

THE AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS

TASMANIAN DIVISION

LUNCHEON ADDRESS HOBART, TASMANIA

31 MARCH 1998

THE COMPANY DIRECTOR: PAST, PRESENT AND FUTURE

The Hon Justice Michael Kirby AC CMG*

PAST

In order to understand the present and to foresee the future, we must study the past. Explaining how the corporation was invented by English law and then found its way to Australia and other lands is an interesting exercise. It teaches that sometimes the law can be highly imaginative. It can be part of the solution rather than part of the problem.

The seeds for the idea of a corporation, a body having a legal personality separate from that of its shareholders, can be traced in

* Justice of the High Court of Australia.

English law at least to the reign of Queen Elizabeth I. Indeed, that time, which was one of great national confidence and economic growth in England, saw many legal developments which laid the foundations of the modern laws of bankruptcy¹, intellectual property² and company law. Lord Wilberforce, one of the great English jurists of this century, has described the way in which the idea of the company developed. He put the development into a broader context³:

"The company, the abolition of the laws of usury, the introduction of cheques, the formulation of Patent Law and trademarks, were all part of a movement which did not merely reflect the expansion of commercial practice; but also, perhaps more truly, gave an essential impulse to it".

In the time of Elizabeth I, Crown monopolies were established to help exploit high risk investments in the overseas colonies, settlements and trading posts of the Crown. Charter companies

1 13 Eliz I, c 5. See *Cannane v J Cannane Pty Limited (In Liq)* [1998] HCA 26 at par 82-88.

2 *Advanced Building Systems Pty Ltd v Ramset Fasteners (Aust) Pty Ltd* [1998] HCA 19 at par 51. The *Statute of Monopolies* 1623 (GB) actually dates from the reign of King James I (21 Jac I c 3).

3 Lord Wilberforce, "Law and Economics" in P W Harvey (ed) *The Lawyer and Justice*, Sweet and Maxwell, London, 1978 at 73. See also *National Acceptance Corp Pty Ltd v Benson* (1988) 12 NSWLR 213 at 222 per Priestley JA and M D Kirby, "Rethinking Company Law and Practice" (1995) 5 *Australian Journal of Corporate Law* 176.

were established with a monopoly from the Crown. These provided the origin of the notion of a body independent of the investors, which was permitted, by law, to engage in sometimes risky and speculative commercial ventures but with only limited personal liability in the adventurers.

The modern reincarnation of laws on bankruptcy, intellectual property and corporations had to await, as Lord Wilberforce pointed out, another period of great national confidence and economic resurgence in England. I refer to the reign of Queen Victoria. It was in that time that the basic legal foundations of the modern capitalist economy were enacted by the Parliament at Westminster. The British colonies took advantage of such laws which were often extended to apply to them. In this way, they inherited the institutional and intellectual framework of law within which their fledgling economies could quickly flourish. As I walked around the beautiful colonial buildings by the harbour in Hobart, it was brought home to me, most powerfully, how confident was the force that propelled the British Empire to the far reaches of the world. In part, as we in New South Wales and Tasmania at least know, the motivation was the disposal of unwanted convicts. But it soon became the pursuit of profit, with personal and economic advantage. And so the first courts were established, laws enacted and corporations set up to provide the infrastructure for economic prosperity, high employment and an ordered civil society.

The idea of an independent corporation, governed by directors and accountable to shareholders, was a brilliant one. It permitted people to raise capital from the public, to invest it without, in most cases, a danger of personal risk and to engage in entrepreneurial activity which, otherwise, would probably not occur. But this legal invention was created under conditions which obliged the corporation and its directors to conform to a number of basic rules. The rule of *ultra vires* that kept the corporation within its charter - a doctrine borrowed from the old charter companies and Crown monopolies of the first Elizabethan era. The doctrine of the separate existence of the corporation and a general unwillingness to lift the corporate veil⁴. The provision of rules limiting the liability of the corporation and defining the relatively rare circumstances in which its directors would be personally liable when things went wrong. The imposition of duties on the directors to act, as such, with honesty, skill, care and diligence. The imposition of duties on the company itself in the raising of capital from the public and the expenditure of the funds so raised. The central problem of the company was, from the beginning, that of securing the advantages of this brilliant legal idea whilst keeping the directors and the management accountable to the shareholders. That problem remains the central challenge for company law and policy right into our own time.

⁴ *Salomon v Salomon* [1897] AC 22. See Wilberforce, above n 3, at 78-79.

When we reflect upon the way in which the law invented the company, this indispensable device for modern economic growth, a question is immediately posed. What contribution is the law making today, of an equivalent kind, to boost the economy, provide jobs, encourage investment and stimulate proper risk-taking? Have we run out of steam in the marketplace of legal ideas? Are we in a kind of doldrums such as those which interrupted legal imagination between the great statutes of the reign of Elizabeth I until there was a new period of imagination in the reign of Queen Victoria? Where is the modern equivalent of the legal imagination that gave birth to the highly successful idea of the limited liability company? On the brink of a new millennium, we should be thinking creatively about the ways in which the law can facilitate economic development and not simply coerce, regulate and control its occasional errors and ugly manifestations. This is not specifically a challenge to company directors. It is primarily a challenge to lawyers. Just as the corporation idea grew out of the early Crown monopolies for the colonies, so future bold strokes of company law will almost certainly grow out of the present idea of the corporation. We should be enquiring as to what the future directions of company law will offer. The seeds of the future usually lie in the past.

If we look into the recent past, we can see some of the explanations for the strategies of company law and policy in Australia over the last decade. What occurred in that time helps to explain the pressure which was placed both upon parliaments and courts, to

endorse stricter rules in order to uphold greater integrity on the part of corporations, their management and directors. Law does not develop in a vacuum. It responds to the perceived needs of the society which it serves.

The extent of the problem is well explained in an essay by Ms Linda English and Dr James Guthrie⁵. In case we had forgotten, they recount the unhappy recent history of corporate failures in Australia:

"The excesses of the late 1980s and subsequent corporate losses have highlighted a litany of accountability and control problems in both private and public sector organisations. Several collapses in the private sector, such as those of Rothwells Banks, the Skase media empire, the Bond group and various property developers, have reverberated in the public sector and combined to financial disasters experienced by government owned banks. In Victoria, the financial collapse of Tricontinental cost the government an estimated \$2.5 billion, while South Australia lost \$3.2 billion through the demise of the State Bank of South Australia ... The political fallout from these disasters has contributed to the governments in Victoria, South Australia and Western Australia being removed from office. The social and financial implications are still being felt in those states as government funding for schools, roads, hospitals and other much needed social infrastructure is cut to help finance the losses".

5 L English and J Guthrie, "An Overview of Directors' Obligations and Accountability Standards for Government Business Enterprises in the 1990s" (1996) 7 *Australian Journal of Corporate Law* 120.

Trevor Sykes, in his book *The Bold Riders* also reminds us of the litany⁶:

"The collapses included Australia's largest industrial group (Adelaide Steamship); the ninth largest enterprise in the nation measured by revenue (Bond Corporation); nearly half the brewing industry (Bond Brewing); all three major commercial television networks (Bond Media, Qintex, Channel 10); Australia's largest car renter (Budget); the second largest newspaper group (Fairfax); Victoria's largest building society (Pyramid); and Australia's largest textile group (Linter) ... Total writeoffs and provisions by banks and financiers amounted to \$28b. Australia's three largest merchant banks (Tricontinental, Partnership Pacific and Elders Finance) had to be rescued by their parents. Two of Australia's four State Banks (State Bank of Victoria and State Bank of South Australia) suffered devastating losses and had to be investigated by Royal Commission ... The four major trading banks (Westpac, National, Commonwealth and ANZ) had to write billions of dollars off their loan books".

It may be mildly irritating to have a reminder of these sorry examples of corporate failures. But it is necessary that we do not forget them. They provide the only foundation upon which effective laws and policies for Australian corporations can be built. Those who forget the past are doomed to repeat its mistakes. Trevor Sykes, in vivid language, has declared⁷:

6 S Miller, "Corporate Crime, The Excesses of the Eighties and Collective Responsibility: An Ethical Perspective" (1995) 5 *Australian Journal of Corporate Law* 139 citing T Sykes, *The Bold Riders*, Allen and Unwin, Sydney, 1994, 1-2.

7 Sykes, above n 6, 2. See also Miller, above n 6, 140.

"Never before in Australian history had so much money been channelled by so many people incompetent to lend it into the hands of so many people incompetent to manage it".

Some people suggest that the explanation for this sorry history, still vivid in mind, is nothing more than the personal failings of a few individual "corporate cowboys" or "bold riders". If this were so, the chances of repetition of such wrongdoing might be minimal. But a more likely explanation is that the events of the late 1980s and early 1990s portrayed a failure of law, policy and ethics. Sykes again:

"If the financial community worked the way it is supposed to, outside directors would have exercised their authority over runaway chief executives; accountants and auditors would have detected and exposed the pea and thimble tricks in the bold riders' accounts; lawyers would have refused to endorse their thefts; merchant banks would not have lent money and imprimatur to their schemes; brokers would not have pushed their shares; fund managers would not have invested in them; and the financial press would have castigated them. Thus another truly remarkable phenomenon of the 1980s was the way in which all these professions prostituted themselves - with the odd honourable exception - to the bold riders".

This, then, is the past against which we must measure the present and the future. The corporation, an idea taken from the past, is still the central legal instrument for our economic well being. This is why directors are so important to the Australian economy and its society. But the memory of recent failures, must propel us to legal and other responses that uphold, in a more effective way, the duties of honesty, of skill, care and diligence in the governance of

companies and in vigilance on the part of those who uphold these central values.

PRESENT

I have said that the response to the events just described was one which resulted in new legal duties being imposed on company directors in Australia. The Federal Parliament, for example, introduced a statutory standard of reasonable care and diligence⁸. Numerous cases came before the courts in which attempts were made to hold directors to higher standards than the common law had earlier expressed. Probably the best known of these cases was *AWA Limited v Daniels*⁹. The decision at first instance of Rogers CJ Comm Div, sitting in the Supreme Court of New South Wales, was the starting point. It was interpreted as adopting a "practical" approach to directors' duties. As reinforcing the notion that non-executive directors were only liable in a case of gross negligence. That their duty of care was to be judged by subjective and not objective standards. That they could delegate most of functions to management. Those who commented on the judgment sometimes

⁸ *Corporations Law* s 232(4). See J Cassidy, "Has the 'Sleeping' Director Finally Been Laid to Rest?" (1997) 25 *Australian Business Law Review* 102 at 115-116.

⁹ (1992) 10 ACLC 933 (SC); (1995) 37 NSWLR 438; 13 ACLC 614 (CA).

considered that it provided a soft charter for "sleeping" directors. In fact, the judgment was probably in the mainstream of Australian case law to that time¹⁰.

Then came the majority decision in the appeal in that case¹¹. The New South Wales Court of Appeal (Clarke and Sheller JJA; Powell JA contra) upheld a more rigorous standard than that which had found favour at first instance. Borrowing from developments in negligence law, the Court of Appeal asserted that the test to be applied was an objective one¹². A minimum standard of competence on the part of all directors was required by the law. All directors would have to ensure that their decisions were informed, independent and involved the active exercise of their discretions. The notion that liability of directors was limited to cases of gross negligence was rejected.

¹⁰ A S Sievers, "Directors' Duty of Care: What is the New Standard?" (1997) 15 *Companies and Securities Law Journal* 392. See also J Cassidy, "Has the 'Sleeping' Director Finally Been Laid to Rest?" (1997) 25 *Australian Business Law Review* 102; R Campbell, "No Hiding Place for CEO's in a Crisis" (1997) 13(9) *Company Director* 10.

¹¹ (1995) 37 NSWLR 438 (CA); (1995) 13 ACLC 614.

¹² cf *Re Property Force Consulting Pty Ltd (In Liq)* (1955) 95 ATC 1, 051.

Superficial reading of the Court of Appeal's decision led to panic in some quarters in corporate Australia. However, more reflective comments suggested that, if the decisions of Australian courts over the past decade were fairly analysed, they would show two trends. First, a growing judicial impatience with "sleeping" or passive directors on the boards of Australian companies¹³. Secondly, a realistic appreciation that directors could not assume all the functions of managers, auditors and systems controllers of companies. Those directors who had exercised their powers and carried out their duties honestly and conscientiously to the best of their ability would normally not be held to have breached their duty of care. They would be exempt from personal liability.

Nevertheless, the concerns lingered following the Court of Appeal decision in the *AWA* case. The anxiety was probably not that courts would fail, in the end, to excuse honest and conscientious directors but that the standard expressed by the Court of Appeal might expose directors, more frequently than in the past and unjustifiably, to expensive and problematical litigation. This would involve risks, could put pressures upon them for adverse settlements and divert the attention of corporations from the serious business of

¹³ cf *Metal Manufacturers' Ltd v Lewis* (1998) 13 NSWLR 315 at 318-319; 6 ACLC 725 at 728; *Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946.

economic entrepreneurship to litigation and lawyering¹⁴. The one thing that all involved in Australian corporate policy were concerned to avoid was the evisceration of companies, such that none could make serious commercial decisions without having the daily approval of lawyers.

It is in this context that the recent announcement of the Federal Treasurer (Mr Peter Costello) is to be understood. On 17 March 1998, the Treasurer stated that the Federal Government would introduce legislation later in the year to reform Australia's company law¹⁵. Amongst the proposals included in the Treasurer's announcement are two of great importance to company directors. One is a proposal to enact a "new business judgment rule to provide more certainty for directors". The other is a proposal for "new shareholders' rights to take action on behalf of companies". At this time the precise content of the new legislative proposals is not known. But, significantly, the proposed reform of directors' duties is given the highest priority in the Treasurer's announcement. It is said to envisage "a safe harbour from personal liability for breaches of the

¹⁴ L. Law, "The Business Judgment Rule in Australia: A Reappraisal Since the AWA Case (1997)" 15 *Company and Securities Law Journal* 174.

¹⁵ Press Release, The Hon Peter Costello MP (Treasurer), "Business Law Reforms to Boost Jobs and Economic Development" (No. 028), 17 March 1998.

duty of care and diligence in relation to honest, informed and rational business judgments".

The Treasurer's announcement has been generally welcomed by the Australian financial press. The reform of the expression of directors' legal liabilities was explained by *The Age* as being designed to provide "marginally less expose[ure] to personal liability for decisions they make"¹⁶. The proposed new "business judgment rule" was described in the *Australian Financial Review* as¹⁷:

"Basically a legislative reversal of the decision of the NSW Court of Appeal in *AWA*, when it overturned an earlier decision of Justice Andrew Rogers in 1995. Rogers had effectively written a business judgment rule into the common law by letting directors off the hook over the shenanigans that went on in *AWA*'s foreign exchange transactions, but the Court of Appeal threw it out and put directors squarely back in the frame".

As reported in the *Australian Financial Review*, although the new "business judgment rule" has been welcomed by the Australian Institute of Directors, there is less enthusiasm for the introduction of new derivative actions which might (depending upon the statutory language) permit minority shareholders, recalcitrant directors and others to bring proceedings in the name of the company which the

¹⁶ "Investors Beware", Editorial, *The Age*, 21 March 1998 at 11.

¹⁷ G Newington, "Back to the Board Room" in *Australian Financial Review*, 21 March 1998 at 60.

directors in control of the company do not favour. Fear has been expressed that this might become a new goldmine for lawyers and another distraction from the real business of corporate governance for economic rather than legal productivity. Supporters suggest that courts will be well able to discourage vexatious litigation.

Against the backdrop of problems of the kind which I have briefly sketched, still remembered by Australian investors and citizens, the need for effective checks upon, and appropriate standards for, company directors is obvious. The challenge before lawmakers is to establish a regime which will provide these checks and uphold such standards without unduly reducing the capacity of the company and its officers to perform the economic functions for which the corporation was established. We are talking of a delicate balance. In Australia, the point at which that balance is struck cannot ignore the recent examples of corporate failures which also evidenced the failures of the legal system and of the independent directors who should have vigilantly protected shareholders, their companies and the public from the devastating losses which occurred. The last word will never be written upon where the delicate balance is to be set. Each age will strike its own legislative and legal standards. It will do so by reference to a number of considerations, including the state of the economy, the contemporary history of corporate failures the business cycle, investor speculation, the "feel good" factor, the strength of the exchange rate and the perceived means of upholding ethical standards of honesty and care in ways that do not stifle the spirit of adventure, risk taking and

entrepreneurship on the part of companies. When the corporation loses that spirit it has lost its essential motivating force.

FUTURE

Because the future will grow out of the present, it is clear that Australian company directors will have to operate in a legal environment which is undergoing reconsideration and change. The basic reason behind the Treasurer's announcement was said to be the Government's desire to boost economic activity, stimulate small business and create employment opportunities: all legitimate purposes at this time.

By the same token, it seems clear that company directors in Australia need to lift their game. I refer not only to the record of shocking failures and neglect of a decade ago. More recently, a report on research undertaken by Professor Ian Ramsay and Mr Richard Hoad of the University of Melbourne produced results which were discouraging. In a survey conducted by Professor Ramsay¹⁸, who is a leader in empirical research on the actual operation of corporations in Australia, he and Mr Hoad record some rather sobering news. The survey shows that:

¹⁸ As reported in Newington, above n 15. See I Ramsay and G Hoad, "Disclosures! Corporate Governance in Practice" (1998) 14(2) *Company Director* 11.

"65% of companies do not discuss procedures for reviewing the performance of management and directors and only 42% of large companies regularly review the performance of management. Apparently the vast majority of companies don't distinguish between executive and non-executive directors".

This report is clearly a disappointment. It suggests that "sleeping" or "passive" directors still occupy valuable seats in Australian board rooms. This presents a danger to the long-term stability of Australian corporations. In the current national and regional economic climate, Australia could not easily afford another era of "cowboys" and "bold riders". Yet the real protection against their re-emergence lies not in courtrooms or even in the work of regulatory authorities. It lies in the boardrooms of the nation. Somehow the standards of vigilance and competence of directors and the superintendence by them of effective, honest and diligent management must be improved. Certainly this is so if the research by Ramsay and Hoad is even partly representative.

Beyond the problems of striking a new balance in the legal position of Australia's company directors and lifting their performance of their duties, there are many long-term challenges which need to be faced. It seems safe to suggest that the long-term challenges facing company directors in Australia will derive from the two great connected engines of change that are at work in the world today. I refer to globalism and technology. These forces are not, of course, unconnected. Technology itself produces global economic markets as well as global problems for lawmakers and regulators. I recently

returned from a meeting in Paris where attempts were being made to secure agreement on the international body which will devise the standards for the conduct of genomic sciences. The ethical, legal and social problems presented by the Human Genome Project are enormous. It is beyond the capacity of any single state to respond effectively to them. A similar challenge is presented by the Internet. And by HIV/AIDS, global warming, human rights and so on. These problems are so pervasive, international and powerful, that nation states appear to have lost the capacity to control or regulate them effectively. It is in this environment that the company of the future must operate. Companies too are increasingly global in their organisation and ownership¹⁹. The problems presented to them, as the Bophal disaster vividly illustrates, can be trans-national and overwhelming. Companies are losing their roots in the states in which they were originally formed. They are taking on a regional or international character, reflecting the dynamic of globalism²⁰.

¹⁹ It has been suggested that the growing number of modern corporations owned offshore requires radical reconsideration of laws and practices developed upon an assumption of local shareholder owned companies. See W Rosenberg, "Directors' Duties" [1998] NZLJ 78; cf M D Kirby, "Australian Corporations Law and Global forces" (1998) 2 *Flinders Journal of Law Reform* 41 at 46ff.

²⁰ J P Lehmann, "Who writes today's economic scripts?" in *Financial Times*, 27 March 1998, Supplement "Mastering Global Business", 2-3; R Donkin, "Global Guidelines", *Financial Times* 27 March 1998, 10 suggests that it "was only a matter of time before someone had the idea of looking at [corporate governance] from an international perspective".

In the law and in the judiciary, we are adapting to new information technology in ways that would have been regarded as unthinkable even a decade ago. High Court decisions may be downloaded from the Internet within minutes of their delivery in Canberra. Judgments are now reported in media neutral format. Many special leave hearings conducted by the High Court use video links to span our continental country. The Australian Law Reform Commission is even suggesting that simple legal problems may, in the future, be susceptible to decision-making by artificial intelligence²¹. Obviously, within corporations, the new information technology provides ways of monitoring developments, accounts and markets that would have been unknown to the managers and directors even of the recent past. If the law can embrace technology, it is essential that Australia's company directors should be alert to the implications for their activities of globalism and technology. Perhaps in these two dynamic forces lie the creative ideas of the corporation of the future. Vigilant company directors in Australia will be on the lookout for the implications of these forces for their companies.

²¹ Australian Law Reform Commission, *Technology – what it means for federal dispute resolution* (Issues Paper 23), March 1998 at pars 6.9-6.15.