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Non-Executive Directors' General Law Duty of Care and Delegation of Duty: But do we need a Common Law Duty of Care?

Abstract

[extract] In Australia, the common law of negligence has developed to a point of being risk adverse. However, non-executive directors operate in a commercial environment which demands of them risk taking. Unless the common law is prepared to descend from its pedestal of high principle, it will not be able to develop a duty or standard of care that takes into account the commercial realities within which non-executive directors operate. But, even if the common law does descend to the level of pragmatism, it is still questionable why there is a need to develop a common law duty of care, given that non-executive directors are subject to fiduciary duties, an equitable duty of care and diligence and such statutory duties as the legislature may care to impose. Furthermore, it is difficult to demonstrate that the demands of practical justice, public interest or corrective justice require such a development. On the other hand, equity, with its well known reputation for flexibility, has attempted to balance two antithetical concepts: risk taking and responsible corporate governance. There is no reason why traditional equitable concepts cannot be moulded to meet modern expectations of the role of non-executive directors.

Keywords

negligence, non-executive directors, duty of care, executive directors, delegation, AWA Ltd v Daniels

NON-EXECUTIVE DIRECTORS' GENERAL LAW DUTY OF CARE AND DELEGATION OF DUTY: BUT DO WE NEED A COMMON LAW DUTY OF CARE?

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Introduction

Speaking at Yale University in 1955, Sir Owen Dixon reflected on judicial technique. He considered that one of the essential features of the common law had been judicial insistence on strict logic. But even then, he saw that the signs were many that the strict logic of the common law had fallen into disfavour.¹ In recent times, McLachlin J, of the Supreme Court of Canada, showed little hesitation in liberating the common law of negligence from the tyranny of logical reasoning. In distinguishing a House of Lord's decision because it was logically precise, her Honour stated:

... the incremental approach of *Kamloops*² is to be preferred to the insistence on the logical precision of *Murphy*.³ It is more consistent with the incremental character of the common law. It permits relief to be granted in new situations where it is merited.⁴

That may be one way of analysing *Murphy*, another may be that *Murphy* 'signalled the retreat from high principle and the resurgence of pragmatism'.⁵ In this state of affairs, it is no wonder that one commentator has viewed the present state of the tort of negligence as representing 'a partnership between exhausted principle and obscured pragmatism'.⁶ When it is necessary to decide whether A owes B a duty of care, the common law has, at least, two competing doctrines. The first being that, historically, the common law of negligence has evolved by creative judicial decisions on a particular situation or relationship and, where a novel circumstance arises, it is open to a court to decide whether to impose a duty.⁷ The second doctrine is that the *proximity* test in Lord Atkin's celebrated speech in *Donoghue v Stevenson* provides the only test to be applied where a novel category of case arises. Lord Atkin said that we owe a duty to persons in the position of 'neighbour' to us with regard to subject-matter, and that all those were:

1 Sir Owen Dixon, 'Concerning Judicial Method' (1956) 29 ALJ 468 at 469.

2 *City of Kamloops v Nielsen* (1984) 10 DLR (4th) 641.

3 *Murphy v Brentwood District Council* [1991] 1 AC 398.

4 McLachlin J, giving the leading majority reasons in *Canadian National Railway Co v Norsk Pacific Steamship Co Ltd* (1992) 91 DLR (4th) 289 at 367.

5 *White v Jones* [1995] 2 AC 207 at 237 per Steyn LJ.

6 Steele J, 'Scepticism and the Law of Negligence' (1993) 52 Camb LJ 437 at 466.

7 Morison WL, 'A Re-Examination of the Duty of Care' (1948) 11 Mod LR 9 at 34; and see Winfield P, 'Duty in Tortious Negligence' (1934) 34 Columbia LR 41 at 44-58.

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neighbours who are so closely and directly affected by my act that I ought to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called into question.⁸

The first doctrine is pragmatic; the second one is based on high principle.

In Australia, high principle has ruled the development of the common law of negligence. In all categories of cases where it has been judicially established that there is a duty of care owed, the duty is to take reasonable care to avoid a reasonably foreseeable risk of injury to another.⁹ Any risk is reasonably foreseeable unless it can be described as far-fetched or fanciful.¹⁰ A reasonable person responds to a foreseeable risk of injury by 'balancing the magnitude of the risk and the degree of the probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities' which may exist.¹¹ To state that the modern common law of negligence is risk adverse is to state the obvious. In recent times, the *AWA* litigation has obliged courts to decide whether non-executive directors owe to their company a common law duty of care, *AWA Ltd v Daniels*. Related to this, courts have had to consider the permissible limits on directors' power of delegation.

This article questions why the common law should be developed to impose upon non-executive directors a duty of care, given that there are subsisting equitable, fiduciary and statutory duties. As well, this article examines directors' power of delegation of duty and seeks to categorise the essence of a non-delegable duty.

***AWA Ltd v Daniels*: - Facts**

AWA was a long established Australian company whose business included importing and exporting electronic equipment. The company decided to hedge against currency fluctuations by engaging in forward purchases of foreign currency against contracts for imported goods. Koval was employed to manage the foreign exchange operations. Koval's dealings caused the company to incur losses approaching \$50 million. Koval managed to conceal the fact of these losses. During the period of Koval's employment, the company's auditor, Deloitte Haskins & Sells, conducted two audits. In neither audit was Koval's activities fully disclosed to the *AWA* Board, although the auditor had noted the defects in the company's system of internal control. *AWA*'s failure to establish adequate internal controls and record and account keeping had allowed the losses to

8 *Donoghue v Stevenson* [1932] AC 562 at 580.

9 *Bryan v Maloney* (1995) 182 CLR 609 at 619.

10 *Wyong Shire Council v Shirt* (1980) 146 CLR 40 at 48.

11 *Miletic v Capital Territory Health Commission* (1995) 69 ALJR 675 at 677.

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be concealed. AWA sued the auditor for negligence for failing to draw attention to these deficiencies and to qualify the audit reports. The auditor denied any breach of duty to AWA and cross-claimed against it and, *inter alia*, the non-executive directors for contributory negligence. It is the claim against the non-executive directors that is of immediate interest.

The trial judge, Rogers J, examined the interaction between directors' statutory duty of care and diligence, their general law duties and the judicial statements made in the insolvent trading cases.¹² His Honour recognised that what is expected of a director of a particular company is dependant upon: the actual knowledge and experience of the individual director; the nature and extent of the corporation's business; and, the distribution of responsibilities in the particular corporation.¹³ Apart from any guidelines set down specifically by statute or by the articles of association, Rogers J said that a non-executive director's duties, as a member of a board of a large public company, include: setting goals for the corporation; appointing the corporation's chief executive; overseeing the plans of managers for the acquisition and organisation of financial and human resources towards attainment of the corporation's goals; and, reviewing at reasonable intervals the corporation's progress towards attaining its goals.¹⁴

His Honour said that non-executive directors were *expected*: to take reasonable steps to place themselves in the position to guide and monitor the management of the company; to obtain a general understanding of the business of the company and the effect that a changing economy may have on that business; and to bring an informed and independent judgment to bear on the various matters that come to the board for decision.¹⁵ Rogers J considered that, applying High Court principles of proximity, non-executive directors owed to their company a common law duty of care.¹⁶

On appeal in *AWA*,¹⁷ the joint judgment of Clarke and Sheller JJA relied heavily on the opinion of the Supreme Court of New Jersey in *Francis v United Jersey Bank*.¹⁸ Their Honours said that that judgment exposed what is generally *expected* of directors not only in the United States but in Australia. Quoting extensively from that opinion, their Honours held that the United States' decision articulated what the law requires of directors in Australia. In *Francis*, Pollock J, giving the opinion of the court, said:

As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director

12 *AWA Ltd v Daniels* (1992) 7 ACSR 759.

13 *Ibid* at 864.

14 *Ibid* at 865-866.

15 *Ibid* at 864-865.

16 *Ibid* at 872-873.

17 *Daniels v Anderson* (1995) 37 NSWLR 438.

18 (1981) 432 A 2d 814.

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should become familiar with the fundamentals of the business in which the corporation is engaged ... Directors are under a continuing obligation to keep informed about the activities of the corporation ... Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies... While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of the financial statements ... The review of financial statements, however, may give rise to a duty to inquire further into matters revealed by those statements... Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign.¹⁹

The majority of the New South Wales Court of Appeal held that non-executive directors owe a common law duty to take reasonable care in the performance of their office.²⁰ The majority's reasoning was based on rejecting outdated historical considerations.²¹ In considering whether the common law should be developed to impose upon non-executive directors a duty of care, their Honours observed that the incremental development of the law, as permitted by *Donoghue v Stevenson*,²² can be adapted to decide whether a director has been negligent. Accordingly, their Honours held that:

A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size and business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office ... [directors are] at the apex of the structure of direction and management. The duty includes that of acting collectively to manage the company. Breach of the duty will found an action for negligence at the suit of the company.²³

A Duty of Care v Risk Taking

In a capitalist society, directors are expected to exhibit entrepreneurial flair which involves taking risk in the hope of obtaining greater profits.²⁴ While a company has every reason to expect its directors to exercise care, it is unreasonable of a company to expect of its directors a guarantee against failure, given the risks involved in entrepreneurial

19 Ibid at 821-823

20 *Daniels v Anderson* (1995) 37 NSWLR 438 at 505; Powell JA dissented on this point.

21 Ibid at 492.

22 The concept of negligence depends 'upon a general public sentiment of moral wrongdoing for which the offender must pay': [1932] AC 562 at 580.

23 *Daniels v Anderson* (1995) 37 NSWLR 438 at 505.

24 See, Farrar J, 'Corporate Governance, Business Judgment and the Professionalism of Directors' (1993) 6 CBLJ 1 at 3 who makes the point that neglect of this simple truth is the source of much error in contemporary debate about directors' duties.

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activity. Moreover, shareholders, investing in a company, know or ought to know that their investment is not secure; they make an insecure investment in the expectation that it yields a greater financial return than what they would obtain from a so-called secure investment. This is to be contrasted with the position of a motorist, an employee, or a client of a professional adviser. Each would expect that a fellow motorist, an employer, or a professional adviser respectively would not expose him or her to unnecessary risk; indeed, each would expect to be dealt with prudentially by the use of care, skill and diligence.

Some commentators have noted this dichotomy in company law. Sealy has argued that a 'duty of care and a liberty to embrace risk are incompatible bedfellows'.²⁵ Finch has noted the 'fundamental contradiction between an essential element of directing a company and the assumptions of tort law'.²⁶ at 205.

Equity, on the other hand, has attempted to sail between the Scylla of risk taking and the Charybdis of responsible corporate governance. It is worth noting the historical developments. By 1742, equity permitted a company to sue its directors for gross negligence - *crassa negligentia*.²⁷ In 1862, company legislation conferred jurisdiction on Chancery judges to administer company law.²⁸ By 1872, equity had developed the test to be applied in determining whether directors had exercised a reasonable degree of care and diligence, namely, whether the directors:

were cognisant of circumstances of such a character, so plain, so manifest and so simple of appreciation that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into.²⁹

And, in 1924, Romer J, in following the tradition that non-executive directors owe an objective standard with respect to care and diligence and a subjective standard with respect to skill, put forward the classic proposition that a non-executive director:

... is bound to take ... reasonable care [and diligence] to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf. [But] ... need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.³⁰

25 Sealy S, 'Directors `Wider` Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon ULR 164 at 176.

26 Finch V, 'Company Directors: Who Cares About Skill and Care?' (1992) 55 MLR 179

27 *Charitable Corporation v Sutton* (1742) 2 Atk 400; 26 ER 642 per Lord Hardwicke LC.

28 *Companies Act* 1862 (Eng), s.81.

29 *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 at 487.

30 *Re City Equitable Fire Insurance Co* [1925] 1 Ch 407 at 427-429.

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This equitable duty is tempered with the proposition that directors are not liable for errors of judgment.³¹ Furthermore, directors' fiduciary duties are tempered with a business judgment doctrine that holds that courts do not second-guess directors' bona fide business judgments.³² But, a breach of a director's fiduciary duty gives rise to strict liability,³³ and the damages for such breach are not troubled by common law considerations of foreseeability or remoteness.³⁴

This equitable standard has been criticised as being too low and not in accordance with modern expectations of the role of non-executive directors.³⁵ In its place has been postulated a standard of the 'ordinary prudent person/reasonable person of ordinary prudence' test espoused by United States courts.³⁶ But, to postulate such a standard is to ossify equity. Equity should prefer to remain flexible and adjust its standard to meet changing circumstances. Moreover, such a standard may be too low or too high in certain circumstances. Take the case of non-executive directors of a bank. It may be thought that the standard of ordinary prudence is too low and that a high prudential standard was more appropriate. On the other hand, take the case of a speculative venture. The standard of ordinary prudence is too high as it may be thought that a reasonable person of ordinary prudence would not entertain a venture where the prospect of failure is a probability. It may be thought that no more is necessary than to impose a standard of rationality³⁷ which makes allowance for idiosyncratic decision making.³⁸ Equity, according to the argument, can reconcile the apparently irreconcilable: entrepreneurial activity and responsible corporate governance. Can the common law achieve a similar objective?

Basis of a Common Law Duty of Care - Proximity?

As recently as 1992, Ford and Austin, considered that there had been no judicial acceptance that non-executive directors owed a common law duty of care.³⁹ However, in *AWA, Rogers J*⁴⁰ at first instance and Clarke and Sheller *JJA* on appeal,⁴¹ by applying the High Court's proximity test,

31 *Re Brazilian Rubber Plantation & Estates Ltd* [1911] 1 Ch 425 at 436-437; *Re City Equitable Fire Insurance Co* [1925] 1 Ch 407 at 429.

32 *Harlowe's Nominees Pty Limited v Woodside (Lakes Entrance) Oil Company NL* (1968) 121 CLR 483 at 493.

33 See *Maguire v Makaronis* (1997) 188 CLR 449; and see discussion of distinction between directors' equitable duty of care and diligence and their fiduciary duties in *Permanent Building Society v Wheeler* (1993) 11 WAR 187 at 235-239; and see Farrar J, 'The Duty of Care of Company Directors in Australia and New Zealand' (1996) 7 Cant LR 228 at 235.

34 *Re Dawson* [1966] 2 NSW 211 at 215; *Permanent Building Society v Wheeler* (1993) 11 WAR 187 at 243-248.

35 Cassidy J, 'Has the 'sleeping' director finally been laid to rest?' (1997) 25 ABLR 102 at 104, 111.

36 *Ibid* at 109, 111.

37 Whincop M, 'A theoretical and policy critique of the modern reformulation of directors' duties of care' (1996) 6 Australian Journal of Corporate Law 72 at 82, 91-92.

38 DeMott D, 'Directors' duty of care and the business judgment rule: American precedents and Australian choices' (1992) 4 Bond LR 133 at 140.

39 Ford & Austin, *Ford's Principles of Corporations Law*, Butterworths (1992), para 1527.

40 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 872-3.

41 *Daniels v Anderson* (1995) 37 NSWLR 438 at 492.

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came to the conclusion that non-executive directors owed their company a duty of care. It is now questionable whether the proximity concept, developed by Deane J and increasingly accepted by a majority of the High Court,⁴² has a secure place in Australian jurisprudence. Dawson J,⁴³ Toohey J,⁴⁴ McHugh J⁴⁵ and Gummow J⁴⁶ have questioned its paramount importance in determining whether a duty of care is owed. Brennan CJ has never been in favour of the concept.⁴⁷

Avoiding the Risk of Loss?

As previously mentioned, in Australia, the modern common law of negligence is risk adverse. It is worth pondering how this law may be applied to speculative ventures such as mineral exploration. When consideration is given to the proportion of all tested mineral prospects to become economically successful prospects, both Morgan and Brant have concluded that about 1% of all those tested makes a viable mine.⁴⁸ As well, Layton has argued that various business cycles and political considerations relate closely to the prospects of developing a successful mine.⁴⁹ Returning to applying the law, the familiar balancing exercise involves, in the opinion of Ipp J:

balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.⁵⁰

Thus, in a prospective mining venture, the risk of failure is so high as almost to amount to a certainty. It is therefore difficult to imagine that competent company directors, acting objectively in performing the balancing exercise, would commit shareholders funds or borrow money for such a venture. This is hardly good news for those engaged in mining ventures or other speculative ventures. It is no wonder that there are calls

42 *Sutherland Shire Council v Heyman* (1985) 157 CLR 424 at 441, 461-462, 471, 495-498; *Stevens v Brodribb Sawmilling Co Pty Ltd* (1986) 160 CLR 16 at 30, 49-53; *San Sebastian Pty Ltd v The Minister* (1986) 162 CLR 340 at 355; *Cook v Cook* (1986) 162 CLR 376 at 381-382; *Burnie Port Authority v General Jones Pty Ltd* (1994) 179 CLR 520 at 542, 543; *Bryan v Maloney* (1995) 182 CLR 609 at 617-618, 656.

43 *Hill v Van Erp* (1997) 188 CLR 159 at 176-179.

44 *Ibid* at 188-190.

45 *Ibid* at 210-211.

46 *Ibid* at 237-239.

47 *San Sebastian Pty Ltd v The Minister* (1986) 162 CLR 340 at 368; *Hawkins v Clayton* (1988) 164 CLR 539 at 555-556; *Gala v Preston* (1991) 172 CLR 243 at 260-263; *Bryan v Maloney* (1995) 182 CLR 609 at 652-653; similarly Sir Robin Cooke, 'An Impossible Distinction' (1991) 107 LQR 46 at 54.

48 Morgan DA, 'A Look at the Economics of Mineral Exploration' in Jones (ed), *Mining and Petroleum Geology, Proceedings of the Ninth Commonwealth Mining and Metallurgical Congress 1969*, Vol 2, 305 at 308.

49 Layton W, 'Influences on the Timing of Mineral Exploration and Mine Development Programmes' in Nesbitt & Nichol (eds), *Geology in the Real World; the Kingsley Dunham Volume*, Institute of Mining and Metallurgy, London (1986) at 245-252.

50 *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395 at 449-450.

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for the legislature to adopt a business judgment rule in this country if the existing duty prevails.⁵¹

A further matter should be explored. The balancing exercise involves weighing 'any other conflicting responsibilities' which may exist. Is it legitimate to regard entrepreneurial activity as a conflicting responsibility? If it is, can the board of a mining company decide to proceed with a venture where the prospects of failure are 99%. If the common law of negligence were to permit this to happen, it may be said that the common law duty of care is void of content for such directors are under no duty to avoid what is clearly a reasonably foreseeable risk of injury to the company.

Standard of Care?

Neither can an objective standard of care be formulated. The difficulty in determining the standard of care was adverted to by Rogers J in *AWA* when he observed:

In contrast to the [duties imposed on a] managing director, non-executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings, and at meetings of any committee of the board upon which the director happens to be placed. Notwithstanding a small number of professional company directors there is no objective standard of the reasonably competent company director to which they may aspire. The very diversity of companies and the variety of business endeavours do not allow of a uniform standard.⁵²

So, recognising that no uniform standard could be formulated, courts have traditionally laid down an objective standard with respect to care and diligence and a subjective standard with respect to skill.⁵³ In *AWA*, Powell JA, in examining this traditional approach, observed:

If there is to be any distinction as to the standards to be met by a director in the performance of his duties to his company, that distinction would seem to be, at best, that, in relation to the directors' duty to exercise a reasonable degree of care and diligence, the standard is that to be expected of the ordinary man, while in relation to any suggested duty to be skilful, the standard to be met is that of the particular directors' skill and experience (if any).⁵⁴

51 Companies and Securities Law Reform Committee, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No. 10 (May 1990), paras. 76-81; Baxt R, 'Do we now need a business judgment rule for company directors?' (1995) 69 ALJ 571.

52 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 867.

53 *Re City Equitable Fire Insurance Co* [1925] 1 Ch 407.

54 *Daniels v Anderson*, (1995) 37 NSWLR 438 at 602.

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It is worth considering whether there is a legitimate basis for departing from an objective standard of care which is applicable to all directors. As the passage already quoted from the judgment of Rogers J in *AWA* demonstrates, there is difficulty in formulating a common law objective standard. Is there another means of formulating the relevant legal principle? Non-executive directors do not possess the same skills or experience; indeed, some may have little or no experience of the boardroom.⁵⁵ They are appointed or elected to a company because of some perceived benefit for the company. They are not in that category of case where the standard of care is the objective standard of an experienced, competent, skilful non-executive director, but in a special category adjusted to the circumstances of each director. In respect of each director, the standard is objective: it takes into account that director's experience and skill and asks what could reasonably be expected of such director. Actions of such director which are to be seen as a result of inexperience, lack of qualification, or skill do not constitute a breach of duty.⁵⁶ On the other hand, as *Vrisakis v ASC* shows, a non-executive director possessed of significant experience and skill is to be judged against a higher standard.⁵⁷

But, these variable common law standards are the core of the problem if directors' duties 'are regarded as a single global concept applying to all directors'.⁵⁸ The problem is that there is no single objective or uniform standard that a non-executive director may aspire to or may be judged against; even those who call for the imposition of an objective standard of care are prepared to acknowledge this difficulty.⁵⁹ So, it would seem that coherency or uniformity is an unobtainable goal for the common law of negligence.

Current Trends in Common Law Negligence

In Canada, as we have seen, the common law of negligence will be developed to accommodate a new category of case where it is merited.⁶⁰ In England, the common law of negligence in modern times has become the gap-filler for perceived deficiencies in the law. As Bingham LJ observed:

Just as equity remedied the inadequacies of the common law, so has the law of torts filled gaps left by other causes of action where the interests of justice so required.⁶¹

What has resulted, in the view of Lord Templeman, is that:

55 The only qualification for appointment as director is that a person has attained the age of 18 years: Corporations Law, s. 228(13)

56 This argument is based by analogy on the reasoning in *Cook v Cook* (1986) 162 CLR 376 at 382-388.

57 *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395 at 455 per Ipp J; Malcolm CJ agreeing.

58 Sievers S, 'Farewell to the Sleeping Director - The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence' (1993) 21 ABLR 111 at 145.

59 See above n 35 at 112.

60 See above n 4.

61 *Simaan General Contracting Co v Pilkington Glass Ltd* (No 2) [1988] QB 758 at 782.

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... a fashionable Plaintiff alleges negligence. The pleading assumes that we are all neighbours now, Pharisees and Samaritans alike, that foreseeability is a reflection of hindsight and that for every mischance in an accident-prone world someone solvent must be liable in damages.⁶²

If it were ever correct to say that judges do not make the law, they only apply it, both the English Court of Appeal and a majority of the House of Lords abandoned any pretence that they were not law makers in *White v Jones*.⁶³ The facts were that the testator, having disinherited certain beneficiaries under an earlier will but having subsequently reconciled with them, gave the solicitor instructions to prepare a new will to include those beneficiaries. The solicitor was tardy in carrying out the instructions. In the meantime, the testator died without the new will being executed. Clearly, there was no contractual relationship between the solicitor and the disappointed beneficiaries. The latter sued for damages for common law negligence. In the English Court of Appeal, Sir Donald Nicholls V-C considered that, where there is a serious lacuna in the law the resources of the law must be sufficient to fill it if the remedy is fair, just and reasonable.⁶⁴ Farquharson LJ was prepared to acknowledge that policy considerations sometimes require the law to fashion a remedy.⁶⁵ The third member of the court - Steyn LJ - saw the resurgence of pragmatism in common law negligence.⁶⁶ He considered that the 'real question is whether it is fair, just and reasonable that the law should impose a duty'.⁶⁷ In the House of Lords, Lord Goff of Chieveley, delivering the leading majority speech, succumbed to a strong impulse to do practical justice if it was possible to fashion an effective remedy for the solicitor's breach of his professional duty to his client.⁶⁸

So, according to this principle, all that it is necessary to ask, where a novel category of case arises and the question is whether a common law duty of care is owed, is: does practical justice favour the plaintiff succeeding? If it does, it would seem that a plaintiff succeeds, not by application of the law but, by imposition of the law.⁶⁹

In Australia, as we have seen, the concept of proximity is under challenge.⁷⁰ Further trends are emerging. In *Esanda*,⁷¹ the question was whether an auditor of a company owed a common law duty of care to a third party. McHugh J considered that, where the existing law already

62 *CBS Songs Ltd v Amstrad Plc* [1988] AC 1013 at 1059.

63 [1995] 2 AC 207.

64 *Ibid* at 224.

65 *Ibid* at 232.

66 *Ibid* at 237.

67 *Ibid* at 238.

68 *Ibid* at 259-260.

69 See *Hill v Van Erp* (1997) 188 CLR 159 at 171 per Brennan CJ.

70 See above n 43-46.

71 *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 188 CLR 241.

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imposed liability, the demands of public interest or of corrective justice did not justify the imposition of an additional duty at common law.⁷² Gummow J considered that the tort of negligence should not displace carefully worked out equitable doctrines.⁷³ Furthermore, he signalled a retreat from the fashion of extending the reach of common law negligence:

Whereas once, when called upon to extend the frontiers of liability, some courts, reflecting academic enthusiasms, may have asked 'why not?', the time has arrived to ask instead 'why?'⁷⁴

Arguments against Directors' Common Law Duty of Care

Relevantly, the arguments that non-executive directors do not owe to their company a common law duty of care can be rehearsed. As already seen, the general law never recognised that such directors had an objective duty to act skilfully. So, the modern common law concept of reasonable care is missing one of its essential ingredients.⁷⁵ Nor has the legislature pointed to the existence of a common law duty of care by including this ingredient in the statutory duty to act with care and diligence.⁷⁶ On the other hand, in equity, directors owe to their company fiduciary duties⁷⁷ and an equitable duty of care and diligence.⁷⁸ They owe cognate statutory duties.⁷⁹ They have had imposed on them a statutory duty to prevent insolvent trading.⁸⁰ A further duty of care cognisable at common law is difficult to justify. Neither pragmatism, practical justice nor the demands of public interest or corrective justice favour such an imposition. Nor can it be shown that a company will be at a disadvantage if a common law duty is not imposed. To impose such a duty is to impose an objective duty to act skilfully, a duty which the legislature has declined to impose. This, essentially, is the point made by Powell JA in his powerful dissent in *AWA* when he observed:

... it seems to me that, given the nature and extent of the duties imposed upon the directors of a company by both the general law and such statutory provisions as s.229 of the *Companies (New South Wales) Code*, and the remedies which are available to a company in the case of breach, and given that no concurrent or alternative liability in tort will be admitted, if its effect would be to extend the

72 Ibid at 282, 289.

73 Ibid at 298; and see *Downsview Ltd v First City Corporation Ltd* [1993] AC 295 at 316.

74 Ibid at 304; see also Fleming J, 'Tort in a Contractual Matrix' (1995) 33 Osgoode Hall LJ 661 at 672.

75 Skill as an essential ingredient, see *Cook v Cook* (1986) 162 CLR 376 at 384; see also, *Byrne v Baker* [1964] VR 433 at 450-453.

76 *Re Property Force Consultancy Pty Ltd* [1997] 1 Qd R 300 at 306 per Derrington J; but cf Malcolm CJ in *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395 at 407-408 who considered that the statutory duty reflected the general concept of negligence at common law.

77 *Australian Growth Resources Corporation Pty Ltd v Van Reesema* (1988) 13 ACLR 261 at 268; *Chan v Zacharia* (1984) 154 CLR 178 at 198-199; *Warman International Ltd v Dwyer* (1995) 182 CLR 544 at 557-558.

78 See, *Permanent Building Society v Wheeler* (1993) 11 WAR 187 at 235-239.

79 Corporations Law, s.232.

80 Corporations Law, Part 5.7B.

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duty of care to which directors would otherwise have been liable - as would need to be the case if a liability in negligence, in the generally accepted sense were to be imposed - it seems to me that no sufficient ground has been made out for imposing upon directors, in addition to the existing liabilities under the general law and under such statutory provisions of s.229 of the *Companies (New South Wales) Code*, a potential liability to an action at common law seeking to recover damages for some alleged breach of the duty of care to which as directors they are already subject.⁸¹

Delegation

Some Perspectives on Delegation

Professor Finn (as he then was) has observed that there has never been a satisfactory analysis, in private law, between the relationship of the prohibition on delegation - the maxim *delegatus non potest delegare* - to the power to appoint agents.⁸² Fridman has taken the approach that the power to appoint agents depends on whether it is reasonable to infer or imply that an agent is authorised to appoint a sub-agent or a delegate.⁸³ Bowstead has considered that an agent's authority, from the principal, to appoint a sub-agent or to delegate, is implied in certain circumstances.⁸⁴ And by 1878, the English Court of Appeal recognised an exception to the maxim where the exigencies of business require that the business be carried out by means of a sub-agent, though the court emphasised that an agent should retain its discretion.⁸⁵ In the Supreme Court of Canada, Hudson J concluded that the maxim *delegatus non potest delegare* 'is at most a rule of construction'.⁸⁶ Professor Willis went further and argued that the rule of construction will yield to 'slight indications of a contrary intent'.⁸⁷

Rule against Delegation

Directors have been described as agents or trustees of their company.⁸⁸ Therefore, it may be expected that the maxim applied. This was the view taken in earlier cases where the issue was whether directors could delegate an express power given to them in the articles of association. In *Howard's Case*,⁸⁹ the power of allotting shares was vested in the board. Under the articles, three directors constituted a quorum. The board delegated the power to allot shares to the manager and two directors. At first instance, Kindersley V-C held that the maxim applied and, thus, the

81 *Daniels v Anderson* (1995) 37 NSWLR 438 at 607-608.

82 Finn P., *Fiduciary Obligations*, Law Book (1977) at 20, fn 6.

83 Fridman S., *The Law of Agency*, 7th ed, Butterworths (1996) at 166.

84 Reynolds, Bowstead and Reynolds on Agency, 16th ed, Sweet & Maxwell (1996) at 158.

85 *De Bussche v Alt* (1878) 8 Ch D 286 at 310-311.

86 Reference Re Regulations (Chemicals) under War Measures Act [1943] 1 DLR 248 at 276.

87 Willis J., 'Delegatus Non Potest Delegare' (1943) 21 Can. Bar Rev. 257 at 260.

88 *Re Faure Electric Accumulator Co* (1889) 40 Ch D 141; *Mills v Mills* (1938) 60 CLR 150 at 185; *Great Eastern Railway Co v Turner* (1872) LR 8 Ch App 149 at 152.

89 *Re Leeds Banking Company* (1866) 1 LR Ch App 561.

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board had no power to delegate their power of allotment.⁹⁰ On appeal, Turner LJ (Knight Bruce LJ not dissenting) affirmed that decision.⁹¹ In *Cartmell's Case*,⁹² the directors, under the articles of association, had power to repurchase the company's shares. The company's manager purported to repurchase some shares. Mellish LJ held that the directors could not delegate to the manager the express power given to them by the articles.⁹³ Thus, at an early stage in corporate law development, courts set their face against directors being entitled to delegate their powers where the articles of association had either imposed upon the board a special responsibility to exercise a power or had reposed an exclusive power with the board - the maxim *delegata potestas non potest delegare* being tacitly applied. There may be another reason why these two cases were decided the way they were. As Powell JA in *AWA* demonstrates, courts, in the latter part of the 19th century, regarded directors as trustees for their company.⁹⁴ At that time, trustees had rights to employ an agent only where there was a moral or legal necessity to do so.⁹⁵ As the articles in the two cases under discussion, reposed a confidence in the directors to perform a particular duty personally, equity would not permit trustees - or directors - to delegate that duty.

Delegation in the Corporations Law

In Australia, unless the contrary is provided in the articles,⁹⁶ the business of the company shall be managed by the directors.⁹⁷ Directors may delegate their powers, authorities and discretions to an attorney,⁹⁸ or their powers to a committee or committees of directors,⁹⁹ or to a managing director.¹⁰⁰ On first impression, these provisions provide ample scope for directors to delegate all of their powers to an attorney, to a committee of directors or to a managing director and, having done so, there would be no room for an argument that such directors had failed to take reasonable care in the exercise of a directorial duty. Whether directors can delegate all of their responsibilities to another will be discussed later.

Directors also have a statutory obligation to take reasonable steps to ensure that information, as to corporate solvency contained in the annual accounts, is not false or misleading.¹⁰¹ On the one hand, the objective standard that a director must ensure that information is correct, if applied strictly, would mean that directors could not delegate the preparation of the

90 Ibid at 563.

91 Ibid at 566.

92 *Re County Palantine Loan and Discount Company* (1874) 9 Ch App 691.

93 Ibid at 695.

94 *Daniels v Anderson* (1995) 37 NSWLR 438 at 594.

95 Megarry and Baker, *Snell's Principles of Equity*, 27th ed, Sweet & Maxwell (1973) at 254-255.

96 Corporations Law, s.175 (3).

97 Corporations Law, Schedule 1, Table A, Regulation 66(1).

98 Ibid at Regulation 67(1).

99 Ibid at Regulation 76(1).

100 Ibid at Regulation 81(1).

101 See, Corporations Law, s.1309(2).

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accounts but would have to satisfy themselves that the information contained in them was not false or misleading. Literally, directors would have to turn themselves into auditors. However, it is submitted that the preferable view is that the statutory obligation should be read down so as to accommodate the differing skills, particularly accounting skills, directors possess. A director, not possessing sufficient skill to form an opinion as to the accuracy of the accounts, would take reasonable steps to ensure that the accounts were accurate by receiving an unqualified auditor's report, and having done so, such director would have discharged his or her statutory obligation.

General Law Power to Delegate - Company Law

In earlier times, it does not appear that articles of association provided expressly that management of a company was reposed exclusively, or at all, with directors. So, it was submitted on behalf of the directors of City Equitable Fire Insurance Limited that they did not contract to manage nor did they manage the company's affairs.¹⁰² It is therefore not surprising that Romer J, apparently accepting that submission, held that:

In respect of all duties that, having regard to the exigencies of business, and the *articles of association* may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.¹⁰³ (italics added)

In *AWA*, Rogers J restated the traditional approach:

A director is entitled to rely without verification on the judgment, information and advice of the officers so entrusted. A director is also entitled to rely on management to go carefully through relevant financial and other information of the corporation and draw to the board's attention any matter requiring the board's consideration ... Reliance would only be unreasonable where the director was aware of circumstances of such a character, so plain, so manifest and so simple of appreciation that no person, with any degree of prudence, acting on his behalf, would have relied on the particular judgment information and advice of the officers.¹⁰⁴

On appeal in *AWA*, the court disagreed with Rogers J.¹⁰⁵ Their Honours referred, with apparent approval, to two decisions of the United States Courts. In one case, Circuit Judge Ripple (United States Court of Appeals, 7th Circuit) said that: 'Certainly, when an investment poses an

102 *Re City Equitable Fire Insurance Co* [1925] 1 Ch 407 at 418; the point appears to have been conceded by the company: at 416.

103 *Ibid* at 429.

104 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 868.

105 *Daniels v Anderson* (1995) 37 NSWLR 438 at 502.

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obvious risk, a director cannot rely blindly on the judgment of others'.¹⁰⁶ In the second case, it was said that:

If ... directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible.¹⁰⁷

Rogers J approached the question of delegation and reliance on the delegate on the basis that reliance is unreasonable only when the circumstances are manifestly suspicious to virtually anyone. On appeal, the court approached the question on the basis that reliance is unreasonable where the circumstances reasonably awaken suspicion. The difference in approach is significant in that, while Rogers J preferred a subjective test, the majority preferred an objective one. The decision of the New South Wales Court of Appeal reflects a change in judicial attitude towards traditional principles of delegation. That change of attitude is doubly noteworthy where, as Professor Baxt points out, the United States decisions relied on by the New South Wales Court of Appeal make no distinction between non-executive and executive directors.¹⁰⁸

Non-delegable Duties - Company Directors

The demarcation between those duties which are delegable and those which are not is a difficult question. As Mason J has acknowledged in the common law context, the classification of a duty as non-delegable rests on little more than an assertion.¹⁰⁹ In His Honour's analysis, the traditional categories of common law cases where courts have imposed a non-delegable duty of care were those of master/servant, hospital/patient, school authority/pupil, and possibly, invitor/invitee, where the:

... special duty arises because the person on whom it is imposed has undertaken the care, supervision or control of the person or property of another.¹¹⁰

With the recent addition of a further category, occupier (from whose property a dangerous substance or fire escapes)/neighbouring owner,¹¹¹ it may not be assumed that the categories of case in which a non-delegable duty exist are closed. Where such a duty exists, the duty holder must ensure or see that care is taken.¹¹²

106 *Federal Deposit Insurance Corporation v Bierman* (1993) 2 F 3d 1424 at 1432-1433.

107 *Rankin v Cooper* (1907) 149 F 1010 at 1013.

108 Baxt R, 'One 'AWA' case' is not enough: The Turning of the Screws for Directors' (1995) 13 C & SLJ 414 at 421.

109 *Kondis v State Transport Authority* (1984) 154 CLR 672 at 684.

110 *Ibid* at 687.

111 *Burnie Port Authority v General Jones Pty Ltd* (1994) 179 CLR 520.

112 *Ibid* at 550.

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In *AWA*, Rogers J considered that effective control in large corporations was now in the hands of management.¹¹³ On appeal, the court rejected this proposition and insisted that a board of a company - whatever its size - should retain effective control over management.¹¹⁴ Directorial control or directorial management places responsibility on the board to manage collectively the company's business.¹¹⁵ Where directors cannot fulfil this task personally, directorial management includes the hiring, monitoring and firing of management. The responsibility of monitoring management received some consideration in *AWA* on appeal. The court held that the board must ensure that it has available means to audit the management of the company so that it can satisfy itself that the company is being properly run.¹¹⁶ But, as already discussed, the *Corporations Law* seemingly enables a board to delegate complete responsibility to others. This proposition does not seem reasonable. Moreover, it is difficult to imagine a situation where the exigencies of business demand complete delegation of responsibility. Thus, the seemingly unlimited statutory power of delegation, perhaps, must be read down somewhat. In *Green v Whitehead*, one of the trustees of land gave an apparently unlimited power of attorney to another. For decision was whether such a delegation was permissible. Eve J held that the effect of such delegation was to denude that trustee of any of his duties, powers and discretions.¹¹⁷ Hence, in equity, the delegation was impermissible. Similarly, if directors, as fiduciaries, were to delegate all of their responsibilities to another, such a delegation would amount to empowering the delegate to decide whether or not the company should be managed.¹¹⁸

Equity and the common law appear to be pulling in the same direction. In equity, a fiduciary must retain ultimate control; at common law, control is a central element of those cases where a non-delegable duty of care exists. As directors are charged with control of the corporate personality, in equity, they cannot delegate that control. The common law approaches the question from a somewhat different perspective but achieves a similar result to equity. Even if directors purport to delegate control, at common law, they will be held personally responsible for the delegate's negligence. So, from whatever perspective, directors cannot free themselves of legal liability by delegating directorial management.

Gallagher and Dempster Revisited

In light of the decision in *AWA* on appeal, it is doubtful whether the views expressed in *Gallagher* are still persuasive. In *Gallagher*,¹¹⁹ the Full

113 *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 832-833.

114 *Daniels v Anderson* (1995) 37 NSWLR 438 at 505.

115 See above n 97.

116 *Daniels v Anderson* (1995) 37 NSWLR 438 at 505.

117 *Green v Whitehead* [1930] 1 Ch 38 at 45.

118 It would also make the delegate a de facto director: *Corporations Law*, s. 60.

119 *Australian Securities Commission v Gallagher* (1994) 11 WAR 105

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Court of Western Australia held that, in the context of a public company namely Rothwells Limited, the non-executive deputy chairman - Mr Gallagher - was entitled to assume that any information detrimental to the company's financial affairs would have been passed on to him and, to accept the chairman's and another director's view of a discussion paper prepared by a third director as to the company's financial affairs, particularly when the formers' view was more optimistic than the latter's view.¹²⁰

As the non-executive deputy chairman had notice of prior mismanagement and a contentious discussion paper as to the company's financial affairs, he ought to have been suspicious and put on his guard and not taken on trust what others had told him. That being so, Mr Gallagher's reliance on others was unreasonable as the circumstances should have awoken suspicion that the company's financial circumstances were delicate.

In *Dempster*,¹²¹ the chief-executive officer advised the non-executive directors of important information concerning the company's poor prospects in obtaining a major asset with a joint venture partner. The source of the chief executive officer's information was the controller of another company - Mr Dempster - which was in a joint venture relationship with the company. The information was fraudulent. A simple check by any of the non-executive directors would have exposed the fraud. The company, believing it was not acquiring the major asset, sold out its interest in the asset to another company at a modest price. The company suffered substantial loss in selling out early when the prospects of obtaining the major asset were better than probable. The non-executive directors were sued for damages for failing to exercise care and diligence pursuant to s.229(2) of the Companies Code.¹²²

The trial judge found that the chief executive officer implicitly trusted Mr Dempster. His Honour also found that the non-executive directors believed that the chief executive officer had accurately reported to them what the chief executive officer had been told by Mr Dempster.¹²³

His Honour held that each non-executive director was: entitled to assume the chief executive officer was accurately reporting to him; entitled to rely on the chief executive officer's judgment that what the chief executive officer had been told by Mr Dempster was true; and, not obliged to make any enquiry or take any step to check the information given to him.¹²⁴

120 Ibid at 121-122.

121 *Biala Pty Ltd v Mallina Holdings Ltd* (1993) 11 ACSR 785.

122 Now Corporations Law, s. 232(4).

123 Ibid at 856.

124 Ibid at 857.

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On appeal, the Full Court of Western Australia held that it was not a breach of duty to accept and not check a statement by a person in charge of an operation at its face value, notwithstanding the consequences.¹²⁵ As the non-executive directors were not put on their guard, the holding of the Full Court is consistent with the reasoning in *AWA* on appeal.

Conclusion

In Australia, the common law of negligence has developed to a point of being risk adverse. However, non-executive directors operate in a commercial environment which demands of them risk taking. Unless the common law is prepared to descend from its pedestal of high principle, it will not be able to develop a duty or standard of care that takes into account the commercial realities within which non-executive directors operate. But, even if the common law does descend to the level of pragmatism, it is still questionable why there is a need to develop a common law duty of care, given that non-executive directors are subject to fiduciary duties, an equitable duty of care and diligence and such statutory duties as the legislature may care to impose. Furthermore, it is difficult to demonstrate that the demands of practical justice, public interest or corrective justice require such a development. On the other hand, equity, with its well known reputation for flexibility, has attempted to balance two antithetical concepts: risk taking and responsible corporate governance. There is no reason why traditional equitable concepts cannot be moulded to meet modern expectations of the role of non-executive directors.

It is now clear that directors must directorially manage their company. This requires directors, as the New South Wales Court of Appeal in *AWA* held, to monitor management by having in place adequate mechanisms to audit management's performance. As directorial management is equivalent to directorial control, equity would deny directors the ability to delegate successfully that control to others. The common law achieves a similar objective by holding directors personally responsible for their delegate's actions.

125 *Dempster v Mallina Holdings Ltd* (1994) 15 ACSR 1 at 62.