The Independent Directors' Dilemma:

Is there ever a safe environment in which to be an independent director?

Elise Margow, BA, LLB

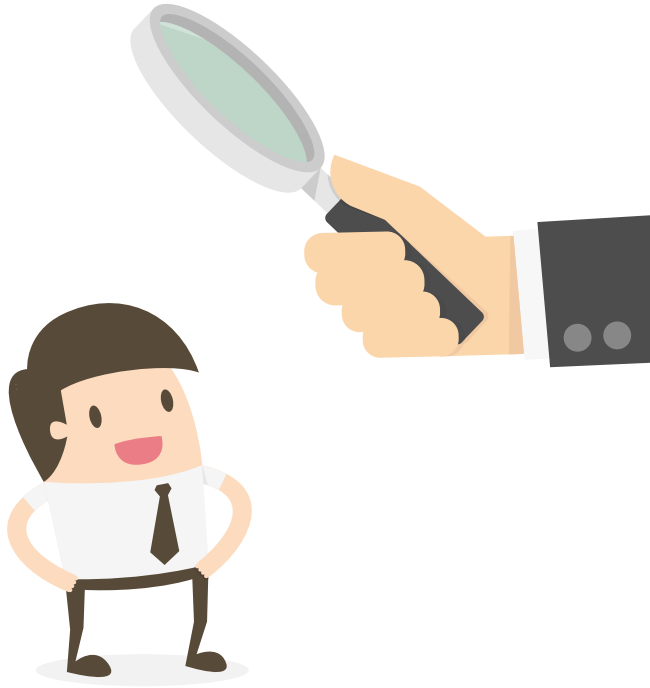
There was a time in the not too distant past when it was generally accepted that directors of corporate boards constituted a closed network. As a consequence, the role of directors and their accountabilities seemed shrouded in mystery – a mystery that few people outside of the directors' circle were interested in solving.

However, after the profligate corporate excesses of the 1980s both regulators and shareholders globally and in Australia began to demand changes to the traditional composition of corporate boards, including a requirement that the directors' club include independent directors outside of the traditional closed networks.

Corporate excesses and collapses in Australia also resulted in the introduction over time of a more stringent regulatory environment replete with personal penalties for directors.

We therefore have a corporate environment today where more diverse directors are invited onto boards as independent directors, while at the same time the personal risk associated with being a director has increased exponentially.

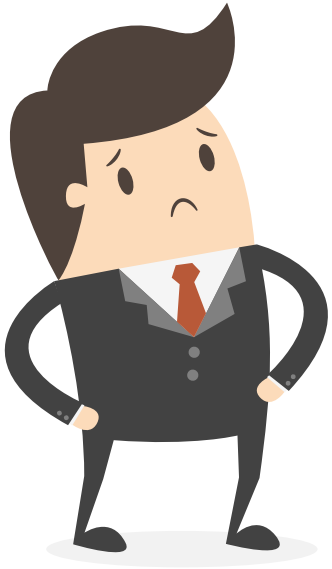
This leaves a budding independent director with a dilemma. The coast which has been cleared to enable directorship opportunities for those previously denied them is also filled with shark-infested regulatory waters.



The risk of personal liability

Today there are hundreds of federal and state laws governing directors' duties and creating potential personal penalties both civil and criminal for breach. Directors' duties have been expanded from the traditional obligations for a corporation's high level strategy and financial health to include responsibility for some of the day to day operations and policies including occupational health & safety and workplace harassment. As a result, it has become easier for shareholders and regulators to pursue directors and officers in their personal capacities for the failures of a corporation and this in turn can deter talented candidates from accepting directorships.

Can nightmare scenarios be transformed into sweet dreams?



There have been a number of high profile cases involving directors over the past five years, some of which have caused great consternation amongst current and wannabe directors. Two such cases are:

- The David Jones Limited case (**DJs case**) which included a claim against directors in their personal capacity on the basis of vicarious liability; and

- *ASIC v Healy & Ors [2011] FCA 717* (**Centro case**) which dealt with the personal responsibility of each director when approving the financial accounts of a corporation.

David Jones: Vicarious Liability and Sexual Harassment

Up until about July 2010, most wannabe non-executive directors would have envied the directors of David Jones Limited (**DJs**). DJs was enjoying profits and had a well-established reputable brand. However, there was nothing to be envied in August 2010 when a former DJs employee sued the company, certain members of the senior management team and each director in their personal capacity alleging sexual misconduct on the part of the Chief Executive.

The main foundation of the claim against individual directors was based on an allegation that the Board had been aware of the chief executives' propensity for sexual misconduct but chose to ignore it. If these allegations were proved, the directors in their personal capacity could have been vicariously liable for a breach of section 28B(6) of the *Sex Discrimination Act 1984 (C'th)* for the sexual misconduct of the chief executive. The only defence available to directors in these circumstances would be to prove that they had taken all reasonable steps to prevent employees engaging in sexual harassment.

The matter was never considered by a court as the parties agreed to settle the claim on a confidential basis. Accordingly, we do not know whether the DJs board at the time would have been held vicariously liable for the alleged misconduct of the Chief Executive.

There has been some disquiet around holding directors vicariously liable for the conduct of employees. Some say that it is one thing to hold management vicariously liable for the behaviour of employees given that management is responsible for the day to day management and operations of the company but it is unreasonable to hold accountable a Board tasked with high level strategic oversight of the company. This feeling of frustration is understandable but appropriate conduct in the workplace is a high level strategic matter. The Board should be taking reasonable steps to ensure that the company has a policy and culture to deter bad behaviour including sexual harassment in the work place. In this regard, a Board can and should:

- Ensure that the organisation has adopted an appropriate system to prevent sexual harassment;
- Monitor the operation of that system by insisting on sufficient reporting around complaints made, complaint management and outcomes;
- Act on any information that demonstrates that the system is insufficient.

[1] Recommendation 2.4 of the ASX Corporate Governance Principles and Recommendations states that the majority of the board of a listed entity should be independent directors.

ASIC v Healey[2] ('Centro Case'): Approval of Financial Statements

The Centro case caused a great degree of consternation amongst directors and potential directors who are not specialists in finance and/or accounting matters. Centro[3] constituted a group of high growth property companies with operations across Australia and the United States of America governed by the same board of directors.

This case involved Centro Board's approval of financial statements by way of declaration required under section 295 of the *Corporations Act 2001 (C'th)*. Subsequently, it transpired that there had been errors in the approved financial statements which the Board had failed to detect. On this basis, seven non-executive directors were held not to have taken reasonable steps required of them to approve the financial statements of the company based on the degree of care and diligence the law required of them.

The non-executive directors in this case conceded that there had been an error in the accounts but felt that as they had *acted honestly and having regard to all the circumstances ought fairly to be excused*[4] from the civil penalty provision for having breached section 295. In particular, directors who were not experts in accounting or finance stated that they had reasonably relied on the advice provided by the Board's audit committee and consultants who had signed off on the financial statements.

Many would sympathise with the directors in this case. After all, if an audit committee plus consultants who are experts advise that all is in order, how could non-experts have detected that there was an issue with the accounts? The issue though was not whether the directors would have detected the issue with the accounts but rather that each director had not *stood back, armed with his own knowledge, and looked at and considered for himself the financial statements.*[5] It was not good enough for the directors to rely on a process involving an audit committee or advisors no matter how trustworthy.

Given the fundamental importance of financial statements and each individual director's duty pertaining to approving these statements, it is important that each director:

- Have the financial competency to understand the financial statements of a company in light of basic accounting concepts and to bring an enquiring mind to a review of these statements;
- Question and test information provided no matter how reliable and trustworthy the source.

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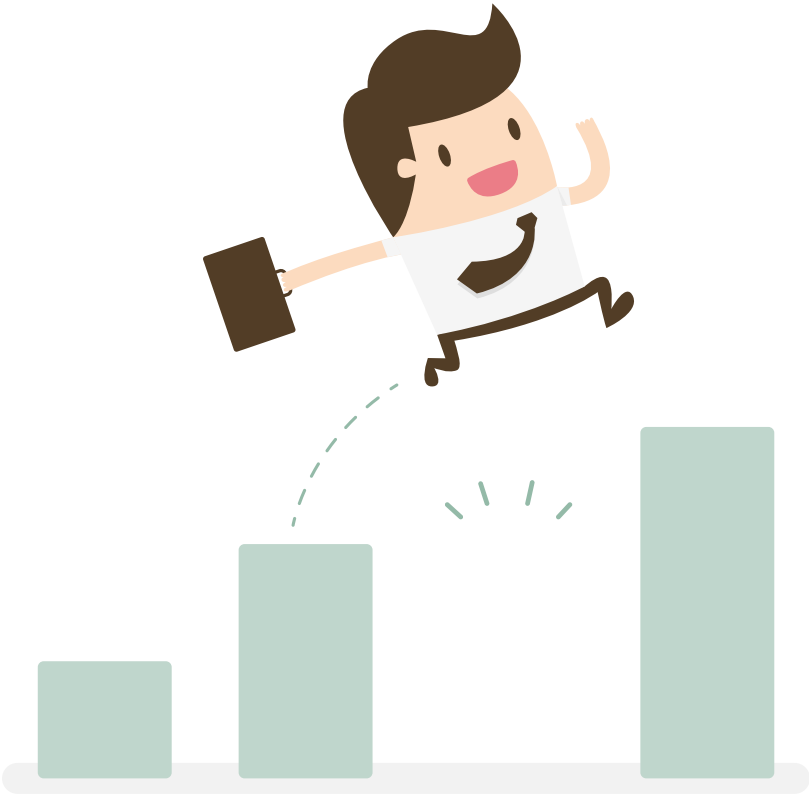
[2] *ASIC v Healey* [2011] FCA 717
[3] Centro Properties Limited, Centro Property Trust and Centro Retail Trust (**collectively Centro**)
[4] Section 1317S of *Corporations Act 2001 (C'th)*
[5] *ASIC v Healey [2011] FCA 717* at [569]

Is it really worth the risk?

The DJ's Case and the Centro Case certainly demonstrate the potential personal risks facing directors. However, these cases should not deter budding directors from joining boards as there are ways and means of avoiding personal liability.

Many books and research papers have been written on the numerous risks facing directors suggesting risk mitigation techniques. It is not possible in this paper to consider every risk or provide extensive suggestions about how to minimise these risks. However, here are a few handy practical risk mitigation tips gleaned from my personal experience and from various discussions I have had with experienced directors and corporate risk specialists.



Tips and traps

1. Although you will not be able to determine the full extent of a company's health until you are on the Board, it is very important to conduct a thorough due diligence of a company before agreeing to join the board. This includes where possible talking to people who have had dealings with the company including clients or previous employees.

2. Just because management is charming, impressive and articulate does not mean that they are doing a good job and telling you everything.

3. Tension between board and management is not necessarily a bad thing – it keeps both parties on their toes and ensures a vigilance that might otherwise be lacking.

4. Boards and management that spend an inordinate amount of times playing political games are hazardous to a company's health as too much time is spent on personal fiefdoms and not enough time is spent dealing with company business.

5. Read financial statements very carefully. If you do not understand certain aspects of the statements, ask questions. Do not rely completely on the Audit Committee, Finance and Risk Committee's opinion neither the advice of the independent auditor. Always ask questions and think carefully about the answer.

Tips and traps

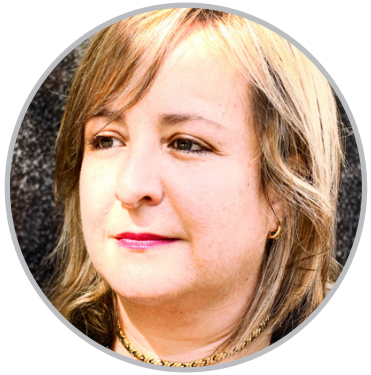
6. Ensure that the organisation has adopted appropriate policies and procedures including workplace procedures and policies. Monitor the operation of policies and procedures by insisting on sufficient reporting around complaints made, complaint management and outcomes.

7. Ensure that the flow of information to the board is adequate and timely so that you have the information needed to do your job, time to assess the information and time for your enquiries to be considered.

8. Where appropriate, spend time understanding the day to day operations of the company whether this be by way of visiting the business from time to time or asking for presentations from various parts of the company.

9. Act on any information that demonstrates that there may be a substantive problem. If you suspect there is a problem, raise this as a formal issue with management and the other directors by ensuring that your concerns and response to those concerns are expressly recorded in minutes. If despite your best efforts substantive problems are not resolved appropriately to your satisfaction, then as a last resort you should resign from the board as quickly as possible in order to avoid personal liability.

About the Author



Elise Margow, BA, LLB

Elise has broad legal and business expertise, having worked in the corporate sector for the past 13 years and in practice at various law firms. She is an alumnus of Arnold Bloch Leibler and Telstra Corporation Limited and has headed up legal, risk and regulatory teams including the team at Liberty Financial Pty Limited. In addition to providing a wide range of legal advice to her clients and reducing the legal spend of clients substantially, she has contributed on credit and due diligence committees, is a director of two companies and has company secretarial experience.

While at Liberty Financial Pty Limited, Elise was responsible for the implementation of the National Consumer Credit Protection Act 2009 and the Personal Property Securities Act 2009 across the business. She and her team worked with both the commercial and operational teams from all areas of the business to ensure that the business complied with regulatory requirements while at the same time achieving commercial imperatives. Elise was a member of the Australian Finance Conference Legal and Risk Committee from 2009 to 2012 being actively involved in strategically analysing proposed new and amended regulations affecting the finance and banking industry.

Elise is a nationally accredited mediator having trained as a mediator with LEADR – Association of Dispute Resolvers. She has represented various clients at mediations and acted as mediator in a wide variety of matters.

Elise was named by The Age Melbourne Magazine as one of the top 100 most passionate, powerful and provocative personalities of 2012.

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