TRANS-TASMAN REGULATION OF FINANCIAL INVOLVEMENT OF DIRECTORS - The Aftermath of the Corporate Collapse

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INTRODUCTION

I start with an 18th century corporate failure, the Charitable Corporation, described in the 1733 Report of the Committee of the House of Commons of the Charitable Corporation for the Relief of the Industrious Poor.

Some directors and officers of that corporation embezzled considerable funds. The cashier and the warehouse keeper set off with some of those funds for the continent. The blame lay with the directors who failed to observe the checks and make the examinations required by the by-laws. Some of the directors had used the corporation's funds to speculate in its own stock. Bonds had been issued in violation of the corporation's charter and dividends recommended without proper consultation of the accounts. A majority of the directors failed to concern themselves actively in the affairs of the corporation. Essentially at issue was whether a director should be liable for failure to act as well as for negligence or culpability in acting. When the question was considered in the Court of Chancery (***Charitable Corporation v Sutton*** (1742) 2 Atk 400, 26 ER 642) the court held that the directors should be held liable for their non-feasance.

The records do not show whether monies were recovered from the directors. The corporation ended up with net liabilities of £120,000. Parliament reacted by providing a lottery for the "Relief or Satisfaction of such of the Sufferers as shall appear upon examination to be proper Objects of Compassion". £80,000 was raised. A parliamentary Commission decided who the "Proper Objects of Compassion" were.

The corporate collapses in Australia in the 1980s have certainly left Australia with some "Proper Objects of Compassion" and have brought sharply into focus the duties and responsibilities of directors. When $5 billion is a conservative estimate of equity lost to corporate Australia (other estimates say at least $8,000,000,000), it is not surprising there is a strong public sense that the money cannot have disappeared. It must, it is agreed, have found its way out of the corporate coffers to those that had the role of their guardian. There is no unequivocal public evidence that those guardians have shared the financial suffering of the investors and there is a strong call for a legitimate Robin Hood to recover for those that have suffered and to demonstrate that such behaviour will not be tolerated.

Australian Parliament has not reacted by providing a lottery. (In Victoria there has been an involuntary lottery of sorts, the tax imposed by the Victorian Government on petrol which is to assist recovery in the Pyramid building society disaster.) Parliament has, however, called for reports on the duties and responsibilities of directors and the adequacy of the current statutory law.

ORIGINS OF CURRENT LAW

Australian statutory law relating to directors' duties finds its origins in the general law. That general law has not undergone significant changes over the last two centuries.

The typical 18th century joint stock company had a general court comprising the proprietors of the company, and a court of directors or assistants elected by the general court and presided over by the governor and the sub-governor. Details of administration were carried out by committees of directors, whose appointment was generally left to the directors.

In these times, removal from office by a vote of the general court was the most usual punishment inflicted on erring directors. This was consistent with the perception of corporations as self regulatory units.

The 18th century was the starting point for our current statutory law. Directors were considered trustees for the proprietors. The concept was borrowed from the Court of Chancery and the law of real property. The concept had to be adapted to fit the business organisation, to deal with those particular commercial trustees.

In the middle of the 19th century, there were some more notable corporate failures: failures of the Royal British Bank and the Tipperary Bank. The Royal British Bank was declared "bankrupt" in 1956 with debts of £550,000. At that time shareholders were liable at law for the debt of each creditor and in order to avoid proceedings against them many of them disposed of their property and departed the realm. The Tipperary Bank suffered a similar demise.

These cases first raised the question of criminal responsibility for directors of fraudulent companies. The only available indictment in the circumstances was conspiracy to defraud new shareholders by false representations as to the bank's financial position. If that indictment could be successful, so every false statement by which the bank obtained credit would be indictable.

Despite the possible ramifications of the success of such an indictment, in 1858 six directors of the bank were successfully prosecuted on an information for conspiracy. The directors were charged in respect of particular acts:

(1) the publication of a balance sheet which included as assets some loans and advances by the bank "long known to be desperate";

(2) declaring a dividend of 6% of the bank, knowing that there should not have been a dividend declared; and

(3) fraudulently issuing new shares when the financial state of the bank was disastrous.

At that time the courts had established various civil remedies available for breach of trust. Directors who increased their attendance remuneration outside the charter were liable to refund those monies with interest. Where payment of a dividend of 5%, let alone any amount, was unjustified, directors were held liable to make good with interest. There was also civil liability for fraud in the case of directors making fraudulent statements in a prospectus to induce potential investors to take up shares.

In 1857, an Act was passed (repealed and re-enacted in the Larceny Act 1861). A director who published or concurred in publishing statements which the director knew to be false so as to induce a person to become a shareholder was guilty of a misdemeanour. Similarly, a director who fraudulently applied to his own, money or property of the company. False entries in books were also misdemeanours. In 1890 the Directors' Liability Act was passed which made directors liable for untrue statements unless made on reasonable grounds or with the authority of an expert.

CURRENT LAW AND LEGISLATION

So developed the scheme of our current law. At its heart were the general principles of trust law, which enabled civil recovery. Criminal liability was imposed for closely defined behaviour. There could also be civil recovery in these circumstances.

As regards the general principles of trust law, they have been reinforced by statute. In their adaptation, there has been a marked reluctance by the legislature to impose anything other than general duties which would be equally applicable to persons who were not involved in a business enterprise. The courts have echoed this sentiment when called to adjudicate between the company and its directors. In the 1901 case of ***Dovey v Corey***, Lord Macnaghten commented:

> "I do not think it desirable to do that which Parliament has abstained from doing - that is, formulate precise rules for the guidance or embarrassment of business men in the conduct of business affairs. There never has been, and I think there never will be, much difficulty in dealing with any particular case on its own facts and circumstances; ... I rather doubt the wisdom of attempting to do more."

Not only have courts been reluctant to formulate precise rules, they have also been reluctant to impose high standards of conduct and resist wherever possible the opportunity to consider the merits of the commercial judgment of the directors. The 1925 case of ***Re City Equitable Fire Insurance Co Ltd*** ([1925] Ch 407) provides a very clear example of the reluctance of the courts to interfere in both of these areas. A director was only obliged to exercise the degree of skill and care that an ordinary man would be expected to take on his own behalf; his skill need only be that reasonably expected from a person of his knowledge and experience; continuous attention to the affairs of the company was not required and reliance on other officers and experts was permitted.

It seems also that the ***Charitable Corporation*** case is a rare example of liability being imposed for failure to attend meetings or take an active part in the running of a corporation.

Howard Smith v Ampol ([1974] AC 821) provides a clear example of courts being conscious of their own lack of expertise in matters of management. In practice the result is some latitude in matters that could be regarded as involving mere errors of commercial judgment.

GENERAL PRINCIPLES AND STATUTORY OBLIGATIONS

The provisions of the Australian Corporations Law which cover directors' duties lie along side the duties imposed by general law. The general law duties can be summarised:

(1) duty of good faith, comprising a duty

- to act bona fide for the benefit of the company as a whole, in the interests of the shareholders as a general body, or (where these interests differ as between different classes of shareholders) in a manner that is fair as between the different classes of shareholder. At least where the company is insolvent or nearly insolvent, directors must also have regard to the interests of the company's creditors.
- to act for proper corporate purposes. Directors will be in breach of this duty if their purpose in exercising a power (but for which the power would not have been exercised) is improper, for instance in their own interests, to preserve their control or to destroy an existing shareholder majority.
- not to make a profit from their position as director.
- not to make or pursue a gain, or promote the interest of a third party, in circumstances where there is an actual or real possibility of a conflict of interest between personal interest and duty to some other party.

(2) a duty to exercise the degree of care and diligence that can reasonably be expected of a person of his knowledge and experience.

These two types of duty are "codified" in sub-sections 232(2) and (4) of the Corporations Law.

The duty of good faith is expressed as the duty to "act honestly in the exercise of his [or her] powers and the discharge of the duties of his [or her] office". The duty to act honestly is expressed as a duty "to exercise a reasonable degree of care and diligence in the exercise of his [or her] powers and the discharge of his [or her] duties."

Under the general law, available remedies for breaches of directors' duties include injunctions, orders to pay damages and orders that a director account to the company for damages. In the recent Western Australian Supreme Court decision of ***Tavistock Holdings Pty Ltd v Saulsman*** Anderson J stated that he considered it to be "now widely accepted in Australia that the Court has an inherent power to award equitable compensation to relieve against loss occasioned by breach of fiduciary duty". Under the Corporations Law, the same remedies can be achieved by reliance on express statutory provisions (ss1324, 232 and in official management or liquidation s452).

Criminal penalties are imposed for breach of sub-s232(2), under sub-s232(3) and for breach of other sub-sections in s232, by s1311 of the Corporations Law.

Alongside the general principles lie specific obligations and prohibitions. One of the aspects of the duty to act honestly is the duty not to apply the company's resources otherwise than for the benefit of the company as a whole. Loans to directors are expressly forbidden, as are loans to entities and persons associated with the director (s234). Companies are prohibited from giving a guarantee or providing a security in connection with another lender's loan to a director or associated entity. Directors who authorise the contravening transaction commit an offence and are jointly and severally liable to indemnify the company against loss.

However, notwithstanding these specific prohibitions, the thrust of the Australian law relating to the conduct of directors remains general. More and more, it seems, specific issues arise in Australia which the general principles appear to be inadequate to address. A trend to "black letter" law is evident - if only in discussion and recommendation how the law should be reformed.

REVIEW OF THE LAW

The statutory law in this area did not change with the recent Australian transformation from the Companies Code to the Corporations Law (with an associated change of section numbers).

There has, however, been substantial recent review of the area.

- In November 1989 the Senate Standing Committee on Legal and Constitutional Affairs (chaired by Senator Barney Cooney) reported on the "Social and Fiduciary Duties of Company Directors" and made a wide range of recommendations for law reform.

- Concurrently in response to a report of the Companies and Securities Law Review Committee on "Directors' Statutory Duty to Disclose Interests and Loans to Directors" (1989) and proposals developed by the Companies and Securities Advisory Committee, the Advisory Committee published a paper the proposals in which it developed into an amendment bill amending s234 of the Corporations Law and regulating the entry into and disclosure of directors' financial transactions where elements of self interest may be involved (ie transactions with associated companies). The Advisory Committee is reviewing submissions it has received in response to the draft bill.

- Following the Cooney report there was an inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs (chaired by Mr Michael Lavarch) into "Corporate Practices and the Rights of Shareholders".

  The ASC made written and oral submissions to the Lavarch Committee which included its comments on the loans to directors reform. The Committee has yet to report.

- Late in 1990 the Attorney-General (the Minister responsible for the Corporations Law) circulated a bill introducing changes to the statutory law on insider trading. These changes are likely to be introduced in the next Commonwealth amendment bill.

In its submission to the Lavarch Committee the ASC expressed its concern that although the law concerning directors' duties was ***expressed*** to impose high standards of behaviour, a lack of enforcement in recent years has led to widespread departures. This was the focus of the ASC concerns. As we saw it, the reasons for lack of enforcement by both regulatory agencies and private parties included:

- lack of resources, financial and human, having regard to the complexity of investigative and enforcement action in this area;
- uncertainties as to precisely where the courts will draw the line in actions for breaches of directors' duties, complementing the resources problems;
- deficiencies in disclosure requirements which make it difficult to detect and document abuses made at an early stage;
- the lack of a sufficient range of legal requirements targeted at specific areas of common abuse, to supplement the general principles concerning directors' duties and to provide an avenue for expeditious enforcement action; and
- legal obstacles and technicalities surrounding the standing of private parties to bring action to redress abuses.

The Cooney report brought to light similar concerns. The comment was made to the Committee that any problems and deficiencies in companies and securities regulation in Australia go to the enforcement of those laws, not their adequacy.

I do not accept unequivocally that the problem lies with enforcement. The ASC submitted to the Lavarch Committee that new law would be appropriate in two areas: first, as had been circulated, in the area of loans to directors. Second, in the area of duties to creditors, which I will cover quickly now.

There is clear authority that directors must have regard to the interests of creditors where the company is insolvent. Authority as to whether, and when the directors should, in the company's downslide to insolvency, begin to have regard to creditors' interests is not so clear.

The ASC considers that it is highly desirable to have a statutory elaboration of directors' duties to creditors, including criteria as to when the directors are subject to that duty.

In this context, it is relevant to look at s592. This exposes directors to personal liability for debts of the company where the debts were incurred if, whether or not as a result of that debt, there were reasonable grounds to expect that the company would not be able to pay its debts as they became due.

The effect of this provision is that directors' only choice if they expect insolvency is to accelerate it. Query whether the result is that directors are exposed by the law to a conflict of duty and personal interest. Where the assets of a company include a large component of goodwill attaching to the business of that company, will it necessarily be in the interests of shareholders, let alone creditors, to wind that company up? In this situation, directors clearly have to face up to their personal interests.

As well as bearing on the question of whether the directors should have a statutorily imposed duty to have regard to creditors when insolvency is expected, the issue raises the question of whether the sudden death regime is appropriate, for companies, and ultimately for public confidence.

Two things have come out of the Australian call for enforcement and new law. First, we have a new regulatory body which can answer the call for a strong enforcement body, primarily because it has been given the resources to perform that function effectively.

Secondly, we have some proposed new law, not amendments to the current law on directors' duties but legislation which will sit alongside it imposing specific and objective obligations. We do not yet have law which addresses our concerns as to directors' duties to creditors but that is a function of time, rather than other considerations, at this point.

ENFORCEMENT

Let me talk about the ASC as the new regulatory body first. The ASC is now in a position to and is enforcing the law in relation to directors' duties. The mission of the ASC is to achieve maximum credibility in Australian corporations and securities markets. To achieve this in the enforcement area, it intends to develop a deterrent net against contravention of the law. Its primary objectives will be preservation of property; civil remedies, including recoveries and other public protection; and lastly prosecution of public offenders in serious fraud situations.

The ASC has been given some wide powers to investigate any cause and intervene in proceedings.

The ASC has power under the ASC Law to make investigations where it has reason to suspect that there has been a contravention of the Corporations Law and any other law where it concerns the management or affairs of a body corporate (sub-s13(1) of the ASC Law).

The ASC may, following the investigation, cause criminal prosecutions to be begun (s49). The DPP will have the carriage of these prosecutions.

The ASC may also cause civil proceedings for the recovery of damages for fraud, negligence, default, breach of duty or recovery of property to be begun on behalf of companies, or (with their consent) natural persons, following an investigation (s50).

In addition, the ASC has power to intervene in proceedings relating to matters arising under the Corporations Law (s1324 of the Corporations Law).

Court proceedings are starting to emanate from the top priority national investigations. These involve actions for breach of s229 of the Companies Codes (now s232 of the Corporations Law) in at least four of the matters.

The major investigations are not the only catalysts for actions under s229. The ASC has recently obtained a number of orders requiring repayment by company directors of substantial amounts of money to the receivers and managers and liquidators of those companies, (eg Victorian Inland Meat Co Pty Limited, Spot On Electronics Pty Limited and BTH Constructions Pty Limited).

LAW REFORM - THE ADVISORY COMMITTEE BILL

Let me now return to the area of law reform. As I said the proposals are not to amend the law relating to directors' duties. The ASC recognises that it is essential to maintain statutory recognition of the general duties imposed on directors. The Advisory Committee targets specific abuses in its Bill. Abuses of duties and responsibilities manifest themselves in a number of guises. These change, sometimes only to avoid the legislation introduced to combat them. The retention of the overriding principles, even with the difficulty in enforcing them, cater for practices not within the scope of the legislation although within its intended target range. In essence the proposed changes to the legislation promoted by the Advisory Committee, which focus on specific types of behaviour, are designed to:

- extend the obligations on directors to disclose their interests in transactions with the company, and prohibit them from voting on these transactions at meetings of directors, where they have a material interest;
- overhaul the obligations of directors and senior officers to disclose the benefits they received from their companies, including those obtained indirectly through "service companies" or "consultancies";
- more closely regulate loans by companies to directors, by extending the reach of the legislation to capture from loans to a range of financial transactions, limit the types of loans that may be given to directors and generally limit the rights of directors to vote themselves loans;
- introduce specific legislative controls on intercorporate loans financial transactions between associates. Under the Bill transactions in excess of 5% of shareholders' funds would require the consent of shareholders.

As I mentioned before, one of the aspects of the duty to act honestly is the duty not to apply the company's resources other than for the benefit of the company as a whole. In that sense the proposed legislation removes the directors' discretion in the exercise of their duty. The new law attempts to remove some of the opportunities for breach of duty.

The Bill also uses disclosure as a preventative of directors' misdeeds. This is not a new idea. The Times Report of the 1844 debate on the British Companies Act put it succinctly: "Show up the roguery, and it is harmless".

This type of law is easier to enforce. It has an objective standard. Either you have done something which falls within the scope of the legislative prescription, or you have not.

The Bill has been criticised for its complexity. As an ex officio member of the Advisory Committee I can comment that there is certainly resistance to a scheme of legislation which is complex, technical and compliance with which is burdensome. I have some sympathy with the proponents of "fuzzy law" but not in this area. We have had only "fuzzy law" and for two major reasons it did not work. First, its reach was uncertain. Second, there were not sufficient resources to enforce that sort of law. I do not believe that it would have been a sufficient response only to follow one of those tracks. We need, and we have been given, resources and in addition we need law that we can enforce without the uncertainty which follows from the statutory enactments of the general principles of the laws of fiduciaries. The amendment bill is a response to both of these.

I believe the case for detailed rules is very strong. The legislation has been challenged because it attempts to define every sort of transaction which directors could enter into in breach of their duties to the company. Commentators call for simple, more general definitions. We have those already in s232. It is essential that new legislation in this area does not, by using general definitions and concepts, become just as difficult to enforce as the existing law. We do not want to substitute the question of what is a breach of the new legislation for what is a breach of s232.

Specific legislation, not necessarily complex, will avoid the necessity for judges to enter the question of commerciality. It enables cheaper enforcement, because it is easier to identify breach and because it gives greater strength to self-regulatory mechanisms. Not only judges can identify breaches but also auditors, accountants and banks.

Having had the benefit of Mr McKenzie's synopsis of his paper it seems that with the encouragement of the Law Commission the New Zealand legislation will take the same track as the Australian legislation is currently following.

I reiterate our comments to the Lavarch Committee. Ultimately better enforcement will be facilitated by appropriately targeted laws. This will assist in the restoration of confidence among Australian and overseas investors, which is necessary for the long term well being, stability and development of Australian enterprises. In this long term sense the burdens of regulation will produce commercial benefits.