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REPRINTED FROM EXCLUSIVE ONLINE CONTENT PUBLISHED IN:

JULY 2012

TalkingPoint: IMPLICATIONS OF RECENT LEGAL DECISIONS ON DIRECTOR DUTIES IN AUSTRALIA

REPRINTED FOR

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FW moderates an online discussion on recent legal decisions affecting director duties in Australia between Keith Bethlehem and David Miller, partners at Colin Biggers & Paisley.

Keith Bethlehem
Partner
Colin Biggers & Paisley

Keith Bethlehem is a partner in the Insurance Group of Colin Biggers & Paisley. His focus is in the areas of financial institutions and directors' and officers' insurance, as well as professional indemnity insurance. Mr Bethlehem's practice incorporates both advice to insurers on coverage issues and defending litigated claims on behalf of insured individuals and entities. He has worked internationally gaining extensive experience in the Lloyd's market, with a particular specialisation in defending claims against financial institutions and investment professionals. He can be contacted on +61 2 8281 4421 or by email: kbb@cbp.com.au.

David Miller
Partner
Colin Biggers & Paisley

David Miller is a partner in both the Insurance and the Commercial Dispute Resolution Groups at Colin Biggers & Paisley. Mr Miller is also experienced in corporate governance and risk management (including regulator actions and Special Commissions of Inquiry), Australian Consumer Law issues, and commercial disputes. He can be contacted on +61 2 8281 4419 or by email: dem@cbp.com.au.

FW: From a legal standpoint, what has been the impact of recent cases such as James Hardie, Centro and Bridgecorp on the duties and liabilities of directors in Australia, including the implication for in-house counsel?

Bethlehem: The Hardie and Centro decisions highlight that directors are accountable for decisions made by the board. Hardie emphasised the importance of each director taking responsibility for the accuracy of company statements to the market. Similarly, Centro clarified directors' obligations with respect to financial matters such as financial reports. Both cases propound the need for directors to understand company documents and the representations they make even where accounting standards or financial structures are complex. In our view that approach by the Courts is uncontroversial and does not create new law. It is not enough for a director to fulfil his or her duties by solely relying on the judgment and approval of fellow directors or expert advisers. In Centro directors were expected to have sufficient knowledge of accounting principles to enable them to objectively assess the company's accounts and, the Court held, cannot simply rely on auditors. Hardie presents specific challenges for those general counsel who also act as company secretary – an 'officer' for the purpose of the relevant legislation. The dual role is common, being held in more than 40 percent of Australian public companies. The High Court held that the two roles cannot be separated to avoid liability as an officer of the company under the Corporations Act by arguing that a task was being performed as general counsel and not as an officer. Bridgecorp, a NZ decision, has caused significant concern in the Australian D&O insurance space because the relevant legislation is mirrored in three Australian States, including NSW. The decision could mean that, in NSW at least, under a D&O policy with a combined defence costs and loss limit, the policy limit should be preserved for the benefit of paying loss to plaintiffs under the statutory charge, not the directors' defence costs. The decision renders directors uninsured and personally exposed to large defence costs where claims exceed the policy. We are already seeing some insurers in Australia being proactive and creating new products to try to overcome the potential exposures a Bridgecorp-style decision could have for Australian directors. We also expect legislative reform shortly.

Miller: The James Hardie and Centro decisions have had a significant impact in focusing attention on directors' duties. The Courts are demonstrating a consistent view that directors should be held to high standards in carrying out their duties. It is in this context of increased potential liability that the Bridgecorp decision, currently on appeal to the New Zealand Court of Appeal (and I understand the appeal will be heard in September and October this year), finds its significance. By way of background and put very simply – following the collapse of the company, civil and criminal proceedings were commenced against the directors who called on their D&O policy to fund their defence costs. However, the Receiver asserted a charge over the policy on the basis that it intended to commence proceedings against the directors. In effect, the Bridgecorp decision means that some D&O policies may not operate intended and provide directors with funding for defence costs in certain circumstances.

FW: What kind of prosecution and penalties might be issued to directors who breach their duties?

Miller: The matters for which a director can be prosecuted range from failure to comply with the regulations preventing those directors, and related parties, whose remuneration is disclosed in the remuneration report from voting on that report to dishonestly using one's position to gain an advantage or cause a detriment. In early June Treasury released the second tranche exposure draft of the Personal Liability for Corporate Fault Bill 2012. The first tranche was released earlier this year. This is worth mentioning because the Bill sets out proposed amendments to director's liability legislation and, if enacted, will see directors held criminally liable for the company's breach of certain legislation, such as the Corporations Act, Insurance Contracts Act, Foreign Acquisitions and Takeovers Act and Pooled Development Funds Act, Classification Act, Health Insurance Act and Therapeutic Goods Act. Penalties will range from imprisonment to a fine or banning orders. A significant consequence of a director breaching his or her duties is the damage to that person's reputation, not to mention potential financial consequences.

Bethlehem: In terms of prosecution and criminal penalties, Australia's corporate regulator, ASIC, can prosecute directors for breaching certain of their duties under the Corporations Act. For example, a director commits an offence and can be subject to prosecution and criminal penalties if they are reckless or intentionally dishonest and fail to act in good faith in the best interests of the company or for a proper purpose. A director who commits an offence under the Corporations Act may be fined up to $220,000, or imprisoned for up to five years, or both. Regarding civil penalties, Sections 180 to 183 of the Corporations Act impose upon directors general duties of care and diligence, good faith, avoiding a conflict of interest, and to not improperly use information. Section 588G of the Corporations Act imposes a duty on directors to prevent companies from trading whilst insolvent. A breach of any of these duties can result in civil penalties for directors and officers, namely, a pecuniary penalty order of up to $200,000, a declaration of contravention, a disqualification order for a period of time which the court considers as appropriate, or a compensation order.

FW: To what extent may directors face criminal and civil proceedings as a result of their business decisions?

Bethlehem: A director's duty is imposed through legislation, common law, equity and a company's constitution.Until the flurry of recent cases, including the Centro decision, it had been generally accepted that a director need not demonstrate any greater degree of skill than that expected of a non-professional reasonable person and that directors were not expected to give continuous attention to the company's affairs. Recent decisions have held that directors should not be 'placid' or 'unquestioning' in their response to company issues. Breach of duties of good faith, for instance where a director has obtained a benefit from use of company information or misused company property to obtain a benefit, may result in an award of damages against the director. Also, a transaction entered into by the director which is later deemed to be a breach of the duty of good faith, may be void. As noted above, statutory duties exist under sections 180 - 183 of the Corporations Act. A contravention of statutory duties may result in a director being subject to a civil penalty order of up to $200,000 on application by ASIC. ASIC may also seek a banning order. A director may also be ordered to pay compensation to the company if it is held that the company has suffered loss as a result of a director's breach of duty. A director can avoid liability in circumstances where the director is held to have acted honestly. For example, in the case of insolvent trading, s 1317S(3) of the Corporations Act sets out matters which the Court will consider including any action a director took to support the appointment of an administrator to the company. This is a reflection of the policy imperative that a director should be proactive in the face of their company's insolvency. Criminal liability of a director for breaches of ss. 180 - 183 will only apply if there is reckless or intentional dishonesty.

Miller: Australia's corporate governance regulations expose directors to criminal or civil liability as a result of their business decisions. First, directors owe duties to the company including the duty to act honestly and not improperly use insider information or their position to gain an advantage or to cause a detriment to the company. Directors are under an obligation to avoid a conflict between their own interests and those of the company, must disclose material personal interests and must always act with an appropriate degree of skill and care. Second, directors owe obligations to third parties, such as creditors, to prevent the company from trading while insolvent. Additionally, there is a plethora of laws pursuant to which a director can be found liable for the conduct of the company. For example pursuant to the Competition and Consumer Act directors can be found personally liable where the company has breached the Act. This exposes directors to both criminal and civil liability with penalties for a breach ranging from banning orders to fines and imprisonment.

FW: Could you outline the general disclosure requirements and key issues that arise when releasing public statements? How can board members ensure they act in a compliant manner?

Bethlehem: The ASX Listing Rules establish the disclosure requirements for listed companies. In particular these are set out in Chapters 3 (Continuous Disclosure), Chapter 4 (Periodic Disclosure), and Chapter 5 (Mining and Exploration Disclosures). A major focus for corporations is Listing Rule 3.1, which requires disclosure "once an entity is or becomes aware of any information concerning it that a reasonable person would expect o have a material effect on the price or value of the entity's securities..." The rule provides examples of these situations. Disclosure issues are very much alive and should be at the fore of any director or officer's mind. This is evidenced by the recent High Court decision in Hardie. The High Court held that directors and an officer breached their duties under s 180(1) of the Corporations Act for approving an announcement on ASX that contained misleading statements.

Miller: The James Hardie decision should serve as a warning: the minutes of the board meeting in question were used by ASIC to support its contention that the directors had approved the announcement in breach of their duties. The decision highlights the importance of keeping minutes that accurately reflect decisions made by the board. To ensure compliance, draft minutes should be circulated and reviewed before being adopted and the company secretary and/or in-house counsel should be sure to check that minutes are accurate. It is also important that responsibility is taken for the content of board packs and draft documents relating to important announcements should be provided with the board papers. It is crucial that directors give careful consideration to draft documents where those documents relate to matters of significance. Directors should be provided with information as to how internal processes governing the preparation of the draft documents have been followed. It is crucial that information presented is correct and significant issues are well researched.

FW: What considerations should be made when obtaining and presenting information to the board of a public company in Australia? Do you believe recent legal developments may lead to an enhanced focus on board administration processes? What impact will the High Court's decision in James Hardie have on in-house counsel's role in those processes?

Miller: The ASX Listing Rules set disclosure requirements. Interestingly, in late 2011 the ASX released a Consultation

Paper on proposed amendments to the Listing Rules that would increase disclosure requirements for listed resources companies. Board members can ensure compliance by taking steps including the following. First, put in place a good internal compliance policy and procedures. Second, carefully consider the form and content of any significant ASX Release. Third, ensure that all directors have an opportunity to consider properly any significant ASX Release. The draft documents grounding such a Release should be provided with the board papers. Fourth, do not delegate approval of such Releases to a sub committee or to the chief executive. Fifth, ensure that the bases for a decision are understood and recorded in the minutes of the board meeting. Finally, directors should ensure that internal processes governing the preparation of the Release have been followed.

Bethlehem: Cases such as James Hardie and Centro, which dealt with the question of information directors should consider, caused some alarm in the legal and business community. We saw two distinct responses to the Centro decision in the legal community. On the one hand the decision was seen as no more than articulating the duties already required under the Corporations Act. On the other, it was seen as overly onerous imposition of additional obligations that makes audit committees redundant. In that environment, it is not easy to give boards and directors a clear cut checklist of what should be considered and what further information should be requested prior to making company decisions. That said, the case law does give some guidance. In Centro, it was considered that a director could fail his or her duties to know and understand the affairs of a company even if that director honestly relied on the advice of advisers and staff. Centro confirmed that a director cannot delegate his or her duty to understand the company's finances, going so far as to say that directors should have basic accounting knowledge. Centro made clear that a Court will not consider it a defence to claim that a director was 'overloaded' with information. With that in mind, when presenting to a board the information should be concise, clear and transparent. The board should be invited to ask questions, and directed to any technical or complicated issue. In light of James Hardie, general counsel should be particularly aware of their involvement in decisions impacting the ongoing affairs of the company, and whether they are advising as general counsel or acting as an 'officer', enlivening all of the duties of a company officer under the Corporations Act.

FW: Have too many directors become reliant on third-party advisers at the expense of making their own personal judgements? What are the risks of doing so?

Miller: It is important that directors do not rely only on the advice of third-party advisers when making decisions. Rather, directors must apply their minds to issues, carefully review material in question and be sure to have considered all material matters including those which may not be raised by management. The Centro decision makes it clear – there are significant risks associated with relying completely on the advice of others, particularly in relation to a matter that falls specifically within the board's responsibilities. Directors must make informed personal judgements otherwise they may not satisfy the duties and obligations imposed by sections 180 and 344 of the Corporations Act.

Bethlehem: Reliance on trusted third party advisers, particularly lawyers and accountants, is a key aspect of corporate governance. That reliance has traditionally been the frontline of a director's defence should things go awry. The key development from Centro is the restriction the Court has placed on reliance on external advisers. Certain aspects of a director's duties, those that go to the heart of a director's role – such as approving the financial accounts of a company – cannot be discharged by delegation to others. When considering any reports and matters on which a director has a legal duty to report, simply relying on external advisers, or management, is not enough and the directors must, put simply, have their mind 'switched on'. A director who only relies on third party advisers without exercising independent review and consideration is open to criticism.

FW: What affect is the onerous regulatory environment having on board recruitment and retention? Is it more difficult to attract top talent to public companies due to the personal risks involved in making business decisions?

Bethlehem: On 4 May 2012 the Australian Financial Review published an article opining that the "James Hardie decision ... may shrink the talent pool for company boards". That became a popular theme in the financial media in comments on the decision. That concern may be overstated. It ignores the peculiar factual circumstances in the Hardie case – particularly the importance of the impugnant announcement in the affairs of the company. The guidance flowing from the Courts in recent months restates clear standards for corporate governance in a way that ought not dissuade appropriate candidates from entering the boardroom. That said, the issues raised by the Bridgecorp decision relevant to the availability of insurance cover for directors must urgently be resolved to give directors certainty that if claims, however spurious, are made, resources are available to enable them to defend appropriate conduct.

Miller: The regulatory environment exposes directors to personal risks that may deter some from taking up a directorship. There is clearly a concern that Australia's regulatory environment is negatively impacting on board recruitment and retention. For example, the most recent AICD Director Sentiment Index indicates that 54 percent of the 500 chairmen, non-executive directors and executive directors surveyed believe that their willingness to serve on a board will be negatively impacted by the perceived expansion of the grounds of directors' liability. Whether or not those concerns are well founded is a matter of debate and we consider that, property advised, quality candidates are unlikely to turn their backs on a board role because of recent decisions.

FW: What steps should directors take to protect themselves in the current legal environment, where heightened scrutiny and enforcement activity is likely to continue?

Miller: Directors should do the following. As always, seek advice from suitably qualified advisers, but avoid falling into the trap of blind reliance. Become familiar with the corporation – its business, its activities and corporate affairs. Keep up to date with the financial status of the corporation by regularly reviewing and understanding financial data. Apply a critical and questioning mind, make inquiries of management, of relevant committees and of other directors. Be sure to focus on and consider the content of materials provided during the decision making process. Consider whether they have the requisite level of financial literacy expected from a director. Ask whether the board is engaging adequately and effectively with shareholders.

Bethlehem: First, directors should ensure the highest standards of corporate governance to reduce the risk of a claim arising in the first place. That is where risk management should be focused. In addition, directors should avail themselves by way of protection from claims should those arise, by way of an appropriate indemnity in their favour from the company. The next step is to ensure that the company has in place a d&o insurance policy which includes both Side A cover – for liability in respect of which the company does not indemnify the director – and Side B cover for liability arising where an indemnity is in place by the company. One important aspect that directors should be alert to, with respect to any such policy, is the inclusion of any Side C cover, which provides cover to the company for shareholder claims. Depending upon policy terms, Side C covered claims have the potential to erode cover which may otherwise be available for Side A or B covered claims. Separate limits of cover may be one way to address this issue. Directors must give careful consideration to each of these issues, including the obtaining of professional advice to ensure that they have in place necessary protections. ■