



# Roles of Directors and Officers Beyond *James Hardie* and *Centro* – Where to from Here?:

(1) What has Really Changed for Boards and Advisers?

(2) The Reform Agenda and Prospects

By

Professor Bryan Horrigan BA, LLB (Qld), DPhil (Oxon)

Louis Waller Chair and Associate Dean (Research), Monash Law Faculty

Expert panel member for the Australian Government's inquiry into unconscionable business conduct and the Franchising Code of Conduct, 2009-10

Author, *Corporate Social Responsibility in the 21<sup>st</sup> Century: Debates, Models and Practices Across Government, Law and Business* (Edward Elgar, 2010)

# Bottom Lines

- *Bell Group, James Hardie, Centro, and Fortescue* cases are symptomatic of mindsets and fissures in the Corporations Act on corporate governance and responsibility that lie increasingly exposed
- There are several short-term practical fixes and even ‘light touch’ reforms for the immediate problems posed by such cases
- The long-term problems are structurally embedded in Corporations Act provisions and how courts (eg in *Centro* and *Fortescue*) make choices in interpreting/applying them
- So, the symptoms in the current round of cases are manageable, but the underlying structural causes and precedential sediment will produce more symptoms until the underlying systemic causes are addressed by proper regulatory reform
- At this stage, any reform agenda focused just on reducing board liability and expanding board protection risks being perceived by too many governmental and community stakeholders as too poorly demonstrated by evidence, too sectional in who it benefits, and too narrow in scope to address the Corporations Act’s structural weaknesses
- Changing the political appetite for further reform requires one or more of:
  - Independent comparative/empirical assessments of current problems and better alternatives
  - Bipartisan political support during ‘hung parliament’ conditions
  - United union, business, and legal profession support for reform
  - Consensus on ‘light touch’ reforms and their separation from broader issues concerning boardroom liability and protection
  - Coordinated reform agenda-setting both within and beyond government

# Corporations Act – A Framework Under Stress of Emerging Fault Lines

- Tension between old and new conceptions of corporate governance, responsibility, and sustainability
- Tension between community/regulator/judicial expectations of boards and business realities for boards (AICD 2010-2011, Baxt 2011, Austin 2011)
- Tension between oversight/management conceptions of board:
  - Internal contradictions in the CA (eg Austin, 2011)
  - Emerging knock-on effects of cascading liability/defence provisions in *Centro* and *Fortescue*
- Tension between ‘shareholder value’ and ‘enterprise value’ conception of corporations and duties owed to them
  - How the CA handles balances of shareholder, creditor, and other stakeholder interests in various contexts
- Tension between capital, labour, and other public policy interests, and their resultant compromises in the CA over time
- Tension between Australian model and other comparative models on key issues:
  - Directors’ duties/defences/safeguards
  - Corporate workouts/recovery in the solvency-insolvency zone
  - Board reliance on management/advice and correlative impact on legislated board responsibilities
  - Matching corporate regulatory regimes to post-GFC economic recovery needs for common benefit of financial, human, and social capital

# Is There a Problem?

- **Regulatory community dissonance:**
  - Judicial v regulator v investor v business v community expectations of boards/management
  - Gap between legal/practical change after *Centro*?
- **Vertical fragmentation of liability/protection:**
  - Proliferation/fragmentation of duties v defences/safeguards/relief
  - No board thinks/decides the way the body of Cth/State law on boardroom liability is constructed
- **Horizontal fragmentation of liability/protection:**
  - ‘piggy-backing’ of directorial liability because of other contraventions (see *Hardie*, *Centro*, and *Fortescue*)
  - Emerging relational blurriness between cascading liabilities and correlative defences:
    - Scope of BJR and the ‘characterisation’ of a ‘business decision’? (see *Fortescue*)
    - Level of BJR preclusion by other operative defences? (see *Fortescue*)
    - Level of BJR co-extension with other operative defences? (see *Centro*)
- **Gap between law and best thinking/practice:**
  - Does **Centro** raise the bar on accounts sign-off and is its aftermath an overreaction or not?
  - Corporate governance thinking on boards now outstrips what’s embedded in Corporations Act (see Austin 2011, Baxt 2011, and Horrigan 2010 on different aspects of this key issue)

# BJR Under Stress

- Push for broadening BJR politically rebuffed for now, and differing expert legal views anyway
- Unsuccessful track record for BJR in major litigation (including *Hardie*, *Centro*, and *Fortescue*)
- Emerging 'piggy-backing' issues involving BJR (eg *Hardie*, *Centro*, and *Fortescue*)
- Latest limits in *Fortescue*:
  - '(T)he decision not to disclose the true effect of the agreements cannot be described as "business judgments" at all. A decision not to make accurate disclosure of the terms of a major contract is not a decision related to the "business operations" of the corporation. Rather it is a decision related to compliance with the requirements of the Act ... A separate but related answer to Forrest's attempt to rely upon the business judgment rule is that s 180(2) cannot be construed as affording a ground of exculpation for a breach of s 180(1) where the director's want of diligence results in a contravention of another provision of the Act **and** where that other provision contains specific exculpatory provisions enacted for the benefit of the director.'
  - Evidences systemic problem of horizontal integration (eg 'piggy-backing')
  - Proper reach of continuous disclosure obligation is a legal policy question
  - 'Characterisation' question about the 'business decision'
  - Legislature/regulators can't have their cake and eat it too on cascading effect of contraventions and applicable defences

# Impetus for Reform in Expert Commentary I

- ‘The business judgment rule arguably offers *nothing but window dressing* [and] it is somewhat difficult to conceive of a situation in which a director makes a good faith, rational decision for a proper purpose and yet breaches section 180(1).’ (Neil Young QC 2008; emphasis added)
- ‘There now seems to be a general perception at public company board level that **Centro has increased the expectations of directors** with respect to their financial literacy and their diligence in approving financial statements. So, from a practical perspective, it is perhaps irrelevant that ... the case is one that is likely to be confined to its facts [because of the errors characterised by ASIC and the court].’ (Webster 2011; emphasis added)

# Impetus for Reform in Expert Commentary II

- ‘In the Centro case, Middleton J addressed the law concerning the need for financial competence on the part of the directors before him, and expressed his conclusions in a way that, in my view, ***clearly raises the bar for listed public company directors*** ... (T)he *Bell Group* and *Centro* cases show that ***the courts have not yet fully adjusted to the new perception of the board’s function*** ... The better approach would be to adopt, preferably by legislation, a binding definition of the board’s role in connection with corporate management, to give effect to the perception that the proper role of boards is essentially oversight, guiding and monitoring, rather than operational management.’ (Dr RP Austin, formerly Justice Austin, 2011; emphasis added)

# Impetus for Reform in Expert Commentary III

- ‘Federal Court judge John Middleton has raised more questions than he has answered by rejecting ASIC pleas for penalties to be handed down against the Centro non-executive directors ... This ending is imperfect and the crystal-clear message left by the original judgment is left somewhat clouded.’  
(John Durie, *The Australian*, 01.09.11)

# Impetus for Reform in Expert Commentary IV

- ‘I have argued for some time that the pressures that are placed on directors by virtue of sweeping legislative provisions such as s 1324 of the Act, together with the growth in litigation funding/class actions, places a further potential constraint on the willingness of directors to be entrepreneurial and to take risks. ***The time has come for CAMAC to be asked to review our current legislative framework dealing with directors’ duties.*** We also need to consider balancing ***the growing strains that are being imposed on directors*** as a result of expanding community expectations that directors will take into account a range of interests in carrying out their duties, with the need to ensure that where appropriate litigation by ASIC and third parties will be necessary to test the performance of company directors.’ (Prof Bob Baxt 2011; emphasis added)

# Obstacles to Reform

- Reform needed, but:
  - Corporations Act currently structured so that a core set of final/mandated board judgments (eg 'true and fair view') cannot be delegated to others (board as 'final gatekeeper') for reliance/advice
  - Necessary reform areas extend beyond directors' duties/defences/safeguards
  - *Hardie, Centro, and Fortescue* cases offer limited impetus for reform
  - Divided expert views (eg Austin/Baxt v Young on BJR)
- Limited political appetite for reform:
  - Previous CSR reforms rebuffed
  - Latest BJR reform push apparently rebuffed
  - Any significant corporate law reform requires bipartisan or multi-party/independent support in a hung parliament

# Is Law Reform Necessary and Achievable?

- Shifts in political appetite for reforming directors' duties/defences and otherwise reducing boardroom regulatory burden:
  - Treasury reviews of corporate law sanctions and insolvency defences
  - COAG agreements
  - Awaiting appeal outcomes in *James Hardie*, *Fortescue*, and *Centro* = path of least political resistance
- Multiple issues, all with differences but also connections:
  - Better alignment of different regulatory community expectations of, and guidance for, directors
  - Better legal synchronisation of directors' duties, defences, and other safeguards (eg reliance/delegation) in light of *Hardie*, *Centro*, and *Fortescue*
  - Broadening the BJR (eg insolvent trading)
  - Inducing greater social responsibility of boards under revitalised CSR agenda
  - Clarifying board-management reliance and liability
  - Reducing regulatory burden on directors under multiple Cth/State/territory laws
  - Broadening the BJR (eg insolvent trading)
  - Improving balance of risk for directors in work-out/recovery/liquidation contexts
  - Relating creditor interests to corporate duties after *Bell Group*

# Knock-On Effects of Reforming Directors' Duties/Defences and Underlying Corporate Governance Rationale

- Section 79: aiding/abetting/involvement in contraventions
- Sections 128-129: assumptions of outsiders (eg financiers/creditors) about compliance with duties
- Sections 134-136: internal management, replaceable rules, and corporate constitutions
- Sections 180, 181, and 187: core board duties of care/loyalty and correlative defences (see *Hardie, Centro*, and *Fortescue*)
- Sections 189 and 190: additional safeguards of reliance and delegation
- Sections 236-237: preconditions for shareholder derivative actions
- Sections 239 and 260E: limits on shareholder approval/ratification (also see general law preconditions and limits (eg *Spies v R* [2000] HCA 43, but note opportunity signalled in *Angas Law Services v Carabelas* [2005]HCA 23)
- Sections 295 and 344: interaction of directors' duties/defences and board reporting obligations (see *Centro*)
- Sections 588G and 588H: directors' duties/defences and insolvent trading
- Section 601FD: duties of responsible entity
- Section 674: interaction of directors' duties and continuous disclosure (see *Fortescue*)
- Sections 1041E and 1041H: interaction of directors' duties and misleading/deceptive market conduct (see *Fortescue*)
- Sections 1317S and 1318: relief from liability for breach of duties
- Section 1324: ASIC/stakeholder intervention for actual/prospective contraventions
- Equivalent provisions on directors' duties and defences:
  - Commonwealth authorities and companies under the CAC Act
  - State/Territory GBEs

# Middleton J – Critical Comment (1)

- ‘A director is an essential component of corporate governance. Each director is placed *at the apex* of the structure of discretion 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. The role of a director is significant as their actions may have *a profound impact on the community*, and not just shareholders, employees and creditors.’

# Middleton J – Critical Comment (2)

- ‘Directors cannot substitute *reliance upon the advice of management* for their own attention and examination of an important matter that falls specifically within the Board’s responsibilities as with the reporting obligations. The Act places upon the Board and each director the specific task of approving the financial statements. Consequently, each member of the board was charged with the responsibility of attending to and focusing on these accounts and, under these circumstances, could not delegate or “abdicate” that responsibility to others ... (H)ere the directors, in some cases on their own admission, clearly looked *solely* to management and external advisers. If they had acted ... as the *final filter*, taking care to read and understand the financial accounts, the errors may have been discovered earlier than they were.’

# Middleton J – Critical Comment (3)

- ‘(I)t 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 ... (A)ll that was required of directors in this proceeding was the financial literacy to understand basic accounting conventions and proper diligence in reading the financial statements.’
- Q: Application to more complex accounting standards and directorial judgments? (see Webster 2011; and cf NZ *Centro*-equivalent decision in *Feltex*)

# Middleton J – Critical Comment (4)

- ‘The general duty under s 180(1) must (in respect of directors’ duties concerning financial statements) be read consistently and harmoniously with the specific requirements of s 344 and with the specific requirements of any other provision in the Act.’
- Didn’t need to decide exact interplay between ss 180(1) and 344 because ...
- ... the failure to raise relevant matters or make relevant queries equates to a failure to take reasonable steps
- Evidences systemic problem of horizontal integration (eg ‘piggy-backing’)

# Middleton J – Critical Comment (5)

- ‘I consider that the published materials on matters of corporate governance, in particular those referring to the role of directors in the review of financial statements, are of some assistance in determining the obligations to be imposed on directors.’
- Follows precedent on this (ie *ASIC v Rich*)
- What ASIC/ASX CGC/AICD publish matters ...
- ... especially when no expert evidence called on standards expected of non-executive directors

# Practical/Behavioural Impact I

- Reality-checks after *Hardie* and *Centro*:
  - Basic steps in *Hardie* (eg ‘plain english’ understanding of ‘fully funded’ claim) and *Centro* (eg basic level of financial literacy to understand solvency implications and what the notes say about applicable accounting standards, read accounts/notes with an enquiring mind), and don’t just rely on others)
  - Ensure all directors in person/teleconferencing have all important documents and adequate opportunity to digest them
- Heightened board, management, and adviser due diligence on ‘bet the company’ decisions and legislated board responsibilities:
  - Current reporting season impact of *Centro* (eg more board time and attention, rethink on how board packs presented, mechanisms for alerting board etc – elevating best practice v unnecessary time/cost)
  - Potential extension of *Centro* principle to other public disclosure contexts (eg (a) prospectus/continuous disclosure (see *Fortescue*); (b) statements and other documents in takeovers/schemes; and (c) management resort to board approval (see *Hardie*): see various law firm client alerts 2011)

# Practical/Behavioural Impact II

- Enhanced mechanisms for ‘raising flags’:
  - Interactions between NEDs, audit committee, and external advisers
  - Attendance/interrogation of adviser/author
  - Assigned/rotated ‘Devil’s Advocate’ role (avoid ‘groupthink’)
  - Standard trigger or drill-down questions for board as ‘final filter’ (in *Centro*’s terms):
    - Eg any material accounting standard changes?; any errors detected in preliminary report? (see Austin/Reynolds 2011); any major assumptions/qualifications/notes that should be flagged?; what’s the investor/market impact of this announcement? etc

# Practical/Behavioural Impact III

- Improve standard-setting beyond laws and to inform future legal development through cases in the absence of meaningful reform:
  - Rethink scope/level of authoritative ASX/ASX CGC/ASIC/AICD guidance in setting standards of conduct (eg prudential guidance/monitoring v operational management)
  - Support high-level independent comparative/empirical research and authoring of authoritative ‘model law’
  - Litigate to push the boundaries of relief provisions post-*Centro* (although maybe too little, too late)
  - Consider practical safeguards of amending corporate constitutions on board/management roles (see Austin judicially and extra-judicially on this) and shareholder resolutions (but both have their limits)
  - Push for ‘light touch’ reform measures, eg:
    - clarifying interactions between multiple contravention/defence provisions;
    - tweaking reliance/delegation safeguards; and
    - introducing legislated principles of interpretation (Horrigan) or other legislative clarification of board/management delineation (Austin), to condition judicial interpretation/applications of contravention/defence/safeguard/relief provisions