



In April this year, Justice Ian Gzell of the New South Wales Supreme Court found that the former non-executive directors (NEDs) and executives of James Hardie Industries had breached the *Corporations Act* when making statements about the adequacy of asbestos compensation funding. In August, each of the seven NEDs was fined \$30,000 and disqualified from acting as a company director for five years.

In September, six of the NEDs filed appeals in the NSW Court of Appeal while the Australian Securities and Investments Commission (ASIC) filed a notice of cross-appeal.

This is one of very few cases where ASIC has sued both executives and NEDs and as such, it has been the subject of much boardroom discussion. While it was the executives who were found guilty of the majority of the alleged contraventions, many NEDs are concerned about the possible impact of the case. Ironically, the fact that the judge found the directors guilty of lack of due diligence rather than bad faith may be compounding the unease.

“Generally, when you read the facts about a case concerning directors’ duties, you think: ‘Yes, I can see a breach there’,” says Priscilla Bryans, a partner at Freehills. “Here, we’re talking about experienced, high-profile and well-regarded directors who were conducting business in a way that other directors can relate to more easily than where bad faith behaviour and a breach of duty is very clear.”

Directors may be feeling more nervous than they need to be, largely because the case turned on a very specific and unusual set of facts. The directors claimed that they had not seen a press release containing misleading and deceptive comments about James Hardie’s ability to meet its asbestos compensation liabilities. The judge found that they had seen it and that they had therefore acted in a way that was misleading. While this makes extrapolation difficult, issues were raised that are worthy of clarification.

Will directors need to approve all media and ASX announcements?

Justice Gzell said the media release in question contained information about “potentially explosive steps” and that market reaction to the announcement was “critical”. His finding that the release was within the purview of the board’s responsibility does not suggest that anything other than the most important communications should be brought to directors’ attention.

The question is not whether the board should approve more announcements, but whether they approved this one.

While the minutes clearly stated that the media release had been tabled, the directors claimed that they had not seen it. A number went so far as to say that they would never have approved something so unequivocal. If this were the case, management would have been guilty of failing to flag such a significant communication. However, the judge found not only that the release had been put before the meeting but that, as none of the directors voiced dissent, the consent of all could be presumed.

"Presumed consent" included two directors who phoned into the meeting from overseas. As they neither asked for a copy of the release to be sent to them nor to have it read out to them yet did not actively abstain from voting, they were held to be in breach of their duties.

Does this mean that boards should now start recording every vote in the minutes?

"Most decisions are made by unanimous consent through discussion," says Bryan. "Boards should be able to present a final resolution without recording who voted for or against."

Are continuous disclosure and director liability mutually exclusive?

Announcements needing board approval may be limited to "transforming" ones but as these are the ones most likely to have an impact on share prices, this raises questions around continuous disclosure.

"The biggest conflict or tension is a pragmatic one," says Tim Bednall, a partner at Mallesons Stephen Jaques. "How do you balance the immediacy requirement of continuous disclosure with the individual board rigour that the decision asks for? We have been advising our clients to do the best they can in terms of board engagement, without compromising the need for prompt disclosure, but then having systems in place to ensure board members have full opportunity for urgent post-review if they did not have sufficient time for pre-review.

"Australian continuous disclosure rules are the most unforgiving globally. Immediate disclosure gives no practical leeway, but that's the law. Where a practical issue arises, a trading halt can and should be used – but halts cannot be used too frequently."

Jan Redfern, a consultant at Sparke Helmore and former ASIC executive director of enforcement, agrees that it can be hard to get disclosure right when a company is under pressure, the issues are complex and the market is volatile.

"In some cases, immediate disclosure will not be practical or indeed, required by the law or the listing rules – particularly with volatile markets and imprecise information which is incomplete and/or confidential," she says. "When you look at the history of cases brought by ASIC, it is clear it has been circumspect and considered in its choices. However, boards must do their best and there needs to be a good understanding at both management and director level about what continuous disclosure means. The key is to have good processes and procedures in place to deal with those issues and if necessary, board debate on how market disclosure should be made and how to deal with the grey areas. Market disclosure should not be dealt with at the last minute as an 'add on'."

Must directors stop delegating to management?

"I can understand that, with increasing regulation and personal liability at stake, directors feel they need to get immersed in detail," continues Redfern. "This is not the best way and I don't think the courts or ASIC expect this.

"NEDs will always need to devote enough time to reviewing board papers and making sure they test and understand the issues raised by management. They need to test the information, understand it and independently assess it, and this can certainly be a challenge for complex businesses or when there are difficult decisions to make and times are hard, as they are now. But this was not a case where the judge said the directors should have challenged information provided by management and undertaken their own investigations. In

fact, he found that the executives had breached duties in failing to provide certain relevant information to the board.”

Directors should be able to work on the assumption that management presents them with all of the information they need to make a decision, including limitations around the information.

“Judge Gzell took it that, at the time of the meeting in question, the directors were able to recall everything they’d been told in previous meetings,” says Bryan. “One practical flow on from that would be for directors to ask management for a summary of information they have previously provided.”

Will directors’ workload increase?

While the James Hardie case may not generate any changes in the law, it does put more focus on board practices, including the dynamics between executives and NEDs in the boardroom.

“We do think directors will have a higher workload as a result of the decision,” says David Friedlander, a fellow partner at Mallesons Stephen Jaques. “Board attention to public disclosures, in announcements and other published company documents, will take a step up. However, we are advising our client boards to put systems in place that minimise the additional burden on board members. The decision puts a stronger spotlight on the need for boards to put in place good internal systems which enable the board to focus on key issues within public disclosures, and ensure that delegated powers are exercised appropriately.”

In some cases, the findings could provide a much-needed wake-up call.

“In the world of ethics and corporate governance, people have been saying for a long time that one of the problems with boards is that some directors see them as a free lunch,” says Dr Stephen Cohen, an associate professor at the University of NSW, a director of the university’s Graduate Programs in Professional Ethics and a director of the Business Ethics Centre at Compliance Australia. “This case might remind them that board positions come with responsibilities – that ‘director’ is not an honorary title.”

It certainly exposed an astonishing disregard for responsibility.

“One director said he took virtually no interest in matters relating to communications issues or strategy,” says Professor Ian Ramsay, director of the Centre for Corporate Law and Securities Regulation of at the University of Melbourne. “He said that his normal practice was not to spend a great deal of time reading board papers dealing with communications strategy and he might ‘tune out or have a break’ during discussions on the subject.

“In this case, the matters identified in the media release would transform the company in a fundamental way. Setting up the Medical Research and Compensation Foundation was designed to take away the asbestos liability that had been hanging over the company for years. It was a critical and controversial time when the company was under a high level of scrutiny and subject to quite a lot of criticism – a time when, presumably, communication strategy had never been more important to the company. Even if he wasn’t an expert in this area, that doesn’t excuse him from not paying attention. It’s just not good enough to say that some things are not your responsibility.”

That doesn’t mean a court would expect directors to have a thorough knowledge of all aspects of the business. In this case, the judge made the point that no high level expertise was required on the part of the directors to form a view on the accuracy of the media release – they just needed to use their knowledge of the company and the transaction to approve the media release designed to explain their strategy to the public.

While this particular director seemed to have no problem in using such behaviour as a defence on the witness stand, others may well have been shocked to find the most intimate workings of the board exposed to public view.

"I'm sure the directors never imagined that their behaviour would be subject to such intense scrutiny," continues Ramsay. "If ASIC, shareholders or a liquidator wants to sue for breach of directors' duties, everything – Powerpoint presentations, minutes, board packs – is open to review. Directors might do well to bear that in mind. While breaches of duty do carry pecuniary penalties, depending on the individual defendant, arguably the biggest sanction is loss of reputation. It's hard to put a dollar amount on that."

A different level of concern

ASIC chairman Tony D'Aloisio has encouraged boards to consider the implications of the James Hardie decision carefully and assess what improvements they can make to their decision making processes, the way they convey decisions to the market and the way they conduct investor briefings and so-called road shows.

"The decision is another important step in improving corporate governance in Australia and that improvement will add confidence to the integrity of our markets," he said.

"I think the case needs to be put in perspective," says Redfern. "Perhaps, with time and proper debate around the issues, NEDs may become less concerned and more certain of what it stands for."

Peter Shaw, a partner at Maddocks, believes that, for many directors, the perceived threat already lies beyond the detail.

"They're seeing the case as part of a growing trend towards class actions on behalf of shareholders," he says. "We've already had the Artistocrat case, which was a class action in respect of an alleged breach of the continuous disclosure rules by the company; there's no doubt that an increasingly sophisticated group of litigation funders and specialist law firms are seeing that there could be much to be gained from going after a company, then the directors of the company, then the directors' insurance policies. People can see the potential risk to both their personal assets and their reputation and are becoming more reticent about accepting board appointments as a result."

Shaw believes that broader application of the business judgement rule could provide the security of a safe harbour.

"At the moment it's a defence to a breach of only certain director's duties," he says. "Directors would have a more complete sense of comfort if those who took on the role in good faith and applied themselves to the best of their ability were, by definition, safe."

Breakout box: How can directors best protect themselves?

Sparke Helmore's Jan Redfern suggests six points for good practice.

- Giving themselves enough time to review board papers, to understand the issues raised and, if necessary, be prepared to ask questions to ensure the issues are covered and clear.
- Directors should not be pushed into making decisions too quickly and without the appropriate briefings. This expectation should be set early so that management knows how and when to present information.
- Make sure board agendas are not cluttered with too much business or unhelpful information. Directors are entitled to expect clear briefings that raise all of the appropriate issues and information for determination.
- If a director is on a board committee and is apprised of certain information through that committee that may be relevant to broader issues, they should make sure this information is available to the rest of the board.
- Attendance of board meetings by telephone conference should be minimised where possible, especially when considering important or complex matters.

- Ensure the company has clear, documented and well understood procedures for market disclosures. If disclosure is to be delegated to key officers but some disclosures are to go to the board, discuss and agree on the policy at the outset.
- Debate how the company will deal with the “grey areas” of disclosure so it can be as agile in its disclosure practices as it is with its decision making on business and operational decisions. Decision making in crisis and “on the run” is not good management and is where most of the problems can arise.