Play fair ASIC, and take care, company directors

The law imposes a duty of care on company directors, and a duty of fairness on ASIC, writes **Ian Ramsay**.

A major challenge for prominent regulators such as the Australian Securities and Investments Commission is that they get judged on the results of major court cases. There is an element of unfairness about this. After all, regulators run many cases a year.

But the reality of being judged on the results of major cases means the regulator needs to work hard to get it right in terms of the cases it decides to bring and also how it runs those cases. It also has to be clear about its litigation strategies.

It is in this context that we read the carefully crafted dual judgments of the NSW Court of Appeal in James Hardie Industries. A preliminary point can be made. The judgments don't represent a total defeat for ASIC as some early commentators have said. The former chief executive, Peter Macdonald, didn't appeal against the multiple breaches of duty that the court found at first instance and the penalties imposed on him — $350,000 and a 15-year management banning order.

The appeal court upheld breaches of duty by the former chief financial officer Phillip Morley and general counsel and company secretary Peter Shafron.

In addition, James Hardie Industries NV, the parent company, lost its appeal that it had breached its disclosure obligations.

However, what has received most attention is that the appeals of all seven non-executive directors succeeded. The first instance judge found five of the directors breached their duty of care by voting at a board meeting in February 2001 to approve a misleading draft Australian Securities Exchange announcement.

There could be no doubt the announcement was misleading. It referred to the establishment of a foundation by the company to provide compensation to those who brought legitimate asbestos claims and said the foundation was "fully funded" and "provided certainty" for those with asbestos claims. In fact, it was underfunded by more than $1 billion.

Two directors were based in the United States and took part in the meeting by phone. They did not ask to see the draft announcement and the judge held they breached their duty of care by failing to familiarise themselves with the draft announcement, or abstaining from voting.

The appeal court held that the evidence did not establish the directors had voted to approve the draft announcement. As this was a central to ASIC's case against the non-executive directors, their appeal succeeded.

The appeal court held that ASIC had a duty of fairness to call a witness (a lawyer present at the board meeting from a law firm that provided advice to the company on key aspects of the transaction), whose role meant there was a significant probability he had relevant knowledge of the meeting. In the words of the appeal court, ASIC "was obliged to call a witness of such central significance to critical issues that had arisen in the proceedings".

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The duty of fairness arises from the special role of ASIC in enforcing breaches of corporate law — only ASIC could have brought the case it did against the directors.

There are important reasons for imposing a duty of fairness on ASIC — it is not an ordinary litigant. For example, it has major investigative powers. And it can seek powerful sanctions from the court such as penalties and management banning orders.

The appeal court's judgment dismissing the company's appeal against findings it had breached its disclosure obligations also contains some uncomfortable words for ASIC. The first instance judge imposed a penalty of $80,000 on the company for these breaches.

The appeal court stated that the company's contravening conduct "demonstrated significant disregard for honesty and transparency and a subjective willingness to interpret its statutory obligations to suit its own corporate purposes".

The appeal court also said the penalty imposed was "light", having regard to the seriousness of the company's conduct.

But the court then said that as ASIC did not appeal against the penalty, there was nothing further for it to say on this matter.

ASIC has had to deal with judicial criticism in other cases, for example, what the court said in ASIC's unsuccessful case for breach of duty against One.Tel executive directors Jodee Rich and Mark Silbermann.

So there are some important lessons for ASIC on how it runs its cases from recent judgments, not just the James Hardie one.

The court of appeal judgment also contains lessons for directors and executives. The court stated that if, contrary to its finding, the directors had voted to approve the draft ASX announcement, they would have breached their duty of care. They would not have been entitled to rely on management and advisers to review the draft announcement and determine whether it was misleading given the special circumstances of the company.

The two US-based directors who phoned in to the board meeting would also have breached their duty by not familiarising themselves with the draft announcement or abstaining from voting. A theme of directors needing to be diligent and inquiring runs through this part of the judgment.

The court also provides its opinion on the responsibilities of the CFO and the company secretary/general counsel to advise the board in its deliberations and states, in a comment that will be of interest to company secretaries, that a company secretary with a legal background would be expected to raise issues such as potential misleading statements and disclosure obligations with the board.

Here we see how key executives failed in their responsibilities and what they should have done to support the board.

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