TIGHTENING THE SCREWS ON DIRECTORS: CARE, DELEGATION AND RELIANCE

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I INTRODUCTION

The obligation of directors and officers to exercise care, skill and diligence in the performance of their duties is one of the cornerstones of the regulation of corporate governance.[1] As such, the balance drawn between the need to encourage directors to advance the business of the company through entrepreneurial decision-making within the modern corporate enterprise and the need to ensure that the interests of shareholders are adequately protected through the exercise of care is of profound significance.

Over the last decade there have been a number of decisions in Australia where the courts have assessed the adequacy of director and officer decision-making in this context.[2] Importantly, those cases demonstrate a willingness by courts to find directors' and officers' conduct to be inadequate.[3]

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1 The current statutory formulation of the duty is one of 'care and diligence'. The threefold expression of 'care', 'skill' and 'diligence' will be used in this article to describe the duty on the basis that this expression best reflects the content of the duty. For reasons set out below the difference in terminology is of no impact on the legal analysis.

2 The most significant decisions discussed in this article are *Australian Securities and Investments Commission v Healey* (2011) 196 FCR 291 ('*Centro*'); *Australian Securities and Investments Commission v Fortescue Metals Group Ltd (No 5)* (2009) 264 ALR 201 ('*Fortescue*'); *Australian Securities and Investments Commission v Fortescue Metals Group Ltd* (2011) 190 FCR 364 ('*Fortescue Appeal*'); *Australian Securities and Investments Commission v Macdonald (No 11)* (2009) 256 ALR 199 ('*James Hardie*'); *Morley v Australian Securities and Investments Commission* (2010) 274 ALR 205 ('*James Hardie Appeal*'); *ASIC v Hellicar* [2012] HCA 17 ('*James Hardie High Court*'); *Australian Securities and Investments Commission v Rich* (2009) 236 FLR 1 ('*Rich*'); *Australian Securities and Investments Commission v Vines* (2005) 55 ACSR 617 ('*Vines*'); *Vines v Australian Securities and Investments Commission* (2007) 73 NSWLR 451 ('*Vines Appeal*'); *Australian Securities and Investments Commission v Rich* (2003) 174 FLR 128 ('*Greaves*'); *Re HIH Insurance; Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253 ('*Adler*').

3 See especially the extensive publicity surrounding the *Centro* decision and the *James Hardie* decision. Note that at the time of writing, aspects of the *Fortescue* decision are on appeal to the High Court of Australia.

This article considers whether or not the current state of the law achieves the right balance between facilitating entrepreneurial decision-making and the exercise of care. Further, the article focuses on the more contentious issues around the current state of the case law, particularly issues of delegation and reliance.

II THE DUTY OF CARE, SKILL AND DILIGENCE

The director's duty of care, skill and diligence first developed during the 19th century as an equitable principle of law.[4] Subsequently it developed into a separate common law duty of care.[5] The common law duty is normally defined as a duty to use a reasonable degree of care, skill and diligence in the discharge of the duties of the office of director.[6]

In Australia these common law principles were also codified in the mid 20th century with potential criminal and civil consequences. Initially the statutory duty was expressed as a duty to use diligence in the discharge of the duties of the director's office and subsequently as a duty to use care and diligence.[7]

The current statutory formulation of the duty is in section 180 of the *Corporations Act 2001* (Cth) ('*Corporations Act*').[8] An officer must exercise the degree of care and diligence that a reasonable person would exercise if they were a director or officer in the corporation's circumstances, occupied the office held by him or her and had the same responsibilities within the corporation as the director or officer.

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4 See, eg, *Overend & Gurney Co v Gibb & Darby* (1872) LR 5 HL 480. The duty was developed by analogy to the fiduciary duty of a trustee.

5 It has been clearly articulated in New South Wales as such by the Court of Appeal: *Daniels v Anderson* (1995) 37 NSWLR 438, 505 ('*AWA Appeal*'). There is a debate as to whether or not the duty of care is fiduciary in nature and whether or not the equitable duty and the common law duty are the same in content: see *Permanent Building Society v Wheeler* (1994) 11 WAR 187, 237 (Ipp J) (concluding the duty was not fiduciary in nature); J D Heydon, 'Are the Duties of Company Directors to Exercise Skill and Care Fiduciary?' in Simone Degeling and James Edelman (eds), *Equity in Commercial Law* (Lawbook, 2005) 185 (concluding that differences between the equitable duty and common law exist); William M Heath, 'The Director's "Fiduciary" Duty of Care and Skill: A Misnomer' (2007) 25 *Company and Securities Law Journal* 370 (concluding that further analysis is required). The characterisation may have implications for issues such as the measure of damages, causation and remoteness. However, resolution of this matter is not critical to the issues discussed here.

6 See, eg, *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395, 405 (Malcolm CJ).

7 Adopted in the *Companies Act 1958* (Vic) s 107 and in the *Companies Act 1961* (Vic) s 124. In the version of the *Companies Act 1981* (Cth) finally enacted, the duty was redefined as an obligation to 'exercise a reasonable degree of care and diligence' and extended this duty from directors to 'officers' (s 292(2)). An earlier bill in 1980 (Companies Bill 1980 (Cth)) had expressed the duty in traditional common law terms as one of 'care, skill and diligence' but this formulation was dropped in the final bill.

8 The *Corporations Act* commenced on 15 July 2001. Previously the duty was set out in the *Corporations Act 1989* (Cth) s 232(4) and the *Corporations Law* (Cth) s 180, as amended by *Corporate Law Economic Reform Act 1999* (Cth). The current statutory provisions have had a convoluted history as the degree of required objective knowledge and skill of directors was debated. For a detailed discussion of the legislative background to the current statutory provision see *ASIC v Vines* (2003) 182 FLR 405; *ASIC v Rich* (2003) 174 FLR 128.

A business judgment rule based on a rational belief that a business judgment is in the best interests of the corporation is a defence to both liability under the statutory provision and at common law.[9]

A breach of the statutory provision is a civil penalty provision and therefore the civil penalty remedies of pecuniary penalties and banning orders (among other remedies) of Part 9.4B of the *Corporations Act* are available to the Australian Securities and Investments Commission ('ASIC').

III TIGHTENING THE SCREWS[10]

There is a popular perception that recent case law demonstrates a dramatic increase in the risk of liability confronting directors. A debate rages in the director community as to whether or not this risk and the high profile findings of liability that have been made are acting to dissuade qualified individuals from joining boards or causing directors to retire.[11] The current Australian legal standard that applies owes much to the quantum shift in expectations set out in the *AWA Appeal* decision.[12]

Historically the courts had assessed the conduct of a particular director by reference to the subjective knowledge and skills of the particular director. That legal standard was pitched ridiculously low.[13]

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9 *Corporations Act* s 180(2).

10 With apologies to Robert Baxt for use of the reference: Robert Baxt, 'One "AWA Case" Is Not Enough: The Turning of the Screws for Directors' (1995) 13 *Company and Securities Law Journal* 414.

11 In a directors' sentiment survey conducted by the Australian Institute of Company Directors, 44 per cent of respondents indicated that legal decisions on directors' liability negatively impacted on their willingness to continue on a board and more than half of respondents indicated that legal decisions on directors' liability negatively impacted on their willingness to accept new board appointments: Australian Institute of Company Directors, *Directors' Sentiment Index: Research Findings – Executive Summary Second Half 2011* (November 2011) <http://www.companydirectors.com.au/General/Header/Media/Media-Releases/2011/~/media/Resources/Events/Director%20Sentiment%20Index/DSI_Research%20findings%20%20%20Executive%20Summary_Second%20half%202011_15Nov11.ashx>.

Having regard to the self-interest of these surveyed it is reasonable to assume that these results reflect a degree of bias and are not representative of the views of the community more generally. However, that being said, if those views are in fact reducing the pool of potential directors that would be a serious concern.

Robert Austin has suggested that there is a 'substantial divergence' between community expectations and directors' own expectation of the role and responsibility of directors of large companies and that directors' self perception is closer than the law to a 'realistic recognition' of the roles and responsibilities that directors are capable of discharging: Robert P Austin, *The Role and Duties of Australian Company Directors: A Restatement* (University of Queensland Press, 2011).

12 *AWA Ltd v Daniels* (1992) 7 ACSR 463; *AWA Ltd v Daniels* (1992) 7 ACSR 759 ('*AWA*'); *AWA Ltd v Daniels* (1992) 9 ACSR 383; *AWA Appeal* (1995) 37 NSWLR 438.

13 The low expectations being graphically illustrated in cases such as *Re Denham & Co* (1883) 25 Ch D 752 (country gentlemen could not be expected to have accounting skills sufficient to detect fraud in accounts prepared by the chairman); *Re Cardiff Savings Bank* [1892] 2 Ch 100 ('*Marquess of Bute's Case*') (director appointed to board at six months of age and attended one board meeting in 38 years excused from responsibility for bank fraud).

In Australia that position slowly began to change from the late 1980s. There was agitation for a regulatory move to a more objective standard of care.[14] Similarly courts began to repeat a catchcry that the days of the 'passive' or 'sleeping' director were over.[15] The restatement of the codified statutory provision in 1992 also assisted in the move to a more objective standard of minimum director skills.[16] The use in the current section 180 of the terms 'degree of care and diligence that a reasonable person would exercise', 'the corporation's circumstances' and 'same responsibilities' all points to a more objective minimum standard of conduct than was previously considered to be the case. The

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For academic discussion of the content of the duty over the years see M J Trebilcock, 'The Liability of Company Directors for Negligence' (1969) 32 *Modern Law Review* 499; Allan L Mackenzie, 'A Company Director's Obligations of Care and Skill' [1982] *Journal of Business Law* 460; James D Cox, 'Changing Perceptions into Reality: Fiduciary Standards to Match the American Directors' Monitoring Function' (1989) 1 *Bond Law Review* 218; Ashley Black, 'Recent Developments in Directors' Duties' (1991) 7 *Australian Bar Review* 121; Vanessa Finch 'Company Directors: Who Cares about Skill and Care?' (1992) 55 *Modern Law Review* 179; A S Sievers, 'Farewell to the Sleeping Director – The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill & Diligence' (1993) 21 *Australian Business Law Review* 111; Jennifer Hill, 'The Liability of Passive Directors: *Morley v Statewide Tobacco Services Ltd*' (1992) 14 *Sydney Law Review* 504; Julie Cassidy, 'An Evaluation of Section 232(4) of the Corporations Law and the Directors' Duty of Care, Skill, and Diligence' (1995) 23 *Australian Business Law Review* 184; Michael J Whincop, 'A Theoretical and Policy Critique of the Modern Reformulation of Directors' Duties of Care' (1996) 6 *Australian Journal of Corporate Law* 72; G P Stapleton, 'The CLERP Proposal in Relation to Section 232(4): The Duty of Care and Diligence' (1998) 16 *Company and Securities Law Journal* 144; Aaron Comerford and Larelle Law, 'Directors' Duty of Care and the Extent of "Reasonable" Reliance and Delegation' (1998) 16 *Company and Securities Law Journal* 103; Joanna Bird, 'The Duty of Care and the CLERP Reforms' (1999) 17 *Company and Securities Law Journal* 141; John S Keeves, 'Directors' Duties – *ASIC v Rich* – Landmark or Beacon?' (2004) 22 *Company and Securities Law Journal* 181; Andrew Hanak, 'The Interaction of the Company Director's Duty of Care and the Director's Obligations Relating to Insolvent Trading and Financial Reporting' (2007) 25 *Company and Securities Law Journal* 180.

14 In the decade before, both the National Companies Bill 1976 (Cth) of the then Coalition Government and the first draft of the Companies Bill 1981 (Cth) had contemplated a more objective standard of conduct in relation to the duty of care, skill and diligence.

A more objective standard was endorsed in the early 1990s by the Cooney Report: Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989) ch 3; and the Lavarch Report: House of Representatives Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Corporate Practices and the Rights of Shareholders* (1991).

15 *Naffai v Haines* (Unreported, NSW Supreme Court, Rogers AJA, 26 November 1991). This move initially developed from the analogue statutory liability provisions that imposed director liability for trading while insolvent. The leading cases in these developments were *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423; *Group Four Industries Pty Ltd v Brosnan* (1992) 59 SASR 22; *Commonwealth Bank v Friedrich* (1991) 5 ACSR 115; *Rema Industries and Services Pty Ltd v Coad* (1992) 107 ALR 374; *Deputy Commissioner of Taxation v Clark* (2003) 57 NSWLR 113.

16 The initial *Corporations Law* (Cth) of January 1991 repeated the predecessor *Companies Act 1981* (Cth) provision: *Corporations Law* (Cth) s 232(4); *Companies Act 1981* (Cth) s 229(2). However the Corporate Law Reform Bill 1992 (Cth) proposed the replacement of the subjective standard with a 'more useful' description of what was required. The Bill introduced in Parliament was altered again following public consultation and s 232(4) was ultimately expressed as 'the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances': Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth) [39]. This was characterised as being to 'reinforce that the duty of care is an objective one': [82].

courts have been clear in enunciating the view that the community expects more of directors than was the case in the past.[17]

In the case law subsequent to the *AWA Appeal* decision there has been no fundamental disagreement on the legal content of the duty. The duty reflects the concept of negligence at common law so that a director or officer owes a duty to take reasonable care in the performance of his or her office.[18] A determination of whether a director or officer has discharged that duty in a particular case is an essentially factual inquiry and will depend on the circumstances that actually exist, including a consideration of the company, the nature of its business, the particular governance structure that exists and the circumstances of the particular director or officer.[19]

The broad legal content of the duty can be summarised by the following general propositions:

- There is a core irreducible requirement that a director or officer be involved in the management of the company and guide and monitor the activities of the company tested by what a reasonable person of ordinary prudence would do.[20]
- From that core irreducible requirement any additional skills and expertise that a director or officer has should be factored in[21] and the role that the director or officer performs in the governance structure must also be assessed.[22]
- A director must acquire an understanding of the business of the company and become familiar with the fundamentals of the business of the company.[23]
- A director must remain informed about the activities of the company and monitor those activities.[24]

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17 *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115, 126 (Tadgell J). In the *AWA Appeal* decision the position was put as follows: 'Neither the law about the duty of directors nor the law of negligence has stood still in the 70 years since the decision in *Re City Equitable Fire Insurance Co*': *AWA Appeal* (1995) 37 NSWLR 438, 497.

18 *AWA Appeal* (1995) 37 NSWLR 438, 504.

19 Ibid 505; *Centro* (2011) 196 FCR 291, 320.

20 *Deputy Commissioner of Taxation v Clark* (2003) 57 NSWLR 113, 140.

21 *AWA Appeal* (1995) 37 NSWLR 438, 505. See also Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth) [85].

22 Most notably illustrated by the characterisation of the role performed by a chairman with deep experience in a company's development as described in the *Greaves* decision. The *Greaves* decision was technically only a ruling on ASIC's statement of claim rather than a liability finding. The defendant ultimately consented to civil penalty orders being made and as part of the making of those orders the judge applied the analysis of the *Greaves* decision: see *ASIC v Rich* (2004) 50 ACSR 500, 508–9 (White J). See also the characterisation of a director who is also chief executive officer: *Vines* (2005) 55 ACSR 617, 857–8. In *Shafron v ASIC* [2012] HCA 18 the High Court again adopted this characterisation for a company secretary who also acted as general counsel: at [20].

23 *AWA Appeal* (1995) 37 NSWLR 438, 503–4, quoting *Francis v United Jersey Bank*, 432 A 2d 814, 821–3 (NJ, 1981).

- A director must maintain familiarity with the financial status of the company and must have the ability to read and understand the financial statements of the company.[25]
- In determining whether the duty has been breached the foreseeable risk of harm must be balanced against the potential benefits that could reasonably be expected to accrue from the conduct.[26]

The legal standard expected under the statutory duty and under the common law principles has telescoped to the point that the legal standards are generally considered to be effectively the same.[27] The case law subsequent to the *AWA Appeal* decision has been very consistent in relation to its acceptance of each of these guiding legal principles.

One aspect of the statutory provisions that has not featured in the case law is the business judgment rule of section 180(2) of the *Corporations Act*. It has been argued that because business judgment considerations apply to the determination of whether or not the duty has been satisfied there is no further role for the defence to play.[28] On the case law to date and the formulation of the scope of the duty by the courts that would appear to be correct.

A significant impact on the development of the duty of care, skill and diligence has been the creation of a penalty regime that is now centred on the civil penalty provisions of Part 9.4B of the *Corporations Act*. Prior to 1992 the

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24 Ibid. This was described in *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405 as a 'diligent and intelligent interest' in the information available to the director or which the directors might request from management and advisors: at 431 (Ormiston J).

25 *Centro* (2011) 196 FCR 291, 298. See also *AWA Appeal* (1995) 37 NSWLR 438, 503.

26 *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395, 448–51; *ASIC v Doyle* (2001) 38 ACSR 606, 641 (Roberts-Smith J); *Rich* (2009) 236 FLR 1, 129.

27 See *AWA Appeal* (1995) 37 NSWLR 438, 602–6; *Sheahan v Verco* (2001) 79 SASR 109, 126–7. In *ASIC v Maxwell* (2006) 59 ACSR 373 it was suggested that the statutory duty reflects, and to some extent refines, the common law duty: at 397 (Brereton J). It has been noted that the reformulation of the statutory provisions as a civil penalty does not make the statutory standard lower than the common law duty: *Vines* (2005) 55 ACSR 617, 621. Earlier the original statutory formulation of a duty to use diligence had been interpreted as a significant difference to the common law standard of 'care, skill and diligence' and that the absence of a requirement of skill resulted in a need to only show a degree of diligence that was reasonable in the circumstances: *Byrne v Baker* [1964] VR 443, 450.

28 Neil Young, 'Has Directors' Liability Gone Too Far or Not Far Enough? A Review of the Standard of Conduct Required of Directors under Sections 180–184 of the Corporations Act' (2008) 26 *Company and Securities Law Journal* 216.The business judgment rule is derived from United States corporations law: see American Law Institute, *Principles of Corporate Governance: Analysis & Recommendations* (1992) [4.01(c)]. See also Deborah A DeMott, 'Legislating Business Judgment – A Comment from the United States' (1998) 16 *Company and Securities Law Journal* 575.

In the *Rich* decision, after a lengthy consideration of the business judgment defence, Austin J concluded that the defence may be capable of providing a defence in some situations where a breach of s 180 might otherwise arise: (2009) 236 FLR 1, 154. Clearly, as Austin J points out, the business judgment rule defence involves slightly different concepts for consideration than the formulation of the duty as summarised above. For example the business judgment rule explicitly refers to the lack of a material personal interest that is not referenced above (but note the discussion of delegation and reliance below) and a proper purpose (which is more relevant to the duty of good faith in s 181). It would seem that the distinction is more of theoretical than practical interest. See also Andrew Lumsden, 'The Business Judgment Defence: Insights from *ASIC v Rich*' (2010) 28 *Company and Securities Law Journal* 164.

consequences of a breach of the statutory duty primarily sounded in the possibility of a criminal prosecution or a civil action for damages.

Following the corporate collapses of the 1980s and a perception that Australia's laws failed to punish corporate wrongdoers appropriately it was argued that a better system of sanctions would involve an enforcement pyramid where the regulator has available a broader range of remedies.[29] The availability of that enforcement pyramid would allow for more appropriate sanctions based on the degree of culpability of the individual.

The primary new initiative of the 1990s was therefore the introduction of civil penalty liability, as recommended by the Cooney Committee in 1989.[30] That regime was introduced in 1992 at the same time as the introduction of the new more objective formulation of the duty of care, skill and diligence. Where a court declaration of contravention is obtained, ASIC may seek a pecuniary penalty order, a disqualification order or a compensation order. The court may make a compensation order whether or not it makes a declaration of contravention. A company may seek a compensation order but not a pecuniary penalty order or a disqualification order.[31]

Where a court has declared that a person has contravened a civil penalty provision, the court may disqualify that person from managing companies for a period that the court considers appropriate.[32]

The civil penalty regime has gradually expanded over the last decade to encompass a broad range of conduct that has potential application to the director. Initially the effectiveness of the remedy was subject to some debate.[33] However, most commentators now believe that the remedy has been a great success.[34]

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29 See, eg, Roman Tomasic, 'Sanctioning Corporate Crime and Misconduct: Beyond Draconian and Decriminalization Solutions' (1992) 2 *Australian Journal of Corporate Law* 82.

30 Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989) 80.

31 *Corporations Act* s 1317J. A corporation can seek to recover compensation (including profits made by any person) arising from a breach of s 180: s 1317H. This remedy is not available to other persons: see the limitation in s 1317HA of compensation for other persons to a breach of the financial services civil penalty provisions, which do not include s 180: s 1317DA.

32 *Corporations Act* s 206C. The criteria to be used in determining the length of the banning order were considered in *Re HIH Insurance (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); ASIC v Adler* (2002) 42 ACSR 80, 83–5; *ASIC v Macdonald (No 12)* (2009) 259 ALR 116, 164–7. In *Rich v ASIC* (2003) 203 ALR 671, the majority of the court emphasised that the purpose of a disqualification order is protective rather than punitive.

33 See Helen Bird, 'The Problematic Nature of Civil Penalties in the Corporations Law' (1996) 14 *Company and Securities Law Journal* 405.

34 See Vicky Comino, 'The Enforcement Record of ASIC since the Introduction of the Civil Penalty Regime' (2007) 20 *Australian Journal of Corporate Law* 183; Michelle Welsh, 'Eleven Years On – An Examination of ASIC's Use of an Expanding Civil Penalty Regime' (2004) 17 *Australian Journal of Corporate Law* 175; Michelle Welsh, 'The Regulatory Dilemma: The Choice between Overlapping Criminal Sanctions and Civil Penalties for Contraventions of the Directors' Duty Provisions' (2009) 27 *Company and Securities Law Journal* 370.

IV ARE DIRECTORS' CONCERNS OVERBLOWN?

While the recent case law has certainly increased publicity surrounding the duty of care, skill and diligence the question is whether directors' concerns as to increased liability are accurate. The amount of litigation that involves claims of breach of the duty is relatively small and the argument that the liability profile has increased is quite subjective having regard to the highly fact specific nature of reported decisions.

One way of gaining an impression as to the accuracy of the concerns is to review the results of the body of reported cases over a period of time. Annexure 1 contains a survey of the results of reported decisions over the last 20 years.[35]

The 29 reported cases reveal a plethora of different fact patterns and reasons for seeking to establish whether or not there was a breach of care, skill and diligence by a director or officer. Frequently breach of the duty is only one of a number of theories of liability that are sought to be propounded. Subject to these limitations the results of the survey are of general interest.

Prior to the *AWA Appeal* decision the results of the cases were mixed. Of the seven cases in the survey a finding of breach was only made in two cases (and compensation awarded on that basis in only one case.).[36] It should also be remembered that the result of the *AWA Appeal* decision itself was that the non-executive directors (but not the chief executive officer) escaped a finding of breach.

A review of cases subsequent to the *AWA Appeal* decision shows two marked things. First, there are more cases reported.[37] There are 21 reported cases in the survey following the *AWA Appeal* decision, admittedly over a much longer period of time. Fifteen of these reported proceedings were civil penalty cases brought by ASIC. Second, of these reported cases the vast majority of decisions resulted in findings of liability against the director or officer in question. In only two cases has the trial judge found no breach of duty.[38] In appeals from the trial

35 The author does not suggest there was any great science applied to the construction of the survey. The methodology adopted was a manual search of reported decisions in the case law reports of the *Australian Corporations and Securities Reports* and *Australian Company Law Cases* series, cases known to the author through experience in this area of law and cross-references to cases noted by judges and commentators considering the duty of care, skill and diligence.

36 *Claremont Petroleum NL v Cummings* (1992) 110 ALR 239.

37 It should also be noted that most of the cases preceding the *AWA Appeal* decision arose at a turbulent time in Australia's history – the entrepreneurial collapses following October 1988. The number of corporate collapses in Australia following the global financial crisis in 2007 is relatively modest in comparison to those events. As such it can be argued that the seven cases were not reflective of a normal trend line of litigation experience.

38 *Rich* (2009) 236 FLR 1; *Fortescue* (2009) 264 ALR 201. In the *Fortescue Appeal* decision the Full Federal Court substituted a finding of breach of duty: (2011) 190 FCR 364.

judge's findings only one case has resulted in the findings being overturned.[39] This extraordinarily high success rate against defendant directors and officers since the *AWA Appeal* decision should be of great interest to directors. Importantly this is not a recent phenomenon as publicity surrounding the *James Hardie* decision and *Centro* decision might suggest, but is a trend that has been readily observable for some years now.

Another area of interest is the penalties being imposed by the courts when ASIC proceeds by way of civil penalty proceeding. Annexure 2 summarises the significant penalties imposed in the civil penalty cases involving allegations of breach of the duty of care, skill and diligence over the last decade.[40] Even more so than the analysis of findings of liability the penalties that have been imposed in the civil penalty cases are extraordinarily fact specific. Again, the penalties imposed are frequently made in the context of findings of liability based on other theories of liability.

A recent survey of director opinion found that approximately 38 per cent of respondents considered the penalties imposed by the trial judge in *James Hardie* decision to be too harsh and more than 80 per cent of respondents considered the penalties imposed by the trial judge in the *Centro* decision to be reasonable or too lenient.[41] Clearly, the opinion of directors on this issue is but one voice and self-interested at that and different sections of the community may have different opinions on this issue.

To be sure, the penalty debate sits as only part of the question as to whether or not Australia's development of a civil penalty regime has been successful. However the very prominence of these cases in the director community and the fact that liability is being imposed on what is negligence rather than more culpable wrongdoing (such as dishonesty or insider trading) mean there is broad interest in the question.

A couple of observations can be made about the penalties imposed in the attached survey. First, banning orders are a very powerful tool of enforcement and act as a significant deterrent. While the review shows a vast array of banning outcomes (from nil to permanent), for many public company directors a banning order will effectively result in their removal from public life.[42] Second, the time may be right to revisit the flexibility available to a court to ensure appropriate deterrence is achieved through pecuniary penalties. The maximum pecuniary

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39 *Whitlam v ASIC* (2003) 57 NSWLR 559. The *James Hardie Appeal* decision resulted in the finding of the trial judge being overturned on the findings of fact underlying the decision. Indeed the Court of Appeal stated that if the relevant press release has been put to the directors their approval of it would have resulted in a breach of duty: *James Hardie Appeal* (2010) 274 ALR 205, 360–1. That finding was reversed on appeal in the *James Hardie* High Court decision.

40 The same methodology was applied as described above n 35.

41 Mallesons Stephen Jaques, *Directions 2012: Current Issues and Challenges Facing Australian Directors and Boards* (16 February 2012), 8 <http://www.mallesons.com/publications/mediaReleases/2012/Pages/Mallesons-launches-Directions-2012.aspx>.

42 It is not just the period of the banning order that is significant but the stigma associated with it.

penalty that has been imposed in any case is $450 000.[43] For a wealthy individual that is hardly an impost and likely to be significantly less than the legal fees incurred in defending litigation of this nature.

In 2005 in the insider trading context a maximum individual fine of $200 000 per contravention was criticised as possibly being too low.[44] Some time has now passed since that judicial comment was made and the debate has not been picked up.

What would be useful is for this issue to be now discussed from a policy perspective, particularly in view of the *Centro* and *James Hardie* penalty findings. This author would argue that there is a policy basis to allow a court to order substantially larger pecuniary penalties in appropriate cases.[45]

V THE NEED TO RECOGNISE PRINCIPLES OF DELEGATION AND RELIANCE

The law of directors' duties has long recognised the practical reality that the role occupied by a director in the governance structure necessitates recognition of the delegation of enquiries and the practical need for the director to rely on officers and advisers in performing his or her functions. As the House of Lords emphatically said in 1901: 'The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.'[46]

If this comment was true in 1901 it is undoubtedly true to a much higher degree in the modern publicly listed corporation. There is a large body of case law in a variety of contexts which supports the general proposition of permissible

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43 *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); ASIC v Adler* (2002) 42 ACSR 80: see App 2 n e.

44 *ASIC v Vizard* (2005) 145 FCR 57. This case involved insider trading by a prominent public figure and acceptance of a civil penalty order for breach of the director's duty not to improperly use corporate information to gain an advantage: *Corporations Act* s 183(1). In making a pecuniary penalty order Finkelstein J stated at 68:

> The proposed penalty is certainly low. Left uninstructed I would have imposed a higher penalty, but not substantially different from that suggested. If this penalty is insufficient, parliament should increase the maximum. The current amount has been in place for more than 13 years and may require review.

In addition the judge doubled the banning order from the period requested by ASIC to a 10 year term, again to satisfy the judge's view of appropriate deterrence.

45 To similar effect see Young, above n 28, 230–1. For example, the maximum penalty allowed for in the Australian context is significantly below pecuniary penalties routinely imposed by United States courts – see the summary of significant financial penalties imposed by the Securities & Exchange Commission since the 2007 financial crisis: US Securities Exchange Commission, *SEC Enforcement Actions: Addressing Misconduct That Led to or Arose from the Financial Crisis* (5 April 2012) <www.sec.gov/spotlight/enf-actions-fc.shtml>.

46 *Dovey and the Metropolitan Bank (of England and Wales) Ltd v John Cory* [1901] AC 477, a case involving allegations that dividends were paid by directors out of capital. The director had authorised the dividend payment on the basis of balance sheets which had fraudulently been prepared by management. The directors had no knowledge of the fraud.

delegation and reliance in the conduct of a director's activities, not just in the area of the duty of care, skill and diligence.[47]

In the *Corporations Act* context the relevance of delegation and reliance is bolstered by specific statutory recognition.[48] Directors have a broad power to delegate powers to committees or any person unless restricted by the company constitution.[49] Where a director relies on a competent employee, competent adviser or other directors where the reliance is in good faith and having made an independent assessment of the information or advice received, the director's reliance is taken to be reasonable unless the contrary is proved.[50] Further, a director is responsible for a power delegated to another unless he or she believes on reasonable grounds, in good faith, and after proper inquiry if the circumstances require, that the delegate was reliable and competent.[51] The traditional case law demonstrates that there is no particular need to have these statutory provisions for principles of delegation and reliance to be recognised and indeed they have not been referred to in the significant case law referred to above.[52]

For the reason that follows, what has changed in recent decades is the degree of second guessing required by the director or officer before he or she is entitled to rely on the work of management and advisers. Historically the orthodox view was expressed most authoritatively in *Re City Equitable Fire Insurance Co Ltd* as: '[A] director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.'[53]

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47 Notable cases include *Re Denham & Co* (1884) 25 Ch D 752, 766 (director may rely on auditor); *Prefontaine v Greiner* [1907] AC 101 (director may rely on officer who had permitted irregular loans leading to collapse of company); *Ammonia Soda Co Ltd v Chamberlain* [1918] 1 Ch 266 (director not guilty of negligence if they rely on officers they are entitled to trust); *Huckerby v Elliott* [1970] All ER 189 (director entitled to rely on fellow director and secretary); *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 (directors liable in negligence for giving another director signed blank cheques); *Norman v Theodore Goddard* (1991) 10 ACLC 3016 (reliance by non-executive director on fraudulent lawyer reasonable in relation to investment of funds involving international tax law and offshore finance considerations); *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30 (inadequate supervision of employees by directors).

48 Introduced by the *Corporate Law Economic Reform Act 1999* (Cth).

49 *Corporations Act* s 198D(1) (includes delegations to employees or any other director). The delegate must exercise the power delegated in accordance with any directions of the directors: s 198D(2). The exercise of the power by the delegate is as effective as if the director had exercised it: s 198D(3)).

50 *Corporations Act* s 189.

51 *Corporations Act* s 190.

52 Of course there may be various differences in the way that judges have expressed the principles in the statutory provisions. This may have some significance to a particular fact situation that may come before a court. In that sense the debate may be similar to the relevance of the s 180(2) business judgment rule: see by analogy the discussion above n 28 and see Austin, above n 11, 10–11.

53 [1925] Ch 407, 429. Justice Romer supported this conclusion by citing the Court of Appeal and House of Lords in *Dovey and the Metropolitan Bank (of England and Wales) Ltd v John Cory* [1901] AC 477. Justice Romer also said in this context that directors are not bound to examine entries in the company's books: at 430, citing *Re Wincham Shipbuilding, Boiler and Salt Co* (1878) 9 Ch D 329 and *Re Denham & Co* (1884) 25 Ch D 752.

The fairly absolute nature of permitted reliance changed during the 1990s with the *AWA Appeal* decision. The trial judge in the *AWA* decision had adopted the fairly strongly expressed formulation of:

> 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 a particular judgment, information and advice of the officers.[54]

The Court of Appeal specifically overruled the trial judge on this issue, stating that this statement did not accurately state the extent of the duty of directors in modern company law. The Court went on to develop the following pre-conditions to the reasonableness of reliance:

- the director must have an understanding of the business of the company;
- the director is under a continuing obligation to be kept informed of the activities of the company;
- the director may not shut their eyes to corporate misconduct and then claim, because they did not see the misconduct, they did not have a duty to look; and
- in monitoring activities of the company, the director must be under a duty to enquire further into matters where suspicions are raised or where a prudent person would be concerned.[55]

Clearly, the *AWA Appeal* decision view of the pre-conditions to reliance are appropriate from a policy perspective, having regard to contemporary expectations that directors must play an active role in supervising the activities of management and setting the strategy of the company. In the subsequent case of *Adler* the list of factors relevant to the factual assessment of the reasonableness of reliance and delegation by a director was put as follows:[56]

- whether the function delegated is such as may be properly left to that person;
- the extent that the director has been put on inquiry of an issue or should have been put on inquiry by the exercise or ordinary care;

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54 *AWA* (1992) 7 ACSR 759, 868. Further, Rogers CJ considered that directors are entitled to rely on auditors without themselves reviewing the accounting records:

> In relation to auditors, if directors appoint a person of good repute and competence to audit the accounts, absent real grounds for suspecting that the auditor is wrong, the directors will have discharged their duty to the corporation. The directors are not required to look at the entries in any of the corporation's books of record, or verify the calculations of the corporation's accountants in preparing the financial statements or of the auditor himself. Directors are entitled to rely on the judgment, information and advice of the auditor: cf *Re Denham & Co* [1883] 25 Ch D 752 at 766; *Dovey v Cory*, supra, at 486, 492. Reliance may properly be more complete where the auditor is acknowledged as being more knowledgeable, skilled and experienced in the particular matter in question than the directors or other auditors.

55 *AWA Appeal* (1995) 37 NSWLR 438, 500–4, quoting from *Federal Deposit Insurance Corporation v Bierman*, 2 F 3d 1424 (7th Cir, 1993); *Rankin v Cooper*, 149 F 1010 (WD Ark, 1907); *Francis v United Jersey Bank*, 432 A 2d 814 (NJ, 1981).

56 *Adler* (2002) 168 FLR 253, 348.

- whether the director holds the belief that the delegate is trustworthy and competent;
- the risk and importance of the issue; and
- the position of the director in the governance structure.

However there are two aspects of the recent cases that bear closer consideration: whether delegation of a particular issue is always permissible and the extent to which a director may be on notice of an issue that requires further inquiry.

VI NON-DELEGABLE ACTS – WHEN DO YOU KNOW YOU HAVE ONE?

The *Centro* decision and the *James Hardie* decision are both significant in that the matters subject to the court's scrutiny were considered to be non-delegable matters. The idea that there are certain functions that a director cannot delegate has become a contentious issue.

In the *Centro* decision approval of the annual financial statements of Centro was considered to be both an obligation that arises in the context of the duty of care, skill and diligence as well as a specific statutory obligation imposed on the director individually. Pursuant to the *Corporations Act* the directors' declaration in relation to the annual financial statements must be to the effect that in the directors' opinion the financial statements and notes are prepared in accordance with the Act.[57] The *Centro* decision makes it clear that this requirement means that the directors must individually adopt the annual financial statements and that it is not possible for the directors to completely delegate their review and consideration of the financial statements.[58] Further, it was held that there is a close interplay between the specific statutory requirement that a director take all reasonable steps to comply with the obligation to prepare financial statements[59] and the general law requirement that the directors were required to exercise care and diligence in their consideration of the approval of the financial statements.[60]

57 *Corporations Act* s 295(4)(d).

58 *Centro* (2011) 196 FCR 291, 321, 324.

59 *Corporations Act* s 344(1). In the *Centro* decision 'reasonable steps' was defined as a standard determined objectively by reference to the particular circumstances of the case and requires that the directors take a diligent and intelligent interest in the information available to them or that they might appropriately demand from executives or agents: *Centro* (2011) 196 FCR 291, 324, citing *ASIC v Fairlie* (1993) 11 ACLC 669 and *Morley v Statewide Tobacco Services Ltd No 1* [1993] 1 VR 423. The analogy to the standard formulation of the duty of care, skill and diligence is obvious.

60 *Centro* (2011) 196 FCR 291, 335–6. The trial judge left open the proposition that the general law duties of directors in the context of financial reporting would be delineated by the specific *Corporations Act* requirement: at 336. This author agrees that it is unnecessary to consider the issue in that way, it is sufficient to acknowledge the obligations overlap and are complementary in nature.

Two questions arise from this analysis. First, how frequent will such a dual obligation arise? Second, what implications does that concept have for the role of board subcommittees and the referral of issues to others?

There is nothing alarming about the suggestion that a director may have a dual obligation under the general duty of care, skill and diligence with a specific statutory obligation under the corporations legislation.[61] Examples of such dual obligations abound in the *Corporations Act*. A good example is the imposition of liability on a director for any misleading and deceptive statement in a prospectus, subject to the availability of a due diligence defence.[62] In this context the prospectus due diligence defence for prospectus liability should be considered a statutory requirement of care, skill and diligence on the part of the director in the preparation of prospectus coupled with an obligation on the part of the director to have considered and reviewed the relevant disclosure document.[63] It is clear that a director must be able to prove that he has read a prospectus to be able to avail himself or herself of the prospectus due diligence defence.[64]

However there is a distinction between finding an obligation on the part of the director to be involved in a particular corporate process such as the adoption of financial statements and the delegation of tasks. The case law needs to make it clear that delegation of tasks is still permitted provided the director has engaged in the general activity in question and that the director is not put on inquiry of a red flag issue or by the exercise of ordinary care would have been out on inquiry.

In that context the analysis of the trial judge in the *Centro* decision is somewhat disappointing. The trial judge stated that the directors could not substitute the advice of management for their own examination of an important matter that fell specifically within their responsibility for the financial statements and in that sense could not 'delegate' or 'abdicate' responsibility to others.[65] There is a significant difference between delegating a particular issue that must be considered and then relying on the results of that delegation as part of the decision-making process and a complete abdication of responsibility for a decision.

It would seem clear from the facts reported in the *Centro* decision that the governance structure that had been adopted for approval of the relevant financial statements was typical of a large Australian listed company.[66] The Board approved the financial statements. There was a properly constituted audit

61 *Corporations Act* s 185 provides that ss 180–184 apply in addition to and not in derogation of any rule of law relating to the duty or liability of a person because of their office in relation to a corporation.

62 *Corporations Act* ss 729, 731.

63 For a discussion of this general proposition: see Greg Golding, 'Prospectus Misstatement Liability in the 1990s: Where Does the Director Really Stand? – Part I' (1997) 7 *Australian Journal of Corporate Law* 177; Greg Golding, 'Prospectus Misstatement Liability in the 1990s: Where Does the Director Really Stand? – Part II' (1997) 7 *Australian Journal of Corporate Law* 299, 299–302.

64 *Adams v Thrift* [1915] 1 Ch 557, 562–3 (Eve J). For a contemporary illustration see *R v Moses* [2011] NZHC 646 (8 July 2011) [394].

65 *Centro* (2011) 196 FCR 291, 332–3.

66 Ibid 341–2. For a description of the role of audit committee, auditor and management, see ibid 361.

committee. Management prepared the financial statements. The auditors reviewed the financial statements.

The *Centro* decision involved a simple failure to correctly characterise debt as short term in the company's annual financial statements and the failure to disclose guarantees given after the balance date in those annual financial statements. The directors argued that consideration of those issues had been delegated to management and advisors and that they had no notice of any issue requiring follow up.

What would seem to have occurred in the *Centro* decision is that while the governance structures were in place there was a complete disconnect between analysis and consideration of the requirements of the accounting standards for recognising liabilities and the presentation of those issues in the financial statements.[67] The *Centro* case makes it clear each director had reviewed the financial statements to varying degrees before approving them. It seems unfair to suggest that was an abdication of responsibilities for the financial statements on the reported facts.[68]

On the facts of the *Centro* decision there was also a difference between the process adopted by the full board of directors and the process adopted by the audit committee of the board in considering the financial statements. The role of the audit committee is clearly enshrined in Australian corporate governance practice and is important to the efficient functioning of Australian listed company boards.[69] It is unfortunate that the trial judge did not recognise and discuss this important distinction in his analysis.[70] The only comment made by the trial judge is that while an audit committee has an important role to play that is not to the exclusion of the role of the director to consider the financial accounts.[71] Courts should encourage the role of the audit committee in the modern corporation and reflect the importance of that body when describing how that aspect of the governance structure affects the duty of care, skill and diligence when applied to individual directors.

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67 The requirement of Accounting Standard AASB 101 that the entity have an 'unconditional right to defer settlement' for 12 months or more to classify a liability as non-current: Australian Accounting Standards Board, *Compiled AASB Standard: Presentation of Financial Statements* (23 September 2011), 29 <http://www.aasb.gov.au/Pronouncements/Current-standards.aspx>; and the requirement of Accounting Standard AASB 110 that post balance date events be disclosed if 'material, non-disclosure could influence' users in making economic decisions: Australian Accounting Standards Board, *Compiled AASB Standard 110: Events after the Reporting Period* (23 February 2010), 13 <http://www.aasb.gov.au/Pronouncements/Current-standards.aspx>.

68 In this context the trial judge refers to the decision of *ASC v Fairlie* (1993) 11 ACLC 669 (an insolvent trading case) as authority that an objective consideration of what a director should do to secure compliance with the legislative requirement is required: *Centro* (2011) 196 FCR 291, 333. However that proposition raises the question of what is required when the issue has been completely overlooked.

69 ASX Group, *ASX Listing Rules* (1 July 2011), [12.7] <http://www.asxgroup.com.au/asx-compliance.htm>; ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations* (30 June 2010) ASX Limited, [4.1] <http://www.asx.net.au/governance/corporate-governance.htm>.

70 In the *AWA Appeal* decision the appropriateness of a listed company board being assisted by subcommittees was specifically endorsed: *AWA Appeal* (1995) 37 NSWLR 438, 500–1.

71 *Centro* (2011) 196 FCR 291, 339.

One debate that has arisen from the *Centro* decision is the question as to what investigation of the accounting treatment would have satisfied the trial judge. There has been press commentary to the effect that the *Centro* decision effectively means a director must turn himself or herself into an accountant and second guess accounting decisions made in preparing financial statements. That clearly is not supported by a proper reading of the *Centro* decision. It is reasonably clear that if the directors had identified the matters in question as issues for further inquiry and asked management for advice on the issues that would have satisfied the duty of care, skill and diligence of the directors even if no change was subsequently made to the financial statements.[72]

On the other hand, the *James Hardie* decision involves a finding by the trial judge of a non-delegable obligation where there is no statutory requirement for a director to assume individual responsibility for a corporate action. The trial judge concluded that approval of the media release in question was not a matter on which a director was entitled to rely on his or her co-directors.[73] The trial judge considered the media release was a key statement in relation to a highly significant restructure of the *James Hardie* group and no member of the board was entitled to abdicate responsibility for the review of the statement by delegating the review of it to a fellow director.[74]

The *James Hardie Appeal* decision does not greatly assist on this important point. The Court of Appeal acknowledged that not every media announcement should go before the board but that on the assumption that it did go before the board it would require a director to apply his or her mind to the release by the exercise of care, skill and diligence.[75] It is disappointing that the Court of Appeal did not specifically comment on the trial judge's finding that the issue was not one that could be delegated.[76]

The proposition of the trial judge that the approval of the press release was a non-delegable duty is not supported by the case law history concerning delegation and reliance outlined above. The proposition is not supported by the specific recognition of delegation in the *Corporations Act*. The conclusion of the trial judge should be considered incorrect to the extent it suggests that approval

72 Ibid 426–7.

73 *James Hardie* (2009) 230 FLR 1, 56. The media release related to a restructure of James Hardie to create a foundation to compensate sufferers of asbestos related diseases. The release stated the restructure would result in the foundation having sufficient funds to meet all future claims. That was not the case. The board minutes recorded that the media release was tabled at the board meeting. The non-executive directors denied that had happened: at 56–7.

74 Ibid.

75 *James Hardie Appeal* (2010) 274 ALR 205, 355. Importantly the court also noted the context of the release was important to an assessment of satisfaction of the duty of care (a decision of high importance, the communication strategy had been discussed by the board for some time and the importance of the decision as to the sufficiency of the foundation's funding). Clearly that is a correct reflection of the need to balance foreseeable risk against the risk of harm.

76 The *James Hardie* High Court decision did not involve consideration of this issue. The High Court overturned the Court of Appeal's finding that ASIC had failed to prove that the directors had approved the media release.

of the press release could not be delegated.[77] If the conclusion was correct it would cause significant uncertainty for directors in assessing in what circumstances a matter will become significant to a degree that it cannot be delegated. The question can be asked as to where the boundary might lie for other important events concerning a company. Examples may be the following:

- investor presentations concerning financial statements;
- earnings forecast announcements;
- acquisition or disposal of significant assets;
- receipt of a merger proposal; and
- changes to employee remuneration policies.

The *James Hardie* decision offers no guidance as to how a director should be able to assess whether or not such a 'significant' event has occurred.

Returning to the base principles set out above, a better conclusion should be that Australian law does not require non-delegable events in the absence of a specific statutory obligation. That would be a better outcome and when considered in the context of the overall analysis would be preferred from a policy prospective.

VII KNOWLEDGE AND RED FLAGS – WHAT SHOULD THE BOUNDARY BE?

Pivotal to the reliance case law is the proposition that reliance is reasonable where the director is not on notice of an issue requiring further enquiry. It is in this context a closer consideration of the *Centro* decision is worthwhile.

The trial judge in the *Centro* decision was clear that the debt maturity issues underlying the accounting issues were well known to the directors or were matters that should have been well known to them.[78] The fact that the trial judge found the specific accounting issue was not raised by management or the auditor as an issue that needed to be assessed is described by the trial judge in the decision as leading to the result that the directors were not on notice of the issue for further inquiry or that a 'red flag' existed.[79]

The case law summarised above suggests there are two ways in which a director will be required to make further inquiry in relation to a task that has been delegated before inquiry will be considered reasonable:

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77 Robert Austin has suggested that the trial judge may have alternatively concluded that reliance was not reasonable in the particular circumstances of the case having regard to the significance of the issue: see Austin, above n 11, 10–11. However the trial judge seems quite clear in his expression of the view that this was a decision that could not be delegated.

78 See *Centro* (2011) 196 FCR 291, 297. Each director was clearly on notice as to the debt maturity profile of the Centro entities and the existence of guarantees: at 345–6, 363–6, 383–7.

79 Ibid 330, 380.

- the director is put on inquiry of an issue – in other words a 'red flag' has been raised; or
- if the director had made inquiry by the exercise of ordinary care he or she would have been put on such inquiry.[80]

In that regard the conclusion of the trial judge was that the errors were: 'matters that could have been seen as apparent without difficulty upon a focusing by each director, and upon a careful and diligent consideration of the financial statements',[81] and that:

> Each director was aware of or should have been aware of the relevant accounting principles which would have alerted each director to the apparent error in the proposed financial statements. Each director could then and should have made the relevant inquiries[.][82]

It is this aspect of the *Centro* decision that is troubling.

It seems harsh to conclude that 'ordinary care' would have caused questions to be asked of accounting standards when the issue of compliance with accounting standards has been delegated to experts and those experts had failed to identify those issues or reported any concern to the directors.[83] Previous cases had recognised that a director is entitled to a high degree of comfort when relying on the work of an auditor.[84] That seems fair as a matter of policy. This is particularly so when the financial statements were being transitioned to the new Australian International Financial Reporting Standards. In these circumstances it seems a harsh conclusion that each director should have been aware of the relevant accounting principles.

A significant aspect of the *Centro* decision was that the notes to the accounts identified the liability recognition required under the new accounting standards and that description was inconsistent with the circumstances known to the directors.[85]

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80 This is the formulation adopted by Santow J in *Adler* (2002) 168 FLR 253, 348. The *AWA Appeal* decision had used the slightly differently expressed formulation of when a prudent person would be concerned: (1995) 37 NSWLR 438, 503. Both formulations seem apt having regard to the development of the duty of care, skill and diligence by reference to the common law duty of care. The Santow J formulation is preferred by this author as better describing the nature of the conduct expected of the director or officer.

81 *Centro* (2011) 196 FCR 291, 299.

82 Ibid 427. In the *Centro* decision the trial judge posed the question: 'it may well be that directors should have a degree of accounting literacy that requires a knowledge of accounting practice and accounting standards. That is not for decision in this proceeding': at 339. In New Zealand it has been held that where the company in question is a finance company the duty of care, skill and diligence requires financial literacy: *Davidson v Registrar of Companies* [2011] 1 NZLR 542, [121]; and the ability to read and understand financial statements and the way in which those statements classify assets and liabilities as current or non-current: *R v Moses* [2011] NZHC 646 (8 July 2011), [402]. Centro was not a finance company.

83 *Centro* (2011) 196 FCR 291, 341–2.

84 See quote from the *AWA Appeal* decision at n 54 and the reference to *Dovey v Corey* and *Re Denham*. In the *Centro* decision, the trial judge did not specifically address this case law.

85 See 'note 1(w)' in the financial statements extracted in the *Centro* decision: *Centro* (2011) 196 FCR 291, 305.

It therefore follows that there were at least two aspects of the issue of which the directors had actual knowledge, or consistent with principles of ordinary care, should have had actual knowledge – the debt maturity profile that underpinned the accounting issues and the note to the accounts being inconsistent with the directors' knowledge of the debt maturity profile. It would have been a far fairer conclusion for the trial judge to base his decision on a finding that these two matters raised red flags that should have been followed up rather than stating there was a broader expectation that the directors be aware of accounting standards more generally as a matter of ordinary care.

On the same general theme, a disappointing finding of the trial judge in the *Centro* decision was the conclusion that the giving of a defective management representation letter constituted a breach of the duty of care, skill and diligence. Pursuant to the *Corporations Act* the chief executive officer ('CEO') or chief financial officer ('CFO') must give the directors a declaration that the annual financial statements have been properly prepared.[86] In the *Centro* decision the certificate given to the directors was defective because it was expressed as an acknowledgement as to the responsibility of the directors and management for the financial statements rather than an opinion by the CEO as to compliance. The facts before the trial judge were that the representation letter was prepared by management using the auditor's precedent, included in board packs and tabled at the board meeting to approve the financial statements.[87] While the trial judge accepted the directors were entitled to trust the management and advisors to correctly prepare the certificate, he found they were in breach of duty (and the obligation to take reasonable steps to ensure the *Corporations Act* was complied with) as they should have received the certificate and read it to assess whether it complied with the *Corporations Act*.[88]

The receipt of the management representation certificate is one of the plethora of materials a director will receive in finalising annual financial statements. To suggest that a director is not entitled to rely on management and advisors (including those with legal expertise) when not having been put on suspicion of any problem seems a step too far.[89] To suggest that 'ordinary care' for a director would result in the director being put on suspicion of this problem seems quite unfair.

86 *Corporations Act* s 295A.

87 *Centro* (2011) 196 FCR 291, 416–8.

88 Ibid 418.

89 The trial judge comments that no director gave evidence that he read or familiarised himself with s 295A: ibid 522; and that a simple reading of the section would have indicated what was required: ibid 521. However, that seems an unreasonable requirement in the context of a complicated legal process for the approval of accounts and where the corporations legislation now runs to more than 2 500 pages in the published compilations.

VIII WHERE TO FROM HERE?

In response to recent case law some have argued that the statutory duty of care, skill and diligence needs to be rewritten to better acknowledge that directors should be entitled to engage in entrepreneurial decision making and to better recognise the realities of the governance relationship between boards and management.[90] Others have argued some of the recent cases are bad law.[91] These concerns seem overblown.

The survey undertaken for this article demonstrates that, following the more objective restatement of the duty in the 1990s, the case law record demonstrates a much more effective liability regime than was previously the case and that this is not just a very recent development. Directors should be conscious of this changed environment but should consider the development in context.

A review of the broad thrust of the legal principles underpinning the duty of care, skill and diligence demonstrate that those principles have been developed by the courts and legislature in recent decades to accord with community expectations and overall seem correctly calibrated by reference to principles of reasonable care. In that sense it would seem that the current state of the law strikes the right balance between facilitating entrepreneurial decision making and the proper exercise of care.

What is desirable is that courts adopt a realistic approach to the role of the modern director in the corporate governance structure when applying those legal principles. While a director is not an 'ornament' he or she is not a guarantor of corporate performance. The aggregate number of cases brought in Australia remains relatively low and the case law record shows this type of litigation rarely intrudes into the boardrooms of major companies.

It is not helpful for directors to complain generally about the burdens and liabilities imposed on them by criticising a legal formulation based on principles of reasonable care. At the end of the day determination as to whether or not the duty of care, skill and diligence has been satisfied is an inherently fact specific task that must be undertaken by the trial judge.[92] Directors and commentators should focus on the application of the legal principles to the specific fact patterns in the reported decisions and be vocal in expressing a view on whether the conclusions reached are consistent with reasonable care.

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90 See Austin, above n 11, arguing for a reformulated codification of directors' duties along the lines of the *Companies Act 2006* (UK).

91 See, eg, John M Green, 'Why the Centro Judgment Made Bad Law' (2011) 27(8) *Australian Institute of Company Directors Company Director* 8.

92 Neil Young reached the following conclusion: 'In fact, in cases where directors have been found to have breached directors' statutory duties, their conduct appears to warrant liability (and in some cases condemned)': Young, above n 28, 232. In reaching that conclusion that author reviewed the facts of the *Adler* decision, *ASIC v Loiterton* (2004) 50 ASCR 693, the *Greaves* decision, the *Vines* decision, *ASIC v Parker* (2003) 21 ACLC 888 and *Sheahan v Verco* (2001) 79 SASR 109 in the context of the duty of care, skill and diligence. In this author's opinion an overall conclusion based on an assessment of the results of litigation will always be a subjective matter having regard to the very fact specific nature of the inquiry (note also the broader range of cases surveyed in this article).

That being said this article has attempted to demonstrate that there are some minor aspects of the technical legal analysis of delegation and reliance in the recent case law where courts might usefully give further consideration as to the way the principles are expressed and applied.

ANNEXURE 1

Survey of reported duty of care, skill and diligence cases 1990–2011

Case Name	**Result**	**Remedy Sought**
Cummings v Claremont Petroleum NL (1992) 9 ACSR 583	Breach of duty found	Damages
Australian Securities Commission v Gallagher (1993) 11 WAR 105	No breach found (both by the trial judge and the Court of Appeal)	Criminal liability
Vrisakis v Australian Securities Commission (1993) 9 WAR 395	No breach found (on appeal, trial judge had found breach)	Criminal liability
Biala Pty Ltd v Mallina Holdings Ltd (No 2) (1993) 13 WAR 11; *Dempster v Mallina Holdings Ltd* (1994) 13 WAR 124	No breach found	Damages
Gemstone Corporation of Australia Ltd v Grasso (1993) 12 ACSR 47	No right to compensation	Damages
Permanent Building Society (in liq) v Wheeler (1994) 11 WAR 187	Breach of duty by CEO but no right to compensation (compensation awarded for finding of improper purpose)	Damages
Re Property Force Consultants Pty Ltd (in liq) [1997] 1 Qd R 300	No breach found	Damages
AWA (1992) 7 ACSR 759; *AWA Appeal* (1995) 37 NSWLR 438	Breach of duty by CEO, no breach of duty by non-executive directors ('NEDs')	Damages
Australian Innovation Ltd v Petrovsky (1996) 21 ACSR 218	Breach of duty found	Invalidation of the convening of a meeting
Gamble v Hoffman (1997) 24 ACSR 369	Breach of duty found	Repayment of monies
Duke Group Ltd (in liq) v Pilmer (1998) 144 FLR 1; *Pilmer v Duke Group Ltd (in liq)* (2001) 207 CLR 165	Breach of duty found	Damages
Australian Securities Commission v Donovan (1998) 28 ACSR 583	Breach of duty found	Civil penalty
Australian Securities Commission v Forem-Freeway Enterprises Pty Ltd (1999) 30 ACSR 339	Breach of duty found	Civil penalty
Sheahan v Verco (2001) 79 SASR 109	Breach of duty found	Damages
Minilabs Pty Ltd v Assaycorp Pty Ltd (2001) 37 ACSR 509	Breach of duty found	Damages
ASIC v Doyle (2001) 38 ACSR 606	Breach of duty found	Civil penalty
Wall v Timbertown Community Enterprises Ltd (in liq) (2002) 42 ACSR 1	Breach of duty found	Damages
ASIC v Whitlam (2002) 169 FLR 383;	Breach of duty found by trial judge	Civil penalty

Whitlam v ASIC (2003) 57 NSWLR 559	(overturned on appeal)	
ASIC v Parker (2003) 21 ACLC 888	Breach of duty found	Civil penalty
ASIC v Loiterton (2004) 50 ACSR 693	Breach of duty found	Civil penalty
Vines (2005) 55 ACSR 617	Breach of duty found	Civil penalty
Re PFS Wholesale Mortgage Corporation Pty Ltd; ASIC v PFS Business Development Group Pty Ltd (2006) 57 ACSR 553	Breach of duty found	Banning order
ASIC v Maxwell (2006) 59 ACSR 373	Breach of duty found	Civil penalty
ASIC v Sydney Investment House Equities Pty Ltd (2008) 69 ACSR 1	Breach of duty found	Civil penalty
James Hardie (2009) 256 ALR 199; *James Hardie Appeal* (2010) 274 ALR 205; *James Hardie High Court* [2012] HCA 17	Breach of duty found by trial judge	Civil penalty
Greaves (2003) 174 FLR 128	No breach of duty found	Civil penalty
Fortescue (2009) 264 ALR 201; *Fortescue Appeal* (2011) 190 FCR 364	No breach of duty found by trial judge (overturned on appeal and breach of duty found by Full Federal Court)	Civil penalty
ASIC v Citrofresh International (No 2) (2010) 77 ACSR 69	Breach of duty found (following reversal of original trial judge findings: *ASIC v Narain* (2008) 169 FCR 211)	Civil penalty
Centro (2011) 196 FCR 291	Breach of duty found	Civil penalty

ANNEXURE 2

Penalties Imposed

Case	Financial Penalty	Banning Order	Other
Centro[a]			
NEDs			Costs order
CEO	$30 000		Costs order
Chief Financial Officer ('CFO')		Two years	Costs order
ASIC v Citrofresh International Ltd (No 3)[b] CEO	$20 000	Seven years	Costs order
James Hardie[c]			
NEDs	$30 000	Five years	
CEO	$350 000	15 years	Costs order
CFO	$35 000	Five years	
Company secretary and general counsel	$75 000	Seven years	Costs order
Vines[d]			
GIO officers	$100 000[e]	Three years	Costs order
	$50 000	Three years	Costs order
	$220 000	12 years	Costs order, compensation order
Adler[f]			
CEO	$250 000	10 years	Compensation order
CFO	$5 000		
Adler	$450 000	20 years	Compensation order
ASIC v Maxwell[g]	$110 000	Permanent	Costs order
	$200 000	12 years	Costs order
		Seven years	
		Five years	Costs order
		Two years	
		Eight years	
		Three years	
		Five years	
ASIC v Loiterton[h]	$400 000	17 years	Costs order
	$285 000	14 years	Costs order
	$120 000	Eight years	Costs order, compensation order
ASIC v Parker[i]		Four years	
ASIC v Whitlam (No 2)[j]	$20 000	Five years	
ASIC v Forem-Freeway Enterprises Pty Ltd[k]		12 years	Costs order, compensation order
Australian Securities Commission v Donovan[l]	$40 000	10 years	Costs order
	$4 000	Three years	Costs order

a *ASIC v Healey (No 2)* (2011) 196 FCR 430.
b (2010) 268 ALR 303.
c *ASIC v MacDonald (No 12)* (2009) 259 ALR 116.
d *ASIC v Vines* (2006) 58 ACSR 298.
e Reduced on appeal to $50 000: *Vines v ASIC* (2007) 63 ACSR 505.
f *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); ASIC v Adler* [2002] NSWSC 171; (2002) 42 ACSR 72. This case involved findings of multiple contraventions of *Corporations Act* provisions including s 180.
g (2006) 59 ACSR 373. Findings of misleading and deceptive conduct were also made.
h (2004) 50 ACSR 693.
i (2003) 21 ACLC 888.
j (2002) 42 ACSR 515. Reversed on appeal: *Whitlam v ASIC* (2003) 57 NSWLR 559.
k (1999) 30 ACSR 339.
l (1998) 28 ACSR 583.