DIRECTORS' DUTIES TO CREDITORS
Current Law & Proposals for Reform

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I do not believe that lawyers are responsible for some of the changes that are being proposed in legislation that we see coming before us almost daily. Indeed, in the context of this area of directors' duties, most of us have not had a chance to catch up to the fact that on the 25th of May, although there was a May Statement, there was also another massive bill tabled in Federal Parliament containing over 1000 sections I believe dealing with the reform of company law. We are going to have quite a lot of work as lawyers and that is going to impact on not only the area that we are talking about today, but to many other areas we are discussing during this conference.

In relation to ss.556 and 557, it is interesting to note that the courts have not yet worked out, in clear terms, how one defines the standard that you apply in dealing with whether directors are liable.

There is a case called R v. Kemish in the Supreme Court of New South Wales in which there was an attempt by Foster J. to deal with this particular issue, but I do not believe that the decision answers all of the issues. And then most recently, in the Metal Manufacturers case, a New South Wales Court of Appeal discussed the defences available to a wife, who was a director of a company but took no active part and relied on her husband who was managing director doing the particular work in a company which was insolvent etc. By a majority the court endorsed the wife's claim that she had not authorised or agreed to the incurring of the debt. The court refused to adopt a broad policy approach in interpreting the legislation dealing with the wife's appeal.

Now both of those cases illustrate to me, and I hope they do to many of you, that we should not be tinkering with the law, we should not be changing the statutes, before the courts have had a chance to interpret them. The courts may be a little slow but we do have to give them some time to develop these rules. If we keep changing our rules all the time, I am afraid that we will never get the answers right.

Insofar as the duty, and whether there is a duty, on the part of directors to creditors, this is a most troublesome and difficult area because of the dicta that Alex Chernov has discussed. In the first place Mr Justice Cooke in Nicholas v. Permakraft (NZ Ltd) ([1985] 1 NZLR 242; 3 ACLC 453) although he started off by saying directors owed a duty to the company, he clearly moves, by use of the neighbour principle later in the judgment, to say there is a duty owed to creditors. That same approach, I think is adopted in the House of Lords in the amazing decision of Winkworth v. Edward Baron Development Company Limited ([1987] 1 All ER 114).

A problem that we have in Australia (which may be different to the problem in New Zealand) is that apart from having to consider the common law duties that directors owe in this particular context, we have to evaluate the impact of statutory duties that have been laid down. These do not exist in England or New Zealand. Courts have had an opportunity to interpret some of these statutory duties and what they have said in two or three cases only, is that when you look at s.229 and look at what is the director's duty to act honestly, this means the same thing as the common law test of acting in good faith. It is a codification, in effect, of the common law. That was the view of Mr Justice Gowans in Marchesi v. Barnes ([1970] VR 434), and more recently the decision of McPherson J. in Marson Pty Ltd v. Pressbank Pty Ltd (6 ACLC 338 at 343).

The implication of there being a parallel common law and statutory duty is that creditors may well have an opportunity to sue directors directly, without having to go through the company and deal with the rule in Foss v. Harbottle. This action is through s.574 of the Companies Code. That section states that where there is a possible contravention of the Code, then either the Commission or any person whose interests have been, are, or would be affected by the relevant conduct, may seek a number of remedies. There is a judgment (and again we are very light on decided cases in this area) of Hampel J. in the Supreme Court of Victoria - Broken Hill Pty Company Limited v. Bell Resources Limited ((1984) 2 ACLC 157) - which gives a very wide reading to the words "any person whose interests ... are affected" and one could argue, I think quite strongly from the cases Alex Chernov referred to, that creditors may well have standing. And if they do have standing, then not only can they seek an injunction in the particular case, but the section has tucked away a further "remedy" (and very few people have noticed it). Under s.574(8), the court is also empowered to give what might amount to a class action remedy in damages. If that is carried through, and there has been some discussion of this in one or two articles, they take the view that if the development of the law is as Alex Chernov has outlined for us, there is a likelihood that the courts may well give creditors a significant remedy where in the past we have assumed that only the company could sue in these particular situations.

The courts are going to face a real conflict, I think, if they ever have a case under s.574 because s.229(7) seems to suggest that it is only the company that can seek a remedy to force directors to disgorge profits or to make them pay damages. It would be interesting to see how they would line up those two sections side by side in the appropriate case, one where the company is seeking a remedy, and the other where the creditors or someone else is seeking to reap the results of the improper action on the part of the directors. In that particular regard it is interesting to note that in the United Kingdom, where they have one very interesting provision only in relation to directors' duties in this area, the duties of directors at common law have been widened to require them to take into account the interests of employees. Having done that the legislation provides that the only person that could bring an action, in the event of the directors breaching that duty, is the company. The statute did not give the employees the action; they gave it to the company, and you can guess that there have been no actions brought under that particular provision.

The existence of statutory provisions raises another problem, in my view. Let us assume that you have a situation where you have creditors, very significant creditors, in the company who wish to appoint a director to represent them on the board. They have a number of problems, and I will advert to some of those in a moment, in relation to how they are supposed to act in that particular situation. Can you in fact write into the articles of association a clause that may limit the obligation or the duties that those directors owe to the company? Whitehouse and Another v. Carlton Hotels Pty Ltd ((1987) 51 ALJR 216) raised the question of whether the governing director of a Queensland company was acting properly or improperly in trying to block out from the control of the company his divorced wife and their daughters in favour of his sons. The High Court suggested (in dicta) that it might be possible to write into the articles of association a clause which could limit the common law duties owed by directors to the company. Can you, however, write into the articles of association a clause that will limit the operation of the statutory provisions? If those statutory provisions lie side by side with the common law duties, then query whether in fact you can write into the articles of association a clause that will exclude the operation of those statutory provisions. It will then depend on just how widely the courts read the statutory duties, and in that regard one again turns to that decision of Gowans J. in Marchesi v. Barnes and to the one or two other dicta that I have referred to, once in my printed notes and today in that recent decision of McPherson J. Both are general and almost side comments, but nevertheless the only comments that I can find on what s.229 might mean in the context of the common law.

In New Zealand the Law Reform Commission is at present grappling with the question of whether New Zealand should reform company law. And one of the questions that they put (and they have issued a very interesting discussion paper) is whether in fact

the New Zealand Companies legislation should codify the duties of directors in the same way as we have in this country, and as has been done in Ontario. I would suggest, in this particular context, that this approach will add more problems than assist the situation.

Another issue that arises in the context of having creditors appoint directors to the board was again referred to briefly in this morning's session by Mr O'Sullivan. The question is just who the directors owe their duty to in that particular context? Do they owe it to the company appointing them? Or do they owe it to the company to which they are appointed? We have conflicting dicta in this country on this particular issue. In fact we have the late Mr Justice Jacobs, when he was a Supreme Court judge in New South Wales, in two classic decisions - Levin v. Clark ([1962] NSWR 686) and Re Broadcasting 2GB Pty Limited ([1964-1965] NSWR 1648) - suggesting that the directors in those particular situations had a fairly wide scope on what they could do, although in 2GB there was some cutting back of this broad approach. We have a similar statement made, it would seem, again in dicta, by the late Mahon J. in the Berlei Hestia case (Berlei Hestia v. Fernyhough [1980] 2 NZLR 150) in New Zealand. As against that we have the very strong statement by Mr Justice Street in Bennetts v. Board of Fire Commissioners of NSW ((1967) 87 WM (Pt 1) (NSW) 307), and we have, of course, the classic comments made by Lord Denning and others that suggest that where there is a situation of potential conflict, there is a real problem, and that directors in that situation should resign.

Now remember that the Companies Code also says something about this. Section 225 provides that where you have a representative director on the board and that person is removed, then that person must be replaced by those who nominated the "representative" director. So there seems to be some implication in the Companies legislation that the directors may well owe some duty, or may well be responsible, to the persons appointing them. It is only in the situation of where there is a direct conflict between the two interests that we have these problems referred to above to solve.

In that particular regard you may find some help in the approach taken by Mr Justice Foster in the Anaray case. Anaray was a case decided in 1982 but recently reported in the CCH Company Law Cases (Anaray Pty Limited v. Sydney Futures Exchange Limited and Others (1988) 6 ACLC 271). It deals with alternates. Foster J. was suggesting that the alternate in that particular case had to look at his position separately from the position of the person appointing him. In that particular case, the judge said that the alternate was certainly entitled to vote on a resolution, even though the person appointing him to the board, would have been disqualified from voting in those circumstances.

These cases do not help us a great deal. The only comment I would make in concluding on that particular point, is that we

start off, unfortunately, with some dicta in this area which is fairly loose but which nevertheless suggests that directors may serve on two boards, and may, in effect, compete with their company. There is a famous dictum in Bell v. Lever Brothers Limited ([1932] AC 161) which has been picked up and relied on in a number of later cases. But as against that, you have a very strong line of cases dealing with the corporate opportunity area, especially in Australia and Canada, which suggest that the directors in that particular situation cannot act selfishly. And if you want to see another case, a fairly strong case on its facts in this particular area, there is a recent Court of Appeal decision in New South Wales - Mordecai v. Mordecai and Others ((1988) 6 ACLC 370) - which emphasises the very precarious position directors face when a conflict situation arises.

Finally, let me just raise one additional issue with you. Jim Kennan QC, when he was Attorney-General for Victoria, and Senator Gareth Evans, when he was Attorney-General for the Commonwealth, both suggested that the time had come to place into legislation specific rules, which whilst not requiring directors to take into account interests of employees, creditors etc., should allow them to do so. I would counsel against introducing such legislation. What happens when you have statutory rules such as this is that the lawyers immediately get to work to try to find a way around them. And I think that we get legislation, which as I noted earlier, becomes 1000 sections long. It is a lovely gold mine for lawyers, but I believe in becomes an inordinate cost to the business community.

I would suggest to you that the common law and the judges administering the common law, have the ability to deal with the conflict situations that arise in the appropriate cases, and that we should not lay down strict rules that interfere with the normal commercial realities of life.

The business judgment rule which the American courts rely on very heavily, and which we also seem to rely on in some situations, has served us reasonably well in the past. The cases where directors step out of line have seen the courts move in and award the appropriate remedy, and I think that is the way we should proceed. To require the changes under discussion in the law which will impose greater burdens on directors. They will not only add to the costs of doing business, but I believe will make it very difficult to persuade people to become company directors.