

Title **One.Tel case—important update on directors' duties**

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ASIC fails to prove its case

Justice Austin in the New South Wales Supreme Court handed down judgement on 18 November 2009 in the case brought by the Australian Securities and Investments Commission (ASIC) against Jodee Rich and Mark Silbermann. The action was commenced in December 2001, shortly after the collapse of One.Tel. ASIC's case was that Mr Rich and Mr Silbermann misled the One.Tel board (which included James Packer and Lachlan Murdoch) about the financial state of the company.

Whilst One.Tel was a listed entity, its major shareholders were Kerry Packer's Publishing & Broadcasting Limited and Rupert Murdoch's News Corporation. Both of those entities lost huge sums in the One.Tel collapse. The question which Justice Austin had to determine was whether or not the executive directors had failed to keep the board informed of the company's financial position. He did not have to determine whether or not the other directors on the board were careless in failing to find out the truth about their company's position, although that issue might arise in other litigation currently on foot.

Waste of time?

Some commentators have pointed out that the case is a lesson for ASIC in how not to run litigation. The case ran for eight years and is reported to have cost ASIC \$20 million in legal fees. If ASIC is ordered to pay the costs of the defendants, then the case could cost ASIC up to \$40 million in total. This is particularly significant when considered in light of ASIC's overall annual budget of about \$300 million. There is no doubt that the case has chewed up an enormous amount of resources and diverted those resources away from other routine compliance and enforcement activities.

However, the case is instructive in relation to the law about directors' duties. Justice Austin is an acknowledged authority on the subject, and he has taken the trouble to write his judgement in a way which is instructive for other directors. The judgement is 3,105 pages long but is conveniently broken up into chapters. Anyone wanting to focus on the important findings regarding directors' duties should read chapter 23 which starts at page 2,942.

We have summarized below some of the important findings from the case. Directors should take note that this represents the current state of the law in Australia and their performance will be judged against these principles.

Duty of care and diligence

Section 180(1) provides as follows:

A director or other officer of a corporation must 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.*

Justice Austin made the following points:

1. There is a general law duty of care which has been developed by the courts over many years, and this has been expanded to encompass the concept of negligence in more recent times. The statutory duty of care and diligence is generally the same, except that there are some important structural and other differences.
2. In talking about the standard required of a director under the *Corporations Act 2001* (the Act), Justice Austin noted that the legislature did not intend to dampen business enterprise and penalise legitimate but unsuccessful entrepreneurial activities. Accordingly, the question whether a director had exercised a reasonable degree of care and diligence could only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.
3. A contravention of the section could be established without proving damage to the company. A necessary element of the statutory standard of care and diligence is that it is reasonably foreseeable that harm to the interests of the company might be caused by the director's act or omission.
4. Justice Austin rejected whole-heartedly a submission put to him by Mr Rich and Mr Silbermann that the statutory provision only applies to negligence gross enough to become a matter of public concern, sufficient to interest the State by reasons of its gravity. The degree of negligence required is no higher than that which would support a claim of negligence of common law.
5. In considering the "*corporation's circumstances*" for the purposes of the section, consideration must be given to the type of company involved, the size and nature of its business, the provisions of its constitution, the composition of the board, the distribution of work between the board and other officers, the status of the company as a listed or unlisted entity, and, in the case of a parent company, the size and nature of the business of its subsidiaries.
6. When considering what "*responsibilities*" a particular director has, this will include arrangements flowing from the experience or skills that he or she brings to bear to the office, and also any arrangements within the board or between the person and executive management affecting the work that the person is expected to carry out. It is not limited to a consideration of the specific tasks delegated to the relevant director by the constitution or by a board resolution.
7. The statutory requirement of diligence incorporates a minimum standard which requires every director to do the following:
 - (a) Become familiar with the fundamentals of the business of the company.
 - (b) Keep informed about the company's activities.

- (c) Monitor the company's affairs.
 - (d) Maintain familiarity with the financial status of the company by appropriate means, including review of the company's financial statements and board papers, and to make further enquiries into matters revealed by those documents where it is appropriate to do so.
 - (e) Have a reasonably informed opinion of the company's financial capacity. This includes the obligation to prevent insolvent trading.
8. The statutory obligation encompasses a duty of competence, which is to be measured objectively. It is to be determined by reference to what a reasonable person of ordinary prudence would do. This is enhanced where the directorial appointment is based on special skill. The statutory standard includes a standard of competence in reading and understanding financial material, and does not make allowance for the director's personal inexperience or lack of skill. Whatever particular skills an individual director actually possesses, or inexperience they may suffer from, they are still accountable to a core irreducible requirement of skill which is measured objectively.
9. These rules may have different consequences for executive and non-executive directors. Non-executive directors are not subject to the same higher standard as executive directors.
10. A fully informed general meeting of shareholders can prospectively or retrospectively ratify actions of the directors that would otherwise be in breach of their general law duty of care. Where the directors and shareholders are the same, ratification is implicit. However, those principles must be applied with great caution where the directors and shareholders are not precisely the same. In the *One.Tel* case, the company was listed so at best there may have been an informal acquiescence of a majority of shareholders. However, this does not have the same effect as a formal resolution at a properly convened general meeting.
11. The reality is that for large companies, management is delegated in large measure to its executive officers. That delegation is generally sanctioned by the law as long as the non-executive directors act reasonably and in good faith, after making an independent assessment of the information supplied to them by the executive officers.
12. In assessing what a reasonable person would do in the position of the director in response to a given risk, the court needs to consider the magnitude of the risk and the degree of the probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities the director may have. In considering the cost of alleviating action, Justice Austin accepted a submission put to him by Mr Rich and Mr Silbermann that the court should avoid a finding that certain information not contained in board papers should have been there where the consequences may be that board papers would grow to the size of a telephone book.
13. The statutory standard of care and diligence for company directors recognises the distinction between negligence and mere mistakes. In particular in the *One.Tel* case, the complaints made by ASIC were about financial forecasting in the context of a telecommunications company. Justice Austin noted that forecasting is a difficult and uncertain process, with much room for mistakes and errors of judgement, and for differences of opinion. He said the issue was not whether the

directors made mistakes in the processing of financial forecasting or whether they formed opinions different from the opinions of ASIC or the court. The statutory issue is whether they failed to meet the standard of care and diligence that the Act lays down. The relevant standard is the degree of care and diligence that a reasonable person would exercise, taking into account the corporation's circumstances, the office occupied by the director and his or her responsibilities within the company. That conduct should be assessed by having regard to the circumstances existing at the relevant time without the benefit of hindsight and with the distinction between negligence and mistakes or errors of judgement firmly in mind.

Business judgement rule

Sections 180(2) and (3) of the Act provide as follows:

- (2) *A director or other officer of a corporation who makes a business judgement is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgement if they: a) make the judgement in good faith and for a proper purpose; and b) do not have a material personal interest in the subject matter of the judgement; and c) inform themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate; and d) rationally believe that the judgement is in the best interests of the corporation. A director's or officer's belief that a judgement is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.*
- (3) *In this section "Business Judgement" means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.*

Justice Austin made the following comments in relation to the business judgement rule:

1. He considered in some detail the question of who bears the onus of proof in relation to the business judgement rule. With some hesitation, he reached the conclusion that the Act casts the onus of proving the four criteria in section 180(2) on the directors. He noted 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. He felt that casting the onus of proof onto the directors was not necessarily incompatible with that purpose, because the onus can be relatively easily satisfied.
2. In considering what constitutes a business judgement, Justice Austin approved U.S. commentary to the effect that it doesn't just encompass risky or economic decisions, but also applies to decisions relating to corporate personnel, the termination of litigation and other less explicitly business decisions. It could embrace decisions including the setting of policy goals and the apportionment of responsibilities between the board and senior management. Justice Austin also considered that it would include matters of planning, budgeting and forecasting.
3. However, he noted that under the Act, it must involve "*a decision to take or not take action*". This means that a decision must consciously be made so that the judgement has actually been exercised. A director who simply neglected to deal with proper safeguards, with no evidence that he or she even turned his or her mind to a judgement of what safeguards there should be, has not made a business

judgement and accordingly, cannot invoke the defence. The important question is whether the director has turned his or her mind to the matter.

4. Justice Austin agreed with the submission made by ASIC that the discharge by directors of their “oversight” duties, including their duties to monitor the company’s affairs and policies and to maintain familiarity with the company’s financial position, is not protected by the business judgement rule, because the discharge or failure to discharge those duties does not involve any business judgement as defined.
5. As can be demonstrated in the One.Tel case, this can be an important consideration. ASIC claimed that Mr Rich and Mr Silbermann had artificially attempted to treat what was, in substance, inaction or omissions on their part as conscious and considered acts involving the exercise of judgement. Justice Austin did not accept that submission. He found that Mr Rich and Mr Silbermann had given evidence, which he generally accepted, to the effect that they made decisions about the matters of which ASIC complained. It was not a case where the directors had failed to turn their minds to decisions that ASIC alleges they should have taken. To a substantial degree, it is a case where the directors considered the matters of which ASIC complained, but made decisions with which ASIC disagreed. In essence, this is why ASIC’s action failed. Justice Austin accepted the evidence from the directors that they had considered the matters but had simply made a different business judgement about what ought to be done.
6. The business judgement rule requires that the directors must inform themselves about the subject matter of the judgement to the extent that they reasonably believe to be appropriate. Justice Austin said that the reasonableness of the belief should be assessed by reference to the following:
 - (a) The importance of the business judgement to be made.
 - (b) The time available for obtaining information.
 - (c) The costs related to obtaining information.
 - (d) The director’s confidence in those exploring the matter.
 - (e) The state of the company’s business at that time and the nature of the competing demands on the board’s attention.
 - (f) Whether or not material information is reasonably available to the director.
7. In considering the requirement that the directors have a “rational belief” as to the best interests of the company, Justice Austin said that requirement is satisfied if the evidence shows that the director believed his or her judgement was in the best interests of the company, and that belief was supported by a reasoning process sufficient to warrant describing it as a rational belief, as defined, whether or not the reasoning process is objectively a convincing one. This is an important conclusion, and highlights the importance of directors recording the thought process involved in making various decisions and recording it either in the board papers or the minutes in case the decision is later called into question and they need to rely upon the business judgement rule.

Conclusion

The reasoning and conclusions in this case are compelling reading for anyone involved in the management of a company. Justice Austin has articulated the principles relevant to assessing the performance of a director in a way that should be readily understandable to company directors and officers.

McMahon Clarke Legal can assist you with any queries regarding directors' liability and obligations.

For more information, email sarah.davies@mcmahonclarke.com or call 07 3239 2960.

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