

Our Ref: JM:LW  
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25 August 2005

Mr John Kluver  
Executive Director  
Corporations and Markets Advisory Committee  
GPO Box 3967  
SYDNEY NSW 2001

Dear Mr Kluver

**Re: CAMAC Discussion Paper: Corporate Duties Below Board Level**

The Law Society of New South Wales congratulates the Corporations and Markets Advisory Committee (CAMAC) on its Discussion Paper addressing the complex issue of corporate duties below board level and would like to thank CAMAC for the opportunity to make this submission.

The Discussion Paper has been reviewed by the Law Society's Business Law Committee (Committee). The Committee is delighted to make a submission in relation to the Discussion Paper, and notes that the submission is not intended to address every aspect raised under the proposed amendments. Rather, it is the intention of the Committee to raise debate regarding the recommendations in general theory, and as they apply to the *Corporations Act*.

**Introductory comments**

At the outset, the Committee expresses the view there is need to balance the inherent time cost to business of further regulation against the suggested benefit of that regulation.

There appears to be some tension between the proposals in the Discussion Paper and the traditional approach taken by the general law, particularly equity. It is this tension that the Committee has focused on as a critical issue to address. The tension lies in the Discussion Paper's proposal that duties owed by people to the corporation should be defined by reference to the role or function they play in relation to the corporation, rather than by reference to the relationship between the person in question and the corporation.

While this proposal seems sensible initially, if someone acts as a board member or similar they should be treated as such and it is necessary to consider the legal proposition being put forward. The duties in question have always been, and continue to be, defined and imposed by reference to the nature of the relationship between the parties. This has been the case in statute, at common law, and in equity. Particularly in relation to the proposals to extend the statutory fiduciary duties to a wider class of

personnel, the Committee expresses concern over an expansion that the courts would not otherwise countenance.

The Committee also queries whether the *Corporations Act* is the appropriate vehicle for instituting wide ranging duties on employees. For example, the *Corporations Act* currently imposes certain duties (see especially ss182 and 183) on employees, the conduct of whom is appropriate for the *Corporations Act* to regulate. One of the questions that the Committee considered was whether it was appropriate for employees to owe a duty not to misuse their position or information gained by virtue of their position and whether it is necessary for the *Corporations Act* to be amended to impose such a duty.

## Discussion of the recommendations

Extension of duties under sections 180 and 181:

For the reasons expressed below, the Committee does not wholly support the proposed amendments to extend those duties imposed on directors under ss180 and 181 to 'any other person who takes part, or is concerned, in the management of the corporation'.

The issues addressed in the Discussion Paper extend to the heart of the relationship that directors and senior officers have to their respective companies. The HIH Royal Commission Final Report raises a series of questions about whether the *Corporations Act* adequately reflects the commercial practicalities of managing (albeit directing) a modern corporate enterprise. Historically, the general law has taken the view that directors, by virtue of their position, are responsibly held out to be the decision makers of a corporation<sup>1</sup> and has dimly viewed the neglect or omission of such duties that ought to be performed.<sup>2</sup>

The challenge, in part, before corporate Australia in this regard was in enforcing legal responsibility for the neglect of a duty that ought to have been performed on behalf of shareholders by the chairman and directors of the company. Importantly in the case of HIH, those individuals responsible for the decisions of the company were held to be accountable in the eyes of the law, and of the public. But, over the 19<sup>th</sup> and 20<sup>th</sup> centuries there appears to be a judicial reluctance to second guess business judgements made in good faith, and an explicit understanding that it is undesirable for courts to attempt to formulate general principles in this area.<sup>3</sup> This view was well articulated in the decision of *Dovey v Cory*, citing judicial interference to establish such principles as undesirable 'for the guidance of embarrassment of businessman in the conduct of business affairs'.<sup>4</sup> Today, this sentiment is well reflected in the exceptions provided by the business judgement rule under s180(2) of the Act.

The issue considered under Recommendation 2 of the HIH report was whether the general duties of directors and officers under Chapter 2D of the *Corporations Act* should apply to a wider class of personnel. Justice Owen recommended that the definition to whom the duties applied should focus on 'the function performed by the relevant person – not the classification of their legal relationship to the

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<sup>1</sup> See especially, *Salamon v Salamon & Co Ltd* [1897] AC 22, House of Lords.

<sup>2</sup> *Re Cardiff Savings Bank; Marquis of Bute's Case* [1892] 2 Ch 100 (Stirling J) 108. Cf *Williams v McKay* (1889) 18 A 824.

<sup>3</sup> Paul Redmond, *Companies and Securities Law Commentary and Materials* (3rd ed, 2000) 378.

<sup>4</sup> [1901] AC 477 (Lord Macnaghten) 488.

corporate entity'. The latter general law however seems to suggest the contrary, arguing that the source of duty of care and diligence lies in the relationship of a director to the company: *Daniels v Anderson*.<sup>5</sup> Here, Justices Clarke and Sheller state that 'we see no reason why the relationship of a director to a company should not, in accordance with the law that has been developed since *Headley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, satisfy the proximity test'.<sup>6</sup>

Although the Discussion Paper rightfully questions the extent of duties under the *Corporations Act*, the Committee does not agree with the view that such obligations be statutorily extended to 'any other person ...' as it is questionable whether any other person who takes part in the management of a corporation is in fact in a position such that duties of care and diligence, as they apply to directors, ought to apply in such cases other than to 'officers'. To allow the reach of the law to extend to middle management away from company directors and officers could be interpreted as permitting the law's interference with the day-to-day conduct of business affairs.

Although *Daniels* sets down that a director's duty 'cannot simply be limited by his or her knowledge or experience, or ignorance or inaction',<sup>7</sup> the Committee submits that the relevant test must consider whether the individual is in a position to make decisions that have '*significant*' bearing on the financial standing of the corporation or the conduct of its affairs.<sup>8</sup> The Committee supports the view that a 'director should become familiar with the fundamentals of the business in which the corporation is engaged',<sup>9</sup> but adoption of the proposed amendments arguably provides the mechanism by which blame for corporate failure is delegated down the management chain. There are for instance, many middle managers within corporations that *do not* make decisions bearing on the financial standing of the company, and the Committee is concerned that the proposed amendments may provide for the dilution of directors' equitable duties.

In the Committee's view, extending such duties to middle management significantly waters down the necessary onus placed on directors to uphold their statutory and equitable obligations, and adoption of a 'functional' definition is arguably not in keeping with the general law. The Committee queries whether a director's fiduciary duties should be extended to middle management and whether in those circumstances company directors and middle management should both be under the same legal and equitable obligations. Perhaps a more contemporary example of these issues is highlighted by the One.Tel case,<sup>10</sup> and, by way of alternative example, comparison could be made with the position taken by the *US Sarbanes Oxley Act* in relation to a company's c-level executives, or 'certifying officers'.<sup>11</sup>

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<sup>5</sup> (1995) 37 NSWLR 438 (Clarke and Sheller JJA) 492 (*'Daniels'*).

<sup>6</sup> At the risk of rekindling the fusion fallacy debate, the Committee does not place sole reliance on this reference to illicit its proceeding argument. The Committee would however like to point CAMAC to the recent decision of the Supreme Court of NSW in *ASIC v Vines* [2205] NSWSC 739, particularly to the arguments raised by Justice Austin at 1070.

<sup>7</sup> Per Clarke and Sheller JJA, 503.

<sup>8</sup> Referring to the definition of 'management' adopted in *Commissioner for Corporate Affairs (Vic) v Bracht* (1989) 14 ACLR 728 (Ormiston J).

<sup>9</sup> *Campbell v Watson* 62 NJ Eq, 416.

<sup>10</sup> See especially, *Australian Securities & Investments Commission v Rich* (2003) 44 ACSR 341.

<sup>11</sup> The Act, for example, holds a company's c-level executives (or 'certifying officers') personally responsible for misrepresentation of financial data (see, eg, s302). These officers then become the focus of subsequent requirements such as the report by management on the company's internal control over financial reporting under s404.

Arguably, section 9 of the *Corporations Act* already embraces a functional definition of 'officer'. Accordingly, as James McConvill suggests, and the Committee agrees, 'there is simply no need to amend the law to extend to the duty of care and diligence, unless of course it is felt that there is a need to shift some responsibility from the board to middle management.'<sup>12</sup> As Judge Lee remarked in *Federal Deposit Insurance Corporation v Lee*, 'a director's duty to exercise due care, skill and diligence in overseeing the affairs of the bank cannot be met solely by relying on other persons ...'.<sup>13</sup> Justice Owen does not appear to be recommending that directors' statutory duties be delegated, but the perceived risk is that if the duties are extended, this may be the adopted interpretation (albeit practical reality). For these reasons, the Committee is of the view also that the statutory provision ought to remain unchanged, but agrees that some clarification of duties is needed to accurately assess the potential impact of the reforms.

If a director is an 'essential component of corporate governance',<sup>14</sup> the Committee queries whether the Discussion Paper is looking to broaden the realm of corporate governance by extending duties to middle management. Justice Owen remarked in *HIH*, '[a]ny legal regime for the enforcement of corporate governance standards that does not extend to ... at least some levels of management is unlikely to be ... effective.' The Committee supports the view that it is not the role of corporate governance theorem to determine the law as it ought to be.

### **Extension of obligations under sections 182 and 183**

For the reasons expressed below, the Committee generally supports the proposed amendments to extend the prohibitions under ss182 and 183 beyond directors, other officers and employees of a corporation to 'any other person who performs functions, or otherwise acts, for or on behalf of that corporation'.

The proposed reforms to ss182, 183 & 184 appear to 'cover the field', extending to independent contractors who do not come within the strict definition of 'employee', but the Committee agrees with the view that the 'executive officer' test may be too narrow a test to apply. Criminal provisions aside, without strict incorporation into section 9, difficulties may lie in tying responsibility to the line of office. In *ASIC v Vines*,<sup>15</sup> drawing on a report published by the Senate Standing Committee on Legal & Constitutional Affairs,<sup>16</sup> Justice Austin suggests that the statutory duties imposed on officers are an objective standard of reasonable competence. In relation to consultants and contractors, the issue then, for example, is whether and how the law applies in determining whether such employees have or could breach their statutory duty.

The importance of recognising the 'legal' role and or operational function of consultants and contractors is that they regularly perform 'acts, for or on behalf of the corporation', but responsibility for breach of duties, unless otherwise provided for under the *Corporations Act*, may better lie as a matter of employment law. The

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<sup>12</sup> James McConvill, 'Corporate Duties: A Need for Care and Diligence', (2005) <<http://www.lawyersweeklu.com.au/articles>> at 11 July 2005. James McConvill is a lecturer at Deakin University Law School, and Principal of the Corporate Research Group.

<sup>13</sup> 770 F Supp 1281 (ND Ind 1991) 1310.

<sup>14</sup> *Campbell v Watson* 62 NJ Eq 443.

<sup>15</sup> [2003] NSWSC 1116.

<sup>16</sup> *Senate Standing Committee on Legal & Constitutional Affairs*, 'Company Directors' Duties: Report on the Social and Fiduciary Duties & Obligations of Company Directors', (November 1989). The Report recommended the enactment of an objective duty of care for directors.

definition of 'employee' and indeed of 'management' under the *Act* would therefore need to be revised.

### **Extension of obligations under sections 1309(1) and 1307**

The Committee's views are in keeping with those expressed in the HIH Royal Commission Final Report that 'if an employee provides information to a director or auditor that he or she knows to be false or misleading', there is 'no reason why they should not be held to have contravened the law'. Here, the Committee points CAMAC to the recent decision of the NSW Supreme Court in *ASIC v Vines*.<sup>17</sup> The Committee therefore generally supports the proposed amendments to extend the prohibitions under ss1309(1) and 1307 beyond officers and employees of a corporation to 'any other person who performs functions, or otherwise acts, for or on behalf of that corporation'.

### **General dishonesty provision**

The Committee's initial concerns with a general dishonesty prohibition is in keeping with CAMAC's, that the prohibition could lead to statutory duplication and difficulty in determining responsibility for enforcement. Otherwise, the Committee does not object with the proposed amendments to extend the current prohibitions dealing with improper use of corporate information and, providing false information, to 'any other person who performs functions, or otherwise acts, for or on behalf' of a corporation.

### **Further submission**

The Committee thanks CAMAC for the opportunity to make this submission, and is keen to contribute to further discussion on the issues raised in the Discussion Paper.

If any further information is required in relation to this submission, please contact Laraine Walker, Executive Member of the Business Law Committee on (02) 9926 0256 or by email to [lxw@lawsocnsw.asn.au](mailto:lxw@lawsocnsw.asn.au).

Yours sincerely,

**John McIntyre**  
President

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<sup>17</sup> [2005] NSWSC 738 (Austin J).