563A (at [204]-[205]). Specifically, where money is paid to *create* the relationship of member, by subscription for shares, the company's obligation to pay damages for fraudulent misrepresentation inducing the subscription is not an obligation whose foundation can be found in the statutory contract (at [205]).

On this reasoning, there appears to be a difference between a claim made in the capacity of member, and a statutory claim made by a member, if the statute confers a cause of action, not on a member as such, but on any person who has suffered loss or is a person aggrieved (see, for example, the causes of action created by ss 175(2), 283F, 729, 1041I, 1022B, 1317HA, 1317J(3A), 1325(2)). But an application for relief under the oppression provisions of the Corporations Act may be made, under the statute, by a member (and certain others) and therefore it seems that a member seeking a compensation order under the oppression provisions will (at least normally) be suing in the capacity of member, and the claim will be postponed under s 563A if the company goes into liquidation.

Shareholder claims when the company is not in liquidation (Ford [24.508])

The analysis presented so far leads to the conclusions that

- the rule in *Houldsworth's* case applies to subscriber claims (but not purchaser claims) where it is not abrogated by statute;
- ss 553A and 563A abrogate the rule where the company is in liquidation.

In cases where ss 553A and 563A do not apply, a subscriber's claim is precluded by the rule, but it is open to the subscriber to take proceedings for rescission, in which restitution in integrum will be ordered if rescission is granted. But the availability of rescission depends upon a number of considerations, including whether third party rights have intervened. Since the courts have held that third party rights intervene when winding up commences (Ford [24.503]), they may well hold that third party rights intervene and preclude rescission where voluntary administrators are appointed under Part 5.3A, or where the company is subject to a deed of company arrangement.

If rescission is not available, the application of the rule in *Houldsworth's* case will deprive the subscriber

of any remedy for misrepresentation inducing the subscription, at least so long as the voluntary administration continues. Presumably if the result of the voluntary administration is to return the company to its directors, the third party rights created by Part 5.3A will be dissolved and the right to rescind and seek restitution in integrum will spring back into life. If the company passes into liquidation or administration under a deed of company arrangement, the right to rescind will remain suppressed.

In *Re Media World Communications Pty Ltd* (2005) 52 ACSR 342 it was held that the rule in *Houldsworth's* case precluded subscribers who complained about false statements in a prospectus from claiming damages against the company in voluntary administration, and consequently the claimants were not entitled vote at a meeting of creditors to consider a proposed deed of company arrangement. With respect, that decision appears to be a correct application of the law, which has not been affected by the *Sons of Gwalia* decision (see the fuller analysis in Ford [24.508]).

Where the company is in administration under a deed of company arrangement, the question is whether anything in the arrangement is inconsistent with the application, to subscriber claims, of the rule in *Houldsworth's* case. In the *Sons of Gwalia* case, the deed of company arrangement contained a provision causing s 563A to apply to the admission of proofs of claim and their ranking for payment. Section 444D(1) says that a deed of company arrangement binds all creditors of the company, so far as concerns claims arising on or before the date specified in the deed. Consistently with the High Court's view that Mr Margaretic's purchaser claim was a "debt" for the purposes of s 563A, the Court appears to have assumed that the claimant was a "creditor" bound by the terms of the deed. However, the Court held that the purchaser's claim was not postponed under the imported s 563A, because it was not a claim made in the capacity of member of the company.

If there is a deed of company arrangement but it does not import s 563A, then it appears that the rule in *Houldsworth's* case will prevent subscriber claims though it will not prevent purchaser claims.

Where the company is not in liquidation and not subject to voluntary administration or a deed of company arrangement, the rule in *Houldsworth's* case will prevent subscriber claims but not purchaser claims, although subscribers may be able to rescind and recover the subscription price by way of restitution in integrum.

All of this is subject to a qualification. Certain statutory damages claims are regarded as overriding the rule in *Houldsworth's* case, with the result that a subscriber may claim statutory damages without having to rescind the contract of allotment.

Statutory claims (Ford [4.509])

Since the rule in *Houldsworth's* case arises by implication from the provisions of companies legislation dealing with share capital and limited liability, it can be abrogated or amended by the Corporations Act or another Commonwealth statute. The High Court in *Sons of Gwalia* held that the rule has been made inapplicable by ss 553A and 563A when the company is in liquidation or otherwise subject to those statutory provisions. The first question to be addressed is whether a subscriber can maintain a statutory cause of action against the company when it is not subject to the statutory liquidation provisions, on the basis that the statute creating the cause of action overrides the rule. An associated question is whether the statutory cause of action overrides the postponement of priority in s 563A in a case where the company is subject to the statutory liquidation provisions.

There are many statutory causes of action that might be invoked by a subscriber for shares. But two sets of provisions are worthy of special note: first, the statutory provisions creating causes of action for damages for misleading or deceptive conduct under the Trade Practices Act, the Corporations Act and the ASIC Act; and secondly, the provisions of the Corporations Act which confer a statutory cause of action where a company has issued a false or misleading prospectus.

As to the misleading and deceptive conduct provisions, in *Webb Distributors* the High Court held by majority that a subscriber's claim was precluded by the rule in *Houldsworth's* case, reinforced by the statutory provision that preceded s 563A, and that the provisions of the Trade Practices Act did not override the company liquidation regime so established. The High Court's decision in *Sons of Gwalia* has the effect that a claim for damages for misleading or deceptive conduct under one of the legislative regimes may be made against a company in liquidation by a purchaser of shares who has relied on the company's misleading statement, without impediment from or postponement under any provision of the Corporations Act. That decision was reached upon the construction of s 553A and 563A rather than on anything in the Trade Practices Act or its equivalents. But Gummow J took the view (at [95]) that the remedial provisions of the Corporations Act itself (such as s 1325(2), and presumably also s 1041I) did

override the liquidation provisions so that the claim was not to be postponed.

On that view, a subscriber's claim for damages may be maintained against the company in liquidation, because *Houldsworth's* case has been abrogated by ss 553A and 563A, but:

- to the extent that the claim is based on the common law of deceit or the like, the claim may be postponed under s 563A (depending upon whether the claim is in the person's capacity as a member by way of dividends profits or otherwise), while
- to the extent that it is a claim invoking a statutory cause of action for misleading and deceptive conduct, the claim is not postponed.

The reasoning of Gummow J implies that even if the company is not in liquidation or otherwise subject to the statutory liquidation provisions, the statutory cause of action for misleading and deceptive conduct is not limited by the rule in *Houldsworth's* case, which it impliedly overrides. The result is that if a subscriber invokes a statutory cause of action, the claim may be pursued without rescission.

As to the statutory right of compensation in respect of a defective prospectus, under s 729(1) of the Corporations Act, in *Cadence Asset Management Pty Ltd v Concept Sports Ltd* (2005) 56 ACSR 309 the Full Federal Court held, in a case where the company was not in liquidation, that the rule in *Houldsworth's* case does not qualify the availability of the statutory right of compensation. The court took the view that the statutory provisions contain a clear statement of the ingredients of entitlement to compensation and the defences to a claim for compensation, and are not to be qualified by reference to the *Houldsworth* rule (at [46]). Further, there is an express statutory right for the subscriber to return securities and obtain repayment if the company becomes aware of the misleading statement in the disclosure document after it has been issued, covering some of the ground that the *Houldsworth* rule would have covered if it had applied.

Although some parts of the judgment in *Cadence Asset Management* appear to be at odds with the High Court's decision in *Sons of Gwalia*, the reasoning outlined above is consistent with the High Court's decision, and therefore remains good law. Consequently *Houldsworth's* case does not apply so as to require that a claimant under s 729(1) against a company not subject to the statutory liquidation provisions must rescind before making the claim.

Concluding observations

There are many important aspects of the question of statutory law reform that is currently before the Corporations and Markets Advisory Committee. The main issues, concerning the appropriate legislative policy to be adopted in order to balance the claims of unsecured creditors and shareholders in an external administration, are touched upon in Mr de Kerloy's paper, but I have not addressed them here. Some suggestions for reform have been made in Ford [24.510].

Another suggestion for reform emerges from the matters raised in this commentary. The effect of the *Sons of Gwalia* case is to compound the technicality of what was already an extremely technical and unsatisfactory part of the law. As has been explained, the rule in *Houldsworth's* case takes its justification from the policy that underlies the principle of maintenance of capital. But the policy basis for the principle of maintenance of capital is not so strong as to trump every other consideration. That is demonstrated by the fact that reductions of capital and share buybacks, and certain other forms of return of capital, are expressly permitted by the Corporations Act. Other policy considerations drive consumer and investor protection legislation, and need to be placed in the balance. Additionally, it must be borne in mind that the law in this area often has to be administered, day to day, by insolvency practitioners rather than senior counsel. They should not be left in a position where they find it necessary to obtain legal advice whenever shareholder claims are made, regardless of the size of the company that is subject to administration. In other words, there is a very strong case for simplification.

Weighing up the policy considerations that underlie the principle of maintenance of capital, against questions of investor protection and the need for legal simplicity, it seems to me that a useful step forward would be to abrogate the rule in *Houldsworth's* case root and branch, by adopting a provision based on s 111A of the UK Companies Act of 1985. The mere fact that the claimant is a shareholder should not stand in the way of the claim, but if (for example) a subscriber provides capital to a company on the basis that it will be returned through a bogus damages claim, there is more to the case than the mere fact that the claimant is a shareholder and the law should intervene. Clearing away the *Houldsworth* rule would more effectively expose for consideration the main policy issue, which is

whether shareholder claims should be postponed to other creditor claims in an external administration.

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Remarks on the launching of Company Directors and Corporate Social Responsibility: UK and Australian Perspectives

Remarks on the launching of *Company Directors and Corporate Social Responsibility: UK and Australian Perspectives* (edited by R. P. Austin)

It is a pleasure for those of us who were involved in the August conference last year to be able to round off that endeavour by publishing the edited transcript of the proceedings. I am very grateful to the Law Society for co-sponsoring the Conference, and especially for all the hard work of Robyn Davies in attending to the administration. I am also very grateful to Associate Professor Barbara McDonald for making the publication possible, and to the speakers for their insightful contributions.

Since our conference, the world has moved on. In November 2006 the UK Bill that we discussed was enacted. At home, in December 2006 the Corporations and Markets Advisory Committee (CAMAC) published its report on *The Social Responsibility of Corporations*, rejecting the idea that the UK legislation should be followed in Australia, in this area. I would like to take the opportunity of the launching of the conference proceedings to make a few remarks on that issue. I am doing so, to the extent that it is possible, in a non-judicial capacity, as a company lawyer with a long-term interest in law reform. Nothing that I say should be interpreted as having application to any particular case.

The question whether Australian company directors may or must take into account the interests of stakeholders other than their company's shareholders, such as creditors or employees or the environment, has been a vexed one for many years. Except as regards the interests of creditors, there is no authoritative pronouncement at the appellate level. We still rely, inter alia, on 19th-century cases that talk quaintly about such burning topics as whether the directors can spend the company's money giving their shareholders cakes and ale.

If the directors of a solvent Australian company have before them a proposal that will generate immediate profits for the shareholders, while being likely or having the potential to damage present or future interests of employees or tort claimants, or to produce some devastating (but not illegal) environmental impact, there is real doubt about where their duty lies. It is at least arguable that they are obliged to opt for short-term profit - I say "at least arguable" in order to make the point that there is a significant risk that their legal advisers will accept that argument, even if (with the benefit of hindsight) it later turns out to be wrong. Conversely, it is also arguable that the directors' duty is to take a longer-term view of shareholder interests and to assess the prospect that the company might be damaged, and hence the value of the shareholders' investment might be diminished, when the consequences of its decision upon other stakeholders become evident.

These doubts are compounded by an ambiguity in the case law, as to whether the duty is "subjective", or "objective", or subjective but circumscribed by objective criteria. I believe the test is essentially a subjective one, that is, the question is whether the directors have subjectively taken into account and acted upon their perception of where the interests of the company lie, rather than whether their decision truly does promote the company's interests. But when a court comes to review the directors' decision, it is likely to disbelieve the directors' protestations that they have acted in what they considered to be the company's interests if, in the court's opinion, no reasonable person acting in the company's interests could have made the decision that the directors made.

That is my view of it, but there is considerable doubt about the matter. The doubt arises partly because of the way the duty has been formulated in some of the case law on the old statutory requirement to act "honestly", and partly because of some textbook pronouncements. And in his second reading speech the then Minister, Senator Conroy, said (wrongly, I think) that the purpose of the introduction of the present s 181 was to introduce an objective test.

The muddy state of the law means that outcomes in the boardroom, guided by legal advice, will be uncertain, and the quality of corporate governance may suffer. The risk is that directors will regard pursuing short-term profit as the easiest and safest solution, especially under the influence of hedge funds (and institutional investors influenced by the hedge-fund view of the world), and analysts, and perhaps even credit rating agencies. It is fertile ground for Professor Coffee's gatekeeper theory. If that risk is substantiated, directors will need some protection from the pressure of short-termism.

Over the years, the question has been referred to various law reform bodies, who have arrived at a split decision. In 1989 the Senate Standing Committee on Legal and Constitutional Affairs recommended an amendment to make it clear that the interests of the company's employees could be taken into account by directors. The intention was to protect directors from claims of breach of duty for actions taken by the board in the interests of employees. New Zealand was persuaded to make such an amendment, and so was the United Kingdom, in the 1985 Act. More recently, the interests of other non-shareholder stakeholders have come to the fore, and demands for law reform have been made, for example, by environmental groups.

These reform ideas do not put other stakeholders on the same level as the company's shareholders. That is, they do not require directors to act in the interests of anyone other than the shareholders; they do not adopt "pluralism", according to which those who manage corporations have a duty to serve the interests of many different groups of stakeholders. Instead, they are driven by what the UK Department of Trade Working Group has called "enlightened self-interest". The same approach is reflected, very strongly, in the new UK provision that was the subject of our conference, s 172 of the Companies Act 2006.

Section 172 makes it clear that the director's duty is subjective, to act in the way that he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members. Moreover, the formulation makes it clear that it is the success of the company for the benefit of the members, rather than the simple generation of immediate profit to be distributed to the members, that is the objective. That is confirmed by the requirement for the directors to have regard to the likely consequences of any decision in the long-term. They must also have regard to the interests of others mentioned in the section, including employees, creditors and the community, amongst other matters. The overall objective is very clearly to promote the company's success *for the benefit of the members*. The provision is intended to protect the directors from the demands of short-termism.

The response of Australian law reformers in recent times has been negative. In June 2006 the Parliamentary Joint Committee on Corporations and Financial Services elected not to recommend statutory amendments to the directors' duty, but their report does not focus specifically on the justification for legislation that has been accepted in the United Kingdom.

CAMAC delivered its report, *The Social Responsibility of Corporations*, in December 2006. In the Committee's view:

- the established formulation of directors' duties allows directors sufficient flexibility to take relevant interests and broader community considerations into account;
- changes of the kind under consideration would not provide meaningful clarification to directors, while risking the obscuring of their accountability;
- concerns about the environmental and social impact of business behaviour are better addressed, if the market is judged unable to give a satisfactory response, by legislation specifically directed to the problem area.

I admire the work of CAMAC, but I must say I was disappointed with the reasoning of this Report, when compared with the depth of analysis undertaken by the UK Law Commissions and the Department of Trade and Industry Working Group in the United Kingdom.

There is a fundamental tension between two concurrent views expressed by the Committee:

- the view that Australian law currently permits, or perhaps requires, directors to do what the UK Act legislates; and
- the view that to legislate along the UK lines would introduce uncertainty into Australian law.

The Committee regards it as an advantage of the existing Australian law that it gives directors "flexibility" to take stakeholder considerations into account. One wonders why this is preferable to declaring a clear duty of directors to take those interests into account in the course of promoting the success of the company for the benefit of its members as a whole (as the UK Act does). The "flexibility" that the Committee wishes to maintain is really, in my view, a profound lack of clarity; and I see no good reason for giving directors a discretion to do or not to do something which, on any

rational public policy basis, they should be duty-bound to do.

As I see it, the Committee has not given sufficient weight to the argument that a provision like s 172 will clarify the law for the benefit of everyone concerned, including the directors themselves, fortifying them to resist the pressures of short-termism.

As you can see, therefore, my personal view is that s 172 of the UK Act is worthy of further consideration. But the publication we are launching today makes it clear that that view is controversial. I hope the publication of the proceedings of our conference will help to clarify the issues that need to be addressed, and stimulate further debate.

R.P Austin 16 March 2007

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Remarks at the launching of the Allens Arthur Robinson Annual Review of Insolvency & Restructuring Law, 2006

Remarks at the launching of the Allens Arthur Robinson Annual Review of Insolvency & Restructuring Law, 2006

The Hon Justice RP Austin,
Supreme Court of New South Wales
13 March 2007

It is a pleasure to join you this afternoon for the launching of the 2006 Insolvency & Restructuring Law Review. It is a privilege to accept your invitation to say a few words to mark the occasion.

The Review, which I have inspected in draft, is a very useful collection of cases decided by the Australian courts in 2006 (plus one case from 2007), together with a spicy leavening of foreign cases from such jurisdictions as the Court of Appeal of England, the High Court of Ireland and the Hong Kong Special Administrative Region Court of Appeal. I enjoyed the succinct discussion of Australian and other law reform proposals, which you will find in the last section of the publication, and also the discussion of changes to the law of foreign jurisdictions.

Some of you may need to know that agricultural entrepreneurs do not fall within the ambit of the reformed Italian Bankruptcy Law, that the new Czech Insolvency Act requires that all *potential* debts must be taken into account in assessing whether an entity's debts exceeded its liabilities, that Danish corporations law at last allows for floating charges (only 120 years too late), and that Hungary's government has acted to stop debtors evading creditors' claims (something no one else has yet managed to do). In my case, knowledge of those matters has simply made me a better person.

The short essay on the *Legend* case drew attention to the Hong Kong Court of Appeal's disapproval of the use of provisional liquidation for corporate rescue. Perhaps I should stand duly chastened for taking a different approach in the *United Medical Protection* case. But as far as I can recollect it, in that case the initial appointment of a provisional liquidator was an application of orthodox principles about the risk of insolvency and protection of assets. It was only later, when the prospect of a rescue with assistance from the Commonwealth Government emerged and there was evidence that the making of a winding up order might trigger default provisions in some reinsurance contracts, with disadvantageous consequences for the company's creditors, that I was persuaded to extend what had become the status quo, while the workout evolved. The provisional liquidator was in office for a very long time, but the outcome appeared on the evidence to be very satisfactory.

An overall impression created by the Review is of intense activity in the Australian courts, leading to the determination of many points that are of legal and commercial significance. There is no court in which that activity is more intense than in the Supreme Court of New South Wales.

When I arrived at the court in 1998, Corporations Law applications before a judge (as opposed to those dealt with by a Master or by the Registrar) were heard each Monday. Pressure of work led to the establishment, a few years later, of a Friday list as well as the Monday list. Then last year, as the caseload continued to increase, we established a "full-time" Corporations List. Therefore there is now a judge sitting in corporations matters every day, with control of his own diary, available to hear urgent applications whenever they are ready to be made (non-urgent applications are still channelled through the Monday list). That is in addition to the hearing of "fixtures" by other Equity judges in matters that may well have a corporations flavour, such as preference and oppression cases. So the volume of corporations work is large and expanding.

Some of the cases heard by the Corporations Judge are factual disputes where it is necessary to hear conflicting oral evidence and make decisions on matters of credit, with many contentious rulings on evidence along the way. Let me supplement the Review by offering some further examples from 2006: the disputes about examination summonses and privilege in the *Bauhaus* and *Southland Coal* litigation, and the argument about the receiver's powers over the assets of aboriginal corporations in *Hillig v Darkinjung*. I suspect that those fact-oriented kinds of cases are increasing, and that they will continue to increase in number as well as intensity, as the litigation funding industry matures and

liquidators make use of it - especially by applications in and around the process of liquidators' examinations.

However, many cases that come before the court in the corporations area are not disputes about what has happened in fact, but instead they are about the application of the Corporations Act or the exercise of some discretion under it. There is normally a dispute, perhaps hotly contested, as to whether the court should make the orders that are sought, but often the factual circumstances in which the question arises are not contested. If you flick through the Review you will find very many examples of such cases. What unites cases of this kind is that they raise questions of construction of a statute, namely the Corporations Act.

Over the last 40 years there has been a gradual, but in the end dramatic, change in the approach of Australian judges to questions of statutory interpretation, a change that applies with full force to the construction of the Corporations Act. The technique of "literal construction" is no longer used, except by hopeful counsel. The construction of the Corporations Act is to be approached upon the foundation of a sound historical understanding, which should reveal where the provision under consideration came from and what it was and is trying to do. Once the historical perception is achieved, the construction of the provision tends to fall into place. Sometimes it is a construction that would not be expected by someone wedded to the literal approach. Let me briefly give two examples.

One is the *Sons of Gwalia* case, the only 2007 case mentioned in the Review. You will remember that Mr Margaretic's claim against the company was a claim for damages for the loss he suffered when he bought shares on market, at a time when the company had not disclosed its true financial circumstances to the market. It was a statutory claim based on the company's alleged failure to meet its continuing disclosure obligation and on its alleged misleading and deceptive conduct. The High Court had to consider the application to that claim of s 563A. Section 563A says that payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed to the claims of external creditors.

A literalist might have expected the court to say that the statutory claim for damages was a claim by Mr Margaretic in his capacity as a member, "whether by way of dividends, profits *or otherwise*", with emphasis on the latter words. But the High Court reached the opposite conclusion upon the basis of historical analysis.

For Hayne J, the court's task of construing the statutory provision required "an understanding of the legislative history that lies behind the particular provisions and the other provisions which together form its context" (at [148]). That was his Honour's starting point. He referred to the UK Companies Act of 1862, which famously adopted the principle of limited liability. He noted a qualification to that principle, which declared that no sum due to a member in his character of a member would be deemed to be a debt of the company payable in competition with other creditors. That was the earliest ancestor of the present s 563A, but seemed to cover provability as well as priority. That appears to have led to the confusion displayed in the earlier High Court case of *Webb Distributors*. Importantly, Hayne J showed that in 1992, when the Corporations legislation was amended as a result of the Harmer reforms, different wording was adopted which severed the question of priority from the question of provability, making it clear that s 563A dealt only with the priority question.

These are important insights. They led directly to the High Court's robust affirmation of the proposition that Mr Margaretic's statutory claims did not fall within s 563A. In the judgment of Gummow J, the same historical technique was called in aid to demonstrate that the so-called rule in *Houldsworth's* case, according to which a member was precluded from recovering damages from his company and could only rescind the contract of allotment (a remedy not available in liquidation) no longer exists. That, in turn, heralds a fundamental shift in thinking about company law, because it expunges the idea that paid-up capital is a "fund" to be preserved for the protection of creditors.

The historical approach is not confined to appellate decisions. Unresolved questions of construction of the Corporations Act arise with surprising frequency in the Supreme Court and other courts of first instance. Sensitivity to the history of the provision under consideration is a mark of properly prepared submissions. For example, in *Simms & anor as liquidators of Enron Australia Finance Pty Ltd (in liq) v TXU Electricity Ltd* (2003) 48 ACSR 266 I had to construe s 568(1B) in the modern context of ISDA swap documentation. Section 568 permits a liquidator to disclaim the company's onerous property, and then s 568(1A) says that the liquidator cannot disclaim a contract (other than an unprofitable contract or lease of land) except with the leave of the court. Subsection (1B) says that on an application for the leave of the court, the court may grant leave subject to conditions, and may make other orders in connection with the contract.

At the commencement of its voluntary administration, Enron Australia was a party to some open electricity swap contracts with TXU. The liquidators of Enron Australia made an application to the Supreme Court for leave to disclaim the swap contracts, and invited the court to make ancillary orders that would ensure that they could recover the net value of the contracts. I was asked to determine whether s 568(1B) empowered the court to make orders causing the disclaimer to take effect as the occurrence of an early termination date under the swap contracts. If it did, the contracts would provide for the valuation of Enron's open positions and would consequently give the liquidator a right to recover that value from TXU.

Clearly enough, s 568(1B) allowed the court to make an order imposing conditions amounting to obligations on the applicant for leave. The question was whether the section allowed the court to make orders imposing obligations on the contractual counterparty.

Section 568(1B), like s 563A, has a long pedigree. Senior counsel for the liquidator endeavoured to persuade me that the historical antecedents of the modern section had been treated as permitting the court to alter the rights of the counterparty to the disclaimed contract, and so the modern equivalent should be construed in equally broad terms. I rejected the argument because I was not persuaded that the ancestors of the modern section had been used in that fashion. I was taken the provisions about disclaimer of onerous property by a trustee in bankruptcy contained in the UK Bankruptcy Act of 1869. My decision turned in part upon an analysis of 19th-century cases under that statute, dealing with such matters as whether, when a contractual tenancy was disclaimed by the trustee in bankruptcy of a tenant, the landlord could be compelled to pay for improvements to the land and for mown hay; and as to the appropriate formal order to be made, upon disclaimer, in respect of tenants' fixtures. The Court of Appeal dismissed the liquidators' appeal: (2005) 53 ACSR 295.

I am privileged to work in possibly the most interesting jurisdiction in the world, for someone who enjoys pure law while also responding to the challenge of resolving human conflict through the process of reasoning. The most intensely absorbing, stressful and exhausting part of our work in the Equity Division happens where individuals find themselves in disastrous predicaments - where what is at stake is more than mere money and the court is the last resort to help them: intervention as parens patriae to save a child from life-threatening danger; to help a family through the corrosive effects of inter-generational conflict; to provide a foundation of fairness that might enable neighbours to live in harmony.

But the bread-and-butter work for me and the other Corporations Judges (Justices Barrett and White) is the Corporations List, where many cases (though not all) involve commercial circumstances where money and reputations are at stake. These cases lend themselves to analysis and the application of clearly articulated legal rules. Certainty and predictability are paramount. The primary rules are in the Corporations Act, and so a robust, predictable approach to statutory construction is required. The literal approach to statutory construction has failed because it does not provide criteria for solving cases of ambiguity. An approach that is sensitive to the historical origins of the statutory provisions looks to be our best option for achieving our goals.

I congratulate Allens for this useful publication, and I look forward to many more editions of it.

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The Legal Standard of Loyalty and Professional Guidelines

INSOLVENCY PRACTITIONERS ASSOCIATION OF AUSTRALIA

NATIONAL CONFERENCE, 2006

"WITHOUT FEAR OR FAVOUR"

Brisbane, 12-13 October 2006

"The Legal Standard of Loyalty and Professional Guidelines"
A paper by Justice RP Austin, Supreme Court of New South Wales

1. Introduction

This paper is about administrators, a term I shall use to apply to the voluntary administrator of a company and the administrator of the deed of company arrangement. I shall confine my attention to the two administrator roles, although much of what I shall say also applies to a court-appointed liquidator or a liquidator in a members' or creditors' voluntary winding up. I do not purport to cover receiverships.

I understand that a few years ago, your annual conference was addressed by Professor Ron Harmer. Professor Harmer was the Commissioner in charge of the General Insolvency Inquiry conducted by the Australian Law Reform Commission, which led to the last general legislative revision of Australian corporate insolvency law. One of the products of that review, by statutory amendments to the Corporations Law enacted in 1993, was the introduction of the system of voluntary administration, which is now by far the most common form of external administration of insolvent companies. I am told that Professor Harmer drew attention to the crucial role played by insolvency practitioners in voluntary administration, and he observed that the success of the voluntary administration regime would be secured by demonstrating that administrators act independently in the interests of the general body of creditors.

Professor Harmer's observation (with which I agree) has some important consequences, including the following two:
(1) administrators need to understand, and observe on a daily basis, their fundamental duty in the area of independence, and also in the connected areas of impartiality, avoidance of conflicts of interest and (more generally) loyalty to the general body of creditors; and
(2) the professional association for administrators needs to be very active in assisting them to appreciate and perform their duties, by adopting a variety of strategies including the development of standards and guidelines, because
(a) obviously, guidance given by the profession "corporately" is likely to be of practical assistance to individual practitioners and firms on a day-to-day basis, given that the professional body is well placed to identify real issues and workable solutions;
(b) the development of standards and guidelines by the professional body is capable of influencing the administration of law and policy by ASIC and CALDB, so as to produce workable outcomes; and may even influence the very content of the law as a growing body of judicial decisions, because the courts are prepared to take such guidelines into account when evaluating a practitioner's conduct in a particular case;
(c) if the professional association fails to establish adequate standards that are observed by its members, it is virtually inevitable that additional standards will be enacted in the law, and there is a significant risk that those enacted standards will be highly prescriptive, detailed and complex, while failing to take into account the practicalities of the administration (including the size of the enterprise and the available funds).

The purpose of this paper is to support these propositions, by considering:

- the administrator's duties as a fiduciary;
- the statutory contexts in which the administrator's fiduciary duties come to be considered;
- some practical illustrations from the cases;
- the current IPAA standards;
- self-regulation versus statutory regulation.

2. The administrator's duties as a fiduciary

2.1 Fiduciary relationships generally

It is sufficient for present purposes to make a brief general statement of the main fiduciary principles.

The law treats certain relationships as fiduciary relationships: for example, the relationship between trustee and beneficiary, between a business partner and the other partners, and between a company director and the company. Where there is a fiduciary relationship, one party (the fiduciary) owes a special *duty of loyalty* to the other (the principal).

The fiduciary's a duty of loyalty to the principal has a positive component and a negative component. The positive component is that the fiduciary must at all times *act in good faith in the principal's best interests*. The negative component is that the fiduciary must *avoid putting himself in a position where his duty to the principal conflicts or may conflict with his personal interest or some extraneous interest* (or a duty to someone else), and if he does, he must account to the principal for any unauthorised profit. The duty to avoid conflicts of interest applies not only where there is an actual conflict between interest (or competing duty) and duty to the principal, but also whenever there is a *real, sensible possibility* that such a conflict may arise.

The legal textbooks emphasise that the duty of loyalty is not the same as a duty of honesty. In some celebrated cases, fiduciaries who have acted with honesty, integrity and great skill, making large profits for themselves out of their fiduciary office whilst also benefiting their principals, have been held to be in breach of their duty, and therefore accountable to the principals for the profits they have made.

The fiduciary's duty of loyalty is a fundamental legal principle and is essentially very simple. Occasionally the application of the law is uncertain or open to debate, but in most situations the application of the law is crystal clear and the fiduciary's duty is beyond question. In any circumstances in which the principal's interests are at stake, the fiduciary must ask:
(i) Is my proposed course of action in the principal's best interests? and
(ii) Do I have any personal interest, or is there some other extraneous interest or duty, that conflicts or potentially conflicts with my duty to my principal?

If the answer to the first question is negative, or the answer to the second question is positive, the fiduciary must not proceed without first obtaining the principal's free and fully informed consent. It is sometimes said that the fiduciary must "disclose or abstain", but this is apt to mislead, as the law requires not merely disclosure but free and full consent by the principal. Further, the standard of disclosure, for the purpose of obtaining consent, is very strict.

The duty of loyalty has a broad application across all of the fiduciary's activities. In some factual contexts, it leads to requirements for the fiduciary to be *independent* and *impartial*.

Independence may be an issue if the fiduciary has, or is perceived to have, a close relationship with someone whose interests are not aligned with the interests of the principal. For example, the board of directors of a company may be considering whether to enter into a major contract with a supplier, in circumstances where one of the directors has a continuing business relationship with the supplier. The business relationship between the director and the supplier may give rise to a "real, sensible possibility" of conflict between the director's duty to act in the company's interests and some personal or extraneous interest arising out of that business relationship. Another way of expressing that conclusion is to say that the company director is not independent. The requirement is for the fiduciary to the actually independent and to appear to be independent.

Impartiality may be the issue where the fiduciary owes duties to more than one principal. For example, a trustee may hold a share portfolio in trust for two beneficiaries, one being entitled to the income for life and the other being entitled to the capital. If the trustee reinvests the fund in risky, high yield shares, then it is plausible to say (in the language of the duty of loyalty) that he has failed to act in the best

interests of the beneficiaries as a whole, and that he has aligned himself with the interests of the income beneficiary in conflict with his duty to the beneficiaries as a whole. But it is more straightforward to say that his duty of loyalty leads to a duty of impartiality, which he has contravened by preferring the income beneficiary to the capital beneficiary. Impartiality, in this context, requires the fiduciary to avoid both actual bias and the perception of bias.

One frequently hears business people (for example, candidates for board positions) claiming to be independent and impartial notwithstanding the most egregious associations and relationships. They assert that independence and impartiality are states of mind, and they regard the suggestion that their relationships might lead to preference or bias as an attack on their personal integrity. They fundamentally misunderstand the fiduciary requirement. The state of mind of the fiduciary is irrelevant. The question is whether the objective circumstances create a position of actual or potential conflict, leading to a real, sensible risk of preference or bias. If they do, the law simply presumes that the fiduciary's conduct is contaminated, and will not allow the fiduciary to demonstrate subjective integrity. The message is that the fiduciary should prevent the compromising circumstances from arising, or step aside, or obtain the free and fully informed consent of the principal to the proposed course of action.

Where a fiduciary fails to comply with his duty of loyalty, the principal may pursue various equitable remedies. Those remedies include undoing what the fiduciary has done by seeking rescission, requiring the fiduciary to account for any profit arising by reason of or in the course of his fiduciary office, and in some cases obtaining compensation designed to restore the principal to the position he would have been in if there had been no breach of duty.

2.2 Administrators as fiduciaries

The courts have come around to the view that an administrator stands in a fiduciary position. Indeed, in *Re Stockford Ltd* (2004) 52 ACSR 279 at [51], Finkelstein J said, broadly and without qualification, that "an insolvency practitioner stands in a fiduciary relationship with the creditors". But the general conclusion that an administrator is a fiduciary was reached through some fairly tentative steps.

The courts had more than a century-and-a-half 's experience of supervising court-appointed liquidators before the system of voluntary administration was introduced. They came to regard court-appointed liquidators as officers of the court, who exercise some quasi-judicial functions, for example functions in relation to deciding whether to admit or reject in proof of debt (*Re Timberland Ltd* (1979) 4 ACLR 259; *Tanning Research Laboratories Inc v O'Brien* (1990) 169 CLR 332). The fact that court-appointed liquidators are (to that extent) delegates of the judges, discharging public responsibilities, was advanced as a reason for insisting that they must be (and be seen to be) independent and impartial: *Re Contract Corp; Gooch's Case* (1872) LR 7 Ch App 207 at 211; *Re Allebart Pty Ltd (in liq)* [1971] 1 NSW LR 24, at 26.

While, in some respects, court-appointed liquidators act in a quasi-judicial capacity, in other respects they clearly does not. For example, a liquidator who is required to sell assets or run a business of a company liquidation can hardly be said to be acting quasi-judicially in doing so. But in discharging functions of those kinds, court-appointed liquidators are in a classically fiduciary position, analogous to the position of a trustee or a company director. They occupy a professional role in which they are entrusted with functions to be performed for the benefit of others, and they have access to funds that are not their own, to be used to carry out their functions. These characteristics of their role, quite apart from their position as officers of the court, have led the courts to conclude that court-appointed liquidators are subject to a duty of loyalty which requires them to avoid positions of conflict, be independent and be impartial. The evolution of the case law was examined by Young J in *National Australia Bank v Market Holdings Pty Ltd* (2001) 37 ACSR 629, a case which I considered in the context of voluntary administration in my judgment in *Bovis Lend Lease Pty Ltd v Wily* (2003) 45 ACSR 612 at [123]-[132].

Once it became clear that a court-appointed liquidator's position in the administration of a company is sufficient to give rise to a duty of loyalty that is not dependent on being an officer of the court, it was open to the courts to declare that a liquidator in a voluntary liquidation, occupying the same kind of position of trust but appointed by members or creditors rather than the court, owes an equivalent duty of loyalty (for example*, Re Lubin, Rosen & Associates Ltd* [1975] 1 WLR 122; *Advance Housing Pty Ltd v Newcastle Classic Developments Pty Ltd* (1994) 14 ACSR 230; *Re Biposo Pty Ltd* (1995) 17 ACSR 730).

Then, when the voluntary administration regime was introduced, the courts focused on the statutory responsibilities of the administrator, which were taken to imply duties of independence and impartiality,

as "part of the very marrow of the voluntary administration system" (*Bovis v Wily* at [133]; see also *Commonwealth v Irving* (1996) 19 ACSR 459 at 462). This reasoning was not diminished by the fact that the voluntary administrator is appointed by the directors or a liquidator, rather than by the court. The position of deed administrators is less clear than the position of a voluntary administrator, but at least under most deeds, the probability is that the deed administrator will have functions that will attract fiduciary principles, such as the functions of getting in and administering a deed fund for the benefit of deed creditors, adjudicating on proofs of debt and making distributions.

Given that administrators are now regarded as occupying a fiduciary position, to whom do they owe their fiduciary duties? The answer is not entirely clear. Finkelstein J said in *Re Stockford* that an insolvency practitioner stands in a fiduciary relationship "with the creditors".

However, as Young J pointed out in the *Market Holdings* case (at [199]), it is difficult to support the proposition that a liquidator owes a fiduciary duty to each creditor of the company, and there are some cases pointing against that conclusion. The same observation may be made in the case of administrators. The practical consequences of this view are that an individual creditor of the company probably cannot take proceedings in a court to complain of the administrator's breach of fiduciary duty, and the administrator cannot be protected from breach by making disclosure to and obtaining the consent of each creditor, one by one, without giving them the opportunity to confer. Finkelstein J probably would not disagree.

Young J said that the duty is owed to the creditors as a whole. This means that the administrator's positive duty is to act in the best interests of the creditors as a whole. Although the issue has not been finally resolved, the administrator's fiduciary position is probably analogous to the fiduciary position of a company director in a case where the company is at or near insolvency. That is, the duty is owed to the company rather than to creditors, but because of the company's financial position, the duty cannot be discharged by obtaining the consent of the shareholders, and the interests of the creditors must be taken into account (*Spies v R* (2000) 201 CLR 603).

The proposition that an administrator is a fiduciary is fundamental to the nature and functions of the administrator's office. It might therefore seem curious that one reaches the conclusion that the administrator is a fiduciary through a fairly tortuous process. But the reasons why this is so are not hard to grasp. The administrator's duty is owed to the company as the embodiment of the interests of the creditors, and therefore (as I have said) an individual creditor is not able to complain of a breach of fiduciary duty. The administrator controls the company during the period of voluntary administration (and may do so under a deed of company arrangement, depending on its terms), and is unlikely to authorise an action to complain of his own breach of duty. In order to complain of a breach of duty in such circumstances, it would be necessary to bring a derivative action, and only a member, former member, officer of former officer can do so (s 236(1)). Perhaps most importantly, there are statutory provisions which allow complaints to be made about of misconduct by administrators, which do not require proof, in terms, of a breach of fiduciary duty.

It is these statutory provisions that are relied upon by creditors and others who wish to take proceedings to complain about administrators. But the statutory provisions do not render fiduciary considerations irrelevant. On the contrary, in applying the statutory provisions, courts typically develop their views by reference to the underlying idea that the administrator owes a fiduciary duty to the company represented (where it is insolvent) by the creditors as a whole, and accordingly must be independent and impartial.

3. Statutory contexts

The Corporations Act is peppered with discretionary powers given to the courts and ASIC which are capable of being used to affect the interests of those connected with a company under administration. Important discretionary powers are also given to CALDB. I shall in my attention to some key discretions given to the courts.

Complaints about the conduct of an administrator on questions going to independence, impartiality, conflicts of interest or (more generally) loyalty to the general body of creditors, may arise under provisions of the Corporations Act including the following:

- s 445D, under which a creditor or another interested person may apply for termination of a deed of company arrangement on various grounds, including the ground that the deed or something done under it is contrary to the interests of the creditors as a whole;

- s 449B, under which a creditor or ASIC may apply to the court for removal and replacement of an administrator;
- s 449E, which allows an officer, member or creditor of the company to seek review of the remuneration of the administrator;
- s 447D, which allows the administrator to apply for the court's directions about a matter arising in connection with the performance or exercise of the administrator's functions or powers;
- s 447E, which allows a member of creditor or ASIC to apply to the court for an order on the ground that the administrator has managed the company's affairs, or has acted, in a manner that is prejudicial to the interests of some or all of the company's creditors or members;
- s 448C, which allows the court to grant leave to a person to act as administrator notwithstanding the potentially compromising matters listed in that section;
- s 1321, which allows a person aggrieved by a decision of an administrator to appeal to the court.

The statutory provisions are not expressed to depend upon establishing a breach of fiduciary duty. In fact none of them refers to fiduciary duties. Sometimes the court is given a discretion without any guiding principle being stated (for example, in the power to remove an administrator under s 449B and the power to review an administrator's decision under s 1321), and sometimes there are some guiding principles but they are expressed very generally by reference to such matters as unfair prejudice or the interests of the creditors individually or as a whole (for example, the power to terminate a deed of company arrangement under s 445D).

Nevertheless it is clear from the burgeoning case law that the judges employ fiduciary concepts in exercising their discretion under these provisions, without regarding themselves as being bound by the strict boundaries of fiduciary law (*Domino Hire Pty Ltd v Pioneer Park Pty Ltd* (2003) 21 ACLC 1330). The basic ideas of acting in the interests of the general body of creditors, avoiding actual and potential conflicts of interest and conflicts of duties, and avoiding the fact or appearance of partiality or lack of independence, are relied on by the judges in their discretionary decisions.

I have the impression that over the past eight years, the period in which I have been a judge, there has been a significant increase in proceedings under these various provisions complaining about the conduct of insolvency practitioners, in the areas of loyalty, conflicts, independence and impartiality. If this is true, it would be a matter having systemic significance, because (as Professor Harmer pointed out) considerations of independence and the like go to the heart of the operation of the voluntary administration regime. It would therefore be a problem needing to be addressed by the professional association for insolvency practitioners, or the regulators, or the Parliament.

According to some rudimentary research made for the purposes of this paper, in the period of 3 years from 1 June 2003 to 30 May 2006, there have been 15 Australian cases in which such complaints have been made, judged sufficiently important by the courts to be placed on the Internet. This compares with 7 cases in the 3 years from 1 July 1994 to 30 June 1997.

Of course, there are many possible explanations for the increase, if I am right that an increase has occurred. Moreover, complaints do not always lead to findings of contravention. But there is at least a non-negligible possibility that insolvency practitioners, grappling with the competitive and other pressures of professional practice in the 21st century, are not complying as adequately with their fiduciary responsibilities as insolvency practitioners did in the mid-90s. I can see no foundation for assuming that insolvency practitioners today are less concerned to carry out their professional responsibilities than the insolvency practitioners of the mid-1990s (largely, in any case, the same group). So this suggests the hypothesis that more practitioners are now laying themselves open to complaints through lack of adequate understanding of what is required of them, and lack of sufficient guidance from their professional association.

The impression of increasing complaints in this area that I have gained as a judge, reinforced by my limited research, seems to be shared by the Government and the regulator. The Insolvency Reform Package announced by the Parliamentary Secretary to the Treasurer in October 2005 includes a proposal designed to "improve the regulation of insolvency practitioners" by enhanced disclosure requirements (para 5). ASIC has become increasingly active in the regulatory supervision of insolvency practitioners in recent years, in both the compliance and enforcement areas, as Stefan Dopking and Maree Blake will explain to you later today. In a series of papers delivered before her appointment to the bench, Commissioner Collier made it plain that one of ASIC's concerns is in the areas of independence, impartiality and avoidance of conflicts of interest.

4. Some practical illustrations from the cases

Questions about loyalty, conflicts, lack of independence and lack of impartiality may arise in all sorts of circumstances, often unpredictably. But there are some recurring problem areas.

The Corporations Act itself gives an indication of some prior relationships that are likely to raise difficulties in the realm of loyalty, conflicts, independence and impartiality. Section 448C says that, unless the court grants leave, a person must not consent to appointment as an administrator of a company in certain cases, that is (in substance) where

- the person or an entity in which he or she has a substantial holding owes the company or a related body corporate more than $5,000 (presumably because the interest of a debtor to avoid payment conflicts with the interest of the general body of creditors to have the company recover payment for their benefit);
- the person is a creditor of the company or a related body corporate for more than $5,000 (presumably because there is a real, sensible possibility that the person, being personally a creditor, will fail to act impartially as between creditors);
- the person is, or has one of a number of specified connections with, those who run or work for the company (presumably because a person in such a position will have a personal interest in a particular sort of outcome for the company, such as an outcome that protects the positions of officers or employees);
- the person or the person's partner or employer is an auditor of the company (presumably because the person will have a personal interest in defending the auditor's certification notwithstanding the company's financial difficulty).

Here are a few examples, taken directly, or with modification, from cases about administrators or liquidators, where a loyalty problem (expressed in terms of conflicts of interest or lack of independence or impartiality) is likely to arise:

- the administrator's firm has at an earlier stage prepared a report on the company's accounting procedures or controls which is arguably negligent, and is therefore a potential subject of investigation or proceedings in the administration, or (more likely) in any liquidation that occurs if a deed proposal fails (compare, in the case of a liquidator, *Re National Safety Council of Australia* (1989) 15 ACLR 355);
- the administrator's firm has previously provided auditing or advisory services to the company or a related company, or a company likely to be investigated during the administration or a subsequent liquidation (compare, in the case of a provisional liquidator, *Re Giant Resources Ltd* [1991] Qd R 107 and in the case of a liquidator, *Advance Housing Pty Ltd v Newcastle Classic Developments Pty Ltd* (1994) 14 ACSR 230);
- the administrator's firm has previously provided auditing or advisory services to a company whose officers are likely to be publicly examined in a subsequent liquidation, on issues concerning the audit or advice (*Re Queensland Stations Pty Ltd* (1991) 9 ACLC 1341);
- there is a dispute between two groups of creditors as to whether a workout by deed of company arrangement should be adopted, and the administrator has, by conduct before the appointment, become aligned with one of the groups (compare *Network Exchange Pty Ltd v MIG International Communications Pty Ltd* (1994) 13 ACSR 544, where the complaint was not made out);
- the administrator acts partially towards a particular creditor, by conferring separately with the creditor, providing the creditor with detailed information about the company's affairs of a kind that would assist the creditor in proceedings against the company, and retaining the creditor's counsel for the examination of the company's directors (*Re Biposo Pty Ltd; Condon v Rodgers* (1995) 17 ACSR 730);
- the administrator acts partially in favour of one of the two directors of the company, by failing to investigate allegations against that director by the other director, and by not disclosing to the court or the other director that fees are being paid by the director (compare, in the case of a liquidator, *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* [2004] NSWSC 1119);
- the administrator exercises his casting vote as chairman in favour of approval of his own remuneration, in circumstances where the resolution to approve the remuneration would not otherwise be passed (*Re Krejci as liquidator of Eaton Electrical Services Pty Ltd* [2006] NSWSC

782).

It appears from the cases that some circumstances do not of themselves disqualify an insolvency practitioner from acting in an administration. The most important of these is where an insolvency practitioner has provided advice to the directors prior to the directors' resolution to appoint that practitioner as administrator. The general question normally asked by the courts is whether the prior relationship between the administrator and the directors would create a reasonable apprehension by any creditor of lack of impartiality on the administrator's part (see, by analogy, *Advance Housing Pty Ltd v Newcastle Classic Development Pty Ltd* (1994) 14 ACSR 230). Where the advice is limited to pre-appointment advice on the question of solvency and the company's options, the courts have answered that question in favour of the administrator.

In *Re Club Superstores Australia Pty Ltd* (1993) 10 ACSR 730 was a case about a liquidator. Thomas J in the Supreme Court of Queensland referred to the common practice of a potential liquidator attending a pre-appointment conference with a creditor or the company's directors, and said that this practice does not contravene the liquidator's duties of independence and impartiality. But he said that the potential liquidator needs to be careful not to "cross the line", for example by giving personal advice to those who attend the pre-appointment conference. In the case before Thomas J, the practitioner had crossed the line, even though acting with the best motives and for no fee, by giving the impression that he was providing personal advice to those in attendance.

Essentially the same approach was taken in a case about voluntary administration, *Commonwealth v Irving* (1996) 19 ACSR 457. There Branson J in the Federal Court said (at ACSR 464-5) that it is permissible to appoint as administrator a person who has had prior contact with the company or its directors or officers, and she continued:
"It is now commonplace for a company to seek professional advice respecting actual or apprehended insolvency and for the advice received to be to appoint an administrator pursuant to Pt 5.3A of the Corporations Law. Not infrequently, and in my view, not improperly, the proponent of the advice to appoint an administrator then accepts appointment as that administrator. There would, I consider, be an air of commercial unreality about any suggestion that this course of events is necessarily improper… However, the authorities make it plain that substantial involvement with the company prior to its administration will disqualify a person from appointment as that company's administrator. Such an involvement will be seen to detract from the ability of the person to act fairly and impartially during the course of administration. In *Molit (No 55) Pty Ltd v Lam Soon Australia Pty Ltd* (1996) 19 ACSR 160 in speaking of the role of an administrator I said:
'In such a role he or she is, in my view, obliged to consider not only means to maximise the chances of the company, or as much as possible of its business, continuing in existence (s 435A), but also issues of fairness between the company and its creditors, and between the company's creditors inter se.'
It is necessary that the person appointed as an administrator can be seen to be independent of the company and of each of its creditors so that his or her ability to perform the above role is not open to question."

In other words, the mere fact that an insolvency practitioner provided advice to a company and its directors and officers about whether the company was or was nearing insolvency and whether an administrator should accordingly be appointed, and having provided that advice, accepted the appointment as administrator, is not enough to disqualify the practitioner from acting in that office on the ground of lack of independence and impartiality. But as soon as the potential administrator goes further than providing advice of that kind there is a risk of "crossing the line". The line will be crossed when the court perceives that what the potential administrator has done creates a reasonable apprehension of lack of independence, or places the administrator in a situation of actual or potential conflict between the duty to the general body of creditors (including the duty to act impartially as between creditors) and a duty to, or a shared interest with, the directors or officers or some particular creditor.

Bovis v Wily is an example of a case where it was found that the line had been crossed. There an accountant who worked as a consultant for the administrator had previously acted for the company's director when the company was in liquidation, advising him whether anything could be done to stop the liquidation process and helping him to prepare the director's report as to affairs. The company's liquidator appointed an administrator and eventually a deed of company arrangement was adopted. It was held that the deed benefited the director and was not in the interests of the creditors as a whole, and should be terminated; and that the administrator should be removed from office as administrator because the consultant's connection with the director would cause a reasonable observer to perceive that the administrator lacked independence and impartiality. The fact that the administrator was not aware of the degree of prior connection between his consultant and the director was no answer to the

claim that a reasonable perception of lack of independence had arisen because of the consultant's conduct (at [363]).

It has been held that there is not any "crossing of the line" simply because an insolvency practitioner makes an arrangement with a particular creditor for payment of costs and expenses; or because the insolvency practitioner retains solicitors who have acted for, or continue to act for, a creditor. The case which is said to establish these propositions is *Re Allebart Pty Ltd* [1971] 1 NSWLR 24. But in a later case (*National Australia Bank Ltd v Wily* [2002] NSWSC 573) Burchett AJ pointed out that in *Re Allebart* there was extreme hostility between the former controller of the company (Mr Barton) and the controller of the petitioning creditor (Mr Armstrong), hostility which led to proceedings in which Mr Barton sought to set aside an agreement on the basis of duress, alleging that Mr Armstrong had threatened to murder him (*Barton v Armstrong* [1976] AC 104). Burchett AJ suggested that *Re Allebart* should be confined to its facts.

It therefore seems, notwithstanding *Re Allebart*, that arrangements for payment of fees may be evidence of lack of independence, at least where they are not disclosed and there is other evidence pointing in the same direction. Thus in *Bovis v Wily*, it was found that there was an arrangement between the consultant and the director of the company, prior to the commencement of the administration, to the effect that the consultant would provide advisory services to the director on the basis that he would be given the opportunity to nominate an administrator from whom he could earn remuneration as a consultant (at [160]). That "contingent fee arrangement" contributed to the conclusion that the administrator, by his consultant, had "crossed the line".

5. The current professional standards for insolvency practitioners

Insolvency practitioners who are members of a professional accounting body are affected by standards proclaimed by that body. Of particular importance in the present context is the *Statement of Insolvency Standards*, APS 7, issued in March 1998 by the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants in Australia. Insolvency practitioners who are members of the Insolvency Practitioners Association of Australia are affected by the Code of Professional Conduct ("the Code") promulgated by that body, amended to May 2001. Since the Code incorporates the substance of APS 7, and adds to it, I shall confine my attention to the Code. The IPAA has also adopted some Statements of Best Practice relevant to the present discussion, namely *Independence* (July 2003), *Calling and Conducting Creditors' Meetings* (July 2005) and *Competition and Promotion* (July 2005).

I do not wish to cast in any doubt on the importance and utility of the IPAA's Code and the Statements of Best Practice. I offer some observations about the present rules on the basis that the time may well be ripe for a review of the drafting of the documents, given the pending release of draft reforming legislation and the increasing activity of ASIC in compliance and enforcement in the insolvency area, to be reflected in guidance notes that are in course of preparation.

I tentatively suggest that in any revision of the Code and Statements of Best Practice, it might be beneficial to separate from one another the various objectives which the documents serve. One can discern several objectives underlying them. The Code serves a purpose in terms of the Articles of Association of the IPAA, in the sense that actions taken contrary to the Code are to be considered by the National Committee in its investigatory role (para 1). Additionally, the Code (and to a lesser extent the Statements of Best Practice) lay down mandatory rules requiring members to do things not required by the law, or not to do things that the law permits. Further, in conjunction with the Statements of Best Practice, the Code serves the function of educating members as to their professional responsibilities.

If the hypothesis that I advanced earlier (that insolvency practitioners need help in understanding their professional conduct requirements in the area of loyalty) is correct, the objective of providing that help will not be achieved by mandatory rules that imperfectly track the contents of the fiduciary law. Mandatory rules are justified only if there is a specifically identified need to add to the requirements of the law, or to provide a foundation for some disciplinary or investigatory jurisdiction of the National Committee. To the extent that the purpose of the rules is to provide guidance to assist practitioners to carry out their professional responsibilities, a better way forward may be to recast the general propositions as statements of principle rather than mandatory requirements, and since statements of principle will necessarily be very general, to provide specific guidance by case studies or illustrations rather than by additional prescriptions.

In its present form, the Code is an amalgam of some very general statements that broadly reflect the

fiduciary principles that I have discussed, and some relatively specific guidance in one limited area. Although para 1 states that the Code provides "guidance on the standards of practice and professional conduct expected" of members, much of the content is prescriptive, purporting to lay down what must or must not occur.

It is important to understand that the Code does not override the administrator's legal duty of loyalty to the general body of creditors. Thus, while the Code rightly requires a member to be, and be seen to be, free of any "interest" which is incompatible with objectivity and independence (para 2), a court applying the law may find that there is a lack of independence where no "interest" of the administrator is at stake. For example, in *Bovis v Wily*, there was a lack of independence even though the administrator was unaware of his consultant's arrangements with the company's director. The *perception* of lack of independence can arise in a multitude of circumstances where no "interest" of the administrator is at stake.

Similarly, the Code addresses actual and potential "conflicts of interest" (para 3), an expression that may not convey to members the important idea that in law, the same principle applies where the member has no personal interest at stake but is subject to an incompatible duty, or is under the influence of an extraneous interest (such as the interest of directors to avoid a liquidation in which their conduct may be investigated). Further, the statement in para 3(ii), that if a conflict or apparent conflict of interest arises during the administration the member must fully disclose details to the relevant parties, leaves open the important question of what to do next. The law says that disclosure is not enough, and if the member continues to act there is a breach of duty unless the appropriate persons give their free and fully informed consent.

A helpful part of the Code, which was considered favourably in *Bovis v Wily*, deals with whether a prior relationship to the company should prevent a member from accepting an appointment (para 4). Here the Code is quite specific and in my opinion, it provides some real guidance. However, the language is mandatory and its effect is somewhat arbitrary. The member "shall not" accept an appointment as administrator if any person in the member's practice has had a continuing professional relationship with the company during the previous two years. A list of matters is excluded from the concept of "continuing professional relationship". Of course, the fact that an engagement is not prohibited by para 4 does not mean that the law is complied with. If, for example, the member's practice did some work which has been the subject of criticism suggesting the prospect of litigation to recover damages for negligence from the firm, the fact that the engagement ended more than two years ago would be to no avail.

Similar comments can be made about the Statements of Best Practice. For example, the Statement on *Independence* tells members that in the notice of the first meeting of creditors, the administrator "shall, at a minimum" provide certain specified details. But, perhaps because this is perceived as a statement of "best practice" rather than a mandatory rule, the information that must be provided in the notice of meeting is left indeterminate, by the use of such expressions as "the relevant details". If the purpose of the Statement is to tell members about their professional responsibilities, arising under the law of fiduciary duties and other applicable rules, it may be best to state the principle about loyalty, conflicts of interest, independence and impartiality, and then to provide a series of factual illustrations of the application of the principle - for example, situations where there is an earlier relationship with the company, or with directors or officers or their associated businesses, or with a dominant creditor.

I mention these matters not for the purpose of being critical, but only to show that mandatory statements in general terms may not always achieve the outcomes that are intended. To the extent that there have to be mandatory statements in order to add particular requirements to the law or to provide a foundation for disciplinary or investigatory jurisdiction for the National Committee, those statements should be clearly made, and kept separate from the rules that are there for the purpose of assisting members to comply with their responsibilities.

These reflections bring me back to the point that the future development of the Code and Statements of Best Practice, to the extent that they are intended to assist members to comply with their professional responsibilities, may lie in combining general statements of principle or standards, not expressed as mandatory propositions to be construed as if they were Acts of Parliament, with practical, factual illustrations.

There are many models of professional rules and standards from which to choose useful precedents. It seems to me important to take care in selecting the best models. The accounting and auditing standards, close at hand, may not be the best models for guidance rules, because they have special statutory effect and have become quasi-legislative. Guides produced by ASIC may also not be the best precedents because ASIC is in the position of a public regulator, able to reinforce its guidance through

the use of regulatory power. Guidance notes by a self-regulator are likely to be more useful.

I regard the guidance notes for the Australian Stock Exchange's Listing Rules as a useful drafting precedent, because (although the legal reinforcement of the ASX guidance notes is quite different from the framework for the IPAA's rules), there has been a sustained effort to segregate precepts, principles and illustrations.

A good illustration of the ASX approach is the continuous disclosure Listing Rule, rule 3.1. The Rule itself has a quasi-statutory force and is drafted accordingly. Then there is a Guidance Note (GN 8) which gives a narrative description of how the rule works, and considers its application in a number of important factual contexts, such as where an analyst's report misrepresents the company's position or some matter of disclosure is mandated by an overseas listing of the company. Interestingly, there is an attachment to the Guidance Note which provides "working examples" of the operation of the Listing Rule. These are hypothetical factual situations accompanied by a distinct statement of what the Listing Rule requires. I think the use of "working examples" would be a particularly good way of explaining to insolvency practitioners the practical operation of the principles that I have been discussing.

A somewhat different drafting approach may be found in the ASX's treatment of corporate governance practices. Listing 4.10 requires companies to disclose in their annual reports a statement of their main corporate governance practices during a reporting period, and to show the extent to which they have followed the ASX best practice corporate governance recommendations. The best practice recommendations, *Principles of Good Corporate Governance and Best Practice Recommendations*, were adopted by the ASX Corporate Governance Council in 2003. If the company has not followed all of the recommendations, it is required by the Listing Rule identify the recommendations that have not been followed and give reasons for not following them.

It is not for me to advocate whether the IPAA is in a position to adopt best practice recommendations supported by a "comply or explain" requirement for its members. What is important for present purposes is that one has, in the ASX system, a reasonably clear idea of the status of the *Principles of Good Corporate Governance and Best Practice Recommendations*, in a document that generally distinguishes between principles and best practice recommendations, and all of that material exists within the framework of a mandatory rule, namely Listing Rule 4.10.

It is of considerable importance for professional associations to take care to achieve clarity and balance in their conduct rules. Any conduct rules adopted by a professional association are likely to have some influence with regulatory bodies because they are seen as reflecting common practice in the profession's own view of proper standards. It may be less generally recognised that a professional body's conduct rules may well assist a court whose job it is to exercise discretions under relevant statutory provisions, and occasionally to clarify uncertain points of law.

There is a vivid analogy in company law. In *ASIC v Rich* (2003) 44 ACSR 341 ("the Greaves case") ASIC contended that Mr Greaves, the non-executive chairman of directors and chairman of the finance and audit committee of One.Tel, had particular responsibilities in his position, going beyond the responsibilities of other non-executive directors. The question for the court was whether to strike out ASIC's pleading on the ground that it disclosed no reasonable cause of action, because no such duty was known to the law. The court found that the standard of care of a company chairman is to be identified in a manner that reflects contemporary community standards, and the court might be assisted in that task by having regard to corporate governance literature describing the special role and responsibilities of a company chairman (assuming it to be admissible in evidence). This material indicated to the court that ASIC had an arguable case.

Similarly, when resolving matters relating to an administrator's duty of loyalty, the court might be expected to have regard to rules and best practice statements of the professional body for administrators, if that material is presented in a useful form. In *Bovis v Wily* (at [163]) it was held to be permissible for a court to take the IPAA Code into account as a useful guide to common practice within the insolvency practitioners' profession, and an indication of the profession's view of proper professional standards, on the question whether a prior relationship with the director of the company should present an insolvency practitioner from accepting appointment as the company's administrator.

6. Self-regulation versus statutory regulation

Consumers of the services of insolvency practitioners, and the community generally, are entitled to demand a system of regulation in which insolvency practitioners are held to standards of loyalty, avoidance of conflicts, independence and impartiality that are:

- fair;
- effective to preserve the system of voluntary administration which depends on compliance with proper standards;
- realistic and practical, and therefore achievable on a day-to-day basis without undue compliance costs;
- comprehensible, so that practitioners can ascertain what is required of them in any given situation, or at least understand the reasoning process that will be applied to assess their compliance.

This is not an area where there is an "all or nothing" choice between self-regulation and statutory regulation. There is a statute in place, and it gives the courts discretionary powers which they exercise having regard to the fiduciary principles of the law. But there is a perceived need to supplement the courts' work by adopting regulatory strategies to secure compliance with the fiduciary standards. The question arises whether this perceived need can be adequately met by enhanced self-regulation, or must be addressed by additional legislation.

Self-regulation is usually better than public regulation in performing the task of designing compliance strategies that are realistic, practical, cost-effective and comprehensible. This is especially so where the regulated enterprises range from corner groceries to vast economic empires and a "one size fits all" approach will not do. Self-regulation has advantages in these respects because self-regulators tend to understand their industry or profession, and the modus operandi of the players, better than public regulators. But self-regulation is sometimes less reliable when it comes to the fairness and efficiency of regulatory outcomes. Self-regulation tends to be treated as sufficient by governments and public regulators only when it is perceived to be pro-active and energetic and there are no unsatisfactory outcomes.

There are indications that the regulation of the conduct of insolvency practitioners is arriving at a turning point. Twelve months after the Government's Insolvency Reform Package was announced, there is still no public exposure draft of a Bill, but all the indications are that its release is imminent. When the Bill is released there will be renewed debate about standards of conduct. There will be issues about whether the Government's enhanced disclosure proposals are, on the one hand, too prescriptive and heavy-handed, and on the other hand, insufficient to address the perceived problems. The alternative of leaving it to the professional body to address the perceived problems, by enhanced disclosure or other means, will necessarily arise for consideration, especially since the IPAA already has a Statement of Best Practice requiring disclosure. But self-regulation will not be preferred unless the professional body's alternative to legislation is manifestly credible.

If the regulatory trend that emerges from the debate about the Government's proposals is towards statutory intervention, insolvency practitioners could well be initiated into a downward spiral of greater and greater technicality, and higher and higher compliance costs.

The regulation of the conduct of auditors provides a chilling point of reference. The Government 's decision to legislate for standards of auditor independence, in the wake of the HIH Royal Commission Report and the introduction of the Sarbanes -Oxley Act in the United States, led to 22 pages of technical drafting. Some of the technicality arose out the need to deal with audit firms, audit partners, and individual auditors, since incorporation was to be permitted for the first time. But it was also necessary for the drafters of the legislation to address the key concept of independence, which led them to the defined expression "conflict of interest situation". The definition of that expression led to other defined expressions such as "professional member of the audit team" and to the concept of an "objective and impart judgment", an expression that is not defined in spite of its central importance. The result was dismally and unnecessarily complex legislative boilerplate. And yet the general law of fiduciary duties was allowed to continue, so there are two layers of standards, one in the general law and the other in the statute.

I do not suggest that there is any present proposal to apply the auditor provisions or any adaptation of them to the independence requirements for an insolvency practitioner. The present Government proposals are merely:

- to require administrators to provide creditors with a "statement of independence" prior to the first meeting, so as to allow creditors to prevent the appointment by directors of a "friendly" administrator";

- to extend the prohibition on inducements for the referral work to directors and other persons; and
- to permit creditors to appoint a new person as liquidator if the company proceeds to liquidation after an administration or deed ceases (so that the new administrator can investigate the conduct of the directors and the previous administrator)

(see the Parliamentary Secretary's October 2005 press release at para 48).

But the implementation of these provisions will necessarily add some technical drafting to the present Corporations Act provisions. The existing provisions already have some complexity and technicality, especially in the list of matters which prevent an insolvency practitioner from consenting to appointment as an administrator without the leave of the court (s 448C). Section 448C, technical though it is, is from an earlier generation of drafting than the auditor independence provisions. If it were re-drafted in the new style, the drafting would expand to several pages.

The biggest risk for insolvency practitioners is that a scandal will emerge causing the Government to react comparably to the reaction in the field of auditor independence. Then there will be full-blown technical legislation of that kind, unless the Government can be persuaded that the professional body is addressing the problem.

7. Conclusion

Apart from death and taxes, the following predictions can be made with absolute confidence:

- the inexorable march of the case law on the administrator's duties of loyalty, avoidance of conflicts, and maintenance of independence and impartiality will continue, and the courts will explain and give further illustrations of the application of the fiduciary principles, in ways that may or may not be palatable to the profession;
- there will be some legislation affecting the duties of administrators, whether as proposed presently by the Government or in some modified form;
- insolvency practitioners as a profession will be criticised publicly, from time to time, for perceived inadequacies in their conduct in this area.

Just how the regulation of insolvency practitioners will proceed, in light of such developments, and whether, in particular, they will be burdened by massive and technical rules and increased compliance costs, may well depend on how they and their professional association respond to the pressures to which they are presently being subjected.

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Hip-pocket injuries in workouts: Accessory liability for bankers and advisers

Banking & Financial Services Law Association

23RD ANNUAL BANKING & FINANCIAL SERVICES LAW & PRACTICE CONFERENCE
Surfers Paradise Marriott Resort,
Friday 11 & Saturday 12 August 2006

Concurrent Session A-1: Hip-pocket injuries in workouts: Accessory liability for bankers and advisers

Paper by the Hon Justice RP Austin, BA, LLM (Syd), D Phil (Oxon),
Supreme Court of New South Wales

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1. Introduction

This paper is about the potential liability of financiers (especially banks) and advisers when they become involved in assisting or guiding a company through a period of financial difficulty. I have in mind the bank's larger corporate customers, either listed entities or large unlisted enterprises.

It can hardly be said that the topic has been overlooked in the literature of corporate law. Much has been written, not only on the general question of liability of de facto and shadow directors, but also specifically on the position of financiers and advisers. In a relatively recent article by Mark Stoney, "Borrower companies approaching insolvency -the potential liability of the lender as a de facto director", (2000) 8 *Insolvency Law Journal* 192, the author begins by citing some 10 journal articles which focus specifically on the position of banks.

On the other hand, the case law is, so far, relatively thin. As Vinelott J has remarked, "the dividing line between the position of a watch-dog or adviser imposed by an outside investor and a de facto or shadow director is difficult to draw" (*Re Tasbian Ltd (No 3), Official Receiver v Nixon* [1991] BCLC 792, at 802). Drawing the line requires not only an understanding of the scope of the statutory provisions and the principles underlying them. It requires close analysis of the facts of the cases that are most germane to the position of banks and advisers in workouts, to ascertain the factual circumstances treated by the courts as relevant to their application of the law, and the weight they have given to those factors.

There are, in fact, only a few cases that bear a reasonably close analogy with the position of banks and advisers in workouts. The leading Australian case, *Standard Chartered Bank of Australia Ltd v Antico* (1995) 38 NSWLR 290, was not about intervention by a banker or other financier *per se*: Pioneer had a combination of interests that made its position vis-a-vis Giant special and readily distinguishable from the typical situation of a bank in a workout.

My addendum to commentary in this area is justified, if at all, by three matters: first, I hope it will be useful to focus closely on the facts of selected cases that seem to me to come closest to the typical situation of a bank or an adviser in a workout; second, I wish to argue that the English cases, and some earlier Australian cases, need to be reassessed in light of the current wording of the Australian definition of "director"; third, though centrally important, exposure to liability as a de facto or shadow director is not the only risk for banks and advisers, and particular note needs to be taken of the risk of direct or accessory liability for misleading conduct, and where the borrower is a listed entity, the new accessory liability under the continuous disclosure regime.

I intend to develop the first two matters under the general heading, "de facto and shadow directorships", and the third matter under the heading "accessory and primary liability for misleading conduct and non-disclosure". But first, it is necessary to give a brief description of the kind of activities that might be involved for banks and advisers in the course of a workout for a large Australian company.

2. Financiers, advisers and workouts

When a bank finds that its corporate customer is experiencing financial difficulties serious enough to raise a real concern about solvency, it has limited options. One possibility is, of course, to extend further credit in the hope that the existing management, with realistic business plans and tight financial controls, will be able to turn the situation round. That passive approach could be expensive for the bank, if management fails. The second possibility is for the bank to exercise its security, typically by appointing a receiver and manager. It is widely believed that the very act of imposing an external administration of this kind, with attendant publicity, will depress the value of the business and its assets and necessarily make it more difficult, and perhaps impossible, for a turnaround to be achieved. If the bank's exposure is well covered by the security, the bank may nevertheless choose to pursue this option, leaving other creditors to share the deficiency. But a bank may prefer to avoid this option where the exercise of the security will not recover 100 cents in the dollar or there are other reasons, for example reputation or public relations reasons, why the bank may not wish to be seen as "pulling the plug". It is the third alternative, engineering or supporting an informal workout outside the strictures of receivership, voluntary administration and liquidation, that is receiving very considerable attention at this stage in Australia's business cycle.

There are some typical kinds of activities involved, on behalf of the bank, in an informal workout for one of its customers. Where the financier is not a bank, the range of activities is probably wider, especially where the financier is not a large bureaucratic organisation and is not subject to prudential regulation.

One thing that might already have happened, especially if the bank has equity in the customer, is the appointment of nominee directors to the company's board. There is some case law as to whether the step creates the potential liability of a de facto or shadow director for the bank. In *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1990] 3 All E R 404, where the bank held 40% of the shares of the company and bank nominees were two of the five directors, the Privy Council held that the bank was not a director, as the nominee directors were bound to ignore the interests and wishes of their employer, the bank, when acting as directors, and there was no allegation that they were accustomed to act on the directions or instruction of the bank. In *Lord v Sinai Securities Ltd* [2004] EWHC 1764 (Ch), Hart J held that under the English provision it is not enough to constitute a person a shadow director that one member of the board is that person's nominee; it would have to be shown that all the directors, or at least a consistent majority of them, had been accustomed to act on the person's directions.

More typically, the bank will not have nominee board positions and will become aware of the company's difficulties through review of overdraft and similar facilities, reporting by the customer or external sources of information. An early priority is likely to be for the bank to investigate to ascertain the true position and form views about the problems and the means of rectifying them.

The bank may have its own specialists in-house to perform this work, or it may prefer to see an external adviser engaged. This is an important choice that may have liability consequences. The bank may consider it safer that any external adviser be engaged by the company rather than by the bank, so as to minimise the bank's exposure to liability as a de facto or shadow director or as an accessory under other provisions. The adviser's exposure to liability may be greater if engaged by the company than if engaged by the bank. The documentary terms of appointment and arrangements for payment, and any indemnities, will affect the characterisation of the engagement, regardless of what the parties say. For example, if the bank not only pays and indemnifies the adviser but also directs the adviser's work from day to day, it may be to no avail that the documents purport to show that the adviser was engaged by the company.

Depending on the adviser's assessment, the bank might wish to persuade the company to take immediate steps to:

- improve governance (where, for example, board meetings have been infrequent or not properly minuted);
- improve financial recording, integration and reconciliation, reporting, information flows and controls;
- replace executive staff, such as CEO and CFO.
- I shall call such steps "intervention in governance" (see 3.5(a) below).

- The bank may wish to set up a system of regular meetings of its representatives with executive management of the company, to develop workout proposals. This may involve discussions, in

which the bank's representatives may wish to play a leading role, about such matters as:
- restructuring of business divisions;
- identifying underperforming businesses and winding them down, or preparing them for sale;
- settling published financial reports;
- establishing leaner cost structures in retained businesses, with limits on such matters as discretionary spending on expenses, advertising, telephones, credit cards etc;
- setting corporate policies and practices on pricing, margin management, cashflow etc
- developing new business plans, forecasts and KPIs.

I shall call such steps "ongoing development and review" (see 3.5(b) below).

Exploration of such matters may lead to discussions with external parties. The bank may wish to be involved in discussions and negotiations of various kinds, for example with:

- the company's auditors;
- the company's advisers;
- major external creditors;
- suppliers and customers or their representatives;
- major shareholders, existing senior management and related creditors;
- employees or their representatives;
- regulators such as ASIC and the ACCC;
- if the company is listed, the ASX;
- ratings agencies and the media;
- (perhaps) shareholders generally.

I shall call such steps "discussions with external parties" (see 3.5(c) below).

Internal and external discussions and negotiations may make it necessary for the bank to consider taking steps such as:

- extending financial accommodation, perhaps temporarily, on conditions relating to corporate management and the implementation of workout proposals;
- providing additional funding by way of equity with or without reduction of existing entitlements to payment of interest and repayment of capital;
- exercising security by sale of businesses or assets;
- participating and perhaps sponsoring an incentive scheme for all stakeholders, including other funders, major creditors and employees;
- withdrawing support and negotiating an exit mechanism.

I shall call such steps, content is free and not entirely accurately, "workout transactions" (see 3.5(d) below).

This is not by any means an exhaustive list. Every case is different, and no doubt presents different risks, challenges and opportunities. However, every one of these steps, and any other steps a bank may take in the workout that I have not listed, will be relevant to the bank's potential liability. They will also be relevant to the position of the adviser, depending on the extent of the adviser's involvement in each step, the formal contractual framework for that involvement and the reality of the working relationships between the adviser and the company and the bank. The lawyer's task in advising the bank or workout adviser is to ascertain just what degree of involvement the client wishes to have, and to make an assessment of the impact of each factor in that involvement on the overall liability equation, having regard to the most relevant case law.

3. De facto and shadow directorships

3.1 The present definition and its significance

The definition in s 9 of the Corporations Act 2001 (Cth) is as follows:

"**director** of a company or other body means:
(a) a person who:
(i) is appointed to the position of a director; or
(ii) is appointed to the position of an alternate director and is acting in that capacity;
regardless of the name that is given to their position; and
(b) unless the contrary intention appears, a person who is not validly appointed as a director if:
(i) they act in the position of a director; or
(ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.
Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity or the person's business relationship with the directors or the company or body."

There is a note giving examples of some provisions in the Act, not presently relevant, which display a contrary intention ousting the extended definition in para (b).

The definition has immense practical as well as theoretical importance. Courts have generally not adopted a narrow approach to its construction, taking the view that the purpose of the legislation is to protect the public (*Re Lo-Line Electric Motors Ltd* [1988] Ch 477, at 489 per Browne-Wilkinson V-C). The attention of the courts and commentators has focused on the concept of shadow directorship in subparagraph (b)(ii). It has been held that the purpose of the legislation is to identify the persons (other than those whose advice is excepted) with real influence in the corporate affairs of the company, though the influence need not be exercised over the whole field of its corporate activities (*Australian Securities Commission v AS Nominees Ltd* (1995) 13 ALR 1, at 52-3 per Finn J; *Re Kaytech International plc* [1999] 2 BCLC 351 at 424 per Robert Walker LJ; *Secretary of State for Trade and Industry v Deverell* [2000] 2 All ER 365 at 376 per Morritt LJ; *Secretary of State for Trade and Industry v London Citylink Ltd* [2005] EWHC 2875 at [15] per Pumfrey J).

Professors Gower and Davies have observed (*Gower and Davies' Principles of Modern Company Law* (7th ed, 2003), page 197):
"The two potential defendants of greatest interest are … banks and parent companies. As far as the former are concerned, the courts have so far taken a cautious line, on the grounds that the definition of a shadow director requires that the board cede its management autonomy to the alleged shadow director and that the taking of steps by a bank to protect itself does not induce such a cession, if the company retains the power to decide whether to accept the restrictions put forward by the bank, even though the company may be thought to have no practicable alternative. In relation to parent companies, such a degree of cession of autonomy by the subsidiary may be more easily found, but much will still depend upon how exactly intra-group relationships are established. The degree of control exercised by parent companies may vary from detailed day-to-day control to virtual independence, with many variations in between."

We are not concerned, here, with the parent-subsidiary relationship, but this quotation is important because it reminds us that different kinds of emphasis emerge in the case law dealing with financiers and advisers, on the one hand, and parent companies on the other. Care must be taken in transposing observations made about a parent company to a case concerning a financier or adviser. Care must also be taken not to apply the reassuring words of Professors Gower and Davies to the exposure of banks under Australian law, without reflecting first on the differences between the Australian and UK statutory language.

The statutory definition is generally relevant to the provisions of Chapter 2D (see s 179(2)), including the directors' statutory duty of care and diligence (s 180). Other provisions of Chapter 2D may be relevant, depending on the facts, but I mention s 180 in particular, because its potential application to financiers and advisers must not be overlooked.

If s 180 applies, the risk to the financier or adviser is that an action for compensation to the corporation may be brought (under the civil penalty provisions ss 1317H and 1317J(2)) by the liquidator suing in the company's name, or by ASIC. Banks and large advisory firms with professional indemnity insurance may be more attractive targets in litigation than the directors and officers of the failed entity. They would be unlikely to be in a position to take advantage of the statutory business judgment rule in s 180(2), because of the probability that they would have a material personal interest in the subject matter of the judgment.

The application of s 180(1) to a de facto or shadow director is syntactically difficult. If a financier or adviser becomes a de facto or shadow director of a corporation, and s 180(1) applies, the section will

require it to exercise the powers arising out of its position of control or influence over the corporation's board with the degree of care and diligence that a reasonable person would exercise if they were a [de facto or shadow] director of a corporation in the corporation's circumstances, and occupied "the office held by, and had the same responsibilities within the corporation as" the [de facto or shadow] director. The language is odd (but not extremely odd: compare s 588G(2)(b)). It could be interpreted as creating by statute a financier's duty of care, something that the Australian case law on the mortgagee's exercise of the power of sale has hitherto skirted around. There is a possibility that the court might be persuaded not to apply the extended definition of "director" in the context of s 180, on the ground that "the contrary intention appears" in that section. But s 180 is the very next section after the statutory pronouncement, in s 179(2), that the definition of "director" is applicable in Part 2D.1.

The definition unambiguously applies, importantly, for the purposes of the directors' duty to prevent insolvent trading by a company (s 588G). Civil contravention occurs if:
(i) the financier or adviser is a de facto or shadow director of a company for a period of time (s 588G (1)(a));
(ii) the company incurs a debt during that time (s 588G(1)(a));
(iii) the company is insolvent at that time, or becomes insolvent by incurring the debt, or debts including that debt (s 588G(1)(b));
(iv) at that time, there are reasonable grounds for suspecting that the company is insolvent or would so become insolvent (s 588G(1)(c));
(v) the financier or adviser fails to prevent the company from incurring the debt (s 588G(2));
(vi) either the financier or adviser is aware at that time that there are such grounds for suspecting, or a reasonable person in a like position in a company in the company's circumstances would be so aware (s 588G(2)(a) and (b));
(vii) the financier or adviser does not prove any of the defences, such as that

- at the time it had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if the company incurred the debt and other debts incurred at that time (s 588H(2));
- the financier or adviser had reasonable grounds to believe, and did believe, that a competent and reliable person (the "other person") was responsible for providing adequate information to it about whether the company was solvent, and that the other person was fulfilling their duty, and that it expected on the basis of information so provided that the company was solvent and would remain so (s 588H(3));
- the financier or adviser took all reasonable steps to prevent the company from incurring the debt (s 588H(5) and (6)).

The financier or adviser commits a criminal offence under s 588G(3) if it actually suspected insolvency and its failure to prevent the company incurring the debt was dishonest. There is potential accessory liability under the Criminal Code (Cth) for the directors and officers of the financier or adviser who are involved in the contravention.

Section 588G(2) is a civil penalty provision (s 1317E(1)(e)). In addition to the prospect of a declaration of contravention, a pecuniary penalty order and a disqualification order, the financier or adviser may be subject to a compensation order under s 1317H on the application of the company or ASIC (s 1317J(1) and (2)). Where the company is being wound up, the liquidator may take proceedings against the financier or adviser, as a de facto or shadow director, under s 588M. The financier or adviser also has potential civil liability for damages payable to creditors under s 588J. If the company is being wound up, creditors may directly sue only with the consent of the liquidator or under the special circumstances identified in s 588T.

In order to consider whether the defendant is a director of a company for any of these statutory purposes, in circumstances where the defendant has not been appointed as a director and has not acted as a director, but may have influenced the directors, the definition in s 9 requires us to consider:
(i) who are the directors of the company;
(ii) whether the defendant has "acted in the position of" a director;
(iii) what are the defendant's relevant "instructions or wishes";
(iv) whether there is evidence that the directors have acted in accordance with such instructions or wishes;
(v) whether that evidence establishes that the directors are "accustomed" to act in accordance with the defendant's instructions or wishes;
(vi) whether the instructions or wishes of the defendant, in accordance with which the directors have

acted, constitute "advice" given by the defendant;
(vii) if so, whether the advice was given by the defendant in the proper performance of functions attaching to his or her professional capacity, or his or her business relationship with the directors or the company.

In the Australian literature, reliance is often placed on UK cases and older Australian cases, as expositions of the current law. The underlying assumptions, that the concept of shadow directorship is the same in Australia and the United Kingdom, and that it has not changed over time in Australia, are both wrong. As Bryson J observed, in *Omnicon Video v Kookaburra Productions* (1995) 13 ACLC 1795 at 1796, that:
"Statutory provisions which extend for various purposes the range of persons who are to be treated as if they were directors by reference to their taking part in management are common in contemporary companies legislation. … Notwithstanding the similarity of concept, care should be used …. [P] rovisions differ in their purpose and also in their detailed expression, and their application must always be affected by the instant facts."

I note, for the benefit of New Zealand participants in the conference, that the provisions of the Companies Act 1993 (NZ), s 126, are different in potentially significant ways from both the Australian and UK counterparts. I shall not explore the position under the New Zealand provisions in this paper.

3.2 History and Australian idiosyncrasies

Some brief observations on the development of the Australian legislation are therefore necessary.

The idea of extending the definition of "director" beyond those formally designated as directors is very old. In the Companies Clauses Consolidation Act 1845 (Imp), "directors" were defined to include those acting "under the name of directors, managers, committee of management, or under any other name" (s 3). The Joint Stock Companies Acts of 1856 and 1862 (Imp) did not contain a definition of the word "director", but a definition was introduced by the Companies Act 1900 (Imp), s 30, which said that the expression "director" includes any person occupying the position of director by whatever name called.

The concept of shadow directorship has appeared in every UK Companies Act since the Companies Act 1929 (UK), which extended the definition of "director" to include a person "in accordance with whose directions or instructions the directors of the company are accustomed to act". It was adopted in the companies legislation of the Australian states. Thus, in the Uniform Companies Acts 1961, the definition in s 5 included both a person occupying the position of director of a corporation by whatever name called, and a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act.

The wording of the definition of "director" has been changed relatively frequently in Australia since the enactment of the Uniform Companies Acts in 1961. Three amendments are of particular significance for present purposes, one to the concept of de facto director and two to the concept of shadow director.

I turn, first, to de facto directorship. The definition in the 1961 Act was as follows:
"**Director** includes any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act."

In *Corporate Affairs Commission v Drysdale* (1978) 141 CLR 236 the High Court held that the part of the 1961 definition that referred to a person "occupying the position of a director of the corporation by whatever name called" extended to a de facto director who continued to act as such after his appointment came to an end. The concept of "de facto director" expounded by the High Court is the same as the concept explained by Millett J in *Re Hydrodam (Corby) Ltd* [1993] 2 BCLC 180. In the latter case his Lordship said (at 183):
"A de facto director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of the company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of the company's affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.

"A de facto director, I repeat, is one who claims to act and purports to act as a director, although not validly appointed as such. A shadow director, by contrast, does not claim or purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself. He is not held out as a director by the company."
These observations were approved by the English Court of Appeal in *Re Kaytech International plc* [1999] 2 BCLC 351. The effect is to give the concept of de facto directorship a relatively narrow scope in the United Kingdom.

An amendment was made upon the enactment of the Companies Code in 1981, said in the explanatory memorandum (clause 31) to be in response to Drysdale. The amendment extended the definition to "any person occupying or acting in the position of director of the corporation, by whatever name called and whether or not validly appointed to occupy or duly authorised to act in the position".

This extension of the definition is very important, because it directs the court's inquiry to the question whether the defendant has acted in the position of an individual director, whether or not the company has authorised or held the person out to do so. This is a wider concept than the one expounded by Millett J. Under the Australian definition, the question is whether the defendant has in fact joined with the other directors in making board decisions for the management of the company. It may be easier for the plaintiff to show that the defendant is a de facto director in this sense, than to establish a shadow directorship, which involves proving some form of dominance of the defendant over the board rather than mere conjoint decision-making (see *Harris v S* (1976) 2 ACLR 51, at 63 per Wells J and at 71 per Sangster J (noting that the decision was before *Drysdale*); *Bluecorp Pty Ltd (in liq) v ANZ Executors & Trustee Co Ltd* (1994) 13 ACSR 386, at 402-3 per Mackenzie J).

By and large, the English decisions have concentrated on shadow directorship. This is not surprising, since the UK definition of "director" does not have any equivalent of our post-*Drysdale* extension and has the more restricted meaning expounded by Millett J. In Australia, there is a growing recognition of the breadth of our de facto directorship concept, illustrated by such cases as *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR 565, applied in *Natcomp Technology Australia Pty Ltd v Graiche* [2001] NSWCA 120.

The two changes to be noted to the shadow directorship concept relate to "advice" and "instructions".

First, following the lead given by the UK legislation, the Uniform Companies Acts 1961 offered some protection for the company's advisers. Section 5(2) said:
"For the purposes of this Act a person is not to be regarded as a person in accordance with whose directions or instructions the directors of a company are accustomed to act by reason only that the directors act on advice given by him in a professional capacity".

The definition was revised on the enactment in 1981 of the Companies Codes of the Australian States. For present purposes, the important change was an extension of the protection afforded when the company acted on advice. Under the 1981 provision (Companies Code, s 5(2)):
"For the purposes of this Act, a person shall not be regarded as a person in accordance with whose directions or instructions the directors of a body corporate are accustomed to act by reason only that the directors act on advice given by that person in the proper performance of the functions attaching to his professional capacity or to his business relationship with the other person."

Amendments in 1983 made it clear that the business relationship could be one between the directors and the person, or between the company and the person. The concept has remained since that time, though the wording has been revised. Its importance for the prospective liability of banks and other financiers is obvious, but the protection is available only in respect of "advice" (note the discussion of this word in *Secretary of State for Trade and Industry v Deverell* [2000] 2 All ER 365). There is no equivalent provision in the UK legislation. I am not aware of any Australian cases explaining the meaning of the change.

It would appear that the banker-customer relationship is a business relationship for this purpose. Identifying the functions attaching to the banker's position seems to be a question of fact, influenced by the documents bearing on the relationship in the instant case, and (subject to that) such matters as the general practices of bankers. One would expect that a bank's functions would usually include reviewing and evaluating the company's businesses so as to decide whether to provide or extend credit or to take steps to protect the security or exercise it. Whether a banker's functions would, in normal circumstances, extend to altering and developing the borrowing company's businesses by means of a workout plan seems to be a moot question. The answer might depend on how closely

connected the bank's activities are to the protection of its security.

The other important change is that the reference to "directions or instructions" in the old legislation was altered, by amendment made in the Corporate Law Economic Reform Program Act 1999, to "instructions or wishes". This seems to mean that the present Australian section is wider in scope than the UK provision: the Companies Act 1986 (UK), s 251, used the words "directions or instructions", as did the older Australian legislation. As far as I am aware, there is no case law explaining the significance of the amendment or the meaning of the word "wishes" in this context.

3.3 Case law relevant to bankers and other financiers

In the leading Australian case, *Standard Chartered Bank of Australia Ltd v Antico (Nos 1 & 2)* (1995) 38 NSWLR 290, Hodgson J did not find it necessary to draw any sharp distinction between the de facto and shadow branches of the definition of "director". On the special facts of that case, he reached the conclusion (at 327-8) that Pioneer was a director of Giant because Pioneer, through its representatives, either acted in the position a director or controlled the Giant board. At the time, the insolvent trading provision applied to anyone who took part in the management of the company, and Hodgson J held that Pioneer took part in the management of Giant, quite apart from his decision that Pioneer was a director of Giant.

There is one observation in his Honour's judgment that has some general relevance to workouts. He said (at 327):
"I accept that a holding company is not a director of its subsidiaries, merely because it has control of how the boards of its subsidiaries are constituted; that it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of the borrower's affairs; and that it is even less uncommon for lenders to require security for a loan, and then to require the sale of property over which this security is given. Certainly, these factors on their own would not amount to assuming the position of a director, or taking part in the management of a borrower company."

As mentioned earlier, it is of assistance, where the principles are stated in broad terms, to examine their application in cognate fact situations. I have selected several cases reasonably close, factually, to the involvement of bankers and (in the next section) advisers in workouts. I am not attempting any comprehensive presentation of the case law.

In *Re MC Bacon Ltd* [1990] BCLC 324 the question was whether a debenture granted by a company to a bank to secure existing indebtedness was a voidable preference under the Companies Act 1986 (UK). Under that legislation the court could not make an order in respect of a preference given to any person unless the company which gave the preference was influenced in deciding to give it by the desire to put the person receiving the preference in a better position in the company's winding up than the person would have been in if nothing were done. Millett J (as his Lordship then was) held on the facts that the company was not influenced by the desire to confer a preference on the bank, because it had no choice but to grant the bank security if it wanted to continue to trade. That finding is not immediately relevant.

The UK legislation created a presumption that the company had been influenced by the desire to confer a preference if the person receiving the preference was a director or shadow director of the company. Initially the liquidator alleged that the bank was a shadow director of the company. The bank sought an order striking out that claim as disclosing no cause of action, but Knox J refused the bank's application (*Re A Company, ex parte Copp* [1989] BCLC 13). The judgment is curious because, after setting out the facts and the law on summary dismissal of claims, his Lordship simply stated his conclusion that the "shadow directorship" contention was not obviously unsustainable, and declined to give his reasons (at 21). When the case came before Millett J for final hearing, the contention based on shadow directorship was withdrawn after six days of oral evidence. Millett J noted this ([1990] BCLC at 326) and merely remarked, without extrapolation, that the shadow directorship claim was "rightly abandoned".

Consequently the facts of the case, given in detail in the judgment of Millett J, are an illustration of intervention by a bank falling short of creating a shadow directorship, though the judgments do not tell us just what it was that led to a conclusion in favour of the bank.

The company had been trading profitably until its major customer withdrew. Shortly afterwards the two

long-standing directors, Mr Creal and Mr Glover, decided to retire and leave the management of the business to Mr Creal's son Martin. By that time the company had reached its overdraft limit with the bank. The bank manager was unhappy with the change of control and he commissioned a report from the bank's financial services section. He also exerted pressure on the directors to grant a debenture in favour of the bank to secure the existing indebtedness.

The report by the financial services section called for further information including a business plan and an integrated profit and loss and cashflow forecast. It recommended that Mr Glover should undertake the role of managing director for a short period in substitution for Martin, and that the company should consider recruiting an outsider. In fact the arrangements implemented as a result of the report were that Martin continued with the title of managing director but was subject to directions by Mr Glover, who accepted responsibility "without portfolio". The bank offered continuation of the overdraft facility on the condition that a first mortgage debenture be granted over the company's fixed and floating assets.

Shortly afterwards the bank manager lost all confidence in the company's management and wrote to Martin. The letter said that the bank would extend the overdraft facility for a further two months, during which time he hoped the company's sale would be concluded. It stipulated that the bank's continuing support was subject to the opening of a separate wages and salaries account. It recommended that the directors seek advice as to their liability under the Insolvency Act given the position portrayed in the report of the financial services section. Millett J said he was satisfied that Mr Glover, Mr Creal and Martin all knew that the company was actually or virtually insolvent at all relevant times, and that if the bank withdrew its support the company would be forced into immediate liquidation.

I suggest that the factors leading Millett J to conclude that the shadow directorship allegation had been rightly abandoned included the following:

- the bank's actions were all consistent with the objective of recovery of the amount owing to it and protection and enforcement and security;
- the bank did not seek to negotiate any additional advantage beyond obtaining and then enforcing the debenture with a view to recovery of the amount lent;
- the report was prepared by the bank's own financial services section and its contents were clearly recommendations, except to the extent that the bank adopted particular recommendations as conditions for continuation of the overdraft facility;
- some of the recommendations in the report were in fact not implemented by the company;
- the evidence did not show that the bank manager moved outside his role as banker and into co-management of the company's affairs with the directors.

It seems to me likely that the same result would have been reached and if the current Australian provisions had been applicable. Analytically, the fact that the bank was purporting to act as creditor to protect and enforce its security would not be an obstacle to the conclusion that the directors were accustomed to act in accordance with the bank's instructions or wishes. Indeed, evidence of that kind might support such a conclusion. But other factors pointed against the bank being a shadow director. The report by the bank's financial services section contained some expressions of opinion that could be regarded as the bank's "wishes", though the only parts of the report that became "instructions" were those that became conditions for continued support. Significantly, some of the matters in the "wishes" category were not implemented by the company. Therefore, on the evidence, it could not have been said that the directors of the company were accustomed to act in accordance with the bank's wishes.

Additionally, the bank's conduct seems on the facts to have been entirely referable to its position as creditor of the overdraft debt. It was not adopting a role of continuous and ongoing input into the company's affairs, and it was not seeking to extract some additional advantage not flowing from its commercial position as creditor. Therefore:

- to the extent that the directors acted in accordance with the demand made by the bank manager for the execution of a debenture, it was not a case where directors were "accustomed" to act in accordance with the instructions of another, but simply a case where the bank manager was using the commercial leverage provided by the company's circumstances to improve the bank's security as creditor;

- to the extent that the directors acted in response to the recommendations in the financial services section's report, they were responding on a single occasion to a particular report rather than exhibiting a custom of acting in accordance with the bank's instructions or wishes; and further, they were responding to advice given by the bank in the proper performance of functions attaching to the bank's business relationship with the company.

In *Re PFTZM Ltd (in liq), Jourdain v Paul* [1995] 2 BCLC 354, the company conducted a hotel and country club. It entered into a financing arrangement with Humberclyde by way of lease and leaseback of the hotel premises. The rental payable by the company represented interest for the first five years, and thereafter interest and capital repayments. After some years the managing director of the company informed Humberclyde that, based on future bookings and general interest, the forecast profits would not be enough to service the rent. After discussions with Humberclyde, it was agreed that the managing director would remain in office but would draw no salary until the project started to show a profit; there would be weekly management meetings attended by representatives of Humberclyde; and all of the revenues of the hotel and country club were to be paid into an account in the name of Humberclyde, which would authorise withdrawals on a four-weekly basis upon receipt of a certificate from the financial controller of the company as to the company's payment needs, subject to a right of veto on the part of Humberclyde; the company's capital expenditure program, and staff changes, had to be approved by Humberclyde.

The issue before the court was whether questions that the company's liquidator proposed to ask officers of Humberclyde in an examination were oppressive, so that the Registrar's order for the examination should be set aside. The court set aside the order. Judge Paul Baker QC said (at [368]: "It is admitted that the applicants are not directors. The examination is directed to show that they are shadow directors. I find that there is no prima facie case made out, and it is unlikely that further information will come to light to show that they are shadow directors. The central point, as I see it, is that they were not acting as directors of the company, they were acting in defence of their own interests. This is not a case where the directors of the company, Steven and his colleagues, were accustomed to act in accordance with the directions of others, ie the applicants here. It is a case here where the creditor made terms for the continuation of credit in the light of threatened default. The directors of the company were quite free to take the offer or leave it."

As in the *MC Bacon* case, it is not easy to see why the fact that Humberclyde was acting in defence of its own interests was an obstacle to the conclusion that the directors were accustomed to act in accordance with Humberclyde's instructions.

One wonders how important it was that, in the judge's view, the directors were free to reject Humberclyde's offer. It appears that if they had done so, Humberclyde would have enforced its security earlier than it did, and the company would have ceased to trade or its business would have been sold. In a sense, therefore, the directors had no choice but to accept the terms laid down by Humberclyde. They were in the same position as the directors of MC Bacon.

Humberclyde had quite a substantial level of participation in the management of the company's business. It seems to me that the requirement that receipts be paid into a Humberclyde account, though a great intrusion into the company's business, is not problematic for a financier because it is clearly directed towards recovery and protection of security. The same can be said of the right to review and veto the capital expenditure program. Humberclyde's right of veto over staffing changes seems less clear, because it seems to amount to involvement in general management. The participation of Humberclyde's representatives at weekly management meetings seems decidedly risky, although we have no evidence in the case as to just what the Humberclyde representatives did. That, presumably, was what one of the matters the liquidators wished to explore. The judge's finding that it was unlikely that further information would come to light to show that they were shadow directors suggests that even if it had emerged that the Humberclyde representatives had had a very active participation in matters of management during those meetings, their activity would not have brought Humberclyde (or themselves) within the definition of "director". I wonder whether Judge Baker QC might have gone too far in this respect.

Under the Australian definition, there would be scope for arguing that Humberclyde had become a de facto director because, though not validly appointed to the board, it acted in the position of a director. It did so by reviewing with other directors the position of the managing director, by participating in weekly management meetings (assuming this was full, voting participation), controlling disbursement of the company's funds, and approving the capital expenditure program and staff changes. There would be even greater scope for arguing that Humberside was a shadow director, because the level of

involvement that I have outlined suggests not merely participation in directors' decisions, but control over management of the corporation's affairs. I find it difficult, with respect, to support Judge Baker's conclusion that there was not even an arguable case for this view.

3.4 Case law relevant to advisers in a workout

Re Tasbian Ltd (No 3), Official Receiver v Nixon [1993] BCLC 297 was a case about the position of an adviser. The question was whether leave should have been granted to the Official Receiver to apply out of time for a disqualification order against the adviser, Mr Nixon. That depended upon whether there was a fairly arguable case that Mr Nixon was a de facto or shadow director of Tasbian.

Tasbian was formed in 1981. Its business was manufacture and retail sale of electronic components. Castle Finance Ltd was the majority shareholder and also lender to Tasbian, on the security of a debenture. Tasbian also obtained a loan from the bank. The company never made a profit. In 1985 Castle introduced Nixon to the company. He was a chartered accountant and an experienced company director. Tasbian retained him as a consultant, to report on the company's financial position and to advise and assist in its recovery. He negotiated an informal moratorium of Tasbian's creditors. He negotiated on the company's behalf with the Department of Trade and Industry in the Inland Revenue. He became a necessary signatory on the company's bank account. He devised and advised on the implementation of a scheme whereby the company's labour force was transferred to a subsidiary.

Vinelott J held that there was a fairly arguable case that Mr Nixon was a de facto or shadow director. In the Court of Appeal, Balcombe LJ (with whom Lord Donaldson MR and Stuart-Smith LJ agreed) upheld Vinelott J's decision. Balcombe LJ observed (at 303) that little weight should be attached to Mr Nixon's role in negotiating a moratorium with creditors. He also expressed the view that Mr Nixon's motive of protecting the interests of Castle was irrelevant (at 304). The issue to be decided at the hearing would be "whether, for whatever purpose, he was controlling the company's affairs in a manner going beyond the province of a company's professional adviser". In his Lordship's view several factors were significant.

First, the company's arrangements with its bank for signing cheques, under which cheques were required to be signed by two directors and countersigned by Mr Nixon or one of his partners, enabled Mr Nixon to exercise the degree of control over the company's finances. Balcombe LJ referred to a letter by the company's managing director, written after Mr Nixon refused to sign certain salary cheques, in which he said he had placed in great deal of trust in Mr Nixon and had given him sufficient freedom to do his work. His Lordship observed that this letter may have been evidence that the directors were complaining that Mr Nixon was usurping their functions. A letter from Castle to the managing director spelled out the dire consequences that would arise if the company chose to counteract Mr Nixon's "instructions" and renege on verbal agreements made. Balcombe LJ concluded that Mr Nixon decided which cheques drawn by the company could and which could not be submitted to the bank, and therefore he was concerned with which of the company's creditors were to be paid and in which order, and to that extent it would appear that he was able to control the company's affairs.

Secondly, in Balcombe LJ's view Mr Nixon's participation in the transfer of employees to a subsidiary was a "weighty matter" (at 304) making it fairly arguable that he was a de facto or shadow director. The full evidence on this matter is not disclosed in the report.

Under the present Australian law, the conclusion in *Tasbian* would be reinforced by the statutory wording, which makes relevant the "wishes" as well as the instructions of the adviser. The Court of Appeal's reasoning does not distinguish between factors going to the establishment of a de facto directorship and factors going to the establishment of a shadow directorship. The emphasis placed by Balcombe LJ on Mr Nixon's position as co-signatory of cheques seems principally directed to de facto directorship. In the case of a shadow directorship, the question is whether the directors are accustomed to act in accordance with his or her wishes. The correspondence referred to by Balcombe LJ suggests that this was the case for the directors of Tasbian, and the facts show that Mr Nixon's involvement went beyond giving advice in the proper performance of the functions attaching to his professional capacity as a consultant.

3.5 Application to bank workouts

What follows are just some brief notes about the issues that may arise in applying the current

Australian definition to the case of a bank engaging in the categories of activities outlined under heading 2. I am conscious of the difficulty that can be created when a judge throws away some extra-curricular obiter dicta without the benefit of the careful and specific reflection that (hopefully) has gone into the legal advices that are no doubt current on these questions today. I shall raise questions, and leave the reader to answer them, perhaps influenced by the general themes I have introduced.

(a) intervention in governance

(i) By intervening in these ways, has the bank "acted in the position of" a director?
(ii) Has the bank communicated "instructions or wishes" to the directors on governance matters?
(iii) If so, have the directors acted in accordance with those instructions or wishes?
(iv) If so, does this show the exercise of real influence over the corporate affairs of the company, though not over the whole field of corporate activities, so as to establish that the directors are accustomed to act in accordance with the bank's instructions or wishes (see *AS Nominees*, per Finn J)?
(v) Are the bank's communications on corporate governance properly to be characterised as "advice"?
(vi) If so, is it advice given by the bank "in the proper performance of functions attaching to [its] business relationship" with the directors or the company?

(b) ongoing development and review

(i) Do activities of this kind, added to the intervention in governance (category (a)), make it more likely that the bank will be held to have acted in the position of a director?
(ii) Do they make it more likely that the bank is exercising real influence over the corporate affairs of the company, thus supporting the conclusion that the directors are accustomed to act in accordance with the instructions or wishes of the bank?
(iii) Can the bank's participation in a committee dealing with such matters realistically be classified as giving "advice"?
(iv) If so, is it advice given by the bank "in the proper performance of functions attaching to [its] business relationship" with the directors or the company?

(c) discussions with external parties

Essentially, the same questions arise as under heading (b), although the circumstances to which those questions are applied are quite different circumstances. Note, also, the risk of civil liability for misleading conduct that arises as soon as dealings with third parties are involved (see 4.1 below).

(d) workout transactions

(i) Do the observations of Hodgson J in the *Standard Chartered Bank* case (at 327, quoted at 3.3 above) mean any conduct of the bank by way of extending financial accommodation on conditions, or exercising security, cannot contribute to the overall conclusion that the bank is a shadow director?
(ii) Is the bank necessarily at greater risk of being a shadow director if, as part of the workout arrangements, it takes equity either by way of capitalisation of existing debt or the injection of new funds?
(iii) Can sponsoring an incentive scheme for the benefit of all stakeholders, including suppliers, customers, employees, management and shareholders, ever be regarded as merely the giving of advice in the proper performance of functions attached to the bank's business relationship with the company?

4 Accessory and primary liability for misleading conduct and non-disclosure

This is a very large topic. Adequate treatment would require a much fuller exposition than is appropriate in this paper. For a fuller exposition, please refer to RP Austin, HAJ Ford and IM Ramsay, *Company Directors: Principles of Law and Corporate Governance* (LexisNexis Butterworths 2005), paras [13.32]-[13.43] and [13.45]-[13.48].

Primary or accessory liability for misleading conduct can arise out of any of the activities of a bank or other financier, described under heading 2 this paper, if misleading conduct (including the making of misleading representations) is involved. Advisers are unlikely to be subject to primary liability, but they are at risk of accessory liability.

In order to give the issue some focus, I shall deal with some hypothetical facts relating, respectively, to

liability for misleading conduct and liability under the continuous disclosure regime. I shall not comment specifically on the adviser's position, which can generally be inferred from my discussion of the position of the bank.

4.1 Misleading conduct

Suppose that as part of a workout, an ad hoc management committee is established, in which the bank's representatives participate. The directors agree not to implement decisions on certain subjects without the approval of the committee. The management committee, at a meeting attended by bank representatives, approves a recommendation of the directors for the issue of an information memorandum for the sale of a subsidiary which carries on a separate business. The information memorandum contains financial statements for the last financial year. The company's executive directors persuade the management committee that it is appropriate for the financial statements to accrue revenue from unbilled services, on the basis that these bills have not been rendered because of a glitch in the billing system. But all members of the management committee know that the bills relate to services performed many months previously. These matters are not adequately disclosed in the information memorandum. A purchaser acquires the business in reliance on the information memorandum, including the financial statements, and later discovers that revenue and EBITDA have been inflated by inclusion of the unbilled services, after it has sent out in bills for the services but then found them to be irrecoverable because of the age of the transactions.

The company has sold the shares in its subsidiary, which are securities and financial products for the purposes of s 1041H(1) of the Corporations Act (see the definition of "financial product" in s 764A(1)). Causing the distribution of the information memorandum is conduct in relation to those financial products. The conduct is misleading or likely to mislead (and may be deceptive or likely to deceive) because of the inaccuracies in the financial statements. The information memorandum is not a fundraising document for the purposes of Chapter 6D and its distribution does not contravene s 728, and so the exception in s 1041H(3) does not apply. Therefore every person who engaged in the conduct of causing the distribution of the misleading information memorandum has committed a contravention of s 1041H(1).

It is irrelevant to inquire whether those who did so intended to mislead, or whether anyone was actually misled by the conduct (although on the present facts, the purchaser was misled), or whether those who engaged in the conduct did so honestly and reasonably or by failing to take reasonable care (see Austin, Ford and Ramsay at [13.32]). That being so, if the bank has engaged in misleading conduct by virtue of its participation in the management committee, it has contravened s 1041H(1). That would be so even if (contrary to our hypothetical facts) its representatives were completely unaware that unbilled data had been brought to account - that is, even if the bank was "innocent" in moral terms.

A person who suffers loss or damage by conduct of another person that was in contravention of s 1041H(1) may recover the amount of the loss or damage by action against that other person or against "any person involved in the contravention" (s 1041I). Section 79 of the Corporations Act explains when a person is "involved" in such a contravention. Included are those who have aided, abetted, counselled or procured the contravention; induced the contravention; conspired with others to effect the contravention; or have been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to the contravention. If the bank's participation in the management committee meeting does not amount to engaging in the conduct of causing distribution of the misleading information memorandum, and is therefore not a contravention of s 1041H(1), it may nevertheless be exposed to civil liability for damages in an action by the purchaser of the business, if it has been "knowingly involved" in the contravention by those who distributed the document, in any of the ways defined in s 79.

Knowledge is an essential ingredient of this accessory liability. In *Yorke v Lucas* (1985) 158 CLR 661, Mr Lucas, the director of an incorporated land agent acting for the vendor of a business, supplied misleading turnover figures to the purchasers, when acting as director of the agent. He obtained the vendor's written confirmation of the accuracy of the figures on at least three occasions, and was not aware and had no reason to suspect that the information was incorrect. The High Court held that he was not liable under the accessory provisions in s 75B of the Trade Practices Act, because he was unaware of the circumstances that made the turnover figures misleading. This was so even though Mr Lucas's company, the agent, had direct primary liability notwithstanding its lack of knowledge. The company, but not Mr Lucas, had directly engaged in misleading conduct.

Accessory liability for involvement in a contravention arises only when it is shown that the defendant

had knowledge of the essential elements of the contravention. But it is not necessary to prove that the defendant knew that the facts were capable of being characterised as misleading conduct under the statute. In *Heydon v NRMA Ltd* (2000) 36 ACSR 462, the Court of Appeal of New South Wales reached the conclusion that a prospectus which claimed that shares offered in a demutualisation would be "free" was not thereby misleading (disagreeing with the earlier decision of the Full Federal Court in *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452). However, both Malcolm AJA (at 559-60) and McPherson AJA (at 600) said that if, contrary to their view, the prospectus had been misleading, the lawyers who advised favourably on it would have been involved in the contravention, even though they believed that the contents of the document were not misleading.

Obviously it will be important to determine whether the bank has engaged in misleading conduct directly, or has merely been involved in misleading conduct undertaken by other members of the management committee. The answer will depend on a close analysis of the bank's role.

In *Hamilton v Whitehead* (1988) 166 CLR 121 a company contravened the corporations legislation by offering interests in a managed investment scheme to the public when it was not a public company and had not complied with the disclosure requirements. The wrongful conduct was actually performed by its director, Whitehead, who was found to be its "directing mind and will". The High Court said that the primary contravention of the corporations legislation was by the company, and additionally, Whitehead was liable as an accessory. He had acted in two capacities, first as the embodiment of the company and secondly as an individual knowingly concerned in the company's act.

Applying this law, it is arguable that the embodiment of the company is its board of directors, not an ad hoc management committee in which the bank participates, and consequently the bank's liability is accessory liability, which will arise only if it has the requisite knowledge. But it will be important to look closely at how the management committee is structured, and its relationship to the board, both in a documentary sense and operationally.

The wise course for banks would seem to be:

- to structure their participation so as to minimise the risk that they might be held to be in anything greater than an accessory position with respect to any misleading conduct that might occur, and
- to install protocols for participation in workouts to ensure that any situations where the bank's representatives might become aware of misleading documents or misleading conduct are identified and managed, with appropriate legal advice.

4.2 Contravention of the continuous disclosure law

This problem arises only if the company with which the bank is dealing is a disclosing entity. The most common example of a disclosing entity is, of course, a listed entity. A listed disclosing entity is subject to Chapter 3 of the ASX Listing Rules and in particular, the general disclosure requirement in Listing Rules 3.1, 3.1A and 3.1B.

Suppose that in the course of its investigations, the bank becomes aware of some material price-sensitive information about the value of the company's quoted securities - for example, a report provided to the managing director, substantially downgrading the value of the company's mining tenements because of very steep and unexpected increases in extraction and transportation costs. The bank knows that neither the report nor the cost increases have been released to the market.

Listing Rule 3.1 would require the listed entity to disclose this information to ASX. Since the report was provided to the managing director, the listed entity is aware of the information contained in it (Listing Rule 19.12). It is information that a reasonable person would expect to be disclosed. There is no basis for saying it is confidential information or a trade secret. Disclosure would not involve any breach of the law. It is not information about an incomplete proposal or negotiation and does not comprise matters of supposition or matters insufficiently definite to warrant disclosure. It is not information generated for internal management purposes. Therefore the exception to the disclosure obligation in Listing Rule 3.1A does not apply.

Under listing rule, the disclosure obligation is imposed on the listed entity. The obligation is reinforced by s 674(2) of the Corporations Act. Under this provision, failure to notify the ASX of information that is

required to be disclosed under the Listing Rules is a contravention if the information is not generally available, and is information that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of the entity's quoted securities. The contravention is a criminal offence by the entity (s 1311(1)), and is also subject to the civil penalty provisions (s 1317E(1)(ja)).

As a result of amendments made by the CLERP 9 legislation of 2004, the law now provides that a person who is involved in a listed disclosing entity's contravention of s 674(2) also commits a contravention of a "financial services civil penalty provision" (ss 674(2A), 1317DA and 1317E). Thus, a person involved in a listed entity's failure to make timely disclosure under the Listing Rules is exposed to a variety of civil consequences including a declaration of contravention, a pecuniary penalty order, and a compensation order (see s 1317HA).

"Involvement in a contravention" for the purposes of s 674(2A) is defined in s 79, briefly discussed above. Liability depends upon knowledge of the essential elements of the contravention by the listed entity. In our hypothetical example it seems that the bank has that knowledge. Merely knowing the disclosable information does not make the bank liable as an accessory, but if, through participation in a management committee or discussions with the directors or executive management or in some other wire, the bank is privy to discussions about the disclosable information and there is no decision to disclose it, the bank might come to be knowingly concerned in the failure to disclose. It is not necessary, for liability, for the bank to participate in a decision not to disclose, because the listed entity's contravention is its failure to disclose information of which it is aware, whether or not there is a formal decision not to disclose.

The bank's defence is in s 674(2B), which provides:
"A person does not contravene subsection (2A) if the person proves that they:
(a) took all steps (if any) that were reasonable in the circumstances to ensure that the listed disclosing entity complied with its obligations under subsection (2); and
(b) after doing so, believed on reasonable grounds that the listed disclosing entity was complying with its obligations under that subsection."

There is as yet no clarity as to the steps that must be taken in order to have the benefit of this defence. One would expect, however, that a bank that becomes aware of disclosable information would have sufficient leverage with the directors to ensure that disclosure is made, and consequently the practical effect of subsection (2B) will be that the bank must require disclosure even where disclosure is likely to reduce the value of the bank's security. Oddly, the defence is not available if the accessory does what it can to persuade the directors to disclose but (2 the knowledge of the accessory) the directors refused to do so. That is an incentive for the bank to be very persuasive.

A lesson to be drawn is that banks need to have in place sound protocols for their participation in workouts of listed entities, to ensure that their representatives identify disclosure issues which the bank can then manage, with appropriate advice.

5. Conclusions

Once a company is placed in some form of external administration, the liabilities of those who have dealt with the company, and who continue to do so, are comparatively clear, because of the accumulated experience of the law. Informal workouts are not governed by any separate chapter of the law. Those involved in a workout must be aware that various laws can impinge on their activities, and that there is no special statutory protection for them. The three areas explored in this paper seem to me to be amongst the most obvious areas of risk. But the risks are not insuperable. The wise course is for banks and other financiers, and workout advisers, to tread carefully and to take advice.

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Superannuation Lawyers Association Of Australia - Libby Slater Plenary Session

SUPERANNUATION LAWYERS ASSOCIATION OF AUSTRALIA

SUPERANNUATION 2004

Marriott Resort, Surfers Paradise, Queensland

Thursday, 26 February to Saturday 28 February 2004
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LIBBY SLATER PLENARY SESSION

"The Incorporated Superannuation Trustee"

By the Hon Justice R P Austin

Supreme Court of New South Wales
Revised 1 March 2004

1. Introduction

It is a great honour for me to present the Libby Slater Lecture to this year's conference, especially for two reasons. One is the distinguished company in which you have placed me, for your Libby Slater speakers in the past have been great luminaries of the law. The other, more important reason is the fondness and admiration I had for Libby Slater. She was a student of mine early in my academic career. Even by the high standards of the law students I was privileged to be able to instruct, Libby had an outstanding intellect.

The title of my paper, "The Incorporated Superannuation Trustee", is designed to enable me to talk about some issues of company law which have applications in the superannuation context, in cases where the trustee is a corporate entity. My purpose is to connect some currents in company law with topical issues for superannuation lawyers. I am especially interested in the contemporary proposal to establish a "fit and proper standard" for superannuation trustees, expressed in the case of an incorporated trustee partly in terms of the duties and responsibilities of its directors and officers. It may be that an examination of trends in the company law of directors' and officers' duties will shed some light on formulation of acceptable standards in the superannuation context.

It is necessary to lay the foundation for considering the duties of directors and officers of superannuation trustees by considering how it is that companies have been employed in the trustee role, and the consequence of doing so, in terms of the trustee's right of indemnity and the potential liability of directors and officers when the right is lost.

2. The parallel development of statutory company law and the regulation of superannuation schemes

Regulation of superannuation schemes

As this audience is well aware, the system of regulation of superannuation schemes was changed fundamentally upon the enactment of the Superannuation Industry (Supervision) Act 1993 (Cth) ("SIS Act"). Writing in 1988, I described the previous system in the following manner (TG Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell, 1989) pp 112-3):

> "In contrast with Canada (at any rate at a formal legal level), Australia and the United Kingdom rely principally on regulation through fiscal incentives and penalties, leaving the basic rights and duties of administrators to be determined by the constitutional instrument and the general law. Australia is perhaps the 'purer' example of fiscal regulation. Except in Queensland, there has been no attempt to set direct standards for superannuation arrangements. Instead, the Federal Parliament has set standards which must be met in order that income of the fund may be exempt from tax. Those standards are to be found in the Occupational Superannuation Standards Act, 1987 (Cth) (which vests regulatory responsibility in the newly constituted Insurance and Superannuation Commissioner) and in the elaborate regulations made under that Act."

There has, of course, been dramatic change in the Australian regulatory landscape since that time. During the 1980s and early 1990s, government policy moved towards the expansion of the superannuation safety net for an ageing population, partly by the introduction of compulsory superannuation. That culminated in the enactment of the Superannuation Guarantee Charge Act 1992 (Cth).

The increasing importance of superannuation, voluntary and compulsory, in government social security policy led to questioning of the adequacy of regulating the security of superannuation funds through the taxation system (not least, one assumes, because the imposition of penalty tax for failure to comply with prudential requirements would harm superannuation members more than those responsible for the non-compliance). On 21 October 1992, the Treasurer, the Hon John Dawkins MP, expressed his Government's thinking in an address to the National Conference of the Association of Superannuation Funds of Australia. He emphasised the importance of ensuring that superannuation savings are secure, so as to maintain public confidence in the notion of private retirement savings. He said that the recent and prospective growth of the superannuation industry had warranted a comprehensive review of the prudential framework in which the industry operated. In light of that thinking, he announced the Government's proposals for what he called "a major enhancement of the prudential supervision of the superannuation industry".

In due course the Government's policy as announced by the Treasurer was given effect in the SIS Act. The object of the Act, declared in s 3(1), is to "make provision for the prudent management of certain superannuation funds, approved deposit funds and pooled superannuation trusts and for their supervision by APRA and ASIC". I shall put to one side approved deposit funds and pooled superannuation trusts. The focus of my attention is those superannuation funds that are regulated superannuation funds under the SIS Act, other than self-managed superannuation funds and public sector superannuation schemes.

Regulation of companies and financial products

By the time the SIS Act commenced, the system of statutory company law had reached an elaborate level, but it was nevertheless in transition. The current regulator, ASIC, had been established, becoming operative at the beginning of 1991 under the name, "the Australian Securities Commission". However its regulatory responsibilities were limited to financial products properly called "securities", including what we then called "prescribed interests", to which futures contracts had been added in 1986.

There was some reform of prospectus and takeover law when the Corporations Law commenced in 1991. New provisions were introduced in 1992 to govern corporate insolvency after the recommendations of the Harmer Committee (including the establishment of the system of voluntary administration), and shortly after the enactment of the SIS Act the statutory regime for continuous disclosure was introduced. Yet little had been done during the 1980s and early 1990s to modify the statutory provisions governing the duties of directors and officers. The main change in that area had been the introduction of a special provision dealing with the liability of a director of a trustee company (see now Corporations Act, s 197), in response to the proliferation of trading trusts. A proposal for a radical restatement of the duty of care of directors, which would have been based on the trustee's duty of care, had been made during the preparation of the national co-operative companies and securities scheme in 1979-1980, but it was withdrawn after strenuous criticism. The most important company law reforms since the Uniform Companies Acts of 1961 were still to come.

For a while during the mid 1990s, the focus of company law reform was on simplification. In the period from 1993 to 1996, the Simplification Task Force (aided by a Consultative Committee) worked its way through the corporations statute, looking for ways to clarify and abbreviate the wording and remove

administrative burdens. The word "simplification" proved to be misleading, for the process produced some profound changes, such as the formal sanctification of the one-person company. But the proposals of the Task Force on the big issues, including reform of the law of directors' and officers' duties, were not brought to fruition immediately because there was a change of government. The new Government took many of the Task Force's ideas and re-badged them under the Corporate Law Economic Reform Program. They were enacted, with modifications, by amendments to the Corporations Law taking effect in 1998 and 2000. The reforms of 2000 included fundamentally important changes to the statutory law of directors' and officers' duties.

Perhaps more importantly for superannuation law reform, the regulation of prescribed interests was overhauled by the Managed Investments Act 1998 (Cth), which introduced Chapter 5C into the Corporations Law. This legislation took into account what had been achieved in the SIS Act, but went further. It abolished the separation between the trustee and the manager of the investment scheme, requiring administration by a single responsible entity, and established a comprehensive system of licensing and registration.

In 1998 the Wallis Committee reported on its review of the financial system, recommending a more functional approach to the regulation of financial services. The Financial Services Reform Act 2001 (Cth) implemented some of the Wallis recommendations by overhauling the parts of the Corporations Act regulating securities and futures contracts, introducing a broader regime for the regulation of financial products and those who deal with and advise on them. Most of the new licensing system under the FSRA reforms is due to commence on 11 March 2004. The FSRA legislation is lengthy (especially when one adds the regulations and various ASIC pronouncements to the text of the statute), complex, and anything but an exercise in simplification of the law. But it is a sophisticated and comprehensive licensing regime. For completeness, I note the most recent law reform proposals, in the wake of the HIH Royal Commission, colloquially identified as "CLERP 9", which affect such matters as audit requirements and continuous disclosure.

It would be dangerous to regard the regulation of superannuation schemes as merely an instance of financial product regulation. The principal thrust of financial product regulation is to achieve adequate disclosure and explanation to investors. While these objectives are important for superannuation, there is also an element of prudential regulation not present in the more general financial product regime (although the regulation of some other financial products such as managed investments is not wholly without a prudential aspect). Nevertheless, accepting this caveat, when one reviews the SIS Act in light of subsequent statutory developments in company law, the Act appears a little dated in some respects. In particular, superannuation products emerge as one of the few financial products for which there is no general registration and licensing regime. It was probably inevitable that this comparison would lead to moves for reform of the regulation of superannuation schemes, even apart from the more specific drivers to which I shall refer.

3. Corporate structures

Once the Commonwealth Government decided that it was necessary to establish a general regulatory regime for superannuation schemes, it was necessary to identify an appropriate head or heads of constitutional power for the new statutory framework. The Commonwealth Parliament does not have any specific head of legislative power under the Constitution in relation to superannuation. At one stage it was proposed that the new legislation would rely only on the corporations power, that is, the power to make laws with respect to foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth (Constitution, s 51(xx)). This led to concern that it would be too costly to require smaller funds to have incorporated trustees.

As a result, the SIS Act relies upon two alternative sources of constitutional power, the corporations power and the power with respect to old-age pensions (Constitution, s 51(xxiii)). Section 19(3) of the SIS Act requires, for a regulated superannuation fund, that either (a) the trustee must be required by the governing rules to be a constitutional corporation, or (b) the governing rules must provide that the sole or primary purpose of the fund is the provision of old-age pensions. In fact, most superannuation funds have opted for a corporate trustee, perhaps because of a concern that lump sum benefit retirements, a form of benefit traditionally provided by Australian superannuation funds, might fall outside the constitutional concept of "old-age pensions".

While the SIS Act stipulates that the trustee must (unless it is an "old age pension" fund) have a corporate trustee, very little is said in the Act about the nature of the corporation that can be appointed to that office. In 1994, when there was a rush to incorporate trustees for superannuation funds, and to amend trust deeds to introduce the prescribed requirements into the governing rules, some consideration was given to the most appropriate form of corporate structure. One idea was that the

trustee be a company limited by guarantee, so as to avoid the administrative costs and expense of issuing and transferring shares. Although that structure was adopted by some funds, problems were perceived to arise out of the fact that a company limited by guarantee is necessarily a public rather a proprietary company. This meant, for example, a strict statutory disclosure requirement for a director with a material personal interest (at that time Corporations Law, s 232A; see now Corporations Act 2001 (Cth), s 191).

The more common corporate structure adopted by superannuation funds was the proprietary company. The disclosure of interest requirements for a proprietary company under s 191 of the Corporations Act are substantially less demanding. A director of a proprietary company is not required to give the board notice of a material personal interest if the other directors are aware of the nature and extent of the interest and its relation to the affairs of the company. But the selection of a proprietary company structure did not solve all problems. One issue was the identification of the shareholders. In some cases, the shares in the trustee were issued to the employer. That raised an issue as to whether the employer was required by the applicable accounting standard to consolidate its holding in the trustee company, and if so, with what consequences. Alternatively, the shares in the trustee might be issued to the directors. That would mean, however, that shares would have to be transferred, with administrative costs and stamp duty, whenever a director was replaced. I understand that proprietary company structures of both kinds may be found today.

There is a trend for employers to close down their corporate superannuation funds and contribute to master funds administered by financial institutions. In the case of master funds, typically the trustee is a wholly-owned subsidiary of the financial institution parent. The employer is able to avoid any corporate law issues with respect to provision of superannuation to its employees (and, of course, many other regulatory issues as well), for a fee, but the corporate law issues remain for the directors and officers who administer the master funds, supplemented by special issues (not addressed here) arising out of the corporate trustee's status as a subsidiary entity.

4. The Corporate Trustee's right of indemnity out of trust assets

A trustee, whether incorporated or not, may incur debts and liabilities in the performance of the trust and the administration of the trust property. Usually any such liability is borne by the trustee personally: *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319, 324-5; *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360, 367. However, the trustee may have a right of recoupment of any expenditure for trust purposes from the trustee's own funds, or a right of exoneration which will allow the trustee to use the trust property to discharge a liability incurred for the purposes of the trust. The right of recoupment and the right of exoneration are together referred to as the trustee's right of indemnity: Ford and Lee, *Principles of the Law of Trusts* (looseleaf), [14000].

Trustee legislation empowers trustees to reimburse themselves out of trust property for expenses properly incurred in the execution of the trusts or their powers and to pay such expenses out of the trust property: for example, Trustee Act 1925 (NSW), s 59(4). But the right of indemnity was afforded to trustees at general law well before the legislation, which does no more than give effect to the rule of equity: *RWG Management Ltd v CCA (Vic)* [1985] VR 385, 399. Importantly where insolvency arises, the right of indemnity is supported by an equitable lien: *Ford and Lee* [14025].

A trustee's right of indemnity out of trust assets is not absolute. If a transaction is entered into in breach of trust, for example because it is prohibited or not authorised by the trust instrument, prima facie there is no right of indemnity (*RWG Management Ltd v CCA (Vic)*), at any rate until the trustee first makes good any loss suffered by the trust estate (*McEwan v Crombie* (1883) 25 ChD 175; *Re Staff Benefits Pty Ltd* [1975] 1 NSWLR 207). It seems that the right of indemnity may be exercised if all the beneficiaries, being unanimous, sui juris and together absolutely entitled, request the trustee to enter into a transaction in breach of trust, or in the absence of such a request, the transaction though in breach of trust confers a benefit on the trust estate: *Jesse v Lloyd* (1883) 48 LT 656. It also appears that the right to indemnity is not necessarily lost where the trustee defaults in a manner not related to the transaction which leads to the claim to indemnity, but the question seems to depend on the seriousness of the trustee's misconduct: *Re Channell* (1877) 8 ChD 492, 502 per Jessel MR; *Corrigan v Farrelly* (1896) 7 QLJ 105, 111-12; *Re Staff Benefits Pty Ltd*, at 215; *Ford and Lee* [14060]; *Jacobs' Law of Trusts in Australia* (6th ed, 1997), 631.

These general law propositions may be amended by the governing rules of the superannuation entity, but the SIS Act limits the extent to which amendments may be made to expand or reduce the scope of the right of indemnity. In particular, s 56(2) says that a provision in the governing rules of a superannuation entity is void in so far as it would have the effect of indemnifying the trustee against a liability for breach of trust where the trustee has failed to act honestly or has intentionally or recklessly

failed to exercise the requisite degree of care and diligence.

This leaves the trustee exposed to personal liability without indemnity where there is a breach of trust of these kinds, even if the governing rules provide protection in other circumstances. The poignancy and immediacy of this exposure is reinforced in various ways.

First, it is plain that the trustee's duty of care in the management of trust funds is especially onerous in the superannuation context, partly because of the standard of competence to which I shall refer. If there were any doubt about that proposition before 1995, it must have been dispelled by Finn J's judgment in *ASC v AS Nominees Ltd* (1995) 13 ACLC 1822. It is inappropriate to take the point further in this paper, although there is a very useful elaboration in Tony Slater QC's paper delivered to this conference in 1995.

Secondly, superimposed on the general trustee standard are the requirements of the SIS Act, including the requirement for covenants in the governing rules (s 52(2)), many of which affect the investment duty. I shall return to the covenants later in this paper.

Thirdly, the sheer volume and complexity of the requirements imposed upon superannuation trustees by the legislation and governing rules must itself enhance the risk that at a given time the trustee may be operating in breach of trust. In many of these cases the breach will not amount to a failure to act honestly, or an intentional or reckless failure to exercise due care and diligence, but the trustee may not appreciate being in the position of having to argue the point.

5. Directors' liability and indemnity out of trust assets

In principle, a director or executive officer of an incorporated trustee who by conduct in breach of duty causes the trustee's right of indemnity against trust assets to be lost, has a potential liability to the company, which may be exercised derivatively by shareholders or perhaps even beneficiaries. The content of the duties of directors and officers under general company law and under the Corporations Act is dealt with later in this paper, where it is noted that there is now a minimum standard of competence, which appears to be enhanced in the case of responsible officers of a superannuation trustee.

There are two parallel provisions that affect the liability of the directors of an incorporated superannuation trustee which loses its right of indemnity out of trust assets. Section 57 of the SIS Act permits the governing rules of a superannuation entity to provide for a director of the trustee to be indemnified out of the assets of the entity in respect of a liability incurred while acting as a director. But a provision of the governing rules is void in so far as it would have the effect of indemnifying a director against liability that arises because the director has failed to act honestly or has intentionally or recklessly failed to exercise the appropriate degree of care and diligence.

This is an especially protective provision which, according to s 57(4), overrides s 241 of the Corporations Act. Surprisingly, the reference to s 241 seems to be a mistake which, one assumes, will eventually be corrected. The intention appears to be to override the restrictions on indemnities for corporate officers which have been located, since the CLERP amendments 2000, in Part 2D.2 of the Corporations Act, ss 199A-199C.

Of course, the director is not protected under s 57 if the governing rules do not contain a protective provision, or if there are protective provisions but there are no trust assets left. In the latter respect, there may be room for argument as to whether a protective provision for directors in the governing rules will be supported by an equitable lien, so as to afford for the director some measure of priority over competing proprietary claims to the trust assets. Perhaps more significantly, the prohibition on indemnities in the Corporations Act will operate to prevent the governing rules from protecting non-director responsible officers of the superannuation trustee, because s 57 applies, in terms, only to directors. Additionally, there is a big difference between indemnifying and exempting. A director is not exempted from liability even if an indemnity is available, and may therefore contravene the law and be exposed to penalties such as a disqualification order. Finally, the presence of an indemnity is not relevant to the question of compliance with a standard such as the Fit and Proper Standard.

The other significant statutory provision is s 197 of the Corporations Act. This provision, which may be traced back to s 229A of the Companies Code of 1981, was enacted to protect creditors of a trading trust company in cases where debts had been incurred in breach of trust and therefore with no right of indemnity against the trust assets: *Ford's Principles of Corporations Law* [looseleaf], [20.170]. But the provision is not confined to trading trusts. It applies where a corporation incurs a liability while acting or

purporting to act as trustee. The provision says that the directors at the time when the liability was incurred are liable to discharge that liability where certain conditions are met. The conditions are that:
(a) the corporation has not, and cannot discharge the liability; and
(b) the corporation is not entitled to be fully indemnified against its liability out of the assets of trust.

The liability of the directors is joint and several. A director is not liable if he or she would have been entitled to be fully indemnified by one of the other directors.

It appears from the wording of s 197 (1) that the director is liable only where the *right* of indemnity is not available to the company. However, there is a puzzling sentence in the subsection, “This is so even if the trust does not have enough assets to indemnify the trustee”. It is unclear what the word “this” refers to. The predecessor provision, s 233(2) of the Corporations Law, contained different wording, to the effect that the director would not be liable simply because the trust does not have enough assets to indemnify the trustee, provided that the *right* of indemnity remains in place.

In *Hanel v O’Neil* [2003] SASC 409 (11 December 2003) a majority of the Full Court of the Supreme Court of South Australia (Mullighan and Gray JJ, Debelle J disagreeing on this point) held that a director may be liable under s 197 simply because the trust has no assets to meet the trustee’s indemnity, although the right of indemnity is apparently still in place. The majority saw the sentence that I have quoted as, in effect, a separate basis for liability, alternative to s 197(1)(b). Debelle J took the view that the word “this” in the sentence refers to the non-liability of the director.

With respect, the majority view seems out of accord with the legislative history and is not fully in harmony with the statutory language. The ambiguous sentence seems to be supplementary rather than an independent ground to liability. But Debelle J’s reading also seems out of accord with the statutory language. I suggest that the ambiguous sentence should be taken to mean that the director’s liability (if it exists because the right to indemnity has been destroyed) is not diminished by reference to the fact that the trust has insufficient assets to indemnify the trustee. On its proper construction, s 197 should not be taken to render the director liable when the right of indemnity remains in place but there are insufficient assets to meet the indemnity.

Section 197 is a creditor protection measure. The liability which flows through to the directors is a liability to meet the trustee's debt. Therefore the section does not apply to render a director liable to pay compensation for breach of trust: *Young v Murphy* [1996] 1 VR 279.

Section 197 has a curious relationship to s 57 of the SIS Act. If the governing rules contain a director indemnity provision, it appears that the director may be protected by that rule from liability under s 197, as well as any other liability "in respect of" the trustee's liability, such as failure to discharge the duty of care. The proviso is that the director has not failed to act honestly, and has not intentionally or recklessly failed to exercise the appropriate degree of care and diligence.

6. The "Safety in Super" Bill

The Superannuation Safety Amendment Bill was introduced into the Commonwealth Parliament on 27 November 2003. The Bill encapsulates the Government's response to recommendations made in the final report of the Superannuation Working Group (28 March 2002), a body established by the Government to undertake industry consultation on the proposals in an Issues Paper, "Options for Improving the Safety of Superannuation". One of the principal questions canvassed in the Issues Paper was the adequacy of governance, particularly trustee competence, risk management systems and disclosure.

The Bill proposes a new licensing regime for superannuation trustees regulated by APRA, and makes provision for the registration of regulated superannuation funds. The Government intends that, to obtain a licence, a trustee must meet a minimum standard of competency. Licensees will be required to continue to meet the minimum standard on an ongoing basis. Transitional provisions will allow existing trustees to continue to operate under the present arrangements, but they will be required to obtain a licence by the end of a transitional period of two years. There will be new enforcement powers. Many of the penalty provisions proposed in the Bill will have both a fault and a strict liability component, said to create "a more robust regulatory framework" (Explanatory Memorandum, [2.7]). It is intended that the new arrangements will commence on 1 July 2004.

The Explanatory Memorandum to the Bill sets out some reasons for imposing "fit and proper" standards for licensees. It points out (at [318]) that superannuation is the only product regulated by APRA for which licensing is not necessary, except for trustees intending to engage in public offer

superannuation, and continues:

> "… [A] trustee can establish a fund and start managing other peoples' money without demonstrating the necessary skills or competence to do so, although APRA has powers to remove disqualified persons from certain roles in relation to a superannuation entity. Also, funds are not required to be registered with APRA prior to accepting member contributions. This is in contrast to requirements in the managed investments regime, where all schemes must be registered, and must be operated by a licensed responsible entity. The licensing of superannuation trustees and the registration of entities with APRA would provide the supervisor with a range of additional tools to enable it to intervene pro-actively to minimise the risk of failure, and to ensure improved governance standards. Without the ability to control who enters the market, APRA can only act to protect member interests when it suspects that the entity is in difficulty, rather than undertake preventative action, by, for example, ensuring trustees are competent and have approved systems to operate an entity."

Clause 29J will make it an offence for a person to act as trustee of a "registrable superannuation entity (RSE)" unless the person holds an RSE licence that enables the person to be trustee of the entity. Section 10 of the SIS Act will be amended to define "registrable superannuation entity" to include a regulated superannuation fund other than a self-managed superannuation fund. Clause 29D(1)(d) will require APRA to grant an RSE licence if, where the application is made by a body corporate, the body corporate meets the requirements of standards prescribed under Part 3 relating to fitness and propriety for trustees of funds and RSE licensees. Under clause 29E(1)(a) it will be a condition of all RSE licences that the RSE licensee complies with RSE licensee law, which will include the Fit and Proper Standard. Under clause 29G(2), APRA will be empowered to cancel an RSE licence if the RSE licensee breaches the licence condition, including the requirements established in the Standard.

Part 3 of the SIS Act provides that regulations may prescribe operating standards relating to the operation of, inter alia, regulated superannuation funds: s 31. The operating standards may deal with, but are not limited to, the matters listed in s 31(2). The Bill will amend s 31(1) to allow operating standards to apply to trustees and RSE licensees of regulated superannuation funds. It will insert additional matters in s 31(2) including the requirements relating to fitness and propriety for RSE licensees of funds and trustees of funds: proposed paragraph 31(2)(ma).

Under Part 29 of the SIS Act, APRA may exempt a person or class of persons from, or modify in relation to a person or class of persons, certain provisions, which will include the Fit and Proper Standard prescribed under Part 3.

The Bill also proposes to impose conditions on all RSE licenses, including a condition that the RSE licensee must have a risk management strategy that complies with Division 8, and must comply with that strategy: clause 29E(1)(c). Clause 29H, which is part of Division 8, will require the risk management strategy to set out reasonable measures and procedures that the body (in the case of a body corporate licensee) is to apply to identify, monitor and manage, inter alia, "the risks associated with governance and decision-making processes". Clause 29H(2) will require that the risk management strategy sets out the circumstances in which audit of the risks is to be undertaken.

In addition to having a risk management strategy for itself, the RSE licensee will be required to have a risk management plan for each RSE under its control. Clause 29E(1)(d) will require an RSE licensee to register each RSE for which it is the licensee. Under clause 29M(1)(d), before APRA registers an RSE it must be satisfied that the risk management plan of the entity meets the requirements set out in clause 29P. Clause 29P will require the risk management plan to set out reasonable measures and procedures to identify, monitor and manage various risks, including the risk to the entity's financial position and risks from entering into outsourcing arrangements. Clause 29P(2) will require that the risk management plan sets out the circumstances in which an audit of the classes of risk is to be undertaken. The RSE licensee will be required by clause 29PA to review the risk management plan for compliance at least annually.

Additionally, APRA will have the power under clause 29EA to impose conditions on an RSE licence. Under clause 29EB, APRA will be empowered to direct an RSE licensee to comply with a licence condition, and failure to comply may be an offence under clause 29JB.

On 11 December 2003 the Government published on the Treasury website its proposed drafting instructions for regulations and operating standards on a number of topics, calling for submissions by

29 February 2004. The topics include "Fit and Proper Operating Standards" (Document 03) and "Risk Management Regulations" (Document 09). These documents give some clues as to what will be included in an "FPOS" (Fit and Proper Operating Standard), and as to how risk management requirements might impact on the duties and responsibilities of directors and officers of incorporated superannuation trustees.

7. An overview of the main duties of directors and officers in company law

Corporate formation involves separation, at least theoretically, of the ownership and control of business assets. The controllers, that is the directors and executive officers of the corporation, must be rendered accountable to the owners, the shareholders. The task of setting appropriate and effective standards of accountability, sometimes referred to as "the agency problem", is the central problem of company law. Where the assets of the company are held in trust, the agency problem is overlaid by the problem of trustee accountability to beneficiaries, but as far as directors and officers of the trustee entity are concerned, the question remains how to impose effective standards of accountability to the entity.

The mechanisms for controller accountability have always been at the centre of thinking about companies and company law, even before incorporation by registration was permitted by Gladstone's Joint Stock Companies Registration and Regulation Act 1844 (UK). One would hope that more than 160 years of reflection about the central problem of company law has produced something sufficiently worthwhile to be taken into account in the development of the Fit and Proper Standard.

During that time, legal thinking about the duties of company directors and officers has developed, in fits and starts rather than smoothly in parallel, in two spheres, namely in the courts and in the legislatures. Broadly, the legal accountability of corporate controllers has been anchored in four general duties:

- a duty of *good faith* (encompassing duties to act honestly and for proper corporate purposes),
- a duty of *loyalty* (encompassing a duty to avoid conflicts of interest in a duty to account for corporate opportunities improperly diverted from the company),
- a duty of *care* (including, at least, a standard of diligence, and probably also a standard of competence), and
- a duty to *avoid insolvent trading*.

It should be noted that with one exception, these principles apply with full rigour where the board is an equal representation board comprising employer and employee representatives. The exception is that the principles concerning nominee directorship may qualify the duty of loyalty to a limited degree. I shall not explore nominee directorship in this paper.

8. The duty of good faith

Case law

It was never contentious that a corporate controller must act honestly and subjectively in good faith, in dealing with the owners' money and other assets. But during the 20th century, courts were able to knead, mould and expand the concept of honesty, in the company law context, by a special application of the equitable doctrine of fraud on a power. The High Court of Australia demonstrated the utility of the fraud on a power doctrine, in its application to company directors, in *Mills v Mills* (1938) 60 CLR 150 and *Ngurli v McCann* (1953) 90 CLR 425, explaining the circumstances in which the directors' exercise of a power, such as a power to allot shares, would be struck down on the ground that the power was not exercised for a proper corporate purpose.

That idea blossomed in a string of cases on the limits of the powers of a target board of directors to take defensive measures (such as a defensive share placement) to defeat an actual or threatened takeover bid: see *Ford's Principles of Corporations Law* [looseleaf] paragraphs [8.200] to [8.280]. The application of the "proper purposes" concept to takeover defences led to an intensive and minute focus on the equitable principles, and some clarification and development. By the time the CLERP reforms, taking effect in 2000, largely deprived the courts of this jurisdiction, the "proper purposes" doctrine had been developed to a point of refinement, and remains to be applied whenever company directors and other corporate officers exercise powers for collateral purposes. Failure to act "honestly" has become, in the company law context, something much broader than intentional dishonesty or deception.

Statute

Developments in the judge-made law about honesty and proper purposes were well ahead of legislative developments for much of the 20th century. The Victorian Parliament enacted a statutory

statement of the duties of company directors in the Companies Act 1958 (Vic), s 107, which was subsequently adopted in the Uniform Companies Act 1961. Relevantly, a standard of "honesty" was prescribed, but it was far from clear that the equitable extension of the concept was encompassed by the statutory language. The issue was considered in *Marchesi v Barnes* [1970] VR 434, where Gowans J, after reviewing the authorities, reached the conclusion that to "act honestly" refers to acting bona fides in interest of the company in the performance of the functions attaching to the office of director (at 438), citing cases in dealing with the use of power for improper purposes. He said that if the term "fraud" were applicable, it would only be so in the sense of "fraud on the power", the equitable concept. A similar conclusion was reached in *Australian Growth Resources Corporation Pty Ltd v Van Reesema* (1988) 13 ACLR 261, especially at 270-1 per King CJ; see also *Corporate Affairs Commission v Papoulias* (1990) 20 NSWLR 503 at 506, *Southern Resources v Residues Treatment & Trading Co* (1990) 3 ACSR 207 at 226-227, *Feil v Commissioner of Corporate Affairs* (1991) 9 ACLC 811 at 817, *Re QLS Superannuation Pty Ltd, ASIC v Parker* (2003) 21 ACLC 888, 915 per Drummond J.

Only recently, in the CLERP amendments, did the legislature adopt the broader language of the courts, by requiring directors and other officers to exercise their powers and discharge the duties in good faith in the best interests of the corporation, and for a proper purpose: Corporations Act s 181(1). The significance of this language is that the legislature has now picked up the breadth of the equitable duty, and has attached to that duty a statutory framework which provides for civil enforcement. The avenues of civil enforcement of the statutory duty of good faith include enforcement:
· by the corporation in external administration,
· by a shareholder or officer in a statutory derivative action (under Part 2F.1A),
· by a shareholder or ex-shareholder in oppression proceedings (under Part 2F.1),
· by ASIC or the corporation in civil penalty proceedings (under Part 9.4B), or
· by ASIC in representative proceedings (under the Australian Securities and Investments Commission Act 1989 (Cth), s 50).

9. The duty of loyalty

Case law

The duty of loyalty has had a similar development, with the courts leading the way and the legislature reinforcing their endeavours and adding new procedures only recently. The Anglo-American case law of the late 19th and early 20th centuries is replete with sweeping and resonant pronouncements of fiduciary duty which sound as much like moral exhortations as statements of legal principle. Thus, in *Meinhard v Salmon*, 249 NY 456, 464 (1928) Cardozo J referred to equity's "uncompromising rigidity" and observed that "only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd". According to Lord Herschell, "[h]uman nature being what it is, there is danger … of the person holding a fiduciary position being swayed by interest rather than by duty", and accordingly it had been "deemed expedient to lay down this positive rule": *Bray v Ford* [1896] AC 44, 51-2.

The courts applied and developed the general fiduciary principles in a series of 20th century company law cases of which *Cook v Deeks* [1916] 1 AC 554, *Furs Ltd v Tomkies* (1936) 54 CLR 583, *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 (note) and *Industrial Developments Ltd v Cooley* [1972] 2 All ER 162 are famous examples: see *Ford's Principles of Corporations Law* [looseleaf], paragraphs [9.020] to [9.290]. Those cases indicate that a director may breach his or her fiduciary duty even though he or she is acting in a subjectively honest way, or is exploiting a corporate opportunity not available to be exploited by the company, or is doing so after he or she has resigned from the board, or is acting with the consent of all other directors.

Statute

The judge-made fiduciary law left the legislatures well behind. Beginning with the Victorian legislation of 1958, there have been statutory requirements for directors and officers not to make improper use of their position or information (now in ss 182-184), expressed in some ways more narrowly than the conflict of interest principle of general law, but in some ways broader. Narrower, for example, in that the statutory provision applies only to improper use of position or information rather than to all occasions of conflict of interest; and broader, for example, because there is a statutory contravention where position or information is improperly used to gain an advantage for anyone at all. Once again, an important consequence of the legislative reinforcement of the general law is that the legislation has provided new procedures within which breaches a duty may be asserted, for example, in civil penalty proceedings, by statutory derivative action, or by representative action by ASIC.

The statutory duties to avoid improper use of information or position have been in place, generally throughout Australia, since 1961. They have not changed much in content, although improper use of information and improper use of position have been segregated from one another and the procedural superstructure has been modified by the civil penalty regime and in other ways. But their potency should not be underestimated. A recent example of their application in a superannuation context is *Re QLS Superannuation Pty Ltd; ASIC v Parker* (2003) 21 ACLC 888.

In that case QLSS was the trustee of the Law Employees Superannuation Fund, established by the Queensland Law Society and regulated under the SIS Act. Initially QLSS invested superannuation contributions which it had received from employer-solicitors in funds managed by specialist professional investment managers, one of which was Suncorp. The directors decided, however, to establish a special administration company owned by QLSS, and to remove Suncorp as fund administrator because Suncorp was competing with the Law Employees Superannuation Fund for contributions.

The board expanded the fund's investment operations into commercial lending, and authorised Mr Parker, one of the directors, to seek appropriate investments. Mr Parker put a proposal to the board whereby QLSS would lend a substantial amount to the operator of a child minding centre on the Gold Coast. Mr Parker declared a financial interest in the transaction, on the basis that he had been promised success fees, and took no part in the board's decision to make the advance. The investment failed when QLSS was forced to realise its security for a loss.

ASIC initially sought relief against all of the directors for breach of the statutory duty of care and diligence in the making of the loan, but the proceedings against the other directors were settled. It alleged against Mr Parker that he had failed to discharge the statutory duty of honesty and the duty not to make improper use of his position. It sought a disqualification order and a pecuniary penalty order.

Drummond J held that the defendant could not avoid his fiduciary obligation as a director of QLSS simply by declaring that he had an interest in the loan being approved (by virtue of his success fee) and then absenting himself while the board discussed the proposal. Although he was not acting deliberately dishonestly, he had acted in reckless disregard for the proper performance of his duties, especially bearing in mind that he had been given the special responsibility of identifying commercial loan proposals and bringing them to the board. In so doing he had made improper use of his position, contrary to the provision which is now s 182.

10. The duty of care

Case law

The broad and rigorous standards of honesty and good faith demanded by equity have not been matched, in the general law, by any high standard of care. The posthumously discredited Marquis of Bute did not fail to meet the requisite standard, as president of a savings bank, when he attended only one board meeting, and that only because he happened to be passing through Cardiff at the scheduled time for the meeting: *In re Cardiff Savings Bank; Marquis of Bute's Case* [1892] 2 Ch 100.

In the celebrated case of *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407, Romer J meticulously analysed and collated the case law to that time, assembling the law in three propositions as follows:
(i) 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;
(ii) a director is not bound to give continuous attention to the affairs of his company, his duties being of an intermittent nature to be preformed at periodical board meetings, and at meetings of any committee to which he is appointed;
(iii) in respect of all duties which 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.

The general law principles about delegation lead to issues about such matters as outsourcing in the superannuation context, a topic which is the subject of another paper at this conference. I shall leave that area to one side. As to the general requirement of diligent attention to the affairs of the company, much has changed since 1925. Although a statutory duty of care and diligence was introduced after that time, it was the general law that evolved an enhanced the duty of diligence, encouraged by a prescient extra-curial contribution by Sir Douglas Menzies, "Company Directors" (1959) 33 ALJ 156. In *Commonwealth of Bank of Australia v Friedrich* (1991) 5 ACSR 115, Tadgell J summarised the development of the law as follows (at 126):

> "As the complexity of commerce has gradually intensified (for better or for worse) the community has of necessity come to expect more than formerly from directors whose task is to govern the affairs of companies in which large sums of money are committed by way of equity capital or loan. In response, the parliaments and the courts have found it necessary in legislation and litigation to refer to the demands made on directors in more exacting terms than formerly …".

(His Honour's reference to the commitment of large sums of money by investors is readily extendable, of course, to the commitment of large sums of money in trust for superannuation members.)

It is Romer J's first proposition that appears to have attracted the highest level of sustained attention in recent case law. Curiously, most of the case law to date has not been directly about the application of the general law duty of care, or its statutory manifestation now found in s 180(1) of the Corporations Act. Rather, the development of a standard of competence, if not skill, for company directors has happened as an incident to the judicial application of statutory provisions concerning liability for insolvent trading (discussed below). Perhaps the most striking of the insolvent trading cases was *Commonwealth Bank of Australia v Friedrich*, from which it emerges that a company director has a duty to understand the financial position of the company, regardless of his or her financial sophistication and training in accountancy, and to that extent there is a basic standard of competence for company directors.

The significance of the insolvent trading cases for the content of the general duty was noted by Rogers CJ Comm Div in *AWA Ltd v Daniels* (1992) 7 ACSR 759. After referring to the "conventional wisdom" expressed in the *City Equitable* case and reaffirmed in *Byrne v Baker* [1964] VR 443, 450, his Honour said (at 864-5):

> "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 the company [citing *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 the business. Directors should bring an informed and independent judgment to bear on the various matters that come forward for decision [citing the article by Sir Douglas Menzies]."

On appeal, Clarke and Sheller JJA made the following observations (sub nom *Daniels v Anderson* (1995) 37 NSWLR 438, 500-501):

> "The insolvent trading cases demonstrate that ignorance is no longer necessarily a defence to proceedings brought against a director. In some respects, at least, the director must inform himself or herself about the affairs of the company.
>
> "There is no doubt reason for establishing a board which enjoys the varied wisdom of persons drawn from different commercial backgrounds. Even so a director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience. That duty involves becoming familiar with the business of the company and how it is run and ensuring that the board has available means to order the management of the company so that it can satisfy itself that the company is being properly run. The board may be assisted by subcommittees consisting of its members, including non-executive directors: see generally, Seivers, "Farewell to the Sleeping Director" (1993) 21 Australian Business Law Review 111 at 115-117.
>
> "In our opinion the responsibilities of directors require that they take reasonable steps to place themselves in a position to guide and monitor the management of the company. The board of AWA met only once a month for half a day. But to our mind the board should meet as often as it deems necessary to carry out its functions properly. The question is what in the particular case are the duties and responsibilities of the directors and then what time is required of them as a board to carry out these duties and responsibilities. It is not a matter of tailoring the extent of the duty or function to pre-fixed intervals between board meetings."

Their Honours (at 501-2) were not prepared to say that the modern public company director should be treated as having acquired a professional status. They drew attention to the variety of businesses with which companies may be concerned, and the tradition that non-executive directors may be appointed for perceived commercial advantage. They recognised that directors must be allowed to make business judgments in an entrepreneurial spirit, and they are not required to behave like conservative investment trustees. They expressed the opinion that the concept of negligence can be adapted to measure appropriately whether the acts or omissions of entrepreneurs are negligent.

But they continued (at 501-2):

> "We are not impressed by this perceived barrier against imposing on directors a duty of care at common law. Nor do we think that the fact that directors come to the task with different backgrounds in terms of training and experience presents any problem. This consideration has given rise to the proposition that a director need not exhibit a greater degree of skill than may reasonably be expected of a person of the director's knowledge and ability. In *Fletcher v National Mutual Live Nominees Ltd* (1990) 3 NZLR 641, Henry J (at 661) expressed reservations about whether the subjective qualities of the particular director are appropriate factors to applied in determining the yardstick for the standard of care to be exercised by a director in today's business world. … The law of negligence can accommodate different degrees of duty owed by people with different skills but that does not mean that a director can safely proceed on the basis that ignorance and the failure to inquire are a protection against liability for negligence."

Their Honours then said (at 503):

> "The modern cases to which we have referred, set in the context of a legislative pattern of imposing greater responsibility upon directors, demonstrate that the director's duty of care is not merely subjective, limited by the director's knowledge and experience or ignorance or inaction. The duties of a director are eloquently explained in the judgment of Pollock J, giving the opinion of the Supreme Court of New Jersey, in *Francis v United Jersey Bank* 432 A 2d 814 (NJ 1981). The relevant legislative context was different. The description of the duties of directors spoke of 'skill'. The New Jersey Business Corporation Act (1969) required directors to: '… discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.' But the judgment exposes by reference to other cases what is generally expected of directors not only in the United States but in Australia and elsewhere. In our opinion, this has become what the law requires of directors."

Their Honours then quoted extensively from the judgment of Pollock J in the *Francis* case. Pollock J said that a director:

- should become familiar with the fundamentals of the business in which the corporation is engaged;
- is under a continuing obligation to keep informed about the activities of the corporation;
- is required to monitor corporate affairs and policies;
- is required to maintain familiarity with the financial status of the corporation, by regular reviews of financial statements;
- may need to inquire further into matters revealed by a review of financial statements.

It is noteworthy that these matters extend beyond diligence into areas normally encompassed by the word "competence", or perhaps even "skill".

Clarke and Sheller JJA continued (at 504):

> "Although there was no reference to skill in s 229(2) of the Companies (New South Wales) Code - nor is there in s 232(4) of the Corporations Law, Malcolm CJ in *Vrisakis* (at 407-408) thought that the duties imposed by the section reflected the general concept of negligence at common law. This means conduct ordinarily measured by reference to what the reasonable man of ordinary prudence would do in the circumstances. Skill is that special competence which is not part of the ordinary equipment of the reasonable man but the result of aptitude developed by special training and experience which requires those who undertake work calling for special skill not only to exercise reasonable care but measure up to the standard of proficiency that can be expected from persons undertaking such work: *Voli v Inglewood Shy Council* (1963) 110 CLR 74. A director may be appointed because of a particular or special skill and may take up the appointment on

the basis that he or she will bring that skill to the performance of the office. In *Gould and Birbeck and Bacon v Mount Oxide Mines Ltd (in liq)* (1916) 22 CLR 490, Isaacs J and Rich J said:

> 'No rule of universal application can be formulated as to a director's obligation in all the circumstances. The extent of his duty must depend on the particular function he is performing, the circumstances of the specific case, and the terms on which he has undertaken to act as a director.'

…

> "We are of opinion that a director owes to the company a duty to take reasonable care in the performance of the office. As the law of negligence has developed no satisfactory policy ground survives for excluding directors from the general requirement that they exercise reasonable care in the performance of the office."

This goes considerably further, as to the standard of skill, than Rogers CJ Comm Div felt able to go at first instance. What emerges is a general standard of competence, involving familiarisation with the business of the company and how it is run, sufficient to guide and monitor the company's management. A director appointed because of a special skill has an additional higher duty to act at that level of skill.

If there were any doubt that, via the insolvent trading cases, we have arrived at a minimum standard of competence for company directors at general law, that doubt was put to rest by Spigelman CJ's judgment in *Deputy Commissioner of Taxation v Clark* (2003) 45 ACSR 332. After reviewing the insolvent trading cases in detail, and considering *Daniels v Anderson*, the Chief Justice concluded (at 355) that "the case law indicates that there is a core, irreducible requirement of involvement in the management of the company".

Statute

A statutory duty of "diligence" for company directors was introduced in Australia by the Companies Act 1958 (Vic), s 107. Contravention was a criminal offence. It was followed in s 124(1) of the Uniform Companies Act of 1961. When the Companies Code replaced that legislation in 1981, the wording of the provision changed in two ways, first by extending the duty to executive officers as well as directors, and secondly by re-wording the duty so that became a duty to "exercise a reasonable degree of care and diligence" in the exercise of the relevant powers and the discharge of the relevant duties.

The case law, especially *Byrne v Baker* [1964] VR 443, was generally to the effect that the statutory words made no difference to the content of the duty, which excluded any standard of “skill”. As I have explained, the standard of care was raised in the case law by borrowing observations made in the context of insolvent trading liability, and by developing the general law rather than, specifically, the statutory duty. But those developments came to be applicable both at general law and under the statute, as the Court of Appeal's judgment in *Daniels v Anderson* makes plain in the passages I have cited.

Some observations in *Vrisakis v ASC* (1993) 11 ACSR 162 might be taken to suggest, wrongly in my opinion, that the general law standard of competence is not reflected in the statutory duty of care and diligence. That was a case decided after the judgment of Rogers CJ Comm Div in the *AWA* case, but before the judgment on appeal. Ipp J observed (at 205) that s 229(2) of the Companies Code was "substantially in the same terms" as s 107 of the Victorian Act of 1958, and that the reasoning in *Byrne v Baker* was therefore apposite to s 229(2). If these observations mean that there is no standard of competence imported into the statutory duty of care and diligence, they appear to be inconsistent with the Court of Appeal's judgment in *Daniels v Anderson*, and Spigelman CJ's analysis in *DCT v Clark*. That was the conclusion I reached in *ASIC v Vines* [2003] NSWSC 1116, [39].

The most important revision of the statutory duty of care and diligence came as part of the CLERP 2000 amendments to the Corporations Law. Prior to the change, the duty was to exercise "the degree of care and diligence that a reasonable person in like position in the corporation would exercise in the corporation's circumstances". That is almost identical, by the way, with the formulation in s 52(9) of the SIS Act, which has not been revised since the CLERP amendments to the Corporations Law. Now s 180 speaks of:

> "the degree of care and diligence that a reasonable person would exercise if they:

(a) were a director or officer of a corporation in the corporation's circumstances; and
(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer".

I had to consider the significance of the new wording in *ASIC v Rich* (2003) 44 ACSR 341. In proceedings seeking a disqualification order and a compensation order under the civil penalty provisions of the Corporations Act, brought against several executive directors and the chairman of directors, ASIC pleaded that the chairman had a number of specific responsibilities as chairman of a public company and chairman of the audit committee, and as a person of experience in financial matters. The chairman sought to strike out this pleading on the ground that ASIC had misunderstood the function of the word "responsibilities" in s 180(1). His contention was that the word "responsibilities" refers only to the tasks specifically delegated to the relevant director, rather than any "responsibilities" that might arise through the holding of a particular position or position of special experience.

I decided that the pleading should not be struck out because ASIC's approach was arguable. In the course so doing, I traced the history of the current wording, holding that, arguably, s 180(1)(b) allows the court to consider such matters as how the work of the corporation is distributed in fact, the expectations placed by those arrangements on the shoulders of the individual director, the individual director's occupation of particular positions in the company (such as chairman and in the audit committee), and the individual director's qualifications, experience and expertise.

Most of the case law as to duty of care focuses on the position of the director, rather than the non-director executive officer. It is interesting that in the United States, post-Enron, litigation has tended to concentrate on the liability of executive officers rather than non-executive directors, especially through SEC proceedings under the fraud provisions of federal securities law. In Australia, the application of the statutory duty of care and diligence to a non-director executive officer was considered in *ASIC v Vines* [2003] NSWSC 1116.

In that case ASIC brought proceedings against three non-director executive officers of the GIO group, relating to alleged deficiencies in GIO's Part B statement in response to the AMP takeover bid in 1998. The reported decision relates to the admissibility of expert opinion evidence. It was held that evidence by an experienced chief financial officer as to whether one of the defendants, the chief financial officer of GIO, had failed to act as would a competent chief financial officer in his position acting reasonably in the circumstances, was admissible evidence.

The case raised for consideration whether the statutory standard of care and diligence (in substance, the standard imposed by s 232(4) of the Corporations Law prior to the CLERP amendments of 2000) incorporated an element of competence. Applying the observations of Rogers CJ Comm Div at first instance, and Clarke and Sheller JJA on appeal, in *Daniels v Anderson*, and referring again to the history of the evolution of the statutory standard, I reached the conclusion (at [48]) that the position of chief financial officer is a recognised position in large corporations, such that there is identifiable specialised skill attaching to that office. Expert opinion evidence was therefore admissible as to what a reasonably competent chief financial officer would do on stated assumptions.

In reaching that conclusion, I reasoned that unlike a non-executive director, a person engaged as chief financial officer (or in another executive position involving the exercise of special skill) has a duty of skill and competence commensurate with his or her position, and that the statutory standard reflects that special duty notwithstanding that it omits the word "skill". If that is correct, then the special skill attaching to the office of the particular executive officer (whether a director or not) is relevant to determining whether that person has discharged the statutory duty. There is therefore a statutory standard of skill and diligence applicable in, for example, civil penalty proceedings, beyond the standard arising out of the officer's contract of employment and the general law.

11. The duty to avoid insolvent trading

Case law

A aspect of the duty of loyalty is that directors and officers must acting good faith in the interests of the company. In this context, the company is the body of shareholders as a whole, rather than other stakeholders such as management, employees, creditors or the community at large. However, in a series of cases beginning in the 1970s, the courts have recognised that in discharging their duties, directors and officers of a company in financial difficulty may have regard to the interests of creditors: *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722, *Walker v Wimborne* (1976) 137 CLR 1,

Spies v R (2000) 201 CLR 603. The courts in Australia have resisted the temptation to elevate this line of authority into an independent general law duty to creditors. Although the case law remains relevant and is occasionally invoked in corporate litigation, it is now much more common for issues concerning the respective rights of shareholders and creditors to be dealt with in the context of external administration, especially since, once the company is in sufficient difficulty to attract the general law principle, it is likely as a practical matter that the directors will place it in voluntary administration.

Statute

A statutory provision exposing the directors of a company to civil liability, and possibly also criminal liability, for insolvent trading was introduced in s 556 of the Companies Code in 1981 (based broadly on s 303 of the Uniform Companies Act 1961). It was subsequently overhauled as part of the Harmer reforms enacted by amendment to the Corporations Law in 1992. Essentially, s 588G applies to a person who is a director when the company incurs a debt, if the company is at that time insolvent, or is pushed into insolvency by the debt, and there are reasonable grounds for suspecting insolvency at that time. Where the section applies, the director contravenes it if he or she fails to prevent the company from incurring the debt and is aware of the existence of reasonable grounds for suspecting insolvency, or a reasonable person in like position in the company in the company's circumstances would be aware.

By virtue of amendments in 1998, certain corporate actions are deemed to involve incurring a debt for the purposes of s 588G, such as paying dividends or giving financial assistance for the acquisition of shares in the company.

There are several important defences available to the director. Under s 588H(2), there is a defence if it is proved that at the time the debt was incurred, the director had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent. Section 588H(3) allows the director, acting reasonably, to rely on a "competent and reliable person" who is responsible for providing adequate information as to whether the company is solvent. Section 588H(4) gives a defence to the director if it is proved that "because of illness or for some other good reason" he or she did not take part at the time in the management of the company. Under s 588H(5), there is a defence if it is proved that the director took all reasonable steps to prevent the company from incurring the debt.

The courts have had occasion, relatively frequently in recent times, to consider the scope of s 588G and the defences. The overall tendency in the case law is to reject submissions which attempt to narrow the scope of the liability or widen the defences. Perhaps the most important case, particularly relevant to passive directors and "sexually transmitted debt", is *Deputy Commissioner of Taxation v Clark* (2003) 45 ACSR 332, now the leading case on the scope of s 588H(4). A carpentry fit-out company paid substantial sums to the Australian Taxation Office before commencement of its liquidation. In proceedings taken by the liquidator, the court held that the payments were an unfair preference and ordered their repayment. The Deputy Commissioner sought indemnity against that judgment from the two directors of the company, who were husband and wife, under s 588FGA. By s 588FGB(5), which is based on s 588H(4), there is a defence to that liability if it is proved that, because of illness or for some other good reason, the defendant did not take part in the management of the company at the relevant time. Mrs Clark became a director when asked to do so by her husband, who wrongly believed that it was necessary that there be two directors of the company. She thought she had to accept as a wife. She was a housewife and mother, who had never been a director of any company and had no business experience. She had no understanding of the duties and responsibilities of a company director. From time to time she signed company documents, but they were not explained to her and she said "I would usually have a frying pan in one hand and be signing with the other".

The Court of Appeal of New South Wales held (at 357) that:
· s 588H(4), and the equivalent defence in s 588FGB(5), operate on the assumption that every director is under a duty to guide and monitor the management of the company, and the words "other good reason" must be read down so that they do not conflict with that general obligation;
· the defence is not confined to cases where non-participation in management of the company is shown to be unavoidable (at 358);
· reasons which cause the director never to participate in management are not capable of constituting "good reason" for not participating at a particular point in time;
· consequently the defence does not authorise total abdication of the duties of a director in reliance on the conduct of a spouse;
· the words "good reason" do not extend to such general matters as duress, undue influence, or misleading or unconscionable conduct (at 359), the focus being on proper standards of conduct for directors as a matter of company law.

12. The content of the proposed Fit and Proper Standard

The general statement of the Standard

The drafting instructions for the Fit and Proper Standard say (at [12]) that "the FPOS should define the Fit and Proper Standard so that it means the overall standard of educational or technical qualifications, knowledge, skills, experience, competence, diligence, judgment, character, honesty and integrity required to satisfactorily discharge the duties and responsibilities of RSE licensee in a prudent manner".

With respect, it is confusing to qualify the whole list of attributes by reference to the criterion of prudence, which really only applies to enhance the duty of care. I suggest that paragraph [12] of the drafting instructions conveys four central ideas:

(a) educational requirements relating to knowledge, experience and technical expertise;
(b) a standard of *skill and competence*, in the discharge of the licensee's duties and responsibilities (to which I shall refer, in abbreviated form, to as the standard of competence);
(c) a standard of *diligence and prudence*, in the discharge of the licensee's duties and responsibilities (in abbreviated form, the standard of prudence);
(d) a standard of *honesty, integrity and good character* (in abbreviated form, the standard of honesty).

I do not intend to explore, in this paper, the educational requirements that the FPOS will impose. I should note, however, that APRA intends to release "Fit and Proper Guidelines", which the FPOS will authorise it to take into account in determining whether an RSE licensee meets the Fit and Proper Standard. The Guidelines will address the broad standards of educational or technical qualifications, knowledge skills and experience APRA will expect RSE licensees to demonstrate.

Duties and responsibilities

The use of the phrase "duties and responsibilities of an RSE licensee" is interesting. The drafting instructions say that trustees of superannuation entities have a number of different duties and responsibilities imposed under the SIS Act, the trust deed and governing rules of the particular fund, and fiduciary duties imposed under the general law (at [13]). It refers to specific duties and responsibilities established in the SIS Act, including the Part 12 duties, covenants in governing rules contained in the Part 6 (including those in relation to formulating and giving effect to investment strategies), reporting requirements in Parts 4 and 13, and operating standards established under Part 3.

The intention appears to be that the FPOS will refer to those various duties and responsibilities and will not restate them. It is curious, however, that the standards are to be confined to the discharge of duties and responsibilities, and not extended to the exercise of powers (compare Corporations Act, s 180(1)). Questions as to the discharge of the duties of honesty, prudence and competence are likely to arise, at times, where the conduct in question is undertaken otherwise than to discharge a duty or responsibility.

Standards for the RSE licensee's directors and officers

The standards of honesty, prudence and competence articulated in the drafting instructions are, of course, duties of the RSE licensee, which will often be a corporation. Although the Bill does not in terms authorise a standard to be made for directors and officers of a corporate trustee, the drafting instructions contemplate that the FPOS and/or APRA will do so.

The drafting instructions say (at [17]) that, as part of assessing whether an RSE licensee meets the overall Fit and Proper Standard, APRA will assess the fitness and propriety of the responsible officers (defined in s 10 of the SIS Act as the body corporate's directors, secretary and executive officers). The reason is that those individuals are said to represent and control the RSE licensee. Therefore the standards of honesty, prudence and competency articulated in the drafting instructions for the RSE licensee itself are also to be applied, apparently without qualification, to each responsible officer.

Fluctuation of Standard to reflect officer's position

Although the drafting instructions do not expressly say so, inevitably the content of the standard of competence (and possibly also the standard of prudence, but certainly not the standard of honesty) will fluctuate depending on whether the officer is the chief executive, or the chief financial officer, or

investment officer, or the chairman of the board, or an ordinary director, or the company secretary, even though the same wording may be used to articulate the standard in each case. In the Corporations Act some allowance has been made for different kinds of officers in s 180(1)(b), which sets the standard of care and diligence as that which a reasonable person would exercise if they occupied the office held by, and had the same responsibilities within the corporation as, the director or officer in question. The introduction of some such wording might clarify the Fit and Proper Standard, whether or not it is strictly necessary.

Are the corporate trustee's circumstances relevant?

Section 180(1) of the Corporations Act sets the standard of care and diligence for directors and officers as that of a reasonable person who is a director of a corporation in the corporation's circumstances. The corporation's circumstances would include the fact that it is, for example, a trustee of a single superannuation fund, rather than a listed public company whose business is to manufacture widgets, or an incorporated corner grocery. There is a similar formulation, apparently borrowed from an earlier version of the corporate standard, but confined to directors, in s 52(9) of the SIS Act, which speaks of "the degree of care and diligence that a reasonable person in the position of director of the trustee would exercise in the trustee's circumstances".

The drafting instructions do not propose similar wording. In the absence of such wording, there may be an argument that a uniform standard is to be applied to the directors and officers of the trustee, regardless of whether the trustee is a corporate trustee of a single regulated fund, or a subsidiary of a financial institution managing many master funds and sub-funds, or something in between. One would have thought that the standard of competence, though perhaps not the standard of prudence and certainly not the standard of honesty, should be allowed to fluctuate depending on such matters.

13. Specific grounds for not meeting the Fit and Proper Standard

Disqualification of a director

The drafting instructions say (at [16]) that the FPOS will specify that if the RSE licensee is a body corporate, and a director is a disqualified person under s 120 of the SIS Act, or is prohibited from being a director of the body corporate under the Corporations Act or similar overseas legislation, then the RSE licensee will not meet the Fit and Proper Standard.

It is curious that the drafting instructions with respect to disqualified persons under s 120 of the SIS Act refer only to directors, rather than "responsible officers" as defined in s 10 (a concept that extends to the company secretary and executive officers, as well as directors).

"Prohibited from being a director"

Part 2D.6 of the Corporations Act deals with the circumstances in which a person may be disqualified from "managing corporations" for a period - a wider concept than being a director of a corporation. Disqualification may occur automatically for certain convictions (s 206B); by the Court where a civil penalty provision has been contravened (s 206C), or where the person has been an officer of two or more corporations that have failed and the Court is satisfied that the manner in which the corporations were managed was wholly or in part responsible for the failure (s 206D), or where the person has at least twice been an officer of a body corporate that has contravened the Act and the person has failed to take reasonable steps to prevent the contravention (s 206E); and by ASIC where a person has been an officer of two or more corporations which have been wound up and were unable to pay their debts (s 206F).

Presumably the drafting instructions intend that if a director of an incorporated RSE licensee is disqualified from managing corporations on any of these bases, the RSE licensee will not meet the Fit and Proper Standard so long as the director remains disqualified and remains a director.

Directors only, or all responsible officers?

The drafting instructions specify (at [16]) that the RSE licensee will automatically not meet the Fit and Proper Standard if any of its directors is a disqualified person under s 120 of the SIS Act or is prohibited from being a director of a body corporate under the Corporations Act. If the person becomes disqualified from managing corporations under Part 2D.6 of the Corporations Act, that person automatically ceases to be a director: s 206A(2). By purporting to act as a director in such a circumstance, the disqualified person is likely to commit offences under s 206A(1). The thrust of the

drafting instructions is that, once disqualification occurs, the disqualified person must cease to purport to act as a director, in an office he or she no longer holds.

It is not easy to see why this part of the drafting instructions is limited to directors and is not extended to responsible officers, defined in s 10 of the SIS Act to include executive officers and the secretary as well as directors. If any responsible officer continues to act as such after disqualification, that person is likely to commit offences under s 206A(1). The RSE licensee might fairly be expected to ensure that the disqualified person is excluded from office in these circumstances.

14. Contraventions and conflicts of interest

In another part of the drafting instructions (at [23]), it is said that in satisfying itself that an RSE licensee or applicant for a licence meets the Fit and Proper Standard, APRA intends to have regard, in the case of the body corporate, to whether any of the responsible officers have:
(i) contravened any provision of banking, insurance, superannuation, securities, or other applicable legislation (including subordinate legislation) designed to protect members of the public against financial loss due to dishonesty, incompetence for malpractice;
(ii) actual or potential conflicts of interest that can influence or appear to influence the entity's ability to carry out its role and functions with the degree of probity and independence required or with regard to the duty of care to superannuation fund members;
(iii) been involved in business practices that appear to be negligent, deceitful, oppressive, or otherwise improper or which otherwise reflect discredit on their method of conducting business;
(iv) been reprimanded or disqualified by a professional regulatory body; and
(v) been substantially involved in the management of a business or company which has failed, where that failure has been occasioned in part by deficiencies in that management.

It is not immediately obvious why these considerations are not put forward as provisions of the FPOS, for they appear to be criteria of broadly the same kind as the disqualification criteria referred to in the drafting instructions at [16]. Nor is it clear from the drafting instructions whether APRA will set out these matters in its Guidelines, to which the FPOS will require it to have regard. They may be simply matters to which APRA intends to have regard, without any express authority in specific terms, on the basis that they will or may be indications of failure to meet the Fit and Proper Standard.

Items (i), (iii), (iv) and (v) appear to relate to the past history of the licensee or applicant, rather than any current state of affairs. The matters identified may have nothing to do with the conduct of the superannuation fund to which the licence relates, or indeed any superannuation fund. Item (v) is expressed in much vaguer terms than the statutory grounds for disqualification of a person from managing corporations in ss 206D, 206E and 206F of the Corporations Act.

Item (ii) is more interesting for present purposes. The general articulation of the Fit and Proper Standard at [12] of the drafting instructions makes no express mention of avoidance of conflicts of interest, although that is a central component of the accountability rules for directors and officers in company law. It seems bizarre to contemplate a system in which avoidance of conflicts of interest is not one of the ingredients of the Fit and Proper Standard, but is nevertheless a matter that APRA may take into account in satisfying itself that a licensee or applicant meets the Standard. It is as if avoidance of conflicts of interest is a second order consideration, which might contribute to a decision that a first order matter such as the standard of honesty is satisfied. If that is the thinking, it is in stark contrast with orthodox thinking in company law.

As a formulation of a principle of avoidance of conflicts of interest, the wording in [23] of the drafting instructions leaves much to be desired. The reference to conflicts that can "appear to influence" the individual's ability to carry out his or her role and functions with probity and independence is problematic. The usual equitable formulation, based on Lord Upjohn's dissenting speech in *Boardman v Phipps* [1967] 2 AC 46, is whether the fiduciary is in a position where there is a "real sensible possibility" of conflict between interest and duty (at 124). The emphasis is on the possibility or the risk of preferring interest to duty, rather than on the "appearance" to others. It is the fiduciary's conscience that is addressed, rather than the impression his or her conduct creates in the minds of others.

It is also troubling that this subparagraph of [23] introduces the idea of "independence", not otherwise articulated in the drafting instructions. Except in the case of the SIS Act provisions on equal representation, where the word is defined in a limited and unusual fashion, "independence" is normally taken to require something beyond the avoidance of conflicts between interest and duty and between duty and duty. Just what should be required by way of "independence", in the case of company directors and auditors, is one of the most hotly debated questions in corporate governance today, and

(as far as auditors are concerned) one of the issues addressed in the CLERP 9 reforms. If "independence" is to be any part of the Fit and Proper Standard, or a matter to be taken into account by APRA in applying the Standard, it is surely incumbent on the drafters to explain with precision what they have in mind.

15. The standard of competence

It appears from the drafting instructions (at [18]) that the standard of competence to be set by the FPOS will not require the responsible officers of the trustee to be technical experts in the superannuation field. It is intended that the FPOS will allow an RSE licensee to use both in-house and outsourced personnel to assist it to discharge its duties and responsibilities. But the licensee or applicant must demonstrate to APRA that its responsible officers "have at least sufficient knowledge regarding the duties and responsibilities of an RSE licensee to make informed decisions based on the advice of technical experts" (at [19]).

Thus, in the case of a group of individual trustees, it will not be necessary for each trustee to have the relevant skills to formulate an investment strategy as required by the covenants in the governing rules established by Part 6 of the SIS Act (drafting instructions at [20]). But the licensee should have access to those skills, either in-house or from an outsourced provider, and each member of the group of individual trustees should have sufficient knowledge regarding the investment of superannuation fund assets to make informed decisions based on the advice that they receive. Although the example given in the drafting instructions relates to a group of individual trustees rather than a corporate trustee, the same reasoning would apply as to the standard of competence to be possessed by the directors of a corporate trustee. The reasoning set out in the drafting instructions also suggests that a corporate trustee need not have any of the requisite skills in-house, provided it accesses those skills from an outsourced provider.

What emerges from the drafting instructions is a distinction between the standard of skill and the standard of competence, similar to what has developed in company law. Officers who are engaged in a position which requires the exercise of skill should possess the requisite level of skill. Thus, if one of the responsible officers of a corporate trustee occupies a position which requires him or her to formulate an investment strategy, that person must have the necessary skill to do so. However, those who occupy positions which do not require the exercise of that particular skill need not have it. Where their positions require them to supervise the holder of the skill, or to make decisions upon the basis of expert recommendations by that person (as will be the case for the directors of the corporate trustee), then they must be competent enough to do so. Competence, in this context, does not mean expertise, but it requires sufficient knowledge and understanding of the expert field to discharge adequately the supervisory and/or decision-making responsibilities. Where the company is a manufacturer of widgets, competency in relevant aspects of the manufacturing business will be required by the general company law. Where the company is a corporate superannuation trustee and RSE licensee, the competency will relate to superannuation activities.

Although the volume and pace of litigation against company directors and officers has increased notably over the last decade or so, it is still true that the jurisprudence of the duty of competence is embryonic, and the principles will need to be applied and tested much more extensively than they have been to date before the true shape of the duty is understood. A specific problem not yet solved is how a director with no more than general financial skills can be expected competently to supervise, and make decisions governing, expert activities of central importance to the company's financial well-being (or at least, of high risk), where the financial expertise is so intense that non-experts have difficulty in reaching even a rudimentary level of understanding. Perhaps, to take a topical example, a bank's foreign exchange dealing room is in this category. Are there some corporate activities for which only the experts should be held accountable?

At least at this stage in the development of the law, it should be assumed that the directors of a corporate superannuation trustee, and those responsible officers whose job it is to supervise the use of expertise they do not possess, have a duty of competence which requires a substantial level of knowledge of investment principles, fund operations and regulatory requirements, measured by what is necessary for a general understanding of the expert activity, which are sufficient for supervision of the activity and/or for decision-making based on expert recommendations. In company law, the level of competence fluctuates with the corporation's circumstances. This suggests that the standard to be achieved is likely to be more onerous for the directors and other responsible officers of the trustee subsidiary of a financial institution than for a single-fund corporate trustee, and perhaps less onerous where the fund is small and the opportunities for prudent investment are orthodox and limited.

Promulgation of a Fit and Proper Standard will essentially reinforce what is in any case indicated by the

general company law, while adding substantially to the range of enforcement mechanisms. At least as importantly, APRA will be required, in the course of administering the new licensing regime, to apply the Standard much more frequently than the courts are asked to apply the law, and will quickly build up its own internal jurisprudence of the standard of competence.

Additional factors influencing the standard of competence of responsible officers of incorporated superannuation trustee

Both the content, in particular applications, of the FPOS and the content of the company law duties of responsible officers will be affected by several additional features of the regulatory system for superannuation schemes.

First, the fact that the scheme operates as a trust means that the entity managing the superannuation fund depends for its viability on the trustee's right of indemnity out of trust assets, to which I have referred. That, in turn, casts a duty on responsible officers including the directors, as part of the duty of competence and the general duty of care, not to act in such a fashion as to put the right of indemnity in jeopardy. That duty is in addition to the specific liability exposure that the directors of the trustee have under s 588G and s 197 of the Corporations Act, as noted above.

Secondly, the content of the standard and the legal duty of competence will be affected by Part 6 of the SIS Act. Section 52(2) causes the governing rules of a superannuation entity to contain various covenants. One is a covenant by the trustee to exercise the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide: s 52(2)(b). Another is a covenant by the trustee to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the entity, including a number of specified matters relating to risk, the composition of the entity's investments, their liquidity, and the ability of the entity to discharge existing and prospective liabilities: s 52(2)(f). And there is a covenant by the trustee, if there are any reserves of the entity, to formulate and give effect to a strategy for their prudential management: s 52(2)(g).

Significantly for present purposes, s 52(8) says that the corporate trustee's covenant also operates as a covenant by each of the directors of the trustee (but not, note, non-director responsible officers) to exercise a reasonable degree of care and diligence for the purpose of ensuring that the trustee carries out its covenants. As previously mentioned, "reasonable care and diligence" are said to refer to the degree of care and diligence that a reasonable person in the position of director of the trustee would exercise in the trustee's circumstances: s 52(9).

Under s 52(8) the director's duty is no more than a duty of care and diligence, and is not expressed to contain any element of skill or competence. But as we have seen, the courts have extracted from identical words in the corporations legislation a minimum standard of competence for company directors. There is no reason to think that any lesser standard would be extracted from s 52(8), and good reason to believe that the standard of competence for the directors of a superannuation trustee would have a more substantial content than the minimum standard for company directors generally. In particular, while s 52(8) speaks only of care and diligence, one of the covenants that it reinforces is the covenant in s 52(2)(b) by the trustee to exercise a prudent degree of skill as well as care and diligence. The director's obligation is to exercise a reasonable degree of care and diligence to ensure that this occurs, and he or she can only do so either by exercising the appropriate degree of skill personally or by engaging someone else to do so under his or her reasonably competent supervision.

Thirdly, the risk management conditions that will be introduced by regulations made under s 52(5) will make a further contribution to the enhancement of the substance of the duty of competence of directors and other responsible officers of a superannuation trustee. The drafting instructions for these regulations specify that risk management strategies and risk management plans must define material risks, and identify and analyse material risks to the RSE licensee and the entity, and the proposed treatment of those risks, including proposed arrangements for internal oversight, implementation and reporting (drafting instructions, at [20] - [22]).

Obviously care and diligence will need to be exercised in the preparation of every risk management strategy and risk management plan. The fact that the strategies and plans are required to be recorded will provide an evidentiary foundation for attacks on the competence of the board and the responsible officers. Additionally, once established, the risk management strategy and the risk management plans will constitute texts by reference to which the content (in relevant respects) of the Fit and Proper Standard and of the legal duty will be measured. When investments go wrong and plan members suffer loss, they and the regulators will find it easier, in proceedings against directors and other responsible

officers for failure to discharge their duties under s 52(8) of the SIS Act and/or s 180 of the Corporations Act, to establish deviation from a particular requirement of a risk management strategy or risk management plan, than to establish a more general failure to meet a minimum standard of competence.

A problem which sometimes arises in litigation, especially where the defendants are non-director executive officers, is to identify with precision the demarcation of executive responsibilities. The requirement contemplated by [28] of the drafting instructions for risk management strategies and plans, that the regulations should require them to include clear demarcation of the roles and responsibilities of the board and management regarding risk management oversight and implementation, should substantially alleviate this problem.

Fourthly, it must be borne in mind that directors (though not other responsible officers) of the superannuation trustee may, as noted above, be protected from liability by the governing rules, to the extent permitted by s 57 of the SIS Act.

"Key person" condition

The drafting instructions (Appendix A) contemplate that APRA may from time to time exercise its power to impose conditions on an RSE licence, to require that a "key person" continue to be involved in running the RSE. This will happen when APRA, considering an application for a licence or reviewing the licensee's compliance with the FPOS, forms the view that the licensee or applicant is heavily dependent upon a certain person or persons to meet the Fit and Proper Standard. The licence condition will also require the RSE licensee to notify APRA if any key person ceases or is about to cease the role he or she occupies within the licensee, and to nominate another suitably qualified person to perform the role.

The imposition of a "key person" condition might give rise to some governance problems within an incorporated trustee. The "key person" might assume a disproportionate importance in the management structure, making it difficult for the directors to discharge their overall supervisory duties in an effective manner. The designation of a person as a "key person" may also have the effect of enhancing the standard of skill and competence required of that person under the FPOS, and even under general company law principles. It may be, therefore, that in many cases both the trustee and the key person will seek to dissuade APRA from imposing a key person licence condition.

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Some Reflections On Managing Corporate And Commercial Cases

Law Council of Australia
Business Law Section

Workshop for Committee Chairs, Deputy Chairs and Members of the Section Executive

9 February 2004

Some reflections on managing corporate and commercial cases

The Hon Justice R P Austin
Supreme Court of New South Wales

I have been asked to make some observations on the management of corporate and commercial cases, based on my own experience. My experience is principally in the management of the Corporations List of the Supreme Court of New South Wales, for which I have been responsible, with Barrett J, since the elevation of Santow J to the Court of Appeal. From time to time, however, I have been responsible in respect of large commercial/corporate disputes, both for case management and for final hearing. I have also endeavoured to keep abreast of developments within the Supreme Court and other courts designed to enhance the efficiency of the litigation process.

Today I shall make a few remarks about the Corporations List, my core experience, and some developments in the management of large commercial cases generally, to do with pre-trial conferences, discovery, experts, mediation and limited-time hearings.

Corporations List

The Supreme Court of New Wales deals with by far the largest portion of Australian corporations litigation. Reliable comparative statistics are not, as far as I am aware, available. My guess is that somewhere between 35% and 40% of all Australian cases under the Corporations Act are in the Supreme Court of New South Wales. I base that partly on a comparison of court statistics for corporations matters (NSW: 3424 disposals in 2003; Vic: 1235 disposals in 2002/03; Queensland: 1338 Registrar disposals in 2002/03; Federal Court (nationally) 429 disposals at first instance; no published corporations figures for Western Australia, South Australia and Tasmania). However, the statistics do not measure precisely the same things and are for different periods of time. I also take into account the proportion of reported company law decisions emanating from our Court, compared with other courts.

Routine applications, including standard winding up proceedings, are handled by the Registrar in Equity, with notable efficiency. Some cases under the Corporations Act, such as unfair preference cases, are set down in the general list, but most of the contested corporations matters, where interlocutory relief or case management is needed, come before the Corporations List Judge.

The principal Corporations List is a Monday list, heard by either Barrett J or me. Last year the Court established a Friday Corporations List as well, to cater for increasing workload. All cases in the Monday list are reached on that day, and almost all are disposed of as required. Contested short hearings (up to two hours) can either be handled on the Monday, or stood over by the Corporations List Judge to the Friday Corporations List before another judge. The Friday list is used where a case is ready for a short hearing and it is convenient to the Court and the parties for the hearing to be set down on a Friday. Longer cases are case-managed in the Monday List until they are ready for hearing, and then they are given hearing dates, normally before Barrett J or me (occasionally, they might be sent to the Expedition Judge).

The Masters of the Equity Division also hear some corporate matters, mainly contested applications to set aside statutory demands, and some of those are also heard by a Judge in the Friday list.

As far as I am aware, there is no significant delay in reaching a hearing of a contested matter in the Corporations List, except such delay as is caused by the parties and their need to have reasonable time to prepare. There is some capacity in the Friday List, generally speaking, to cater for further

expansion of work.

If matters arise too urgently to wait for the next Monday, the Corporations List Judge may be approached in chambers and normally appropriate arrangements can be made for hearing. Alternatively, the Equity Duty Judge may be approached.

If it is necessary to reserve a judgment in a Corporations List matter, judgment is typically reserved for only a very short time. You will see that the pages of the specialist company law reports are filled with judgments that arise out of the Corporations List, frequently dealing with interesting and gritty points of law.

Our most recent statistics indicate that of the 3424 cases disposed of in 2003, 89% (or 3046 cases) were disposed of within 6 months of the filing of the originating process, and 94% (3233) were disposed of within 12 months. Most of the cases formally recorded as pending more than 12 months after commencement are winding up cases where the order was made a long time ago and there is a pending application by the liquidator, for example for approval of remuneration.

There is a Corporations List Users Group in which we discuss with representatives of the profession and of insolvency practitioners, any issues that arise out of the administration of the list, and explore ways to improve efficiency. Recently we introduced a “short call-over” process which seems to be effective in clearing the courtroom and letting people have an idea of how long they will have to wait in the court precincts before their case comes on. This year we have in mind a trial of arrangements for the making of consent orders in chambers, so as to prevent the parties having to attend personally at court. We are also looking at ways of abbreviating the process of taking objections to the admissibility of affidavit evidence. Most importantly we expect to move to the Courtnet electronic filing system in about October 2004.

Improving efficiency in commercial/corporate cases

In our Court, major commercial litigation is conducted through the Commercial List, currently managed by Bergin J with assistance from two other judges. There is a substantial practice note (No.100) outlining the procedures in that list for case management and trial preparation. Sometimes, however, large commercial matters involving company law issues begin in the Corporations List and are managed by the Corporations List Judges. One sub-category of large cases is *ASIC* proceedings for civil penalties for breach of the Corporations Act, which are typically large matters.

The extent to which the Court can engineer or enhance efficient outcomes depends upon the position of the parties. Where both sides are commercial entities who share an interest in having a speedy resolution of their dispute, a great deal can be done because of the parties’ willingness to co-operate in order to achieve that shared objective. Where it is in the interests of one side to delay the resolution of the dispute, the considerations are at least potentially different. Where the proceedings are brought by a regulator for remedies in consequence of alleged contraventions of the law, the case for truncating the normal procedures will normally be weak, because the procedures are intended to ensure fairness and protect the strict rights of the parties.

I have seen a number of efficiency measures taken which it might be useful to note. As a general observation, where commercial parties agree to co-operate for a speedy resolution of their dispute, it should be possible to run the litigation process on commercial lines, in which deadlines are set early and strictly enforced, and the whole process is moulded into an agreed timeframe.

Pre-trial directions and conferences

Pre-trial directions hearings are regarded as an essential part of the preparation of a case for final hearing. The Court is concerned to prevent surprise and trial by ambush, and applications for adjournment, by making sure that the pleadings are in proper order and all affidavit evidence is filed and served in a timely manner. A “cards on the table” approach is encouraged: see, for example *Glover v Australian Ultra Concrete Floors Pty Ltd* [2003] NSWCA 80. In addition, there will be directions for a chronology and bundle of documents and for submissions and objections to evidence, and similar matters.

Sometimes it may be appropriate to go beyond the standard procedures. For example, some form of conference could occasionally be appropriate to assist the parties to distil the real issues for determination. This is most likely to be useful where the parties are united in the desire for an early

determination of the real issues between them. I am informed that pre-trial conferencing was recently used to good effect by French J in the Federal Court.

In my own experience, pre-trial directions hearings have been conducted in Court rather than round a conference table. I once had a round table discussion in order to understand some complex financial documents, where the application was uncontested and it was useful to have the accountants and actuaries answer my questions directly. Transcript was taken.

It has been suggested that the round table environment can be useful for pre-trial conferences, because, if some of the parties is holding out on some issue and slowing down the process, the 'recalcitrants' can be quickly identified in a manner that will create an effective physiological pressure for them to lift their game. I can see that in some commercial cases this may be useful, although obviously there is a danger of unfairness.

Discovery

Large cases are blighted by enormous, time-consuming and expensive discovery exercises, even though over the last decade or so the courts and the profession have been able to streamline the process. Sometimes it is obvious at an early stage that there will be a series of disputes about categories of discovery, legal professional privilege, the breadth of notices to produce and subpoenae, and like matters.

Although I personally have not done so, other judges in this and other courts have experimented with a process of mediation to resolve these issues. The Court has a broad power to appoint a mediator in respect of any part of a proceeding, including a dispute limited to interlocutory circumstances. A mediator appointed to resolve discovery issues would probably be a member of the legal profession, perhaps a senior barrister. He or she would be "on call" to the parties during the information-gathering process. The same outcome might be achieved, perhaps with less flexibility but with reporting back to the Court, by appointment of a referee under Part 72 of the Supreme Court Rules.

Experts

A tremendous amount of time and cost can be consumed at a hearing by taking sequentially the evidence of experts for each of the parties. Then the judge has the task of resolving inconsistencies. Often, during the process, it becomes evident that if the experts had conferred before giving their evidence, they could have reduced the issues in dispute between them and possibly even eliminated them. Where there is more than one expert, the Court now has the power under Rule 36.13CA, as part of the pre-trial process, to direct the experts to confer and produce a joint report which identifies areas of agreement and disagreement, giving reasons. I think that the profession now realises that joint conferences will be expected in commercial matters.

Recently there has been much discussion in our Court as to an approach taken up in the United Kingdom, under which in some circumstances a single joint expert is appointed by the parties. This is different from a court-appointed expert. The parties agree to trust the expert judgment of the appointee, who effectively replaces the court within his or her field of expertise. We are exploring the utility of this in our Court generally, especially where the issue relates to quantification (see Spigelman CJ, "Expert Witnesses: Forensic Accounting in an Adversary System" (2003) 41 LSJ 60).

In corporations matters, the question of expert evidence arises in areas such as insolvency (accountants) and valuation of business property and shares. The courts are generally fairly sceptical as to the utility of expert evidence outside established and clear categories: see *Quick v Stoland* (1998) 87 FCR 371, *Dean-Willcocks v Commonwealth Bank of Australia* [2003] NSWSC 466, *ASIC v Vines* [2003] NSWSC 1095

Mediation

Since 2000 the Court has had an express power to direct mediation between the parties to proceedings, before a mediator selected by the parties or appointed by the Court: Supreme Court Act, s 110K. Initially the power was used cautiously, and some doubts were expressed as to its efficacy in cases where there was strong resistance by one side: see, for example, *Morrow v chinadotcom Corp* [2001] NSWSC 209. The Court still proceeds cautiously, but it is not uncommon nowadays for mediation to be directed over the objection of one or even both parties: see *Idoport Pty Limited v National Australia Bank* [2001] NSWSC 427, *Remuneration Planning Corporation Pty Limited v Fitton*

[2001] NSWSC 1208, *Higgins v Higgins* [2002] NSWSC 455. Experience suggests that when confronted with the necessity to mediate, the parties frequently change their attitude and a resolution is achieved.

Obviously some matters are more appropriate for mediation than others. For matters in the Corporations List, frequently there is only a limited range of disagreement - surprisingly frequently, disagreement on a point of law. It can be more cost-effective to run the point before the Corporations List Judge and obtain an answer that resolves the matter, than to have a negotiation which, in these circumstances, can actually take longer and be more costly. I do not disregard the prospect of appeal. In fact, however, that there are very few appeals from Corporations List decisions.

There are special problems in requiring mediation where one of the parties acts in a representative capacity (such as liquidator: see *Hathaway v Cavanagh* [2002] NSWSC 1113), but our recent experience is that mediation can produce a resolution even in such circumstances.

Stop-watch trials

In an illuminating address to the Law Society of New South Wales on 3 February 2004, Spigelman CJ floated the idea of "stop-watch" trials, in which the parties agree as to the amount of time allotted to the presentation of their respective cases, and are required to adhere to those estimates absolutely. It is then up to each party to organise the presentation of the case within that timeframe. Such an approach has recently been taken in a very complex case by three international arbitrators, evidently with success: *Anaconda Operation Pty Ltd v Fluor Australia Pty Ltd*, discussed by Bergin J, "Commercial Litigation: Tips for Success and Traps for the Unwary: A Judge's Perspective on Case Preparation", paper delivered at the Lexis Nexis Butterworths Practice and Procedure in Commercial Litigation Conference, Sydney, 26 August2003; see also Mason P, "Changing Attitudes in the Common Law's Response to International Commercial Arbitration", keynote address to the International Conference on International Commercial Arbitration, 9 March 1999.

I think that may be an appropriate procedure to explore in certain circumstances, where the commercial combatants are united in the desire for a quick resolution. Indeed, something like this occasionally happens already, de facto.

In a recent high-profile and urgent matter which arose out of the Corporations List, the judge had only a limited amount of time (two days) available for the hearing. Although he was prepared to offer to sit on the weekend, counsel were not enthusiastic about that suggestion. The hearing therefore proceeded on the agreed basis that a limited amount of time would be allocated to each party. One beneficial by-product was this: when confronted with the usual long list of objections to affidavits, the judge observed that the parties could spend their two days arguing about admissibility of affidavit evidence if they wished, but there would then be no time to hear the oral evidence of the witnesses and to cross-examine them. He then adjourned for short time to give the parties an opportunity to consider their positions, and on resumption found that very few of the objections to the affidavits were pressed.

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Directors Duties and Financial Responsibilities

UNIVERSITY OF NEW SOUTH WALES

Faculty of Law
Directors Duties and Financial Responsibilities
Tuesday 26 November 2002

Introductory Remarks by Justice R P Austin, Supreme Court of New South Wales

It is a pleasure for me to be here and to open your seminar, on such topical subjects. Yesterday the organisers sent me two of the four papers, dealing with the financial reporting responsibilities of directors and their duties in the context of corporate takeovers. Both of them are thoughtful and thorough presentations which you will find interesting and enlightening. You will also hear papers on the duties of directors of listed companies under the continuous disclosure regime, and on their duties when the company is in financial distress. I have not seen those papers and cannot comment on them.

I have responsibility for the Corporations List of the Supreme Court, which I share with Justice Barrett. The Court is by a substantial margin the busiest court in corporate litigation in this country, accounting for over 40% of reported decisions. The Registrar in Equity processes a huge volume of winding up applications each week, and in the Corporations List administered by either Justice Barrett or me, there are on average around 15 applications per week. Additionally, we case manage larger corporate matters, which include quite a few civil penalty cases conducted by ASIC. Three large civil penalty cases are coming up for hearing in the not too distant future.

In those circumstances, I thought you might be interested to hear from me some comments on those aspects of the law of directors' duties that are currently of concern in corporate litigation in the Supreme Court. These are only my own remarks. The perspectives of Justice Barrett and the other Judges of the Equity Division, all of whom adjudicate corporate proceedings from time to time, may well be different.

I shall not be able to express opinions on matters currently before the Court, for obvious reasons. I shall, however, raise some questions that are pertinent to current litigation.

I do so with a purpose in mind. The Court is being asked to deal with a multitude of matters upon which statutory and case law do not provide clear direction. It is my belief that legal scholarship provides the surest foundation for a judge in these circumstances. The areas that I shall touch upon are areas where there has been some scholarly work, but I believe much more could be done. I make this point in a self-interested way. Legal scholarship is needed to assist the Court to perceive the way forward on important issues of corporate law. I encourage those of you who write seminar papers, or who listen to them, to consider whether you might apply your skills in legal scholarship to answering some of the questions that I shall raise.

I shall make some remarks about problems in the law of directors' duties, civil penalty proceedings, and (briefly) some aspects of insolvency litigation.

Directors' duties

Section 659B limits the jurisdiction of the courts in a manner that prevents the combatants from applying for relief during the bid period. The full scope of that privative clause has yet to be settled, but as a practical matter it has virtually eliminated tactical takeover litigation. Complaints about the conduct of the target board during the bid period are now brought to the Takeovers Panel.

However, the Court still has plenty of opportunities to develop the general and statutory law of directors' obligations.

The statutory duty of care of directors and other officers of the corporation remains a fairly mysterious area. The standard set by s 180 (1) refers to the degree of care and diligence that a reasonable person would exercise, but the section demands that the reasonable person be placed in a corporation in the corporation's circumstances, and that he or she must occupy the office held by the defendant, with the very same responsibilities that the defendant had as a director or officer.

This blend of the subjective and the objective leaves room for debate as to how much of the defendant's personal circumstances should be taken into account. The legislature has, somewhat self-consciously, refrained from imposing a standard of skill, but the wording seems to leave room for argument that the individual skills of the defendant, especially his or her financial skills, can be taken into account in determining whether there has been a breach of the statutory duty. This is because individual skills might affect the "responsibilities within the corporation" that have been allocated to the defendant.

As the Hon Andrew Rogers QC recently remarked in a presentation to the Chartered Institute of Company Secretaries, the Court has yet to decide whether participation on a board committee affects the statutory and general law liabilities of a company director. By taking an appointment on the audit committee, for example, the director arguably undertakes (sometimes for additional remuneration) additional work, suggesting additional responsibility. On the other hand, if the director is a non-executive director, the nature of his or her office arguably limits the responsibility that can be fairly attributed to the director, even as a member of a board committee.

Allied to that problem is the question whether the director who does not serve on the relevant committee is entitled to rely upon the committee and follow the committee's recommendations with its sphere of responsibility, without further inquiry. The *AWA* case told us that directors must approach their work with an inquiring mind, but it may be hard to see what inquiries might reasonably be expected of the director who receives a competent report by a board committee on a complex matter. Of course, the report must on its face be a competent one, where the reasoning and conclusions of the committee are clearly set out, and the scope and content of the committee's work program is explained.

I expect that the answers to these questions will evolve fairly gradually, through the traditional mechanism of judicial decisions. However, the volume of corporate litigation involving the duty of care of directors has increased over recent times, and that trend is likely to continue. This is because questions of breach of the duty of care typically arise after a corporate collapse, and we have had our fair share of those recently. Additionally, ASIC is now using its powers under the civil penalties provisions of the Corporations Act quite frequently. As I have said, there is a substantial number of civil penalty cases, including some very large ones, in the Court at the present time.

It must be remembered that allegations of breach of the directors' duty of care are frequently combined, in corporate litigation, with allegations of breaches of other statutory and general law duties. Apart from the special statutory duties of directors for a misleading prospectus or takeover disclosure document, we must bear in mind the general provisions concerning misleading and deceptive conduct, found in the Commonwealth Trade Practices Act and the Fair Trading Acts of the States, as well as (with respect to financial products and financial services) the ASIC Act. We should specially note the ancillary liability of those knowingly involved in the contravention.

Where the conduct complained of includes some information released by the directors, such as a statement to the market or an information memorandum, there is likely to be an issue as to whether that statement was misleading and if it was, whether it has caused loss. The Australian Stock Exchange announced over the weekend that it will require directors to provide "management discussion and analysis" reports. Those reports will be another occasion for the publication of potentially misleading information and therefore potential liability for directors. Once the misleading character of the information, and the causal relationship between it and the plaintiff's loss, are established, questions of materiality and negligence are irrelevant. In a market context, if the misleading information has caused a substantial price movement (or prevented it), the damages could be very large.

The law of directors' duties has not kept place with the burgeoning literature of corporate governance. One of the general questions confronting the Court is whether, assuming they are admissible as evidence, papers by expert corporate governance committees such as those chaired by Sir Adrian Cadbury and Mr Henry Bosch should be allowed to influence the Court's determination of legal liability. Generally the pronouncements of these committees are directed to best practice rather than legal obligation, but they may nevertheless reflect changing community standards which might have

an impact on the liability of directors. It has often been said that community standards and expectations have changed, and correspondingly the law has changed, since the *Marquess of Bute's* case. May the Court refer to the reports of corporate governance committees as an indication of current community standards?

Recourse to corporate governance literature might affect such issues (at any rate, in the case of a large listed public company) as
· whether the law should now accept that there are different standards for executive and non-executive directors;
· whether membership of a board committee such as the audit committee should carry additional legal responsibility;
· whether the chairman of the board has greater legal duties than other members of the board.

Civil penalty proceedings

One of issues that the Court is required to confront quite frequently relates to civil penalties cases. These are cases in which ASIC, as plaintiff, alleges breaches of duty by the defendant, and seeks a variety of remedies including an order that a civil penalty be paid, or a compensation order, or a banning order. The *Adler* and *Whitlam* cases are recent examples.

The significance of civil penalty proceedings can hardly be overstated. This is especially so now that the civil penalty regime has been expanded to apply to the market offences provisions of the Corporations Act, such as those relating to continuous disclosure and insider trading.

From a lay perspective, it is easy to confuse a civil penalty case with a criminal prosecution. The Court's decision often leads to a headline in the press, such as "Mr X banned for 20 years" or "Mr Y banned and fined". Press reports can read very like reports of a criminal verdict.

The problem for the Court relates to whether, or more precisely to what extent, these cases are to be treated purely as civil cases, and to what extent analogies from the criminal law should be applied. The problem is all the more acute for a court like the Supreme Court of New South Wales, where ASIC civil penalty cases are allocated to the Equity Division, notwithstanding that Equity abjures penalties.

Amongst the questions that have recently been, or are being, considered, which seem to depend upon whether civil penalty cases should be given a "quasi-criminal" character, are the following:
1) Is the standard of proof more demanding than the balance of probabilities standard, and if so, how precisely should it be formulated, and in particular, should there be any special statement to replace the *Briginshaw* formulation?
2) Should the rule in *Jones v Dunkel* be applied in the same way as it is applied in other civil cases, or should there be a stricter limit on inferences to be drawn from the failure of the defendant to call a person to give evidence?
3) In dealing with civil penalty cases, especially where interlocutory injunctive orders are sought, should the Court treat ASIC as a special plaintiff?
4) Should the "quasi-criminal" nature of the proceedings affect the nature of the particulars that ASIC should be required to provide, and lead to the Court limiting ASIC at the trial to the case so particularised?
5) Should the Court give the usual directions that it makes in civil proceedings, requiring the defendant to file and serve affidavits according to a timetable prior to the hearing?

Insolvency

The context in which insolvency becomes an issue is of great importance in deciding what has to be proven, and to what standard. Where a question of insolvency arises under Part 5.7B of the Corporations Act, various presumptions may arise. In the context of directors' liability for insolvent trading, much depends upon objective and subjective standards of knowledge of insolvency, from which the concept of insolvency cannot readily be extracted.

It is arguable that a case of directors' liability for insolvent trading can also be pleaded in negligence. If it is, and the contention is that the directors allegedly failed to act when there is evidence pointing to insolvency, a question may arise as to the application of a statutory limitation period. The law seems to be that the limitation period begins to run when the directors should first have realised that the company was insolvent and should therefore have taken remedial action. That issue was the subject

of a recent contest in the Court.

One of the perennial difficulties in cases where insolvency is an ingredient is this: how does one prove insolvency? Sometimes the issue is beyond doubt. At the relevant time, the company's balance sheet shows a net deficiency, and an inadequate cashflow to service creditor demands. On other occasions, the question can be very complicated. For example, in a construction business of any degree of sophistication, insolvency may depend upon the validity of variations, the application of obligations concerning retention monies, the contractual effects of non-completion, and the interaction of various building contracts to produce an overall picture.

Frequently the parties to a contested case in which insolvency is in issue seek to tender and rely upon the reports of accountants. The admissibility of expert evidence of that kind was explained in *Quick v Stoland*, especially in the judgment of Justice Emmett, but the application of the principles is not always easy. In a case where insolvency depended upon facts within a narrow compass, all of which were before the Court, it was recently held that expert evidence was inadmissible, but in a case where the question related to the solvency of a substantial construction company, expert evidence in the nature of fully reasoned reports was allowed.

In cases of directors' liability for insolvent trading, not much has changed, as far as I can see, since the celebrated decision in *Friedrich's* case. That means, of course, that the law remains as significant for directors as ever it was.

Conclusions

Most of you in this audience are advisers. Directors need competent and thorough advice, because the law is not self-evident and in some cases, directors who subjectively believe that they have acted "innocently" might nevertheless find themselves liable for breach of duty. The seminar therefore raises some very important issues. I am confident that you will benefit from it and through you, your clients and the community will also benefit.

I shall hand the microphone back to the chairman, who will introduce the first speaker.

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The Company Secretary: Then and Now

CHARTERED SECRETARIES AUSTRALIA LTD

Celebration of the Centenary of the grant of the Royal Charter to the Institute of Company Secretaries and Administrators

Sydney, 19 November 2002

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"The Company Secretary: Then and Now"

By R P Austin, BA, LLM (Syd), D Phil (Oxon)
Judge of the Supreme Court of New South Wales

Introduction

In an episode of "The Vicar of Dibley", Alice hears that the British Government has announced the appointment of a new Foreign Secretary. She tells the Vicar how disappointed she is that the Government could not find a nice British girl to do the job.

There is some popular misapprehension about the concept of a "secretary". The word derives from the Latin "secretarius", meaning a confidential officer, connected in turn with "secretum", which means secret. The New Shorter Oxford English Dictionary succinctly captures the ambiguity of the concept. The primary meaning of the word is given as "a person entrusted with private or secret matters". The secondary meaning is "a person whose duty or occupation it is to conduct the correspondence or organise the affairs of another". Then three instances are given, of a person employed to assist with correspondence, record-keeping and making appointments etc; an official appointed by an organisation to conduct correspondence, keep records and organise the affairs of the body; and a civil servant employed as the principal assistant to a government minister. That is, the personal secretary, the company secretary and the secretary of state, who are linked together by the confidential nature of their duties.

There is a wide range of functions and responsibilities within these definitions. Indeed, it is difficult and, to a degree, dangerous to generalise about the functions of a company secretary, given the infinite varieties of corporate sizes, corporate businesses and corporate management structures. The great Professor Al Conard of Michigan was fond of warning his students not to assume that the legal rules most appropriate to regulate the affairs of the corner grocery were necessarily the right rules to regulate the producer of Boeing 747s. Even so, if we confine our attention to the larger Australian listed public companies, there is sufficient commonality that we can, I believe, make some sensible statements about "the company secretary" as such.

It is my thesis that the function of company secretary has changed beyond recognition over the last 100 years - indeed, during my time in commercial law, which began when I took articles of clerkship in 1965. While there are many aspects to this change, the one that I wish to identify for attention is a fundamental change in the functions of the board of directors which the company secretary serves.

I should point out that there are real restrictions on what I can say. One of my responsibilities as a judge of the Supreme Court is to administer the Corporations List. The Court handles a substantially greater proportion of the corporate litigation of this country than any other court, and questions of corporate governance arise very frequently. It would be wrong for me to express an opinion here about issues before the Court, or issues that are likely to come before the Court, because the proper forum for ventilating those issues is the courtroom, and the proper basis for the judge's decision is the evidence and arguments presented in court. However, I believe I can offer some reflections anchored in my observation of the literature of corporate governance. I emphasise that my remarks are directed towards the position that emerges from the literature, and are not intended to express any view about controversial aspects of the content of the legal responsibilities of corporate officers.

Administration v Management

When lawyers reflect on the role of the company secretary, they tend to focus on whether the company secretary has a management role, with authority to bind the company contractually. In 1887 (in *Barnett v South London Tramways* (1887) 18 QBD 815) the English Court of Appeal resoundingly denied that a company secretary had ostensible authority to bind the company in the commercial matter of holding retention monies on behalf of contractors. And yet the same court held in 1971, in *Panorama Developments v Fidelis Furnishing* [1971] 2 QB 711, that a company secretary has ostensible authority to sign contracts connected with the administrative side of the company's affairs, such as employing staff, ordering cars and so forth. The *Panorama Developments* case was hardly news in New South Wales, where our Court of Appeal had reached a similar conclusion five years earlier, in *Donato v Legion Cabs* (1966) 2 NSWR 583.

The *Panorama Developments* case was generally acknowledged to be an important statement of the changing role of the company secretary. Paul Monsted and Geoffrey Garside said so, for example, in their useful and thoughtful book, *The Role of the Company Secretary: A Practical Guide* (1991). It remains the legal position, nevertheless, that the ostensible authority of a company secretary is limited to the administrative sphere, and in the absence of express authorisation, does not extend to commercial management of the company. The New South Wales cases of *Club Flotilla v Isherwood* (1987) 12 ACLR 387 and *Holpitt v Swaab* (1992) 6 ACSR 488 have confirmed that this is so. Whether that line will hold forever is a matter for debate. In 1984 Monsted and Garside discovered that 73% of the company secretaries who participated in their survey said "yes" when asked "Are you involved in management of the company?" When the survey was conducted again in 1990, the figure had risen to 87%. Presumably it would be higher now.

Expansion of the administrative function

I think the lawyers' obsession with the expansion of the company secretary's contractual authority can seduce us into overlooking a much more important development. Lawyers acknowledge that, whether or not a company secretary has authority to act in the commercial management of the company, the company secretary's central role is to act in the administration of the affairs of the company and the business of the board. There has been an enormous expansion of the content of that function. This, in my opinion, is the single most important difference between the company secretary's role when the Institute of Company Secretaries and Administrators received its Royal Charter 100 years ago, and the role assigned to the company secretary in the 21st century.

To a degree, the expansion of the administrative function has been due to direct statutory impositions on the company secretary. For example, under s 188 of the Corporations Act, breaches of certain provisions of the Act constitute breaches by the company secretary. Perhaps more importantly, ss 180 to 183 impose general statutory duties on directors and "other officers" of the corporation, with potentially heavy civil penalties for contravention. A company secretary is an officer for this purpose.

To a much greater degree, the expansion of the administrative function flows from the explosion of regulation of all aspects of commercial activity, in such areas as industrial relations, the environment, health and safety, taxation, stock exchange listing requirements, trade practices, and corporate regulation. Typically the compliance obligations are placed upon the corporate entity and/or directors and senior executives, rather than on the company secretary. But the burden of administering the company's system for regulatory compliance is often placed on the company secretary's shoulders, even where someone else has primary responsibility for the particular regulated activity.

There has been another development, more subtle but in the end of almost overwhelming importance, over the last 40 years. Not only have the responsibilities of company directors expanded greatly over that time. There appears to have been a change in the very function of the board and especially of the non-executive members of it. This has led to a palpable increase in the volume of the company secretary's work and, more importantly in the end, an enhancement of the expertise needed to do the company secretary's job.

I want to explore these themes briefly, by looking at changes in the role and responsibilities of non-executive directors over the last 40 years, and their impact on the company secretary's administrative function. This is a very large topic, upon which the massive weight of the scholarship of corporate governance bears down. I cannot possibly give more than a few impressions in the time available to me. This is consistent with your invitation to me to speak tonight, which was an invitation to offer some reflections rather than to present a lecture or scholarly paper.

Company directors in the "second stage of capitalism"

Writing in 1981, Professor Robert Clark (subsequently Dean of Harvard Law School) identified what he called "the four stages of capitalism" (94 Harv LR 561). The first was the age of the entrepreneur, the fabled promoter-investor-manager who launched large-scale business organisations in corporate form. He was primarily a 19th-century phenomenon. The second stage, which Professor Clark called "the age of the professional business manager", reached maturity early in the 20th century. It was the system of corporate organisation which separated ownership from control. The second stage led to the need for the legal system to make managers accountable to investors, on the basis that full control of business decisions rested with the managers. This was done principally by recognising that the managers occupied a fiduciary position. The consequences and risks of the second stage were exposed by Berle and Means in their classic work, *The Modern Corporation and Private Property*.

When I studied company law under the late Professor Ross Parsons in the 1960s, the fiduciary model was central. No significant distinction was drawn between executive directors and non-executive directors. They were all "managers" of the investment funds provided by the shareholders, and as such they were all equally fiduciaries.

What I heard at Sydney Law School was reflected in what I saw and read about as an articled clerk. People were appointed to boards because of what they could contribute to the profitable management of the business enterprise and the strength of the share price. Thus, some were selected for their expertise in finance or accounting, or their participation in the chain of production to which the company contributed. Others were appointed because of their eminence and contacts and therefore the likely support of investors. Others were there because of their expertise in services that the company needed - for example, it was very common for a senior partner of the company's firm of solicitors to be on the board. In other words, non-executive directors were brought on the board because of their capacity to contribute to the management function.

In summary, I believe that, by and large, Australia in the 1960s was in Professor Clark's second stage of capitalism.

Non-executive company directors in the third stage of capitalism

Professor Clark's third and fourth stages of capitalism are not of direct relevance for my themes. The third stage, the age of the portfolio manager, involved the splitting of the ownership function into the function of supplying capital and the function of investing it, professionalising the investment function. The fourth stage, which was merely predicted in 1981, was to be the age of the savings planner, in which the function of supplying capital was to be subdivided into the holding of the benefits of capital and the process of planning how and when to supply it, the latter component becoming professionalised.

Professor Clark's third and fourth stages subdivided the "ownership" side of the separation between ownership and control. It seems to me that there have been parallel subdivisions on the "control" side. I wish to identify, as my third and fourth stages of capitalism (with apologies to Professor Clark), the age of the monitoring of management performance for the benefit of shareholders, and the age of monitoring management performance for the benefit of a more general group of stakeholders.

In the third stage, which is probably now upon us in practice (whatever may be the legal position), "control" of the corporate business (once regarded as co-extensive with "management") has been subdivided into the management function and the function of monitoring management. In Australia, as in the United States and the United Kingdom, the board of directors comprises executive managers and non-executive part-time appointees. That being so, subdivision of control into management and monitoring has led to increasing emphasis on the role of non-executive directors, given that it would be nonsensical to require managers to monitor their own management.

The perception that the functions of non-executive directors and senior executives are fundamentally different is, I think, a product of corporate governance thinking. As far as I am aware, the concept of corporate governance first entered the literature of corporate regulation in 1962, when Richard Eells of Columbia Business School published his book, *The Government of Corporations*, the first chapter of which was entitled "The Study of Corporate Governance". American scholars were, to a degree, influenced by an analogy between the governance of the United States, by a system of checks and balances upon executive power, and the governance of US corporations, in which the power of managers was to be checked and balanced by the presence of non-executive directors on the board, the latter representing the interests of shareholders. The role of the non-executive directors was to

monitor management.

The idea was developed within the US legal framework by scholars such as Mel Eisenberg of Berkeley, whose early thinking was assembled in *The Structure of the Corporation* (1976). Professor Eisenberg later became Reporter for the American Law Institute's project, *Principles of Corporate Governance*, published in 1992. That publication listed the functions of the board of directors, as functions of "overseeing" and "reviewing" the work of the senior executives of the company rather than directly managing the company's business.

This thinking about company boards found its way into Australia principally via the United Kingdom. I recall participating in, and on one occasion hosting, presentations by Professor Eisenberg in Sydney during the 1980s. He was listened to with great interest, but his ideas were clearly received as an exotic foreign plant unlikely to take root here. When, however, Sir Adrian Cadbury, Sir Richard Greenbury and Sir Ronald Hampel, and others, began saying similar things in the United Kingdom, and after UK corporate collapses such as Polly Peck and BCCI, the ideas were given more weight.

The English writing influenced the thinking of Henry Bosch and his working group. *Corporate Practices and Conduct* (first published by Mr Bosch and his team in 1991) has been very influential in this country. The first point made in that publication is to draw distinction between executive and non-executive directors and to identify their different functions.

A little publication called *Strictly Boardroom* (1993), by a committee chaired by Fred Hilmer, aggressively took up the "monitoring" theme, while emphasising the board role in encouraging better-than-average performance by management. It did not take long for corporate governance ideas to become part of the mainstream thinking about corporations in Australian universities.

In my opinion, the factors that have most contributed to the growth of support for corporate governance ideas have been the impact of the corporate abuses of the 1980s, followed by the spectacular corporate collapses of 2000-2001. The much-publicised abuses associated with the failure of the Bond, Linter, Mirage and other corporate empires seemed to have a common thread - failure of the system to protect the shareholders from excesses by management, which ultimately destroyed the value of the shareholders' investments. As Berle and Means had predicted, the system of fiduciary accountability was shown to have been inadequate. The need for a more effective mechanism to check management opportunism gradually came to be recognised. It became evident that the Commission could not address the problem comprehensively by prosecution, notwithstanding the first Chairman's well-publicised "hit-list". Corporate governance, and in particular the presence at the boardroom table of "independent" non-executive directors who would monitor management, seemed to be an important part of the solution.

The Australian commercial community had an ambiguous attitude to corporate governance throughout the 1990s, and so the process of acceptance was not smooth or rapid. The Australian Stock Exchange declined to bring the prescriptions of corporate governance into its listing rules as mandatory requirements. Influential captains of industry were very sceptical about the efficacy of corporate governance for a long time, and their views tended to hold sway during the stockmarket boom of the late 1990s. There was a strong feeling that some of the most successful Australian companies were those whose management structures defied every corporate governance tenet.

Scepticism was not confined to Australia. As recently as 1998, for example, Fidelity Investments (the biggest mutual-fund manager in the US) voted against a proposal that Tyco International should alter its board to make the majority of the board members independent. Of course, Tyco subsequently became insolvent, and it is almost certain that Fidelity would vote differently if the issue arose now.

As I see it, opposition to the corporate governance model has been dramatically weakened by the most recent round of corporate disasters, including HIH, One-Tel, Ansett and Harris Scarfe in this country, Enron, WorldCom and Tyco in the United States, and Marconi in the United Kingdom. The Australian Stock Exchange has established a Corporate Governance Council, which intends to release best-practice corporate governance guidelines in March 2003. Those aspects of corporate governance dealing with the audit function and the role of the audit committee will be reinforced upon the enactment of CLERP 9, just as they have been in the Sarbanes-Oxley Act in the United States. Of course, the audit committee concept presupposes a board containing a substantial component of non-executive directors, who will use the audit committee as a means of carrying out their monitoring function.

It remains to be seen whether the tenets of corporate governance, now dominant in the commercial

community, have been or will be reflected in the law. The judgment of Rogers J in *AWA v Daniels* (1992) 7 ACSR 759 was of particular importance in this country because it articulated the thinking underlying the ALR Project in an Australian setting, recognising the monitoring role of non-executive directors. In that case the Court of Appeal of New South Wales ((1995) 37 NSWLR 438) accepted that the function of the board is to "guide and monitor" the management of the company, but declined to adopt Rogers J's distinction between executive and non-executive directors. Proving that there exists a life after judging, Prof the Hon Andrew Rogers QC presented a paper at the equivalent in Melbourne of tonight's Centenary Event, on 19 September 2002, in which he contended that the Court of Appeal had adopted an unrealistic position. We shall have to wait to see whether there are further developments in the law in this area.

Non-executive company directors in the fourth stage of capitalism

During the 1990s another "age of capitalism" has emerged on the "control" side of the split between ownership and control. In the 1980s the predominant wisdom was that directors owed their duties to the shareholders as investors of capital. Law professors occasionally spoke of the duties of directors to employees, creditors and the environment, but their ideas were generally not taken seriously by the Australian commercial community. If, therefore, non-executive directors were to adopt the role of monitoring the performance of management, the whole point of doing so would be to protect and maximise shareholder wealth.

This idea is now under challenge. There is a growing demand for the law to recognise that company directors have duties to some stakeholders other than the shareholders. The idea has gained great impetus in the United Kingdom. In a recent presentation at the University of Sydney, Dr Alan Dignam of Queen Mary College, University of London, referred to the current UK White Paper, *Modernising Company Law*, which proposes a statutory re-formulation of the duty of directors. Directors in the United Kingdom will be required to take account in good faith of such matters as the company's need to foster its business relationships with employees and suppliers and customers, and its need to have regard to the impact of its operations on the communities affected and on the environment. Dr Dignam saw this proposal as the product of forces that included the privatisation of utilities in the United Kingdom without adequate regulatory surveillance, a phenomenal growth in public shareholding through those privatisations, the correlative development of interest in accountability issues within the British press, and the rise of new Labour, under which stakeholding has become a political philosophy.

In Australia the pressures in corporate law reform have been different. We do not yet have privatised utilities that have moved outside the influence of public regulation. Conversely, we have many examples of failure properly to take care of the interests of the primary stakeholders, the public investors who have put their money into shares in failed companies. Not unnaturally, the focus of our attention has been the protection of investors, rather than other categories of stakeholders. That proposition is to be qualified, however, by reference to consumer protection, especially through the Trade Practices Act.

If the British developments come to be mirrored here, the monitoring task of non-executive directors will be expanded and will become more difficult. They will then be monitoring not only to promote efficient and profitable business conduct by management, as well as accountability to shareholders and compliance with the law, but also compliance by management with their duties to all other categories of stakeholders including creditors, employees, the community and the environment.

The new company secretary

In the third stage of capitalism, it has become necessary for the company secretary to understand and anticipate the needs of non-executive directors, who are expected to perform the monitoring role allocated to them by the tenets of corporate governance.

Non-executive directors cannot monitor management performance by sitting passively through board meetings and voting by consensus when called upon. They must approach their task with an inquiring mind. They are expected to identify deficiencies in management proposals and reports, and to demand accurate and complete information. This means that the quality and quantity of documentation passing across the board table should be carefully supervised with a view to maximising their efficacy as monitors.

Non-executive directors cannot hope to be effective in monitoring the performance of management if the information flow is controlled by the chief executive. This inevitably means that others than the senior executive team must have a role in procuring and vetting information on sensitive topics,

especially where management may be a position of conflict of interest.

It appears that the need of non-executive directors for help in the performance of their monitoring role may be placing increasing pressure on the chairman, whose functions could be expanding. *The Economist* (2 November 2002, page 66) recently remarked that "just as Americans and Britons are divided by common language, so their firms are divided by a common board structure". Noting that in America, the chief executive is typically also the chairman, *The Economist* continued:
"The big difference has been the creation of a dual corporate leadership [in the United Kingdom], by a part-time non-executive chairman of the board and a full-time chief executive".

If the chairman's role in Australia is developing in the same fashion, then there will be a corresponding increase in the importance of the role of the company secretary. The company secretary is not in a position to manage the information flow to the board, but the company secretary can work with the chairman to enhance the quality of board papers, and to assist the chairman to discriminate between what is important and what is immaterial. What seems to be emerging, though there is room for debate as to how fast developments are occurring, is a close partnership between the chairman, to whom non-executive directors will look for assistance to discharge their critical task, and the company secretary to whom the chairman will turn for delivery of that assistance.

The company secretary, ceding all discretionary decisions to the chairman, must occupy a "phantom position", as Peter Speakman recently said ("The Role and Liability of the Company Secretary", (1997) *New Zealand Law Journal* 263). But in the words of Sir Adrian Cadbury's committee in their Report (para 4.25), the chairman looks to the company secretary for "guidance", and not merely for mechanical administration of corporate affairs. That guidance might include, for example, briefing the Chairman on current developments in corporate governance – although that would depend on whether the company has a general legal counsel and if so, the subdivision of functions between the company secretary and that person.

Be that as it may, the company secretary comes to "act as the 'grout' to fill knowledge cracks that might otherwise appear during a board meeting", as Theresa Handicott recently remarked ("A Board Member's Perspective on the Secretary's Role", (2002) *Keeping Good Companies* 592, 594).

Conclusion

I can only imagine how much extra work and extra skill are involved in assisting the chairman, and through him the non-executive directors, to discharge their monitoring function in the interests of shareholders - compared with serving a board in the 1960s before the monitoring function was invented. Those of you who are company secretaries know what is involved, by personal experience. Your experience will enable you to assess how much more work will be involved if the monitoring function is extended to monitoring for the benefit of stakeholders other than shareholders.

Just what effect these changes should have on the remuneration package of the company secretary is a matter that neither of us has the power to decide!

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Conference on the Future of Corporate Regulation

CONFERENCE ON THE FUTURE OF CORPORATE REGULATION
CENTRE FOR CORPORATE LAW AND SECURITIES REGULATION
UNIVERSITY OF SYDNEY LAW SCHOOL
3 NOVEMBER 2000

'The Role of the Courts following Referral of Power - Some Brief Comments'
by Justice R P Austin
Supreme Court of New South Wales

Introduction

1. My remarks are supplementary to the paper by Justice G F K Santow. I shall confine myself to a few thoughts about the role of courts under a Commonwealth Corporations Law. My thoughts are very much my own, not to be attributed to anyone else.

2. The most striking feature about Australian company and securities law reform over the last 40 years has been the inexorable march towards uniformity in a federal environment. The Europeans admire and even envy us for it, and the Americans puzzle about why we have chosen to eliminate competition amongst the States. But they are united in identifying uniformity as our singular achievement.

Uniformity of the legislative text

3. The modern movement towards uniformity of the text of legislation began with the Uniform Companies Act of 1961. It was enhanced by the work of the Standing Committee of Attorneys-General (Eggleston Committee) in the late 1960s, and was further encouraged by the Interstate Corporate Affairs Commission and the uniform Securities Industry Act of 1976.

4. It was achieved, for all practical purposes, by the introduction of the national co-operative companies and securities scheme in 1981/82, because that scheme provided a mechanism for national amendments which were effective in every State. The Corporations Law used the same mechanism. The mechanism to be used in the proposed Corporations Act, namely Commonwealth enactment after referral of State legislative power, has the same basic co-operative elements.

Uniformity of administration

5. Experience under the national co-operative companies and securities scheme demonstrated that uniformity of the text of legislation is a hollow achievement unless it is accompanied by uniformity of administration of the law. Perhaps the most important advance made by the Corporations Law in 1991 was the replacement of State Corporate Affairs Commissions with a single national Commission, supported eventually by a single national database.

'Uniformity' of interpretation and application

6. One further ingredient was needed for a system of national uniformity of company and securities law. There needed to be 'uniformity' of interpretation and application of the law. Of course, 'uniformity' is not quite the right concept here. Statutory provisions often have an open texture, and ideas must be allowed to evolve as cases present new factual applications. 'Uniformity' of interpretation should be taken to mean no more than consistency, and even that kind of 'uniformity' can only be a goal not ever fully attained.

7. It must be said that progress towards achieving uniformity in this sense has been slower and more tentative than progress towards uniformity of the statutory text and administration.

The evolving jurisdiction of Supreme Courts

8. In the 1950s the task of interpreting and applying statutory and general company law fell to the State Supreme Courts. There was no Federal Court of Australia. The State Courts were relatively insulated from one another. They relied on precedents from the Privy Council and the High Court of Australia, and the courts of England, and they gave less attention to decisions of the courts of other States, even decisions on appeal.

9. Because each step to date in the movement to uniformity of the text of the law has involved the

exercise of State legislative power, the State Supreme Courts have retained their role as interpreters of the uniform law. However, their jurisdiction was initially limited by reference to home State boundaries. The national co-operative companies and securities scheme of the 1980s expanded the jurisdiction of State Supreme Courts to deal with matters connected with other States, but many technical problems remained. Orders of certain kinds could only be made by the Supreme Court of the State of incorporation of the relevant company (for example, orders for winding up and the approval of a scheme of arrangement), and different systems of State administrative law governed judicial review of regulatory decisions. Those problems were overcome only when the Corporations Law established a system of cross-vesting in 1991, and "federalised" company law by applying the Commonwealth system of administrative law.

The Federal Court
10. During the late 1970s and 1980s the Federal Court of Australia came to exercise jurisdiction in company law matters through reliance on the emerging doctrine of accrued jurisdiction. But in the nature of things, the advent of the Federal Court could not be a strongly unifying influence on the interpretation of company law, but only another source of company law jurisprudence. This remained the case when the Federal Court acquired plenary jurisdiction under the Corporations Law in 1991, concurrently with the State Supreme Courts.

Improvements in the 1990s
11. The insularity of the various courts is slowly changing. Most importantly, in 1993 the High Court declared that uniformity of decision in the interpretation of the Corporations Law is a sufficiently important consideration to require that an intermediate appellate court (and all the more so a judge at first instance) should not depart from an interpretation based on the legislation by another Australian intermediate appellate court, unless convinced that the interpretation is plainly wrong: *ASC v Marlborough Gold Mines Ltd* (1993) 10 ACSR 230, 232. The implications of that decision are still being worked out by the advocates who appear before us in company matters, and by the courts themselves. The High Court's observations have led judges at first instance to pay closer attention to decisions of other Australian courts at first instance.

12. The jurisdictional problems of the courts that are involved in the interpretation of company and securities law were thought to have been overcome by the Corporations Law (except that State Supreme Courts were denied jurisdiction to review decisions of the Commission under the Administrative Decisions (Judicial Review) Act 1977 (Cth)). But, of course, *Wakim* told us that the system of cross-vesting was ineffective to vest jurisdiction in the Federal Court with respect to the Corporations Law of a State.

The proposed Commonwealth Corporations Act
13. I take it that under the new legislation the Federal Court of Australia and State Supreme Courts will be given plenary jurisdiction in more or less coextensive terms. There will be no *Wakim* problem for the Federal Court because jurisdiction will be conferred by and in respect of a Commonwealth law. The State Supreme Courts will be invested with federal jurisdiction to exercise the judicial power of the Commonwealth under the new law.

14. One hopes that the legislation will not contain any relevant jurisdictional limits on any of the Federal Court and the State Supreme Courts vis-a-vis the others, so as to ensure that the court before which a matter comes has the jurisdiction to deal with all aspects of it and that duplication of proceedings is avoided. Equally, one hopes that there is ample and flexible power for any of these courts to transfer proceedings to one of the other courts, in the exercise of its discretion.

15. As far as the State Supreme Courts are concerned, all that is needed is to continue their existing jurisdiction, subject to one point. When the Corporations Act 1989 (Cth) was amended earlier this year to give State Supreme Courts jurisdiction under the Administrative Decisions (Judicial Review) Act 1977 (Cth) (see s 51(2A)), a limitation was imposed requiring a State Supreme Court to transfer a judicial review proceeding to the Federal Court except in special circumstances (s 53(3)). This restricts the ability of State Supreme Courts to review, for procedural fairness or error of law, administrative decisions by bodies such as the Commission. Given the overall policy of conferring ample jurisdiction on all relevant courts, there appears to be no justification for restricting the State Supreme Courts in this way, and I hope that an equivalent of s 53(3) will not appear in the new legislation.

16. Broadly, the introduction of the new legislation will bring us to the point thought to have been reached by the Corporations Law - that is, a judicial system for the interpretation and application of company and securities law in which the Federal Court and the State Supreme Courts will operate concurrently in civil matters. But that is a fairly modest achievement on the road to national uniformity,

compared with the absolute national uniformity of the text of legislation, and the general uniformity of administration by a single Commission (perhaps not yet fully perfected in practice). What should the next steps be, assuming that national uniformity of interpretation and application of company and securities law is the agreed objective?

The next steps

17. In my view the goal will not be achieved by any step that limits or excludes the jurisdiction of any Court. Questions of company and securities law are bound to arise in the Federal Court and the State Supreme Courts whether or not they are invested with jurisdiction under the corporations statute. It would be productive of much uncertainty and expense to leave any of those courts in doubt about their jurisdiction to hear matters that have properly come before them.

18. That means, however, that the judges having jurisdiction to deal with company law matters will include some, in both the Federal and State spheres, who have no background or experience in that field of law. This could be an impediment to the achievement of a national approach to the interpretation and application of company and securities law.

The need for judicial expertise

19. In the time of Sir Frederick Jordan or even Sir Owen Dixon, it may have been possible for judges at first instance to maintain adequate expertise to deal effectively with all legal subjects. But in my view, if ever that was so it is certainly not the case now. Expertise has become a prerequisite of adjudication in many fields, from criminal law to taxation.

20. Specifically, company and securities law is one of those fields of law in which certain kinds of experience and expertise are an advantage to the judge at first instance, and a level of specialisation is needed in the judicial decision-making process.

Expertise in company and securities matters

21. I believe there are at least three aspects to this in company and securities area. First, it is necessary for the judge to have an understanding of the legislative and regulatory policies that specially apply to these matters, and the functions and operations of the regulator. For example, a judge inexperienced in the administration of company and securities law by the Commission might recoil against the depth and range of the Commission's discretions to grant exemptions from or modify the law. A judge who understands the policies leading to the conferral of these discretions, and is familiar with their use, is likely to make better decisions in cases where the use of the discretions is in question. If decision-making is allocated to judges who have this kind of experience, the likelihood of uniformity of decisions is enhanced.

22. Secondly, transactions involving the application of company and securities law are sometimes complex in typical or characteristic ways. Familiarity with the typical transaction structures can be useful, especially where the matter for decision involves the exercise of a discretion - as it does, for example, in a decision to approve a scheme of arrangement.

23. Thirdly, an important role of the court that administers statutory company and securities law is supervision of the conduct of certain intermediaries, such as insolvency practitioners and securities dealers. In some respects the court's role is quasi-administrative. The development of views as to proper standards of conduct requires a level of specialisation. For example, coherent standards of conduct for voluntary administrators will only be fully developed by the courts (in a process which is now well under way, by virtue of the growing number of cases in this area) if the courts considering questions about the conduct of voluntary administrators have a level of specialisation on that question.

Some modest proposals

24. I believe that if we are to move to effective ‘uniformity’ of interpretation and application of company and securities law, we must allow specialisation to develop within the courts of plenary jurisdiction. One obvious way of doing so is to establish a corporations list in each relevant court. This has occurred in some of the State Supreme Courts, and presumably the Federal Court will restore its corporations lists, which operated in some States, when the new law commences.

25. Then it is necessary for the judges who administer corporations lists to establish and maintain contact with one another. This is why the recent establishment, by Santow J and others, of a national group of corporations list judges has been so important.

26. Immediate access to relevant judgments is also essential, and in this respect the establishment of

a web-site for corporations law judgments at the Centre for Corporate Law and Securities Regulation is also an important development.

27. The adoption of national uniform Corporations Law Rules has been important, partly because it denotes that company and securities law matters are to be treated separately and specially.

28. These are modest beginnings. We are well short of the emergence of a national corporations list, a phenomenon that may have to await the introduction of a national uniform judicial system. But once each relevant court has identified one or more specialist company law judges, and the specialists are put in touch with one another regularly on a national basis, any residual tendency towards insularity is unlikely to survive, and the likelihood of judicial disagreement should also be reduced.

29. The fact that various courts have concurrent plenary jurisdiction should then be no bar to the achievement of national uniformity of interpretation and application of company and securities law.

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