Directors’ and Officers’ Liability – It’s a Jungle Out There

Introduction

D&O insurance cover offers protection for directors and officers and is often required to secure their appointment to company boards because claims against directors and officers can involve substantial damages or financial penalties, and significant defence costs.

As discussed in recent newsletters, directors’ conduct has come under the increasing scrutiny of regulators and shareholders. More is being expected of directors at a time when the environment in which they operate is becoming ever more complex.

It is therefore critical for directors (including non-executive directors) to have a thorough appreciation of their obligations to both minimise their potential exposure and understand the scope of insurance cover they require. In that context, this newsletter examines the main source of claims against company directors.

Liability of Directors and Officers

Directors and officers owe a variety of duties at common law, under statute and in equity, many of which are found in the Corporations Act 2001 (Cth) (the Act).

Those statutory duties reflect the need to ensure the interests of the company are always paramount, and in summary comprise:

- Section 180 - discharging duties with the degree of care and diligence that would be expected of a director in the company’s circumstances. The so-called “business judgment rule” is a defence under this section if the decision is made in good faith and for a proper purpose; the director does not have a personal interest in the subject matter; has appropriately informed him or herself about the issue and rationally believes the decision is in the company’s best interests.¹
- Section 181 – exercising powers and discharging duties in good faith in the company’s best interests and for a proper purpose.
- Section 182 – not using the position to gain personal advantage or to cause detriment to the company.
- Section 183 – not using information to gain personal advantage or cause detriment to the company.
- Section 184 – not acting in a way that is intentionally dishonest or reckless.
- Section 588G – not permitting the company to incur a debt when it does not have the capacity to repay the debt and the director knows or ought to know that to be the case (insolvent trading).

A number of these duties relate to the financial records and accounts of the company, Directors and officers face disqualification and civil penalties² for any (and each)³ breach of these provisions. This is in addition to liability for compensatory damages at common law and in equity, and in addition to criminal liability for failing to disclose a conflict of interest or for regulatory infringements relating to matters such as the registered office, prospectuses, issuing shares and complying with ASIC requirements.⁴

A number of these duties again relate to the financial records and accounts of the company for which civil penalties and disqualification apply, and which may constitute a criminal offence where dishonesty is involved carrying a fine of up to $220,000 and/or up to five years imprisonment, in addition to directors’ personal exposure to pay compensation to creditors for insolvent trading.

It should also be remembered directors’ liabilities extend beyond the Act, including for example duties owed pursuant to occupational health and safety legislation in the various states, environmental laws, Australian Consumer Law and liability for tax and superannuation contributions.

¹ The test is objective – see ASIC v Rich [2003] NSWSC 85.

² Of up to $200,000 for individuals on a preliminary basis.

³ Section 185 Corporations Act (2001) makes those remedies cumulative and not alternative.

⁴ See ASIC v James Hardie [2009] NSWSC 211.
An action against directors and officers is most likely to be brought by the company itself (the company that the director or officer represents) or the liquidators of the company, since the directors’ duties as fiduciaries are owed to the company.

In addition to the company, various regulators (in particular the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA)) will monitor corporate governance and commonly intervene to bring proceedings against directors for breaches of the Act.

Although the duties owed by directors and officers are owed to the company itself (which in essence can be said to comprise the shareholders as a whole) and not its individual shareholders, where the directors or officers who have caused the loss to the company also control the company (such that they would not elect to sue themselves), a class action (known as a derivative action) can be brought on behalf of shareholders, and these derivative actions are becoming increasingly common with the benefit of litigation funding.

There are also other special circumstances where individual shareholders can bring a claim against the company. In Brunninghausen v Glavanics, the New South Wales Court of Appeal held that special circumstances existed where a director/shareholder owed a duty to disclose to another director/shareholder details of the transaction he had negotiated for the sale of the company, the duty arising because the second director was also a shareholder.

It is also theoretically possible for claims to be brought by employees, creditors and the general public.

Although directors do not owe fiduciary duties to employees in Australia, Commonwealth legislation does provide some protection for employees where a company collapses owing large sums to employees, particularly where substantial bonuses have been paid to the directors – examples where one-off special arrangements have been made include One.Tel, Ansett and James Hardie.

In the UK decision Stone & Rolls Ltd v Moore Stephens, the House of Lords did not impose on the company auditors a liability to the bank as a creditor of the company, however it would be a risky enterprise for directors to ignore the interests of creditors, particularly upon insolvency.

Directors do not owe a duty to society at large, however this is a live issue in the context of the push for better corporate governance and social conscience and will continue to be closely monitored by the media, to the extent the risk of adverse publicity, the loss of investors or clients and staff becomes the incentive for directors to behave appropriately.

# Increasing role of ASIC

As Australia’s financial services regulator, ASIC has in recent years increased its focus by the pursuit of civil penalties and criminal proceedings, and has been particularly active in the courts. In its 2011/2012 annual report, ASIC is noted as having completed 133 civil litigation investigations, 118 investigations, 14 criminal proceedings, and secured 13 criminal convictions and 10 imprisonments.

In a media release following the High Court decision of Shafron v Australian Securities and Investments Commission, ASIC Chairman Greg Medcraft made the following statements:

...The case brought into sharp focus the fundamental responsibilities of both executive officers and non-executive directors who are ultimately responsible for significant public company decisions, and the release of information concerning those decisions, to the share market, employees, creditors and the public.

...ASIC took this case to the highest court in the land and I am certain this case has and will be studied in boardrooms across Australia and in legal circles, and I know that it is already shaping corporate behavior and is having a positive deterrent effect.

Another example of the push for transparency and the importance of directors making properly informed decisions can be seen in ASIC v Hellicar (the James Hardie case), where seven non-executive directors of James Hardie Industries Ltd were named as defendants in proceedings brought by ASIC.

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5 Percival v Wright (1902) 2Ch 421.
6 See for example Campbell Cash and Carry Pty Limited v Fostif Pty Limited [2006] HCA 41.
7 See for example the comments of Chesterman J in Southern Cross Mine Management v Ensham Resources Pty Ltd (2003) QSC 486.
11 See for example the comments of Mason J in Walker v Wimborne (1976)3 ACLR 529.
ASIC alleged the directors were in breach of section 180 of the Act following the directors’ decision to approve an announcement to the ASX regarding the financial viability of the organisation, which included two directors from the United States who – it emerged - had voted on the ASX announcement via telephone without seeing the relevant documentation and who were therefore not competent to vote on the issue. ASIC was successful, despite the High Court awarding lesser penalties than those sought.

**Comment**

The increasing awareness of shareholders of their ability to make claims and the availability of D&O insurance has given rise to the trend for those claims to be vigorously pursued, particularly in the wake of the so called Global Financial Crisis and the rising number of insolvencies.

In addition, directors can expect ASIC to continue to pursue its role as corporate watchdog, notwithstanding the company or its shareholders may not take legal action.

Directors should therefore carefully consider their potential exposure with their brokers, to ensure they obtain adequate insurance protection.

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De Facto Directors – Lurking in the Company’s Shadow

By Tony Stumm, Partner

**Introduction**

The recently reported case in the matter of Idylic Solutions Pty Ltd – Australian Securities and Investments Commission v Hobbs [2012] NSWSC 1276 provides yet another example of the Court’s willingness to identify people as de facto directors (hence exposing them to liability for breach of directors’ duties).

**Background / Facts**

The ASIC took action against 15 defendants who were involved in promotion of un-regulated investment schemes where $AUD50 million had been raised and invested in offshore funds. Fourteen of the schemes involved ASIC allegations that investment in the schemes was unlawfully sold to unsophisticated investors as a result of investment seminars and meetings convened by the promoters who were not appropriately licensed.

**Identifying a de facto director**

After considering the statutory definitions of “director” and “officer” in the Corporations Act 2001 (Cth), the Court concluded that a de facto or shadow director of a company includes a person who, though not validly appointed as a director, acts in the position of a director (i.e. a de facto director) whose instructions or wishes are ones in accordance with which the directors of the company are accustomed to act. This also includes a de facto or shadow director who makes or participates in making decisions that affect the whole or a substantial part of the company’s business, and who has the capacity to significantly affect the company’s financial standing or in accordance with whose instructions or wishes the directors of the company are accustomed to act.

The Court followed tests enunciated in Grimaldi v Chameleon Mining NL (No 2) (2012) 200 FCR 296 in order to clarify what is meant by someone acting “in the position of a director.” These indicia were endorsed:

1. A person may be a director even without any purported appointment of that person to the position at any time.
2. That the shadow director must have contemplated, at least to some degree, doing the work of a director of the company. Alternatively expressed, that the shadow director has been acting in a role or roles within the company and performing functions one would reasonably expect to have been performed by a director of that company given its circumstances.
3. It is quite possible for the role of a person to evolve into one of de facto director over time. It is also possible that a person could act as de facto director for a limited period.
4. Titular names such as “consultant” are not determinants as to whether a person is (or isn’t) a director. The test is to look at the substance of the person’s role.

17 To the effect that an asbestos foundation that was established would have sufficient funds to meet asbestos claims against the James Hardie Group.
directors’ and officers’ duties of care and diligence having regard to the corporations administering the schemes. The Court also found breaches of s 181(1) of the Corporations Act 2001 (Cth) i.e. breaches of duties of good faith, s 182 obtaining a benefit at the detriment of the corporation and a number of other breaches relating to misrepresentation. The lack of ASIC licensing and unlawful promotion of unregistered schemes added to the defendants’ misconduct.

**Conclusion**

The case of Idylic Solutions did not create any new law. However, it is significant that ASIC focused on the individuals behind the scheme companies so that these individuals could not escape any personal liability by claiming that they were not directors of the relevant scheme companies. This case is also significant to the extent of demonstrating that cases such as this are becoming increasingly complex and lengthy. The case was heard over 32 hearing days, the reasons for judgment extended to 455 pages of transcript and over 200 cases were cited.

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