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DIRECTORS' JOINT OBLIGATIONS OF CARE AND DILIGENCE

8 December 2011

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DIRECTORS' JOINT OBLIGATIONS OF CARE AND DILIGENCE

From time to time calls are made for the legislature to make duties owed by individual directors more demanding. Sometimes the call is to make them less demanding. With respect to those who make them, they are naïve. There is no common standard of care for directors.[i] One size does not fit all. A part-time non-executive director acting gratuitously will never be held to the same standard of care owed by a qualified, experienced and highly paid managing or executive director. For many years it has been common for companies to appoint as directors persons whose name might be thought to add lustre to its enterprise, rather than the skill and experience they are able to bring to the post. That is the shareholders' choice. It is hoped that the whole will be bigger than the sum of the parts. If shareholders are prepared to appoint such a person, it is unfair that such a director should be held to a standard that he or she did not contract, or warrant or hold him or herself out as having. This explains the rule that, generally speaking, individual directors need only exhibit such care and diligence as can be reasonably expected from them having regard to their knowledge and experience. So, it is said:

> "In determining whether a director has exercised reasonable care and diligence one must ask what an ordinary person, with the knowledge and experience of the defendant might be expected to have done in the circumstances if he or she was acting on their own behalf."[ii] :.

The difficulty with this proposition is that it is counterfactual. An ordinary person, acting on his or her own behalf, could not possibly conduct a business on the scale that many listed companies presently do. The size of companies and the issues thrown up in the conduct of their businesses is beyond the capacities of any individual human being.

Looking back, and speaking broadly, it can be seen that there have been three critical stages in the law's conception of directors duties in Australia: (1) *In re City Equitable Fire Insurance Co. Ltd.* [1925] Ch 407; (2) *Daniels v Anderson* (1995) 37 NSWLR 438; (3) The introduction of the statutory business judgment rule in s.180(2) of the Act. Each step is premised on the understanding that directors' duties impose a several form of liability. There is no cause of action known to the law which asks "Did the Board fail its management obligation to the company?"

When will we see a fourth stage and what will it be? I am mindful of the danger of suggesting new law without fully understanding the old. My tentative thesis is that the fourth stage will be developed by the High Court, not the legislature. It will involve a comparison between company law (as it is presently understood) and partnership law and trust law. The mechanism will include an appreciation of s. 140(1)(b) and its interaction with constitutional provisions such as in s. 198A. S. 198A requires the board (as a collective) to manage the business of the company by voting on resolutions at board meetings and then implementing those resolutions. S. 198A reflects a joint promise by the directors to manage the company. Each director who

1. Company law conceives the company as principally a bundle of contracts between members, directors and the company. S. 140 *Corporations Act 2001* gives content to this suite of contracts.

2. A company is primarily constituted by two organs: the board of directors and the members in general meeting. Both organs operate collectively. Both have quorum and notice requirements which support but do not mandate individual participation.

3. A director sometimes acts as an agent of the company. Agency is best seen as a notion by which a principal (company) confers authority or capacity on an agent (director) to bring the principal into legal relations (usually contractual) with a third party. The two capacities are significantly different.

4. A director's acts are not, without more, the acts of the company. Such acts could only be the acts of the company if the board of directors delegated the particular functions concerned, giving the director a mandate involving a full discretion, free to act independently of instructions. But the board of directors may delegate some part of their functions of management giving to their delegate full discretion to act independently of instructions from them. In that case there is no difficulty in holding that the board put such a delegate its place so that within the scope of the delegation the delegate can act as the company.

votes in favour of a resolution in furtherance of that management obligation performs a joint obligation. (Those directors who are not present, or abstain, or vote against the resolution and in favour of the status quo perform no obligation.) If the management obligation is breached, the voting directors would be jointly liable for the adverse financial consequences as for a breach of contract. Rights of contribution between directors would exist. The enquiry concerning breach would not concentrate on individual directors. It would focus on the resources available to the board to implement systems and processes to assist in the discharge of their collective management obligation.

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[i] As Maitland said in speaking of the duties of care and diligence owed by trustees (page 94) "you will find that generally there are not hard and fast rules – they will admit of exceptions…" Maitland referred to a text book "to cite authorities, as is often done, to show what amounts to reasonable care, prudence or intelligence, is, it is submitted, a misleading and dangerous practice. It is an attempt to decide a point of fact, not by evidence but by authority….." To the same effect was Justice Gummow speaking extra-judicially in 2003 (77 ALJ 30 at 41-42). He cited a passage from an 1822 decision and said "A court of law works its way to short issues, and confines its views to them. A court of equity takes a more comprehensive view, and looks to every connected circumstance that ought to influence its determination upon the real justice of the case." Justice Gummow continued "if the administration of equitable relief in these and other cases is inherently more "uncertain" than, say, the quantum of compensatory or exemplary damages, then so be it. All are manifestations of the "rule of law".

[ii] *Wheeler* at 159 per Ipp J, approved by Santow J at in *HIH* 168 FLR 253 at 347 and by Austin J in *Rich* This is not very different to the statement concerning trustees in *Speight v Gaunt*.

5. In *Daniels v Anderson (1995)* 37 NSWLR 438 at 505 Clarke and Sheller JJA said that the duty of directors "includes that of acting collectively to manage the company."

6. In *Hospital Products* Mason J said: "in these situations it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction." (1984) 156 CLR 41 at 97