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Director's Duties – recent developments

Introduction

The area of law concerning director's duties has in the last few years seen a lot of high profile cases through the courts. Most of the recent litigation in this area has been undertaken by the Australian Securities and Investment Commission (ASIC) against large corporations and their board of directors including Rodney Adler of HIH Insurance, Jodee Rich and Andrew Silberman of One. Tel, Peter MacDonald of James Hardie Industries, former AWB managing director Andrew Lindberg, James Forrest of Fortescue Metals and most recently criminal charges against Opes Prime managing director Laurie Emini. These recent cases assist in fleshing out the legislation and its application to commercial businesses and help define what these common law and legislative duties mean for individual directors.

Co-operatives Act duties

The relevant piece of legislation that applies to the duties of directors of a co-operative in NSW is the *Co-operatives Act* 1992. The key provisions in the Act are set out in Division 2 and Division 4.

Officers

Beginning with Division 2, section 220 states that the application of the provisions regarding director's duties applies to all "officers" of a co-operative. Under the Act,

an officer in relation to a co-operative means a director or secretary of the co-operative or a person who is concerned, or takes part, in the management of the co-operative, whether or not as a director. Any person acting in these positions in the co-operative could be liable under any of the director's duties provisions.

Duty of Good Faith

Section 221 is the duty of good faith which states that an officer must act honestly in the exercise of his or her powers and the discharge of his or her duties.

Duty of care and diligence

Section 222 is the duty of care and diligence and states that an officer must, in the exercise of his or her duties, exercise the degree of care and diligence that a reasonable person in a like position in a co-operative would exercise in the co-operative's circumstances.

Duty not to Misuse Position

Section 223 is the duty not to misuse information or position and states that an officer must not make improper use of information acquired as an officer or to make improper use of the position of an officer to gain a personal advantage or an advantage for someone else or to cause detriment to the co-operative.

Duty to avoid Conflicts of Interest

This duty is in Division 4 which relates only to directors, not officers. Section 234 is the duty to avoid conflicts of interest and states that where a director of a co-operative who is or becomes in any way interested in a contract that the co-operative has or may be entering, this interest must be disclosed to the board.

Comparing Duties of Company directors

For companies, as opposed to co-operatives the applicable legislation is the Commonwealth *Corporations Act* 2001. The *Co-operatives Act* director's duty obligations are similar to those imposed by the *Corporations Act* on company directors. However, the *Corporations Act* provisions are somewhat more refined and sophisticated. A large part of the reason for this is that the statutory duties in the *Co-operatives Act* were drafted almost twenty years ago and they were based on the then applicable corporations legislation. Corporations legislation however has moved on from where it was twenty years ago. Unfortunately, co-operatives legislation has not.

One prime illustration of this is in relation to the duty of care and diligence. Under the Corporations Act, where directors are accused of not exercising sufficient care or diligence, they have available to the so-called "business judgement" defence. This essentially says that actions that may otherwise be taken to be a breach of duty will be legitimate if they were the result of a business judgement in good faith. This recognises that business is inherently risky and directors will from time to time have to make decisions that entail risk. Regrettably, the business judgement defence is not available for directors of co-operatives, since the Co-operatives Act does not incorporate it.

Despite the fact that the *Co-operatives Act* is in a twenty year old "time warp" as far as director's duties are concerned, the core concepts between those duties and the duties in the *Corporations Act* are broadly similar. As such, directors of co-operatives can gain guidance as to their obligations from cases against company directors.

There have been a number of recent decisions dealing with the ambit of director obligations. We will deal with some of the major ones.

ASIC v John David Rich (the One.Tel case)

One.Tel was a publically listed Australian company which was part of a much larger corporate group with subsidiaries conducting several major businesses in Australia, the UK, Hong Kong and four European countries. One.Tel was established in 1995 soon after deregulation of the Australian telecommunications industry. The company was established by Jodee Rich and Brad Keeling and had high-profile investors James Packer and Lachlan Murdoch who also sat on the board of the company. One.Tel was involved in the sale of mobile phones and internet services and, before collapsing in 2001, became Australia's fourth largest telecommunications company.

Jodee Rich and members of his board continued to pay themselves multi-million dollar bonuses right until the collapse of the company in 2001. With the collapse James Packer and Lachlan Murdoch lost their family companies PBL and NewsCorp around a billion dollars.

This decision is the most recent in the ongoing litigation which has lasted about a decade between ASIC and the board of directors of the company One.Tel. Litigation was first initiated in 2001 by ASIC against some members of the board of directors. In these proceedings, ASIC sought relief against the director and CEO Jodee Rich and financial director Mark Silbermann.

ASIC alleged that Rich and Silbermann breached their statutory duty of care and diligence by withholding from the board the true financial position of the company over a period of months. Packer and Murdoch also alleged that they had been "profoundly misled" by the two directors. The statutory duty of care and diligence requires a director or officer of a company to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they were a director of a company in the company's circumstances and held the same responsibilities as the director. This is the same as the duty applicable to co-operative directors.

ASIC built its case around proving that the financial position of the One.Tel Group in Australia and overseas was much worse in terms of cash, cash flow, creditors, debtors, earnings and liquidity than the information provided to the board revealed. ASIC sought to show that Rich and Silbermann as directors were aware or should have been aware of the Group's financial position but failed to make proper disclosures to the board.

ASIC took the approach that the financial position of One.Tel was the key issue in the proceedings. ASIC reasoned that if their submissions about the poor financial situation of One.Tel were true, there could not be any doubt that Rich and Silbermann knew or should have known about the situation and should have informed their board.

The court criticised ASIC for taking this approach as it felt that the scope of this case, endeavouring to prove the financial circumstances of a large multinational corporate group over a number of months entailed establishing a case that "was far too wide and produced an excessively long and burdensome proceeding".

In the end, the court found that ASIC's claims about the poor financial status of the company were unpersuasive when the underlying financial detail was investigated. Because of ASIC's inability to demonstrate the company's dire financial situation both directors were not charged with breach of the statutory duty of care and diligence. The Court therefore found that ASIC had failed to prove its case for breach of the statutory duty of care and diligence against Rich and Silberman..

This case is useful as a discussion of what is expected of directors of corporations (and in turn co-operatives) as the court clarified in general terms what the statutory duty of care and diligence means for all directors in a general application. The court stated that a director must:

- be familiar with the fundamentals of the business of the company;

- keep informed about the company's activities;
- monitor generally the company's affairs;
- maintain familiarity with the financial status of the company by means such as reviewing the company's financial statements and board papers and making relevant additional requirements about these documents where appropriate; and
- have a reasonably informed opinion of the company's financial capacity.

The court accepted a number of submissions from ASIC about the standard which is expected of a director which also has general application for all company and co-operative directors. The court held that the duty of care encompasses a duty of competence that is measured objectively. Compliance with the duty is determined by reference to what a reasonable director of ordinary intelligence would do in the same circumstance in the same company. Whatever particular skills or lack of skills an individual director actually possesses, the director will be accountable "to a core irreducible requirement of skill, measured objectively". The court went on to say that the question of breach is not to be resolved merely by asking whether Rich and Silbermann had a subjective appreciation of the dangers or risks affecting the financial health and position of One.Tel. The objective test that the courts apply is whether they *should* have known the danger.

It is also interesting to note that Rich and Silberman utilized the business judgement defence available to them under the *Corporations Act (*but not the *Co-operatives Act)*. Under the Act, a business judgement means any decision to take or not take action in respect of a matter relevant to the business operations of the company. The business judgement rules provides that a director of a company who makes a business judgement is taken to have not breached the duty of care and diligence if they:

- make the judgment in good faith for a proper purpose; and

- do not have a material personal interest in the subject matter of the judgment; and
- inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- rationally believe that the judgment is in the best interests of the corporation.

The court said that the business judgement rule is not "mere window dressing" as it is capable of providing a defence to a breach of the duty of care and diligence where, if the defence did not exist, the breach would be established. The court said this could happen in cases where:

- the impugned conduct is a business judgment as defined;
- the directors or officers are acting in good faith, for proper purpose and without any material personal interest in the subject matter;
- they make their decision after informing themselves about the subject matter to the extent they believe to be appropriate;
- their belief about the appropriate extent of information gathering is reasonable in terms of the practicalities of the information gathering exercise including such matters as the accessibility of information and the time available to collect it;
- they believe that their decision is in the best interests of the corporation; and
- that belief is rational in the sense that it is supported by an arguable chain of reasoning and is not a belief that no reasonable person in their position would hold.

The disadvantage for directors of co-operatives is that the business judgment rule is not open to them at all as it does not exist in the *Co-operatives Act*. If any of the above situations occur during an investigation of the charge of breach of the duty of care and diligence, a director of a co-operative would not be able to plead the business judgment defence and would be convicted of breach of the duty.

ASIC v Macdonald (the James Hardie Case)

The James Hardie Group manufactured and sold asbestos products in Australia. The group had become subject to numerous damages claims for asbestos related diseases from sustained exposure to asbestos. James Hardie Industries Limited (JHIL) was the holding company of the James Hardie Group. Two wholly owned subsidiaries of JHIL, which also manufactured and sold asbestos, became the main recipients of the Asbestos Claims, within the James Hardie Group.

During a board meeting of directors of JHIL a Medical Research and Compensation Foundation was formed to manage and pay out the Asbestos Claims against members of the James Hardie Group. JHIL made a gift of its shares in the two subsidiaries as well as a sum of $3 million dollars to the Foundation. These gifts then became the assets of the Foundation which were intended to be used to pay out future Asbestos Claims.

ASIC alleged that a draft announcement about the formation of the Foundation was approved by the board and later forwarded to the ASX. Statements were also made to the public about this announcement. It alleged that the draft announcement stated that the Foundation would commence operations with substantial assets and that it would have sufficient funds to meet all future Asbestos Claims. ASIC alleged that those statements were false and misleading.

ASIC alleged that the board of directors approved this draft announcement and, in doing so, contravened the duty of care and diligence because, on the material provided to them, they could not have been satisfied that the Foundation had sufficient funding.

Peter Macdonald was CEO and a director of JHIL. ASIC alleged that he failed to enquire of the other directors whether they had formed the opinion that the Foundation had sufficient funds and he failed to advise the board that the draft

announcement was false and misleading. Various reports had also been made by other accounting organisations which were relied upon by the board. ASIC alleged that Macdonald had breached his duty of care and diligence by failing to advise the board of the limitations of these reports, the uncertainty of their findings and their usefulness in being used as a determination of the assets of the Foundation.

Justice Gzell of the NSW Supreme Court found that ASIC had established its case against the board and Macdonald with regard to the breach of their duty of care and diligence for failing to recognise that the Foundation did not have adequate funding to meet the Asbestos Claims and for releasing false statements to the ASX and the public. The board was also criticised for relying on insufficient and inadequate information to reach its decision.

ASIC also alleged that Macdonald was in breach of the duty of good faith in making the announcement to the ASX and the public. The duty of good faith under the *Corporations Act* requires an officer of a corporation to exercise their powers and discharge their duties in good faith in the best interests of the company and for a proper purpose.

The court stated that the establishment of this duty required subjective dishonesty. That is, the duty of good faith is only contravened where a director engages deliberately in conduct knowing that it is not in the best interests of the company. In this case, ASIC failed to establish breach of this duty. The court found that although Macdonald had been misguided about the announcements he made to the public and to the ASX he did not act for an improper purpose but thought he was acting in the interests of the JHIL. The court stated that he did not make any secret profits, he did not misappropriate company assets for himself and there was no conflict of interests between himself and JHIL. He was merely acting in the best interests of the company as he saw it, so did not breach this duty.

As such then, the Court found that while Macdonald had breached his duty to take reasonable care, he had not breached his duty of good faith. He honestly thought what he was doing was in the interests of JHIL, but he was careless in doing it.

Under the *Co-operatives Act*, the duty of good faith is defined differently than under the Corporations Act in that s 221 simply states that an officer must act honestly in the exercise of his or her powers. The term 'honestly' is very broad and also very vague. Arguably, it is not a very high threshold for conduct and therefore it is could be much easier to prove. Perhaps if the requirement under the Corporations Act had just been 'act honestly', as it is under the *Co-operatives Act,* Macdonald may have been convicted.

What this means is that directors of co-operatives are not offered the same protection as directors of companies because of outdated legislation.

The James Hardie case demonstrates that the courts are willing to find directors liable for breach of the duty of care and diligence if they fail to investigate the financial position of their company or a particular decision or course of action which the company is about to make. The James Hardie directors should have scrutinized the material on which they based their decision to create the Foundation and their assumption that it had sufficient assets to cover future Asbestos Claims. The case reminds directors to be extremely careful when making public disclosures – they must make sure that the information they are disclosing is correct. The case also demonstrates the difference between the duty of good faith and the duty of care and diligence. The first duty is about honesty and acting for a proper purpose in the best interests of the company while the second duty is about having the requisite skill for the position.

ASIC v Fortescue Metals Group Ltd

Fortescue Metals Group (FMG) is a publicly listed company with Andrew Forrest as its Chairman and CEO. In 2004, FMG planned to establish a mine in Western Australia as well as a railway from the mine to the port in order to export iron ore. FMG commissioned a Feasibility Study. The entire project was contingent upon the Feasibility Study establishing that FMG had the necessary finance required for the project. FMG made notifications to the ASX as well as public statements that it had executed binding agreements with three Chinese companies for each to build and finance the project.

ASIC alleged that FMG did not have a genuine or reasonable basis for making these disclosures as the Chinese companies were not legally bound to fund the project.

ASIC alleged that FMG engaged in a course of knowing and deliberate conduct to make these notifications which were false. It alleged dishonesty of FMG, its board of directors and in particular, Andrew Forrest. ASIC claimed that Forrest had breached the duty of care and diligence as a director by failing to ensure that FMG both complied with its disclosure obligations and did not engage in misleading or deceptive conduct and, as a result, he exposed FMG to a risk of serious harm.

Justice Gilmour of the Federal Court of Australia found that Forrest had not breached his duty of care and diligence. The court accepted that Forrest as managing director was responsible to a greater extent for the performance of the board as whole. The court said that a CEO or MD of a company may reasonably be expected to have more information available to him and to be more diligent than other board members. However, the court was satisfied that Forrest truly believed the agreements with the Chinese companies were legally binding and this belief was reasonably and honestly held by Forrest and the entire board.

The court stated that Forrest and the board did not seek to deceive in making statements about the legality of the Chinese contracts and that the FMG board had the benefit of competent professional legal advice from their in-house counsel, Mr Huston. The court found that Mr Huston advised the board that the Chinese contracts were legally binding and the board had no reason to doubt the correctness of his views. Because of these reasons the court found that FMG's opinions, which underpinned its disclosures as to the legal effect of the framework agreements, were reasonably and honestly held by its board including its CEO Andrew Forrest.

It should be noted that ASIC has flagged its intention to appeal against the decision in this case.

ASIC v Andrew Lindberg (AWB Case) (2007 Ongoing)

The litigation against the former board of the Australian Wheat Board (AWB) relates to AWB's contracts with Iraq under the United Nations Oil-for-Food Programme. In 1990, following the invasion of Kuwait by Iraqi forces, the United Nations imposed trade sanctions on the Iraqi administration. The effect of these trade sanctions was to deprive the country of foreign currency. In 1995, in order to alleviate some of the consequences this had on the Iraqi population, the United Nations established the Oil-for-Food Programme that permitted Iraq to sell oil with the proceeds of sale being paid into an account controlled by the United Nations. The proceeds of the account could be used by Iraq to purchase humanitarian goods, including wheat. Contracts for such purposes were to be approved by the United Nations.

In exchange for the sale of wheat purchased under the program, the AWB paid kickbacks to the Hussein government disguised as trucking charges. These 'trucking charges' were negotiated with the Iraqi Grain Board (IGB) and were paid to a Jordanian company who was supposedly involved in the distribution of Australian wheat in Iraq. The company had in fact nothing to do with the distribution process and simply handed the money on to the Iraqi government. The AWB was fully

compensated for these charges by an increase in the purchase price for the wheat while the Iraqi government was able to cipher hundreds of millions of dollars in hard currency from the program.

In late 2007, ASIC began its civil case against the former board of AWB. ASIC sought declarations, civil penalties and an injunction against each of the directors alleging that they have breached their duty of good faith and their duty of care and diligence in relation to AWB's contracts with Iraq under the United Nations Oil-for-Food Programme.

ASIC alleged that the board knew or ought reasonably to have known the contracts including the 'trucking fee' were not fees for the provision of transport services but were amounts being paid to the Iraqi government and that the AWB was not entitled to claim the 'trucking fees' from the United Nations' account.

ASIC alleged that the transactions harmed AWB and that the directors knew or ought to have known that they would do so. ASIC submitted that if AWB behaved in a manner which was inconsistent with the UN resolutions concerning international wheat trade with Iraq, this would expose it to international and domestic criticism and harm its business. ASIC alleged that there had been a loss of share price in AWB, loss of confidence from the Australian wheat growers and staff disruptions. It claimed that there had also been a loss of the 'single desk', AWB's monopoly right to export wheat, which was of great financial and commercial value.

ASIC alleged the board owed duties to AWB, namely the duty of good faith and the duty of care and diligence, and contravened those provisions by taking no reasonable steps to ensure that the payment by AWB of the 'trucking fees' was disclosed to the United Nations. The board took no reasonable steps to prevent the contracts being entered into and took no reasonable steps to ensure compliance with the United Nations program.

ASIC's central argument is that the entire board, including its managing director Andrew Lindberg, knew or ought to have known that the dealings between AWB and Iraq, in particular the payment of 'trucking fees' and the obtaining of money from the United Nations' account to pay those fees, was in breach of United Nations Resolutions, was in breach of the duty of good faith and the duty of care and diligence and risked causing harm to the finances and reputation of AWB.

This litigation was undertaken against the former board of AWB and its former managing director Andrew Lindberg in late 2007 and the case is ongoing.

Conclusions

These recent cases demonstrate how the courts have approached the issue of director's duties.

It seems that the duty of care and diligence is used more frequently when director's conduct is under scrutiny. Courts hold directors to a high standard and expect that they display a level of care and diligence in their positions which is particular to their company (or co-operative). The courts will not allow a director to plead that they did not have knowledge of relevant facts about a company's financial state of affairs or a particular course of action (such as setting up a Foundation with insufficient assets as in *James Hardy*) to escape liability. The courts expect directors to have the level of skills and knowledge peculiar to the company (or co-operative) they are running and the position which they hold in the company (or co-operative) even if they do not actually possess them.

The courts will however allow directors **of companies** (but not co-operatives) to plead the business judgment defence if they made a decision about a particular course of action that is in good faith, which they were informed about and rationally believed it was in the best interests of the company.

Directors owe a civil duty to their company or co-operative to make decisions that are in the best interests of the company or co-operative and do not harm the business. They must carefully examine all available information and ask questions about any material that is before them.

Courts will not look kindly on directors who do not involve themselves with the reality of their businesses situation and investigate the issues, contracts and finances of their business before making decisions about its future and its dealings with the public and other organisations.

Better Protection: the future of co-operatives legislation

The case law shows us how the courts apply the different statutory duties to individual directors and their boards. It also shows us how the differences in the *Co-operatives Act* and *Corporations Act* could possibly result in different outcomes regarding breach of duties for directors of co-operatives and directors of companies in the same circumstances.

The case law suggests that there is a real need to amend the *Co-operatives Act* to bring it in line with the *Corporations Act* on which it was initially based. It is clear that the duty of good faith needs to be extended to raise the threshold past the requirement of mere "acting honestly" to "acting in good faith in the best interests of the co-operative and for a proper purpose". If this is done it will allow the courts to look further at the conduct of a director of a co-operative to judge the decision or inaction on more criteria that just honesty. It will also mean there co-operative directors have exactly the same good faith duty as company directors and the scope for confusion from having differently worded duties is removed.

It is also clear that there needs to be an introduction of a statutory defence of business judgement to the charge of breach of care and diligence. In the *One.Tel,* the court said that the purpose of the introduction of the business judgement rule was to ensure that directors are not discouraged from taking advantage of opportunities that involve responsible risk-taking. There is no reason why this defence should not be available to co-operative directors to encourage them to make competent business decisions and to be protected when these decisions do not (in hindsight) benefit the co-operative.

The *Co-operatives Act* needs to be amended to reflect the current changes that have been made in the *Corporations Act* so that directors of co-operatives and directors of companies are afforded the same protection.

It is noted that regrettably the proposed new "national co-operative legislation" does not update co-operative director duties to reflect current company director duties under the Corporations Act and it does not include the defences that are available for company directors under the Corporations Act, such as the business judgement defence. This is truly a great shame.

It is also very disappointing that the new co-operative legislation does not simply adopt relevant provisions of the Corporations Act so that whenever director duties of company directors change, duties for co-operative directors change automatically. This automatic adoption already applies with the financial reporting obligations of co-operatives so that whenever there is a change for companies, it automatically flows on to co-operatives. There is no reason why the same sort of mechanism could not apply to director duties. If it does not, co-operative directors will again face the prospect of being subject to duties that reflect legal thinking of 20 years ago. Unfortunately, that is the current position.

Practical Tips for Directors

Despite the legal deficiencies in co-operative director duties, there are nevertheless some useful steps that co-operative directors can take to maximise their protection. The following are a list of practical tips for Directors:

- Directors must have a good understanding of the co-operative's financial reporting systems and accounting practices – directors need to be financially literate
- Directors should have a good understanding of core director duties
- In making decisions, directors should **never** put their person interests ahead of their duties to act in the best interests of the co-operative as a whole
- The Board should prepare and formally adopt a directors code of conduct
- The Board should establish an audit committee
- The Board should require management to prepare and implement a risk management and internal control system to identify and manage the co-operative's material business risks and to report to it on whether those risks are being managed effectively
- Directors should not get involved in management – they are there to oversee and monitor management, not to manage themselves: if they do embark on management, they will significantly increase their exposure
- The Board should clearly outline the functions delegated to management and those reserved to the Board
- Directors should receive and familiarise themselves with documents to be tabled at board meetings well in advance of the scheduled meetings
- Directors should actively question management, experts and external advisors and investigate the validity of advice provided

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