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Directors' backsides exposed if "noses in, fingers out" becomes "hands off, eyes shut"

Recent cases in Australia and New Zealand involving directors' obligations sound a warning for any directors who think:

- the difference between "governance" and "management" means that "directors don't do detail"
- directors don't need a basic level of financial literacy, or
- directors don't need a good understanding of the company's business.

Some assumptions disturbed?

"Governance of the company rests with the board. The board's primary role is to set or approve the company's key strategic direction and major decisions, and monitor their implementation by management. Good governance means "noses in, fingers out" – ensuring that the board has oversight of management but does not try to do management's job for it."

Sound familiar? It should. Variations on the theme that good governance involves respecting the difference between governance and management are commonplace in governance literature.

And, so far as they go, they are fine. But, like all nutshell summaries, they don't tell the whole story. And if they lead directors to be too hands-off, they are dangerous. "Take a helicopter view" might be a useful rule of thumb. But recent cases on both sides of the Tasman are reminders that sometimes the helicopter needs to get closer to the ground.

A (very) brief synopsis of the six cases

Lombard

The directors of Lombard Finance & Investments Limited[1] were convicted for disclosure breaches in relation to an amended prospectus and three investment statements issued in December 2007. The Court found that the documents had misled the market regarding the severity and imminence of the liquidity squeeze confronting Lombard. There was never any suggestion that the directors had been "other than honest". But it is enough to establish simply that the documents were misleading, regardless of whether there was any intention to deceive. Sentencing is on 29 March. The Judge has said that the level of offending is "a material step away from the seriousness required for a custodial sentence".

Feltex

The directors of Feltex Carpets Limited[2] were charged with non-compliance under the Financial Reporting Act 1993 after the company failed to disclose in its half year results that it had breached a banking covenant with the ANZ and that a loan it held with the ANZ was a current liability. The decision (*MED v Feeney*, Auckland District Court) was released on 2 August 2010. All five men were acquitted. The directors were awarded costs (unusual in criminal actions, although the amount was reduced on appeal).

Nathans

The directors of Nathans Finance Limited[3] were charged under the Securities Act 1978 with issuing offer documents containing untrue statements. Nathans was a wholly owned subsidiary of VTL Group Limited, which had rights to a unique software application for vending machines. The misinformation related to the nature and level of Nathans' exposure to VTL. The decision (*The Queen v Moses, Doolan, Young,* High Court) was released on 8 July 2011. Two of the men got jail time and a third home detention in addition to financial penalties.

Centro

The directors of Centro Properties Group[4], an Australian development company specialising in shopping malls, were found to have breached their directors' duties as a result of the company's financial statements failing properly to disclose significant short-term liabilities and certain related-party guarantees. The judgment (*ASIC v Healey*, Federal Court of Australia) was delivered on 27 June 2011. The Judge issued a statement of contravention against the directors but imposed no further penalty.

James Hardie

James Hardie Industries Limited[5] *(JHIL)* directors were alleged to have breached their directors' duties by approving misleading market disclosure to the effect that a special foundation created to handle JHIL's compensation liability arising from its historic asbestos production was fully funded to meet all present and future claims. Their appeal was successful (*Morley v ASIC*, NSW Court of Appeal, 17 December 2010), but only because it was not sufficiently proved that they had actually approved the relevant company disclosures. Had there been such proof, it is clear that the court would have come to a different view.

Davidson v Registrar of Companies

Bruce Davidson[6], a former director of the failed Bridgecorp group, appealed against a banning order by the Registrar of Companies on the basis that he had relied on others who were better qualified in financial matters. Mr Davidson had been disturbed at the activities of the managing director and majority shareholder, Rod Petricevic, but was persuaded not to resign his directorship because his resignation would alarm the market. No-one disputed that his motives were honourable but the court upheld the Registrar's action, stating that it was not Mr Petricevic's misconduct but Mr Davidson's failure to respond that evidenced bad governance and that directors cannot rely on other directors when making important decisions. (*Davidson v Registrar of Companie*s, Wellington High Court, 27 August 2010).

Governance v management

It is uncontroversial that the board's job is to govern and management's job is to manage. But where is the boundary between these two functions? And how deeply should a director engage with the affairs of the company in order to satisfy his or her governance obligations?

The Nathans, Lombard and Centro judgments addressed this issue in some detail, and brought a level of specificity and responsibility to the director's role which might surprise some directors.

Centro: "The case law indicates that there is a core, irreducible requirement of directors to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor".

And: "Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her".

Nathans: "They (the directors) wrongly left it to management to take professional advice and to confirm to them that the prospectus and investment statement was "compliant". That was not a delegable duty. It was for them to read the contents of the offer documents and to determine for themselves whether they reflected the position of the company, as they knew it to be".

Lombard: "To the extent that [the defence] proposes that directors can rely on the judgement of managers until the directors are on notice that something of substance has gone wrong, then that puts permissible reliance too highly. Directors are appointed to exercise judgement and that extends to testing the competence of management within areas in which managers are relied upon. Each circumstance of reliance on management needs to be assessed within its own context".

Directors must exercise their own independent judgement

A director's duties are owed by that director, personally, not by the board as a whole. Individual directors cannot hide behind some concept of collective decision-making or see the presence of other, more experienced, directors as relieving them of their individual obligations.

Centro: "A board should be established which enjoys the varied wisdom, experience and expertise of persons drawn from different commercial backgrounds. Even so, a director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience or expertise. A director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise".

And: "All the directors failed to see the 'obvious errors' (in the 2007 annual report) because they all took the same approach in relying exclusively upon those advisers and on those processes. No director stood back, armed with his own knowledge, and looked at and considered for himself the financial statements".

Lombard: "Certainly in the negative sense, had the accused proceeded to issue the offer documents whilst a professional adviser questioned the need for different or additional content, then that would adversely affect the reasonableness of their belief in the accuracy of the offer documents. I am not satisfied that the same relevance can be attributed in the positive sense to the absence of warning signals from competent external advisers, as supporting a positive finding that there were reasonable grounds for the directors' belief in the accuracy of the offer documents. The directors' obligations in relation to the accuracy of content of offer documents are non-delegable".

Financial literacy is important

Obviously some board members will have greater financial literacy than others. But even those directors who bring specific expertise in other areas (e.g. IT, marketing, R&D) must have sufficient financial literacy to ensure they can adequately serve their primary function of monitoring and supervising the company's business. If they find some of the material difficult or unfamiliar, they should ask questions until they are confident that they do understand it.

Centro: "A reading of the financial statements by the directors is not merely undertaken for the purposes of correcting typographical or grammatical errors or even immaterial errors of arithmetic. The reading of financial statements by a director is for a higher and more important purpose: to ensure, as far as possible and reasonable, that the information therein is accurate. The scrutiny by the directors of the financial statements involves understanding their content".

Nathans: "It is axiomatic that a director of a finance company will be assumed to have the ability to read and understand financial statements and the way in which assets and liabilities are classified".

Davidson: "A director must understand the fundamentals of the business, monitor performance and review financial statements regularly. It follows that a degree of financial literacy is required of any director of a finance company. Without it, [he] could scarcely understand the business, let alone contribute to policy decisions… yet his presence and reputation might encourage investors to believe that the group was well-managed".

Although Nathans, Lombard and Davidson all concerned finance companies, as Centro makes clear the requirement for a basic level of financial literacy is of general application. The extent of financial literacy will depend on the company and its business – a large, complex, highly leveraged business with a large derivatives portfolio will require greater financial literacy than a small, unleveraged, sole-product business.

But what is inescapable is a judicial consensus that a basic level financial literacy is a must – that level being whatever is required for directors properly to understand, monitor, supervise and govern the company's business.

Understanding the business is also important

Of course, understanding financial statements sufficiently to be able to properly supervise the business is only half the picture. The other half is understanding the business. It is clear from the cases that a significant level of engagement is required by each director, together with a good knowledge of the company's business and financial position, particularly any risk areas.

The court, for example, considered that the Nathans directors should have known enough about the relationship between Nathans and its parent VTL to recognise that its offer documents were misleading.

"As at the date on which the investment statement and prospectus were distributed, the directors of Nathans knew there was no reasonable prospect that inter-company debts could be repaid without VTL selling all or some of its business units. The directors knew that the money received would be used primarily as working capital for VTL and that was not disclosed."

Similarly, in the Centro case, the court took the view that, if the directors were not aware of the company's debt position, they should have been: "The significant matters not disclosed were well-known to the directors or, if not well-known to them, were matters that should have been well-known to them".

In both these cases, the non-disclosure or inaccurate disclosure related to issues at the heart of the business – Centro's high levels of indebtedness and Nathans' exposure to VTL. Accordingly, they were matters of which the directors should have been well-informed.

Advice may be relied upon…

Directors are able to rely upon advice. But not unquestioningly. Only when, and to the extent, it is reasonable to do so. In particular, they must make proper inquiry where the need for inquiry is indicated by the circumstances.

The directors in each case sought to invoke a "reasonable reliance" defence, but only in the Feltex litigation was this accepted. The Feltex breaches occurred as New Zealand was moving from GAAP to NZIFRS and related to the different treatment of specific liabilities in the two systems.

The Feltex board, recognising that the company would be one of the first to report under the new rules, put in place a detailed and multi-faceted strategy to manage the transition. "They took these steps not because they were seeking to protect themselves but in order to promote the interests of the company by ensuring compliance with the FRA in this new and challenging accounting standards environment," the Judge said.

In the event, the advice they received from their expert external advisers was incorrect. However the Judge was satisfied that they were "entitled to seek and rely upon specialist advice" in this area and that they had taken all reasonable and proper steps to ensure that the company met its obligations.

In each of the other cases the courts were not satisfied that the directors' reliance was appropriate.

…but advice should be treated critically

The reliability of advice can be affected by the quality of the data on which it is based, and by the scope of the adviser's brief. It is not sufficient simply to point to a "sign off". The question is whether that sign off is adequate – or whether it contains assumptions and limitations which limit its utility or which should put directors on notice of matters which they need adequately to address themselves.

Nathans: "The quality of any advice is only as good as the information provided to the professional, on the basis of which he or she is asked to advise. In considering the extent to which directors are entitled to rely on external advice, some assessment must be made of the prime information on which the adviser acted and whether he or she was on inquiry as to the accuracy of that information".

In the James Hardie case, for instance, the external experts that JHIL had commissioned to do the actuarial analysis for the foundation had been asked to report only on the logical soundness and technical correctness of the model, not on the assumptions underpinning it. These included an assumption of an 11.7% return on investments.

The non-executive directors in the James Hardie case were successful in their appeal, but only because there was insufficient proof that they had, in fact, approved the announcement which was found to be misleading. Had that been proved, the court was clear that it would have found their "blind acceptance" of the actuarial report fell short of their duty to act with the required care and diligence: "We do not think this was an occasion of reasonable reliance on management or others".

You can be wrong – provided you have made all reasonable efforts to avoid error

The Feltex directors were acquitted although the company's half year results breached the FRA. The law recognises that honest mistakes can be made. All it asks of directors is that they take all reasonable steps for the avoidance of error.

Centro: "The final point to observe is that ASIC does not allege... that the directors needed to get it right... All that is being alleged is that they should have detected the apparent error and acted accordingly by, for instance, asking the appropriate question of management".

Governance – the legal perspective

None of these cases involves radically new statements of the law. They are all heavily fact-specific, and involve the application of relatively settled legal principles to specific circumstances. In that sense, they cannot be said fundamentally to restate the law on directors' obligations.

But their focus on basic levels of financial literacy and business understanding, and a requirement for engagement with detail when the occasion warrants it, are significant. At a minimum, directors should be well aware that:

- the difference between governance and management does not mean directors should only ever take a high level/strategic view
- particularly where public statements having legal effect or ramifications are concerned (prospectuses, financial statements, market disclosures), directors cannot ignore the detail, but must bring an enquiring mind and their own knowledge of the company to bear
- bringing an enquiring mind to bear on a material statement requires the director actually to read it, not simply assume that management and/or advisers have done so
- directors who are not sufficiently financially literate to be able adequately to monitor the business of the company should up-skill quickly
- directors who do not understand the company's business (and, in particular, key drivers and risks) should up-skill quickly
- being wrong is not a breach of duty in and of itself – but being wrong because of unquestioning reliance on others, inadequate financial literacy or failure to bring an enquiring mind and knowledge of the business to the matter at hand is
- if directors have doubts, they need to drill into them
- just because the lawyers, auditors, trustee and the Financial Markets Authority have not raised red flags, does not mean directors are okay. The Courts have more than once ruled that directors' duties are non-delegable, and
- balancing the interests of new investors with those of current investors is not a justification for not disclosing material information on offering documents. If something is material, it must be disclosed regardless of whether disclosure will have an adverse effect on the value of existing securities.

The courts start from the fundamental premise that:

- the company's business must be managed by or under the supervision of the board, and
- statutory obligations (such as approval of financial statements and offering documents) are obligations of directors, not of management.

Of course reliance on others is permitted. Modern corporations could not function otherwise. But reliance on others in the performance of a task does not mean the underlying duties are abdicated. Those duties remain to be discharged, and reliance is only acceptable when it is reasonable.

To the courts, "governance" means properly supervising management (as an alternative to directors actually doing the management themselves). It does not mean merely painting the big picture and letting management get on with joining the dots.

Some tips

Against this backdrop, here are some things which directors should ask themselves next time a prospectus, financial statements, market disclosure or major transaction comes before them.

- Do I understand enough of the detail, and enough about the company, to understand the material implications for the company and be comfortable that there are no material issues which have not been properly addressed?
- In particular, do I understand the financial implications for the company?
- Have I read the proposed disclosure/prospectus/financial statements? Do I understand it/them, and the company, sufficiently to assess its/their material accuracy?
- Who has signed off? Do those sign-offs, together, leave any material gaps – whether because of express assumptions or limitations, or because some key areas have simply not been addressed?

Footnotes

1. http://www.chapmantripp.com/publications/Pages/Pending-law-change-may-have-saved-Lombard-directors.aspx
2. http://www.chapmantripp.com/publications/Pages/Feltex-decision-will-provide-comfort-to-the-diligent-director.aspx
3. http://www.chapmantripp.com/publications/Pages/Does-the-nathans-decision-raise-the-bar-for-directors.aspx
4. http://www.chapmantripp.com/publications/Pages/Australian-case-finds-the-buck-stops-with-the-Board.aspx
5. http://www.chapmantripp.com/publications/Pages/Lessons-from-a-corporate-catastrophe.aspx
6. http://www.chapmantripp.com/publications/Pages/On-knowing-when-to-resign-as-director-lessons-from-Davidson-case.aspx

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