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By Cameron Jorss, Partner - January 2010

# JODEE RICH LANDS ONE.TELLING BLOW ON ASIC

***In this newsletter we examine the protection the business judgement rule gives to directors and what practical steps directors should take to maximise the likelihood of the rule applying to their decisions.***

After the James Hardie decision in 2009 many directors feared that courts had set the bar too high to meet their duties. Now, thanks to the tenacity of Jodee Rich in the One.Tel case, boards around Australia have been reminded that the “safe harbour” for directors in the statutory business judgment rule should allow legitimate entrepreneurial activity. In this newsletter we examine the protection the rule gives to directors and what practical steps directors should take to maximise the likelihood of the rule applying to their decisions.

## The One.Tel collapse

Those with good memories will recall that One.Tel collapsed in 2001. Before its collapse, the company operated a telecommunications business in eight countries and had around 3,000 employees. Publishing and Broadcasting Limited and News Corporation had together invested around $430 million in the company, and the board included the heirs of Australia’s two most famous business families: James Packer and Lachlan Murdoch.

## ASIC’s claim against the directors

In late 2001, ASIC sued four One.Tel directors: chairman John Greaves, joint chief executives Jodee Rich and Brad Keeling and finance director Mark Silbermann. ASIC’s claim was that they had breached their statutory duty of care and diligence.

ASIC settled its case against Keeling in 2003 and its case against Greaves in 2004. Both accepted bans from acting as directors and substantial compensation obligations.

The case against Rich and Silbermann was not settled though and ASIC claimed, in substance, that they had failed to disclose to, and had withheld from, the One.Tel board information about the true financial position of One.Tel during the early part of 2001. As a result, ASIC claimed that they had not met their statutory duty to exercise reasonable care and diligence.

## ASIC’s case fails

Eight years later, in November 2009, the Supreme Court of New South Wales ruled against ASIC.[1] In a judgment over 3,000 pages long, Justice Austin found that ASIC had not proved that Rich or Silbermann had failed to disclose to, or had withheld from, the One.Tel board information about the true financial position of the company. As a result, the reasons for this significant corporate collapse remain unclear.

## The “safe harbour” for directors

Although the One.Tel decision turned on the failure of ASIC to prove its case, the court considered in detail the operation of the statutory business judgment rule. This was because Rich and Silbermann had relied upon the business judgment rule in respect of ASIC’s claims against them.

The business judgment rule was introduced to the Corporations Act in 1998 to provide directors with a “safe harbour” from personal liability in relation to honest, informed and rational business judgments.[2] The court’s analysis appears to be the first detailed judicial discussion of the rule in Australia since it was introduced. For that reason alone it is worthy of attention by directors. First though, we should consider the duty of directors to exercise care and diligence.

## The directors’ duty of care and diligence

A director has a statutory duty to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they were a director in

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the company's circumstances and occupied the office held by, and had the same responsibilities within the company as, the director.[3]

In the One.Tel decision the court found that to apply this duty in practice, consideration must be given to the type of company involved, whether it is listed or unlisted, the size and nature of its business, the provisions of its constitution, the composition of its board and the distribution of work between the board and other officers.

When considering the responsibilities of a particular director, the court considered it appropriate to look at the way in which work was in fact distributed within the company and the expectations placed on the shoulders of the individual director.

## What does the duty mean in practice?

As a minimum, the statutory duty requires each director, including a non-executive director, to:

§ become familiar with the fundamentals of the company's business;

§ keep informed about the company's activities;

§ monitor, generally, the company's affairs;

§ maintain familiarity with the financial status of the company and make further enquiries into financial matters where appropriate; and

§ have a reasonably informed opinion of the company's financial capacity.[4]

This is a minimum standard only and it seems clear that the actual standard to be met by a director will depend upon their particular role and responsibilities.

## Look forward, not back with hindsight

In deciding whether a director has met the statutory duty of care and diligence, the court confirmed it will look forward from the time when the decision is made by the director and will consider whether the risk of harm from the decision was foreseeable, and whether countervailing benefits might accrue from the decision. Directors should take comfort from this approach as it means that the court will not look back on what is known to have happened. In other words, the court will not look back with the benefit of hindsight.[5]

## Mere mistakes do not attract liability

Directors may also take comfort from the confirmation by the court that there is a distinction between negligence and a mere mistake by a director.[6] Not every mistake by a director will result in a breach of duty. It is only where the director has failed to exercise reasonable care and diligence that they will fail in their duty. This is particularly important in situations such as financial forecasting, which the court recognised is a difficult and uncertain process, with much room for mistakes and errors or judgment, and for differences of opinion.

***Business judgements include decisions in response to takeover bids, in proposing a scheme for arrangement for the purposes of acquisition or corporate reconstruction, decisions to enter into transactions for financial purposes, matters of planning, budgeting and forecasting, decisions relating to corporate personnel and the termination of litigation.***

## Business judgment

In addition to these general considerations, the duty of care and diligence is subject to the statutory business judgment rule.[7] The five elements of the rule are:

1 **The director must have made a business judgment.** A business judgment is a decision to take or not to take action in respect of a matter relevant to the business operations of the company. Business judgments include decisions in response to takeover bids and in proposing a scheme for arrangement for the purposes of acquisition or corporate reconstruction, decisions to enter into transactions for financial purposes, matters of planning, budgeting and forecasting, decisions relating to corporate personnel and the termination of litigation.[8]

For the defence to apply the director must make a decision though. A director who simply neglects to deal with proper safeguards,

without turning their mind to a judgment of what safeguards there should be, has not made a business judgment and so is not protected by the defence.[9]

2 **The judgment must be made in good faith for a proper purpose.** If a director decides not to do something, and that decision results in failure to discover substantial corporate losses, there may be a question of whether they have acted in good faith, subject to evidence to the contrary.[10]

3 **The director must not have a material personal interest in the subject matter of the decision.** A "material personal interest" is likely to exist if the interest is one that has the capacity to influence the vote of the particular director upon the decision to be made, bearing in mind that the interest must be of a real or substantial kind.[11]

4 **The director must inform themselves about the subject matter of the decision to the extent they reasonably believe to be appropriate.** The reasonableness of the belief is to be assessed by reference to:

- the importance of the decision;
- the time available to obtain information;
- the costs of obtaining information;
- the director's confidence in those exploring the matter;
- the state of the company's business and competing demands on the board's attention; and
- whether or not material information is reasonably available to the director.[12]

5 **The director must rationally believe that the decision is in the best interests of the company.** The director's belief is treated as rational unless it is one that no reasonable person in their position would hold. This requires the belief to be supported by an arguable reasoning process.[13]

If the five elements are present, the director is taken to have complied with their statutory duty to exercise reasonable care and diligence, and also their equivalent duties at common law and in equity.

## Who bears the onus of proof?

An important question is who must prove that the elements of the business judgment rule are present or not: is it the defendant director who has the onus of proving that they are present or the plaintiff, for example, ASIC who has to prove that they are not?

In ASIC v Rich the court gave this question lengthy consideration and, after expressing some hesitation, concluded that the onus of proof rests with the director.[14] This decision is of important practical significance as it means that if a director wishes to claim the protection of the business judgment rule, they will need to prove that the elements of the rule are present.

***Directors should ensure that they have access to the company's records relating to the relevant decision, including board papers, management presentations at board meetings and minutes of board meetings to maximise their chances of proving the defence in the business judgement rule. They should also ensure that the board minutes record the reasoning process that has been followed in reaching a decision.***

## What should directors do?

For directors to maximise their chances of proving the defence in the business judgment rule, they should ensure that they have access to the company's records relating to the relevant decision, including board papers, management presentations at board meetings and minutes of board meetings.

Directors have some statutory and common law rights of access to the records of the company, however, to give them clear access to the evidence they would need, directors should also ensure that they have a contractual right of access to the company's records. Such a right is usually contained in a deed of access between the company and each director.

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Directors, in conjunction with the company secretary, should also ensure that the board minutes record the reasoning process that the directors have followed to reach their decision. This should help them to establish that they rationally believed that the decision was in the best interests of the company. Some companies take a minimalist approach to their minutes and only record the board's decisions. Such an approach would not help directors to prove that they had made an appropriate business judgment.

## The future of the rule

The merits of the business judgement rule have been widely debated. One senior lawyer has recently suggested that the business judgement rule is arguably "nothing but window dressing".[15] Justice Austin in ASIC v Rich did not accept this view, and instead found that its potential is "particularly high" in certain circumstances. Directors should therefore keep it in mind when making business decisions.

1 *ASIC v Rich* [2009] NSWSC 1229 (Unreported, Austin, J, 18 November 2009).

2 Commonwealth, *Parliamentary Debates*, House of Representatives, 3 December 1998, 1284 (Joe Hockey, Minister for Financial Services and Regulation).

3 *Corporations Act 2001* (Cth) s 180(1).

4 *ASIC v Rich* [2009] NSWSC 1229 (Unreported, Austin, J., 18 November 2009) [2954].

5 Ibid [2968].

6 Ibid [2970].

7 *Corporations Act 2001* (Cth) s 180(2).

8 *ASIC v Rich* [2009] NSWSC 1229 (Unreported, Austin, J., 18 November 2009) [2986].

9 *ASIC v Adler* (2002) 42 ACSR 80.

10 *ASIC v Rich* [2009] NSWSC 1229 (Unreported, Austin, J., 18 November 2009) [2990].

11 *McGellin v Mount King Mining NL* (Unreported, Supreme Court (WA), Murray J, 7 April 1998).

12 *ASIC v Rich* [2009] NSWSC 1229 (Unreported, Austin, J., 18 November 2009) [2990].

13 Ibid [2993].

14 Ibid [2984].

15 Neil Young QC, '*Has directors' liability gone to far or not far enough? A review of the standard of conduct required of directors under sections 180-184 of the Corporations Act*' (2008) 26 C&SLJ 216, 222.

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