

## Men over board – the burden of directors’ duties in the wake of the Centro case

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1. When the Federal Court handed down its decision in the Centro case in late June 2011 finding that the six non-executive directors of the Centro group were in breach of their duties, there was a collective intake of breath.<sup>1</sup>
2. Non-executive directors, it seemed, would be liable for errors in company accounts no matter how many internal accountants were involved in preparing the accounts, and no matter that a top tier accounting firm had audited the accounts and given them an unqualified audit clearance. One person whom, had he still been alive, may well have been less surprised, is Sir Douglas Menzies. Shortly after his appointment to the High Court, Sir Douglas considered the evolution of directors’ duties and predicted that “the degree of skill required of a director will certainly be raised. As more is expected of directors, so more will be required of them.”<sup>2</sup> While the Marquis of Bute may have escaped liability by steadfastly not engaging himself with the affairs of the company,<sup>3</sup> Menzies observed that “[t]he narrow conception of the duties of a director [which required honesty more than skill or application] is, of course, no longer the case so far as most companies and most directors are concerned and there can be no doubt that, as time goes on, it will become progressively less the case.”<sup>4</sup>

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<sup>1</sup> *ASIC v Healey & Ors* (2011) 278 ALR 618; (2011) 83 ACSR 484; [2011] FCA 717 (the **liability judgment**).

<sup>2</sup> Sir Douglas Menzies, “Company Directors” (1959) 33 Australian Law Journal 156 at 156. Similarly, Sir Douglas observed that “what is expected is the best indication of the content of the duty of care that rests upon an office holder” at 164. The theme of expectation driving requirements was echoed (without reference to Sir Douglas) by Justice Tadgell in *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 where His Honour said (at [126]) “As the complexity of commerce has gradually intensified ... the community has of necessity come to expect more than formerly from directors. ... In response, the parliaments and the courts have found it necessary in legislation and litigation to refer to the demands made on directors in more exacting terms than formerly”.

<sup>3</sup> The Marquis of Bute attended only one board meeting in twenty years but successfully resisted a liquidator’s application to make him liable by reason of neglect or omission, to contribute to assets depleted by the frauds and defalcations of the company’s actuary and officer: (1892) 2 Ch 100.

<sup>4</sup> Sir Douglas Menzies, “Company Directors” (1959) 33 Australian Law Journal 156 at 156.

3. Even if, after the Centro judgment, the boardrooms of corporate Australia did not empty overnight<sup>5</sup>, their occupants were certainly extremely concerned about the implications of the decision. How were they to personally ensure the accuracy of the figures in the accounts when they did not have a detailed day to day engagement with the affairs of the company? Did they all need to become amateur accountants and study the accounting standards? More practically, how could they ensure that human errors did not infect the accounts in the first place? What did the decision mean for other areas in which the board signs off on company documents? What did the decision mean for the role of a director generally? What did the decision mean for the ability to delegate or divide up tasks, with all the attendant efficiencies that result? On the other side of the ledger, however, the Centro decision provides non-executive directors with a clear basis upon which to be more demanding in their requirements of management, including in the absence of any indication that there is any cause for concern.
4. Dr Bob Austin observed in a paper delivered at The Supreme Court of Victoria Commercial Law Conference in August 2011<sup>6</sup> that:

*“Whenever a financial disaster occurs in the corporate world, or even a failure of risk management, sooner or later the press will want to know why the directors allowed the problem to occur..”*

Directors and aspiring directors could perhaps be forgiven for thinking: *“It doesn’t matter what processes and people I have in place, how careful I am or how skilful others on the Board are, if a mistake is made on my watch, and ASIC want to make an example of us, my family and I will endure years of anxiety and stress. The game is not worth the candle.”*

5. Indeed, even ASIC, or at least some within ASIC, appeared to have misgivings about the wisdom of commencing proceedings against all of the non-executive directors of Centro in respect of the errors in the financial statements.<sup>7</sup> Shortly prior to the

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<sup>5</sup> Liability judgment at [15].

<sup>6</sup> RP Austin, “Directors’ Duties after James Hardie and Centro” (draft presented August 2011).

<sup>7</sup> It is worth noting that in the class actions commenced against Centro, only the then Chairman of Centro (Mr Healey) and the members of the audit committee (Messrs Kavourakis, Hall and Cooper) have been joined to those proceedings. The other two non-executive directors, Messrs Goldie and Wilkinson have not been sued.

commencement of the liability trial, the former Chairman of ASIC, Tony D'Alosio was interviewed by The Australian newspaper. The article reported that:

*"ASIC chairman Tony D'Alosio says there are concerns the law 'is going to discourage good people from becoming directors'.*

*The corporate regulator has called on the federal government to re-examine the law applying to directors' duties, warning that the current regime could be imposing too many obligations on non-executive directors.*

*Australian Securities & Investments Commission chairman Tony D'Alosio said while ASIC had an obligation in the public interest to pursue legal action against the directors of companies such as James Hardie, Centro and Fortescue Metals for breaching the law, there needed to be more debate about whether the law was too tough.*

*"As I look at it as a former lawyer, the duty of negligence does look like a very high standard when you consider that board members are advisers and they are not really involved and don't have the knowledge that management has," Mr D'Alosio told The Australian yesterday.*

*On directors criticising ASIC's pursuit of directors in high-profile cases, he added: "I think part of the issue here may be the law itself. They may not be complaining about us. They are really complaining about the law. And the law has moved too far in imposing obligations on non-executives that should be imposed more on executives."*

6. Some months after the liability judgment, the Court handed down its decision on penalty.<sup>8</sup> Again, the decision attracted widespread media attention, but this time the concern came from the shareholder lobby groups and, predictably perhaps, the media, concerned that simply making declarations for contravening conduct watered down the impact of the liability decision and amounted to judicial condonation of the non-executive directors' breaches. The penalty handed down against the CEO,

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<sup>8</sup> *ASIC v Healey (No 2)* [2011] FCA 1003 (the **penalty judgment**).

Andrew Scott, included a penuniary penalty of \$30,000 as well as declarations<sup>9</sup>, but was also perceived as lenient. The Chief Financial Officer (who before trial admitted the substantiative allegations against him) was disqualified from being a director for two years.

7. For those more familiar with the facts of the matter, the penalty decision was less of a surprise. Personal deterrence, as ASIC conceded, was never in issue. General deterrence – considered in the context of the contribution that the liability decision made to the ever more demanding role of being a director - had to some extent been served by the case itself and the widespread publicity which attended the trial.
8. Further, the Court pointed out that it had refused the non-executive directors' application for complete exoneration. The seriousness of the contraventions and the need for general deterrence meant that exoneration was not appropriate, despite the finding that the errors in the accounts had occurred by reason of the failure of a number of safety nets, through no fault of the non-executive directors.<sup>10</sup> It was obvious from the conduct of the trial that none of the non-executive directors regarded it as part of their job to personally attend to the detail of the accounts, and that they had relied on the processes and procedures (including the auditors) Centro had in place to ensure the accounts were accurate. The wake-up call had been delivered and, as the Court found, imposing fines or banning orders on the non-executive directors would have served no further purpose.
9. Now that the dust has settled, not only on the liability findings, but also on the penalty judgment, it is opportune to reflect on the Centro decision and how it has contributed to the development of the law of directors' duties. This question falls to be considered, not just in terms of the ultimate standard of conduct required, but also having regard to the coherence of the statutory regime and how the provisions of the

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<sup>9</sup> Penalty judgment at [4] and [197]ff.

<sup>10</sup> Penalty judgment at [97], [132]-[133]; see also [169], [174] and [175] on the failure of the safety nets. And compare *McLellan (in his capacity as liquidator of The Stake Man Pty Ltd) v Carroll* (2009) 76 ACSR 67. That case concerned the insolvent trading provisions of the Act. The liquidator and the company applied for orders, pursuant to s 588M(2), that Mr Carroll pay debts incurred in contravention of s 588G. While Goldberg J found that Mr Carroll contravened s 588G(2) by failing to prevent the company incurring the specified debts, he nevertheless exonerated him (under s 1317S) wholly from any liability to pay the company under s 588M. Relevantly, Goldberg J exonerated Mr Carroll because he relied on the advice of an accountant who told Mr Carroll that he did not believe the company was insolvent.

*Corporations Act 2001* were interpreted to arrive at the result. Principal among those sections with whose interaction the case was concerned are:

- (a) s 180, which requires that directors “exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they: (a) were a director or officer of a corporation in the corporation’s circumstances; and (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer”; and
- (b) s 344(1), which provides that “[a] director of a company, registered scheme or disclosing entity contravenes this section **if they fail to take all reasonable steps to comply with, or to secure compliance with, Part 2M.2 or 2M.3**”.  
[(Emphasis added)]

All of the other sections central to the Centro decision are found in Part 2M.3: ss 295 (contents of annual financial report), 295A (declaration by CEO and CFO), 296 (compliance with accounting standards), 297 (true and fair view), 299 and 299A (requirements for directors’ report).<sup>11</sup>

- 10. Sections 180 and 344 are civil penalty provisions,<sup>12</sup> the contravention of which requires that declarations of contravention be made (unless, arguably, the relief provisions apply) and exposes directors to pecuniary penalties and disqualification orders.<sup>13</sup>
- 11. Other questions of ongoing significance arise from the Centro decision as well. At least in the area of financial reporting, what place is left for reliance on management and external advisers, particularly in the absence of any “red flags” which might alert non-executive directors to the fact that something is amiss within management? Should non-financially literate but talented people act as consultants rather than directors? Will the Board be populated by ex lawyers and accountants who think more like regulators and judges? Is this a good or a bad thing? What has happened to the audit committee – does it have any ongoing role – and what has become of the

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<sup>11</sup> We confine ourselves here to discussing s 180 and s 344 but note that the parallel provisions of s 601FD (sub-s 1(b) (due care and diligence) and 1(f) taking all reasonable steps to ensure compliance with the Act)) applied in relation to those entities which were responsible entities (CPTM and CMCSM).

<sup>12</sup> As is s 601FD: s 1317E.

<sup>13</sup> Section 206C (disqualification) and s 1317G (pecuniary penalty orders).

distinction between executive and non-executive directors? The latter question arises particularly because ASIC's case on liability, and the Court's judgment, drew no distinction between the executive director of the Centro Group and the non-executive directors. ASIC's case also drew no distinction between the members of the Audit Committee and the other non-executive directors.

12. While we address some of these issues below, it is worth noting at the outset that all of these questions fall to be considered in the context of a greater, over-arching theme, namely the changing role of directors. In his paper, Bob Austin spoke of the ambiguity regarding the basic governance role of the board of directors. He described a "kind of schizophrenia" between the recognition on the one hand that the board, (as a body meeting periodically comprising part-time members) cannot participate in operational management except on isolated occasions, and a determination on the other hand to perceive directors as seated at the "head table" of the company's management system, bearing ultimate responsibility for everything that occurs within the organisation.
13. While recognising that tension, it seems to us that the de facto ratchet mechanism which has tended to operate in relation to the law of negligence and directors' duties - standards are only ever raised, and to voice the proposition that things may have gone too far is heretical – means that the gravitation pull is towards the second pole described by Dr Austin. In the longer term, that trend, if it continues, will have wide-spread implications for the structure and personnel of boards, the way in which they work, and the time commitment required of non-executive directors.
14. Our more immediate concern, however, is with the current position. As Dr Austin pointed out in his paper, the current position is something of an awkward hybrid. The Centro decision did not resolve, but rather reinforced, the tension between the two poles of perception regarding the role of non-executive directors.
15. There remains a recognition that boards are enriched by having a diversity of personnel, with different skills which they can bring to bear for the benefit of the company. Not all of them will be closely familiar with accounting principles or standards. Some may not even find their strength in the numerate fields. For example, a company seeking to penetrate the youth market in a particular product range may well appoint an expert in viral marketing to its board. Another company may wish to have on its board someone who has excellent contacts in a country or region in which the company is operating but has no particular financial acumen and

is more than content to rely on those on the board who do, as well as on the company's internal processes and external auditors.

16. Nevertheless, and particularly in relation to public companies where directors draw payments for part-time work which dwarf the annual salaries of most Australians, something akin to the notion of Ministerial responsibility<sup>14</sup> is now pervasive.
17. Before progressing further, it is necessary to set out the background facts for those not familiar with the case.

## **A. Facts**

18. The Centro Group was a large group of retail property and property fund companies. Broadly, the group was divided into two sub-groups, the Centro Properties Group (known as **CNP**) and the Centro Retail Group (known as **CER**). CNP comprised Centro Properties Ltd (and entities controlled by it) (**CPL**) and the Centro Property Trust (**CPT**) (and entities by it). Each share in CPL was stapled to a unit in CPT and traded on the ASX. The responsible entity of CPT was CPT Manager Ltd (**CPTM**).
19. The structure of CER was similar. CER comprised Centro Retail Ltd (**CRL**) (and entities controlled by it) and the Centro Retail Trust (**CRT**) (and entities controlled by it). Each share in CRL in was stapled to a unit in CRT and traded on the ASX. The responsible entity of CRL was Centro MCS Manager Ltd (**CMCSM**).
20. The boards of the relevant entities were identical and comprised the six non-executive directors and Andrew Scott, who was also the CEO of the Centro Group. The CFO of the Centro Group was Romano Nenna, also a defendant.
21. As one would expect with boards of listed companies, the backgrounds of the non-executive directors were diverse. With one exception, none of them held accounting qualifications.<sup>15</sup> Two directors (who were not members of the audit committee) had backgrounds in retail and property management. Another director was a former lawyer with expertise in corporate governance.

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<sup>14</sup> At least as traditionally understood.

<sup>15</sup> Liability judgment at [296].

22. There were two areas in which the accounts of CNP and CER<sup>16</sup> were found to be deficient. The first deficiency, which affected both CNP and CER's accounts, was the misclassification of debt. The annual report of CNP, which was released on 18 September 2007, disclosed current interest bearing liabilities of \$1.1bn and non-current interest bearing liabilities of \$2.5bn. Approximately \$1.5bn of the debt classified as non-current should have been classified as current.
23. Importantly, in terms of the overall significance of the misclassification issue, if the accounts had been correct, CNP would have disclosed to the market a net current asset deficiency (calculated as total current assets less total current liabilities) of \$1.93bn as at 30 June 2007, compared to a net current asset surplus of \$0.44bn as at 31 December 2006. In other words, as at 30 June 2007, CNP's current assets could only meet 41% of its current financial obligations. This had declined from the reported surplus positions of 182% and 273% as at 31 December 2006 and 30 June 2006 respectively.<sup>17</sup>
24. The annual report of CER, also released on 18 September 2007, classified all interest bearing debt as non-current whereas in fact about \$600m of interest bearing debt was current. As a consequence, the accounts contravened ss 296 (on the basis that they did not comply with accounting standard AASB 101) and 297 of the *Corporations Act* for the same reasons. Again, the effect of the error was to conceal a net current asset deficit, this time in the order of \$630m.
25. The second issue affected only CNP and related to guarantees given by CNP in connection with the New Plan acquisition in April 2007. CNP and CER owned a US company, Centro Super LLC, which acquired the share capital of the New Plan Excel Realty Property Trust, known as New Plan. In the first instance, the acquisition was funded by a facility from JP Morgan Australia and a facility from JP Morgan Chase Bank in the US, which was a bridging loan. In late July and early August 2007, arrangements were made to refinance that bridging loan, including the provision by CNP (more particularly the entities comprising CNP, CPL and CPTM) of several guarantees. The circumstances in which the guarantees might be called were complex in some respects, but it suffices for present purposes to note that the guarantees included a payment guarantee to an aggregate of approximately

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<sup>16</sup> CNP and CER are the economic, rather than legal entities, but for most purposes, it is convenient to refer to their accounts and reports, rather than referring to the specific legal entities.

<sup>17</sup> Liability judgment para [473].

\$1.75bn. The guarantees were not disclosed as events subsequent to the balance date in the annual report of CNP or in the directors' report. It is noted that the auditors had reviewed the board minutes, recorded the existence of the guarantees in their audit check list, but apparently overlooked the fact they were not disclosed in the accounts. ASIC again alleged that the accounts contravened ss 296 (based on non-compliance with accounting standard AASB 110) and 297. ASIC also alleged that the directors' report did not comply with ss 299 and 299A (and thereby the directors had breached ss 180 and 344) because it did not disclose the existence of the guarantees.

26. As listed entities, CNP and CER published Appendix 4E preliminary final reports. PwC, the group's auditors, gave audit clearance to the Appendix 4E financial accounts.<sup>18</sup> The Appendix 4E reports were considered by the audit committee at a meeting on 2 August 2007. That meeting (consistent with good practice) was also attended by directors who were not members of the audit committee. There are two features of the Appendix 4Es and the meeting held to consider them that are important for present purposes. First, there was a change between the debt figures in the CNP Appendix 4E accounts approved by the board in early August 2007 and the figures in the final accounts released in September 2007. Where the final accounts disclosed \$1.1bn in current interest bearing liabilities, the CNP Appendix 4E did not disclose any current interest bearing liabilities. The Court found that this change in the classification of \$1.1bn in debt between the Appendix 4E in August 2007 and the final accounts in September 2007 was not disclosed to the board by management or the auditors, PWC.<sup>19</sup>

27. The second important feature of the Appendix 4Es<sup>20</sup> was that the audit committee, in the presence of the other directors, conducted a "page turn" of the Appendix 4Es. Middleton J described the page turn as being "punctuated by questions" from members of the audit committee, and answers from management or the auditors,<sup>21</sup> and the evidence revealed that the questioning was extensive and probing. While the Court did not dwell on this aspect of the evidence in the liability judgment, it may have been evidence such as this, demonstrating (at least in part) the board's general

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<sup>18</sup> Liability judgment at [214]; penalty judgment at [45].

<sup>19</sup> Liability judgment at [215]; penalty judgment at [52].

<sup>20</sup> Liability judgment at [327].

<sup>21</sup> Liability judgment at [327].

diligence, which lay behind the Court's opening remark that the directors are "intelligent, experienced and conscientious people".<sup>22</sup>

28. The relevance of the page turn exercise lies in the fact that, for all practical purposes, Appendix 4E accounts are a listed company's accounts. When the final accounts come to be approved, the natural expectation is that the hard work has been done in preparing and reviewing the Appendix 4E statements. It would only be additions to, or changes to, the information presented in the Appendix 4E statements that would attract significant attention. Naturally, the board would have a reasonable expectation that any such additions or changes would be drawn to their attention. Extraordinarily, that did not occur here.
29. The final accounts were approved by the board, on the recommendation of the audit committee, on 6 September 2007. Mr Healey and Mr Scott signed the directors' declaration under s 295(1)(c) and the directors' report the same day. While it is not necessary to go into any detail on the point, it is worth noting that (unknown to the non-executive directors) there was considerable uncertainty concerning the actual content of the draft final accounts available to the directors for review prior to the meeting on 6 September 2007. With management and the auditors working on the accounts and numerous drafts being produced even after the board signed off on the accounts, it was not clear whether a note referring (obliquely) to the change from the Appendix 4E accounts was in the versions available for review.<sup>23</sup>
30. While not decisive in the Centro case, it would certainly be highly advisable for boards and company secretaries to consider the manner of preparation of the draft accounts and the way in which they are provided for review by directors. If draft accounts are made available in a central room and replaced as new versions become available, without any record keeping recording the changing versions or which version has been reviewed by whom, directors will be exposed where accounts change and the changes are not brought to their attention.<sup>24</sup>

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<sup>22</sup> Liability judgment at [8].

<sup>23</sup> Liability judgment at [351]-[355].

<sup>24</sup> The problems that arose in that regard in the Centro case are explicable by reason of the fact that there were over 90 sets of accounts due to the application of the managed investment scheme provisions of the Act and the fact that separate accounts needed to be prepared in respect of each managed investment scheme. There were so many sets of accounts that practically they could not all be sent to the directors. They were therefore made available for inspection at the offices of Centro.

31. A contextual factor that is of some interest (although found by the Court not to have been relevant on the facts of the case) was that the errors of misclassification of debt occurred in circumstances where the relevant accounting standard had changed with the move from the old AGAAP standards to the new AIFRS accounting standards.
32. In general terms (at least as interpreted by the accounting profession), the old standard allowed a debt to be classified as non-current if, at the time of signing off on the accounts, there was a reasonable expectation that the debt would not have to be repaid in the coming period (for example because it was expected to be rolled over or refinanced). Under the new AIFRS standard, however, in general terms any debt due in the coming period had to be classified as current unless, by the reporting date, the company had the right to defer payment. The evidence revealed that in one way or another, all of the “Big Four” accounting firms (or at least some of their staff) had apparently failed to appreciate the significance of the change. The evidence established that some staff of Centro’s auditors had applied the old standard in auditing the relevant accounts. Centro’s accounting manual, prepared with the involvement of two accounting firms including Centro’s auditors, also incorrectly recorded the test in accordance with the old standard.<sup>25</sup> The error that was made in respect of classification in the accounts of CNP and CER was one that would not have been regarded as an error under the old standard.
33. One final aspect of the facts requires mention: note 1(w). Each relevant set of accounts contained a note – the numbering differed but it was note 1(w) in the accounts of CPL – which stated that “[b]orrowings are classified as current liabilities unless the Group has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.” The Court accepted (over the objection of the directors) that that note had been pleaded as a part of the knowledge which the directors had or should have had. The proposition, accepted by the Court,<sup>26</sup> was that, in reviewing the liability figures, the directors were not required to know the ins and outs of the relevant accounting standard. The note, while not a comprehensive statement of the accounting standard for classification of liabilities, was accurate, and told them all they needed to know in order for them, knowing what they did (or should have) about the debt position, to recognise that the classification of debt in the CNP and CER accounts was incorrect and understated current interest

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<sup>25</sup> Liability judgment at [213].

<sup>26</sup> Liability judgment at [272].

bearing liabilities. The proposition seems to assume that it is a matter of legal obligation for all directors to read all the notes to the financial statements before approving the accounts; perhaps a surprising proposition, at least before this case.

**B. Statutory construction and the establishment of personal responsibility for the content of the company's accounts:**

34. In the liability judgment, the Court found that the directors had contravened ss 180, 344 and 601FD. In so finding, the Court concluded that the directors had not taken "all reasonable steps" to secure compliance by the relevant companies with specific provisions of the Act (ss 296, 297, 299 and 299A).

35. The chain of reasoning by which the judge arrived at those conclusions is (in summary form) as follows:

- (a) the annual reports of CNP and CER misclassified interest bearing debt as non-current when it was current and thereby:
  - (i) the financial reports of CNP and CER did not comply with accounting standard AASB 101 and therefore did not comply s 296 of the Act;
  - (ii) the financial statements of CNP and CER did not give a true and fair view of the financial position and performance of the entity, and therefore did not comply with s 297 of the Act;
- (b) the accounts and directors' report of CNP failed to disclose the existence of the guarantees and thereby:
  - (i) the accounts did not comply with AASB 110 (events after the reporting period);
  - (ii) the directors' report failed to disclose a matter which significantly affected the state of affairs of CPT and its controlled entities and was information that members of CPL would reasonably require to make informed decisions, and thereby breached s 299(1)(d) and s 299A of the Act;
- (c) the information which was not disclosed (regarding the true level of current debt of CNP and CER and the existence of the guarantees given by CNP) were matters of significance for the assessment of risks facing CNP and CER;

- (d) directors are “an essential component of corporate governance”, “placed at the apex of the structure of direction and management of a company”;<sup>27</sup>
- (e) there is a “core, irreducible requirement” to be “involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor”;<sup>28</sup>
- (f) directors must read, understand, focus upon each document they approve, adopt or “sign-off” bringing to bear the knowledge that they have or should have by virtue of their position and determine whether (in the case of financial statements) those statements are “consistent with his or her own knowledge of the company’s financial position”;<sup>29</sup>
- (g) the directors were required to understand “basic accounting conventions” and have a “sufficient knowledge” of the accounting standards relating to classification of liabilities<sup>30</sup>;
- (h) the directors knew, or should have known, of the relevant information concerning the currency of debt and the guarantees;<sup>31</sup> and
- (i) the omissions in the financial statements were matters that could have been recognised without difficulty by a director focussing on the task at hand and undertaking a careful and diligent consideration of the financial statements.<sup>32</sup>

36. As noted above, the chain of reasoning which led from inaccuracies in the companies’ accounts to findings that the directors had breached their duties required the Court to focus on the role of directors in the modern corporate structure, and particularly their role in financial affairs vis-à-vis that of management and external auditors, who would in the ordinary course have a much greater knowledge and closer involvement in such matters. The proposition that directors must be “involved

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<sup>27</sup> Liability judgment at [13].

<sup>28</sup> Liability judgment at [16].

<sup>29</sup> Liability judgment at [15] and [17]. See also [22]: directors are to read financial statements to “ensure, as far as possible and reasonable, that the information included therein is accurate”.

<sup>30</sup> Liability judgment at [124] and [573].

<sup>31</sup> Liability judgment at [226]-[228] and [317].

<sup>32</sup> Liability judgment at [23].

in the management of the company” is not novel. It is a proposition that has been developed over many years, particularly in insolvent trading cases.

37. What is, perhaps, the more novel proposition is that, in order to fulfil their duty of being sufficiently involved, directors must very actively take stock of the knowledge made available to them over the course of the year, consider the basis upon which the figures in the accounts were prepared (for example, by individually reviewing the notes setting out the accounting policies) and consider for themselves whether those figures are questionable. Each director must do this even if others on the board (or indeed management or the auditors) are more qualified to do so. That result rested, not so much on a development of or change in the case law on the content of directors’ duties *per se*<sup>33</sup>, but on the interpretation and application of that body of case law to the facts of the case in the context of a particular construction of s 295(4) of the Act.
38. Section 295(1) provides that the financial report is to include, *inter alia*, “the directors’ declaration about the [financial] statements and notes”. Section 295(4) provides that the directors’ declaration is a declaration by the directors whether, *inter alia*, “in the directors’ opinion, the financial statement and notes are in accordance with this Act, including: (i) section 296 (compliance with accounting standards); and (ii) section 297 (true and fair view).” It is the directors who are required by s 295(4) to declare:
- (a) whether, in their opinion, the financial statements and notes are in accordance with the Act, including s 296 (compliance with accounting standards) and s 297 (true and fair view); and
  - (b) that they have been given the declarations required by s 295A.
39. Section 295(4) is the statutory lynchpin of the liability decision which defeated the argument propounded by the defendants that the accounts are those of the company and (putting it broadly) directors take all reasonable steps to ensure that the company complies with its obligations under s 296 and 297 (and also exercise due care and diligence) by ensuring that the company has good systems and procedures, putting in place a competent financial management team, responding to issues (or

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<sup>33</sup> Although that body of case law was rehearsed in orthodox fashion in the liability judgment.

“red flags”) when they arise<sup>34</sup>, appointing competent auditors and satisfying themselves that the auditors have received all necessary cooperation and information from management by means of a private part of the meeting without management being present.

40. The non-executive directors argued that they had expressed the opinion required by s 295(4) and they had done so relying upon the expert people and processes Centro had in place to ensure the production of accurate accounts. They argued that, if a mistake had been made, the directors were not liable unless they knew or should have known that that reliance was misplaced. On the facts of this case, that argument (which the Court accepted as a general proposition) did not succeed. We return to this topic below.
41. On one view of the case, it is henceforth necessary for all directors to have a degree of accounting literacy that requires a knowledge of accounting standards. Certainly, that is what ASIC alleged. For example, at paragraph 170 of its Amended Statement of Claim, ASIC relevantly alleged:

*“A reasonable director of a corporation in the circumstances of CPL and CPTM as described in paragraphs 45 to 104 who was a director with Mr Goldie’s responsibilities within those companies would have taken care and exercised diligence so that:*

*(a) they took any necessary steps to ensure that they had sufficient knowledge of conventional accounting practice to enable adequately to carry out their responsibilities, including the knowledge that:*

*(i) liabilities are conventionally classified in the balance sheets as either current or non-current;*

*(ii).current liabilities generally mean financial obligations which must be paid or satisfied within 12 months of the balance date;*

*(iii) significant events occurring after the balance sheet date must be disclosed in an annual financial report;*

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<sup>34</sup> An example of a red flag would be where the auditor expresses concern to the board regarding the competence of the financial management staff or an accounting treatment adopted by management which the auditor considers to be in breach of relevant accounting standards.

*(b) they took any necessary steps to ensure that they had sufficient knowledge of the requirements of Parts 2M.2 and 2M.3 of the Act, including sections 292, 295, 296, 297 and 298, to enable them to take all reasonable steps to comply with, or secure compliance with, those provisions...*<sup>35</sup>

42. However, it is important to note that this is not what the Court in fact decided. For example, the Court said:

*“Further, 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. All that is being alleged is that where the accounts on their face refer, as here, to classification of debt and post balance date events, the director adopting and approving the accounts should have a knowledge of and apply the basic elements of the one or two standards relevant to this proceeding.”*

43. Although this statement might be said to leave open the possibility that where the accounts on their face refer to other standards and the error is not picked up, all non-executive directors will be liable, it is important to emphasise that the Court regarded it as very important that the errors that occurred here were so obvious and of such a magnitude, and such significance, or potential significance to solvency, that in all of the circumstances it was negligent for the directors not to detect them.

44. Section 292 requires *the company* to prepare a financial report and the directors’ report. The requirements for the accounts are, inter alia, set out in ss 296 and 297. Prima facie, the obligations fall on the company rather than the directors per se. What, then, are the directors’ obligations in relation to whether the company meets or contravenes those provisions?

45. The imposition of the financial reporting requirements on the company is relevant because, in this context s 344 refers to taking all reasonable “to secure compliance with” Part 2M.3. This is to be contrasted with the situation where the obligation falls directly on a director, when the obligation is to take all reasonable steps “to comply with ... Part 2M.3”. Consistent with the statutory scheme imposing the relevant

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<sup>35</sup> The allegation was relevantly the same for all the directors. Section 296 of the Act requires the financial reports to comply with the accounting standards.

requirements on the company, s 344 anticipates that reasonable steps “to secure compliance” will be taken through the machinery of the company and its external advisers and consultants. The pairing of an obligation on the company to prepare the financial report and the directors’ report with an obligation on the part of directors to take reasonable steps to ensure the company complies with its obligations was introduced by the *Company Law Review Act 1998* (Cth). Prior to the 1998 amendments, the legislation imposed the primary obligation with respect to financial reporting on directors rather than the entity. Nevertheless, by using s 295(4) to elevate and personalise the directors’ responsibility for the substance of the financial report and directors’ report, the *Centro* decision substantially limits the extent to which directors can rely on the establishment of proper processes as constituting “reasonable steps”.

46. In the *Centro* case, it was because s 295(4) required that the directors make a declaration in the terms specified that the Court considered that a director must have an understanding of the classification of liabilities and disclosure of post balance date events and form a personal view as to the compliance of the accounts with the accounting standards and statutory criteria. That understanding was, the primary judge found, necessary in order for the directors to form the opinions required by s 295(4)(d).<sup>36</sup> The statutory requirement for that declaration is what, according to the Court, constitutes the statutory imposition of “ultimate responsibility” on directors “in a way that they cannot delegate”.<sup>37</sup>

### **C. Reliance on others – what role remains?**

47. It has long been recognised that the scale and nature of many modern companies effectively precludes the involvement of directors in the day to day affairs of management of the company. While directors are required to take reasonable steps to place themselves in a position to guide and monitor the management of the company, they are entitled to rely upon others, at least except where they know, or by the exercise of ordinary care should know, facts that would deny reliance.<sup>38</sup>

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<sup>36</sup> Liability judgment at [124].

<sup>37</sup> Liability judgment at [125]. See also [128].

<sup>38</sup> *Australian Securities and Investments Commission v Maxwell* (2009) 59 ACSR 373; [2006] NSWSC 1052 at [101]; *Re City Equitable Fire Insurance Co*; *Biala Pty Ltd v Mallina Holdings Ltd (No 2)* (1993) 13 WAR 11 at 81–2; 11 ACSR 785 at 856–8; *Daniels v Anderson* at NSWLR 502–4; FLR 308–10; ACSR 665–6; *Re Property Force Consultants Pty Ltd* [1997] 1 Qd R 300; (1995) 13 ACLC 1051 (QSC).

Without seeking to trace the judicial history in this somewhat fraught area, the position at the time of the Centro case was, as far as non-executive directors were concerned, captured by Gzell J's statement *Australian Securities and Investments Commission v Macdonald (No 11)* that:

“While Clarke and Sheller JJA in *Daniels* rejected the test propounded by Rogers CJ Comm Div for the limit of a director's entitlement to rely on management, they did recognise that the role of a non-executive director was to guide and monitor the management of the company rather than to be involved at an operational level.”<sup>39</sup>

48. The Centro decision casts doubt on the continued accuracy of statements which describe the role of non-executive directors in terms only of oversight, or guiding and monitoring, at least in the area of financial reporting. On one view, the Court, however, went further and required that directors not only form the view that the company's accounts comply with the accounting standards and present a true and fair view, but form that view by a personal evaluation of those matters, not by relying on the advice of the management accounting staff or the company's auditors. On this view of the decision, the Court has limited the capacity of directors to rely on the advice of those who might be expected to be more appropriately equipped - not only by their qualifications but also by their in-depth involvement in the preparation and auditing of the accounts - even though the legislation only requires that the directors form the specified opinion. In reality, people often form views on matters of great importance based on the advice of those they consider competent and expert in the matter at hand. The statutory recognition of the appropriateness of directors' reliance on advice is recognised repeatedly in the *Corporations Act*.

49. Section 344 requires that “all reasonable steps” be taken “to secure compliance” with, relevantly, Part 2M.3. On its face, by referring to the taking of “all reasonable steps”, in conjunction with the reference to “securing compliance” by another person (relevantly, the company) with obligations imposed on it, s 344 allows for a director to discharge his or her duties by methods that include reliance on others. Section 180 (which in the Centro decision was treated as being relevantly no different from s 344<sup>40</sup>) does not have the same kind of in-built statutory scope for reliance on others.

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<sup>39</sup> (2009) 71 ACSR 368; (2009) 230 FLR 1 at [255].

<sup>40</sup> Liability judgment at [185]-[189].

Nevertheless, and putting s 189 aside for the moment, exercising due care and skill does not necessarily preclude appropriate reliance on others.

50. While the Court of Appeal in *Daniels v Anderson* wound back the extent to which directors could rely on management, they nevertheless accepted that there was scope for reliance unless there is notice of mismanagement or where a matter for decision by the board poses an obvious risk.<sup>41</sup> Even so, the decision caused alarm and, as Dr Austin notes in tracing the trajectory of the case law on reliance, led to the enactment of ss 189 and 190 in 1999.<sup>42</sup> While providing statutory recognition and protection for reliance on others in the circumstances there set out, s189 is a confined section which may not offer directors much comfort. In particular, the requirement that the director have made an “independent assessment of the information or advice, having regard to the director’s knowledge of the corporation and the complexity of the structure and operations of the corporation”, raises as many questions as it answers. Nevertheless, s 189 still stands as statutory recognition that the directors of corporations, particularly large ones, necessarily rely on advice and information provided by others.<sup>43</sup> The insolvent trading provisions also provide for protection where a director relies on advice as to solvency. Section 588H(3) provides a defence where the director relies on a competent and reliable person responsible for providing information as to solvency. Interestingly, that statutory defence is not qualified by any requirement that the director have personally evaluated solvency by reference to his or her own knowledge.

51. In the *Centro* judgment, the Court was at pains to point out the ways in which the board may continue to rely on management and auditors. It was said that the directors were still entitled to “seek assistance in carrying out their responsibilities, and may rely on others”.<sup>44</sup> Similarly, the Court stated that, “while directors are required to take reasonable steps to place themselves in a position to guide and

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<sup>41</sup> (1995) 37 NSWLW 438 at 502.

<sup>42</sup> RP Austin, “Directors’ Duties after James Hardie and Centro” (draft presented August 2011).

<sup>43</sup> It should be noted that s 189 was of no direct assistance to the directors in this case for a number of reasons. For a start, the section was of no direct assistance to the allegations of breach of s 601FD as s 189 only applies for the purposes of Part [2D.1] (s 180 etc) and the general law. Secondly, the section requires a director to make an independent assessment of the information or advice, having regard, inter alia, to the director’s knowledge of the corporation. Here, the case of the directors was that they had relied on others, and by doing so had taken all reasonable steps to secure compliance and therefore had not contravened s 344, s 180 or s 601FD.

<sup>44</sup> Liability judgment at [129].

monitor the management of the company, they are entitled to rely upon others, at least except where they know [or should have known of] facts that would deny reliance".<sup>45</sup>

52. More specifically, having regard to the facts of the Centro case, the Court found that the non-executive directors reasonably expected that the accounts produced would comply with the new (AIFRS) accounting standards and that, if they did not, the auditors or the accounting staff would identify the error.<sup>46</sup> The Court also accepted that there were no "red flags" which ought to have alerted the board to any deficiencies in the processes or personnel of Centro or its auditors.<sup>47</sup> Notwithstanding the soothing statements regarding the continued place for reliance on others and the favourable findings referred to, all of the Centro directors were still liable.

53. Various of the findings made in the Centro liability judgment cast doubt on whether this reliance can extend to matters of substance, as compared with tasks such as preparation of the draft accounts for review. The Court found that, even where a director went through the financial statements "line by line" he did not take all reasonable steps if, in so doing, he was not considering for himself the statutory requirements and applying his knowledge of the company.<sup>48</sup> Further, it seems that all directors (including all non-executive directors) must review the accounts with a view to identifying errors.<sup>49</sup> With personal responsibility for the content of the financial reports (imposed, it was found, by the s 295(4) mechanism), personal attention to the task by all directors is necessary in order for the directors to make the declaration of opinion required by s 295(4)(d).<sup>50</sup>

54. It is in this way that the gravitational pull of the emerging management paradigm of directors' duties exerts itself. It is increasingly difficult to regard directors' duties as

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<sup>45</sup> Liability judgment at [167]. Middleton J went on to quote extensively from authorities regarding reliance in a due care and diligence context, which Middleton J essentially distinguished on the basis that what ASIC was contending for was not involvement at an operational level [174].

<sup>46</sup> Liability judgment at [384]. See also the penalty judgment at [48]-[52].

<sup>47</sup> Liability judgment at [384].

<sup>48</sup> Liability judgment at [581].

<sup>49</sup> Liability judgment at [22].

<sup>50</sup> See also [174]-[175].

being confined to guiding and monitoring,<sup>51</sup> and statements such as that in the United Kingdom's Combined Code on Corporate Governance (2003) set out below appear increasingly dated. In describing the role of directors, the Code (at [1.10], p 46) anticipates that it is only where there are "red flags" that the board's role changes from being one of high level guidance and monitoring to close engagement with the detail that is usually the concern of management:

"However, the high-level oversight function may lead to detailed work. The audit committee must intervene if there are signs that something may be seriously amiss. For example, if the audit committee is uneasy about the explanations of management and auditors about a particular financial reporting policy decision, there may be no alternative but to grapple with the detail and perhaps to seek independent advice."

55. The line between permissible and impermissible reliance was drawn, as regards the facts of the *Centro* case, at the preparation of the accounts. The Court found that, while tasks associated with the preparation of accounts could be delegated, in order for *all* reasonable steps to have been taken, the directors must read and understand the financial statements and consider them closely in light of their knowledge (actual or imputed) of the company's affairs.<sup>52</sup>

56. On one view, s 344 and s 601FD(1)(f) are intended to make clear that, in the "mechanical" area of financial reporting, directors are only liable if the steps they put in place to *secure compliance* with the Act are not reasonable. On this view, section 344 represents a carve out from the general duty in s 180 and qualifies that duty. Section 344 is implicit recognition that financial reporting is a complicated area, calling for reliance upon experts. In order to "secure compliance", directors do not have to personally perform the task; very often it will be pointless or inefficient for them to attempt to do so in such an area. This argument did not succeed in *Centro*, essentially because of the nature and significance of the undetected errors and the presence of note 1(w), which contained an accurate summary of the gist of the test

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<sup>51</sup> As to which see Spiegelman CJ in *Deputy Commissioner of Taxation v Clark* [2003] NSWCA 91 at [108]-[109].

<sup>52</sup> Liability judgment at [240]. Similarly, in connection with the s 295A letter, the primary judge proceeded on the basis that directors ought to read for themselves parts of the Act imposing obligations on them, this raises the prospect of directors similarly needing to review many other pieces of legislation imposing obligations or liability on them, such as occupational health and safety legislation and other legislation which may well vary from state to state. The Corporations and Markets Advisory Committee has identified over 650 pieces of legislation imposing liability on directors or officers: CAMAC *Personal Liability for Corporate Fault* (September 2006).

for classification of liabilities. As no party appealed the liability judgment, the point remains untested at appellate level.

57. The apparent intention of Parliament to recognise the need for reliance on experts in relation to financial reporting is reflected in the 2007 Treasury report: *Review of Sanctions for Breaches of Corporate Law*. In discussing the possible introduction of a general defence for directors, the report stated:

“Application of a general defence

3.9 Submissions to the CFSR review in support of the introduction of a general defence emphasised the beneficial effect that a general protection would have on corporate decision making, by reducing the risk of liability where business decisions are made by directors that meet the proposed general criteria. These submissions suggest that such a reform has the potential to improve the balance between deterring wrongdoing and ensuring that directors are not unduly constrained in acting in the best interests of the company.

3.10 Generally, the submissions in support of the general defence focussed on its application to the ‘core’ duties in relation to good faith, care and diligence, use of position and use of information in sections 180-183 of the Corporations Act, and the duty to avoid insolvent trading in section 588G. These ‘core’ duties govern a broad range of conduct by company officers, and may raise questions of potential liability under a variety of fact scenarios.

**3.11 The submissions in support of the general defence did not canvass its extension to those directors’ duties that are more ‘mechanical’ in nature. For example, the financial reporting obligations, where the scope of the duty is more narrow and the requirements to avoid liability are relatively clear, are less likely to give rise to the types of concern identified about compliance with the ‘core’ duties.”**  
(Emphasis added)

58. The responsibility given to directors and the requirement for close personal engagement effected by the Centro decision introduces a distinct point of difference between the Australian law of directors’ duties and that of the United Kingdom. A director in the United Kingdom will only be liable under s 414(4) of the *Companies Act 2006* if he or she fails “to take reasonable steps to secure compliance” with the requirements of the Act having knowledge that the accounts did not comply with the Act or being reckless as to that fact”.<sup>53</sup> For Australian directors, not having

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<sup>53</sup> Similarly, in the US, s 141(e) of the Delaware General Corporation Law, a director who relies in good faith on the advice of any reasonably carefully selected advisor as to matters in that advisor’s area of expertise gains a large measure of protection from breach of fiduciary duty. These matters, and the Centro liability judgment, are discussed in a note published by the Harvard Law School Forum

knowledge of any errors and not being reckless as to accounting errors will not be enough.

59. Another illustration of the difficulty of the diminishing scope for reliance arising out of the Centro decision is the Court's approach to s 295A. The Court found that the management representation letter did not comply with the requirements of s 295A of the Act and that the non-executive directors contravened s 344 and s 180 because they failed to read the management representation letter and ensure that it complied with the requirements of s 295A.<sup>54</sup> The judge said:

"The approach I take may come close to placing a burden on each director akin to each director having not only to take reasonable steps to secure compliance with the Act, but actually complying with the Act. If this is the practical result, it arises out of the nature of the requirements in s 295A and 295(4), and the operation of s 344(1). I do not regard this obligation as onerous."

60. This finding was made even though the Court found that the non-executive directors were "entitled to place trust in PwC, Moore Stephens (another auditor), the CFO, Mr Hutchinson (Chief Legal Counsel), Mr Belcher (senior accounting staff) and Ms Hourigan (company secretary and solicitor) to ensure that the management representation letter provided to them complied with s 295A of the Act."<sup>55</sup> A reasonable expectation that others will deliver accounts that comply with accounting standards or will provide management representation letters that comply with the legislation will not be enough. Independent scrutiny and independent effort, even to the extent of acquiring a first-hand familiarity with the *Corporations Act*, is the now the requisite minimum.

61. Similarly, a first-hand enquiry into accounting standards may be necessary so as to have the necessary "financial literacy" to identify errors. In this area, directors have no clear guidance from the Centro decision. The Court rejected the submission that ASIC's case required that directors have a working knowledge of *all* accounting standards on the basis that ASIC's case required only a "routine knowledge of and basic application of the test for classification of liabilities" and not a working

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on Corporate Governance and Financial Regulation: Katz "For Directors, A Wake-Up Call from Down Under".

<sup>54</sup> Liability judgment at [522].

<sup>55</sup> Liability judgment at [519] and penalty judgment at [64].

knowledge of all accounting standards, or even AASB 101 and AASB 110.<sup>56</sup>

Importantly, the Court also found that the question of whether directors should have a degree of accounting literacy that requires a knowledge of accounting practice and accounting standards was not for decision in the proceeding.<sup>57</sup>

62. In the *Centro* case, the existence and accuracy of note 1(w) provided a ready means to avoid what might otherwise be the full implications of a decision that the directors in that case were required to have a sufficient personal knowledge of the accounting standards to identify the relevant errors. As noted above, note 1(w) recorded the essential characteristics of AASB 101 which, on the facts of that case, were sufficient to allow a person familiar with the debt profile of the relevant companies to identify that debt had been misclassified. As the Court found, “no director needed to be apprised of the changes made in the standards<sup>[58]</sup>; he just needed to understand and apply the standard applicable in 2007, which on its terms was straightforward. ... All that the directors, including Mr Scott, had to know was clearly stated in note 1(w), which they either read or should have read and understood.”<sup>59</sup> In another case, the relevant figures may be inaccurate, but for reasons which depend on a more detailed understanding of the accounting standards than that which can be gleaned from reviewing a note to the accounts. The Court in *Centro* did not need to, and did not seek to, provide any guidance as to the requirements of directors in such a case.

63. The role of note 1(w) in the *Centro* case may explain why such a radically different result was reached in the *Centro* case, as compared with the *Feltex* case in New Zealand, which bore a striking similarity to the facts before the Federal Court in *Centro*. *Ministry of Economic Development v Feeney & Ors*<sup>60</sup> (**Feltex**) concerned analogous provisions to s 344. The defendants were the directors of *Feltex Carpets Limited*. It was alleged that the financial statements of the company failed to comply with applicable accounting standards and that the directors had failed to prove that they took all reasonable and proper steps to ensure that the applicable requirement of the applicable standards would be complied with. The first charge related to a

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<sup>56</sup> Liability judgment at [288].

<sup>57</sup> Liability judgment at [208]. Although it should be noted that ASIC did plead and open (but not close) such a case.

<sup>58</sup> Referring to the changes from the old AGAAP standard and the new AIFRS standard.

<sup>59</sup> Liability judgment at [389].

<sup>60</sup> (District Court of New Zealand, Auckland CRI-2008-044-29199, 2 August 2010).

failure to disclose breaches of certain financial covenants contained in an ANZ Bank facility agreement. The other concerned a failure to classify the ANZ liability as a current liability. In 2005, New Zealand was also in a transition period from its previous accounting standards (GAAP) to the adoption of the New Zealand equivalent of International Financial Reporting Standards (NZIFRS).<sup>61</sup>

64. In seeking to demonstrate that they took all reasonable and proper steps to ensure that the accounting standards would be complied with, the directors relied on the fact that they had a competent, well-resourced financial management team, had put in place a comprehensive transition process to manage the change from the GAAP to IFRS standards and had engaged Ernst & Young to review the relevant accounts.<sup>62</sup> The regulator, on the other hand, submitted that the directors should have themselves engaged in a study of the accounting standards, of the way in which they applied to Feltex and the financial statements and of whether in their own individual judgments, the financial statement complied.<sup>63</sup> The Court in Feltex concluded that the directors did take appropriate steps to obtain advice upon which they relied, as they were entitled to do. The Court, referring to the complexity of the IFRS standards, their assumption of an in-depth knowledge of accounting principles and the specialised expertise usually held by those called on to apply those standards, described the regulator's contention that the directors should have engaged in the verification exercise personally as an utterly unrealistic proposition.<sup>64</sup>

65. As noted above, in the Centro case, it was the presence of note 1(w) which meant that ASIC's case did not depend on directors acquiring the kind of specialist expertise and combing the standards in the way that led the Court in Feltex to the opposite conclusion. On the other hand, it might be observed that in order to reach that conclusion, it was necessary to conclude that **all** of the directors (whether on the audit committee or not) had an obligation to engage with the accounts and read all of the notes to them.

66. Notwithstanding the outcome in the Centro case, in our opinion the extent of the permissible reliance on experts (internal and external) in the financial reporting area

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<sup>61</sup> At [60].

<sup>62</sup> At [77].

<sup>63</sup> At [141].

<sup>64</sup> At [143].

will be assessed by the Court on a case by case basis and will vary with the perceived complexity of the accounting issue, although such uncertainty and variability makes it harder for non-executive directors (and their legal advisers) to know where they stand.

67. It is important to recognise that the accounting issues in question in the Centro case were found by the Court to be straightforward and the errors “obvious”<sup>65</sup>. However, the statutory construction of s 295(4)(d) adopted by the Court in Centro (and the consequences that construction holds for provisions which, on their face, provide for reliance on others) suggests that it would be unwise to be too complacent regarding the capacity of the board to rely on others in different situations. On the contrary, the Court’s logic suggests the need for personal evaluation across the spectrum of issues and tasks before the board, at least whenever legislation calls for the expression by the board of an opinion or otherwise suggests that board members should be personally involved in the detail of the issue. While the Court repeatedly noted in the liability judgment that the case brought, and the judgment delivered, was confined to the facts of that case, only hindsight (which may be acquired through the painful experience of impugned directors) will serve to identify which other accounting issues a Court may regard as sufficiently straightforward to require personal evaluation by each director.

#### **D. Are directors’ duties uniform? The audit committee and executive directors**

68. Before the Centro case, conventional wisdom had it that members of a company’s audit committee were necessarily more exposed in relation to matters relating to the company accounts than directors who were not members of the audit committee. In describing the role of the board, guidance such as that issued by the ASX in its *Corporate Governance Principles*, uses terms such as “oversee” and “monitor” and refers to tasks such as ensuring that that senior executives have appropriate resources and providing input into strategy. The Australian Institute of Company Directors’ booklet, “How to Review a Company’s Financial Reports – a guide for boards”, emphasises in the Introduction that “directors need to remember they are not expected to be experts in financial reporting requirements”. The general responsibility of a director is described in terms of being satisfied that the accounting

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<sup>65</sup> Liability judgment at [569].

systems are adequate, appropriate expertise is applied and expert advice is obtained, where appropriate. It is in this way that directors are said to be able to have the necessary confidence in the integrity of the information being received from management. The focus of that guidance is on systems, not personal scrutiny of accounts.

69. By way of contrast, guidance issued, for example by the big accounting firms and the Australian Institute of Company Directors<sup>66</sup>, regarding the role of audit committees focus more closely on financial reporting. Even so, the AICD guidance on the role of audit committees, still describes the role of the audit committee as one of monitoring and oversight.
70. Likewise, conventional wisdom would have had it that, as executive directors are deeply engaged in the day to day affairs of the company by virtue of their managerial role, the nature and level of their responsibility is different. They, unlike part-time non-executive directors, will have a more in-depth knowledge of the operations of the company, and the details contained in and supporting the accounts. They, unlike non-executive directors who rely on reports from management, have a much better vantage point from which to identify issues emerging in the company. While the penalty judgment drew a limited distinction between the CEO's level of responsibility and that of the non-executive directors, imposing a pecuniary penalty of \$30,000 in addition to a declaration, the distinction was certainly not marked. The additional penalty was imposed on the CEO as a necessary general deterrent.<sup>67</sup> ASIC's case did not distinguish between the non-executive directors and Mr Scott.
71. In the Centro case, the Court imposed the same penalty (namely declarations of contravention) on all of the non-executive directors. Although ASIC brought its case on liability on the basis that all of the directors bore and had failed in respect of the same duty, it submitted, somewhat faintly, that a distinction could be drawn when it came to penalty on the basis that their differing roles may have a bearing on how far short of the mark each of them fell.<sup>68</sup> Similarly, in relation to the CEO, ASIC submitted that his role as a highly paid executive responsible to the board for the

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<sup>66</sup> AICD "Audit Committees: A Guide to Good Practice" (2008).

<sup>67</sup> Penalty judgment at [102].

<sup>68</sup> Penalty judgment at [156].

performance of management ought to result in a higher penalty.<sup>69</sup> While the Court accepted that a distinction ought to be drawn between the non-executive directors and the executive director and CEO<sup>70</sup>, no distinction was drawn between the non-executive directors based either on their backgrounds or on their membership of the audit committee because “in this proceeding, ASIC focussed on treating the non-executive directors as all having the same care and responsibility. Whilst pleading each individual non-executive director’s responsibilities and background, the proceeding was in essence one involving the board as a whole having the same responsibility with respect to the financial statements.”<sup>71</sup>

72. The uniformity of application of the *Centro* case to all directors, whatever their background, role on the board or within management, raises real questions about the extent to which those who serve on the executive or the audit committee bear, or should bear, a higher degree of responsibility. While the Court, in deciding the case, did not emphasise those distinctions (because ASIC’s case did not so distinguish), it is important to note that (as the Court expressly recognised in the penalty judgment<sup>72</sup>), the case was brought by ASIC on the basis that all of the directors, whether on the executive or not, and whether members of the audit committee or not, relevantly bore the same responsibility. In this area again, the *Centro* case raises questions, but has left unresolved issues as to the ongoing role of the audit committee in the approval of accounts and the connection between the audit committee and the board as a whole. By virtue of the statutory mechanism upon which the decision hinges (s 295(4)(d)) the construction of that section and ss 344 and 180 adopted by the Court, and the way ASIC pleaded its case, those issues did not need to be addressed by the Court. While the answers will emerge in time, at the very least, board members should be very cautious about making resolutions based on the faith of a recommendation from the audit committee.

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<sup>69</sup> Penalty judgment at [157]-[158].

<sup>70</sup> Penalty judgment at [212]-[213].

<sup>71</sup> Penalty judgment at [193].

<sup>72</sup> Penalty judgment at [193].

## E. Conclusion

73. In considering the ongoing significance of the Centro decision and the extent to which directors, particularly non-executive directors, will be expected to detect errors in the accounts, it should be noted that the case involved a rare combination of circumstances.
74. Interest bearing debt is, for any company, an item of major concern, not least because the comparison between current debt and current assets is at least the starting point for an analysis of the solvency of the business. For some investors, it may also be the end of the analysis. However, for a corporate group which has, as the Centro group did, expanded rapidly and on a massive scale using short term debt, the currency of debt and plans to manage the refinancing of debt are of even greater significance. Shortly after Centro's erroneous accounts were issued, the first signs of the forthcoming GFC emerged and started to have a material impact on the financial markets. Suddenly, the ease with which Centro's management had previously rolled over debt was a thing of the past and a real crisis emerged in December 2007. While the Centro Group survived and the debt was refinanced, the share prices collapsed.
75. The board were let down by the processes Centro had in place to ensure accurate accounts were produced.<sup>73</sup> That, of itself, is alarming enough, but what is painfully striking when the facts are reviewed is just how close the classification errors came to being uncovered and corrected before the final accounts were released. Accounting staff at Centro intended to, but somehow failed to, advise the board that the CNP Appendix 4E accounts contained a classification error. If the known error in the Appendix 4E had been drawn to the board's attention, the accounts would not have appeared before there was a thorough investigation<sup>74</sup> and the errors would likely have been detected and remedied.
76. It may be that such a potent combination of circumstances will not arise again for many years to come. Nevertheless, while the combination of those circumstances may explain why the Centro Group was investigated and the proceedings brought, the Federal Court's decision adopts a very deliberate and considered statutory

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<sup>73</sup> Penalty judgment at paras [43]-[56], [159], [175] and [179].

<sup>74</sup> Penalty judgment at para [176].

construction of the relevant provisions which does seem to require more of directors than was previously understood to be the case, in requiring all directors to engage with the detail of the accounts and not rely on other apparently competent people to perform that task. The central proposition of the *Centro* case is that s 295(4)(d) requires that all directors of all companies read, understand and focus upon the contents of financial statements. As we have explored above, on the facts of the *Centro* case (where the necessary information as to debt and a summary of the accounting standard were before the board in a comprehensible form), the permissible scope for reliance did not extend much beyond the discharge of mechanical tasks. In other cases, the issues may well be substantially more complex. Even so, and while the debate on reliance certainly will continue to occur, the *Centro* decision sounds a caution against regarding accounting as a specialised field, the discharge of which can be wholly delegated to competent experts. One thing that can be said with some certainty is that, notwithstanding s 344, it is not enough for directors to ensure that appropriate systems and expertise are in place.

77. The upside of the *Centro* case ought not be overlooked. The decision unquestionably arms non-executive directors with a strong basis upon which to make demands of management. Those demands may relate, for example, to the form and nature of management's reports to the board. Non-executive directors may also be emboldened in the questions they ask of management, including CEOs who may have a strong business agenda to pursue and be pressing the board for approval.

78. Finally, leaving the detail of statutory provisions and accounting standards behind and taking the wider view, the *Centro* case constitutes a further step in the evolution of directors' duties and one that has been taken in the direction of imposing on directors a degree of managerial responsibility. As the Court concluded in *Centro*, "A director is an essential component of corporate governance. Each director is placed at the apex of the structure of direction and management of a company. The higher the office that is held by a person, the greater the responsibility that falls upon him or her."<sup>75</sup> For a director, sitting at the "apex" of management is quite a different proposition from being engaged in "guiding and monitoring" the affairs of the company.

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<sup>75</sup> Liability judgment at [14].