



# Insight

Commercial Dispute Resolution

14 July 2011

## Directors' duties: A reality check – more than just an ornament!

A reality check is exactly what the decision of Federal Court judge Justice Middleton will bring for the hundreds of directors in Australia who sit on company boards.

Justice Middleton's use of the phrase *'a reality check'* and his findings in the case ASIC initiated against eight Centro board members is a wake up call for all directors who fail to pay significant attention to the goings on of the companies over which they preside.

In a 130 page judgment, Justice Middleton found that the directors of the Centro board failed to perform their duties as directors with the level of care and diligence that the Corporations Act, 2001 (the Act) required of them.

### The claim

ASIC's allegations against the eight defendant directors centred on the approval of consolidated financial statements of three Centro entities for the financial year ending June 2007. All directors, save for one, defended the allegations.

The claim related specifically to the annual reports of the Centro entities and a failure by the members of the board to detect the non-disclosure of significant matters; namely millions of dollars worth of short term liabilities and the guarantees of the short-term liabilities of an associated company.

### The law

ASIC alleged (and Justice Middleton ultimately found) that the directors had contravened sections 180(1), 601FD(3) and 344(1) of the Act.

Section 180(1) sets an objective standard and requires a director to exercise their powers and discharge their duties with a degree of care and diligence. Section 601FD outlines the duties of officers and amongst other things requires directors to take all steps that a reasonable person would take to ensure that a company complies with the provisions of the Act and Section 344(1) contemplates a contravention of the financial record keeping and reporting obligations contained in Parts 2M.2 and 2M.3 of the Act.

ASIC sought declarations that the defendant directors be fined and disqualified from managing corporations. A hearing on penalties is scheduled to be heard on 1 August 2011.

### The defence

The directors who defended the allegations submitted that:

They had fulfilled their responsibilities under the Act by *"adopting processes and relying on proper advice"*.

ASIC's contentions lacked any sense of reality and sought to extend the responsibility of directors well beyond financial literacy.

### The findings

In finding that the directors had contravened the relevant sections of the Act, Justice Middleton made a number of important observations regarding the Centro directors and the role of directors generally.

With specific reference to the Centro directors, His Honour held that:

- Whilst acting honestly, the directors had failed to exercise the degree of care and diligence required of them.
- The information not disclosed in the reports was a matter of significance to the risk assessment of the entities and ultimately the shareholders.
- The directors knew or should've known of the matters not disclosed and in consideration of this; they should not have certified the truth and fairness of the financial reports. Information concerning short term liabilities had previously been put before the board and was readily available to each of the directors.
- The basic concepts and level of financial literacy required by the directors to properly challenge the errors in the reports were 'not complicated'.



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With regard to the role and responsibility of directors generally, His Honour held that:

- Directors are “at the apex of the company structure” and their actions can have a “profound effect on the community, and not just shareholders, employees and creditors”.
- Directors are entitled to delegate the preparation of books and accounts to others and rely on that information but they also must also ensure, as far as possible and reasonable, that the information is accurate and in accordance with their own knowledge and information available to them.
- Before directors make declarations in accordance with section 295(4) of the Act, financial reports and documents must be read and understood and be consistent with that director’s own knowledge of the company’s financial status. Furthermore, the opinion required to be formed to make such a declaration requires an ability to comprehend the classification of assets and liabilities as current and non-current.
- Directors, whilst not auditors; should maintain a questioning mind in relation to financial statements prepared by their agents.
- The complexity and volume of information provided to a director is not an excuse for failing to properly read and understand financial documents; it is the board’s responsibility to determine the information it does or does not require.

### The consequences

Justice Middleton’s decision may well be appealed by the Centro directors. However, it does not detract from the significant matters he raises regarding the importance of the role of directors and the impact of the decisions they make.

His Honour’s findings should also act as a reminder to directors and board members that the law will come down on those who ‘rubber stamp’ financial reports and statements without properly comprehending or inquiring as to their accuracy.

**AUTHOR** Kylie Hall - Senior Associate

### Our team

*Holding Redlich’s commercial dispute resolution team has extensive experience advising in relation to directors’ duties and responsibilities, the Corporations Act and ASIC investigations and prosecutions.*

#### Melbourne



Howard Rapke, Partner

T: +61 (0)3 9321 9752

E: [howard.rapke@holdingredlich.com.au](mailto:howard.rapke@holdingredlich.com.au)

#### Sydney



Harold Werksman, Partner

T: +61 (0)2 8083 0405

E: [harold.werksman@holdingredlich.com.au](mailto:harold.werksman@holdingredlich.com.au)

#### Brisbane



Paul Venus, Partner

T: +61 (0)7 3135 0613

E: [paul.venus@holdingredlich.com.au](mailto:paul.venus@holdingredlich.com.au)

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