



AUSTRALIAN
INSTITUTE OF
COMPANY
DIRECTORS

ABN 11 008 484 197

Submission

to

Corporate and Markets Advisory Committee

on

Corporate Duties Below Board Level

26 August 2005

Introduction

The AICD supports the extension of the duties of care and diligence and good faith in the *Corporations Act 2001* (CA) sections 180(1) and 181(1) to a person who takes part, or is concerned in, the management of a corporation.

The AICD acknowledges, indeed urges, that it is almost certainly impossible to devise a statutory definition of such personnel, or of the term ‘management’, that would improve upon the former definition of ‘executive officer’ in the CA, and, for the reasons advanced in relation to Proposal 1, urges it be reinstated as the best practicable definition of the non-director personnel intended to be covered. This would address the major concerns raised by the HIH report, and as the definition had been used since 1981 up to March 2000 there is a body of case law available to give guidance as to the meaning of these phrases. Set out in the Appendix is a short description of the development of the legislative history in this area.

In the light of those general comments, the AICD makes the following submissions on the proposals put forward in the Discussion Paper (DP).

Proposal 1

Section 181 and 184(1) (the duties of good faith and proper purpose) should be extended beyond directors and other officers of a corporation to any person who takes part, or is concerned, in the management of that corporation.

The AICD supports the extension of the duty of good faith in CA sections 181(1) and 184(1) to a person who takes part, or is concerned in, the management of a corporation. The AICD agrees with the recommendation of the HIH report that the best way of achieving the extension is to re-adopt the definitions of ‘executive officer’ in CA section 9 and of ‘officer’ in CA section 82A as in force before the commencement of the *Corporate Law Economic Reform Program Act 1999* (CLERPA). The current definition captures a significantly narrower class of persons than the pre-CLERPA definition of ‘executive officer’. To fall within the current definition the person must ‘participate in making decisions that affect the whole or substantial part of the business of the corporation, or who has the capacity to affect significantly the corporation’s financial standing’.

The pre-CLERPA definition of ‘executive officer’ was:

‘a person, by whatever name called and whether or not a director of the body or entity, who is concerned, or takes part, in the management of the body or entity’.

That definition was first enacted in the *Companies Act 1981* and the corresponding State and Territory Companies Codes. It was thus operative for 24 years until 30 June 2004, during which a useful body of case law on its meaning had developed, as set out in Appendix 2 to the DP.

For reasons not stated in the Explanatory Memorandum for the Bill for CLERPA, CLERPA introduced into the CA a new definition of ‘officer’, which incorporated – as the HIH Report noted – part, but not all, of the gloss put by Ormiston J in *Bracht* on the definition of

'executive officer'. In particular, the HIH report (as extracted on page 43 of appendix 1 of the DP) indicates:

'The failure to include a person 'concerned in' management, which was considered by his Honour to have had a significant effect in expanding the scope of the definition of 'executive officer' was a material omission.'

From a policy perspective, the AICD considers it appropriate that the wider class of persons who are 'concerned in' or 'take part' in the management of the corporation should be subject to the duties of good faith and proper purpose. Such examples could be full time executives in a company who are self employed but contract their services to an organisation and a people who take on a senior role in a company on an interim basis. In short, it is the function which the person fulfils that should determine whether that person will be subject to the duties.

The AICD, however, considers that it would be preferable not to include a definition of 'management' given the meaning of the word is somewhat elastic and can be appropriately interpreted by a court on the basis of the relevant facts before it. Also there is a body of case law giving guidance as to the meaning of the word and a statutory interpretation is likely to create confusion rather than clarify the meaning of the term.

Proposal 2

Sub-section 180(1) (the duty of care and diligence) should be extended beyond directors and other officers of a corporation to any other person who takes part, or is concerned in the management of that corporation.

The AICD supports this proposal.

Proposal 3

As a corollary of Proposal 2, section 180(2) the business judgment rule) should be extended beyond directors and other officers of a corporation to any other person who takes part, or is concerned, in the management of that corporation.

The AICD supports this proposal.

Proposal 4

Sections 182 and 184(2) (improper use of corporate position) should be extended beyond directors, other officers and employees of a corporation, to any other person who performs functions, or otherwise acts, for or on behalf that corporation.

See Proposal 5 below.

Proposal 5

Sections 183 and 184(3) (improper use of corporate information) should be extended beyond past and present directors, other officers and employees of a corporation, to any person who performs, or has performed, functions, or otherwise acts or has acted, for or on behalf of that corporation.

The AICD opposes the extension of CA sections 182-184 beyond directors, officers and employees of a corporation to 'any other person who performs functions, or otherwise acts, for or on behalf of the corporation.'

The very nature of the obligation in section 182 (civil obligations) and section 184 (criminal offences) is for the person not to 'improperly use their position'. The persons to whom this obligation should properly fall are those that in fact have a 'position' with the corporation rather than simply being third party contractors. The broader approach canvassed on page 26 of the DP to extend the provision to 'any person who performs functions, or otherwise acts, for or on behalf of the corporation' may well avoid technical questions as to whether a particular individual is a director, other officer or employee, however, this would extend the reach of the provision in an inappropriate manner.

Further, the real concern that the HIIH report focuses on in this respect is that certain persons may undertake activities which are very similar to those of an employee under the guise of independent contractors or consultants where 'they may be in fact be performing functions very analogous to those performed by employees'. The broader approach canvassed by the DP goes very much beyond addressing the problem identified by the HIIH report in this respect. Indeed the adoption of the former definition of 'executive officer' addresses the problem identified in the HIIH report. This is because the definition of 'executive officer' is a functional definition in that it applies to any person whether or not a director that is concerned in or takes part in the management of the body or entity. In this regard, the HIIH report (extracted on page 46 of Appendix 1 of the DP) states as follows:

'In my opinion it is the performance of the relevant function that should attract the legal duty, not the precise legal relationship between the person performing that function and the relevant corporate entity. The definition which applied prior to the CLERP amendments - namely, that which embraced a person who 'is concerned, or takes part, in the management of the relevant entity' - seems appropriate.'

Persons dealing with a company falling outside the definition of director, executive officer or employee should be regulated by contract. To do otherwise would place the independent contractor or consultant with a corporation subject to the rules different from that with any other entity. Australia is a relatively small market for consulting services and the proposed extension might limit the availability of those services. Consultants are usually engaged precisely because they have gained knowledge from other companies and that is the value they add when on assignment. Invariably they are bound by confidentiality provisions as part of their contract.

More fundamentally, there is in principle no reason - except in the context of insider trading in securities - why a consultant should not take advantage of information acquired by him or her in that capacity from a corporation, except where the information is imparted to him or her on the basis of confidentiality. Disclosure of information in breach of confidentiality is generally actionable at the hands of the relevant corporation. In the absence of fraud, or theft, there is no justification for imposing penalties, civil or criminal, under the CA.

Furthermore, to extend the duty beyond officers of the company may well erode those officers' understanding of their duty to engage contractors on appropriate terms and to supervise them. It is for the officers of the company to ensure that the work done for the company is performed to standards which are in the interests of the company and that cannot, and should not be able to be, delegated. It is unreasonable to expect a contractor to have the same understanding of the 'best interest' of the company as a senior officer.

Proposal 6

Sub-section 1309(1) (knowingly provide false or misleading information) should be extended beyond officers and employees of a corporation to any other person who performs functions, or otherwise acts, for or on behalf of that corporation.

The concern outlined in the HHH report is that section 1309 at that time used the phrase 'officer of a corporation' which did not extend to employees and covered only those 'who make or participate in making decisions that affect the whole or substantial part of the business of the corporation or who have the capacity significantly to affect the corporation's financial standing'. This was a significant narrowing of the persons covered by section 1309 before those amendments became effective in March 2000 as prior to that date the definition of 'officer' set out in section 82A covered employees. As outlined in the DP, the CLERP 9 legislation enacted in 2004 has now extended 1309 to include employees. The AICD considers that the amendment of 1309 to include employees and the re-inclusion of the old definition of 'executive officer' (which includes a functional definition for those involved in management) addresses the problem identified in the HHH report and no further extension of the persons covered by section 1309 is warranted.

Proposal 7

Sub-section 1307(1) (misconduct concerning corporate books) should be extended beyond past and present officers, employees and shareholders of a company to any other person who performs, or has performed functions, or otherwise acts or has acted, for or on behalf of that company.

The AICD does not believe that section 1307(1) should be extended to persons, other than officers and employees, who perform functions, or otherwise act, for or on behalf of a corporation. That would extend it to, for example, a storage or recycling facility to whom the relevant corporation had sent 'books'. The offence in section 1307(1) is engaging in conduct that results in concealment, destruction etc, and it is difficult to conceive of circumstances where 'books' had been destroyed by an independent contractor without an officer or employee of the corporation having engaged in conduct to that end.

General Dishonesty Provision

This proposal was put forward in the HIH Report as 'an appropriate balance between the broad ambit of operation of the law prior to March 2000 (namely the duty of honesty in the now-repealed section 232(2), which applied to all executive officers), and its unduly narrow operation now...'. If the AICD's submissions on Proposals 1 and 2 were adopted, the need for such a general honesty provision, on the Report's own reasoning, would disappear. There are, of course, in addition the several difficulties with introducing such a provision that are set out in the DP.

Need for definition of employee

The CA, and its predecessors reaching back to the UCA, have used the word 'employee' without attempting to define it, and without giving rise to any difficulty in obvious need of remedy. The AICD does not share either the view expressed in the DP that the common law tests to distinguish between a contract of service and a contract for services are either complex or imprecise, or with the implied assumption in the DP that a statutory definition would be less complex or less imprecise.

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Appendix

Because we are so accustomed to referring to the fiduciary duties owed to a corporation as directors' duties, it is easy to overlook that they apply also to non-director officers of the corporation acting in a managerial capacity. After making that point half a century ago in his *Modern Company Law*, Professor LCE Gower went on to say:

'This is a matter of considerable practical importance now that it is common for the management of public companies to be delegated by the board to a smaller body. At present the managers to whom the directors delegate their powers are likely themselves to be managing and other full time service directors. But the modern tendency seems to be towards to a clear distinction between the management which runs the business and the board of directors which oversees the management and lays down broad lines of policy. This may, in time, lead to the practice of delegating managerial powers to professional managers without seats on the board. In that event, certain statutory rules will need amplification but the general principles of equity are already sufficiently all-embracing to deal with most of the resulting possibilities. In the following discussion we shall refer to directors but, except where the context requires otherwise, what is said is equally applicable to all agents of the company; their fiduciary duties are the same but, of course, the lower one goes in the official hierarchy, the less opportunity there is for a breach of these duties.'

At the time that passage was written, neither in England or Australia did the *Companies Act* contain any provisions covering the general duties of directors and officers to their company. It was, however, only shortly afterwards that the *Companies Act 1958 (Vic)* introduced a new section 107, which from 1962 became section 124 of the *Uniform Companies Acts*, which read:

- (1) A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.
- (2) An officer of a company shall not make use of any information acquired by virtue of his position as an officer to gain directly or indirectly improper advantage for himself or to cause detriment to the company.
- (3) An officer who commits a breach of any of the provisions of this section shall be –
 - (a) liable to the company for any profit made by him or for any damage suffered by the company as a result of the breach of those provisions; and
 - (b) guilty of an offence against this Act.Penalty: Five hundred pounds.'

'Officer' was defined in UCA section 5 as including, inter alia, 'any director, secretary or employee' of a corporation.

The Explanatory Memorandum for the relevant Bill said in regard to this provision that it is new 'and so far as is known not to be found in any other legislation relating to companies in the English-speaking world.' It was 'introduced as a result of consideration of the Statute Law Revision Committee's report' on the inquiry into the affairs of Freighters Limited by an

inspector appointed pursuant to the provisions of the *Companies (Special Investigations) Act 1940 (Vic)*.

The Explanatory Memorandum went on: 'It was decided to introduce this provision rather than the particular provisions suggested by the Statute Law Revision Committee as it was thought that a more general provision would be more effective. To a large extent the section 'is declaratory of the existing law, but it is believed that a restatement of the principles of the honesty and good faith that should govern directors' conduct, clearly set out in the Act, would be an effective deterrent to misconduct and will free the Courts from the technicalities of the existing law in dealing with all forms of dishonesty and impropriety of directors.'

Apart from its novelty in the context of companies legislation, the section was also notable for being the first measure in the common law world to make breach of a fiduciary duty of itself a crime, in order - as the then Victorian leader of the County Party put it - to put 'teeth' into the new section.

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