THE DUTY OF CARE OF COMPANY DIRECTORS IN AUSTRALIA AND NEW ZEALAND

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Australia and New Zealand share the confused inheritance of English Law with regard to the duty and standard of care of company directors. However, unlike the United Kingdom, both have now opted for clarification of the basic duties by statutory restatement and in doing so have considered the enactment of a United States style of Business Judgment Rule which immunises directors from negligence liability for business decisions taken in good faith and without self interest. Australia was the first in the British Commonwealth to enact a statutory duty in s 107 of the Victoria Companies Act 1958. This provided quite simply that a ‘director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office’. This section was the basis for the equivalent provision in the Uniform Companies Acts 1961-1962. By the time of the Corporations Act 1989 the wording of the provision read ‘An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his or her powers or the discharge of his or her duties’. In 1992 this was amended to require the officer to exercise a degree of care and diligence ‘that a reasonable person in a like position in a corporation would exercise in the corporation’s circumstances’. The New Zealand Law Commission’s draft section was influenced by the Canada Business Corporations Act s 117(1)(b) which provides: ‘Every director and officer of a corporation in exercising his powers and discharging his duties shall (b) exercise the care, diligence and skill that a reasonable prudent person would exercise in comparable circumstances’. However, the final version of section 137 of the New Zealand Companies Act 1993 has been influenced by both the latest version of the Australian legislation and the Canadian section. Section 137 now provides

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3 Op cit 11-12.
5 On which, see F Iacobucci, M Pilkington, J R Prichard Canadian Business Corporations pp 287 et seq.
A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation,

(a) the nature of the company; and
(b) the nature of the decision; and
(c) the position of the director and the nature of the responsibilities undertaken by him or her.

The purpose of this article is to look in detail at the Australian and New Zealand sections and to compare and contrast them. We will then deal with six outstanding issues.

I. THE AUSTRALIAN SECTION

The Explanatory Memorandum to the Corporate Law Reform Bill 1992 paragraph 83 stated that the government considered that the new section did not change the law but merely confirmed the present position expounded in recent decisions such as Hussein v Good,7 Heide Pty Ltd v Lester,8 Statewide Tobacco Services Ltd v Morley,9 Commonwealth Bank of Australia v Friedrich10 and AWA Ltd v Daniels.11 The reference to 'reasonable person' was intended to confirm that the required standard of care and diligence was to be determined objectively. It should be noted that the basic duty extends to officers, unlike the New Zealand provision, which is limited to directors. Also the obligation is expressed in terms of a duty of care and diligence, not a duty of care, skill and diligence. In relation to the latter it is worth bearing in mind the comment in Byrne v Baker2 in 1964 in relation to the original provision: 'The legislature, though it has omitted the requirement of skill, which forms part of the concept of 'reasonable care', has clearly enough followed Romer J by limiting the requirement of diligence which it imposes to what may reasonably be expected of the director in the circumstances'. It is arguable that the omission of the reference to skill may be important as we will see in relation to its inclusion in the New Zealand section.

The new wording of the Australian legislation is similar to that of para 8.30 (a)(2) of the Model Business Corporation Act (US) which refers to 'the degree and ordinarily prudent person in a like position would exercise under similar circumstances'. The commentary to the Model Business Corporation Act states that the phrase 'in a like position' recognises that the care under consideration is that which would be shown by the ordinarily prudent person if they were a director of the particular corporation. The combined phrase 'in a like position ... under similar circumstances' is intended to recognise that the nature and extent of the responsibilities will vary, depending upon such factors as the size, complexity, urgency and location of activities carried on by the particular corporation; that decisions must be made on the basis of the information known to the directors without the benefit of hindsight; and that the special background, qualifications and management responsibilities of a particular director may be relevant in evaluating his compliance with the standard of care. Even though the phrase takes into account the special

6 See Jones op cit pp 108 et seq.
7 (1990) 1 ACSR 710.
8 (1990) 3 ACSR 159.
9 (1990) 2 ACSR 405.
background, qualifications and management responsibilities of a particular director, it does not excuse a director lacking business experience or particular expertise from exercising the common sense, practical wisdom, and informed judgment of an ordinary prudent person.

The Explanatory Memorandum stated that Australian law recognised that a special background, qualifications and management responsibilities of the particular officer may be relevant in evaluating their compliance with the standard of care. At the same time, Australian law also recognised that decisions must be made on the basis of the circumstances at the time and without benefit of hindsight. This mirrors the United States commentary. Likewise the Explanatory Memorandum stated that the new subsection recognises that what constitutes the proper performance of the duties of the director of a particular corporation will be influenced by matters such as the state of the corporation’s financial affairs, the size and nature of the corporation, the urgency and magnitude of any problem, the provisions of the corporation’s constitution and the composition of its board.

The Explanatory Memorandum stated that in the case of a business corporation, the standard reflects the fact that corporate decisions involve risk taking. In a report which the author prepared for the Business Council of Australia and the Australian Institute of Company Directors in 1992\textsuperscript{13} the significance of risk taking in entrepreneurism and the diversity of business enterprise were emphasised. The government considered this report in the context of criticism of an earlier draft bill and the pressure by the business community for a United States Business Judgment Rule. The Commonwealth government gave some recognition to risk taking. In the Explanatory Memorandum reference was made to the fact that directors or officers are not liable for honest errors of judgment and the courts have shown a reluctance to review business judgments made in good faith. In addition, the courts have exercised their discretion under s 1318 of the Corporations Law to excuse directors who have acted honestly and fairly. The government endorsed this approach and did not intend any change in the law by the revised wording of s 232(4). However, at the end of the day no attempt was made to enact a United States style of Business Judgment Rule. The reason given was that at that time no state in the United States of America had adopted a legislative statement of the rule but had left the matter to the courts to develop. Likewise the Explanatory Memorandum stated that the government considered that the development of such principles in Australia was better left to the courts.\textsuperscript{14}

The standard of care is now clearly objective.\textsuperscript{15} The personal characteristics of the particular officer are less significant although the Explanatory Memorandum states that the new provision did not change the law. The reason for this apparent contradiction was that there have been changes in Australian case law particularly in the insolvent trading cases,\textsuperscript{16} which now predicate a basic competence in relation to accounts and the monitoring of solvency. The new wording reinforces these changes. Secondly, the new wording supports the distinction between executive and non-executive directors recognised in recent case law. However, this distinction has been somewhat undermined by subsequent case law as we

\begin{footnotes}
\item Explanatory Memorandum, para 89.
\item Farrar (1993) CBLJ at 25.
\item See footnotes 7-10 supra.
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shall discuss later. Thirdly, although there is no statutory Business Judgment Rule there is a reinforcement in the Explanatory Memorandum of a Business Judgment Doctrine, that is, a judicial policy of unwillingness to second guess good business decisions which turn out badly, given basic honesty and competence, as opposed to decisions which are simply bad or self interested.  

II. THE NEW ZEALAND SECTION

As we have seen, this is contained in s 137 of the Companies Act 1993 which must now be read in conjunction with s 135 and s 136.  

Section 135 deals with reckless trading and s 136 deals with the duty in relation to incurring obligations in general. The latter provisions have no counterpart in the Australian legislation with the exception of s 588G of the Corporations Law which deals with preventing insolvent trading. All are limited to directors and do not apply to officers unless they behave as directors. Justice Tomkins in a valuable lecture given in 1994 at the University of Waikato said that the test is an objective test of a reasonable director judged in the same circumstances. The new section states expressly that there is to be taken into account the nature of the company, the nature of the decision, the position of the director and the nature of the responsibilities undertaken by him or her. His Honour referred to a change which had occurred in the Select Committee hearings. The Law Reform Division had inserted into the bill a considerably higher standard of care by requiring that a director in a professional occupation or possessing special skills or knowledge must exercise the care, diligence and skill that a reasonable director ‘in that profession or occupation or possessing those special skills or knowledge would exercise in the same circumstances’. This requirement has been deleted. In its place there is to be taken into account the particular matters which have been referred to above. The nature of the company allows one to consider factors such as the size and status of the company, whether it is a publicly listed company or a small incorporated firm. The nature of the decision allows one to consider the importance and significance of the decision or its routine nature. Clearly the greater the significance the greater the need for care. The reference to the position of the director and the nature of the responsibilities undertaken by him or her allows one to consider the executive or non-executive nature of the appointment although this will not necessarily be conclusive on the standard of care.

The relationship of s 137 to the earlier sections seems a bit problematic because of the degree of overlap and the reforms to the reckless trading provisions seem to render what was a reasonably clear and graduated law in the old s 320 of the Companies Act 1955 now rather obscure. At the same time one welcomes the additional provisions relating to delegation and advice which are contained in ss 130 and 138 and again which have no counterpart in the Australian statute law.

Section 130 expressly permits the Board to delegate its powers to a committee of directors, a director, an employee or other person subject to certain exceptions. No liability will be incurred in respect of improper acts

17 Farrar op cit 25-6.  
18 See Jones op cit and Tompkins op cit footnote 1 supra.  
19 Op cit at 28.  
20 Op cit at 29.  
provided the Board believed on reasonable grounds that the delegate would exercise the powers properly and the Board monitored the delegate’s performance by means of reasonable methods. Section 138 expressly deals with reliance provided the reliance is in good faith, after proper inquiry and there is no knowledge that reliance was unwarranted. Section 138 is based on the ALI’s Principles of Corporate Governance and has counterparts in state laws in the USA.

III. OUTSTANDING ISSUES

1. The objective/subjective distinction

In the past there has been a lot of confusion on this point. It has often been said that the case law duty and standard are to some extent subjective. This has always been an incorrect view. The standard is an objective standard but the question is the extent to which the particular characteristics of the director in question can be taken into account in formulating the characteristics of the class to which he or she belongs. Both the Australian and the New Zealand provisions now make it quite clear that the standard is objective but set out the particular factors that have to be taken into account in assessing the objective standard. The factors are similar but not identical. The Australian section does not expressly refer to the nature of the decision but this is almost certainly implicit in the new wording as the Explanatory Memorandum indicates.

2. Executive/non-executive director distinction

The old English case law as demonstrated by the judgment of Romer J in Re City Equitable Fire Insurance Co Ltd did not recognise any distinction between executive and non-executive directors. In 1991 Tadgell J in Commonwealth Bank v Friedrich and Others said that the Australian Companies Code (as it then was) ‘does not in terms distinguish between executive and non-executive directors or between paid and honorary directors ... There is nothing in the Code to suggest that the standard to be expected of a part-time non-executive director of a company not for profit is different from the standard expected of any other director of a profit making company; both are required ... to exercise a reasonable degree of care and diligence in the exercise of their powers and discharge of their duties’. His Honour added that in considering the availability of relief under the legislation it may be relevant to take into account the non-executive part-time nature of a particular director’s position.

In the AWA decision Rogers CJ at first instance dealt directly with the role of non-executive directors. In that case AWA sued its auditors for negligence following the discovering of substantial losses from various transactions conducted by a manager. AWA alleged that the auditors had failed to draw to the board’s attention serious inadequacies in the company’s system of internal control and accounting records. The auditors counter

22 Cf LCB Gower Principles of Modern Company Law 5th ed p 587.
23 On this question see Australian Senate, Company Directors’ Duties, Report by the Senate Standing Committee on Legal and Constitutional Affairs on the Social and Fiduciary Duties and Obligations of Company Directors, November 1987, Chapter 3.
24 [1925] 1 Ch 407.
26 (1992) 7 ACSR 463; 10 ACLC 933.
provisions, then I would agree that the Commission has become more active in those respects. That is an important part of the Commission’s role. But if those commentators are suggesting that the Commission is seeking to become a corporate policeman and to exercise a more extensive enforcement role, then my response is that the Commission does face pressure from many in the financial community to move actively to bring sanctions to bear on those who mislead the market or are involved in marketplace wrongdoings. The Commission has resisted that pressure. As I have earlier indicated its statute does not make it a corporate policeman. Those functions quite properly belong and are better dealt with by separate enforcement agencies such as the Commercial Affairs Division and the Serious Fraud Office. I prefer to see the Commission’s role as that of a referee whose job it is to see that the rules of the game are fair and are evenly applied, to blow the whistle when foul tactics are spotted, but to otherwise keep the ball in play.

There are certain respects in which the legislation requires the Commission, in order to carry out its regulatory functions effectively, to intervene and take regulatory action or make application to the Court in order to stop certain practices and secure compliance. Examples are the Commission’s long-standing powers to prohibit advertisements and to suspend or prohibit prospectuses, and its more recent power to apply to the court for an injunction and for permanent orders such as forfeiture where the Commission suspects that a substantial securityholder has not disclosed its position. In all of those cases, the Commission’s powers to intervene have been to promote a more orderly market and the penalising of the party involved has been incidental to that. I do not see that position changing.

4. Law Reform

On Colin Patterson’s death in February 1990, there were two structural reforms on which he was working which remained to be enacted. One was the establishment of an accounting standards review board with the function of approving accounting standards and an appropriate regime for enforcing financial reporting requirements. The other was the regulation of takeovers. The Financial Reporting Act 1993, although it did not adopt the recommendations in the Commission’s report of December 1989, gave substantial effect to them. The regulation of takeovers remains as unfinished business. In my time as Chairman the Commission came very near to securing legislation which would have given substantial effect to the recommendations made by the Commission in its report on company takeovers of October 1988. In the end through a combination of bureaucratic intransigence and very effective lobbying by a small section of the marketplace, the Takeovers Act 1993, although passed, was sidelined. The history of this matter is curious and provides an interesting commentary on the political process. In summary it went as follows:

1. Following the Commission’s report in late 1988 the then Minister of Justice announced that the report on takeovers would be implemented. The draft Bill was prepared and by early 1990 awaited only final policy clearance.

2. A committee of officials charged with recommending priority in commercial legislation recommended in mid-1990 that the Companies Act should first be enacted and the Takeovers Bill should have a low order of priority in the commercial law reform package. This ensured that the
Takeovers Bill would not be introduced into Parliament before the election in November 1990.

3. The new Government declined to adopt the Takeovers Bill and the new Minister sought advice from officials, the Commission and the Stock Exchange on an appropriate policy for takeovers. The outcome was a policy initiative by the Minister of Justice which had the support of the Securities Commission and of the Chairman of the Stock Exchange. This policy was carried through into the Takeovers Act 1993. It provided for the appointment of a Panel drawn from the marketplace which would advise on an appropriate Code having regard to certain guidelines set down in the legislation and the legislation would provide for the Panel to have certain enforcement powers and the ability to make application to the Court in order to support decisions of the Panel.

4. An advisory panel was appointed, a draft Takeovers Code was produced and circulated and at that time received generally supportive comment from the marketplace including the Stock Exchange.

5. When submissions were later received by the Takeovers Panel opposition to the Code was expressed by the Stock Exchange and by certain funds managers and the Business Roundtable.

6. When the draft Takeovers Bill came before Cabinet for a decision on its introduction to Parliament there was a sharp division among Ministers. The Minister of Justice was only able to secure the passage of the Takeovers Bill on the understanding that the Bill would not come into force and a Takeovers Code would not be implemented until there had first been time to evaluate whether the Companies Act provides for adequate regulation of takeover activity.

7. When after a lengthy period of consideration the Panel produced its final Takeovers Code for approval by the Minister of Justice, there was renewed and vigorous lobbying against the introduction of the Takeovers Code. After lengthy deliberations, Cabinet decided to defer the introduction of the Code.

We are therefore left with the situation in New Zealand where we have a Takeovers Act, a Takeovers Panel and Takeovers Code, none of which are in operation. The Takeovers Code hangs like the sword of Damocles over the marketplace available for introduction if there is a change of heart on the part of the government. In the meantime, listed companies are governed by the Stock Exchange regime. Having regard to the general quiescence of minority shareholders in the face of the choices which have been opened to listed companies, it can now be said to be desirable to give the Stock Exchange regime the opportunity of proving itself. The Companies Amendment Act 1963 continues on the statute book in relation to both listed and unlisted companies but compliance with that regime is very largely a voluntary matter. It should not be forgotten that there are some quite substantial companies which do not come under the Stock Exchange regime. In addition, there is no provision available to unlisted companies for compulsory acquisition by a bidder who acquires 90%.

IV. REFLECTIONS ON THE ROLE OF THE COMMISSION AND ITS FUTURE

One of the privileges of a former Chairman is the opportunity to muse and comment on the organisation he has left, knowing that he or she cannot be called to account. Knowing, therefore, that the Commission is not in any

accountant and even in the case of a non-accountant member of the Board he or she is only expected to demonstrate care as a member of the Board, not as an accountant. The responsibilities of an executive director who is an accountant would normally be defined by his or her service contract.

4. The juridical nature of the duty and its significance

Under both Australian and New Zealand law the present duty is statutory. The question is whether the case law duty which still coexists is a common law or equitable duty. The correct position seems to be that it is equitable but not fiduciary and this now overlaps with common law negligence. The English decision of Romer J in *Re City Equitable Fire Insurance Co Ltd* recognised the equitable origins of the duty. This was not a common law situation and indeed *Re City Equitable* preceded the formulation of a general duty of care in *Donoghue v Stevenson* which was decided seven years later. The duty is an incident of an equitable relationship but the content of the duty is not fiduciary. This has been clearly recognised by the Full Court of the Western Australia Supreme Court in *Permanent Building Society v Wheeler* in 1994. More sweeping statements about the common law nature of the duty were made by Clarke and Sheller JJA in the New South Wales Court of Appeal in *Daniels v AWA Ltd* but their statements are unhistorical and too wide. More correct analysis is to be found in the dissenting judgment of Powell JA. Their analysis causes Clarke and Sheller JJA to engage in a discussion of all the paraphernalia to be found in the common law duty of care. Such analysis was in fact irrelevant as there was no need to establish matters such as proximity since the duty already exists in equity and discussions of such matters are redundant. This view, however, still leaves open the question of whether an additional duty at common law can subsist with the statutory duties. Powell J thought that, although directors may in certain circumstances be liable to third parties for common law negligence, given the nature and extent of the duties imposed upon directors by both the general law and the statute no sufficient case had been made out for imposing an additional duty of care at common law.

The question arises as to why this is still relevant in the modern law. The judgment in *Permanent Building Society v Wheeler* shows that these questions are still relevant because that case showed a distinction between the common law and equity on the question of causation in the case of breach of fiduciary duty. Strict liability ensues from breach of a fiduciary duty in equity. This is not so at common law nor in respect of an equitable duty which is non-fiduciary. Other possible significances of the distinction are the impact of equitable delay, limitation and waiver. The question of whether equitable negligence is covered by contributory negligence legislation is also problematic although the modern tendency in the cases is to assume that it is covered. Clearly it should be even if it is not.

39 [1925] 1 Ch 407. But see also *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392 at 435 per Lindley MR.
40 [1932] AC 562.
43 Ibid 727 et seq.
44 Ibid 744.
45 (1994) 12 ACLC 674.
5. Consequences of a breach

Recent cases have shown that if directors are negligent this will enable the company to sue them for breach and their breach may constitute the company’s breach for the purpose of contributory negligence. This is of particular significance with regard to claims against auditors. There are, however, additional and different consequences which can result in Australia. The original legislation in 1958 not only codified the duty of care but criminalised breach. The 1992 amendments removed criminality in the absence of mens rea but still retained the concept of civil penalty. Breach of the section can constitute a civil penalty situation. This can lead to disqualification and/or a fine.

6. Finally, do we need a Business Judgment Rule?

In the lead up to the Australia reforms of 1992 and the enactment of the New Zealand Companies Act 1993 there were calls by the business community in both countries for the enactment of a United States style of Business Judgment Rule. There was considerable confusion as to what exactly was the nature of such a rule but the work of the American Law Institute on its Principles of Corporate Governance provided some clarification of the concept. This formulated the basic Business Judgment Rule as follows:

A director or officer who makes a business judgment in good faith fulfils the duty under this section if the director of officer (1) is not interested in the subject of the business judgment; (2) is informed with respect of the subject of the business judgment to the extent to the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interest of the corporation.

Such a rule exists under the case law of the various United States jurisdictions and now has been codified to some extent in the Virginia Stock Corporations Act, 13.1-690A which provides that ‘A director shall discharge his duties as a director ... in accordance with his good faith business judgment of the best interests of the corporation’. In the ALI formulation the rule gives an immunity from liability for negligence to directors who satisfy the three prerequisites. Neither the Australian Federal Parliament nor the New Zealand Parliament decided to enact a Business Judgment Rule. We have seen above how the Australian Parliament dealt with the matter by adopting amendments which clarify the law and including material in the Explanatory Memorandum which gave a green light to the courts to develop a case law Business Judgment Rule in Australia. At the same time there was

49 S 1317 DA.
50 See J H *Farrar* “Corporate Governance, Business Judgment and the Professionalism of Directors” (1993) CBLJ 1. See also the Senate Standing Committee on Legal and Constitutional Affairs Report (footnote 23 supra), Chapter 3 and the Companies and Securities Law Review Committee Report No 10 Company Directors and Officers: Indemnification, Relief and Insurance para [75].
a tightening up of related party transactions in the new Part 3.2A of the Corporations Law. In New Zealand the approach was different. The only reference to a Business Judgment Rule in the 1993 Act is in the long title in paragraph (d) which provides that an object of the Act is "to encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power". New Zealand opted for the rather loosely worded Canadian model on self interested transactions in s 141 which turns ultimately on fair value. In both Australia and New Zealand there have been increasing pressures on the courts to expect more of company directors. At the same time the Australian courts have begun to recognise the legitimacy of some degree of risk taking in business judgment. In the words of the majority in *Daniels v AWA Ltd*.

The courts have recognised that directors must be allowed to make business judgments and business decisions in the spirit of enterprise untrammelled by the concerns of a conservative investment trustee. Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate but ephemeral, political insights, a feel for future economic trends, trust in the capacity of other human beings. Great risks may be taken in the hope of commensurate rewards. If such ventures fail, how is the undertaking of it to be judged against an allegation of negligence by the entrepreneur?

Consistent with their view of the duty as a common law duty their Honours thought that the law of negligence could accommodate differing degrees of duty subject to the ultimate test resting 'upon a general public sentiment of moral wrong doing for which the offender must pay'.

The recent trend in Antipodean case law in general insolvent trading cases has been increasingly rigorous and many of the cases have contained general statements which have been used by the courts in tightening the law on the duty of care. Such rigour is in fact potentially inconsistent with an increased recognition of the legitimacy of risk taking and a United States style of Business Judgment Rule. On the other hand, judging by the United States experience, the introduction of a Business Judgment Rule, without tightening up on disclosure requirements and the effective policing of self interested transactions could be disastrous for investors. The United States pursues more coherent corporate law policies of latitude for business error balanced by rigorous policing of self-interested transactions. In Australia and New Zealand the matter of business judgment has now been left to the courts to strike the appropriate balance against a background of differing approaches to the regulation of self interested transactions. This is not an easy task for the courts and there is the risk that, like the old English War Office, they will always be busy preparing for the previous war. Society has constantly to balance the demands of efficiency and fairness in its corporate law. Efficiency is predicated because the company is a firm operating in various markets in an increasingly internationally competitive environment

53 See generally Farrar op cit 23 et seq.
55 See Sievers op cit (footnote 1) supra.
and fairness is predicated because of the public interest in the goals of investor and creditor protection and the integrity of capital markets."