

Officers' duties under the microscope

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The headlines are full of stories about the latest corporate crook being sent to jail in the USA, in Europe, Asia or in Australia. There is often a degree of fraud involved and the amounts of money that have been personally gained and the massive losses the shareholders and creditors have suffered are overwhelming. What is little understood is the split between criminal and civil actions against corporate officers and, in particular, directors.

On 22 August 2005 Justice Austin handed down a very significant case, which examines in detail the corporate officers' role in the GIO Group of companies during the takeover bid by AMP. The case, *Australian Securities and Investments Commission (ASIC) v Vines, Robertson & Fox*¹ provided another opportunity for the key officer's duties to be examined under the *Corporations Act 2001* (Cth) in front of a well-known and respected commercial judge. The case, through the doctrine of precedent, will be examined by many lawyers, academics, officers and regulators for years to come, but there may be an appeal to the NSW Court of Appeal or even the High Court of Australia in the long term.

The significance of the case must be placed in the context of the jailing of Rodney Adler², Ray Williams³ and The Bond Corp executive, Tony Oates⁴ earlier this year and the civil penalty action against Steve Vizard⁵ for misuse of his position as a director of Telstra. The Federal Government asked the corporate law think-tank, the Corporations and Markets Advisory Committee (CAMAC)⁶ to examine both the legal duties of officers and employees below board level and the personal liability for corporate fault. This led to the release of two discussion papers which have been open to public comment prior to a final report, with recommendations to be provided later this year.

Definition issues

Before the Vines case can be examined in-depth, it is worthwhile commenting on the definition of 'officer' within the *Corporations Act 2001*. Section 9 defines an officer to include a director and secretary. It goes on to say that it includes a person who makes, or participates in making, decisions that affect the whole, or a substantial

part, of the business of the corporation; or who has the capacity to affect significantly the corporation's financial standing. Before 1998 this second functional definition was simply expressed as an 'executive officer' and after the Corporate Law Economic Reform Program No 9 (following a suggestion from the HIH Insurance Royal Commissioner, Justice Owen) the phrase 'senior manager' was given the same meaning as has been used after 1 July 2004.

In practice it is not often raised as an issue, as most people in an organisation know whether they are senior enough to be deemed an officer of the company and attract a higher level of duty and responsibility. But it gets confusing, as in the Vines case, where a person holds a number of positions between holding companies and subsidiaries.

Finally, it should be noted that the procedure for civil actions (such as the company suing the directors for breach of contract or the tort of negligence) is quite different from the Commonwealth Director of Public Prosecutions bringing a criminal prosecution for dishonesty. This current case is an example of a civil penalty, which is a hybrid action, brought by the regulator, ASIC, to both collect damages on behalf of the company, and impose an element of punishment through disqualification orders and pecuniary penalties (like a fine paid to the Federal Government).⁷

Factual background

A great deal of the 292-page (1500-paragraph) judgment deals with the complex area of re-insurance and contractual matters. The heart of the case is a civil penalty proceeding brought by the plaintiff, ASIC, against three executive officers of the GIO Group. The matter arose out of the profit forecast made by GIO Australia in its formal legal defence document (then known as a 'Part B statement') against the unwanted takeover offer by AMP.

GIO Australia Holdings was a listed public company until a time well after the AMP takeover bid had finally closed. It was the holding company for GIO Insurance and GIO Re (the re-insurance arm of the business). From July 1998, when the laws and the facts must be applied to

this case, the board of directors of GIO Insurance were full-time executives of the GIO Group. Mr Vines was the chief financial officer of the GIO Group. Mr Robertson was an executive director of GIO Insurance until November 1998 and continued in a role with GIO Re after that period. Mr Robertson was replaced by Mr Fox in early November 1998 at GIO Insurance.

ASIC's claim was that during the period of the AMP takeover of the GIO Group (August to December 1998) the three defendants breached their statutory duties of care and diligence as executive officers. Further, Mr Fox had failed to act honestly in exercising his powers as an officer. The defence statement issued by GIO against the AMP takeover used an inflated profit forecast for the year ending 30 June 1999. This profit forecast included a business profit before tax of \$80 million. This figure was fundamentally flawed due to the financial exposure GIO Re had to the September 1998 Hurricane Georges which passed through the Gulf of Mexico causing substantial damage.

The three defendants had failed to inform GIO Australia Holdings (the listed company), their directors or due diligence committee of the true potential effect of the claims on the company's profit likely to be received due to the hurricane.

Before examining the statutory duties in depth, it is worth noting that Mr Vines was a chartered accountant and registered auditor, who had worked for Price Waterhouse from 1968 until 1995. Mr Vines joined GIO as its chief financial officer in July 1995. Mr Vines was responsible for the financial reporting and taxation affairs of the GIO Group, including the consolidation of reports from subsidiaries, but did not actually prepare any of the financial reports from the subsidiaries. He attended the monthly board meetings of GIO Australia and the quarterly board meetings of the subsidiaries, but was not a director of them. Mr Robertson was an actuary of longstanding experience and extensively involved in the privatisation of GIO from the NSW Government in 1992.

The statutory officer's duties

ASIC primarily alleged that the three executives were in breach of their statutory duty to exercise

reasonable care and diligence in discharging their duties as an officer of a corporation. The relevant provision at the time was s 232(4) of the *Corporations Law*:

In the exercise of his or her powers and discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in the corporation would exercise in the corporation's circumstances.

The equivalent section is now s 180(1) of the *Corporations Act 2001 (Cth)*. Justice Austin in his judgment then sets out very clearly all the elements that ASIC was required to prove to demonstrate that the defendants had fallen short of this statutory standard. The three key questions⁸ to be answered were:

- (a) What is an executive officer?
- (b) What is the content of the statutory duty of care and diligence?
- (c) What is the content of the statutory duty of honesty?

Executive officers

The term 'executive officer' relates to those persons who are concerned or take part in the management of the corporation. Thus, it was necessary for the judge to look at the meaning of management and the degree of participation that is necessary to fit within the definition. There have been competing case law on this topic, but it appears that the judgment of Justice Ormiston in *Commissioner for Corporate Affairs v Bracht*⁹ took a wide view of the meaning of both management and participation. The concept of management should be confined to 'central management'. It is stated that merely administrative work performed by a company secretary or accountant would not constitute management¹⁰ nor would the execution of instructions by an agent obeying orders or following set policies.¹¹

A narrower view of management was put forward in *Holpitt Pty Ltd v Swaab*¹² by Justice Burchett, which was an insolvent trading case rather than a director's duty case.

Justice Austin carefully weighs up the authorities and decided that the Ormiston J approach in *Bracht* case is correct and thus Mr Vines is an executive officer of GIO Australia Holdings and Mr Robertson and Mr Fox are executive officers of GIO Insurance. He said 'the definition of executive officer is to identify, among those who work for the corporation, that group whose responsibilities are significant enough to justify the imposition of special statutory duties.'¹³ On the facts, all the defendants were involved in the management of the

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relevant entity, GIO Holdings and, for Mr Robertson and Mr Fox, for GIO Insurance as well. They clearly took part and were concerned in the management of the company as in the accepted approach of the NSW Court of Appeal in *Forge v ASIC*.¹⁴

The *ASIC v Vines* case makes a clear link between the statutory duty of care under the *Corporations Act* and the developments within the common law tort of negligence. In fact, Justice Austin relies on the famous High Court tort case of *Wyong Shire Council v Shirt* to help determine what a reasonable person would do.

Statutory duty of care

The next question to be answered is the content of the statutory duty of care and diligence. It is important to note that the applications of the relevant words to the three defendants in this case are issues of fact rather than law. The statutory words of the previous s 232(4) and the current s 180(1) incorporate an objective standard of skill for executive officers, as expressed by Justice Santow in *Re HIH Insurance; ASIC v Adler*.¹⁵ Is there truly an objective duty of skill in respect of their offices which are part of their duty of care and diligence? Skill is taken to mean 'that special competence which is not part of the ordinary equipment of the reasonable man but the result of aptitude developed by special training and experience'.¹⁶

The standard applied by Justice Austin in this case is stated as:

The statutory formulation adopts an objective standard of care, measured by reference to what a reasonable person of ordinary prudence would do, enhanced where an appointment to the board of directors is based on the appointee having some special skill, by an objective standard of skill referable to the circumstances.¹⁷

Expert evidence was admitted into court to help the judge determine what a reasonably competent chief financial officer would do in certain assumed circumstances. Each of the defendant officers owed a duty of care and diligence at this higher objective level based on their purported skills and expertise in the context of the corporation's circumstances.

The duty requires that the judge look at a 'like' position, so as to compare a particular officer with a person holding a similar position. This enables the court to look at both any special expertise held by an individual director and the distribution of functions within the corporation.¹⁸ The words 'corporation's circumstances' relate to 'the type of company, the size and nature of the company's business, the composition of the board and the distribution of its work between the board and other officers' as stated in the case of

Commonwealth Bank of Australia v Friedrich.¹⁹

The *ASIC v Vines* case makes a clear link between the statutory duty of care under the *Corporations Act* and the developments within the common law tort of negligence. In fact, Justice Austin relies on the famous High Court tort case of *Wyong Shire Council v Shirt*²⁰ to help determine what a reasonable person would do. Consideration of the magnitude of the risk and the degree of probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities the defendant may have, are also pertinent to these facts.

There was a degree of danger that the GIO shareholders might be left in, if they accepted or rejected the offer by AMP based on the accuracy of the information provided in the defence documents. It is necessary to apply a general standard of care and diligence to a professional person such as a lawyer, auditor, actuary, reinsurance manager or chief financial officer. There is a balance between negligence and mere mistakes.

Forecasting in a re-insurance business is a difficult and uncertain process, where there is much room for differences of opinion, and small variations of input can produce widely different outcomes. The defence of the takeover bid by GIO against AMP was based on a due diligence process and the provision of accurate information to the shareholders. The due diligence committee was relying on the senior executives (including the three defendants) to give their conscientious and careful attention to the documents and information provided. They failed to do this up to the appropriate standard of care as required by the corporate legislation.

Justice Austin concludes that all three defendants have in fact been found to have breached the reasonable standard of care and diligence as laid out in s 232(4), which is now s 180. For specific other reasons and facts, Mr Fox had additionally been held to have breached the duty of honesty under the previous s 232(2).²¹ The civil standard of proof (that is, the balance of probabilities) is applied in the civil penalty proceedings, but there is some flexibility allowed where there are equivalent criminal issues and consequences to take into account.²²

Conclusion

After carefully evaluating all the law and all the relevant facts over 56 hearing days and over 800 pages of written submissions, the three defendants were all found to have breached the corporations' legislation over a dozen times. The court's imposition of civil penalties, whether damages,

pecuniary penalties up to \$200,000 or any disqualification orders, will be determined at a later date. The judge allowed a period of time for submissions and the adducement of more evidence now that the three executives have been found to have breached the law. This case has expressly stated that a higher duty of care is expected from professionals that hold themselves as having special skills on their appointment to the board or for the board as an executive officer of the company. No officer can be caught 'sleeping at the wheel'.

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Notes

- 1 [2005] NSWSC 738 (22 August)
- 2 *R v Adler* [2005] [2005] NSWSC 274 (14 April); 53 ACSR 471
- 3 *R v Williams* [2005] NSWSC 315 (15 April); 53 ACSR 534
- 4 *R v Oates* [2005] WASC (7 September)
- 5 *ASIC v Vizard* [2005] FCA 1037 (28 July)
- 6 <www.camac.gov.au>
- 7 For a more detailed explanation see: M Adams, 'Whether to protect or punish: legal consequences of contravening the *Corporations Act*', *Keeping good companies*, vol 56 no 10, Nov 2004, pp 592–598
- 8 *ASIC v Vines* [2005] NSWSC 738 at [1035]
- 9 [1989] VR 821
- 10 *Sycotex Pty Ltd v Baseler* (1994) 13 ACSR 766
- 11 *Gibson v Barton* (1875) 10 QB 329
- 12 (1992) 33 FCR 474
- 13 *ASIC v Vines* [2005] NSWSC 738 at [1049]
- 14 (2005) 52 ACSR 1
- 15 (2002) 41 ACSR 72 and supported on appeal in *Adler v ASIC* (2003) 46 ACSR 504
- 16 Clarke and Sheller JJA in *Daniels v Anderson* (1995) 37 NSWLR 438 at 667
- 17 *ASIC v Vines* [2005] NSWSC 738 at [1058]
- 18 This was discussed in detail in *ASIC v Rich* (2003) 44 ACSR 441
- 19 (1991) 5 ACSR 115
- 20 (1980) 146 CLR 40
- 21 Following the principles laid down in *Marchesi v Barnes* [1990] VR 435 and followed in *Fitzsimmons v R* (1997) 23 ACSR 355
- 22 This is known as the Briginshaw principle after Sir Owen Dixon's observations in the High Court in *Briginshaw v Briginshaw* (1938) 60 CLR 336 ●



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