

**COPING WITH JAMES HARDIE AND CENTRO:
A DIRECTORS' GUIDE
ADDRESS TO THE AUSTRALIA-ISRAEL CHAMBER OF COMMERCE
BOARDROOM LUNCH
BY THE HONOURABLE T F BATHURST
CHIEF JUSTICE OF NEW SOUTH WALES
9 SEPTEMBER 2011**

Thank you for inviting me here today. It is a pleasure to have this opportunity to speak to you.

The title I chose for this speech is something of a misnomer. That is for two reasons. First, it implies that the decisions in James Hardie¹ and Centro² have brought about a significant change in the responsibilities of directors. As I will try to show, they have not. Second, and aligned with that proposition, is the suggestion that the decisions have resulted in additional burdens with which directors have to cope.

This is important because it has been widely argued that the outcomes of the James Hardie and Centro litigation create significant

¹ The primary judgment in the James Hardie litigation can be found in *ASIC v MacDonald* (No 11) (2009) 256 ALR 199; [2009] NSWSC 287. The Court of Appeal judgment is: *Morley & Ors v Australian Securities and Investments Commission* [2010] NSWCA 331.

² The judgment in the Centro litigation is: *Australian Securities and Investments Commission v Healey* (20110) 278 ALR 618; [2011] FCA 717.

disincentives for people to take up positions as directors. Some have gone so far as to suggest there will be a mass exodus from the boardrooms across the country. I do not think there is a need to be so panic-stricken about the results of this litigation. This is not only because the perceived exodus has not occurred, but more importantly because whilst the legal duties that are imposed upon directors are onerous, they are neither new nor impossible to meet.

The decisions have also led to some commentators calling for legislation to limit directors' responsibilities. Some of you may have seen recently reports of comments by Professor Bob Austin calling for a change in law to enshrine a board's role as one of oversight³. He is reported to have stated: "There is a kind of schizophrenia in the perception of the board's role". He is reported to have argued that on the one hand there is a perception that the board meeting periodically cannot participate in operational management except on isolated occasions, but on the other hand the board is seen as "seated at the head of the table of the company's management system, bearing ultimate responsibility for everything that occurs within the organisation". In my opinion, neither of these perceptions are correct. A non-executive

³ See comments by Professor Bob Austin quoted in Katie Walsh, 'Legal oversight on boards pinpointed' *Australian Financial Review* 12.

director is not required to take part in the operational management of the company, but that does not mean that non-executive directors are entitled to rely blindly on advice from management in reaching their decisions. At the other extreme it is not correct that directors have ultimate responsibility for everything that occurs within the organisation.

There is no denying that over the past few decades the role of a board has changed. As companies have exponentially expanded in size a vast difference has developed between boards of small companies (which may take an active role in the daily management of the company) and boards of large companies (where the role of the board is strictly limited to governance and strategy while the operation of the company on a daily basis is strictly the domain of management). Further, the prevalence of non-executive directors in modern business raises a number of significant questions about the obligations imposed on those directors.

That having been said, directors have had for many years an obligation to exercise reasonable care in carrying out their functions and exercising their powers. Whatever doubts there were as to whether the standard was an objective one, those doubts were excised by the decision of the Court of Appeal in New South Wales in the AWA

litigation: *Daniels v Anderson*⁴. The standard requires consideration of what an ordinary person with the knowledge and experience of the director would be expected to have done in the circumstances in question if he or she was acting on his or her own behalf.

Neither the decision in James Hardie nor that in Centro expanded this definition. Indeed, as I will seek to show the conclusions reached by the Court and their statement of their duty of directors were hardly surprising and should not be of overwhelming concern to directors who are carrying out their duties conscientiously.

In making good that proposition, I do not propose to express views on the correctness of either decision. It would be inappropriate for me to do so for two reasons. First, the appeal process in each case has not yet ended. Second, as a member of the Bar I was involved in the James Hardie litigation and in proceedings relating to the Centro litigation. If you came expecting, or hoping for, a blistering criticisms of the judgments I am afraid you are going to be disappointed.

⁴ (1995) 37 NSWLR 438.

The facts in each case are well known. In James Hardie it was alleged by ASIC that the non-executive directors, in announcing the establishment and funding of a foundation to deal with legacy asbestos claims, negligently approved a draft press release to the effect that the foundation would have sufficient funds to meet all legitimate asbestos claims and provide certainty for people with such claims. It later became clear that the foundation was substantially under-funded.

The Court of Appeal ultimately found that it was not established that the directors had approved the press release. However, they said had it gone before the board, the directors would have breached their duties in approving it because of the particular circumstances in which it went to the board. Those circumstances were described by the Court of Appeal as being: in the course of a decision of high importance intended to bring separation of the group's liability to asbestos claims; where the separation and attendant communication strategy had been considered at board level over a long period and important to the decision was sufficiency of the foundation's funding and communication of sufficiency to stakeholders. The Court considered in those circumstances that a non-executive director exercising due care and diligence had to give independent consideration to the draft news

release and was not entitled to merely rely on management for its accuracy.

The Court held that this obligation extended to overseas directors who were present at the meeting and participated in it even though they did not have the press release before them and in circumstances where there was nothing to suggest that it was inaccurate.

The conclusion (except perhaps in the case of the overseas directors) did not involve, in my view, any extension of the legal principles. In essence, what the Court was saying was that where the press release related to a matter of considerable significance to the company, where it had been expressly provided to the board for its approval and where the directors had long been familiar with material that showed the difficulty in quantifying with any certainty prospective asbestos liabilities, it was incumbent on them to give consideration to its accuracy. Considered in this way the task was not one that could be described as particularly onerous for a prudent director to undertake.

There is, however, one aspect of the decision which should serve as a warning bell to directors. The overseas directors did not have the document nor did they participate in the decision. However, it was

accepted that their silence would have amounted to acquiescence in the decision and they could not acquiesce without considering the actual document. It means that if directors are not in a position to make a decision one way or the other, they should formally abstain.

Centro involved breach of the statutory duty to take care in the signing off of the annual accounts. The accounts in essence failed to disclose some \$2 billion of short-term liabilities that had been classified as non-current and failed to disclose around \$1.75 billion worth of guarantees that had been given after the balance date.

The directors submitted they had placed reliance on the competence of the financial management team and the company's auditors, neither of whom identified the omissions. It was further submitted that failure to detect an error in documents prepared and provided by management or external auditors could not constitute a breach of duties by non-executive directors.

Those submissions were rejected and it was held that the directors acted in breach of duty in not exercising the degree of care and diligence required of them. No distinction was drawn between executive and non-executive directors or whether or not a director was a member of the

audit committee. The judge stated that what was required was that such documents, before adoption by directors, be read, understood and focused on with the knowledge each director has or should have by virtue of his or her position as a director. The judge stated that he did not consider this requirement overburdened a director or as argued before him would cause the boardrooms of Australia to empty over night.

It should also be noted in this regard that the comments of the trial judge were made in the context of a finding that the directors either knew or ought to have known that there was very significant short-term debt which was not disclosed in the accounts.

Once again in this context the result was not particularly surprising. The directors had an obligation under s 295(4) of the *Corporations Act* 2001 (Cth) to declare whether in their opinion the financial statements comply with accounting standards and presented a true and fair view of the affairs of the company. What the directors had to do in the circumstances of Centro was simply to inquire whether all debt was correctly classified. The failure to do so amounted to a breach of duty.

Viewed in that light the requirements went no further than what was stated in the AWA litigation to be the responsibility of a director:

that they take reasonable steps to place themselves in a position to guide and monitor the management of the company, to acquire an understanding of the fundamentals of the business and to keep informed about the corporation's activities. It would not seem too much to ask that a director of a company such as Centro keep themselves informed as to the debt profile of the company and inquire as to the correct classification.

There are two further matters which I should mention. First, the decisions do not stand for the proposition that directors can never rely on the advice of management or external consultants. James Hardie at its highest said that reliance could not be placed on the draft press release provided by management where there were facts known to the directors which would tend to show that it was inaccurate. Centro was a case where the trial judge found there was no inquiry at all.

There are, of course, many instances where directors will be compelled to rely on management and will be entitled to do so. The extent of such inquiry will almost invariably depend on the importance of the decision being made, the knowledge of the directors as to the circumstances in which a recommendation is put to them and whether the results of the inquiry would satisfy a reasonable person in the

position of the directors. The decisions do not mean that directors have to, as it were, investigate each proposal of management from the bottom up before approving it.

Second, it has been suggested that decisions such as the ones in question would paralyse the operation of the boardroom. I have already said why I do not believe this to be the case but there is one other important matter to be mentioned. In neither case was the appropriateness of what might be called the underlying decision put into question. It was not suggested in James Hardie that the directors acted negligently in exercising their judgment to establish the foundation and it was not suggested in Centro that the directors were negligent in approving the very substantial level of debt. Thus, there was no attack on the business judgment of the directors.

Thus, I think, directors can cope with James Hardie and Centro. Perhaps the best way of coping is to observe three rules:

1 Prepare

Receive tabled documents and board papers well before meetings, with time to digest their contents, prepare some questions or concerns for the meetings.

While it might sound obvious, it is also important to ensure that directors participating from a remote location have all relevant documents before them when participating in meetings. It is usually the moments where diligence is highly inconvenient in which directors breach their duties.

Ensure that important matters which are tabled for resolution are emphasised and cannot be construed as being provided just for information purposes. These items should be highlighted on a meeting agenda and properly considered before the meeting.

2 Engage

Actively question management, experts and external advisors and investigate the validity of the advice provided. Directors should ensure that any market announcements or press releases put before them for approval (or even for general reference) are carefully reviewed.

It is important that directors make their own independent assessments of documents or proposals rather than simply relying on management recommendations, or even the advice of special counsel. Significant decisions should be considered by the board and not

delegated. This is not to say that, for example, every ASX announcement will, or should properly, be scrutinised by a company board. However, as I stated above, in the James Hardie litigation the Court of Appeal suggested that a draft ASX announcement should be reviewed and approved by the board if the board's decision is of high importance to the future direction of the company, where the communication strategy has been considered at board level over a long period of time, and where the announcement is important to stakeholders.

In the Centro litigation, Middleton J stated that directors are entitled to delegate the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. However, directors are expected, and obliged by law, to take a "diligent and intelligent interest" in the information available. As a general rule, directors should come to independent decisions: if something comes before the board from management, directors cannot abdicate responsibility to one another.

It is important to ensure that all directors actively participate at meetings and individually ratify the minutes of previous meetings.

Abstain from voting if not all information required to make an informed decision is provided.

3 Keep accurate records

The board should have a formal, comprehensive agenda and make decisions by passing formal resolutions. Abstention of votes should be recorded. Directors have a collective obligation to ensure that board decisions are correctly recorded and minuted. Recording decisions made at meetings provides evidence of proper conduct and can be extremely useful in countering accusations about improper conduct.

Additionally, take note of the assumptions and qualifications made in expert reports.

Conclusion

There is no doubt that the James Hardie and Centro litigation made a lot of directors feel very uncomfortable. It is difficult for many directors who are physically distant from the management of a company and who are tasked with governance of an organisation to know exactly what goes on day-to-day. However, in the litigation arising out of the conduct of officers of these two companies, courts have sent a clear

message that oversight means active engagement with what a company is doing and what it purports to be doing. If things do not make sense, directors need to ask questions. Before public statements are made, directors must verify that they are true. It is not sufficient to rely on the expertise of management or of fellow directors: each director has an individual obligation to ensure compliance with corporate regulatory standards. It might be a tough task, but it is an important one. The integrity and cohesion of our economic system depend on it.