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Corporate Governance Update:
For Directors, A Wake-Up Call from Down Under

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Earlier this summer, the Federal Court of Australia handed down an important corporate law decision that would appear to have a substantial impact on the way that the statutorily defined responsibilities of directors are understood in Australia.[1] In *Australian Securities and Investments Commission v. Healey,* the entire board of directors (consisting of seven non-executive directors and the chief executive officer) was found to have breached its duty in failing to notice a significant error in the financial statements, an error that also went uncorrected by the outside auditors and internal employees. The directors were subject to possible financial penalties and bans as a result of the decision, though in the penalty phase of the case, the court determined that the liability judgment itself, with its associated embarrassment and reputational damage, was adequate punishment and deterrence.[2] Though the case involved interpretation of an Australian corporation law statute and was necessarily fact-specific, nonetheless it is worth careful scrutiny, as it serves as a powerful reminder to directors that their role is an active one and, further, may signal the direction in which the understanding of the role of directors generally could be headed.

Responsibilities of Directors

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[1] Australian Securities and Investments Commission v. Healey [2011] FCA 717, available at afr.com/rw/2009-2014/AFR/2011/06/27/Photos/14532968-a066-11e0-b761-5204ee499fb0_CENTRO%20JUDGMENT.pdf.

[2] Australian Securities and Investments Commission - 11-188MR Centro civil penalty proceedings, Aug. 31, 2011; *see* ASIC Press Release (Aug. 31, 2011) at www.asic.gov.au/asic/asic.nsf/byHeadline/11-188MR%20Centro%20civil%20penalty%20proceedings?opendocument.

The Australian Securities and Investments Commission (ASIC) sued all of the directors and the chief financial officer of the Centro Group over certain errors in the group's 2007 financial statements. Specifically, the financial statements improperly classified approximately Au$2 billion in short-term debt as long-term debt and failed to properly disclose certain guarantees as post-balance date events.[3] The multi-billion dollar error arose because of a misinterpretation of an accounting standard for short-term debt, and, as a result, the short-term repayment obligations were significantly understated.

The directors argued in their defense that they had relied on the advice of management and the auditors and that, as directors, they had fulfilled their duties by ensuring that the company had in place all reasonable procedures and processes to prevent errors in the financial statements. They also argued that expecting directors to find errors in financial statements would be imposing an impossibly high burden.[4] On the other side, ASIC pointed out that the directors had very recently supervised the largest acquisition in the company's history, which was financed through short-term debt, and that the directors therefore could not have applied any meaningful scrutiny to the financial statements.[5]

In June 2011, Justice John Eric Middleton of the Federal Court of Australia handed down the decision. He emphasized the importance of the financial statements to investors and the significance of the errors involved in this specific case. He found that each director knew or should have known of the short-term debt and of the guarantees, as well as of conventional accounting principles and practices concerning short-term debt, and that had they "understood and applied their minds to the financial statements and recognised the importance of their task," they would have questioned the errors rather than signed off on the financial statements.[6]

Justice Middleton stated that directors are required to carefully read and understand financial statements before they approve them and elaborated that this requires directors to (1) "acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged"; (2) "keep informed about the activities of the corporation"; (3) "whilst not required to have a detailed awareness of day-to-day activities, … monitor the corporate affairs and policies"; (4) "maintain familiarity with the financial status of the

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[3] ASIC v. Healey, ¶ 9.

[4] *See* Leonie Wood, "Boards Watching the *Centro* Case," *Sydney Morning Herald*, May 23, 2011.

[5] *Id.*

[6] ASIC v. Healey, ¶ 12.

corporation by a regular review and understanding of financial statements"; and (5) "whilst not an auditor, … have a questioning mind."[7]

It is noteworthy that Justice Middleton did not distinguish between audit committee members and the rest of the board, nor did he single out the chief executive officer from the rest of the (non-executive) directors (except in the penalty phase). He opined that, while the board should have "the varied wisdom, experience and expertise of persons drawn from different commercial backgrounds," each director "has a duty greater than that of simply representing a particular field of experience or expertise." Justice Middleton stated, "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."[8]

Although Justice Middleton commented that the defendant directors are "intelligent, experienced and conscientious people" and that there had been "no suggestion that each director did not honestly carry out his responsibilities," nonetheless he found that the directors "failed to take all reasonable steps required of them, and acted in the performance of their duties as director without exercising the degree of care and diligence the law requires of them."[9]

Significance of *ASIC v. Healey*

Under the facts of *ASIC v. Healey*, it was not enough for the directors to have acted in good faith, to have had the right procedures in place, and to have relied upon auditors and employees to ensure that the financial statements were correct. It would appear that under the reasoning of this case, it will be incumbent upon Australian directors to be alert to any glaring and significant errors in the financial statements, particularly when they are aware or should be aware of the background information necessary to notice the errors. The case makes clear that there can be no substitute for, and no excuse for failing to engage in, the directors' own thoughtful examination of a matter as important as the company's public financial statements.

As stated in his opinion, Justice Middleton's view of a director's duty is not out of line with common sense expectations. He summarizes the responsibilities of directors with respect to reviewing financial statements as follows: "[S]crutiny by the directors of the financial statements involves understanding their content. The director

[7] *Id.*, ¶ 17.

[8] *Id.*, ¶ 18.

[9] *Id.*, ¶ 8.

should then bring the information known or available to him or her in the normal discharge of the director's responsibilities to the task of focussing upon the financial statements."[10] Each case must turn on the specific facts at issue, as fundamentally the question remains whether a director has taken "all reasonable steps" to comply with his or her duties. Reasonableness would naturally take into account the nature of the issues involved, such as the volume and complexity of the financial information in the financial reports.[11] Despite his findings, Justice Middleton made clear that directors are not held to a standard of perfection.[12]

Directors in Australia and, by extension, elsewhere, may be concerned about the implications of this case for the ability of directors to rely upon expert advisors and management in making their decisions or participating in the approval of important statements and reports. It remains clear in Delaware and other U.S. jurisdictions that directors are entitled to rely on management, outside experts, and other advisors and have the protections of the business judgment rule. Under Delaware General Corporation Law § 141(e), a director who relies in good faith on the advice of any reasonably carefully selected advisor as to matters that the director reasonably believed to be in the advisor's area of expertise is "fully protected" from liability for breach of fiduciary duty.[13]

Indeed, Justice Middleton's opinion recognized that directors are entitled to and necessarily do rely upon advisors, "except where they know, or by the exercise of ordinary care should know, facts that would deny reliance."[14] The directors in this case received a sharp reminder that, in the court's view, they cannot rely on advisors and management without asking hard questions and using the information they have to evaluate the answers. Generally, a director should not simply substitute an advisor's judgment for his or her own. Even in Delaware, reliance on advisors is not intended to be blind; the protection of §141(e) may not cover a case in which an advisor's opinion was so clearly wrong that a director could not reasonably have relied upon it. Other recent cases have reinforced the idea that directors must be conscientious and probing in their evaluation of an advisor's suitability, objectivity, and competence.[15]

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[10] *Id.*, ¶ 22.

[11] *See Id.*, ¶ 217.

[12] *Id.*, ¶ 180.

[13] Delaware General Corporation Law § 141(e).

[14] ASIC v. Healey, ¶ 167.

[15] *See, e.g.,* In re Del Monte Foods Company S'holders Litig., Consol. C.A. No. 6027-VCL (Del. Ch. Feb. 14, 2011) (finding fault with a board process that permitted the board's financial advisors to have a financial stake in the transaction itself).

Justice Middleton also made an important point about the information that directors receive and are expected to understand. "A board can control the information it receives," he noted. "If there was an information overload, it could have been prevented."[16] This suggests that since directors have the ability to command the flow of information, it is incumbent upon them to ensure that they receive it in a form and quantity that is intelligible to them and that they set aside an adequate amount of time to read and understand the information provided to them in their roles as directors.

Although directors in the United States are, of course, not directly affected by the Australian case of *ASIC v. Healey*, this case is an illustrative example of a court's willingness to look beyond directors' good faith intent and reliance on advisors and management, and instead scrutinize their actions in light of the specific facts and knowledge attributed to them. Note that this standard is significantly different than the standard enunciated in Delaware's *Caremark* decision[17] which found that once a corporation's management implemented a monitoring system, only a "sustained or systematic" failure to monitor would result in liability for the directors of that corporation.[18] Furthermore, the court's decision in *ASIC v. Healey* indicates that simply "checking the boxes," as it were, or following proper procedures and relying on qualified advisors is not enough to fulfill the Australian version of the duty of care. Ultimately, at least some courts view directors as shareholder representatives who should use their experience and intelligence to supervise, evaluate, and, where necessary, challenge management in order to cause management to fulfill their duty of care obligations. Regardless of the jurisdiction, directors should take this case as a reminder that fulfilling their duties is an active role, not a passive one.

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[16] ASIC v. Healey, ¶ 229.

[17] In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996)

[18] *See, e.g.,* Alec Orenstein, "A Modified *Caremark* Standard to Protect Shareholders of Financial Firms from Poor Risk Management." 86 NYU Law Review 766, 771-772 (June 2011) available at www.law.nyu.edu/ecm_dlv4/groups/public/@nyu_law_website__journals__law_review/documents/documents/ecm_pro_069453.pdf.