

# The Director's Perspective - What the law is doing

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## Table of contents

<b>1.</b>	<b>Introduction</b> .....	<b>i</b>
<b>2.</b>	<b>Direct liability</b> .....	<b>i</b>
<b>3.</b>	<b>In depth look at directors' duties</b> .....	<b>i</b>
3.1	General outline of duties .....	i
3.2	To whom the duties are owed.....	ii
3.3	Enforcement .....	ii
3.4	Ratification of breached duties .....	iii
3.5	Wholly owned subsidiary .....	iii
<b>4.</b>	<b>Duty to exercise care and diligence</b> .....	<b>iii</b>
4.2	<i>ASIC v Vines</i> .....	iv
4.3	<i>ASIC v Rich</i> .....	iv
4.4	Civil obligation only .....	vi
4.5	Business judgment rule .....	vi
<b>5.</b>	<b>Business judgment rule</b> .....	<b>vi</b>
5.1	Safe harbour .....	vi
5.2	Section 180(2) – business judgment rule .....	vii
5.3	Who does the business judgment rule protect? .....	vii
5.4	What decisions attract the business judgment rule? .....	vii
5.5	Does the business judgment rule protect a director or company officer from personal liability against all breaches of the law? .....	viii
5.6	When will a director have a material personal interest? .....	viii
5.7	Will the business judgment rule lessen a director's chances of being sued for a breach of the duty of care and diligence? .....	ix
5.8	Can a director rely on others to inform him or her about the subject matter for decision? .....	ix
<b>6.</b>	<b>Duties to act in good faith and for a proper purpose</b> .....	<b>ix</b>
6.1	Duties.....	ix
6.2	Criminal liability .....	x
6.3	Directors of wholly owned subsidiary.....	x
<b>7.</b>	<b>Duty to avoid conflicts of interest</b> .....	<b>x</b>
<b>8.</b>	<b>Duty not to misuse position or information</b> .....	<b>xi</b>
8.2	Criminal liability .....	xii
<b>9.</b>	<b>Duty to prevent insolvent trading</b> .....	<b>xii</b>
9.1	Duties.....	xii
9.2	Defences.....	xiii
9.3	Parent company liability .....	xiii
<b>10.</b>	<b>CLERP 9 - Continuous Disclosure</b> .....	<b>xiii</b>
<b>11.</b>	<b>Derivative liability and the defence of due diligence</b> .....	<b>xiv</b>
11.1	Derivative liability .....	xiv
11.2	The test of reasonable steps .....	xvi
11.3	Due diligence .....	xvii
<b>12.</b>	<b>Directors' duties - environmental</b> .....	<b>xix</b>
12.1	The EPBC Act.....	xix
12.2	The CLM Act.....	xix

12.3	POEO Act .....	xx
12.4	"All due diligence" - what does it require and how can the defence be successfully plead? .....	xxi
<b>13.</b>	<b>Occupational Health and Safety .....</b>	<b>xxi</b>
13.1	Occupational Health and Safety Duties .....	xxi
13.2	Deemed liability for directors and persons concerned in management .....	xxii
13.3	Defences .....	xxiii
13.4	Ritchie's Case .....	xxiv
<b>14.</b>	<b>Trade Practices Act .....</b>	<b>xxiv</b>
14.2	Immunity policy for cartel conduct .....	xxv
<b>15.</b>	<b>Litigation funding .....</b>	<b>xxv</b>
15.1	Background .....	xxvi
15.2	Litigation funding .....	xxvi
15.3	Representative proceedings .....	xxvii
15.4	Ramifications of High Court's decision .....	xxvii
<b>16.</b>	<b>Future law reform .....</b>	<b>xxviii</b>
16.1	OH&S Act .....	xxviii
16.2	CAMAC .....	xxviii
16.3	TPA .....	xxix

# DIRECTOR'S EXPOSURE

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## 1. Introduction

In recent times, directors have become increasingly exposed to the risk of regulatory action or claims. The exposure of directors to liability refers to the risk of a claim for a penalty or compensation or some other form of relief being made by a third party against a director personally. The third party claimant may on occasions be the directors' corporation, fellow officers or a statutory body such as the Australian Competition and Consumer Commission ("ACCC") or Australian Securities and Investments Commission ("ASIC").

The most serious exposure for directors in the current environment is derivative liability. This paper first explores direct liability before addressing the circumstances whereby a director will be deemed liable on the basis of their involvement in the management of a body corporate (ie. their derivative liability).

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## 2. Direct liability

There are a number of duties, both at common law and statute, which the directors of corporations have to observe. These include the duties to exercise their powers with due care and diligence, in good faith, in the best interests of the corporation and for a proper purpose. Also, they must not use their position to improperly gain an advantage for themselves or disadvantage the corporation.<sup>2</sup>

Recently, and in addition to these duties, there has been increasing public opinion and government pressure placed on companies and directors to consider the effects of their actions on the wider community. It now seems that directors, in performing their duties, are expected to consider more than just the most effective ways to legally maximise shareholder wealth.<sup>3</sup>

One way in which this phenomenon has manifested itself is through the increasing range of civil and criminal penalties for corporate misfeasance appearing in both Federal and State legislation. However, due to the nature of a corporation, experience has shown that it is difficult to make these penalties a meaningful deterrent. It is argued that penalties imposed on corporations, especially monetary penalties, have the potential to be displaced by the corporation onto "innocent" third parties (shareholders, employees and consumers).<sup>4</sup> The irony of this situation is that it is ultimately the victim of corporate offences, society, which ends up paying the costs of the penalties given to corporation intended to remedy the harm done to it.<sup>5</sup>

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## 3. In depth look at directors' duties

### 3.1 General outline of duties

Directors are in a fiduciary relationship with their company and owe various common law fiduciary duties to the company, the most important being:

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<sup>2</sup> Sections 180 - 183 *Corporations Act 2001* (Cth); Giblett R, "A Fresh Look at Directors Duties - Taking into Account Social and Moral Responsibilities" (2006) Presentation for NSW College of Law at p 1.

<sup>3</sup> Giblett R, above fn 2 at p 1.

<sup>4</sup> "Liability of Corporate Officers" Chapter 8 of ALRC 95 *Principled Regulation: Civil and Administrative Penalties in Australian Federal Regulation*, Southwood Press, 2002.

<sup>5</sup> Ibid.

- the duty to act in good faith and in the best interests of the company;
- the duty to exercise powers for a proper purpose;
- the duty to avoid conflicts of interest with the company; and
- the duty not to abuse a corporate opportunity.

These fiduciary duties are supplemented by various overlapping statutory civil duties under the *Corporations Act 2001* (Cth) ("**Corporations Act**"), including:

- section 180, which requires directors and other officers to exercise their powers and discharge their duties with care and diligence;
- section 181, which requires directors and other officers to exercise their duties in good faith and for a proper purpose;
- sections 182 and 183, which concern misuse of position and company information; and
- section 588G, which prohibits directors to permit trading while the company is insolvent.

Section 184 of the *Corporations Act* further provides that directors who fail to properly exercise their powers and discharge their duties will commit an offence if they are reckless or intentionally dishonest in doing so.

Even if no offence is found, breach of a statutory duty may also result in ASIC taking court action against the director for a civil penalty of up to \$200,000.<sup>6</sup>

### **3.2 To whom the duties are owed**

Generally speaking, a director's duties are owed to the company. This means that if a duty is breached, the company may sue that director and obtain a remedy for the breach. Because the board of directors has control over the company, it is the board of directors which makes a decision about whether the company will exercise its right to sue the director.

However, this principle is subject to a number of exceptions, which means that where there is a breach of duty by a director, other parties who have suffered as a result of a breach may have a direct or indirect remedy against the director.

### **3.3 Enforcement**

In certain circumstances, shareholders who have been uniquely disadvantaged by a director's breach of duty to the company can bring an action against a director. Where a minority of shareholders have been so affected, the members in a general meeting may not be able to give validity to an irregular act, as this could be considered a fraud on the minority.

In some circumstances a director's duty can be owed directly to shareholders or creditors, and recently to other directors.

Some breaches of directors' duties give rise to civil or criminal liability under the *Corporations Act* and may be enforced by ASIC against one or more directors.

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<sup>6</sup> Section 1317G of the *Corporations Act*.

### 3.4 Ratification of breached duties

A breach of a director's duty may be ratified (ie. excused) in at least some circumstances, but only by the shareholders in a general meeting by ordinary resolution, and provided that there has been full and frank disclosure to shareholders.

The shareholders may refuse to ratify a breach and direct the board of directors to enforce the remedy of the company against the director (or elect a board of directors which will enforce the remedy of the company). This option may not be available where the stated objects of the company withhold this power from the general meeting.

### 3.5 Wholly owned subsidiary

Where there is not a spread of shareholders and the company is a wholly owned subsidiary of another company those duties are owed to the sole shareholder.

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## 4. Duty to exercise care and diligence

At both common law and under the *Corporations Act*, directors have a duty to exercise care, diligence and skill.

Section 180(1) of the *Corporations Act* provides that a director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- (a) were a director or officer of a corporation in the corporation's circumstances; and
- (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

The standard of skill required is an objective one. However, where a specific role is held, for example, a finance director, any alleged breach by the director will be tested objectively by reference to the body of knowledge and expertise possessed by persons in the same field.

Various Court decisions concerning the exercise of care, diligence and skill indicate that:

- (a) A director has a greater duty than that of simply representing his or her field of experience. The duty involves becoming familiar with the business of a company and how it is run and ensuring that the board has sufficient means to audit the management of the company so that it can satisfy itself that the company is being properly run.
- (b) A director should devote sufficient time to the company to ensure that it runs properly.
- (c) A director may rely on other persons (ie. company officers) in the running of the company where appropriate. However, such reliance cannot be a substitute for the director's own obligation to be familiar with the running of the company and to oversee its affairs.

The effect of this requirement appears to be that all directors must exercise a minimum standard of care reflected in the requirement to become familiar with the company's business and to ensure that they actually carry out their role of supervision of the company's business. Beyond that point, the question of whether a director has fulfilled their duty will be judged by reference to whether they displayed a level of competency expected of someone of their ability, experience and position.

There have been many recent cases involving directors' duties. Some of those brought by ASIC exemplify where the law is moving.

## 4.2 **ASIC v Vines**<sup>7</sup>

In 1998, GIO Australia was the holding company of a group of companies including GIO Insurance. GIO Insurance's business included the provision of reinsurance.

On 25 August 1998, AMP Insurance made a takeover offer for all shares in GIO Australia. On 16 December 1998, the Board of GIO Australia issued its Part B statement, as required by the Corporations Law in operation at the time, which recommended that shareholders reject AMP's takeover bid. The Part B statement included a profit forecast of \$80 million for GIO Re, the reinsurance component of GIO Insurance's business. The profit forecast was made despite identification of significant exposures to GIO Re's book of insurance from Hurricane Georges, a major hurricane that battered the Caribbean and the US in September 1998.

ASIC commenced civil proceedings for breach of directors duties against three former executive directors of GIO Insurance Limited - Geoffrey Vines, Francis Robertson and Timothy Fox. The case focused on two broad areas:

1. the formulation and methodology used to maintain an \$80 million profit forecast for GIO in response to the takeover offer from AMP; and
2. entering into a financial reinsurance agreement with American Re, which purported to protect the \$80 million profit forecast.

Austin J of the Supreme Court of New South Wales held that all three former directors had breached their duties during the course of AMP's 1998-99 takeover bid for GIO Australia and that Fox had breached his duty to act honestly. The decision was described by Jeffrey Lucy as a "*landmark decision that clarifies the roles and responsibilities of company executives*".<sup>8</sup>

Austin J's decision in *ASIC v Vines* highlights the fact that executive officers are subject to the statutory duty of care and diligence. Liability of executives is not determined merely by their position, but by their responsibilities and whether their "dishonesty or disloyalty or negligence" could "cause very substantial harm to the corporation".<sup>9</sup> Where an officer occupies a position requiring identifiable skill the content of the statutory duty will be expanded. For example, the duty could potentially attach to positions such as CEO, general counsel and company secretary. An individual in such a position would be required to meet an objective standard of reasonable competence or skill and may be exposed to liability if they lack the skill and expertise to be expected of a reasonably competent officer in their position.

Although the decision of *ASIC v Vines* related to the statutory predecessor of section 180(1) of the *Corporations Act*, Austin J's analysis seems equally applicable to the statutory duty of care and diligence now formulated in section 180(1).

## 4.3 **ASIC v Rich**<sup>10</sup>

Two decisions associated with the demise of One.Tel have important implications for the chairpersons of companies registered under the *Corporations Act*. The first was an interlocutory decision on whether ASIC's statement of claim disclosed a reasonable cause of action against the former One.Tel chairman Mr Greaves under section 180(1) of the

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<sup>7</sup> *ASIC v Vines* [2005] NSWSC 738.

<sup>8</sup> ASIC media and information release dated 23 August 2005 titled *Court finds against former officers of GIO Insurance*.

<sup>9</sup> [2005] NSWSC 738 at [1049].

<sup>10</sup> *ASIC v Rich* [2003] NSWSC 85.

*Corporations Act*. ASIC alleged that, by virtue of his various positions and expertise, Mr Greaves had special responsibilities beyond those of the other non-executive directors. These responsibilities led to a higher standard of care and diligence which, according to the Commission, Mr Greaves failed to meet. Mr Greaves argued he was a non-executive director in essentially the same position as the three non-executive directors who had not been targeted by ASIC.

Justice Austin affirmed that the standard of care and diligence required of a director is determined by the corporation's circumstances *and* the director's position and responsibilities within the corporation. Although the standard is objective, His Honour held that the director's "responsibilities" would include arrangements flowing from the director's own qualifications, experience and expertise.

Mr Greaves' roles as chairman of directors and chairman of the Finance and Audit Committee, combined with his extensive qualifications and experience in financial matters, contributed to Justice Austin's view that there was a reasonable cause of action against Mr Greaves under subsection 180(1). His Honour accordingly dismissed Mr Greaves' application for summary dismissal of ASIC's statement of claim.

In subsequent proceedings White J also dealt with some of the issues addressed by Austin J when he gave the seal of approval to Mr Greaves' settlement with ASIC<sup>11</sup>. The decision has been criticised for being unrealistic and failing to distinguish the role of a non-executive chairman from a full time executive.

ASIC alleged that Greaves, the non-executive chairman of OneTel, had breached s 180(1). Greaves admitted the breach and consented to orders under section 206C, 206E, 1317E and 1317H. Despite the parties' agreement, White J said that he still had a duty to evaluate the evidence, so that he could be satisfied that Greaves had contravened section 180.

Specifically, Greaves admitted that he had breached his section 180(1) duty by failing to ensure that financial information supplied to the board had been accurate and adequate. To evaluate this admission, White J had to arrive at a conclusion as to what the duties of a non-executive chairman are. He held that those duties include:

- (a) taking reasonable steps to ensure that the chairman and the other members of the Board monitor the management of the company, properly assess the company's financial position and performance, properly and promptly detect and assess any material adverse development affecting its financial position or performance;
- (b) taking reasonable steps to ensure that the chairman and the other members of the Board are informed of all material financial information concerning the company which is necessary to enable the Board to monitor management, to properly assess its financial position and performance, to properly and promptly detect and assess any material adverse development affecting its financial position and performance; and
- (c) taking reasonable steps to ensure that the material financial information referred to in (b) includes information which reveals:
  - (i) the adequacy of the cash reserves within the company;
  - (ii) the actual (and not simply the estimated) financial position and performance of the various segments of the business of the company; and

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<sup>11</sup> *ASIC v Rich & Ors* [2004] NSWSC 836

- (iii) key events or transactions, which affected the financial position or performance of the company.

Later in the judgment (when considering a banning order under s 206C and 206E), White J added some comments about delegation:

*"87 [T]he third defendant's responsibilities required diligent attention to whether the system of reporting by management was operating efficiently, and whether the individuals in the system who were exercising delegated powers from the Board were discharging their duties efficiently. Section 198A(1) of the Corporations Act provides that the business of a company is to be managed by or under the direction of the directors. In a large business the directors must delegate their powers. However as Thomas J said in Dairy Containers Limited v NZI Bank Limited (1995) 13 ACLC 3211 at 3222:*

*"Executives in running the day to day business of a company are exercising delegated powers. It is to be borne in mind always that they are delegated, and not original, powers and that they are therefore subject to the ultimate responsibility of the directors for the oversight of the company."*

*88 The corollary is that those who have delegated their powers have a duty to exercise reasonable care and diligence to ensure that the powers delegated are being efficiently discharged."*

These decisions are important and go further in extending the responsibilities of company chairpersons. The standard required of directors in performing their duty of care and diligence will vary with the corporation's circumstances. The decision places an increasing importance on directors identifying their position and responsibilities within a corporation and actively planning (and perhaps even documenting) the key steps required, and the systems and processes to be implemented, in order to properly fulfil their legal duties.

#### **4.4 Civil obligation only**

Section 180 provides a civil obligation only. There are no criminal sanctions for breach of the statutory duty. Instead, a breach may result in the imposition of a civil penalty.

#### **4.5 Business judgment rule**

Importantly, the duty of care and diligence is subject to a statutory "business judgment rule" that seeks to temper the scope of a director's duty.

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## **5. Business judgment rule**

### **5.1 Safe harbour**

The business judgment rule provides directors and other officers with a safe harbour against liability for breach of their duty of care in relation to honest, informed, disinterested and rational decisions about the ordinary business operations of the company.

The rule aims to give directors and other company officers the confidence to engage in responsible entrepreneurial activities.

The rule does however place an onus on directors to establish suitable systems to ensure that their decisions are made with proper care and diligence.

## 5.2 Section 180(2) – business judgment rule

Section 180(2) provides that a director of a corporation who makes a business judgment is taken to meet the requirements of section 180(1) and their equivalent duties at common law and in equity, in respect of the judgment if they:

- (a) make the judgment in good faith for a proper purpose; and
- (b) do not have a material personal interest in the subject matter of the judgment to the extent they reasonably believe to be appropriate; 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.

The director's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

A *business judgment* means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.

## 5.3 Who does the business judgment rule protect?

The business judgment rule protects:

- (a) a director;
- (b) the company secretary;
- (c) an executive, manager or employee of the company who is an "officer" of the company;<sup>12</sup>
- (d) a receiver and manager;
- (e) an administrator;
- (f) a liquidator appointed in a voluntary winding up; and
- (g) a trustee or other person administering a comprise or arrangement.

## 5.4 What decisions attract the business judgment rule?

Only *matters relevant to the business operations of the company* can attract the business judgment rule. These may include judgments as to:

- (a) the company's strategy;
- (b) the company's business plans and budgets;
- (c) marketing the company's business;

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<sup>12</sup> The definition of "officer" includes a person (a) who makes or participates in making, decisions that affect the whole, or a substantial part, of the business of the company; (b) who has the capacity to affect significantly the company's financial standing; or (c) in accordance with whose instructions or wishes the directors are accustomed to act (this does not include professional advisers).

- (d) acquiring and disposing of assets; and
- (e) raising capital.

The business judgment rule will not protect judgments on matters not directly relevant to the business operations of the company such as:

- (a) the company's constitution;
- (b) the conduct of board meetings or shareholders' meetings; or
- (c) oversight of company executives.

For the business judgment rule to apply, a director must inform him or herself about the subject matter to the extent they reasonably believe to be appropriate and must make a conscious exercise of their judgment. That is, the onus is on directors to establish proper systems for ensuring they are appropriately informed.

The resulting decision may be to take action or to refrain from taking action. A director not consciously involved in making a decision will not be protected by the business judgment rule in respect of that decision.

## **5.5 Does the business judgment rule protect a director or company officer from personal liability against all breaches of the law?**

The business judgment rule only operates in respect of an officer's duty of care and diligence under section 180(1) of the *Corporations Act* and the equivalent duties under common law.<sup>13</sup>

The business judgment rule will not protect an officer for liability for breach of any other obligation or provision of the *Corporations Act*, including:

- (a) directors' duty to prevent insolvent trading;<sup>14</sup>
- (b) the prospectus and disclosure document requirements;<sup>15</sup>
- (c) the takeovers provisions;<sup>16</sup>
- (d) the prohibitions against insider trading; or
- (e) obligations under other legislation eg. the *Trade Practices Act 1974* (Cth) ("**TPA**"), environmental protection and workplace health and safety legislation, taxation, superannuation and insurance legislation.

The business judgment rule will not protect a director from breach of his or her duties to act in good faith and to refrain from gaining an advantage or causing damage to the company.

## **5.6 When will a director have a material personal interest?**

*Material personal interest* is not defined. It is likely to cover circumstances in which a director would be regarded as having a conflict of interest and where he or she may personally

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<sup>13</sup> Including the duty of care that arises under the common law principles governing liability for negligence.

<sup>14</sup> Section 588G of the *Corporations Act*.

<sup>15</sup> See Division 1 of Part 6D.3 of the *Corporations Act*, esp. sections 728 and 729.

<sup>16</sup> See Part 6.5 of the *Corporation Act*, esp. section 636.

benefit from the decision in a material respect, eg. if the company decided to enter into a contract with a director or an associate of the director.

Due to the peculiar drafting of the legislation, it is likely (but not entirely clear) that a director will not be regarded as having a material personal interest merely by being a shareholder (subject to the size of the director's shareholding interest), a guarantor or a director of a related body corporate.

## **5.7 Will the business judgment rule lessen a director's chances of being sued for a breach of the duty of care and diligence?**

The business judgment rule presents a new hurdle for a plaintiff seeking to bring a claim based on an allegation of breach of duty of care and diligence. If the director or officer brings evidence to show he or she is within the business judgment safe harbour, the plaintiff would have to show the business judgment rule defence does not apply (in addition to establishing a claim for breach of care and diligence).

## **5.8 Can a director rely on others to inform him or her about the subject matter for decision?**

The *Corporations Act* entitles a director (but not another type of officer) to rely on the advice of professional advisors, experts and employees whom the director reasonably believes to be competent as well as other directors on matters within their authority but only if the director acts in good faith and makes enquiries if the circumstances point to the need for enquiry.<sup>17</sup>

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# **6. Duties to act in good faith and for a proper purpose**

## **6.1 Duties**

At common law and under the *Corporations Act*, directors must act in good faith and exercise their discretion bona fide in what they consider to be the interests of the company as a whole and not for a collateral purpose.

Section 181 of the *Corporations Act* provides that directors and other officers of corporations must exercise their powers and discharge their duties:

- (a) in good faith in the best interests of the company; and
- (b) for a proper purpose.

Directors must act in the interests of the company as a whole and not for a collateral purpose. The general rule is that directors owe this duty to the company (ie. the members as whole) and not to any one member or particular group of members. In particular, directors may not use their powers for the purpose of influencing control.

Given the fiduciary relationship, directors cannot exercise their powers to obtain some private advantage or for any purpose foreign to the powers. Fiduciary powers and duties of directors may be exercised only for the purposes for which they were conferred and not for any collateral or improper purpose.

The duty to act for a proper purpose is an absolute one. In determining whether the duty not to act for an improper purpose has been breached, the courts have taken a two step approach. Firstly, the court will consider the nature of the relevant power by defining the limits within

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<sup>17</sup> Section 189 of the *Corporations Act*.

which it may be exercised. Second, the court should examine the substantial purpose for which the power was exercised.<sup>18</sup>

## 6.2 Criminal liability

Section 184 of the *Corporations Act* provides that a director or other officer will commit an offence if they:

- (a) are reckless or intentionally dishonest; and
- (b) fail to exercise their powers and discharge their duties:
  - (i) in good faith in the best interests of the company; or
  - (ii) for a proper purpose.

## 6.3 Directors of wholly owned subsidiary

Directors are required to act in the best interests of their company. However, sometimes there can be a difference in the interests of the subsidiary and its parent company. If the Australian company is a wholly owned subsidiary of a body corporate, a director of the subsidiary is taken to act in good faith in the best interests of the subsidiary if:

- (a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company;
- (b) the directors act in good faith in the best interests of the holding company; and
- (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

A company will be a wholly owned subsidiary if all the shares are held by:

- (a) another body corporate (eg. the parent);
  - (b) a nominee of the parent;
  - (c) a wholly owned subsidiary of the parent; or
- a nominee of a wholly owned subsidiary of the parent.

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## 7. Duty to avoid conflicts of interest

By reason of their fiduciary relationship with the company, a director must not enter into engagements in which he or she has a personal interest conflicting, or which possibly may conflict, with the interests of those whom they are bound to protect. The concern is the possibility of persons in a fiduciary position being swayed by their personal interest rather than their duty to the company.<sup>19</sup>

It is generally considered that the duty to avoid a conflict of interest requires that a director must not:

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<sup>18</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 NSWLR 68.

<sup>19</sup> *Bray v Ford* [1896] AC 44 at 51.

- (a) in any matter falling within the scope of his or her office, have an interest that conflicts or may possibly conflict with his or her duty to the company, except with the company's fully informed consent;
- (b) in any matter falling within the scope of his or her office, have an inconsistent engagement with a third party, except with the company's fully informed consent;
- (c) misappropriate the company's property for the director's personal or a third party's benefit;
- (d) misuse his or her position for his or her own or a third party's possible advantage, except with the company's fully informed consent; therefore a director must account to the company for any gain made in connection with the fiduciary office; or
- (e) divert any profit making opportunity, in the same line of business as the company's present or prospective business, to himself or herself or to some other person, except with the company's fully informed consent.

The duty of the director in these circumstances is, at the very least, to make a full disclosure to the board of directors of the company of his or her conflict of interest and to abstain from attending any meeting at which the transaction is discussed.

These requirements are also found in section 191 of the *Corporations Act*, which generally requires directors to disclose material personal interests, subject to a number of specific exceptions.

Like all fiduciary duties, this duty is absolute, regardless of any dishonesty or intention to defraud. For there to be a breach of director's duty as a result of the conflict, it is not necessary for the company to either incur a loss or for the director make a profit. Even where the transaction is evidently in the interests of the company and the company made a gain, a breach of duty may still have occurred. A fiduciary must account for profits made in connection with his or her fiduciary office.

That said, the Courts have recently become somewhat more accepting of the realities of commercial life and have also come to accept that a fully informed company can in some circumstances properly release a director from the full effects of this duty. Nevertheless, the core of the duty is that directors must be scrupulous in separating their own interests from those of the company.

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## **8. Duty not to misuse position or information**

Directors have common law and statutory duties not to misuse their position as a director or misuse information obtained as a director.

Section 182(1) of the *Corporations Act* provides that a director, secretary, other officer or employee of a corporation must not improperly use their position to:

- (a) gain an advantage for themselves or someone else; or
- (b) cause detriment to the corporation.

Section 183(1) provides a person who obtains information because they are, or have been, a director or other officer or employee of a corporation must not improperly use the information to:

- (a) gain an advantage for themselves or someone else; or
- (b) cause detriment to the corporation.

This duty continues after the person stops being an officer or employee of the corporation.

A director should consider whether any use to which he or she puts the position of director, or information gained as a director, might breach any of the duties so far discussed, and overall the duty to act in the best interests of the company. This may include such acts as diverting business opportunities away from the company to the benefit of themselves or others, or disclosing confidential information inappropriately.

## **8.2 Criminal liability**

Misuse of position and information can also result in a criminal offence.

Section 184(2) of the *Corporations Act* provides that a director, other officer or employee of a corporation commits an offence if they use their position dishonestly:

- (a) with intention of directly or indirectly gaining an advantage for themselves, or someone else, or causing detriment to the corporation; or
- (b) recklessly as to whether the use may result in themselves or someone else directly or indirectly gaining an advantage, or in causing detriment to the corporation.

Section 184(3) provides that a person who obtains information because they are, or have been, a director or other officer or employee of a corporation commits an offence if they use the information dishonestly:

- (a) with the intention of directly or indirectly gaining an advantage for themselves, or someone else, or causing detriment to the corporation; or
- (b) recklessly as to whether the use may result in themselves or someone else directly or indirectly gaining an advantage, or in causing detriment to the corporation.

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## **9. Duty to prevent insolvent trading**

### **9.1 Duties**

A director has a duty under section 588G of the *Corporations Act* to prevent a company from incurring a debt if:

- (a) the company is insolvent;
- (b) incurring the debt would cause the company to become insolvent; or
- (c) there are reasonable grounds to suspect the company is insolvent or would become insolvent if it incurred the debt,

and if:

- (d) the director is aware of the insolvency or grounds for suspicion of insolvency; or
- (e) a reasonable person in the director's position would be aware of the insolvency grounds for suspecting insolvency.

If a director breaches this duty the director may be personally liable for the debt in question.

The effect of this statutory requirement is that if a company is trading close to insolvency directors must be aware they no longer have to consider only a duty to the company and its shareholders, but also a duty which is owed to creditors.

The consequence of breach of this duty is that if the company goes into liquidation, the liquidator may sue the director personally for the amount of the debt so incurred and if the liquidator declines to sue, a creditor, with the permission of the liquidator, may sue the director.

ASIC may also seek a civil penalty against the director and/or an order that the director be disqualified from managing corporations.<sup>20</sup>

If it is found that the failure of the director to prevent the company incurring the debt was dishonest, criminal action may result.

## 9.2 Defences

Predictably, the defences that a director may rely on in respect of such liquidator recovery action go to disproving the elements of the claim.<sup>21</sup>

Thus if the director can show that he had reasonable grounds to expect and did expect that the company was solvent at the time the debt was incurred and would remain solvent even if it incurred the debt, the claim may be resisted.

In addition, if the director had reasonable grounds to believe and did believe that a competent and reliable person was responsible for providing to that director adequate information about whether the company was solvent and that competent and reliable person was fulfilling that responsibility and the director had the relevant expectation on the basis of that information, then the claim may be resisted.

It is also a defence if it is proved that the director took all reasonable steps to prevent the company from incurring the debt. In determining whether such reasonable steps were taken, regard is to be had, among other things, to:

- (a) any action the person took with a view to appointing an administrator of the company; and
- (b) when that action was taken; and
- (c) the results of that action.

The option of resigning as director in circumstances where the board of directors of the company may be of a view to take or not take action that would result in a breach of these duties may well be an appropriate action to take.

## 9.3 Parent company liability

The *Corporations Act* renders the holding company of a subsidiary liable for insolvent trading by that subsidiary if the holding company or one or more of its directors is or are aware at the time that the debt is incurred that there are reasonable grounds for suspecting that the company is insolvent or would become insolvent by the incurring of the debt.

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# 10. CLERP 9 - Continuous Disclosure

Corporate Law Economic Reform Program ("CLERP") 9 introduced a range of legislative amendments of potential relevance relating to executive remuneration, fundraising and the protection of whistle blowers.

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<sup>20</sup> See section 588J of the *Corporations Act*.

<sup>21</sup> See section 588H of the *Corporations Act*.

However, in terms of D&O liability, the most concerning amendment was the insertion of section 674(2A) in the Act providing that a person who is involved in a listed disclosing entity's contravention of the continuous disclosure obligations set out in subsections 674(1) and (2) is in breach of the Act and becomes subject to the civil penalty regime (with a possible maximum fine of \$200,000).

Section 1317HA relating to compensation orders for breaches of financial services civil penalty provisions was also inserted. The financial services civil penalty provisions include section 674(2A) of the Act together with sections 675, 1041A-D (market manipulation, false trading, market rigging and dissemination of information about legal transactions) and 1043A (insider trading).

Accordingly, directors and officers have been opened up to a new range of potential civil penalties for breach of the continuous disclosure provisions of the Act. It is important that cover is therefore provided for penalties and compensation orders under sections 1317G, 1317H and 1317HA. As considered above, cover (except for defence costs) is expressly excluded for pecuniary penalties. In addition, no mention is made of sections 1317H and 1317HA.

This is presumably because orders under these sections are compensatory in nature and therefore the insurer may consider them to already fall within the definition of "loss". However, in our view, specific reference should be made to compensation orders under sections 1317H and 1317HA confirming that such compensation orders fall within the definition of loss and are not subject to the pecuniary penalties sublimit.

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## **11. Derivative liability and the defence of due diligence**

### **11.1 Derivative liability**

Recently there has been a growing statutory trend to make directors and senior managers of companies derivatively liable for any breach of the company, regardless of whether they had any direct or accessorial involvement in the conduct constituting the breach.<sup>22</sup> This is particularly the case in environmental legislation and that dealing with workplace safety, however the derivative liability provisions extend over a wide range of areas, with most imposing criminal penalties.<sup>23</sup>

The imposition of derivative liability is said to be justified by the fact that it creates a greater incentive for those involved in the management of a corporation to monitor corporate compliance. The essential aim of derivative liability is to impose an obligation on at least some individuals in key positions within a corporation to inform themselves and assist in the prevention of any misconduct by the corporation.<sup>24</sup> These regimes seek to provide an incentive for directors to put in place effective risk management programs.<sup>25</sup> On the other hand some might argue that derivative liability is not necessary, and that fines and penalties

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<sup>22</sup> Ibid.

<sup>23</sup> In the Federal sphere for example, section 8Y of the *Taxation Administration Act 1953*; section 495 of the *Environment Protection and Biodiversity Conservation Act 1999*; s 188 of the *Corporations Act*; section 40B of the *Hazardous Waste (Regulation of Exports and Imports) Act 1988*; section 230F of the *Life Insurance Act 1995*; Division 9 of Part VI of the *Income Tax Assessment Act 1936* and s 11CG of the *Banking Act 1959*.

<sup>24</sup> Allens Arthur Robinson Focus - Corporate Governance – July 2005: "Extent of liability of corporate officers and other individuals under review."

<sup>25</sup> Corporate Law Economic Reform Program Paper No 3 *Directors' Duties and Corporate Governance* (1997) cited in Corporations and Markets Advisory Committee, Personal Liability for Corporate Fault: Discussion Paper, May 2005 at p.3.

imposed on a corporation itself are an effective incentive to ensure that corporations comply with their regulatory obligations. After all if the shareholders are sufficiently concerned with the governance of the corporation they could move for the dismissal of the directors.<sup>26</sup>

An example of a provision imposing derivative liability on an individual is provided by section 493 of the *Environmental Protection and Biodiversity Conservation Act 1999* (Cth). The section states that any person, whether a director or not, who is concerned in, or takes part in, the management of the corporation may be liable for either a civil penalty (under s 494) or a criminal penalty (under s 495) if that person:

- (a) knew or was reckless or negligent as to whether a contravention would occur;
- (b) was in a position to influence the conduct of the corporation in relation to the contravention; and
- (c) failed to take all reasonable steps to prevent the contravention."<sup>27</sup>

Another controversial element of many of the provisions making directors derivatively liable for corporate fault is that they reverse the onus of proof. Traditionally, the onus of proof is placed on the person seeking the penalty to prove the elements of an offence, whereas some of these provisions automatically deem a director liable for corporate fault. An example is provided by the operation of section 8Y(1) of the *Taxation Administration Act 1953* (Cth). This provision is used to establish the criminal liability of directors for tax offences committed by their companies and provides that:

*"Where a corporation does or omits to do an act or thing, the doing or omission of which constitutes a taxation offence, a person (by whatever name called and whether or not the person is an officer of the corporation) who is concerned in, or takes part in, the management of the corporation shall be deemed to have committed the taxation offence and is punishable accordingly."*

As can be seen, the effect of this provision is to reverse the onus of proof. However, a director may escape liability if he or she can prove that he or she was not "directly or indirectly knowingly concerned in, or party to" the relevant act or omission and did not "aid, abet, counsel or procure the particular act or omission".<sup>28</sup>

The reversal of the onus of proof has been justified by some by the fact that society considers some offences so serious that there is a need to ensure that someone is found guilty and punished. In other cases this may be justified as there may be aspects of a case that would be too difficult for a prosecutor to prove - for example, confidentiality obligations or privileges prevent them from gaining access to critical documents or information.<sup>29</sup> However, it has also been suggested that where "no fault" criminal liability is being imposed on a director for the fault of the company, the presumption of innocence requires that the burden of proof be placed on the prosecutor.<sup>30</sup>

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<sup>26</sup> Corporations and Markets Advisory Committee, *Personal Liability for Corporate Fault: Discussion Paper*, May 2005 at p. 15.

<sup>27</sup> See "Liability of Corporate Officers" above fn 4.

<sup>28</sup> Section 8Y(2) *Taxation Administration Act*; *Ibid.*

<sup>29</sup> "Liability of Corporate Officers" above fn 4.

<sup>30</sup> Bednall T, "Mallesons Stephens Jacques On board update - 9 August 2005: Personal liability of directors for corporate fault".

## 11.2 The test of reasonable steps

Most Federal legislation imposing derivative liability on directors includes, in addition to the fault elements, a further threshold test for liability that requires the prosecution to prove that the director or other person failed to either:

- (a) take all reasonable steps to prevent the contravention; or
- (b) take reasonable steps to ensure that a direction was complied with.<sup>31</sup>

These two tests are variations on the requirement of "due diligence".<sup>32</sup>

Section 496 of the *Environmental Protection and Biodiversity Conservation Act* lists matters which must be considered by a court in determining whether an executive officer failed to take "all reasonable steps" to prevent a contravention. The court must look at what action was taken by the officer before the contravention (proactive steps taken) and in response to the contravention (reactive steps taken).<sup>33</sup> The court is specifically directed to consider:

- (a) what action (if any) the officer took directed towards ensuring the following (to the extent that the action is relevant to the contravention):
  - (i) that the body arranges regular professional assessments of the body's compliance with this Act and the regulations;
  - (ii) that the body implements any appropriate recommendations arising from such an assessment;
  - (iii) that the body has an appropriate system established for managing the effects of the body's activities on the environment;
  - (iv) that the body's employees, agents and contractors have a reasonable knowledge and understanding of the requirements to comply with this Act and the regulations, in so far as those requirements affect the employees, agents or contractors concerned; and
- (b) what action (if any) the officer took when he or she became aware that the body was contravening:
  - (i) this Act; or
  - (ii) the regulations; or
  - (iii) if the body contravened Part 3 or section 142 or 142A—any environmental management plan that was prepared by the body, and approved by the Minister, as required by a condition attached to an approval under Part 9 for the purposes of a provision of Part 3 of the body's taking of an action."

Therefore, it seems that where there is some effective compliance system in place it will be more difficult for the prosecuting party to establish that a director failed to take all reasonable

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<sup>31</sup> "Liability of Corporate Officers" above fn 4.

<sup>32</sup> Ibid.

<sup>33</sup> Ibid.

steps. In many pieces of Federal legislation the existence and efficacy of a compliance program is relevant to determining liability.<sup>34</sup>

Where, as required by some statutes, the onus of proof is reversed, "reasonable steps" becomes a specific defence akin to due diligence, rather than a threshold test for liability.<sup>35</sup>

### 11.3 Due diligence

Due diligence defences become relevant where directors and other corporate officers are faced with liability under some derivative liability provision, because of the actions of the corporation that they represent. The essence of a due diligence defence is that the director or senior manager can escape liability if he or she can show that there was an effective internal control or compliance system in place to prevent the breach or contravention occurring.<sup>36</sup> In other words, to prove due diligence it must be shown that the company did what was reasonable to do to prevent what actually occurred from occurring.<sup>37</sup> Whilst it is common for State and Territory legislation to provide defences of "due diligence" or "all due diligence" to provisions making corporate officers derivatively liable for corporate wrongdoing, in New South Wales, there is no statutory definition of "due diligence" or "all due diligence".<sup>38</sup>

In order to discover what is required to make out a defence of due diligence one must examine the applicable caselaw. The question is one of fact and must be decided objectively according to the standard of the reasonable person in the circumstances.<sup>39</sup>

The leading case on the general principles for determining due diligence in Australia is *Universal Telecasters (Qld) Ltd v Guthrie*.<sup>40</sup> In this case Bowen CJ said that in order to establish a due diligence defence a defendant would have to show that:

*"It had laid down a proper system to provide against contravention of the Act and that it had provided adequate supervision to ensure the system was properly carried out....[However] the mere fact that its system and supervision has proved inadequate to prevent error does not necessarily establish that its system is defective."*<sup>41</sup>

In the case of *Town of Kwinana v Woolworths (WA) Ltd*<sup>42</sup> a defective can of food had been sold by the respondent. In order to escape liability the respondent had to satisfy a due diligence defence. In considering the defence Ipp J accepted that due diligence meant no more than reasonable care in all the circumstances and noted that the means by which reasonable care could be exercised were many and not capable of enumeration. The result of the case was

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<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> Parker C, Conolly O "Is there a duty to implement a corporate compliance system in Australian law?" (2002) 30 ABLR 273 at 286.

<sup>37</sup> Lalich P above at fn 26 at 507.

<sup>38</sup> "Liability of Corporate Officers" above fn 4.

<sup>39</sup> Cowley B, "Personal Liability for Nominee Directors" Presented at the 27th Annual AMPLA Conference, July 2003.

<sup>40</sup> (1978) 32 FLR 360.

<sup>41</sup> Id at 363.

<sup>42</sup> (1992) 8 WAR 1.

that the respondent did not satisfy the defence as there was no evidence that it had ever inspected the manufacturer's plant or satisfied itself of the manufacturing procedures used.

In *Australian Iron & Steel Pty Ltd v Environment Protection Authority*<sup>43</sup>, Abadee J concluded that 'the notion of due diligence appears to involve an absence of negligence or fault'. In *State Pollution Control Commission v Kelly*<sup>44</sup>, Hemmings J held that, although it was not necessary to show that a standard of perfection had been met, the defence of due diligence requires consideration of precautions which should have been taken.

*"Due diligence, of course, depends upon the circumstance of the case, but contemplates a mind concentrated on the likely risks. The requirements are not satisfied by precautions merely as a general matter in the business of the corporation, unless also designed to 'prevent the contravention.' Whether a defendant took the precautions that ought to have been taken must always be a question of fact and, in my opinion, must always be decided objectively according to the standard of a reasonable man in the circumstances."*<sup>45</sup>

In Australia the general theme arising from the case law is to treat a lack of due diligence as something similar to negligence, or at least, a lack of reasonable care.<sup>46</sup>

The defence of due diligence has been most comprehensively considered in the Canadian judicial system, particularly those cases dealing with environmental law. In Canada, "due diligence" is a defence available to directors and other officers of corporations charged with environmental offences under provincial law. The leading Canadian case, *R v Bata Industries Ltd [No 2]*,<sup>47</sup> involved an environmental pollution incident. Although this case is not binding on Australian Courts, there is no doubt that it is a useful reference when considering the defence of due diligence. In the case, Ormston J of the Ontario Provincial Court held that it was necessary to "establish that [the directors] exercised all reasonable care by establishing a proper system to prevent [the] commission of the offence and by taking reasonable steps to ensure the effective operation of the system". Ormston J listed a number of factors relevant to establishing a due diligence defence that are similar to those mentioned above in section 496 of the *Environmental Protection and Biodiversity Conservation Act*.<sup>48</sup> These included whether the directors had helped to establish or had established a pollution prevention system; whether the directors had ensured that officers of the company reported periodically to the board of directors any substantial non-compliance; and also whether the directors had immediately and personally reacted when they became aware of the system failure.<sup>49</sup>

Due diligence requires the identification and assessment of specific risks likely to be faced having regard to the activities of a corporation. In order to establish a due diligence defence a risk management system must be in place that specifically addresses the risks facing the corporation. The test of whether these risks have been appropriately handled, and therefore whether due diligence has been exercised, is an objective one and does not depend on whether the directors and officers did the best that they could. Instead the test focuses on the

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<sup>43</sup> (1992) 66 A Crim R 134 at 147.

<sup>44</sup> (1991) 5 ACSR 607.

<sup>45</sup> Id at 608-9.

<sup>46</sup> Cowley B, above fn 35.

<sup>47</sup> (1992) 70 CCC (3rd) 394.

<sup>48</sup> "Liability of Corporate Officers" above fn 4.

<sup>49</sup> Brazil P, Boreham K "The Liability of Company Officers for Corporate Breaches of the New Federal Environment Legislation" (2000) 19 AMPLJ 145 at 156.

reasonableness of the directors' actions with regard to the circumstances in attempting to prevent the risk from occurring.<sup>50</sup>

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## 12. Directors' duties - environmental

In New South Wales directors/managers may be deemed liable for a breach of environmental legislative obligations occasioned by the company they direct. The three main areas of director/manager liability are regulated by:

- (a) the *Environment Protection and Biodiversity Conservation Act 1999* (Cth) ("**EPBC Act**");
- (b) the *Contaminated Land Management Act 1997* (NSW) ("**CLM Act**"); and
- (c) the *Protection of the Environment Operations Act 1997* (NSW) ("**POEO Act**").

The focus of this paper will be on the liability of directors/managers under the POEO Act, which is the primary environment protection legislation in New South Wales, and under which directors are most likely to face liability.

### 12.1 The EPBC Act

The EPBC Act contains a number of environmental offences relating to matters of national environmental significance. Under Part 17, Division 18, "*executive officers*" may be found civilly or, in some instances, criminally liable for environmental offences committed by the company if they:

- knew that or were reckless or negligent as to whether the offence would be committed by the company; and
- were in a position to influence the conduct of the company; and
- failed to take reasonable steps to prevent the contravention.

An "executive officer" means:

*"a person, by whatever name called and whether or not a director of the body, who is concerned in, or takes part in, the management of the (corporation)."*

### 12.2 The CLM Act

The CLM Act establish a process for investigating and (where appropriate) remediating land areas where contamination presents a significant risk of harm to human health or some other aspect of the environment. Directors may be held responsible by a Court for the clean-up of a site which was contaminated by a company that they directed, if the company has:

- been wound up within the 2 years before the Court's order is made; or
  - transferred the land within the 2 years before the Court's order is made
- and
- the company has failed to comply with the investigation or remediation order.

The Court may only make such an order against a director if:

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<sup>50</sup> Lalich P above fn 26 at 508

- the person was a director of, or a person concerned in the management of, the company at the time when the investigation or remediation order was made; and
- there is reason to believe that the company was wound up or transferred as part of a "scheme" to avoid compliance with the investigation or remediation order.

Further, the director will have a defence to the making of an order against it if he/she can satisfy the Court that they:

- had no knowledge, actual, imputed or constructive, of the scheme or any element of the "scheme";
- were not in a position to influence the conduct of the company in relation to that "scheme"; or
- if in such a position, they used all due diligence to prevent the pursuit of the scheme by the company.

### 12.3 POEO Act

The POEO Act covers a range of environmental offences including land, air, noise and water pollution. It has 3 Tiers of offences, the most serious of which are Tier 1 offences that require wilful or negligent conduct. All other offences are Tier 2 offences (strict liability offences), unless dealt with by a way of a penalty notice (Tier 3).

Penalties under the POEO Act for a conviction include, for tier 1 offences, up to 7 years imprisonment for individuals.

#### Director/ manager liability under section 169

In May 2006, significant amendments to the liability of directors and managers for the environmental offences of a company came into force by way of amendments to the POEO Act. Upon its introduction into Parliament in 2005, the Minister for the Environment said that a "head in the sand approach" by directors to environmental management was no longer acceptable.

Section 169 of the POEO Act provides that if a corporation commits an offence under the Act or its regulations, each person who is a director of the corporation or who is "concerned in the management of the corporation" is taken to have contravened the same provision. An individual may be prosecuted and convicted whether or not the corporation has been proceeded against or convicted. It is not necessary for the prosecution to establish any fault or negligent conduct on the part of the director or manager.

It is a defence under section 169 if the director or manager can demonstrate that:

- (i) he/she was not in a position to influence the conduct of the corporation in relation to the offence, or
- (ii) he/she, if in such a position, used all due diligence to prevent the offence by the corporation.

Prior to the amendments to the POEO Act this year, directors and senior managers were also able to rely on a "no knowledge defence". Prior to May 2006 it was a defence if the director or manager could establish that:

*"the corporation...(committed the offence)...without the knowledge actual, imputed or constructive of the (director/manager)."* (emphasis added)

This amendment to the POEO Act brought it into line with section 26 of the *Occupational Health and Safety Act 2000* (NSW) ("**OHS Act**"). As a result of the 2006 amendments to section 169 the critical issue for directors and manager is what is necessary to demonstrate that they have used "all due diligence".

#### **12.4 "All due diligence" - what does it require and how can the defence be successfully plead?**

The POEO Act provides no legislative guidance on the meaning of "all due diligence". The issue was specifically considered by the Land and Environment Court some time ago in *State Pollution Control Commission v R v Kelly* (1991) 5 ACSR, here the court held that:

- due diligence contemplates a mind concentrated on the likely risks; and
- whether the defendant took the precautions that should have been taken must always be a question of fact.

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### **13. Occupational Health and Safety**

Occupational Health and Safety ("**OHS**") legislation across Australia effectively requires directors and managers of companies to ensure that all practicable measures are taken by the company to protect the health and safety of persons employed by the company or working at workplaces controlled by the company. This is based on the rationale that directors and persons concerned in the management of companies are in a position to take action to ensure the health, safety and welfare of employees, contractors and others at worksite by requiring the implementation of comprehensive OH&S management systems.

OHS legislation differs in each Australian State and Territory. The variations between the jurisdictions relate to the circumstances in which a director (or manager) can be personally liable, the categories of persons (eg directors, "officers" or "persons concerned in management") who may be personally liable, and the available defences. Accordingly, the potential for directors to be personally liable under the relevant legislation will depend on the jurisdiction in which the company operates.

Generally the relevant provisions fall into two categories:

- deemed liability irrespective of fault- in jurisdictions adopting this model Directors (and certain other officers of the company) are automatically deemed to be personally liable for any contravention of the Act by the company. This means that the prosecution is not required to establish that the individual had personal responsibility or culpability. NSW, Queensland and Tasmania have legislation which adopts this model; and
- liability only if negligent/culpable conduct - in jurisdictions adopting this model the prosecution is required to establish some deliberate conduct on the part of the relevant director or manager which caused or contributed to the incident. For instance, in Victoria the prosecution must show a failure to take reasonable care and in Western Australia and the Northern Territory the prosecution must show that the individual consented to, connived in or was negligent in respect of the relevant corporate conduct which led to the breach by the company.

For the purposes of this outline we focus on the position in New South Wales.

#### **13.1 Occupational Health and Safety Duties**

The OH&S Act imposes a broad duty on employers to ensure the health, safety and welfare of employees and others at the workplace. This duty encompasses a requirement to provide:

- safe premises;
- safe machinery and substances;
- safe systems of work;
- information, instruction, training and supervision; and
- a suitable working environment and facilities.

In addition, "controllers of workplaces" are required to ensure that their workplaces are safe and without risks to health.<sup>51</sup>

Breach of these duties is a criminal offence. A company can defend a prosecution if it can establish that it took all reasonably practicable steps to prevent the contravention.

The maximum penalties under the OH&S Act for breach of the general duties in sections 8 and 10 for corporations are:

- \$825,000 (for previous offenders), or
- \$550,000 (for first offenders).

Higher penalties apply if the workplace deaths provisions are contravened.

### **13.2 Deemed liability for directors and persons concerned in management**

Section 26 of the OHS Act deems directors and "persons concerned in management" to be personally liable for any breach of the Act by the company. There is no requirement for the prosecutor to establish fault on the part of the individual. Once a contravention by the company is established, whether or not proceedings were taken against the company, the individual is by virtue of his or her position automatically guilty of an offence.

The categories of persons who are relevantly "concerned in management" has been broadly interpreted by the Industrial Relations Commission ("IRC"). It has said a "person concerned in management":

- must be a person who was in a position to influence, by advice or decision making, the conduct of the corporation;
- need not be at the highest levels of management in the company;
- may include persons who provide advice or information to the decision makers in the corporation; and
- possibly need not be an employee of the corporation that has contravened the Act.

The maximum penalty under the OHS Act for individual is:

- \$82,500 or imprisonment for 2 years, or both (for previous offenders); or
- \$55,000 (for first offenders).<sup>52</sup>

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<sup>51</sup> Section 10 OHS Act NSW 2000

<sup>52</sup> Section 12 OHS Act NSW 2000. Note higher penalties apply in respect of the workplace deaths offence. However, this is not an offence for which directors and managers are deemed to be personally liable for any contravention by the company.

The largest penalties to date include a \$70 000 fine in 2004 for a demolition company director associated with two fatalities caused by excavation works near gas lines<sup>53</sup>, and a \$42 000 fine for a trucking company director arising out of the death of a truck driver who was driving in a fatigued state.<sup>54</sup>

### 13.3 Defences

A director or persons concerned in management will be able to defend a prosecution if he or she can satisfy the court that:

- he or she was not in a position to influence the conduct of the corporation in relation to its contravention of the provision of the Act;<sup>55</sup> or
- he or she, being in such a position, used all due diligence to prevent the contravention by the corporation.<sup>56</sup>

The OHS Act does not contain a definition of all due diligence, however it has been the subject of some judicial and academic consideration.

In one decision<sup>57</sup>, the IRC considered that, to establish the defence, the director must show that he did all that was required to ensure the putting in place of a system of work within the company designed to identify and manage risks to safety in his employee's worksites. This required more than "*hoping others would or could do what they were told*", but required the director to ensure that:

*"they have the skills to execute the job they are required to do and then ensuring compliance with that in accordance with the safe standards established. Compliance requires a process of review and auditing, both formal and random, in order to ensure the safe standards established are in fact being adhered to and under ongoing review."*

In *WorkCover Authority of New South Wales (Inspector Childs) v Kirk Group Holdings Pty Limited and Anor*<sup>58</sup> the Commission reiterated that the duty of a director or manager is:

- (a) absolute;
- (b) proactive;

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<sup>53</sup> *WorkCover Authority of New South Wales (Inspector Mansell) v Robert Josef* [2004] NSWIRComm 323. The charges against the defendant arose as a result of a gas explosion in the vicinity of the Kogarah Railway Station on 4 December 1995. That explosion occurred because on that day an employee of Josef & Sons Contracting Pty Limited, operating a mechanical excavator on a demolition site, snagged a length of charged gas pipe and pulled it free from its seat. Escaping gas under pressure was then ignited causing a violent explosion. Two people were killed and a number of persons injured.

<sup>54</sup> *Campbell v Hichcock* NSW IRC 34/2005 in which a company director (being the heart and mind of the company) was fined \$42 000 for allowing a driver to drive whilst in a fatigued state leading to a fatality.

<sup>55</sup> Section 26(1)(a) OHS Act NSW 2000.

<sup>56</sup> Section 26(1)(b) OHS Act NSW 2000.

<sup>57</sup> *WorkCover Authority of New South Wales (Inspector Childs) v Kirk Group Holdings Pty Limited and Anor* [2004] NSWIRComm 2070.

<sup>58</sup> In *WorkCover Authority of New South Wales (Inspector Childs) v Kirk Group Holdings Pty Limited and Anor* [2004] NSWIRComm 207.

- (c) unable to be delegated; and
- (d) extends to careless/reckless employees.

Essentially directors and persons concerned in management are required to ensure that a systematic and comprehensive occupational health and safety management system, which has been developed in accordance with sound risk management principles is in place. Case law indicates that the courts are particularly focussed on considering what the relevant director or manager did to ensure that the management system (including policies and procedures) was implemented and enforced in practice.

To make out the due diligence defence a director would need to establish that he or she personally:

- (a) ensured there was a system of work in place that was designed to identify and manage risks to safety;
- (b) ensured that adequate supervision (including internal and external audit) was provided to ensure the system was properly implemented;
- (c) had an understanding of the company's safety management system and took an active role in auditing and enforcing it; and
- (d) objectively considered and critically reviewed the information provided to him or her and did not rely unquestioningly on the actions of his or hers predecessors.

#### **13.4 Ritchie's Case**

In *Inspector Ken Kumar v David Aylmer Ritchie*<sup>59</sup>, the Court found the CEO of a large multinational company guilty of an OHS offence. The offence took place in Australia after an employee was fatally injured while cleaning a tank with a highly combustible solvent. Ritchie, a resident of New Zealand, argued that he was too remote to influence the company and that he had used all due diligence to prevent the contravention.

Both defences were rejected by the court on the basis that all directors by their nature and their role are capable of influencing the corporation. This highlights that remoteness from the daily operations of the company may not be sufficient to make out that a director was not in a position to influence the day-to-day operations of their company.

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### **14. Trade Practices Act**

A number of provisions in the *Trade Practices Act 1974* (Cth) ("**TPA**") give rise to personal liability. This liability is not just restricted to directors. It extends to all individuals in a corporation. For example, in 2005 a \$50,000 penalty was ordered by the Federal Court against a site manager of a petrol station in Brisbane who had been involved in price fixing.

The provisions which attract personal liability relate to anti-competitive behaviour (Part IV) and consumer protection (Part V). With directors potentially facing pecuniary penalties of up to \$500,000 D&O liability insurance cover is essential. Increasingly courts are becoming more willing to impose substantial fines on directors. This is particularly the case where individuals have been involved in price fixing.

While the provisions in the TPA apply to corporations liability for individual directors can arise in three ways:

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<sup>59</sup> *Inspector Ken Kumar v David Aylmer Ritchie* [2006] NSWIRComm 323

- (a) In relation to both Part IV and Part V a court may make an order against any person who:
- (i) "aided, abetted, counselled or procured"<sup>60</sup>;
  - (ii) "induced, or attempted to induce"<sup>61</sup>; or
  - (iii) "has been in any way directly or indirectly, knowingly concerned in";<sup>62</sup>
- a contravention. Any such order will be in the form of a pecuniary penalty.

Under Part VC an individual may face criminal prosecution if it breaches a relevant consumer protection provision including a failure to meet product safety standards.

A director may be joined as a defendant to any private litigation. This liability arises from section 82 of the TPA which allows any person who "suffers loss or damage" as a result of contravention of certain provisions to sue for damages.

## 14.2 Immunity policy for cartel conduct

In September 2005, the ACCC introduced an immunity policy which only applies to cartel conduct. The immunity policy seeks to maximise the incentives for cartel participants to self-report their involvement in a cartel and to provide certainty for applicants about how the ACCC will deal with immunity applications. It confers full amnesty from prosecution and penalty to the first eligible cartel participant to report its involvement in a cartel and cooperate with the ACCC's investigation and prosecution of other cartel participants. Despite the immunity policy applicants remain exposed to civil damages actions by persons who allege loss as a result of the cartel conduct.

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## 15. Litigation funding

Historically, Australian common law prohibited both maintenance (supporting litigation, regardless of the reason) and champerty (supporting litigation in exchange for a share of the proceeds of that litigation). The basis for the prohibition was that they were considered contrary to public policy. Today, maintenance and champerty have been abolished in most Australian jurisdictions. This has been reinforced by the recent High Court of Australia decision in *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd; Australian Liquor Marketers Pty Ltd v Berney*<sup>63</sup>.

In *Fostif*, the first decision by the High Court on litigation funding, the Court held by a five to two majority that litigation funding was neither an abuse of process nor contrary to public policy. The majority was composed of Gummow, Hayne and Crennan JJ (in a joint judgment) and Gleeson CJ and Kirby J.

However, the appeals were allowed on the separate ground that the proceedings did not meet the requirement for a representative proceeding that 'numerous persons have the same interest' in the proceedings. The majority on this point was composed of Gummow, Hayne and Crennan JJ (joint judgment) and Callinan and Heydon JJ (joint judgment).

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<sup>60</sup> TPA section 76(1)(c).

<sup>61</sup> TPA section 76(1)(d).

<sup>62</sup> TPA section 76(1)(e).

<sup>63</sup> *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd; Australian Liquor Marketers Pty Ltd v Berney* [2006] HCA 41 (30 August 2006).

The decision will undoubtedly lead to an increase in funded litigation, although the decision about representative proceedings means that it remains to be seen what form such litigation will take.

The companion case, *Mobil Oil Australia Pty Ltd v Trendlen Pty Ltd*<sup>64</sup>, was decided on the same grounds.

## 15.1 Background

The proceedings in *Fostif* concerned claims for the recovery of amounts paid by tobacco retailers to tobacco wholesalers, allegedly for the purposes of the wholesalers paying a licence fee, later found to be unconstitutional.

The proceedings were instigated by a litigation funder who was prepared to underwrite the litigation in exchange for one third of any amounts recovered, plus the benefit of any costs order. The proceedings were brought in the NSW Supreme Court as representative proceedings, but persons who wished to participate had to "opt in" and agree to the funder's terms.

## 15.2 Litigation funding

The joint judgment of Gummow, Hayne and Crennan JJ explained that in jurisdictions that had abolished maintenance and champerty as crimes and torts (namely New South Wales, Victoria, South Australia and the ACT<sup>65</sup>) there were no public policy questions beyond those that would be relevant when considering the enforceability of the agreement for maintenance of the proceedings as between the parties to the agreement.<sup>66</sup> In other words, once you have abolished the crimes and the torts of maintenance, these concepts cannot be used to found a challenge to proceedings that are being maintained. Their only relevance is in a dispute between plaintiff and funder about the enforceability of the agreement. The Court did not decide the position for those states where legislation has not abolished maintenance and champerty.

The joint judgment also considered a range of factors specific to the instant litigation, that alone or in combination were not contrary to public policy or did not lead to an abuse of process.<sup>67</sup> These factors included:

- the funder seeking out of claimants to make a claim against the defendant (which the appellants described as 'officious intermeddling');
- the degree of control which the funder would have over the proceedings (the litigants' interests being said to be 'subservient' to those of the funder);
- the funder retaining a solicitor to act for the plaintiffs and represented parties (which was said not to lessen the funder's control of the proceedings but to give rise to possible conflicts of duty for the solicitor); and
- the funder obtaining rights to litigate and doing so with a view to profit (the funder described as 'a speculative investor in other persons' litigation').<sup>68</sup>

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<sup>64</sup> *Mobil Oil Australia Pty Ltd v Trendlen Pty Ltd* [2006] HCA 42 (30 August 2006).

<sup>65</sup> *Civil Law (Wrongs) Act 2002* (ACT) s 221; *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW) ss 3, 4, 6; *Criminal Law Consolidation Act 1935* (SA) Sch 11 ss 1(3), 3; *Wrongs Act 1958* (Vic) s 32 and *Crimes Act 1958* (Vic) s 322A.

<sup>66</sup> *Fostif* at [84]-[86].

<sup>67</sup> *Fostif* at [88].

Gleeson CJ and Kirby J agreed with the reasoning of the joint judgment.<sup>69</sup>

### 15.3 Representative proceedings

The appeals were allowed on the basis that, at the time the proceedings were commenced, they did not meet the requirement for a representative proceeding that 'numerous persons have the same interest' in the proceedings.<sup>70</sup>

The joint judgment in *Fostif* held that, while the nominated plaintiff had brought its own claim, it made no claim on behalf of any other tobacco retailers. Their participation in the proceedings, and any consequence for their rights, depended upon them choosing to 'opt in' to the proceedings. That could only occur once they had agreed to the funder's terms. While the funder obviously hoped that many retailers would opt in after the proceedings were instituted, that was only a hope as to future events. Consequently, at the time the summons was issued to commence the *Fostif* proceedings, there were no persons, other than the respondent Fostif Pty Ltd, who had an interest in the proceedings which were instituted. The requirement of "numerous persons" was not satisfied.<sup>71</sup>

### 15.4 Ramifications of High Court's decision

The High Court's decision has lifted a cloud of uncertainty surrounding litigation funding. It is now clear that, at least in those jurisdictions that have abolished the crimes and torts of maintenance and champerty, funded litigation of all stripes will proceed without the threat of a challenge from defendants based on the existence of the funding.

A number of consequences will flow from this decision. First, there will, undoubtedly, be an increase in class actions promoted by litigation funders. Indeed, a number of class actions that have been 'on hold' awaiting the High Court's decision will now proceed. Second, new participants who see the opportunity for profitable investment in litigation will enter the litigation funding market.

Finally, there will be renewed calls from plaintiff lawyers for the legislation governing the legal profession to be amended to allow lawyers to enter into true contingency fee agreements with their clients. If there are no sound public policy reasons to prohibit contingency fee agreements with funders, it is hard to see why lawyers should be prevented from entering into the same arrangements.

That being said, the shape of the emerging litigation funding industry and its overall effect on litigation will depend to a large extent on whether the various governments choose to regulate the industry and, if so, in what way.

There are still some areas of uncertainty, including the capacity of disgruntled claimants to challenge the enforceability of funding arrangements and the way in which funded litigation may structure "class action" procedures, especially in light of what the High Court has said about the NSW representative procedure. These areas of uncertainty merely illustrate the extent to which litigation funding is an emerging phenomenon with the capacity to change the way in which litigation occurs in this country.

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<sup>68</sup> *Fostif* at [87].

<sup>69</sup> *Fostif* at [1] and [146].

<sup>70</sup> *Fostif* at [51] and [60].

<sup>71</sup> *Fostif* at [56]-[60].

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## 16. Future law reform

### 16.1 OH&S Act

The NSW Government has released for public consultation a revised Bill that proposes to amend the OH&S Act. The Government has indicated that the Bill is likely to be put before Parliament this year. The draft of the Bill released earlier this year proposes three key changes that will significantly impact on the liability of directors and managers:

- The prosecutor will have to demonstrate that the company failed to take all practicable measures to ensure safety before a contravention of the Act can be made out;
- Deemed liability will attach to "officers" of the company (as defined by s9 of the *Corporations Act*) rather than to "directors and persons concerned in management";
- The prosecutor will be required to establish that the relevant "officer" failed to take "reasonable care". In determining whether or not reasonable care was taken, the court is required to have regard to the officer's knowledge and ability to make or participate in decisions about the matter, and whether the contravention is attributable to the act or omissions of any other person.

### 16.2 CAMAC

In September 2006, the Corporations and Markets Advisory Committee ("**CAMAC**") released its report on Personal liability for corporate fault ("**the Report**"). The Report focused on when directors and managers may incur personal criminal liability for corporate misconduct arising in consequence of misconduct by a company (i.e. where an individual is deemed criminally responsible for a breach by a company of a statutory requirement).

CAMAC concluded that in general:

- Individuals should only be penalised for the misconduct of a company where they were accessories to the misconduct. In other words, individuals must either have personally assisted or been privy to the misconduct.
- There should be consistency between corporate and non-corporate organizations regarding personal liability for organisational fault. At present, officers of companies incorporated under the *Corporations Act* are exposed to personal penalties which do not apply to other companies.
- There should be consistency in the approach taken to personal liability in the Commonwealth, State and Territory jurisdictions. This would reduce complexity and aid understanding which would in turn promote effective corporate compliance and risk management.

The Commonwealth Government has indicated that it will consider the CAMAC report and make recommendations to the Ministerial Council for Corporations.

Normally, a CAMAC report is three or four major steps removed from legislation. However, this report recommends that Federal and State legislation be harmonised and therefore, any implementation of this report is likely to take significantly longer. Also, State Governments may be unwilling to support any proposals to reduce individual sanctions on corporate breach in light of the James Hardie situation.

## 16.3 TPA

As a result of the Dawson Review this legislative regime is likely to be strengthened in the next couple of years with a number of proposed changes to the TPA currently before the Federal Parliament. Tougher penalties for anti-competitive conduct will for the first time fully expose company executives to substantial fines. While the maximum fine of \$500,000 for individuals will remain in place, it will no longer be a penalty that can be passed on to shareholders. Directors caught engaging in anticompetitive conduct may have to pay fines and the legal costs themselves. This would bring the TPA in line with the *Corporations Act*.

Beyond a pecuniary penalty, judges will have the power to ban anyone implicated in anticompetitive conduct from managing a company. The Court would be able to order, on application by the ACCC, a person's disqualification for a duration, the length of which would be left to the court's discretion. Criminal penalties for "hard core" cartels will also be introduced. Executives involved in "hard core" cartels will face up to 5 years in jail and fines of up to \$220,000.

A further addition to the regime is the inclusion of a new offence of providing misleading information to the ACCC in the context of a merger review or proceedings before the Australian Competition Tribunal. This offence would apply where a person has been negligent as to whether information is false or misleading "in a material manner". A contravention of this offence will attract a penalty of \$6,600.<sup>72</sup>

Furthermore, under the proposed subsection 77A(1) a body corporate ("**the first body**"), or a body corporate related to the first body, must not indemnify a person (whether by agreement or by making a payment and whether directly or through an interposed entity) against any of the following liabilities incurred as an officer of the first body:

- (a) civil liability; or
- (b) legal costs incurred in defending or resisting proceedings in which the person is found to have such a liability.

For the purposes of subsection 77A(1), a corporation is not considered to be indemnifying an officer if, for example, it advances monies or makes a loan to an officer to enable that person to defend or resist legal proceedings, but only if the monies advanced, or loan made, must be repaid if the officer is found to have contravened Part IV of the TPA and is liable to pay a pecuniary penalty of any size pursuant to section 76 of the TPA. The term "officers" has the same meaning as under the *Corporations Act* and includes directors and most senior employees.

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<sup>72</sup> Trade Practices Legislation Amendment Bill (No 1) 2005 (Cth), proposed section 95AZN and proposed section 76(1B)(b).