

# WILLIAMS LOVE & NICOL

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## LAWYERS

### ADVISING DIRECTORS EXPOSED TO DERIVATIVE LIABILITY

Limited liability was never a concept that extended to protect directors from the risks undertaken by a Corporation.

You should be on notice that the protection offered to directors and officers within a corporation is “*statute thin*”. At its simplest, protection from the liabilities of a Corporation afforded to the Corporation’s directors and officers arises through the ability of the director or officer being able to say, “*the act or omission was not mine, but that of the company*”. Naturally, officers have always been liable for their personal malfeasance and for being an accessory to and for aiding and abetting the Corporation’s misconduct.

The basic standard of care expected of management and directorship owed to the corporation is codified into the Corporations Act, as follows:

*s.180 Care and diligence—directors and other officers*

*(1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:*

*(a) were a director or officer of a corporation in the corporation’s circumstances; and*

*(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.*

This invites the Court to consider the particulars of the individual directors’ roles. It takes into account the nature of the entity concerned. That duty endeavours to apply an objective test to the subjective circumstances of the officer concerned.

As the NSW Court of Appeal observed in *Daniels v Anderson* (1995) 37 NSWLR 438 at 505:

*A person who accepts the office of director of a particular company undertakes the responsibility of ensuring that he or she understands the nature of the duty a director is called upon to perform. That duty will vary according to the size of the business of the particular company and the experience or skills that the director held himself or herself out to have in support of appointment to the office. None of this is novel. It turns on the natural expectations and reliance placed by shareholders on the experience and skills of a particular director. The duty is a common law duty to take reasonable care owed severally by persons who are fiduciary agents bound not to exercise the powers conferred on them for private purpose or for any purpose foreign*

*to the power and placed ... at the apex of the structure of direction and management. The duty includes that of acting collectively to manage the company.*

Thus, to understand the extent of your responsibility and hence your exposure, you must understand that as an officer or director of the Company, you owe a broad duty to manage the company and come to grips with what that duty entails.

The majority of the New South Wales Court of Appeal in *Daniels v Anderson* (1995) 37 NSWLR 438 at 503 believed the United States' decision of *Francis v United Jersey Bank* 432 A 2d 814 (NJ 1981) at 821-823, "eloquently explained" the duties of a director and endorsed this passage as expressing what the law requires of directors in Australia – my emphasis added:

*"As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. Because directors are bound to exercise ordinary care, they cannot set up as a defence lack of the knowledge needed to exercise the requisite degree of care. **If one "feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act.**"*

*Directors are under a continuing obligation to keep informed about the activities of the corporation. Otherwise they may not be able to participate in the overall management of corporate affairs. Directors may not shut their eyes to corporate misconduct... Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies....**Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign.**"*

Together with the "business judgment rule", which forms the second part of s.180 of the *Corporations Act 2001*, these rules set the basic foundation that assists directors protect themselves from liability. Meeting the standards for discharging these duties is fundamental to controlling personal liability for corporate malfeasance. This process of diligence and enquiry is the minimum required as you face to the current crop of "derivative liability" regulation. The real question is – is this enough?

In Australia, virtually every aspect of an organization's conduct is regulated in some manner. The critical focus of this topic includes legislation regulating occupational health and safety, environmental law and hazardous waste disposal; these are only areas where "derivative liability exists".

This "derivative liability" arises under specific legislation which cuts through the thin shield of protection offered by incorporation. It makes officers directly liable for offences of the corporation, even where the officers were acting reasonably.

On the severe end of the "derivative liability" provisions which now exist is s.26 of the *Occupational Health and Safety Act 2000* (NSW). It states:

- (1) *If a corporation contravenes, whether by act or omission, any provision of this Act or the regulations, **each director of the corporation, and each person concerned in the management of the corporation, is taken to have contravened the same provision unless the director or person satisfies the court that:***

- (a) *he or she was not in a position to influence the conduct of the corporation in relation to its contravention of the provision, or*
- (b) *he or she, being in such a position, used all due diligence to prevent the contravention by the corporation.*

This poses a fundamental reversal of the onus of proof: guilty unless you prove otherwise. The requirements of s.26 are more severe than the ACT's or Commonwealth's versions of derivative liability; for example, from the *Environment Protection and Biodiversity Conservation Act 1999* and *The Hazardous Waste (Regulation of Exports and Imports) Act 1989*.

Consider ACT's Workers compensation ACT 1951 s.203:

### **203 Criminal liability of executive officers**

(1) *An executive officer of a corporation commits an offence if—*

- (a) *the corporation commits an offence (a **relevant offence**) by contravening a defined provision of this Act; and*  
*Note See s (6) for the **defined provisions** to which par (a) applies.*
- (b) *the officer was reckless about whether the contravention would happen; and*
- (c) *the officer was in a position to influence the conduct of the corporation in relation to the contravention; and*
- (d) *the officer failed to take all reasonable steps to prevent the contravention.*

*Maximum penalty: the maximum penalty that may be imposed for the commission of the relevant offence by an individual.*

(2) *This section applies whether or not the corporation is prosecuted for, or convicted of, the relevant offence.*

(3) *In deciding whether the executive officer took (or failed to take) reasonable steps to prevent the contravention, a court must have regard to the following*

:

- (a) *any action the officer took directed towards ensuring the following (to the extent that the action is relevant to the act or omission):*
  - (i) *that the corporation arranges regular professional assessments of the corporation's compliance with the defined provision;*
  - (ii) *that the corporation implements any appropriate recommendation arising from such an assessment;*
  - (iii) *that the corporation's employees, agents and contractors have a reasonable knowledge and understanding of the requirement to comply with the defined provision;*
- (b) *any action the officer took when the officer became aware that the contravention was, or might be, about to happen.*

- (4) *Subsection (3) does not limit the matters to which the court may have regard.*
- (5) *This section does not apply if the corporation would have a defence to a prosecution for the relevant offence.*

Consider “*the role of the Board*” as Justice Rogers identifies it (said to be in addition to the statutory duties now under ss.180 to 183) in *AWA v Daniels* (See (1992) 7 ACSR 759 at 865-866):

- (a) *Setting the goals for the corporation;*
- (b) *Appointing the corporation’s chief executive;*
- (c) *Overseeing the plans of managers for the acquisition and organization of financial and human resources towards attainment of the corporation’s goals; and*
- (d) *Reviewing, at reasonable intervals, the corporation’s progress towards those goals.*

And the Board’s ability to rely on management to (See *AWA Ltd v Daniels* (1992) 7 ACSR 759 at 867):-

- (a) *Carry out the day to day control of the corporation’s business affairs;*
- (b) *Establish proper internal controls, management information systems and accounting records;*
- (c) *Reduce to writing (if appropriate) and communicate policies and strategies adopted by the Board;*
- (d) *Implement the policies and strategies adopted by the Board;*
- (e) *Have knowledge of and review detailed figures, contracts and other information about the corporation’s affairs and financial position and summarise such information for the board where appropriate;*
- (f) *Prepare proposals and submissions for consideration by the Board;*
- (g) *Prepare a budget; and*
- (h) *Attend to personnel matters including hiring and firing of staff and their terms of employment.*

Given the duties owed by company officers, how can it be said that, *prima facie*, every member of a Board and substantial parts of senior management are “*not in a position to influence the conduct of the corporation in relation to its contravention of the provision*”?

From *ASIC v Plyman, Elliot & Harrison* (2003) VSC 123 at paragraph 424:

*“Reference was made to the entitlement of a non-executive director to rely on management’s judgment, information, advice and supply of financial information. Of course, as is well known, both common law and statute have placed an increasing onus on non-executive directors. A non-executive director is expected to take steps to*

*put himself in a position to monitor the company and to exercise and form an independent judgment and to take a 'diligent and intelligent interest in the information' either available to him and or which he might with fairness demand from the executives of other employees and agents of the company."*

The ACT and Commonwealth statutes at least have the added requirements that the officer concerned "*knew that, or was reckless or negligent as to whether, the contravention would occur*".

Applying the ordinary corporate duties to that requirement would mean ensuring that:

1. management was charged with the obligation of ascertaining the application of the particularly regulatory regime;
2. applying a check list approach to the compliance with the Act;
3. regular investigation as to whether the compliance regime is being adhered to and reporting of that compliance to the Board.

And for appropriate caution, directors should ensure that these endeavours are minuted in detail.

The *Corporations Act 2001* offers scope to a director to (reasonably) rely on information, or professional or expert advice, relying on s. 189:

(a) *given or prepared by:*

- (i) *an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or*
- (ii) *a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence; or*
- (iii) *another director or officer in relation to matters within the director's or officer's authority; or*
- (iv) *a committee of directors on which the director did not serve in relation to matters within the committee's authority; and*

(b) *If the reliance was made:*

- (i) *in good faith; and*
- (ii) *after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation; and*

(c) *if it was reasonable for the director to rely on the information or advice.*

And further gives the director scope to rely on powers of delegation (s. 190):

*If a Board properly delegates a power, as permitted by s.198D, a director is not responsible for the exercise of the power by the delegate if:*

- (a) the director believed on reasonable grounds at all times that the delegate would exercise the power in conformity with the duties imposed on directors of the company by this Act and the company's constitution (if any); and*
- (b) the director believed:*
  - (i) on reasonable grounds; and*
  - (ii) in good faith; and*
  - (iii) after making proper inquiry if the circumstances indicated the need for inquiry;*

*that the delegate was reliable and competent in relation to the power delegated.*

In defence of the Commonwealth's model, a code for "all reasonable steps to prevent the contravention" is provided and one can only hope that these considerations will be taken into account as Judges in the Courts in ACT and NSW consider whether a director has infringed the legislation, notwithstanding their "innocence", as we had come to know it.

#### **496 Did an executive officer take reasonable steps to prevent contravention?**

*(1) For the purposes of sections 494 and 495, in determining whether an executive officer of a body corporate failed to take all reasonable steps to prevent the contravention, a court is to have regard to:*

- (a) what action (if any) the officer took towards ensuring the following (to the extent that the action is relevant to the contravention):*
  - (i) that the body arranges regular professional assessments of the body's compliance with this Act and the regulations;*
  - (ii) that the body implements any appropriate recommendations arising from such an assessment;*
  - (iii) that the body has an appropriate system established for managing the effects of the body's activities on the environment;*
  - (iv) that the body's employees, agents and contractors have a reasonable knowledge and understanding of the requirements to comply with this Act and the regulations, in so far as those requirements affect the employees, agents or contractors concerned; and*
- (b) what action (if any) the officer took when he or she became aware that the body was contravening:*
  - (i) this Act; or*
  - (ii) the regulations; or*

- (iii) *if the body contravened Part 3 or section 142 or 142A—any environmental management plan that was prepared by the body, and approved by the Minister, as required by a condition attached to an approval under Part 9 for the purposes of a provision of Part 3 of the body's taking of an action.*

This provides a template for your compliance, though it remains to be seen whether following such a compliance model will demonstrate whether:

- (a) the officer was not in a position to influence the conduct of the corporation in relation to its contravention; and
- (b) the officer used all due diligence to prevent the contravention by the corporation;
- (c) it was not reasonably practicable for the officer to comply with the infringed provision;
- (d) the commission of the offence was due to causes beyond the control of the officer: or
- (e) it was impracticable for the officer to make provision against the offence being commissioned.

Mark Love  
Williams Love & Nicol  
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ACCREDITED SPECIALIST  
BUSINESS LAW