Comment and Notes

The Liability of Passive Directors: *Morley v Statewide Tobacco Services Ltd*

A frisson ran through the Australian business community with the decision in *Statewide Tobacco Services Ltd v Morley*.[1] There, Ormiston J held that Mrs Morley, a passive director in a small family company, was liable under s556 of the Companies Code for a debt of over $165,000 incurred by the company at a time when it was insolvent. The reverberations continued with the even more dramatic result in *Commonwealth Bank of Australia v Friedrich*,[2] where judgment of $97 million was given against Mr Eise, honorary and part-time chairman of the National Safety Council of Australia.

Recently, the Full Court of the Supreme Court of Victoria has, in *Morley v Statewide Tobacco Services Ltd*,[3] dismissed an appeal from the first instance decision, substantially agreeing with the approach of Ormiston J.

There were two basic issues in the case. The first was whether Mrs Morley, who had acquiesced in her son effectively running the business but herself took a negligible and passive role in the company's operations, could rely upon the defence under s556(2)(a) that the "debt was incurred without [her] express or implied authority or consent". The second was whether Mrs Morley could rely upon her own failure to become acquainted with facts which would have revealed to her the true state of the company's financial position to establish, as a defence under s556(2)(b)(i), that she "did not have reasonable cause to expect that the company would not be able to pay all its debts as and when they became due". With the decision of the Full Supreme Court that neither defence was available to Mrs Morley, the trend towards increased liability for passive and negligent directors and the attenuation of the grounds of defence available to a director under s592 of the Corporations Law (the current equivalent to s556 of the Companies Code) seems in full-swing and irreversible.

Or is it? In the background to developments in this area of law lies the earlier New South Wales Court of Appeal decision in *Metal Manufacturers Ltd v Lewis*,[4] another case concerning a passive director. In the *Metal Manufacturers* decision, the facts of which at first blush appear very similar to those in *Morley*, Mrs Lewis was, in contrast to her Victorian counterpart, able to deflect liability for a debt incurred while the company was insolvent, by use of the defence that the debt had been incurred without her express or implied authority or consent.

The scope of the decision in *Metal Manufacturers Ltd v Lewis* and its relationship with other more recent cases in this area is somewhat obscure.

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1 (1990) 8 ACLC 827.
2 (1991) 9 ACLC 946.
3 (1992) 8 ACSR 305 per Crockett, Southwell and Hedigan JJ.
4 (1988) 6 ACLC 725.

Three distinct approaches emerged from the case. Kirby P, in dissent, was clearly more attuned to the reasoning employed in the later decisions. Strong policy considerations on the role of directors and the purpose of the insolvent trading provision, as being designed "to instil a high sense of responsibility" in directors, underpinned Kirby P's construction of the defence under s556(2)(a). The fact that Mrs Lewis acquiesced in her husband acting as managing director, although she herself took almost no part whatever in the management of the company, was, according to Kirby P, sufficient to establish the requisite "authority or consent" for liability to attach.

At the other end of the spectrum in the *Metal Manufacturers* case was McHugh JA, who adopted a construction of the defence under s556(2)(a) which would ensure that a passive director, merely acquiescing in another running the company, could never be liable under the insolvent trading provision. This was by virtue of his insistence that the authority or consent referred to under the defence must be "an authority or consent to the incurring of the very debt and not an authority or consent to the incurring of debts generally". Confining liability to a defendant who has had involvement in the particular debt results in a substantial contraction of the scope of s556(1) from that which it would have under Kirby P's interpretation of the provision. The "particular debt" argument favoured by McHugh JA has now been specifically disapproved by the Full Supreme Court in *Morley*, on the basis that it "would render otiose" the reference to a director in the expression "any person who was a director of the company or took part in the management of the company" in the offence provision.[5]

The third judge in the *Metal Manufacturers* case, Mahoney JA, was however prepared to accord Mrs Lewis the protection of the defence under s556(2)(a) on rather different grounds. This involved a detailed examination of the source of a managing director's powers. Viewing the position of managing director as "an office", he considered that it was from this "office" and ultimately from the articles making provision for such office that the managing director derived authority, not from the other directors. Since there was no evidence given of any indirect control exercisable by Mrs Morley upon her husband in his role of managing director through, for example, the manner of his appointment, restrictions on his exercise of power or ability to terminate his office, Mahoney JA interpreted Mr Lewis' powers as inviolable vis-a-vis Mrs Lewis. Since she had no control over any of his actions, so the argument ran, she could not be treated as authorising or consenting to them.

Were the reasoning of Mahoney JA to be limited to the special facts (or lack of them) in *Metal Manufacturers*, where no evidence as to the articles of association was given, it might be of no great moment. It is however seized upon and given potentially wide scope by the Full Court in *Morley's* case as an explanation and justification for the different results in the two cases. In *Morley's* case, although in practical terms the son exercised similar powers to those of a managing director, he was not appointed to such position pursuant

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5 (1992) 8 ACSR 305 at 313. See also, more recently, the decision of the Full Court of the Supreme Court of South Australia in *Group Four Industries Pty Ltd v Brosnan* (1992) 10 ACLC 1437.

to the articles. According to the Victorian Full Court, Mrs Morley's acquiescence to her son running the business *as if* he were managing director was sufficient to establish that she had given her implied authority or consent to the incurring of the debt; whereas Mrs Lewis' continued acquiescence of her husband running the business *as* managing director was not.

Such a distinction is certainly odd on its face. It is premised on the view that the powers of a managing director flow from the office per se, whereas Mrs Morley's son derived his authority through direct delegation from the other directors. Is this distinction tenable? In *Metal Manufacturers Ltd v Lewis*, the model of managing director adopted by Mahoney JA seemed to reflect the position where the managing director has powers expressly conferred by the memorandum or articles and thereby operates as an independent organ of the company. According to Professor Pennington,[6] only in these circumstances does the managing director obtain immunity from intervention by other directors in the exercise of his or her powers.

Yet this is not the only, nor is it argued, the most common or appropriate model to capture the interrelation of managing director with board. On the second model, the managing director is viewed merely as the delegate of the board of directors. The language of Table A reg 81 of the *CorporationsLaw* is far more suggestive of such a delegation model. Under that article, the directors may "upon such terms and conditions and with such restrictions as they think fit, confer upon a managing director any of the powers exercisable by them". The conferral of powers may be "concurrent with, or be to the exclusion of, the powers of the directors" and the directors retain the right to "withdraw or vary any of the powers so conferred" at any time. This view was clearly accepted by Rogers CJ Comm D in the recent case of *AWA Ltd v Daniels*, when he stated that the managing director is generally "a director to whom the board of directors has delegated its powers of management of the corporation's business".[7]

Such a delegation model is considerably more in keeping with our modern conception of the role and duties of directors than the stark portrait of board impotence drawn by Mahoney JA. Directors are increasingly being viewed as monitors of conduct by management and there is a movement, exemplified by the provisions relating to directors' duties in the Corporations Law Reform Bill 1992, for the imposition of more stringent duties upon them. All this looks decidely irrational, if the model assumed by Mahoney JA is adopted. Yet, if the explanation for the decision in *Metal Manufacturers* is merely that, in the absence of evidence of any indirect control possessed by Mrs Lewis pursuant to the articles, she was presumed to have none, the significance of the case would be minimal. If, on the other hand, the case were perceived to show that the powers of a managing director derive from that office, and not from the directors — an interpretation which the Full Court in *Morley* appears to countenance, though Ormiston J at first instance clearly doubted — *Metal Manufacturers Ltd v Lewis* would continue to play a large, but incongruent, role in this developing area.

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6 *Pennington's Company Law* (6th edn, 1990) at 583.
7 (1992) 10 ACLC 933 at 1014.

Determining the second major issue in *Morley v Statewide Tobacco ServicesLtd*, whether Mrs Morley was entitled under s556(2)(b) to rely upon her ignorance to show that she did not have "reasonable cause to expect that the company would not be able to pay all its debts as and when they became due", required consideration of the High Court decision in *Shapowloff v Dunn*.[8] The question was which of two possible tests should the court follow in delineating the scope of the defence under s556(2)(b). Should the court, as was suggested by dicta in *Shapowloff*, determine what the defendant *ought* to have deduced concerning the solvency of the company *from the facts actually known to her*? Or should the hypothesising go one level deeper, with the court determining what the defendant *ought* to have deduced from the facts which she *ought* to have known were she properly performing her duties as director?

The debate epitomises two fundamentally divergent approaches to directors' duties. Although the Companies and Securities Law Review Committee, in its report on "Indemnification, Relief and Insurance" in relation to company directors and officers,[9] regarded the duty of directors to exercise reasonable care and diligence as being "so fundamental to the proper administration of companies" that it should not be capable of attenuation, the duty has in fact had a rather languid and lacklustre history under English and Australian law. Cases like *Re City Equitable Fire Insurance Co Ltd*[10] and *The Marquis of Bute's Case*[11] confirmed that directors had little to fear from this branch of the law.[12]

Furthermore, because of the absence of any special requirements for qualifications as a director, it was assumed that directors would need to rely extensively on the advice of others. Standards of supervision required of directors were low and the already protected position of directors was bolstered by difficulties of enforcement of the duty of care and diligence as a result of the restrictive operation of the rule in *Foss v Harbottle*.[13] Justification for this approach was found in a partnership theory of the corporation, which viewed the shareholders as ultimately responsible for unwise appointments of directors — a view that sometimes re-emerges even today.[14]

This then was a model in which the role of directors was to manage the company; but since they were often quite ill-qualified to manage, they might delegate to someone more competent to do so. Against this background, passivity by directors could be seen, not as something to be punished, but rather in certain circumstances, to be encouraged.

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8 (1981) 148 CLR 72.

9 "Company Directors and Officers: Indemnification, Relief and Insurance"*Companies and Securities Law Review Committee Report No 10*, May 1990, para [43].

10 [1925] Ch 407.

11 [1892] 2 Ch 100.

12 See Trebilcock, "The Liability of Company Directors for Negligence" (1969) 32 *MLR* 499 and Finch, "Company Directors: Who Cares About Skill and Care?" (1992) 55 *Mod LR* 179.

13 (1843) 2 Hare 461.

14 See Hill, "Protecting Minority Shareholders and Reasonable Expectations" (1992) 10 *C&SLJ* 86 at 102.

This contrasts with a more stringent approach to passive directors in the US. While there is no equivalent to the insolvent trading provision in the US, there is a line of cases dealing with the issue of passive directors. In *Gamble v Brown*,[15] for example, the defence raised by a director of a bank in an action for breach of statutory duty, that he should be excused from liability on the basis of age, bodily and mental infirmity and illiteracy was rejected. According to the court, even if such infirmities made it difficult for the director to carry out his duties as director, "he nevertheless voluntarily remained in office, and thereby retained his responsibility to the corporation".

A similar approach was taken in *Rankin v Cooper*[16] where the court considered that, to permit non-attendance at board meetings to operate as a defence would discriminate unfairly between directors, by treating those who fail to participate at all in board meetings more favourably than those attending regularly. A more recent US case in which a strict line was adopted by both the trial court and the Supreme Court of New Jersey is *Francis v United Jersey Bank*.[17] There the argument of a passive director that she should be absolved from liability on the basis that she was "a simple housewife who served as a director as an accommodation to her husband and sons" was soundly rejected. The courts took the view that had she made the slightest effort to discharge her reponsibilities as a director of the company, she would have discovered that her sons were plundering it to the tune of over $10 million. According to the Supreme Court "[a] director is not an ornament, but an essential component of corporate governance".[18]

Decisions such as *Francis* have been seen to reflect a different model of the function of directors — a revised perception of directors as monitors of corporate affairs and policies rather than as managers themselves.[19] The model of directors as monitors, which emanates in the US from the writings of Professor Melvin Eisenberg, gives a new perspective to many familiar areas of law relating to directors' duties. We have, for example, traditionally viewed directors as having a *right* to obtain corporate information. Under a monitoring model of the role of directors, however, such a "right" may need to be recast as a "duty" to actively seek out corporate information. Such an approach is apparent in the statements in *Francis v United Jersey Bank* that "directors are under a continuing obligation to keep informed about the activities of the corporation" and "may not shut their eyes to corporate misconduct and then claim that because they did not see misconduct, they did not have a duty to look".[20]

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15 20 Fed R 2d 366 (1928).

16 149 Fed R 1010 (1907).

17 392 A 2d 1233 (1978) (Superior Court of New Jersey); 432 A 2d 814 (1981) (Supreme Court of New Jersey).

18 432 A 2d 814 at 823 (1981).

19 See Cox, "Changing Perceptions into Reality: Fiduciary Standards to Match the American Directors' Monitoring Function" (1989) 1 *Bond LR* 218.

20 432 A 2d 814 (1981) at 822. See also *Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946 at 1001, where Tadgell J stated that directors "should take reasonable steps to place themselves in a position to guide and monitor the management of the company by reference to information appropriate for the purpose".

A monitoring model of directors may be seen to underlie many of the recent Australian decisions which have imposed more demanding standards upon directors. The decision in *Morley v Statewide Tobacco Services Ltd* is no exception. The determination that the court should not, in delineating the scope of the defence in s556(2)(b), follow the approach in *Shapowloff v Dunn* is certainly consistent with such a model. Some of the arguments used by the court to support its decision in *Morley* are also reminiscent of those appearing in the US line of cases. Echoing the discrimination argument from *Rankin v Cooper*, for example, the court states that "[i]t does not seem right that in this day and age a director who takes sufficient interest in his duties to be fixed with knowledge of insolvency, may, if he neglects to act, become criminally and civilly liable, whereas a director who wholly ignores the obligations imposed upon him by the Code, can escape that liability by pleading his own ignorance of the relevant facts".[21]

There is another aspect of the monitoring model of directors however which may in certain circumstances mitigate the strict approach in *Morley's* case. This is the fact that a monitoring model presumes that executive and non-executive directors are distinguishable in their roles and treatment under the law. This message was clearly accepted by Rogers CJ in *AWA Ltd v Daniels*.[22] Speaking of large public companies, the judge stated — "The true oversight of the activities of such companies resides with the corporate bureaucracy . . . It is something of an anachronism to expect non-executive directors, meeting once a month, to contribute anything much more than decisions on questions of policy, and, in the case of really large corporations, only major policy".

Differentiation between directors and management on the basis of the former's monitoring role opens the way to a more finely tuned approach to the question of what a director "ought to know" to properly discharge the duties of office. Such an approach was apparent in the discussion in *AWA Ltd v Daniels* of whether the non-executive directors of AWA had been negligent in their failure to know of the inadequacy of effective controls over the company's foreign exchange dealings. In finding that they were not negligent, Rogers CJ pointed out that the non-executive directors had no reason to believe that their prudential policy was not being observed and were entitled to have confidence in senior management. *Morley* and *CommonwealthBank of Australia v Friedrich* were both extreme cases. *Morley's* case involved nonfeasance through egregious failure to become acquainted with the basics of the corporation's affairs. *Friedrich's* case, as well as involving ignorance of corporate affairs, raised an additional element of failure to follow up leads on impropriety presented to the board. The more interesting and difficult cases will not be those at this extreme end of the spectrum.

Thus, the approach of the Full Supreme Court in *Morley's* case of taking into account what directors ought to have known in the proper performance of their duty is in accordance with changing perceptions of the role and duties of directors. There is, however, a fundamental tension involved in such an

21 (1992) 8 ACSR 305 at 320.
22 (1992) 10 ACLC 933 at 988.

approach being taken in relation to a provision such as s592 of the *Corporations Law*, which involves not only civil, but also criminal liability. As was stated in *Morisette v US*,[23] "[t]he contention that an injury can amount to a crime only when inflicted by intention is no provincial or transient notion".

The criminal aspect of the provision would seem then to invite a narrower reading of the section. The difficulties raised by the presence of criminal liability were not lost on Ormiston J at first instance in *Morley's* case,[24] however he classified the form of liability as "regulatory criminal liability" — a somewhat dubious categorisation — and considered there to be no true ambiguity necessitating a narrow construction of the section.

As a matter of policy there may be good reason for differentiating between the elements comprising the obligation for the purposes of civil and criminal liability, so that what a director "ought to have known", but did not, can be taken into account for the purposes of the former though not the latter. An obstacle to this approach is the statement of the majority judgment in *Waugh v Kippen* [25] that "[t]he legislature cannot speak with a forked tongue". Others however have been less inclined to view this form of utterance as impossible,[26] and it would seem to be a sensible method of achieving the objectives in both the civil and criminal spheres.

JENNIFER HILL*

23 342 US 246 at 250-51 (1952).

24 (1990) 8 ACLC 827 at 843.

25 (1986) 160 CLR 156 at 165.

26 See, eg, *Hurst v Vestcorp Ltd* (1988) 13 ACLR 17 at 26 per Kirby P and *Chugg v Pacific Dunlop Ltd* (1990) 170 CLR 249 at 254-55 per Deane J.

* Senior Lecturer, Faculty of Law, Sydney University.