perspective (which might be called the stakeholder perspective of corporate governance) focuses upon companies being "socially responsible" and often subordinating profit maximisation to other goals. It can, therefore, be seen that the corporate governance debate is intrinsically linked to the important question: For whom do directors govern? Do they govern for shareholders or for a broader range of stakeholders? This issue is further discussed below: see 1.41 and 1.42.

Why is corporate governance an issue?

1.5 According to Oliver Hart,[9] corporate governance issues arise in an organisation whenever two conditions are present. First, there is a conflict of interest (or an agency problem), involving members of the organisation; and, second, the conflict of interest or agency problem cannot be dealt with through a contract. In relation to the second point, Hart observes that there are several reasons why contracting to overcome agency problems might not always be possible. In particular, it is not possible to contract to cover all eventualities. In addition, there are costs associated with negotiating contracts and enforcing them. This means that there will not always be comprehensive contracts governing participants in companies.

What are some of the conflicts that may exist in companies? Many can be identified. For example, conflicts may arise between:

- managers (including the chief executive officer) and directors — particularly between managers and non-executive directors over issues such as the appropriate level of remuneration for managers;[10]
- shareholders and directors and/or managers over issues relating to the degree of effort and loyalty expected of directors and managers;
- creditors and shareholders in relation to issues such as:[11]
  - payment of excessive dividends,
  - claim dilution (through taking on debt with similar or higher priority),
  - asset substitution (for example, substituting saleable for non-saleable assets),

9. O Hart, "Corporate Governance: Some Theory and Implications" (1995) 105 *Economic Journal* 678.
10. Although some of the early corporate governance literature viewed managers and directors as one group, it is clear that each may have separate interests and, therefore, should generally be viewed as being different stakeholders in public companies. Of course, in many small companies, the same people may be the managers and directors. In addition, it may not always be correct to view non-executive directors as having similar interests. Some directors may be representatives or nominees of particular groups of stakeholders such as shareholders, creditors or employees. The interests of these stakeholders may conflict.
11. The following four sources of conflict are identified in C W Smith and J B Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979) 7 *Journal of Financial Economics* 177.

  - excessive risk-taking (whereby shareholders in a leveraged company have incentives to invest the company's resources in risky projects: if a project is successful, the excess returns will be distributed among the shareholders as dividends but will not be shared with the creditors who are only entitled to a fixed return on their investment. Company losses, however, are shared among both creditors and shareholders);
- employees and managers/directors/shareholders over issues such as wages and other conditions of employment;
- shareholders themselves (for example, between small shareholders and large institutional shareholders); and
- different types of creditors (for example, between secured and unsecured creditors).

A key objective is to minimise these conflicts and there are a number of corporate governance mechanisms that may operate to achieve this.

Mechanisms that play a role in corporate governance

1.6 A number of mechanisms play a role in corporate governance by operating to ensure that companies are directed and controlled in a manner that protects and promotes the interests of participants. Each will have a different degree of influence in relation to particular companies. The mechanisms include:

- ***Directors' and officers' legal duties*** which have, as their objective, ensuring that directors and officers act with reasonable care and diligence, in the interests of the company, and for a proper purpose.[12] A detailed examination of these duties, and their enforcement, is the focus of this book.
- ***The structure of the board***, including matters such as the proportion of non-executive directors constituting the board and the splitting of the positions of chairperson of the board and chief executive officer. An important question is whether non-executive directors are better at monitoring managers on behalf of members than their executive counterparts.[13]
- ***Auditors***, who assist in the monitoring of managers by attesting to the accuracy of companies' financial statements.
- ***Institutional investors***. A major debate is occurring regarding the extent to which institutional investors are effective monitors of the companies in which they invest. This is an important issue given that institutional

12. These duties are discussed in Chs 6–15.
13. For a review of the theoretical and empirical literature, see G Stapledon and J Lawrence, "Board Composition, Structure and Independence in Australia's Largest Listed Companies" (1997) 21 *Melbourne University Law Review* 150. See also A Klein, "Firm Performance and Board Committee Structure" (1998) 41 *Journal of Law and Economics* 275.

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- ensure a balance of authority so that no single individual has unfettered powers.

How to achieve best practice

Recommendation 1.1: Formalise and disclose the functions reserved to the board and those delegated to management.

Principle 2: Structure the board to add value

1.22 Have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties. An effective board is one that facilitates the efficient discharge of the duties imposed by law on the directors and adds value in the context of the particular company's circumstances. This requires that the board be structured in such a way that it:

- has a proper understanding of, and competence to deal with, the current and emerging issues of the business; and
- can effectively review and challenge the performance of management and exercise independent judgment.

Ultimately the directors are elected by the shareholders. However, the board and its delegates play an important role in the selection of candidates for shareholder vote.

How to achieve best practice

Recommendation 2.1: A majority of the board should be independent directors.

Recommendation 2.2: The chairperson should be an independent director.

Recommendation 2.3: The roles of chairperson and chief executive officer should not be exercised by the same individual.

Recommendation 2.4: The board should establish a nomination committee.

Recommendation 2.5: Provide the information indicated in "Guide to reporting on Principle 2".

An independent director is defined in the Principles as a non-executive director who:

- is not a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company;
- within the last three years has not been employed in an executive capacity by the company or another group member, or been a director after ceasing to hold any such employment;
- within the last three years has not been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided;
- is not a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer;

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- has no material contractual relationship with the company or another group member other than as a director of the company;
- has not served on the board for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company; and
- is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.

Principle 3: Promote ethical and responsible decision making

1.23 Actively promote ethical and responsible decision making. The company should:

- clarify the standards of ethical behaviour required of company directors and key executives (that is, officers and employees who have the opportunity to materially influence the integrity, strategy and operation of the business and its financial performance) and encourage the observance of those standards; and
- publish its position concerning the issue of board and employee trading in company securities and in associated products which operate to limit the economic risk of those securities.

How to achieve best practice

Recommendation 3.1: Establish a code of conduct to guide the directors, the chief executive officer (or equivalent), the chief financial officer (or equivalent) and any other key executives as to:

3.1.1 the practices necessary to maintain confidence in the company's integrity

3.1.2 the responsibility and accountability of individuals for reporting and investigating reports of unethical practices.

Recommendation 3.2: Disclose the policy concerning trading in company securities by directors, officers and employees.

Recommendation 3.3: Provide the information indicated in "Guide to reporting on Principle 3".

Principle 4: Safeguard integrity in financial reporting

1.24 Have a structure to independently verify and safeguard the integrity of the company's financial reporting. This requires the company to put in place a structure of review and authorisation designed to ensure the truthful and factual presentation of the company's financial position. The structure would include, for example:

- review and consideration of the accounts by the audit committee; and
- a process to ensure the independence and competence of the company's external auditors.

Such a structure does not diminish the ultimate responsibility of the board to ensure the integrity of the company's financial reporting.

Aspects of corporate law theory and implications for governance

Theories of the company and governance: managerialist or contractual

1.41 Recent corporate law debates focus upon two alternative theories of the corporation. The first is the institutionalist or managerialist theory of the corporation. The second is termed the contractual theory of the corporation. The essential features of each of these theories are briefly described. Each theory has different implications for corporate governance. They are similar to the extent to which each has, as its central concern, corporate governance. In particular, each theory endeavours to formulate ways to ensure that directors and managers of companies act in the interests of shareholders. However, they differ fundamentally with respect to how this objective is to be accomplished.

The institutionalist or managerialist theory of the corporation emphasises the importance of corporate management and the power that it wields. The issue is whether management holds and exercises this power legitimately. Critics of management argue that managers often exercise power without accountability to shareholders. In public companies, shareholders are unable to monitor effectively the managers of their companies. The result is that, under this theory, legal intervention is needed to protect the interests of shareholders.

Central to accomplishing this accountability is the imposition of mandatory legal duties upon directors and other officers. These duties include duties to exercise care and diligence, to act in good faith, not to make improper use of information acquired by virtue of being an officer of the company and not to make improper use of position as an officer of the company: ss 180ff; see Chapters 6–10. A second aspect of managerial accountability achieved through legal regulation is the imposition of disclosure obligations upon corporate officers. These disclosure obligations apply both generally — for example, where a director has a personal interest in a matter that is before the board of directors (ss 191ff — see Chapter 8) or is providing information for a meeting of members (see Chapter 12) — and in specific contexts such as where the company is raising capital from investors (Ch 6D of the Corporations Act — see Chapter 13). Finally, enforcement of these legal duties and obligations is important to ensure managerial accountability. This enforcement may be undertaken either by the company itself (where duties are owed to the company rather than to individual shareholders), by shareholders or by the Australian Securities and Investments Commission (see Chapters 18–19).

A different view of the role of corporate law is inherent in the contractual theory of the corporation. The contractual theory emphasises the importance of market forces in aligning the interests of corporate managers and

shareholders rather than legal rules. The theory is based upon the works of Coase, Fama, Jensen and Meckling.[36]

According to the contractual theory, competitive markets are more important than mandatory legal rules in providing managers with appropriate incentives to maximise shareholder wealth. These markets include the product market, the market for corporate control and the managerial labour market. The contractual theory does not imply the absence of legal rules. Rather, the theory asserts that market forces require managers to act in the interests of shareholders. This means there is less need for mandatory corporate law rules imposed by government which have the objective of requiring managers to act in the interests of shareholders.

Clearly, the validity of the contractual theory depends upon the efficiency of the markets. With respect to the product market, adherents to the theory argue that management must ensure that the company competes effectively in the market for the company's goods and services. Otherwise the company will lose business and may be forced into liquidation. Critics of the theory argue that the product market will not always be competitive, with the result that the company can be operating inefficiently without this inefficiency being disciplined by the market.

The market for corporate control will also operate to discipline managers. If a company is operating inefficiently this should be reflected in the company's share price. This creates an opportunity for a raider to take over the company, install more efficient managers and thereby profit. Yet there are limits on the effectiveness of the market for corporate control. If the inefficiency in the management of the company results in only a minor reduction in the company's share price, this means that the likelihood of a takeover is increased to only a limited degree. Indeed, Bebchuk[37] asserts that the market for corporate control cannot be relied upon to discourage managers from taking action that increases their wealth at the expense of shareholders. Further, Coffee[38] has argued that the market for corporate control applies only within a limited range. Companies in which the degree of inefficiency is not extreme enough to create a sufficient reduction in the share price to cause a takeover, and companies in which the degree of inefficiency is so extreme as to preclude a takeover because it is such a risky undertaking, fall outside this range and the market for corporate control may only weakly discipline these companies.

Another market force which may operate to discipline management is the managerial labour market. Any reduction in shareholder value because of

36. Coase, "The Nature of the Firm" (1937) 4 *Economica* 387; Fama, "Agency Problems and the Theory of the Firm" (1980) 88 *Journal of Political Economy* 228; Jensen and Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

37. Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law" (1992) 105 *Harvard Law Review* 1437.

38. Coffee, "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 *Columbia Law Review* 1145.

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Significance of a company's power to alter its constitution

2.66 A company has statutory power to alter its constitution (s 136) and it cannot bind itself in a manner which prevents it from altering its constitution; despite any contract that it will not alter its constitution, an alteration will be valid once made. However, a company acting on the basis of an altered provision in its constitution may be acting in breach of contract, and the other party to the contract may accordingly be entitled to recover damages from the company: *Bailey v New South Wales Medical Defence Union Ltd* (1995) 132 ALR 1; 18 ACSR 521; 13 ACLC 1698 at 1702, per Brennan CJ, Deane and Dawson JJ.

The relationship between the constitution and the terms of a contract made between the company and another party is a matter of construction of the contract in the relevant circumstances of the case: *Bailey's* case, ACLC at 1708 per McHugh and Gummow JJ. Broadly speaking, there are three possibilities. First, the contract may be constituted by the constitution with no external facts, as part of the statutory contract under s 140 of the Corporations Act. The subject-matter of the statutory contract is limited to the governance of the corporation and the exercise of its constitutional powers, and does not extend to commercial rights: *Bailey's* case, ACLC at 1718 per McHugh and Gummow JJ. While this is a possible outcome in the case of some contracts, the contract between a company and its managing director is not part of the statutory contract constituted by membership of the company.

The second possibility is a contract which is external to the constitution expressly or impliedly importing one or more terms of the constitution in alterable form. If a managing director has no express service contract and consequently no external agreement for employment for a stated period, but there are relevant provisions in the company's constitution, it is likely that the court will construe the contractual arrangement as importing the relevant terms of the constitution in alterable form. Consequently, the company will not be in breach of contract if it alters the constitution to facilitate dismissal, and then dismisses the managing director on the basis of the altered constitution.

In *Shuttleworth v Cox Bros and Co (Maidenhead) Ltd* [1927] 2 KB 9 the plaintiff had been appointed under the constitution as a director for life unless disqualified on specified grounds. The constitution was later altered to add a further ground and he was dismissed on that ground. It was held that the company was not in breach of contract. Any contract with the plaintiff was subject to any alteration of the constitution permitted by the companies legislation.

In such a case "the articles do not themselves form the contract, but from them you get the terms upon which the director is serving": *Swabey v Port Darwin Gold Mining Co* (1889) 1 Meg 385 per Lord Esher. In *Hunt v Carrier Australasia Ltd* (1938) 39 SR (NSW) 12 at 16 (appeal dismissed (1939) 61 CLR 534) Jordan CJ described *Shuttleworth v Cox* as a case of "an agreement constituted solely by the articles of association themselves, not supplemented by any external facts, and therefore inherently and necessarily alterable in the manner provided by the Statute". Even in such a case the company cannot, by amending its constitution retrospectively, abrogate the vested or accrued rights or interests of the other party to the contract: *Bailey v New South Wales Medical Defence Union Ltd* (1995) 132 ALR 1; 18 ACSR 521; 13 ACLC 1698 at 1713 per McHugh and Gummow JJ. It appears that an attempt to do so will be invalid, notwithstanding the unqualified language of s 136, and not merely a breach of contract sounding in damages.

The third possibility is where the company and the managing director have entered into an identifiable contract outside the constitution which is inconsistent with a provision of the constitution as in force at the date of the contract or a provision subsequently introduced by amendment. In such a case, the court must determine, as a matter of construction, whether the parties intend at the time of contract that the contractual terms are to prevail over the present, or the present and future, provisions of the constitution. The mere fact that the constitution is inherently alterable under s 136 does not resolve the issue of construction: *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 at 671–4.

Thus the court may solve the problem by finding an implied term in the service contract to the effect that the company will not exercise the power of alteration of the constitution to put an end to the contract.

In *Southern Foundries (1926) Ltd v Shirlaw* [1940] AC 701 S was appointed managing director of X company for 10 years by a written agreement. The agreement was not expressed to be subject to the constitution. The constitution set out various grounds on which the office of director would be vacated "subject to the terms of any subsisting agreement". The constitution also provided that if the managing director should cease to be a director, he would automatically cease to be managing director. After Y company obtained voting control of X company, the constitution was altered so as to empower Y company to remove any directors of X company. S was removed from his directorship and this terminated his appointment as managing director. The House of Lords held by a majority of three to two that S was entitled to damages for wrongful dismissal. The majority considered that conduct of the company which rendered it incapable of performing its promises in the contract was a breach of contract.

Agreement which incorporates provisions of constitution relating to managing director

2.67 Suppose that there is a service agreement for a specified period and the agreement, expressly or impliedly, incorporates the provisions of the constitution relating to a managing director. There is then a question of construction as to whether the company has the right to alter the contract unilaterally, by the board exercising a power to revoke the appointment conferred by the constitution. It may be that the construction of the constitution solves the problem.

In *Nelson v James Nelson & Sons Ltd* [1914] 2 KB 770 the constitution empowered the directors to appoint one of their number as managing

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retirement benefits to a non-executive director within the limits allowed by Pt 2D.2 of the Corporations Act: see Ch 15.

The ASX Corporate Governance Council has expressed some "best practice" views about directors' remuneration in listed companies.[11] There are guidelines as to the appropriate framework for determining executive remuneration packages, which distinguish between fixed remuneration, performance-based remuneration, equity-based remuneration and termination payments. Recommendation 9.3 advises that there should be a clear distinction between the structure of the non-executive directors' remuneration and the structure of the remuneration for executive directors. In the case of non-executive directors, the Council recommends remuneration by way of fees without participation in executive remuneration schemes, without options or bonus payments, and without retirement benefits other than statutory superannuation.

Excessive remuneration may be challenged under the oppression remedy contained in Pt 2F.1: *Sanford v Sanford Courier Service Pty Ltd* (1987) 10 ACLR 549. In the case of directors of public companies, Ch 2E makes special provision for the payment of remuneration. Chapter 2E is discussed in Ch 15 of this book. The ASX Listing Rules impose further requirements for listed companies. The provisions of Ch 2E and the Listing Rules may lead to a requirement for shareholder approval.

There are also extensive disclosure requirements for director remuneration, under the Corporations Act and (for listed entities) the ASX Listing Rules. The disclosure requirements do not directly affect the directors' rights, but knowledge that disclosure is required is likely to shape the agreed entitlements.

Under s 202B a company is required to disclose remuneration paid to each director of the company or a subsidiary, by the company itself or a controlled entity, if directed to do so by at least 100 members or members with at least 5% of the votes that may be cast at a general meeting.

The Act[12] requires a listed company to include in the annual directors' report a discussion of board policy for determining the nature and amount (or value) of the remuneration of directors, secretaries and senior managers: s 300A(1)(a)(i). If an element of the remuneration is dependent on satisfaction of a performance condition, details of the performance condition must be given, together with an explanation of why the methods of satisfaction of the condition were chosen, and a summary of the factors used in any external comparisons: s 300A(1)(b). The Act also requires details in relation to the remuneration of each director and each of the five named company executives who received the highest remuneration for the year, and various particulars about performance conditions in their remuneration: s 300A(1)(c). The Act makes it specifically clear that if consolidated

11. *Principles of Good Corporate Governance and Best Practice Recommendations*, March 2003, Recommendations 9.1–9.5.
12. As amended, effective from 1 July 2004, by the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004.

financial statements are required and the person is a group executive of two or more entities in the consolidated entity, that person's remuneration includes the remuneration from each of those entities: s 300A(4).

Section 250SA provides that at a listed company's annual general meeting, the chairman must allow a reasonable opportunity to the members as a whole to ask questions about, or make comments on, the remuneration report (that part of the directors' report in dealing with remuneration matters). Under s 250R, a resolution that the remuneration report be adopted must be put to the vote at the annual general meeting, but the vote on the resolution is advisory only and does not bind the directors or the company.

The requirement for a non-binding vote on the remuneration report is novel. It has been described as a "chocolate teapot".[13] It has been supported on the ground that it presents shareholders with an opportunity to place their views on record in order to guide the directors and inform them of their expectations.[14]

One can anticipate that the debate at the annual general meeting, required by s 250SA, will be dominated by small shareholders and will have limited impact on remuneration practices. But the "non-binding" vote, required by s 250R, could prove to be significant, because it may crystallise opposition on the part of institutional shareholders who might otherwise be acquiescent.

There are some recommendations as to the content and presentation of disclosure of remuneration in Principle 9 of the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations* (March 2003). There is also an Australian Accounting Standard on disclosure of remuneration: AASB 1046.

Participation in board decisions

4.6 The right of a director to participate in board decisions, by receiving notice of board meetings, attending and voting, or signing a written resolution, is found in the corporate constitution. Typically there are provisions authorising the director to call a meeting by giving a reasonable or specified period of notice to each other director (see s 248C — replaceable rule), for decisions to be made by majority vote at a meeting of directors (see s 248G(1) — replaceable rule), for directors' meetings to be called or held using any technology consented to by all directors (see s 248D — replaceable rule), and to allow resolutions to be adopted by each director signing a written resolution (see s 248A — replaceable rule). These provisions are enforceable by every director against the company under s 140(1).

In the absence of a clear contrary provision in the constitution, each director is entitled to notice of a board meeting, even if he or she is overseas, provided that the director can be reached by notice (having regard to

13. Parliamentary Joint Committee on Corporations and Financial Services, *Report on the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Part 1)* (4 June 2004), para 5.33.
14. Parliamentary Joint Committee on Corporations and Securities, op cit, para 5.43.

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two defendant directors were directors of Girvan Corp Ltd, Girvan Corp (New Zealand) Ltd and Maronis Holdings Ltd.

Nippon Credit provided a loan of $15m to Girvan Corp Ltd. The loan was to be used exclusively by Girvan Corp Ltd and was of no commercial benefit to Maronis Holdings Ltd. The two defendant directors caused Maronis Holdings Ltd to mortgage the company's property to Nippon Credit to secure the loan to Girvan Corp Ltd. At the time the security was provided, Duncan and Ambler were aware that Girvan Corp Ltd was experiencing serious cash-flow problems and there was a real possibility that it might not be able to discharge the loan of $15m. The two defendant directors did not consider what protection Maronis Holdings Ltd needed against the risk of Girvan Corp Ltd defaulting on the loan.

Bryson J found:

- The powers of directors of a company must be used for the purposes of that company.
- This does not preclude the exercise of a power with a view to an advantage to be received by another company if the transaction is one for the benefit of the company entering into it. The benefit need not be direct and immediate; it may arise indirectly. The purpose of obtaining an advantage for a related company does not necessarily result in a breach of duty. There would not be a breach of duty where a benefit is derived from a transaction by two or more companies or if the company entering into the transaction receives some indirect benefit. Considering the interests of the group does not automatically result in a breach of duty. What does result in a breach of duty is lack of regard for the interests of the company entering into the transaction.
- A reasonable person in the position of a director of Maronis Holdings Ltd would have been aware that there was a real possibility that Girvan Corp Ltd would be unable to discharge the loan to Nippon Credit.
- The two defendant directors did not consider the interests of Maronis Holdings Ltd when having that company grant security for the loan to Girvan Corp Ltd. The interests of Maronis Holdings Ltd were wholly disregarded by the defendant directors and no person in the position of a director of Maronis Holdings Ltd could have reasonably believed that the transaction was for the benefit of Maronis. The company obtained no tangible benefit from the loan yet gave security over all its assets without obtaining protection of any kind.

In *Sydlow Pty Ltd (in liq) v Melwren Pty Ltd (in liq)* (1994) 13 ACSR 144 at 147, Santow J found that the process by which two directors restructured operations within a group breached their duty to act in good faith for the benefit of Sydlow (S).

In that case, the group restructure resulted in one of the companies, S, of which the two defendants were directors, relinquishing its assets to another group company. The recipient company was to carry out the operations. No consideration was provided by the recipient company to S other than an agreement to guarantee S's overdraft. His Honour found that the

directors' decision to relinquish assets in such circumstances amounted to a breach of their duty to S, as being an act not in the best interests of S.

These principles have an obvious practical application to intra-group loans and guarantees. In this context, legal practitioners often summarise the case law by referring to the requirement of "commercial benefit" where a loan is made by one group company to another or a guarantee is given by one group company in respect of a loan of another group company. In respect of loans from the parent company to a subsidiary or the parent guaranteeing a loan to a subsidiary,[19] it can usually be seen that the transaction is made in the interests of the parent since the financial return to the parent through dividends from the subsidiary may be enhanced by a transaction that adds to the subsidiary's resources. But, where it is an "upstream" loan or guarantee given by a subsidiary to or for the benefit of the parent, the advancement of the subsidiary's interests may be less apparent:[20] *Charterbridge Corp Ltd v Lloyds Bank Ltd*, above; *ANZ Executors and Trustees Co Ltd v Qintex Ltd* (1990) 2 ACSR 307; 8 ACLC 791; *ANZ Executors and Trustees Co Ltd v Qintex Australia Ltd (recs & mgrs apptd)* [1991] 2 Qd R 360; (1990) 2 ACSR 676 at 687; 8 ACLC 980 at 989. Where the loan or guarantee is made or given in respect of a sibling company, the advancement of the interests of the lender or guarantor may not be easy to discern: *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd* (1972) 5 SASR 386 at 402; (1972) CLC 40–074.[21]

Where a director of a parent company acts in a way which is not in the best interests of a subsidiary company of which he or she is not a director, it does not follow that the act is invalid. The director is a fiduciary in relation to the parent company but is not in a fiduciary relationship with the subsidiary company, at least where the subsidiary has an independent board: *Lindgren v L & P Estates Ltd* [1968] Ch 572.

It may seem commercially unrealistic to refuse to treat the group as a single financial entity. But until such time as the law is changed so that each member of a group is made liable for the debts of another member (cf *Qintex Australia Finance Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267; 9 ACLC 109), each member of the group must be treated as a separate estate.

In its *Report on Reform of the Law Governing Corporate Financial Transactions* (July 1991), the Companies and Securities Advisory Committee expressed concern that "the lack of specific provisions regulating inter-corporate loans could be interpreted as a statutory licence to make these loans, without sufficient consideration by directors of their legal duties". The report eventually led to the enactment of Pt 3.2A of the former Corporations Law (now Ch 2E of the Corporations Act). Chapter 2E is discussed more fully in Ch 15. It should be noted here, however, that one of the applications of s 208 is to prevent a subsidiary or other "child entity" of a public company from giving financial benefits to related parties of its public company parent

19. Morgan [1970] *JBL* 256.
20. Astley (1967) 41 *ALJ* 368.
21. Armitage, "The Debenture Trust Deed" in R P Austin and R J Vann (eds), *The Law of Public Company Finance*, Law Book Co, Sydney, 1986, p 292.

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Although the statutory exemption is available, in such a case there may be a breach of general law fiduciary duty.

(iii) *relates to a contract the company is proposing to enter into that is subject to approval by the members and will not impose any obligation on the company if it is not approved by the members*

The idea seems to be that where the effective decision is to be made by the members, the director's disclosure obligation is to the members rather than to the board.

(iv) *arises merely because the director is a guarantor or has given an indemnity or security for all or part of a loan (or proposed loan) to the company*

(v) *arises merely because the director has a right of subrogation in relation to a guarantee or indemnity referred to in subparagraph (iv)*

These exemptions protect the interests of financiers, when they require a director guarantee to support their loan to the company. The guaranteeing director obviously has a material personal interest in a proposal to obtain finance subject to his or her guarantee. If the director gives a guarantee, and is required to honour it, he or she is subrogated to the rights of the financier to any security against the company and again has an obvious material personal interest. It appears that the director's interest is disregarded because the benefit to the company from having access to finance can outweigh the possibility of harm from the conflict of interest and duty. But the exemption does not protect the director from liability under the fiduciary rules of the general law, which might arise, for example, if the director supports a proposal for the company to give more security for the loan than is commercially necessary, in order to lessen the possibility of the guarantee having to be honoured.

(vi) *relates to a contract that insures, or would insure, the director against liabilities the director incurs as an officer of the company (but only if the contract does not make the company or a related body corporate the insurer)*

(vii) *relates to any payment by the company or a related body corporate in respect of an indemnity permitted under section 199A or any contract relating to such an indemnity*

There is no need to insist upon disclosure of the director's obvious interest in a proposal to obtain directors' and officers' insurance, and it would be inappropriate to exclude the directors who will benefit from the proposed insurance from participating in the decision to obtain it. It is likewise thought to be inappropriate to require disclosure and prevent participation in decision-making where the proposal is for the company to make a payment in respect of a permitted indemnity of directors.

(viii) *is in a contract, or proposed contract, with, or for the benefit of, or on behalf of, a related body corporate and arises merely because the director is a director of the related body corporate*

This is a case, like (i) above, where the exemption is probably not necessary, because merely being a director of another entity, to which the

proposal before the board relates, is unlikely to give the director a material personal interest, unless there are additional facts (such as that as a director of the other entity, the director stands to gain a special bonus if the transaction proceeds). The specific idea underlying this exemption appears to be that a common director of two related bodies corporate in substance serves only one master. That is a plausible view where the two related bodies are a holding company and a wholly owned subsidiary, or sibling wholly owned subsidiaries of the one holding company, but the exemption goes further by extending to the case where one of the entities is a partly owned subsidiary.

The director need not give notice of an interest under s 191(1) if the company is a proprietary company, and the other directors are aware of the nature and extent of the interest and its relation to the affairs of the company: s 191(2)(b). It is noteworthy that this exemption is confined to proprietary companies, although similar reasoning was applied to the interpretation of a constitutional disclosure requirement in a public company, in *Woolworths Ltd v Kelly* (1991) 22 NSWLR 189; 4 ACSR 431. Perhaps the statutory provision excludes public companies, not through any view that they should be forced to make unnecessary disclosure, but because the exemptions in s 191 flow on to s 195 as well, by virtue of s 195(1A)(b). It may be thought necessary to exclude the director from participating and voting even if the interest is known to the other directors, unless they positively resolve to allow the interested director to participate.

There are also exemptions for directors who renew their notices of interest when there is a change in board composition, or where they give a standing notice: s 191(2)(c) and (d). They are considered below.

The contents and timing of the notice

8.32 Section 191(1) requires a director who has a material personal interest to give the other directors "notice of the interest". Under the former s 231, it was enough to declare only "the nature of the interest", but now s 191(3) is more demanding. It requires that the notice must give "details" of "the nature and extent of the interest", and "the relation of the interest to the affairs of the company". The notice is not required to be a written notice, but the details must be recorded in the minutes of the directors' meeting.

The statutory language might seem daunting for the person preparing the notice, but the purpose of the requirement is clear enough. The other directors must be told enough about the position of the interested director that they can understand the scope of the benefit and potential profit to the director: *Camelot Resources Ltd v MacDonald* (1994) 14 ACSR 437. Obviously, as Santow J observed in that case, "mere suggestions" at a meeting of directors will be insufficient. But it is unnecessary to disclose detail for detail's sake. It is still correct that "the amount of detail must depend in each case upon the nature of the contract or arrangement proposed and the context in which it arises": *Gray v New Augarita Porcupine Mines Ltd* [1952] 3 DLR 1 at 14.

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think the members should have, remembering that there are problems in presentation, such that too much information can pose difficulties for members as much as too little information: *Buttonwood Nominees Pty Ltd v Sundowner Minerals NL* (1986) 10 ACLR 360; further, see Ch 11.

Where the members in general meeting consider a proposal to give consent, can interested directors use the voting power of any shares held by them? An affirmative answer, provided there is no improper dealing with the company's property, was given in *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589; see also *Burland v Earle* [1902] AC 83.

However, there is a strong legislative and regulatory trend to exclude interested parties from voting at members' meetings. Examples can be found, in the Corporations Act, in the related party provisions (see s 224), selective reductions of capital (s 256C), selective buy-backs (s 257D), financial assistance (s 260B), and acquisitions exceeding the 20% threshold with approval by resolution of the members of the target (s 611, item 7).

There are some important ASX Listing Rules which require that certain transactions be approved by members' meetings. The Listing Rules generally stipulate that the notice of the meeting must include a "voting exclusion statement". For example, the Listing Rules require prior member approval and a voting exclusion statement for directors to acquire securities under an employee incentive scheme: LRs 10.14 and 10.15. Again, the Listing Rules require prior member approval and a voting exclusion statement for certain substantial transactions between the listed entity or entities with which it is associated, and its related parties (including directors): LRs 10.1 and 10.1; *TNT Australia Pty Ltd v Poseidon Ltd (No 2)* (1989) 15 ACLR 80. The requirements for a voting exclusion statement are explained in LR 14.11.

It has been suggested that the trend towards excluding interested parties from voting at members' meetings, in statutory and regulatory contexts, will eventually be recognised in the general law, with the result that the *North-West Transportation* case will be overruled, at any rate for public companies, and controlling shareholders will be treated as fiduciaries to be prevented from using their voting power in a self-interested way.[18] Australian law has not yet taken this step.

Nevertheless, the power of members to vote in a self-interested way is subject to some constraints. Members cannot vote in such a manner as to perpetrate a fraud on the minority, and Pt 2F.1 provides a statutory remedy in cases of oppression, unfair prejudice or unfair discrimination. At least on occasion, an attempt by members to authorise or ratify a breach of fiduciary duty would constitute a fraud on the minority or oppression or both.[19]

The clearest case of an invalid attempt to authorise or ratify a breach of duty would be where the breach is tantamount to theft of the company's property, contrary to the misappropriation rule. It is arguable that a breach of this kind cannot be condoned, even by unanimous decision of members, because the members' decision would simply endorse the misappropriation.

18. *Ford's Principles of Corporations Law* (looseleaf), at [11.040].
19. Further, see 17.6.

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Conversely, the *Regal (Hastings)* case and *Furs Ltd v Tomkies* hold that certain kinds of breach of duty are ratifiable by ordinary resolution. It seems to be relevant that in those cases the fiduciaries were acting honestly, believing that their conduct would not harm the company. It may also be relevant that in neither case did the directors misappropriate any pre-existing company property.

Cook v Deeks [1916] 1 AC 554 cannot be confidently reconciled with these principles. There, as has been seen, the Privy Council held that a purported ratification of the directors' conduct by majority resolution of the shareholders was ineffective, on the ground that the contract which the directors had acquired for their own benefit "belonged in equity" to the company. If the case were truly one of misappropriation of property, that conclusion would be understandable. But the contract in question came into existence, as an item of property, only pursuant to the breach, just as the profit of the Regal directors arose out of their breach.

Perhaps the result in *Cook v Deeks*, but not Lord Buckmaster's reasoning, can be explained on the ground that the circumstances were so extreme as to constitute a fraud on the minority. There the defendants diverted away from the company a contract with Canadian Pacific that they had been actively pursuing on the company's behalf, effectively excluding the plaintiff from the profits that they would enjoy by performing the contract through another company. By any standard, the conduct was objectionable. If, as Jacobs J suggested in *Crumpton v Morrine Hall Pty Ltd* [1965] NSWR 240 at 244, the law of fraud on the minority involves the court making a value judgment on the majority's conduct, it is plausible to say that the majority's conduct in purporting to ratify their own diversion of the contract negotiations for their benefit would be judged, on any objective analysis, to be lacking in probity.

Is it possible to authorise or ratify conduct that would otherwise contravene s 182 or 183? A decision by the members to authorise directors, in advance, to engage in conduct that would otherwise be in breach of the statutory provisions would appear, in most cases, to forestall any argument that the directors' subsequent conduct, pursuant to the authority, would constitute an "improper" use of information or position. Obviously, full disclosure is a critically important component of that conclusion. Ratification by the members after the conduct has occurred cannot eliminate the existing contravention of a statutory provision. However, a court might be persuaded to take the members' opinion into account, if it is fully informed, in determining what remedies are appropriate, and whether an order should be made relieving the directors under s 1317S or 1318. These may be circumstances where it would be advisable for the affected directors not to vote, as members, at the meeting of members. A court is more likely to exercise, in favour of the affected directors, whatever discretion it has, if the opinion of members can be seen to be independent of their influence.[20]

20. Further, as to ratification of breach of the statutory duties of honesty and care, see 17.5.

adversely affected where the trustee lost a right of indemnity as a result of acting in breach of trust.

A further reason for lack of entitlement is that in some jurisdictions the terms of the trust can deny the trustee a right of indemnity out of trust assets. Paragraph 301 of the Explanatory Memorandum to Exposure Draft 2 of the Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985 shows that this case was also intended to be within the new provision, now s 197.

Another situation in which a trustee may have no right of indemnity is where company X enters a contract as trustee for company Y yet to be formed. Y is formed but does not ratify the contract. Because of s 132 company X has no right of indemnity against company Y.

Where trustee corporation has insufficient trust assets to provide full indemnity

10.64 The exposure of a draft forerunner to s 229A for public comment evoked some submissions asking for it to be made clear that the measure referred to the legal right of indemnity and did not impose liability on directors where the only reason for the corporate–trustee not obtaining full indemnity was insufficiency of assets in the trust: see para 299 of the Explanatory Memorandum to the Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985. Section 229A(2) made it clear that full entitlement might exist although the trust had, in fact, no assets. The liability of directors for insolvent trading was already imposed by another provision now represented by s 588G of the Corporations Act 2001 (Cth). Section 588G, unlike s 197, provides defences. Section 229A(2) was reproduced with no substantial change in s 233(2) of the Corporations Law.

Section 233(2) provided:

> For the purposes of this section, a trustee of a trust shall not, merely because:
> (a) the trust has no assets; or
> (b) the assets of the trust are insufficient to indemnify the trustee in respect of the liability concerned;
> be taken not to be entitled to be fully indemnified out of the assets of the trust in respect of a liability.

Section 197(1) does not reproduce s 233(2). After stating the conditions for the liability of a director, s 197(1) provides that "This is so even if the trust does not have enough assets to indemnify the trustee". That language was included in s 197 when it was introduced into the former Corporations Law as a simplified replacement for s 233 by the Corporate Law Economic Reform Program Act 1999 (Cth).

The attempted simplification has introduced some complexity. The Explanatory Memorandum to the 1999 Act did not refer to any intention to make a substantive change in this matter. What is the effect of the ambiguous sentence?

- Is the ambiguous sentence saying that given satisfaction of conditions (a) and (b) the director is liable irrespective of the trust's lack of enough assets to provide indemnity?

- Does the ambiguous sentence refer to condition (b) so as to emphasise that it is absence of entitlement to be indemnified that is in question and that any inquiry as to whether the trust has enough assets to provide indemnity is irrelevant? That was the position clearly provided under the former s 233(2).
- Another possibility is that the ambiguous sentence can be seen to have work to do if it can be read as excluding argument about causation so that a director who is liable because conditions (a) and (b) are satisfied is precluded from avoiding liability by arguing that the immediate cause of the corporation's inability to discharge the liability is the trust's lack of assets rather than any lack of entitlement to a full indemnity.

Yet another interpretation has the authority of a majority decision of the South Australian Full Court in *Hanel v O'Neill* (2003) 48 ACSR 378; 22 ACLC 274; [2003] SASC 409. Mulligan and Gray JJ (Debelle J disagreeing on this point) held that the ambiguous sentence does not have the same meaning as the former s 233(2) and that a director can be liable under s 197 simply because the trust has no assets to meet the trustee's indemnity, although the trust instrument confers a right of indemnity. The majority construed the ambiguous sentence as, in effect, providing a separate basis for liability, alternative to s 197(1)(b). With respect, the majority view may be questioned for departing from the legislative history, for elevating what seems to be an exegetical sentence into a substantive provision and for causing overlap of s 197 with s 588G without the director of a trustee–corporation having the defences provided by s 588H (see 10.44ff) which would be available if he or she were proceeded against under s 588G.

It is submitted that even if it be accepted that the ambiguous sentence departs from the meaning of the former s 233(2), it should not be read as creating an independent basis of liability and that it has either the first or third of the meanings posed above.

Hanel v O'Neill is discussed by Cooper J in (2004) 22 *C&SLJ* 313. McDougall J of the New South Wales Supreme Court in *Intagro Projects Pty Ltd v ANZ Banking Group Ltd* (2004) 50 ACSR 224; [2004] NSWSC 618 expressed reservations about the reasoning in *Hanel v O'Neill*. In its absence, he would have held that s 197(1) made no change to the pre-existing law. However, his Honour considered that he should follow the majority view consistently with the requirement stated in *Australian Securities Commission v Marlborough Gold Mines Ltd* (1993) 177 CLR 485 at 492; 112 ALR 627 at 629; 10 ACSR 230 at 232 that intermediate appellate courts and single judges should not depart from an interpretation placed on such legislation by another Australian intermediate appellate court unless convinced that that interpretation is plainly wrong. See also obiter dicta about s 197 in *Edwards v A-G (NSW)* (2004) 50 ACSR 122; [2004] NSWCA 272 at [148]ff.

Where a director would be entitled to indemnity against fellow director

10.65 Section 197(2) excludes from liability a person who would have been entitled to be fully indemnified by one of the other directors against the liability had all the directors been trustees when the liability was incurred.

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introduced by the Corporate Law Economic Reform Program and implemented in 1999 (now found in ss 728–733) reverted to a model for civil liability broadly similar to the 1890 legislation, though more sophisticated in detail. *Adams v Thrift* remains an important guide for the interpretation of the current legislation and, in particular, the scope of the defences for directors.

Negligent misstatement

13.6 Case law stemming from the decision of the House of Lords in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 shows that liability in tort to pay damages may arise from misrepresentations which are carelessly made without dishonesty or recklessness amounting to deceit. There is scope for an investor using the tort of negligent misstatement to recover damages for investment loss arising out of a defective prospectus. Financial advisers and independent experts have been held to owe a duty of care to those who retain them, and consequently to be liable for reasonably foreseeable losses resulting from negligent preparation of their reports: *Esanda Finance Corp Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241; 23 ACSR 71; *Hill v Van Erp* (1997) 188 CLR 159; *Pilmer v Duke Group Ltd (in liq)* (2001) 207 CLR 165; 38 ACSR 122.

In the normal course, directors owe their duty of care to their company and would not be exposed to an action for negligent misstatement at the suit of an investor: see the discussion in Ch 19, and also (in the present context) *Al-Nakib Investments (Jersey) Ltd v Longcroft* [1990] 3 All ER 321. The nature and content of the director's common law duty of care to the company was explored in *Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438; 16 ACSR 607. The director's common law and statutory duties of care are considered in Ch 6, and have an important application in the prospectus context.

Equitable compensation

13.7 It has been held that the promoters of a company and the proprietors who seek extra funds can owe a fiduciary duty of disclosure. There are judicial statements which equate a contract by which a person takes up securities with a contract of utmost good faith, so that the promoters and others who issue the invitation to invest in the company have a duty of "utmost candour and honesty": *Central Railway of Venezuela v Kisch* (1867) LR 2 HL 99 at 113 per Lord Chelmsford LC.

The precise nature of this duty of candour is open to debate. There are statements of high authority to the effect that fiduciaries have a heavy duty of disclosure where the principal seeks their advice: for example, in the case of a stockbroker, *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 370 at 385 per Brennan J; and see the case law on the directors' fiduciary duty of disclosure to members who are to make a decision at a meeting, discussed in Ch 12. There is, however, a developing line of thought which holds that such a duty of disclosure is not strictly a fiduciary duty, and might even be an

instance of the emerging duty of good faith: see *Breen v Williams* (1986) 186 CLR 71; *Aequitas Pty Ltd v Australian European Finance Corporation Ltd* (2001) 19 ACLC 1006; P D Finn, "The Fiduciary Principle" in T G Youdan (ed), *Equity, Fiduciaries and Trusts*, Carswell, Toronto, 1989, p 1; R P Austin, "Moulding the Content of Fiduciary Duties" in A J Oakley (ed), *Trends in Contemporary Trust Law*, Clarendon, Oxford, 1996, p 153; P Birks, "The Content of Fiduciary Obligation" (2000) 34 *Israel LR* 3.

Perhaps the precise classification of the duty is less important than the propositions that a director may owe the duty to someone other than the company, and that the person to whom the duty is owed may recover equitable compensation assessed on a restitutionary measure,[3] based on *Nocton v Ashburton* [1914] AC 932. On this basis, directors who invite subscriptions without performing their fiduciary duty of disclosure can be held liable to indemnify the investor against loss through the company not being able to repay the money it receives: *Hill v Rose* [1990] VR 129. It appears that in proceedings for equitable compensation for breach of such a duty, the plaintiff does not need to show that the breach caused the loss, but only that the loss would not have occurred but for the breach: *Wilkinson v Feldworth Financial Services Pty Ltd* (1998) 29 ACSR 642 at 753, citing *O'Halloran v RT Thomas & Family Pty Ltd* (1998) 45 NSWLR 262; 29 ACSR 148.

An outline of the structure of Ch 6D

13.8 It is necessary to give a brief overview of the statutory procedural requirements for corporate fundraising, before examining the statutory liability provisions. What follows is merely a summary, in which attention is confined to a new-issue prospectus offer.[4]

The following requirements are pertinent to the procedure to be followed for a new-issue prospectus offer:

1. a new-issue prospectus offer is an offer of securities for issue that "needs disclosure to investors" under Pt 6D.2, according to s 706;
2. while the modern statutory disclosure requirements do not depend on the offer being made to the public or a section of the public, a general public offer will not attract any of the disclosure exemptions in s 708;
3. where an offer of securities needs disclosure to investors under Pt 6D.2, a prospectus must be prepared unless an offer information statement is permitted: s 709;
4. where the amount to be raised is more than $5 million, an offer information statement may not be used and a prospectus will be required: s 709(4);

3. See W M C Gummow, "Compensation for Breach of Fiduciary Duty" in T G Youdan (ed), *Equity, Fiduciaries and Trusts* (1989); C E F Rickett, "Where are We Going with Equitable Compensation?" in A J Oakley (ed), *Trends in Contemporary Trust Law* (1996).
4. For a fuller treatment of Ch 6D, see *Ford's Principles of Corporations Law* (looseleaf), Ch 22.

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4. "the public company or entity must obtain the approval of the public company's members ..."

15.16 Member approval is not just one of the exceptions, on the same level as, for example, the "arm's length transaction" exception. Rather, as the structure of s 208 makes plain, the legislative policy is for proposed financial benefits to be put before the members for their consideration, and member approval is the fulfilment of this policy. This suggests that if there is doubt as to the availability of another exception, the prudent course will be to obtain member approval.

The giving of the financial benefit is permitted if member approval is obtained "in the way set out in sections 217 to 227". If member approval is obtained but the procedural requirements stipulated in those sections have not been met, then the protection from contravention afforded by member approval is lost. The member approval procedure is very inflexible, as will be seen.

Where what is proposed is the giving of a financial benefit by a public company or its controlled entity to a related party of the public company, and none of the exceptions is available, member approval must be obtained and the benefit (if given at all) must be given within 15 months after the approval. There is only one exception to these requirements. If:

- the giving of the benefit is required by a contract, and
- the making of the contract was approved by the members as a financial benefit given to a related party, and
- the contract was made within 15 months after that approval, or it was made before the approval but was conditional on the approval being obtained,

then member approval for the giving of the benefit is taken to have been given, and also the benefit need not be given within the 15 months: s 208(2). The purpose of this provision is to avoid the need for double approval where the members have approved the contract and the benefit is required to be given under the contract. But the dispensation appears to apply only if there is a valid contract under which the giving of the benefit is required, rather than the kind of unenforceable agreement envisaged by s 229(2)(b).

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The approval required by Ch 2E is approval by the members of the public company, even where the benefit is to be given by the public company's controlled entity rather than by the public company itself. The obligation to obtain that approval is imposed, under s 208(1), on the public company or the controlled entity, depending on which of them proposes to give the benefit. If the controlled entity is required to obtain the approval of the public company's members, it will look to the directors of the public company to co-operate but if they do not a requisitioned meeting may be necessary.

Importantly, s 217 states that the resolution of members may specify anything either in particular or by reference to class or kind. This implies that the approval by members can be a "generic" approval and need not be a

separate approval given on each occasion a benefit is conferred, provided that the conferring of each benefit falls within an approved class. Section 217 will allow members to give annual approval to such arrangements as executive employee share plans, housing assistance schemes, and other similar generalised related party schemes. Where the company is listed, the ASX Listing Rules will impose additional requirements in such cases.

Sections 218–227 set out in detail the requirements for valid member approval. In summary, the procedure is as follows. At least 14 days before the notice convening the relevant meeting of members is given, the public company must lodge with ASIC the material that will be put to members: s 218(1). ASIC can approve in writing a period of less than 14 days for the receipt of this material: s 218(2). The material that must be lodged includes:

- a proposed notice of meeting setting out the text of the proposed resolution;
- a proposed explanatory statement;
- any other document that is to accompany the notice of meeting; and
- any material document that the company, the related party who will benefit from the proposal, and the associates of either, proposes to put before the members before or at the meeting.

The legislation appears to assume that the public company will be the author of the explanatory statement, even where the proposal is being made by its controlled entity.

Section 219 specifies the requirements for the explanatory statement. The statement must set out:

- the related parties to whom the proposed resolution would permit financial benefits to be given;
- the nature of the financial benefits;
- in relation to each director of the company, the director's recommendation on the proposal and his or her reasons for it (if the director wants to make a recommendation), or the director's reasons for not wanting to make a recommendation, or the reasons why the director was not available to consider the proposal (if that is the case);
- in relation to each director, whether the director has an interest in the outcome of the proposal and if that is so, what that interest is; and
- all other information, known to the company or any of its directors, that is reasonably required by members in order to decide whether or not it is in the company's interests to pass the proposed resolution.

Section 219 spells out the required disclosure to members, rather than leaving the matter to the general principles discussed in Ch 12. It limits the disclosure obligation to information known to the company or its directors, impliedly excluding any obligation to make external due diligence inquiries. In that respect, the general law disclosure obligation (which co-exists with the statutory obligation) appears to be wider, as shown in Ch 12 (see, especially, *Fraser v NRMA Ltd* (1995) 55 FCR 452 at 466). But a degree of "due diligence" will be needed for the public company and its directors to

cases have denied that directors owe a duty to beneficiaries merely by reason of the relationship of the director to the company and the relationship of the company to the beneficiary: *Cope v Butcher* (1996) 20 ACSR 37; *Australian Securities Commission v AS Nominees Ltd* (1995) 62 FCR 504 at 522; 133 ALR 1 at 18; 18 ACSR 459; 13 ACLC 1322; *Collie v Merlaw Nominees Pty Ltd* [1998] VSC 203. By the same token, directors of a company that owes fiduciary duties because it is an agent or other recognised fiduciary or because it has become a fiduciary by becoming party to an ad hoc fiduciary relationship are not themselves subject to those duties

If a company's breach of fiduciary duty is brought about by the director being in breach of directorial duties owed to the company under the Corporations Act 2001 (Cth) Pt 2D.1, the company will have an action against the director to be recouped for any loss arising from its liability to redress the breach of duty. Depending on the particular directorial duty breached, the company might recover compensation from the director even though the director was not dishonest, either subjectively or objectively. See, for example, the duty imposed by s 182 to abstain from making improper use of position: cf *Robins v Incentive Dynamics Pty Ltd (in liq)* (2003) 45 ACSR 244; [2003] NSWSC 71 at [54].

No liability in tort for procuring a breach of fiduciary duty

16.16 A director cannot be made liable in tort for procuring a breach by the company of its fiduciary duty. There is no tort of procuring a breach of trust comparable with the tort of procuring a breach of contract. Any protection of the interest of a beneficiary against a person procuring a trustee or other fiduciary to commit a breach is to be found in equity. The reasons are historical. Before the fusion of common law and equitable jurisdictions (see 18.4), equitable fiduciary duties would, for the most part, have been outside the cognisance of common law courts: *Metall Und Rohstoff AG v Donaldson Lufkin and Jenrette Inc* [1990] 1 QB 391. Nor is there any tort of conspiracy to procure a breach of trust: *Coomera Resort Pty Ltd v Kolback Securities Ltd* [1998] QSC 20; *Terranora Leisure Time Management Ltd (in liq) v Harris* [2002] QSC 424.

Director's accessorial liability

16.17 A director can be liable in equity (see 18.5) for dishonestly assisting the company to commit a breach of fiduciary duty: this is known as "accessorial liability". Equity provides a remedy against third persons who give knowing assistance to a fiduciary in the commission of a breach of fiduciary duty. This equitable wrong, referable to the second limb in a much-cited formulation by Lord Selborne in *Barnes v Addy* (1874) LR 9 Ch App 244, has been said to be the equitable counterpart of the economic torts: *Twinsectra Ltd v Yardley* [2002] 2 AC 164; [2002] UKHL 12 at [127] per Lord Millett.

Where a company is a trustee or other fiduciary, its directors can be personally liable in equity to the beneficiary or principal if they dishonestly assist the company to commit a breach of its fiduciary duty: *Biala Pty Ltd v*

Mallina Holdings Ltd (1993) 11 ACSR 785 affirmed sub nom *Dempster v Mallina Holdings Ltd* (1994) 15 ACSR 1; *Young v Murphy* (1994) 13 ACSR 722; *Australian Securities Commission v AS Nominees Ltd* (1995) 133 ALR 1; 18 ACSR 459; *Educational Resources Pty Ltd (in liq) v Poteri* (1996) 20 ACSR 628; *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 3 WLR 64; [1995] 3 All ER 97 (PC). See also *Turner v T R Nominees Pty Ltd* (unreported, SC(NSW), Santow J, 1151 of 1993, 3 November 1995) where a director of a family-trust company who caused the trustee company to misapply funds credited to a beneficiary was held to have knowingly assisted the trustee company's breach.

A finding of liability exposes the director to the full range of equitable remedies available against a trustee, including a declaration that the director holds certain property on a constructive trust for the beneficiary or principal or an order for payment of equitable compensation: *Australian Securities Commission v AS Nominees Ltd* (1995) 62 FCR 504; 133 ALR 1; 18 ACSR 459; 13 ACLC 1322.

A plaintiff does not have to show that the defendant knew the precise legal category, such as trust, agency or otherwise, from which the fiduciary's duty arose: cf *Twinsectra Ltd v Yardley* [2002] 2 AC 164; [2002] UKHL 12 at [24].

Accessorial liability is dealt with more fully at 18.49–18.52.

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Director's liability for company's criminal offences

The company's offences and the director's offences

16.18 On occasion, conduct of individuals in the course of a company's activity might constitute a criminal offence. A director might then be liable as a principal either solely or concurrently with the company. Alternatively, a director might be liable as a secondary participant in an offence committed by the company.

Director liable as a principal for his or her own offence

16.19 The terms of a particular law creating an offence involving a company may show a legislative intention that a director of the company is to be directly liable as a principal offender.

Sometimes a director is made liable as a principal for an offence which can be committed only by the director. For example, under the Corporations Act s 344 a director commits an offence if he or she dishonestly fails to take all reasonable steps to secure the company's compliance with certain provisions of Pt 2M.2 (maintenance of financial records) and Pt 2M.3 (financial reporting).

In other cases, the legislation contemplates the company and the director being concurrently liable as principal offenders, each committing a particular offence although it is constituted by the same facts. In *Mallan v Lee* (1949) 80 CLR 198; [1949] ALR 992 s 230(1) of the Income Tax Assessment Act 1936 (Cth) provided that: "Any person who, or a company on whose behalf the

> There is a long history known to the legislature, of ratification of such releases, with limits established by the cases. One would not expect that history to have been expunged with no reference in any explanatory memorandum or ministerial speech, or in the words of [s 199A(2)] itself. Section [199A(2)] is concerned with 'blank cheque' indemnification and exemption, while ratification requires specific release after full disclosure of the particular cause for claim.

One of the clauses in the agreement under consideration by his Honour specifically required indemnification from the company. His Honour held that this did not breach s 199A(2). The result is that indemnification, following an effective ratification and release by deed or for consideration, does not contravene s 199A(2). This is because (at 88):

> … if there has been a prior effective release, following valid ratification, there is simply no liability against which indemnification can operate, so that [s 199A(2)] is not contravened. Section [199A(2)], it should be remembered, embargoes an indemnity 'against a liability' and the release simply eliminates that liability, if supported by valid ratification.

However, the ratification must be within the scope permitted by that doctrine, as to which see 17.6 and 17.7.

Payment of insurance premiums[6]

17.16 Section 199B is derived from Report No 10 of the Companies and Securities Law Review Committee and prohibits a company or its related body corporate from paying, or agreeing to pay, a premium in respect of a contract insuring a present or former officer or auditor against liability incurred in that position, arising out of conduct involving wilful breach of duty in relation to the company, or a contravention of s 182 or 183. The contract of insurance is void if this prohibition is contravened: s 199C(2).

In addition to the statutory limitations on payment of insurance premiums, the terms of directors' and officers' liability insurance policies will typically contain exclusion clauses: *Silbermann v CGU Insurance Ltd* (2003) 21 ACLC 1425 (a case determining that under the terms of the relevant policy, the directors, who were defendants in proceedings brought against them by ASIC, were not entitled to have advanced to them the costs of defending themselves in the ASIC investigation and in legal proceedings brought by ASIC).

Material personal interest and financial benefit

17.17 Section 191 states that a director of a company who has a material personal interest in a matter that relates to the affairs of the company must give the other directors notice of the interest. However, the director does not need to give notice of an interest if the interest:

- relates to a contract that insures, or would insure, the director against liabilities the director incurs as an officer of the company (but only if the contract does not make the company or a related body corporate the insurer); or

6. Finch (1994) 57 *MLR* 880; Daniels and Hutton (1993) 22 *Can Bus LJ* 182.

- relates to any payment by the company or a related body corporate in respect of an indemnity permitted under s 199A or any contract relating to such an indemnity.

Section 191 is discussed in Ch 8.

Chapter 2E of the Corporations Act deals with related party transactions and requires a public company (or an entity that the public company controls) that wants to give a financial benefit to a related party of the public company to obtain the approval of the public company's members unless the financial benefit is exempt. Section 212 provides an exemption for indemnities, insurance premiums and payment for legal costs for officers provided that the benefit is reasonable in the circumstances of the public company or entity giving the benefit. Chapter 2E is discussed in Ch 15.

Indemnities and the payment of premiums are required to be disclosed in the directors' report under s 300(8).

Exoneration by the court

Statutory power to excuse breach

17.18 Under s 1318 if, in any civil proceedings against a certain type of person for "negligence, default, breach of trust or breach of duty", the defendant demonstrates to the court that he or she has acted honestly and that, having regard to all the circumstances of the case including those connected with his or her appointment, the defendant ought fairly to be excused for the negligence, default or breach, the court may relieve the defendant either wholly or partly from his or her liability on such terms as the court thinks fit.

Section 1318 is based on United Kingdom legislation stemming from the report of the Reid Committee 1906 (Cmd 3052) para 24. The Committee saw a need for legislation to prevent penal provisions in the Companies Act 1862–1900 from operating unfairly. The Committee recommended that the court be given a power to relieve from (1) liability for breach of duty imposed by the Companies Acts and (2) liability in an action for negligence or breach of trust. The first recommendation was negatived by the House of Commons (HC Debates, 21 August 1907). In 1929, with the enactment of new penalties for "defaults" of company officers, the word "default" was introduced into the section empowering the court to relieve. In *Customs and Excise Cmrs v Hedon Alpha Ltd* [1981] 2 All ER 697 the Court of Appeal held that the section applied not only in civil cases but also where a director had failed to discharge statutory obligations. By contrast, the Victorian Full Court in *Lawson v Mitchell* [1975] VR 579; (1975–76) CLC 40–200 held that the section applied only to civil liability. Under the influence of that decision the section included in the National Companies Bill 1976 (Cth) was expressly limited to civil liability and when the Companies Act 1981 (Cth) was drafted s 535 was similarly limited.

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that, if the court agrees, ASIC may convert a proceeding for an injunction into a proceeding in a representative capacity on behalf of a class of complainants, provided that the Commission obtains the written consent of everyone on whose behalf it seeks compensation.

Relationship of s 1324 to equitable principles governing equitable injunctions

18.14 In general, courts have made clear that they are not confined by traditional equitable principles when considering an application for an injunction under s 1324. However, there is some inconsistency between courts as to the principles which apply when considering an application for an interim injunction under s 1324(4).

In *ASIC v Mauer-Swisse Securities Ltd* (2002) 42 ACSR 605; 20 ACLC 1637; [2002] NSWSC 741, the court outlined the following principles relevant to s 1324:

- the jurisdiction which the court exercises under s 1324 is a statutory jurisdiction and not the court's traditional equity jurisdiction;
- parliament has made it increasingly clear by successive statutory enactments that the court, in exercising its statutory jurisdiction under s 1324, is not to be confined by the considerations which would be applicable if it were exercising its traditional equity jurisdiction;
- courts may take into account in relation to s 1324 wider issues than arise under traditional equitable principles governing injunctions, with these wider issues including whether the statutory injunction would serve a purpose of the Corporations Act;
- these wider issues are to be taken into account regardless of whether the application is for a permanent injunction under s 1324(1) or for an interim injunction under s 1324(4);
- where an application under s 1324(4) is made by ASIC rather than a private litigant, the court is more likely to give greater weight to the question whether the injunction would serve a purpose within the contemplation of the Corporations Act;
- where there is an appreciable — that is, not fanciful — risk of particular future contraventions of the Corporations Act by a defendant, it would serve a purpose within the contemplation of the Corporations Act that the court grant not only a permanent injunction but, in an appropriate case, an interim injunction restraining such conduct;
- although traditional equitable principles, requiring that there be a serious question to be tried and requiring attention to where the balance of convenience lies, will not circumscribe the court's consideration in an application for an interim injunction under s 1324(4), the interests of justice will always require that those questions be examined carefully when restrictions are sought to be imposed before the case has been properly examined by the court; and

- the balance of convenience will be viewed differently according to whether the applicant under s 1324(4) is ASIC or a private litigant. Where ASIC is acting to protect the public interest, the absence of an undertaking as to damages will usually be of little consequence. However the court may give more weight to the absence of an undertaking as to damages where the application is brought to advance a plaintiff's private interests.

There are earlier judgments which have held that an application for an interim injunction under s 1324(4) is to be determined in accordance with traditional equitable principles governing injunctions: *Liquorland (Aust) Pty Ltd v Anghie* (2002) 20 ACLC 58; [2001] VSC 362; *ASC v Cooke* (1996) 22 ACSR 580; 15 ACLC 435. However, the court in *ASIC v Mauer-Swisse Securities Ltd* (2002) 42 ACSR 605; 20 ACLC 1637; [2002] NSWSC 741 was not prepared to follow these earlier judgments.

In *ASIC v Triton Underwriting Insurance Agency Pty Ltd* [2003] NSWSC 1145 the court, while recognising that the court is not constrained by the traditional methods of equity, looked to the balance of convenience in the ordinary way and concluded that it lay with the defendant. After reviewing that preliminary conclusion against ASIC's statutory role and the wider question of what was "desirable" in the statutory context, the court saw no reason to modify its preliminary conclusion.

Section 1324 is similar to s 80 of the Trade Practices Act 1974 (Cth). The relationship between s 80 and the traditional equitable principles governing the granting of injunctions was considered in *ICI Australia Operations Pty Ltd v TPC* (1992) 38 FCR 248; 110 ALR 47; see also *TPC v Gold Coast Property Sales Pty Ltd* (1994) 49 FCR 442; 126 ALR 139. In *ICI Australia* Lockhart J observed that there are a number of significant differences between s 80 and the traditional equitable principles. First, parties bound by injunctions granted under s 80 and persons who knowingly counsel, procure or induce breaches of injunctions are themselves directly responsible for those breaches, but only principals are proper respondents to a claim for injunctive relief under ordinary equitable principles. Second, s 80 empowers the court to grant injunctive relief notwithstanding that the defendant has not previously engaged in the prohibited conduct or does not intend to engage in it again or to continue to engage in it or there is no imminent danger of substantial damage. However, these are the traditional requirements for equitable injunctive relief. It is to be noted that these provisions of s 80 referred to by Lockhart J are also contained in s 1324(6) and (7). Lockhart J stated that the provisions of s 80 are designed to ensure that once the condition precedent to the exercise of injunctive relief has been satisfied, the court is to be given the widest possible injunctive powers, devoid of traditional restraints, though the power must be exercised judicially and sensibly: 38 FCR at 256.

Lockhart J stated that the differences between s 80 and the traditional requirements for equitable injunctive relief are explained by the fact that the traditional principles governing the grant of injunctive relief were developed primarily for the protection of private proprietary rights. Public interest injunctions, such as those in s 80, are different because they relate to

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The general principles of criminal responsibility and defences contained in Ch 2 of the Criminal Code Act 1995 (Cth) apply to many offences against the Corporations Act. See s 1308A which applies Ch 2 subject to the Corporations Act. But despite s 1308A, Pt 2.5 of the Criminal Code dealing with corporate criminal responsibility does not apply to offences based on provisions in Ch 7 of the Corporations Act which deals with financial services and markets. Corporate criminal responsibility for the purposes of offences based on provisions in Ch 7 is provided for by s 769B.

Civil penalties

Civil penalty provisions in the Corporations Act

18.71 Some of the statutory provisions regarding the duties of directors and officers are among the provisions listed as civil penalty provisions in s 1317E(1). These include:

s 180 — the duty to exercise reasonable care and diligence;

s 181— the duty to act in good faith in the best interests of the company and the duty to act for a proper purpose;

s 182 — the duty to refrain from making improper use of position; and

s 183 — the duty to refrain from making improper use of information.

Section 588G(2) which imposes the duty to prevent insolvent trading is also a civil penalty provision: see 10.7ff.

All those sections are corporation/scheme civil penalty provisions as distinct from financial services civil penalty provisions. For the difference, see s 1317DA and 18.54.

Civil penalty provisions are the outcome of recommendations by reformers who thought that directors and others who contravene the corporations legislation should not be branded as criminals unless they have acted dishonestly: for example, Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (AGPS, November 1989), Ch 13. But some of the consequences of orders that the Federal Court or a state or territory Supreme Court can make after finding that a contravention of a civil penalty provision has occurred are sufficiently penal to attract the law of privilege against exposure to penalties so that, for example, persons against whom proceedings in relation to a contravention are brought cannot be forced to make discovery of documents: *Rich v ASIC* (2004) 50 ACSR 242; [2004] HCA 42.

What can follow contravention of a civil penalty provision?

18.72 On an application by ASIC under s 1317E to the Federal Court or a state or territory Supreme Court, the court must, on being satisfied that a person has contravened one of the provisions specified in s 1317E, make a declaration of contravention containing the particulars required by the Act.

On the making of a declaration of contravention, see *ASIC v Adler* [2002] NSWSC 268.

Once a declaration of contravention has been made:

- ASIC may apply to the Federal Court or a state or territory Supreme Court under s 1317G for a pecuniary penalty order; and
- ASIC may apply to the Federal Court or a state or territory Supreme Court under s 206C for an order disqualifying the contravener from managing a corporation for a period that the court considers appropriate.

Whether or not a declaration of contravention is made, a contravener can under s 1317H be ordered by the Federal Court or a state or territory Supreme Court to pay compensation to a company for damage that resulted from the contravention of a corporation/scheme civil penalty provision. The order can be made on the application of ASIC: s 1317J(1). The company may also apply for a compensation order: s 1317J(2) and see 18.54. A compensation order under s 1317HA concerned with contravention of a financial services civil penalty provision may be made on the application of ASIC, the company or any other person who suffers loss or damage in relation to the contravention.

Proceedings for a declaration of contravention, a pecuniary penalty order or a compensation order may be started no later than 6 years after the contravention: s 1317K.

The court proceedings for a declaration of contravention or a pecuniary penalty order are civil proceedings in terms of the application of rules of evidence and procedure: s 1317L. This means that there can be proof on the balance of probabilities that there has been a contravention of a civil penalty provision rather than proof beyond reasonable doubt. On the need for caution in applying the civil standard of proof when dishonesty is alleged, see *Briginshaw v Briginshaw* (1938) 60 CLR 336; [1938] ALR 334; *Rejfek v McElroy* (1965) 112 CLR 517; *Neat Holdings Pty Ltd v Karajan Holdings Pty Ltd* (1992) 110 ALR 449; at 449–50; and Evidence Act 1995 (Cth) s 140.

Pecuniary penalty order

18.73 Where a court has declared that a person has contravened a corporation/scheme civil penalty provision, the court may order that person to pay a pecuniary penalty of up to $200,000 to the Commonwealth government, if the contravention:

- materially prejudices the interests of the company or its creditors;
- materially prejudices the company's ability to pay its creditors; or
- is serious: s 1317G(1).

As to when a pecuniary penalty order can be made where there has been a contravention of a financial services civil penalty provision, see s 1317G(2).

For discussion of the principles governing the imposition of a pecuniary penalty, see *Re HIH Insurance Ltd (in prov liq); ASIC v Adler* (2002) 42 ACSR 80; [2002] NSWSC 483 at [125]ff, appeal allowed in part on other issues *Adler v ASIC* (2003) 46 ACSR 504; [2003] NSWCA 131.

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