Good Governance

in

Independent Schools

A paper presented to the NCISA Conference
in July 2000

by Terry Chapman
Good Governance for Independent Schools

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Paper by Terry Chapman - NCISA Conference 2000
Good Governance in Independent Schools

Introduction

Research in the area of effective schools contends that the most important decision that a school board will make is the choice of its principal. In addition, it is frequently argued that the quality of a school is largely dependent on the quality and commitment of its teaching staff. Research also suggests that parents’ attitude to education and to the nature of their relationship with the school are factors that significantly contribute to the quality of the school and to the benefits derived by the children at the school.

While many of these assertions are undoubtedly valid, the benefits derived from sound leadership, committed teachers and involved and supportive parents can be severely diminished or even entirely negated if the governance of the school is not effective. There is no doubt that the quality of a school is dramatically affected by the quality of its governance process and it is the level of dedication, commitment and expertise of all involved in the governance process that will determine how effective and efficient the school will be. Poor governance will jeopardise, not only the delivery of quality education, but the very ongoing viability of the school.

Accepting membership of a school board of directors entails much more responsibility than is generally understood. The over-riding responsibility is to contribute to the effectiveness of the board, but this must be done in the context of meeting a number of obligations including statutory obligations and others imposed by common law. A clear understanding of these obligations is an essential pre-requisite to membership of any board of directors and it separates those who serve as members of a social or working committee from those who can serve effectively on the board of directors of a non profit company that owns and operates an independent school.

Accountability

Current trends throughout government is to place a much greater focus on the accountability of all people and organisations who administer public funds. It is an individual and an organisational responsibility to be aware of compliance requirements. Lack of knowledge has never been an adequate defence against allegations of non compliance with the law. Consequently, all who serve on school councils/boards have an obligation to be both well informed and to be seen to be well informed.

In addition to the accountability to regulatory authorities, members of the public now have a much higher expectation regarding the efficiency and fairness of institutions such as schools and therefore the demands on those involved in the governance of schools are of a very high order. In situations in which a product or a service that a person has purchased does not meet their expectations there is an assumption that there will always be someone to whom to turn to have their concerns redressed. They frequently turn to the particular Industry Association, the Consumer Affairs Bureau, the Dept of Fair Trading, the local member of parliament, the Minister, the Board of Studies, the Ombudsman or anyone else who is willing to listen. This seems to be a community wide trend to have someone else resolve one’s concerns, often without having taken the matter up themselves.
The board of directors of an independent school needs to consider how it will deal with this trend. The relationship of the board to its school should be seen in the same context as the relationship of the Department of Education or the Minister to a state school. If it is not seen in this way, or if it does not have processes in place to effectively manage these developing community trends, it will be more likely to expose itself to legal or political action.

Irrespective of this complaints issue, arguments are being raised about the need for independent schools to be more accountable than they are at present. This is very debatable as in many ways independent schools are more accountable than their state counterparts. Nevertheless, both state and federal governments alike are seeking to impose greater accountability requirements on independent schools.

The emerging question is how boards of independent schools will meet these new challenges. In the first instance the board must consider the quality and accountability of its own directors. This paper is based on the prime assumption that those who perform in an honorary capacity on school boards must meet the same high level expectations as directors of other companies and need to be supported in a number of ways including through educational programmes that are designed to assist them to meet their individual and collective responsibilities.

The Origins of this Workshop

Over many years member schools have asked for assistance with governance issues including attempts to repair relationships between school councils and Heads. AIS(NSW) has responded to increasing requests for workshops that will assist with a broad range of governance issues and the experiences of many of the governors, heads and bursars have contributed to the constant revision of the content of the courses and workshops offered.

An early version of governance workshops was reported upon at the NCISA/AHISA Chairman of Governors Conference in 1991. AIS(NSW) now conducts a two day Certificate course in Independent School Governance in association with the University of NSW. In addition, one day workshops are conducted for individual schools upon request. No two workshops have been the same as each is tailored to the school’s needs through discussion with the chairman and the principal and while we believe the content is constantly being amended, our conclusion is that those that have been conducted over less than six hours have been less effective.

It is with trepidation that we have accepted the invitation to adapt the content to a ninety minute presentation for this conference.

Terry Chapman
Executive Director

Geoff Newcombe
Director - Governance
Topics

- About governing bodies
- Obligations of individual school governors
- Obligations of the governing body
- Models of governance - structure and role
- The Board's Operational Processes
  - Financial affairs
  - Contracts
  - Acquisitions of goods and services
- Delegations of Responsibility/Authority
- Policy Issues.

The Governing Body

What is it?

- The Committee that runs the school?
- The Committee that everyone appreciates?
- The Committee that everyone blames?
- The Committee that does all of the work?
- The Committee of people who want to control the way the children are taught?...
What is it called?

- The School Council
- The Governing Body
- The Board of Trustees

- The Board of Directors
  - of the Company that owns and operates the school...

The Significance of the Board

- Without it the school cannot exist
- Without the voluntary effort, the school would not exist.
- The level of dedication, commitment and expertise of Directors will determine how effective the school will be.
- A Board that does not operate effectively will put the school into jeopardy...
The Company

What type of incorporation?

The Corporations Law The Associations Incorporations Act

- Private (proprietary) company
- Public Company
  - Limited by guarantee
  - Limited by shares
    - Listed
    - Unlisted
- Independent Schools are generally non profit public companies, limited by guarantee.

The Company

Who is involved - what are their roles?

- Company Membership - Company Board of Directors

  - How many are there?
  - What is the maximum number allowed?
  - Who can be members?
  - How do they become members?
The Obligations of School Governors

What Governors should know about the company and its board.

- Its legal structure
- Its organisational structure
- Its operational processes
- Its financial management processes
- Its assets and liabilities
- Its role and the responsibilities it has delegated...

Each Governor's Operational Responsibilities

- A Director's responsibilities to the board:
  - Responsible participation in meetings
  - and in decisions
  - Confidentiality should be assumed
  - Support for decisions of the Board...
The Role of the Company

- The "Keepers of the vision"?
- It elects/appoints the directors.
- It considers the annual accounts
- It appoints the auditor...

The role is more limited than many appear to think!

The Role of the Board of Directors

- It conducts the affairs of the company

The role is more extensive than many appear to realise.
Obligations

Imposed by Others

- Statutory Obligations
  - Acts and Regulations

- Those imposed by the Constitution
  Previously known as the Memorandum and Articles of Association

- Common Law Obligations

- Other imposed obligations ?..

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Obligations - Statutory

Acts and Regulations
Federal, State and Local Government

- Corporations Law
- Industrial Relations Act
- Anti Discrimination Acts
- Workers Compensation Act
- Children, Care and Protection Acts
- Education Act
- Other Acts.. 

Exercise 2
Obligations - Incorporation

Constitution
(Memorandum and Articles of Association)

- Objectives
- Appointment of Directors
- Appointment of Chairman
- Meeting Procedures
- Non Profit Status...

Exercise 3 and 4

Obligations

Imposed by Common Law

- Directors must
  - Act honestly
  - Exercise reasonable care and diligence
  - Act in Good Faith - best interests of the company as a whole.
  - Not fetter their discretion
  - Avoid a conflict of interest
  - Not make improper use of their position
  - Not make improper use of information acquired..

Exercise 5
Obligations

Documents that may help

- Memo on directors’ duties and liabilities
- Corporate Law Economic Reform Programme
- Memo on Directors’ duties to prevent insolvent trading
- Case note on Daniels v AWA Ltd (1995) 37 NSWLR 438
MEMORANDUM ON
DIRECTORS' DUTIES AND LIABILITIES

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1. **INTRODUCTION**

1.1 This Memorandum contains a general summary only of the law relating to the duties and liabilities of Directors. Specific legal advice should be obtained on issues arising in practice as the facts of a particular situation may affect how the law will apply to the issue or situation in question.

1.2 This Memorandum deals only with the duties and liabilities of Directors of unlisted companies under the Corporations Law and common law and does not, therefore, cover obligations and duties arising under, for example:

(a) the ASX Listing Rules;

(b) any other legislation that may impose specific obligations and duties in the case of a company carrying on business in a particular industry sector.

1.3 A director has two fundamental duties:

(a) to exercise care, diligence and skill; and

(b) as a fiduciary of the company, to exercise his powers for a proper purpose and for the benefit of the company.

1.4 These duties require a director to:

(a) act honestly;

(b) act in good faith for the benefit of the company;

(c) avoid actual or possible conflicts between the director’s duty to the company and his personal interests or duties or others;

(d) account for business opportunities which come to him by reason of, or in the course of, his role as director, or which are in the same line of business as the company’s business.

2. **ACT HONESTLY**

An officer of the company is required to act honestly in the exercise of his powers and the discharge of his duties (section 232(2) of the Corporations Law - maximum penalty $200,000). If a contravention is committed with an intent to deceive or defraud, a penalty of $200,000 and/or five years’ imprisonment applies.

3. **CARE AND DILIGENCE**

3.1 Officers of a corporation are required to exercise a reasonable degree of care and diligence in the exercise of their powers and the discharge of their duties (section 232(4)).
3.2 The duty is owed to the company, though members will be able to enforce it for the company’s benefit if proposed amendments to the Corporations Law in relation to statutory derivative actions are enacted.

3.3 Breach of section 232(4) may result in:

(a) the imposition of a civil penalty of up to $200,000; or
(b) a civil action for damages by or on behalf of the company; or
(c) a criminal prosecution if a contravention is committed with an intent to deceive or defraud.

3.4 Section 232(4) reinforces the common law duty of care outlined recently in AWA v Daniels (1995) 13 ACLC 614 (‘AWA Case’). The AWA Case also expanded the duty of care that directors owe to their company. This duty of care now includes a requirement that directors ‘take reasonable steps to place themselves in the position to guide and monitor the company’. Therefore, directors cannot rely blindly on the judgment of others. They must understand the major activities of the business and establish systems to manage risk within the company.

3.5 As a result of the AWA Case it is important that all directors should:

(a) exercise an active discretion;
(b) exercise careful supervision of executives and managers; and
(c) ensure proper procedures are in place to receive all material information on the company’s operations.

3.6 In order to satisfy the third obligation a director has a right to inspect documents of a company and to take copies of those documents to properly discharge his duty.

3.7 Section 232(4) draws attention to the degree of care and diligence that a ‘reasonable person in a like position in a corporation’ would exercise, and attention must be given to ‘the corporation’s circumstances’. Therefore, it is important to take into account the position of the company and the responsibilities assigned to the directors under the Articles of Association, as well as the responsibilities of non-director officers.

4. DELEGATION

4.1 While it is appropriate that the board of directors delegate certain expert tasks to accountants, auditors, lawyers and others, and to rely upon their advice, directors should not attempt to abdicate responsibility or supervisory functions once delegation has taken place. Reliance on others is permitted, but this may not be a defence to an alleged breach of duty. Directors therefore should act with care in a supervisory capacity, particularly where they have been made aware of a matter that should lead them to further inquiry.

4.2 Boards often delegate certain tasks to special purpose committees. Those committees may divide work among directors to ensure that the information considered by the full board has been properly assessed. For example, a common means of ensuring adequate
communication between company auditors and directors is the establishment of an audit committee.

5. CONFLICTS OF INTEREST AND DUTY

5.1 A director should not:

(a) allow a situation to develop in which his duty is subject to a conflict of interest; or

(b) make use of his position to gain a personal advantage or advantage for a third party.

5.2 A range of activities are embraced by this duty, including:

(a) misuse of corporate assets;

(b) misuse of confidential information;

(c) dealings with the company;

(d) taking, for personal gain, a business opportunity that belongs to the company.

Conflict of Interest

5.3 A director of a public company who has a ‘material personal interest’ in a matter that is being considered at a meeting of directors:

(a) must not vote on the matter; and

(b) must not be present while the matter is being considered at the meeting (Section 232A(1)). This provision does not apply to a proprietary company.

5.4 However, if the board passes a resolution that:

(a) specifies the director, the director’s material personal interest and the matter before the board; and

(b) states that the directors voting for the resolution are satisfied that the interest should not disqualify the director, then the interested director can vote and be present while the matter is being considered (Section 232A(3)).

5.5 The interested director cannot vote on or be present at the board’s consideration of a resolution permitting him or her to be present and vote on the substantial matter (Section 232A(1)).

Proper Purposes

5.6 A director must not:

(a) make improper use of information acquired by virtue of his position; or
(b) make improper use of his position;

to gain, directly or indirectly, an advantage for the director, for any other person or to cause a detriment to the company (Section 232(5) and (6)).

5.7 Without proper authority, a director is not free to take up a particular opportunity which is being pursued or considered by the company. A director’s fiduciary position inhibits him not only in respect of business opportunities the company is pursuing but also opportunities in which the company might reasonably be expected to be interested given its current line of business. Even where a company appears not to be interested in the opportunity, a director who exploits the opportunity, and profits from it, may be called upon to account for that profit to the company.

5.8 A contravention of the provisions relating to conflict of interest and duty attracts a maximum fine of $200,000 and/or imprisonment for five years. The contravening director may also be liable to the company for the loss it has suffered as a result of his or her actions.

6. DUTY TO ACT WITHIN POWER

6.1 Just as trustees are absolutely liable for breach of trust if they allow trust property to be applied unlawfully or contrary to the terms of the trust instrument, whether or not they have acted intentionally or negligently, directors are liable for breach of duty if they allow the company’s property to be applied unlawfully or contrary to its constitution: *Mulkana Corporation NL (in lig) v Bank of New South Wales* (1983) 1 ACLC 1143; *Pennington’s Company Law*, 6th ed (1990), p.583-4.

6.2 Consequently, directors are liable for breach of duty if they approve a proposal or authorise corporate expenditure for an illegal purpose or without authority. The key question is whether the directors’ decision itself involves some illegality or is unauthorised by the company’s constitution: *Cullerne v London and Suburban General Permanent Building Society* (1890) 25 QBD 485.

6.3 This means that if directors expend money in connection with a proposal that is illegal or contrary to the Articles of Association/Constitution, their decision would constitute a breach of their duty. The duty is one of strict liability - the directors can be liable even if they have acted honestly and carefully. Their remedy in those circumstances is to seek a court order relieving them from liability under section 1318 of the Law. If the directors have acted carefully, on legal advice and for proper purposes, relief would normally be given (*Lawson v Mitchell* (1975-6) CLC 40-200 at 28,210).

7. DIRECTORS’ BENEFITS

Chapter 2E of the *Corporations Law* regulates the giving of financial benefits to directors by public companies, so that in general terms the company is prohibited from directly or indirectly making a loan to a director, his relatives or affiliates without a resolution from the members in general meeting. Some exceptions are available. Chapter 2E does not apply to a proprietary company.
8. DUTY TO CREDITORS AND INSOLVENT TRADING

Please see ‘Memorandum on Directors’ Duties to Prevent Insolvent Trading’.

9. CONFIDENTIALITY

Unauthorised disclosure of confidential information will amount to a breach of duty. Information that comes into the possession of a director will be confidential information where it is of a confidential nature (that is, it is not public knowledge and has been communicated to the director in circumstances giving rise to an obligation of confidence).

10. OTHER AREAS OF POTENTIAL LIABILITY

10.1 Another area of potential common law liability for directors and officers is where a company is liable to third parties in tort, for example:

(a) defamation;
(b) breach of duty not to disclose confidential information;
(c) infringement of patent, trade mark or copyright;
(d) economic torts of conspiracy and inducing breach of contract;
(e) negligent misstatement;
(f) fraudulent misrepresentation; and
(g) negligence.

10.2 A director is not personally liable for the tortious acts of his or her company just because he or she is a director. However, the director will be personally liable for tortious acts that he or she commits and also for the tortious acts of his or her company that he or she has ordered or procured to be done.

10.3 Directors may also face common law liability to third parties in contract. Usually, if a director binds the company while acting as its agent, he will not be personally liable. However in some circumstances he will incur liability for:

(a) breach of warranty of authority - if an officer contracts on behalf of a company when he or she has no authority to do so he or she is not personally liable on the contract but may be liable in damages for breach of implied warranty of authority; and

(b) breach of contractual obligations incurred on behalf of a company - if an officer contracts on behalf of a company and does not disclose that he or she is acting on the company’s behalf, he or she will be liable for any breaches of contractual obligations.

MINTER ELLISON

27 April 1999
CORPORATE LAW ECONOMIC REFORM PROGRAM
THE NEW RULES EXPLAINED IN RELATION TO
DIRECTORS' DUTIES AND CORPORATE GOVERNANCE

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A. INTRODUCTION

The Corporate Law Economic Reform Program (CLERP) will introduce a range of significant changes to the Corporations Law. In a number of areas, these changes reflect long histories involving discussion papers, submissions, reports, judicial comment and academic discussion.

In late 1997 the Commonwealth Government published Proposal for Reform papers covering the following six areas:

- directors’ duties and corporate governance;
- corporate fund raising;
- takeover rules;
- accounting standards;
- electronic commerce; and
- financial markets and investment products.

The first four of these are embodied in the Corporate Law Economic Reform Bill 1998, introduced to the House of Representatives on 2 July 1998.

This paper will only consider the effect of CLERP as it applies to directors’ duties and corporate governance.

B. DIRECTORS’ DUTIES AND CORPORATE GOVERNANCE

1. Business Judgment Rule

1.1 Proposed section 180(1) sets out the duty of care and diligence applicable to directors and other officers. Section 180(2) then provides that a director or other officer who makes a ‘business judgment’ is taken to meet the requirements of section 180(1), and the equivalent requirements at common law and in equity, in respect of the judgment if they:

(a) make the judgment in good faith for a proper purpose;
(b) do not have a material personal interest in the subject matter of the judgment;
(c) inform themselves about the subject matter of the judgment to the extent they would reasonably believe to be appropriate; and
(d) rationally believe that the judgment is in the best interests of the corporation. The directors’ or officers’ belief that the judgment is in the best interests of the corporation is stated to be a rational one unless the belief is one that no reasonable person in their position would hold.

1.2 ‘Business judgment’ is defined in section 180(3) to mean any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.
1.3 The inclusion of a business judgment rule in the Law was first recommended in 1989 by the Cooney Committee. The report of that committee noted that little attention has been paid to the issue in Australia, but included its recommendation (apparently without having received any submissions) on the policy grounds that informed business judgments should be encouraged in order to stimulate innovation and risk-taking and that judicial intrusiveness ought not to interfere with private sector decision making. Similar recommendations were made by the Companies and Securities Law Review Committee in 1990; the Lavarch Committee in 1991; and the Companies and Securities Advisory Committee in 1991.

1.4 The Explanatory Memorandum to the Bill declares that ‘a failure to expressly acknowledge that directors should not be liable for decisions made in good faith and with due care, may lead to failure by the company and its directors to take advantage of opportunities that involve responsible risk-taking’.

1.5 Proposed section 180(2) makes it clear that a business judgment meeting the specified conditions is taken only to meet the requirements of section 180(1) and equivalent duties at common law and in equity. Other statutory provisions, and fiduciary duties generally, are not covered. The protection will not apply, for example, to business judgments made in the context of insolvent trading or misstatements in prospectuses or takeover documents.

1.6 The proposed introduction of the rule must be seen in the light of the Court of Appeal decision in Daniels v Anderson (1995) 37 NSWLR 438 (the AWA litigation) and, in particular, the decision that the directors were subject to a common law duty of care to the company. This introduced a significantly higher standard than Rogers J. had applied at first instance, reflecting the older line of cases based on Re City Equitable Fire Assurance [1925] Ch. 407.

1.7 The requirements of section 180(2) are closely based on the formulation of the rule by the American Law Institute. Professor Eisenberg, the Chief Reporter of the American Law Institute’s Principles of Corporate Governance, has commented that the business judgment rule is an easy standard for directors to satisfy, and that a director will not be found negligent unless he has made an extremely bad decision.

1.8 The question whether there is a need for a statutory business judgment rule in Australia has been much discussed since 1989. The points which have most often been made include the following:

(a) Australian Courts have shown a reluctance to interfere with business decisions. The High Court has said that:

‘Directors in whom are vested the right and duty of deciding where the company’s interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the Courts.’

Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL (1967) 121 CLR 483 at 493;
there is, nevertheless, a concern that Courts may tend to invoke this rule without evaluating whether the business decision has been made with due care;

Section 1318 of the Corporations Law provides the Court with power to relieve an officer who has acted honestly, in circumstances where the person ought fairly to be excused, from civil liability for negligence, default, breach of trust or breach of duty in that capacity. It seems, however, that this remedy is not often requested or granted; and

the availability in Australia of section 246AA (formerly section 260) provides the Court with power to make a wide range of orders in cases where the affairs of the company are being conducted in a manner that is oppressive to or unfairly prejudicial to or unfairly discriminatory against a member or members or in a manner contrary to the interest of the members as a whole. This type of remedy is not generally available in the US and, despite judicial reluctance to interfere in business decisions, creates the potential for review of the merits of such decisions.

1.9 In any event, the AWA litigation appears to have tipped the balance by affirming the existence of the common law duty of care.

1.10 It will be noticed that the conditions in section 180(2) overlap significantly with proposed section 181(1), which sets out the proposed duty of good faith. In broad terms, the conditions necessary to meet the business judgment rule could be expressed as being compliance with the statutory duty to act in good faith (section 181), where the director is properly informed and having no material personal interests.

1.11 The term ‘business judgment’ appears exceptionally broad. The decision must be in respect of a matter relevant to the business operations of the corporation. The Explanatory Memorandum says that:

‘The operation of the business judgment rule will be confined to cases involving decision making about the ordinary business operations of the company. For example, the decision to undertake a particular kind of business activity promoted in a prospectus will be the kind of business judgment to which the proposed rule may apply. However, compliance (or otherwise) with the prospectus requirements imposed by the Law would not be a decision to which the proposed rule could apply.’

1.12 It will be interesting to see if the Courts agree that the definition should be so confined.

2. Statutory Derivative Action

2.1 The proposed new Part 2F.1A (sections 236-242) will include in the Corporations Law a statutory derivative action. Like the business judgment rule, this is an issue which has been much discussed and reported on. It was the subject of a CSLRC recommendation in 1990 and was considered in subsequent reports by the Lavarch Committee (1991) and CASAC (1993).

2.2 The usual reasons suggested in support of such an action is that existing law is inadequate to provide a method of enforcement where a company improperly refuses or fails to pursue a course of action. The Explanatory Memorandum lists a number of
difficulties associated with the common law action based on the exceptions to the proper plaintiff rule in *Foss v Harbottle*:

- the effect of ratification of the impugned conduct by the general meeting of shareholders;
- the lack of access to company funds by shareholders to finance the proceedings; and
- the strict criteria which need to be established before a Court may grant leave.

2.3 Various arguments have been made in support of the proposition that a statutory derivative action is not needed in Australia. These include:

(a) Australian Courts have generally ignored the perceived common law deficiencies in shareholder litigation, for example, by expanding the statutory remedy for oppression;¹

(b) the main purpose of shareholder litigation is to reduce agency costs between management and shareholders, such as monitoring costs incurred by shareholders to ensure that managers are acting in the interests of the shareholders and bonding costs incurred by managers for the purpose of assuring shareholders that their interests are being pursued.² It is suggested that there is a suite of other factors, such as shareholder voting, market forces, the appointment of independent directors and enforcement action by regulators, which is directed to achieving this objective and that shareholder litigation is merely one part of this suite;

(c) derivative actions may not always be in the best interests of the company and may deter legitimate risk-taking by management;

(d) the deterrent effect of derivative actions is difficult to estimate and may be quite limited;

(e) the availability of remedies under section 1324 of the *Corporations Law* (including injunctions and orders for damages) where there is conduct in contravention of the *Corporations Law* may present a viable alternative to a statutory derivative action. However, the decision of Young J in *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 14 ACLC 519 casts some doubt on the usefulness of section 1324 in this context. His Honour said that:

'I doubt very much, however, whether the legislature intended to abrogate the rule in *Foss v Harbottle* for internal disputes where sections of the law repeat in a statutory form ... what were the general law obligations of officers of a company.';


² Ramsey op cit. page 151.
(f) the number of claims made may be expected to increase greatly if disgruntled shareholders have access to company funds to support the proceedings.

2.4 Proposed section 236 limits the class of persons who may bring proceedings on behalf of a company or intervene in proceedings to which a company is a party, to members, former members (or a person entitled to be registered as a member) of the company or a related body corporate, and officers or former officers of the company. This is a broader class of persons than applicable under the common law, which only permits members to bring a derivative action. Despite recommendations in earlier reports, neither creditors nor the ASIC are eligible. This reflects the width of ASIC’s other powers, the intent that the statutory action is not intended to be regulatory in nature and the inappropriateness of allowing creditors to bring such actions.

2.5 Proposed section 236(3) abolishes the right of a person at general law to bring, or intervene in, proceedings on behalf of a company, but preserves the common law personal action exception to the rule in Foss v Harbottle. This appears to leave significant scope for argument over the notoriously difficult issue whether a person is seeking to enforce rights in particular circumstances in their capacity as a member or rights which are personal in nature, and will require this issue to be dealt with before the substantial issues are heard.

2.6 The precondition to availability of the statutory derivative action will be the obtaining of leave of the Court under proposed section 237. The section requires the Court to grant leave if five conditions are met:

- inaction by the company;
- the applicant is acting in good faith;
- it is in the best interests of the company;
- there is a serious question to be tried;
- the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying at least 14 days before making the application, or circumstances are such that it is appropriate to grant leave in any case.

2.7 Section 237(3) provides that there is a rebuttable presumption that granting leave is not in the best interests of the company in circumstances where (in summary) the proceedings involve a third party; the company has decided not to bring or defend the proceedings or has decided to discontinue, settle or compromise the proceedings; and all of the directors who have participated in that decision met certain listed requirements reflecting the conditions for availability of the business judgment rule. This would seem to be very difficult to rebut, especially if, for example, directors establish probity committees to deal with alleged misconduct. In proceedings which do not involve third parties, it will remain necessary for the Court to determine whether it is in the best interests of the company that the applicant be granted leave. Accordingly, the Court will be placed in a position of reviewing the merits of a business decision.
2.8 The CSLRC Report in 1990 had suggested that a criterion no higher than the establishment of a prima facie case was appropriate and quoted 'Cross on Evidence' for the proposition that:

'A prima facie standard involves production of evidence of such weight that no reasonable person, in the absence of further evidence, will find against the proponent of the relevant issue.'

2.9 Having made that suggestion, the CSLRC decided not to include any criteria in its draft legislation. The CASAC Report recommended the inclusion of the need to show a serious question to be tried. The Explanatory Memorandum indicates that the 'serious question to be tried' test was preferred to the alternative of requiring the applicant to show a prima facie case because it is important that the application for leave to take proceedings is not turned into a trial of the substantive issues. It also noted that this criterion would prevent the proceedings being abused by frivolous or vexatious claims.

2.10 Proposed section 239 has the effect that ratification or approval of conduct by the members of a company does not prevent a statutory derivative action from proceeding or necessitate a conclusion that the proceedings must be determined in favour of the defendant or that the application for leave must be refused. The Court may, however, take the ratification or approval into account in deciding what order or judgment to make, having regard to how well informed the members were in making their decision and whether the members were acting for proper purposes. The Explanatory Memorandum states in this context that:

'The provision will make it clear that the Court may only have regard to ratification if it is satisfied that the ratification was effected by the Company's fully informed independent members.'

Accordingly, there appears to be a link in the drafter's mind between the concept of 'proper purposes' and 'independence' of members.

2.11 Proposed section 241 confers on the Court wide power to make orders and give directions as it considers appropriate including an order appointing an independent person to investigate and report to the Court on the financial affairs of the Company; the facts or circumstances giving rise to the cause of action; and the costs incurred by the parties. This is supplemented by proposed section 242, which allows the Court at any time to make any orders it considers appropriate about the costs incurred by relevant parties to the proceedings, including an order for indemnification for costs. This would appear to be an appropriate response to the concern that the availability of the statutory derivative action will result in an increase in vexatious litigation, but appears to create a very high hurdle for prospective applicants.

C. DUTIES OF OFFICERS AND EMPLOYEES

1. Care and Diligence

1.1 As already discussed, proposed section 180(1) sets out the duty of care and diligence applicable to directors and other officers. It is in the following terms: