# FOREWORD

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It is my privilege to provide this introduction to an excellent collection of essays on directors' duties by leading scholars of company law.

The importance of the matters under discussion deserves emphasis. The weight of historical research confirms that the development of the limited liability company, principally in the United Kingdom ('UK') and United States ('US') in the 19th century, provided a tremendous boost to wealth-creating business activity in major Western economies. An editorial in *The Economist* of 18 December 1926 made the point graphically:

> The economic historian of the future may assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honour with Watt and Stephenson, and other pioneers of the Industrial Revolution. The genius of these men produced the means by which … huge aggregations of capital required to give effect to their discoveries were collected, organized and efficiently administered.

A weakness of the corporate form is the agency problem that arises because ownership and control are separated, and so there must be satisfactory mechanisms for protecting the owners (the shareholders) from the opportunism and carelessness of managers (including, in this context, the directors). The law of directors' and officers' duties is an essential part of these mechanisms, and if it fails, the community's confidence in the limited liability company will fall away and the ability of the company to continue to function as an engine of economic growth for the community will disappear.

True to form, a recent leader in *The Economist* warns of 'the endangered public company'.[1] It reports that the number of [listed] public companies has fallen dramatically over the past decade (by 38 per cent in the US since 1997 and 48 per cent in Great Britain), and that the number of initial public offerings in the US has declined from an average of 311 a year in 1980–2000 to 99 a year in 2001–11. One problem is said to be the growing burden of regulation, while balancing that, another problem is that '[s]hareholders are also angry' because '[t]heir interests seldom seem to be properly aligned at public companies with those of the managers, who often waste squillions on empire-building and

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1 'The Endangered Public Company', *The Economist* (London), 19 May 2012, 11.

sumptuous perks'.[2] These problems matter, according to *The Economist*, because public companies have long been 'the locomotive of capitalism'. They are central to innovation and job creation, they let in daylight on the operation of large businesses, and they give ordinary people a chance to invest directly in capitalism's most important wealth-creating machines. The challenge is to set and apply legal and regulatory principles that protect the unsophisticated investor, but not so tightly that entrepreneurs will start to dread the prospect of a public listing.

In summary, having the right settings for directors' and officers' duties is a task of central economic as well as legal importance – all the more so after the global financial and sovereign debts crises. Misjudgments by legislators, judges and regulators can be extremely costly to the community.

Apart from Professor Kingsford Smith's thoughtful discussion of 'soft regulation', which covers the field of corporate governance, the authors have focused their attention on only two of the duties of directors. Three of the articles (namely those by Professor Redmond, Ms Marshall and Professor Ramsay, and Dr Williams) are about the duty of directors to act in good faith in the best interests of their company. The other three articles (by Professor Hill, Dr Golding and Ms Gibson and Ms Brown) are, at least principally, about the duty of care and diligence. Very little is said about the company directors' other duties, such as their duties to avoid conflicts of interest and to account for misappropriated corporate opportunities.

If a law journal forum on directors' duties had been arranged in Australia 40 years ago, or even 20 years ago, the focus of attention would have been very different. When I began teaching at the University of Sydney's Law School in 1969, the structure and content of company law as a law faculty subject were dominated by the elegant analysis presented by Professor L C B Gower in his widely used English text.[3] The law of directors' duties was centre stage, as it is in the modern exposition of company law, but the emphasis of the exposition was on the director's fiduciary position and its consequences. The text presented a clear and penetrating analysis of the director's duty with respect to conflicts between duty and interest, in contracting with or competing with the company, and in using corporate property, information or opportunity. The duty to act for proper purposes, especially in a takeover context, was given a good airing, and of course in Australia, we supplemented Gower's analysis with major High Court decisions in that area.[4] But the duties to act in good faith in the best interests of the company, and with due care and skill, each accounted for about one quarter of the space allocated to the fiduciary duties.

No doubt Professor Gower's emphasis was influenced by the striking and then recent decision in *Boardman v Phipps*.[5] *Boardman* was not itself a

2 Ibid.
3 L C B Gower, *Principles of Modern Company Law* (Stevens & Sons, 3rd ed, 1969).
4 Such as *Mills v Mills* (1938) 60 CLR 150 and *Ngurli Ltd v McCann* (1953) 90 CLR 425.
5 [1967] 2 AC 46 ('*Boardman*').

company law case, but it was an important exposition of the duties of an honest fiduciary agent. In *Boardman* the House of Lords followed, and in a sense resurrected, an earlier House of Lords decision on directors' fiduciary duties, namely *Regal (Hastings) Ltd v Gulliver*,[6] which was republished as a note to the authorised report of *Boardman*.[7] In comparison with the excitement surrounding those cases (and comparable Australian cases),[8] the case law on the duties of good faith and care and diligence was quite sparse in 1969.

Professor Gower's analysis of the company director's duty to act in good faith in the best interests of the company was dominated by some older cases about corporate gifts, establishing the proposition that 'charity has no business to sit at boards of directors'[9] and more recently affirmed in a superannuation context.[10] More significant in the modern context, but standing in isolation, was a case[11] in which counsel submitted that 'the prime duty must be to the shareholders; but boards of directors must take into consideration their duties to employees in these days', to which the judge responded tersely, '[b]ut no authority to support that proposition as a proposition of law was cited to me; I know of none, and in my judgment such is not the law'.[12] There was brief reference to whether shareholders' interests would be served by having regard to the interests of employees, trade unions, customers, the public or government, but Gower was writing before the radicalisation of academia had arrived at the law schools, and in any event the corporate social responsibility movement was in its infancy.

In fact, not much has happened by way of new case law on the duty of good faith since 1969, except in the context of corporate groups.[13] Indeed, that is one of the criticisms of the law advanced by Professor Redmond in his Forum article. In contrast, there has been an enormous outpouring of scholarly and other writing on corporate social responsibility, as Professor Redmond, Ms Marshall and Professor Ramsay, and Dr Williams all note. To the extent that the law implies that directors must give priority to the interests of shareholders in a financial sense over any conflicting interests by other stakeholders such as employees, customers and the environment, some commentators see the law as an instrument of the raw capitalism that has been at the root of the corporate recklessness leading to the global financial crisis. But sometimes the commentators miss the nuances of the present law, under which it is seldom inappropriate for directors to make decisions that, in the longer term interests of the shareholders, reflect the interests of other important stakeholders. Dr Williams makes the point well. But I have some sympathy with Professor Redmond's suggestion that some clarifying

6 [1942] 1 All ER 378.
7 [1967] 2 AC 134.
8 See, eg, *Furs Ltd v Tomkies* (1936) 54 CLR 583.
9 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 673 (Bowen LJ).
10 *Re W & M Roith Ltd* [1967] 1 All ER 427.
11 *Parke v Daily News Ltd* [1962] Ch 927.
12 Ibid 963 (Plowman J).
13 As to the modern cases on corporate groups, see R P Austin and Ian M Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Butterworths, 14th ed, 2010) [8.140].

legislative amendments would assist directors in the situation of the James Hardie board in 2001. Of his three alternatives, I would prefer the clarity of section 172 of the *Companies Act 2006* (UK), although I acknowledge that there is a degree of hostility to that idea in the local corporate and legal community.[14]

Professor Gower's short discussion of the duty of care and skill was rightly dominated by Justice Romer's influential analysis in *Re City Equitable Fire Insurance Co*.[15] The principles in that case had set a purely subjective standard of skill, permitted a director's diligence to be intermittent, and liberally allowed directors to rely on company officials. At that stage there had been no modern revision of the principles by litigation, perhaps for three reasons.

The first was that private litigation to complain of breach of the directors' duty of care was difficult to mount because of the proper plaintiff rule in *Foss v Harbottle*,[16] according to which, since the duty was owed to the company, the company was the proper plaintiff to complain of breach. If the complaint was about negligence without any allegation of fraud, the general law derivative action exception to the rule was not available.[17]

The second was that there was no statutory statement of the duty of care in the UK, and in Australia the statutory provision created a criminal offence not amenable to civil proceedings, and so there was no public regulatory enforcement of the civil duty.

The third reason is perhaps the most interesting. As Professor Gower remarked, whereas their training and experience made judges well-equipped to adjudicate on questions of loyalty and good faith, 'they move with less assurance among complicated problems of economics and business administration'.[18] When Gower wrote those words, the board of directors was essentially regarded as the senior management in committee, and the notion that the fundamental role of the board is to guide and monitor management rather than be part of management was (if on the horizon at all) not the predominant theory. To review the conduct of the senior management team in terms of a standard of care, the judges would be required to absorb themselves in matters of detailed management, and according to Gower, they were not well-suited to the task. But once it became established by modern corporate governance that the board's

14 See the criticisms of the UK legislation in R P Austin (ed), *Company Directors and Corporate Social Responsibility: UK and Australian Perspectives* (Ross Parsons Centre of Commercial, Corporate and Taxation Law, University of Sydney, 2006).
15 [1925] Ch 407.
16 (1843) 2 Hare 461.
17 *Pavlides v Jensen* [1956] Ch 565.
18 Gower, above n 4, 603.

principal role is a monitoring role,[19] the judges could be more comfortable in assessing the efficacy of the performance of that function.

In this context, the most important change of the last two decades in Australia has not been the introduction of the statutory derivative action now found in Part 2F.1A of the *Corporations Act 2001* (Cth), but the creation of a relatively well-funded national corporate regulator, coupled with the placing of the statutory duty of care in the civil penalty regime. This has meant that the Australian Securities and Investments Commission ('ASIC') has been given a new and very sharp weapon to use in serious cases of corporate misfeasance. When ASIC invokes the statutory duty of care and diligence it opens the door to disqualification orders as well as pecuniary penalties. As the UK experience related by Dr Williams also shows, disqualification from managing corporations is a potent response to wrongdoing. As the Appendix to Dr Golding's article graphically reveals, ASIC has demonstrated its willingness to wield this weapon in serious cases, especially over the last decade. And the statutory duty of care and diligence is widely available – even as an additional ground of complaint, easier to prove, in cases where it is alleged that directors have been involved in their company's contraventions of the misleading conduct and continuous disclosure laws, as Ms Gibson and Ms Brown point out in their article.

In summary, in the hands of ASIC the statutory duty of care and diligence in Australia has become a kind of universal tort available for the regulator to use when it wishes to reinforce or establish standards of care in prominent circumstances. That is why *ASIC v Healey* ('the Centro case'),[20] usefully discussed by Professor Hill, Dr Golding and Ms Gibson and Ms Brown, is so important.

In my opinion, the Centro case raised the objective standard of skill for directors of Australian listed public companies, who are now required as a matter of law (not just good practice) to carefully review proposed financial statements, determine whether the information contained in them is consistent with their knowledge of the company's affairs obtained from all sources, know enough about conventional accounting practice and basic accounting concepts to discharge their responsibilities, and make appropriate enquiries if they are uncertain.[21] In this respect, while the standard has been raised, it has not been elevated above the level of good corporate practice, and so the enhanced objective standard of skill should not dissuade well-informed candidates for board positions from applying.

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19 In my address, 'Director's Duties after James Hardie' (Speech delivered at the Supreme Court of Victoria Commercial Law Conference, Melbourne, 15 August 2011), I suggested the monitoring idea did not obtain prominence in the UK and Australia until the publication of the *Report of the Committee on the Financial Aspects of Corporate Governance* (1992) ('Cadbury Committee Report'), and not in the US until writings on management theory in the 1980s were crystallised by the American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1992).

20 [2011] FCA 717.

21 *ASIC v Healey* [2011] FCA 717, [13], [124], [211], [583]. Compare this with the earlier cases, in a non-public company context, in which the standard was set at a lower, and less specific, level up to and including *Deputy Commissioner of Taxation v Clark* (2003) 57 NSWLR 113.

More generally, the decision in the Centro case was an emphatic warning to all company directors to take care over the approval of financial statements, whether they serve on the audit committee or not, and to make sure that the inputs they receive as a board are accurate, succinct and helpful. That is a salutary outcome.

ASIC can achieve quick results by settling civil penalty cases or by proceeding by way of enforceable undertaking and, in some cases, infringement notice. But taking civil penalty proceedings to judgment will establish standards that the business community will be required to accommodate. That is ASIC's charter responsibility.

Would *The Economist* say we have set the standard of care and diligence so high as to endanger the public company? Generally, I think not. But the Centro case has drawn attention to an underlying concern in corporate governance. The amount of information that directors, executive and non-executive, are required to digest for each board meeting of a large company is now so formidable that, in some cases, there must be a question whether any human being can carry out the director's guidance and monitoring function satisfactorily. Directors say anecdotally that public company board papers, especially for regulated financial institutions, now extend to hundreds of pages and there is no obvious way of abbreviating them, even though Middleton J said in the Centro case that the board can and should control the volume of information it receives.[22]

If a worker in any other context is overloaded, then the burden has to be shared with others in order to get the job done. That suggests, in the boardroom context, that there should be greater use of board committees, not merely to make recommendations to the board (thus increasing the volume of paper) but to make final decisions by delegation, if the subject matter is capable of delegation. Professor Hill provides an interesting account of the US approach on delegation to board committees but, as Dr Golding points out, we are presently left in a fog, after the Centro and James Hardie cases, as to the kinds of decision-making that are part of each director's 'core, irreducible' duties and therefore cannot be delegated. That problem should be clarified by law review, as a matter of urgency.

22 *ASIC v Healey* [2011] FCA 717, [222], [226], [229].