

Directors and Owners of Small Corporate Enterprises: Managing Legal Risk

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Abstract

Entrepreneurs and developers of small business enterprises naturally reach a point in their business planning where the legal structure of their venture becomes crucial. For reasons of obtaining finance, property ownership (real or intellectual property) or attempting to limit personal liability, a company, is often chosen as the vehicle for the business. Initially, attention is naturally given to how the company is to be set up and procedural matters associated with the new enterprise. It is suggested however that a lot of faith is placed in the corporate structure and little thought is given to how the new directors/owners can protect themselves against personal risk.

Entrepreneurs will regularly undertake a risk assessment in analysing the potential success of any new idea. In the same way, directors or potential directors of any corporate enterprise should engage in some practical legal risk management. Internationally, the number and severity of corporate collapses have meant a renewed focus on issues of corporate governance. There should be a realisation that the duties, responsibilities and potential liabilities of corporate officers have grown. And not just for the larger corporations. Theory recognises that it is within the smaller closely held company that the incentives and opportunities for improper conduct are at their greatest.

The purpose of this paper is to identify for small business developers and owners the personal responsibilities and risks that come with the corporate structure. More importantly, the paper aims to provide practical advice on matters to consider at the time of creation of the company and how to monitor and manage the legal risk through the life of the company.

1. Introduction

1.1 Increasing Personal Liability of Corporate Officers borne out of dramatic corporate failures

Within just the last few years we have witnessed some extraordinary corporate collapses. Some well-known companies on such a list would include Enron Inc; WorldCom Inc. and Harris Scarfe Limited. Within Australia we are still feeling the effects of the failures of Ansett Ltd and One-Tel Ltd last year and HIH Insurance Ltd the year before. In the case of the latter, a Royal Commission was established to report on the collapse and examine why the company may have lost some A\$5 billion. In some cases the sums of money involved are astronomical, and the subsequent losses to shareholders and employees are devastating, however, there are other direct consequences for us to consider.

What makes some of these recent corporate failures extraordinary has been the conduct of the boards of directors and other management leading up to the collapse. So the processes of investigation, recommendations from various bodies and legislative change gather new momentum to address the apparent failings in corporate governance.

In the United Kingdom a fundamental revision of company law has been underway since March 1988. In April 2002 Derek Higgs was appointed to give an independent report on the role and effectiveness of non-executive directors. In The United States, The Securities and Exchange Commission, the New York Stock Exchange and NASDAQ have created some new rules in respect of corporate governance and better reporting and disclosure requirements. There has also been substantive legislative change in the form of the Sarbanes-Oxley Act of 2002 to particularly protect

corporate investors. We should also not forget the work of the OECD evidenced in the publication “OECD Principles of Corporate Governance”¹

In Australia we have seen continuous legislative amendments under our Corporate Law Economic Reform Program and changes to Stock Exchange Listing Rules. Most recently there is the Corporations Amendment (Repayment of Directors’ Bonuses) Bill 2002. Also in the spotlight of directors behaviour come recommendations from various bodies including the Australian Council of Super Investors Inc. (ACSI) and the Australian Shareholders Association (ASA).

It is not the fact that the companies have failed that is in issue. After all, the very nature of the limited liability company is that it is a structure to encourage business risk. Failures of companies are to be expected. Rather, it is the misconduct of management, and in some cases, the deliberate abuse of their position, that has proved to be the focus. This means that all corporate officers from those within the very small family enterprise to huge public companies, are facing more and more regulation and potential liability for their conduct. However, the personal risk of liability, though growing, is still not being well assessed, and programs to try and practically manage that risk are seemingly not taking hold.

This paper focuses on the small private company with a view to identifying for owners and managers, the personal legal risks that inherently come with this structure.² Size, in this sense, is irrelevant as the underlying principles designed to catch the multi-nationals are the same as those applicable to the smaller companies (There will be specific differences though where the public companies must also comply with Stock Exchange Listing Rules and there may be procedural variations for “small proprietary companies”³). More importantly however, is some assessment of

¹ www.oecd.org

² The Corporations Law discussed in this paper will, of necessity, refer to the Australian jurisdiction however no doubt the equivalent obligations and potential liability in other jurisdictions will be readily apparent. Though there may be specific variations the common underlying principles should be able to be identified with ease.

³ Relevant legislation may draw a distinction between small and large proprietary companies

practices, throughout the life of the company, that may limit, reduce or at least take account of those risks.

1.2 The Limited Liability Company

Entrepreneurs and developers of small business enterprises naturally reach a point in their business planning where the legal structure of their venture becomes crucial and for a range of reasons the company will be the vehicle of choice. Its primary advantage is, of course, the limited liability of its members and the ability to separate one's personal assets/wealth from the risk of the business. It is also an effective means of dealing with the ownership of primary business assets such as real and intellectual property and provides a safer mechanism when obtaining finance whether it be through external (financiers) or internal (investors) sources. The advantages of limited liability have been canvassed at length and is said to be fundamental to the promotion of an efficient capital market.⁴ The theory suggests that while creditors bear greater risk they are better equipped to deal with that risk.⁵ The benefit is that the structure is more likely to attract the necessary investment to advance business endeavours generally.

However, one should not overlook the fact that the company is purely a creature of statute. Therefore, its ability to provide individuals with protection against the multitude of business risks is only as good as the terms of the legislation and their interpretation by the courts. So although the theory may be right in so far as creditors bear the greater risk, the regulation of corporations has been making it easier to attack the individuals behind them. As suggested above, changes continue worldwide, to increase the risk of personal liability for corporate officers. In general terms, that risk can flow from the following:

⁴ P Halpern, M Trebilcock and S Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 University of Toronto Law Journal 117; F H Easterbrook and D R Fischel, "Limited Liability and the Corporation" (1985) 52 The University of Chicago Law review 89.

⁵ J M Landers, "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" (1976) 43 The University of Chicago Law Review 527; R A Posner, Economic Analysis of Law (1986) Third Edition.

- The courts ability to lift the veil of incorporation and attach liability to the individuals behind it in order to ensure compliance with specific statutory requirements (eg taxation) or because of an abuse of corporate law;
- The way the corporation deals with creditors and, in particular, when corporate officers allow the company to trade while insolvent;
- Personal liability for breaching one of a myriad of directors' duties;
- Non-compliance with legal requirements relevant to the area of business of the company which may specifically target corporate officers in order to ensure compliance by the company (eg Environmental Protection Legislation)

This paper will focus on those areas of potential liability over which corporate owners/officers can exercise some control. As suggested, some of this liability, inherent in the company structure itself, should be foreseen and can be managed to reduce risk. It is proposed to identify the risks in general terms (the potential liability and its extent will vary across jurisdictions) and provide some practical guidance in reducing, managing or transferring that risk. In considering the latter, the extent to which a company can provide insurance and indemnities for its officers will also be canvassed. One's approach to the issues raised will obviously depend upon the interest you are trying to protect.

2. Issues prior to registering your new company

It should be obvious that companies are not homogeneous. Depending on the requirements of each jurisdiction, the proprietary company can vary dramatically in its structure. Such variations can include the way it deals with the following key issues:

- The objects and authority of the company;
- The authority of directors and other officers, as a board, and individually;
- The structure of its membership through variations in voting rights, rights to dividends and the ability to share in the assets of the company on winding up;

- Internal procedures to deal with operations of the entity

All such matters would be covered in the constitution of the company. Therefore it is vital that the parties turn their minds to the questions of whether, and to what extent, they wish to place limitations of the operations of the company and or its managers, and this obviously this needs to be done before the company is even registered.

It may be that one does not wish to place any limitations on the company (One may not even have to register a constitution at all⁶). However, this may mean that it will be more difficult to prevent any abuse of authority or process. For reasons that will be explained, the fact that a company does have a constitution with various restrictions will not of itself prevent liability through the actions of unscrupulous managers acting outside those restrictions but it can provide an opportunity to reduce that risk.

The way in which a company attracts liability is based on the principles of agency law. Although a company is considered to be a separate legal entity it cannot operate without the assistance of its human agents. Therefore, whether a company will be bound by the dealings of those agents will depend upon their relevant authority. Significantly, this authority can not only be express (detailed in the constitution or delegated appropriately through the board) but also implied or ostensible. That is, where it is appropriate, parties that deal with company agents are entitled to assume that the representative has the usual authority one would expect to rest in someone holding that position.⁷ The implied or ostensible authority can be very broad depending upon the position that the agent holds. Accordingly, this may be the subject of abuse. Given that this abuse can relate to obtaining credit the risk can be significant.

⁶ In which case the general processes of the company are governed by “replaceable rules”: ss134,135 Corporations Act

⁷ Refer to the indoor management rule and ss128,129 Corporations Act

This may be so, even if the constitution places limitations on that authority. The reason is that a company is not entitled to rely upon its failure to comply with its own constitution as a means of avoiding liability with an external party. However, the external party cannot rely upon an agent's implied or ostensible authority when they are aware or ought to be aware of the actual limitations on that authority.⁸ Therefore, a constitution, which is explicit on the authority of its officers, can play an important role where, as a matter of practice, these are brought to the attention of those with whom the company deals. Clearly, it cannot provide absolute protection from rogue officers but if key creditors and usual contracting parties have knowledge of the limitations it may go a long way in reducing the risk. This may be achieved by formally advising financiers and other usual parties of the constitutional requirements.

Interestingly, theory suggests this risk is greater with smaller companies where the managers also represent a large percentage of the shareholders. The more closely held a company, the more incentive that exists, particularly where the company is approaching insolvency, for managers to act improperly to defeat the interests of creditors and other shareholders for their own benefit.⁹

There are also secondary benefits to having constitutional limitations, even where external parties can still enforce the unauthorised dealings of company officers. These include:

- If the company/members can act quickly enough, the conduct can be prevented by way of an injunction;
- The company and/or members may be able to recover from the relevant officer for their breach of warrant of authority.

⁸ s128(4) Corporations Act

⁹ L S Sealy "Directors' 'Wider' Responsibilities – Problems Conceptual, Practical and Procedural" (1987) 13 Monash University Law Review 164; r Baxt "a Senior Australian Court Gives the 'Thumbs Up' to the Winkworth Principle – Directors Owe a Duty to Creditors Both present and Future" (1989) Company and Securities Law Journal 344.

The major risk being discussed relates to the unauthorised creation of a liability for the company. However, there is another key component to any constitution which deserves attention for this and other reasons. It is usual, particularly in smaller companies, to apportion authority within the company as follows. Those matters which the relevant legislation requires members to decide will be left to them as there is no other choice. However, power in respect of all other matters will vest in the board of directors. This is a usual division of power in smaller companies because of its ease of application and because the directors are more likely to have a substantial interest in the company itself and would demand the power. Depending upon whose interest one is trying to protect however it may be appropriate to vary such authority. The reason is that such a distribution of power has been interpreted as being absolute. In other words, once the power has been given to the board, the members cannot interfere in the way in which that power is exercised even if they unanimously direct the board.¹⁰ The authority could only be varied by altering the constitution itself, which may prove difficult.

Implications for Owners/Officers

1. *Consider the structure of your new venture carefully particularly as it relates to:*
 - *the division of power between the directors/board and members; and*
 - *the rights attaching to various shares (eg voting, dividends and distributions) and whether or not there will be limitations on the ability to transfer those shares¹¹*
2. *Consider placing appropriate limitations on the company itself and the authority of its officers/agents; and*
3. *Ensure creditors and usual external parties with whom the company deals are aware of the relevant limitations of authority.*

3. Duties and Liabilities of Officers Generally

The liability of company officers may generally be categorised as falling into one of two groups:

¹⁰ John Shaw and Sons (Salford) Ltd v Shaw [1935] 2 KB 113

¹¹ This may only be appropriate with small, closely held, proprietary companies

1. Duties of good faith; and
2. Duties of care and diligence

These may not only be found in the relevant Corporations Legislation but also stem from general legal principles which acknowledge the special fiduciary relationship.

3.1 The Duties of Good Faith

The first group of duties for corporate officers usually have the following characteristics:

- The officers must exercise their powers in the interests of the company and they must not misuse or abuse their powers;
- They must avoid conflict between their personal interests and those of the company;
- They should not take advantage of their position to make secret profits; and
- They should not misappropriate the company's assets for themselves.¹²

Because a director is in a fiduciary relationship with the company their primary goal is to act in the interests of that company. This naturally means that a director should not exercise their powers for a purpose that is unrelated to that goal. The classic example of a breach of this duty is for a director to ensure decisions are made which will secure a private benefit for themselves or a related party.

Some more specific examples of a breach of this duty would include the following:

- The issuing of shares to reduce the voting powers of particular members or to enhance the powers of others;¹³

¹² *Chew v R* (1991) 4 WAR 21; 5 ACSR 473.

¹³ *Mills v Mills* (1938) 60 CLR 150; 11 ALJ 527; *Ngurli Ltd v McCann* (1953) 90 CLR 425; 27 ALJ 349; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 NSWLR 68; [1974] AC 821; (1974) 3 ALR 448; [1974] 1 All ER 1126; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285; 70 ALR 251; 61 ALJR 216; 11 ACLR 715; 5 ACLC 421; *Gray Eisdell Timms Pty Ltd v Combined Auctions Pty Ltd* (1995) 17 ACSR 303; *Piercy v S Mills & Co Ltd* [1920] 1 Ch 77; [1918-19] All ER Rep 313; *Grant v John Grant & Sons Pty Ltd* (1950) 82 CLR 1; 24 ALJ 374; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483; 42 ALJR 123; *Ashburton Oil NL v Alpha Minerals NL* (1971) 123 CLR 614; 45 ALJR 162; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 NSWLR 68; [1974] AC 821; (1974) 3 ALR 448; [1974] 1 All ER 1126, *T C Newman (Qld) Pty Ltd v DHA Rural (Qld) Pty Ltd* [1988] 1 Qd R 308; (1987) 5 ACLC 922.

- The refusal to register a transfer of shares due to personal matters rather than proper business considerations;¹⁴ and
- Dealing with company assets or providing security to benefit another entity or person.¹⁵

The fiduciary relationship also means the director is required to put the interests of the company above his or her own. Part of this responsibility is to ensure that they avoid any conflict of interest.¹⁶ He or she should not allow the perception that the exercise of their powers is affected by their personal interest.¹⁷ The breach of duty will arise because of the conflict with their fiduciary relationship regardless of whether or not their personal position has ultimately been improved and whether or not they had pure motives or intentions.¹⁸

Where there is even the potential for the company's matters to conflict with the personal interests of the director, that director needs to be very careful to ensure that there is full disclosure of the conflicting interest and that the company provides the appropriate consent.¹⁹ If the director fails to obtain the appropriate approval of the company they can not defend themselves by arguing that the company was not disadvantaged or that the company could not have benefited in any event.²⁰

A common example of the breach of this duty is where a director or related party actually contracts with the company. This would not be uncommon with small, closely held, companies. The contract might be between one company in which he or she is a director and another company he or she

¹⁴ *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 NSWLR 68; [1974] AC 821; (1974) 3 ALR 448; [1974] 1 All ER 1126, PC; *Gray Eisdell Timms Pty Ltd v Combined Auctions Pty Ltd* (1995) 17 ACSR 303; *Re Gresham Life Assurance Society; Ex parte Penney* (1872) 8 Ch App 446; *Re Smith and Fawcett Ltd* [1942] Ch 304; [1942] 1 All ER 542; *Re Coalport China Co* [1895] 2 Ch 404; *Re Bede Steam Shipping Co Ltd* [1917] 1 Ch 123; *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199; 30 ALR 53; *Charles Forte Investments Ltd v Amanda* [1964] Ch 240; [1963] 2 All ER 940.

¹⁵ *Bishopsgate Investment Management Ltd (in liq) v Maxwell* (1993) 11 ACLC 3,128; *Permanent Building Society (in liq) v McGee* (1993) 11 ACSR 260; 11 ACLC 761.

¹⁶ *Boardman v Phipps* [1967] 2 AC 46 at 124; [1966] 3 All ER 721; [1966] 3 WLR 1009; *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1; 52 ALJR 399; 3 ACLR 176.

¹⁷ *Bray v Ford* [1896] AC 44 at 51; [1895-99] All ER Rep 1009.

¹⁸ *Ibid.*

¹⁹ *Biala Pty Ltd v Mallina Holdings Ltd (No 4)* (1993) 13 WAR 11; 11 ACSR 785.

²⁰ *Furs Ltd v Tomkies* (1936) 54 CLR 583; 9 ALJ 419; *Gemstone Corp of Australia Ltd v Grasso* (1994) 62 SASR 239; 13 ACSR 695; 12 ACLC 653; *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1; 52 ALJR 399; 3 ACLR 176.

directs or has an interest in.²¹ These are classic cases where the director cannot, while apparently benefiting themselves or a related entity, protect the interests of their company. These circumstances may arise as a result of matters outside the control of the director. In those cases the only way for the director to avoid the conflict is to make full disclosure to the company and receive its approval.²² Directors should be careful of course to ensure full and accurate disclosure is given so it may truly be said that the company granted “informed” consent.

Related to the concept of conflict of duty is also the equitable obligation to protect confidential information. It would be easy to identify numerous ways in which directors could abuse information they become privy to simply because of their position as director. The obvious example is insider trading.²³ There are other more subtle cases involving such things as disclosure to others of the parties with whom the company has dealings.²⁴ It could also extend to the rearranging of one’s personal affairs (or those of a related party) prior to confidential information becoming public.²⁵

All these duties have one simple issue at their core. That is, the honesty, integrity and loyalty of the company officers. Seemingly there is little one could do, other than being particularly careful about the selection of those officers, to reduce the risk of deliberate abuse. The key however may be to look beyond the minimum requirements of the corporations legislation, which is not always readily understood even by seasoned officers. The company could consider adopting and disseminating a code of ethics²⁶ or conduct and even binding company officers by deed or otherwise to a set of standards which may not only meet legislative requirements but extend beyond. It may be explicit for example that the officer disclose all personal shareholdings or other business interests (upon appointment and ongoing) so that independence may be monitored. The Corporations legislation

²¹ *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488; [1914-15] All ER Rep 987; *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549; [1967] 3 All ER 98.

²² *Biala Pty Ltd v Mallina Holdings Ltd (No 4)* (1993) 13 WAR 11; 11 ACSR 785; 11 ACLC 1,082.

²³ *Commissioner for Corporate Affairs v Green* [1978] VR 505; *Waldron v Green* (1978) 3 ACLR 289; ACLC ¶40-381.

²⁴ *Thomas Marshall (Exports) Ltd v Guinle* [1979] Ch 227; [1978] 3 All ER 193; [1978] 3 WLR 116.

²⁵ *Grove v Flavel* (1986) 43 SASR 410; 11 ACLR 161; 4 ACLC 654.

²⁶ Investment and Financial Services Association, “Corporate governance: a Guide for Investment Managers and Corporations” (1999)

may otherwise leave it up to the officer to disclose any potential conflict of interest. By way of deed, officers could also bind themselves to the protection of intellectual property and confidential information. It would be the overt nature of these documents that may assist in reducing the risk of abuse. It would obviously be advantageous to closely monitor and review officer performance on a regular basis.

Implications for Owners/Officers

1. *Consider drafting and implementing a code of ethical conduct which would express overtly not only the principles but the specific conduct required in circumstances of potential conflicts of interest and the receipt of personal benefits;*
2. *Prepare a deed for officers to execute that addresses such issues as:*
 - *Full disclosure of all personal interests*
 - *Protection of intellectual property and confidential information*

3.2 Duties of Care and Diligence

3.2.1 The Duty Generally

It is the expectations in respect of this duty that has changed most significantly over recent years.

Unlike the duties of good faith, which examine the personal motivations and characteristics behind management decisions, this duty attaches to one's competency.

In Australia the corporate collapses of the late 1980's and early 1990's stimulated the growth of stronger duties.²⁷ The courts also took a more commercial and practical view about what should be expected of directors. The cases that drove this change, primarily revolved around corporate

²⁷ *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115; 9 ACLC 946.; *AWA Ltd v Daniels t/as Deloitte Haskins & Sells* (1992) 7 ACSR 759; 10 ACLC 933.; *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395; 11 ACSR 162; 11 ACLC 763.; *AWA Ltd v Daniels t/as Deloitte Haskins & Sells* (1992) 7 ACSR 759; 10 ACLC 933.; *Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438; 118 FLR 248; 16 ACSR 607.; *Permanent Building Society v Wheeler* (1994) 11 WAR 187; 14 ACSR 109; 12 ACLC 674.

insolvencies. The major issue in many of these was therefore whether or not the directors had allowed the company to trade while it was insolvent. However, these duties are inextricably linked. The courts often had to consider whether the directors' lack of knowledge of the true position of the company was defensible. This meant a review of the sort of skills and abilities that should be expected of directors in certain positions and a move towards a more objective assessment of what should be expected.

It is now abundantly clear that directors must take positive steps to keep abreast of the true position of the overall state of the company.²⁸ Their ignorance of the company's financial position, for example, cannot be defended on the basis that they did not have actual knowledge of this or were not informed. Although they may be able to delegate some of their responsibilities they cannot rely upon this where such delegation was not responsible and where they do not take a diligent interest in the information that is presented or should be demanded.²⁹

Generally, directors need to display the degree of care and diligence that could be objectively expected. This objective test however can not be equally applied to all directors of all companies. Rather one is assessed against what should be expected of someone in their type of position and in their type of company.³⁰ So although the courts have given us useful general guidelines directors should turn their minds to the rigours of their own corporate enterprise the peculiarities of their own competitive environments.

²⁸ *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115; 9 ACLC 946.

²⁹ *Ibid*

³⁰ *AWA Ltd v Daniels t/as Deloitte Haskins & Sells* (1992) 7 ACSR 759; 10 ACLC 933.; *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395; 11 ACSR 162; 11 ACLC 763.; *AWA Ltd v Daniels t/as Deloitte Haskins & Sells* (1992) 7 ACSR 759; 10 ACLC 933.; *Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438; 118 FLR 248; 16 ACSR 607.

3.2.2 The Business Judgement Rule

Some jurisdictions have a “business judgement rule” that can operate as a defence for officers alleged to have been in breach of their duty to exercise care and skill. While a similar rule has applied in other jurisdictions,³¹ Australia has only recently adopted it as a result of intense lobbying from interested parties concerned by the growing attacks on company officers. The purpose of the rule is to provide directors with more confidence to know that their decisions will not be the subject of future litigation provided their actions and decisions fall within certain guidelines. The effect of the rule is that once its elements are satisfied it will deem that the directors’ conduct cannot be in breach of the relevant duty. Those elements, in Australia, are that an officer must:

- (a) make their judgment in good faith for a proper purpose; and
- (b) not have a material personal interest in the subject matter of the judgment; and
- (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- (d) rationally believe that the judgment is in the best interests of the corporation.³²

It would be prudent to be conservative in assessing the value of this rule. It still incorporates the principles underlying the duties as they have developed and it would be difficult to see it providing protection to directors who act outside those principles. For example, it would be unwise to suggest that the rule will save directors who subjectively believe they are doing the “right thing” but who have not adequately informed themselves and acted with the appropriate objective level of skill. The objective element of the duty has not been lost in the rule. One benefit however comes in the deeming of the director’s judgment to be rational as an evidentiary matter, although this can still be overturned on an objective assessment of that judgment.

³¹ Such as in the United States of America

³² s180(2) Corporations Act

The rule however does serve to strengthen the cause of risk management. By adopting and implementing a risk management strategy, a company officer will be well placed to convince a court of the appropriateness of the steps they have taken in reaching management decisions later put under scrutiny. The risk management process itself will go a long way in making a “business judgement rule” defence accessible.

Implications for Owners/Officers

1. *There is no substitute for officers being fully informed regarding any decision that is to be made. What is vital, from a legal point of view, is that the officer can demonstrate this at the relevant time. This means implementing thorough information control mechanisms.*
2. *Officers should take advantage of company executives in information gathering however they should not lose sight of their independence and ensure they open all available information channels and appropriately delegate to ensure they are fully informed.*

4. When the Wolves are at the Door: Personal Liability for Insolvent Trading

It is the insolvent trading provisions that have been predominantly responsible for recovering losses from directors of failed companies and possibly the major cause of concern in terms of personal risk. In essence the provisions apply the directors allow the company to incur debts at a time when there were reasonable grounds for suspecting that the company was insolvent or would become insolvent.³³

It is not simply a question of what the director did know about the solvency of the company but what they ought to have known on the basis of an objective assessment. In other words a director cannot hide behind their own personal failure to properly assess the solvency of the company as a means of

³³ s588G Corporations Act

avoiding this potential liability. This has been highlighted by numerous decisions.³⁴ Whether or not a director should suspect insolvency is to be tested against someone of ordinary competence.³⁵

The law does recognise the practicality of needing to rely upon the work of others. However care should be taken if one wishes to use this as a defence. In Australia it can only assist where:

- the director had reasonable grounds to believe and in fact did believe that a competent and reliable person was responsible for providing adequate financial information and that the other person was fulfilling that responsibility; and
- the director expected on the basis of that information that the company was solvent.

Again, the objectivity of these elements means the director bears a considerable onus of proof.

Finally, a director may be able to defend an insolvent trading action by being able to prove that they took all reasonable steps to prevent the company from incurring the debt.³⁶ This will include consideration of such matters as:

- any action taken to appoint an administrator;
- when that was done; and
- the results of that action.³⁷

³⁴ *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423; *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405; 8 ACLC 827; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115; 9 ACLC 946, SC(VIC); *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371; 4 ACLC 185; *Re New World Alliance Pty Ltd (rec and mgr apptd)*; *Sycotex Pty Ltd v Baseler* (1994) 51 FCR 425; 122 ALR 531; 13 ACSR 766; 12 ACLC 494; *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699; *Hawcroft General Trading Company Ltd v Edgar* (1996) 20 ACSR 541; *Credit Corporation Australia Pty Ltd v Atkins* (1999) 30 ACSR 727; *Pioneer Concrete (Vic) Pty Ltd v Stule* (1996) 20 ACSR 475; *Group Four Industries Pty Ltd v Brosnan* (1991) 56 SASR 234; 8 ACSR 463; 9 ACLC 1181; *Standard Chartered Bank of Australia Ltd v Antico (Nos 1&2)* (1995) 38 NSWLR 290; 131ALR 1; 18 ACSR 1; 13 ACLC 1381.

³⁵ *Group Four Industries Pty Ltd v Brosnan* (1991) 56 SASR 234; 8 ACSR 463; 9 ACLC 1181; *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699; *Standard Chartered Bank of Australia Ltd v Antico (Nos 1&2)* (1995) 38 NSWLR 290; 131ALR 1; 18 ACSR 1; 13 ACLC 1381.

³⁶ s588H(4) Corporations Act

³⁷ s588H(5) Corporations Act

Implications for Owners/Officers

1. *Whenever a company is in liquidation the administrator has an obligation to consider whether the circumstances of the failure warrant attempts to recover from company officers personally to help meet outstanding debt. To defend this, the officers must be able to show that when the relevant financial decisions were made they knew the true state of the company's financial status. As with other duties discussed earlier the best way to do this is to have in place appropriate financial control mechanisms.³⁸ What must be stressed is the importance of independent advice in this regard and the independence of accounting and auditing controls.*
2. *Officers must be prepared, at the earliest indication of doubt about the solvency of the company, to seek voluntary administration procedures. This act itself will assist in defending any subsequent claim should the company ultimately be placed in liquidation.*
3. *Officers must be prepared to lose the company and all its assets to truly be able to protect personal wealth.*

5. Indemnities and Insurance

Despite the trepidation officers will feel as a result of the above analysis, there are other avenues that remain to limit or reduce the consequences of liability.

The first of these avenues that should be considered is that of insurance. In that context it should be remembered that there may be certain limitations on the company's ability to pay for insurance in favour of a director. Those limitations in Australia are as follows:³⁹

A company...must not pay...a premium for a contract insuring a person who is or has been an officer...of the company against a liability (other than one for legal costs) arising out of:

³⁸ The manner and extent of these mechanisms are beyond this paper but are otherwise well covered in the accounting and finance literature.

³⁹ s199B Corporations Act. Any such insurance in breach of s199B would be void: s199C Corporations Act

- (a) *conduct involving a wilful breach of duty in relation to the company; or*
- (b) *a contravention of the duties that relate to an abuse of one's position or insider information.*

Apart from the question of insurance there is also the potential for the members to exonerate or indemnify directors. It may be possible for example, for members to protect a director from liability for a breach of duty to avoid conflicts of interest by approving or ratifying their acts. This would have to be done after full disclosure.⁴⁰ It would not be appropriate of course where the director held a majority of the shares.⁴¹ It would also not be possible for members to exonerate any breach that could affect a third party.⁴²

The Corporations Act precludes a company from exempting a director from liability.⁴³ It also lays down some specific limitations on when the company can indemnify against liability and legal costs.⁴⁴ Importantly however, a company can indemnify a director against legal costs provided they are not incurred:

- (1) in defending or resisting proceedings in which the person is found to have a liability to the company;
- (2) in defending or resisting criminal proceedings in which they are found guilty;
- (3) in defending or resisting proceedings brought by ASIC or a liquidator (other than investigations) for a court order if the grounds for making the order are established; or
- (4) in connection with proceedings for relief to the person under the Corporations Act in which the court denies relief.⁴⁵

⁴⁰ *Bamford v Bamford* [1970] Ch 212; [1969] 1 All ER 969; [1969] 2 WLR 1107; *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666; (1975) 1 ACLR 219; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; 10 ACLR 395; 4 ACLC 215; *Woolworths Ltd v Kelly* (1991) 22 NSWLR 189; 4 ACSR 431; 9 ACLC 539; *Pascoe Ltd (in liq) v Lucas* (1998) 27 ACSR 737.

⁴¹ *Cook v Deeks* [1916] 1 AC 554; [1916-17] All ER Rep 285.

⁴² *Bay Marine Pty Ltd v Clayton Properties Pty Ltd* (1984) 3 ACLC 16; *Davison v Vickery's Motors Ltd (in liq)* (1925) 37 CLR 1; 31 ALR 465.

⁴³ s199A Corporations Act

⁴⁴ s199A(2) and (3) Corporations Act

⁴⁵ s199A(3) Corporations Act

Implications for Owners/Officers

1. *The extent to which a company can indemnify acts of directors and insure them will vary across jurisdictions. However, from the directors' perspective, these issues are fundamental and they should seek to ensure the most favourable position is protected by a deed with the company. From the company's perspective, setting out the extent of protection will save subsequent disputes.*
2. *Any deed which covers such matters should also deal with the ability of the officer to have access to the information of the company that may be necessary for them to protect themselves. Legislation granting such access may otherwise be quite weak.*

6. Conclusions

It is now quite easy to find any number of publications advocating the principles of good corporate governance. What can be more difficult is ensuring implementation in a practical and meaningful way. A study in the early 1990's in Australia concluded that the vast body of Corporations Law had little impact upon directors in general. Rather, vague notions of good corporate citizenship helped to keep the law at bay.⁴⁶ Although times have no doubt changed, it is advocated that rather than purely relying upon statutory requirements, companies should be more pro-active in protecting itself and promoting the type of governance expected. Part of this strategy would include:

- Placing appropriate boundaries upon officers' authority and disclosing and monitoring same;
- Preparing and implementing codes of conduct to which officers are a party;
- Ensuring appropriate and independent information and financial controls are in place not only to protect the company from poor decision making but the officers from personal liability;
- Entering into deeds with officers that were explicit about levels of indemnification and insurance applicable to the office.

⁴⁶ R Tomasic and S Bottomley "Corporate Governance and the Impact of Legal Obligations on Decision Making in Corporate Australia". The study was based upon interviews conducted with officers from the top 500 Australian listed public companies.