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CAN DIRECTORS RELY ON EXPERTS?

Two recent remarkably similar cases in the New Zealand and Australian courts have come to quite different conclusions on the common law requirement for directors to exercise due care and skill and the extent to which in exercising those duties they can rely on experts. In this comparison of the two judgements, **Niamh Brennan** highlights the issues.

There is considerable controversy and debate in the New Zealand and Australian business press following judgements[1] concerning the common law requirement for directors to exercise due care and skill in executing their duties and whether they can rely on experts in exercising those duties. The two cases are very similar.

FELTEX CASE

The first case, which took place in the New Zealand courts in 2010, concerns a criminal action taken by the Ministry for Economic Development against five directors of carpet manufacturer Feltex – the CEO and four non-executive directors. One of the non-executive directors was a financial expert, having served as chairman of a Big-4 accounting practice and as chairman of the New Zealand Accounting Standards Review Board. The directors decided to be path-leaders by being the first company in New Zealand to early adopt International Financial Reporting Standards (IFRSs) in Feltex's interim statement for the six months ended 31 December 2005. Feltex went into receivership in September 2006.

Accounting issues

Liabilities of NZ$100 mn were classified in Feltex's 2005 interim statement as non-current even though bank covenants had been breached allowing the bank to call in the liabilities at any time.

Under IFRSs, for a liability to be classified as non-current, the entity had to have an unconditional right to defer repayment of the debt.

The previous New Zealand Generally Accepted Accounting Principles (GAAP) were less prescriptive than IFRSs, favouring a substance over form approach. Although bank covenants had been breached, the bank had rolled over the loans in previous years. As a result, the directors had a reasonable expectation that the bank would roll over the loans for another 12 months, justifying classifying these loans as non-current under New Zealand GAAP. In addition, breaches of certain banking covenants were not disclosed in the interim statement.

The directors subsequently admitted in court that this treatment was incorrect, breaching the statutory requirement for the accounts to show a true and fair view.

Defence of the charge that the directors did not exercise due care and skill

The directors invoked the statutory defence that they took all reasonable and proper steps in exercising their duties, including:

- ➤ Relying on a qualified, competent, well-resourced financial management team;
- ➤ Establishing a comprehensive transition process in adopting IFRSs;
- ➤ Engaging a reputable Big-4 accounting practice to prepare a review identifying key areas and issues to be addressed in transitioning to, and in ensuring compliance with, the new IFRS standards. It is notable that a full audit was not conducted, as IFRSs were first-time adopted in the interim statements;
- ➤ Establishing a steering committee comprising Feltex's own financial managers and staff of the Big-4 practice to review and ensure compliance with IFRSs;
- ➤ Engaging a Big-4 accounting practice to review IFRS compliance and advise the board thereon;
- ➤ Obtaining declarations from the CEO and CFO that Feltex's internal financial controls were adequate and effective;
- ➤ Using an appropriately constituted audit committee whose responsibilities extended to overseeing the integrity of the financial reporting and control process.

The evidence

Evidence in the Feltex case revealed that the audit committee meeting to review the interim statement commenced at 11.30am and finished at 4pm. At the audit committee meeting the CEO asked the Big-4 audit partner "Can you assure me that these accounts comply with IFRSs?" The Big-4 audit partner provided an unequivocal "yes" response to the CEO.

CENTRO CASE

The second case in the Australian courts in 2011 concerned a civil action taken by the Australian Securities and Investment Commission (ASIC) against eight directors of shopping mall investment group, Centro – the CEO and seven non-executive directors. One of the non-executive directors was a qualified accountant.

"EXPECTATIONS OF DIRECTORS REGARDING THE EXECUTION OF THEIR DUTIES ARE INCREASING ... NO PERSON SHOULD TAKE ON A DIRECTORSHIP WITHOUT UNDERSTANDING THE RISKS ..."

Accounting issues

In the 2007 annual financial statements (the first statements to adopt IFRSs), A$2.1 bn liabilities due to mature within 12 months were classified as non-current rather than current. Further, guarantees of US$1.75 bn provided after the balance sheet date in favour of an associate were not disclosed as a post-balance sheet event.

Defence of the charge that the directors did not exercise due care and skill

The directors took the following steps:

- a competent finance team was put in place;
- a properly functioning audit committee was in place;
- the board obtained the advice of a Big-4 accounting practice.

The evidence

The following evidence came to light during the Centro case:

- The board met monthly;
- Papers for meetings were voluminous (usually around 450 pp);
- Directors knew (or should have known) that the bank facilities were short term, as this was indicated in two pages buried deeply in a 1,180-page board pack that had been circulated a number of months prior to the approval of the financial statements;
- A note to the financial statements stated that borrowings are current unless there is an unconditional right to defer settlement for at least 12 months.

LEGAL PRINCIPLES

Both judgements cited prior common law findings in relation to the duty of care and skill to be applied by directors and whether directors are entitled to rely on experts.

DUTY OF CARE AND SKILL

A case cited in the Feltex judgement was *ACIS v Adler & Ors*[2] which sets out 15 summary propositions/principles applicable to directors in exercising their duty of care and diligence in delegating tasks. Those cited in the Feltex judgement included requirements for:

- Familiarity with the fundamentals of the business;
- Continuing obligation to be informed;
- Regular attendance at board meetings;
- Familiarity with the financial status of the company, including regular review of the financial statements;
- Entitlement to rely without verification on the judgement, information and advice of management, except where reliance would be unreasonable as the directors know, or by the exercise of ordinary care should know, any facts that would deny reliance on others;
- In determining whether delegation is reasonable, (i) whether the function delegated is appropriate for delegation, (ii) the extent to which the director are put on inquiry, (iii) directors must honestly believe that the delegate is trustworthy, competent and someone on whom reliance can be placed, (iv) the nature and risk of the transaction, (v) the steps taken by directors, enquiries made concerning engendering of trust, (vi) whether the director is executive or non-executive.

RELIANCE ON EXPERTS

At the heart of the two cases is the question of whether directors can rely on the work and advice of company managers, external accountants and auditors when approving financial statements. The Feltex judgement cited the findings in *Jagwar Holdings Limited v Julian Holdings.*[3] In that case, even though the directors had not checked the calculations themselves, the judge found that they had exercised reasonable care in relying on the financial controller in preparing a financial forecast and on the review of that forecast by a Big-4 accounting practice. While acknowledging that directors have only limited obligations to search out information, they must pay attention and give appropriate consideration to matters placed before them. If directors cannot delegate to managers in a position of trust, it would render the conduct of business impossible. However, the growing desire of courts to limit directors' ability to wash their hands of obligations to intelligently oversee company affairs was noted.

THE JUDGEMENTS

The Feltex judgement found in favour of the directors; conversely, the Centro judgement found against the directors.

Feltex case

In relation to delegation of duties, the Feltex judge said that directors "...are entitled to impose trust in others so long as they take reasonable steps to ensure that such trust is warranted and are not alerted to reasons why the trust may be misplaced". On the question of whether the directors could rely on professional expert advice, the Feltex judge observed that:

- IFRSs are highly complex and presume an in-depth knowledge of accounting principles;

- Those applying IFRSs, and advising on IFRSs, have undergone specialist training;
- Interpreting and applying IFRSs requires highly specialist expertise in an already specialised field;
- Specialist auditors look to specialist technical experts in their firms for advice on interpreting and application of IFRSs.

Accordingly, the Feltex judge concluded that the directors were entitled to rely on specialist advice. She found in their favour that they had taken due care and skill in exercising their responsibilities.

The Centro case

The Centro judge arrived at quite a different conclusion. Firstly, he observed that: "A director is an essential component of corporate governance. Each director is placed at the apex of the structure of direction and management of a company. The higher the office that is held by a person, the greater the responsibility that falls upon him or her. The role of a director is significant as their actions may have a profound effect on the community, and not just shareholders, employees and creditors." In relation to the question of delegation, the judge concluded that the legal declaration required of directors that the accounts show a true and fair view could not be delegated – "They must themselves determine to adopt the required resolution." Further, he said that directors cannot substitute reliance on the advice of management for their own attention and examination of an important matter that falls specifically within the board's responsibilities such as their financial reporting obligations.

In arriving at his judgement, the Centro judge observed:

- Directors should have detected apparent errors in the financial statements and made relevant enquiries of management and auditors;
- The volume of papers going to the board was within the power of the board to control;
- None of the non-executive directors had the practice of reviewing annexes to board papers;
- Directors assumed if the information in annexes was important it would be drawn to their attention by management at board meetings;
- Each director was aware (or should have been aware) of the short-term debt.

The Centro judge pointedly questioned whether the directors went far enough, and took all reasonable steps required of them. He cited the US case *Francis v United Jersey Bank*[4] which makes it clear that more than a mere 'going through the paces' is required for directors – "a director is not an ornament but is an essential component of corporate governance".

In finding against the directors, the judge acknowledged that directors are entitled to rely on others, but that such reliance does not discharge their entire obligation. Directors cannot substitute the reliance on management for their own review of the financial statements. Neither the audit committee nor the financial expertise of the directors exempts all directors from reviewing the accounts. Nor does full audit clearance exempt the directors from their own fundamental duty to review and understand the financial statements. Directors must have sufficient knowledge of accounting practice and basic accounting concepts. They must apply their knowledge based on all the information they receive as directors, even if that information is provided in a different context.

THE CONTRADICTORY FINDINGS

The judge in the Centro case was acutely conscious of the findings in the Feltex judgement, and extensively referred to that case in his judgement. The Centro judge agreed that "it cannot be denied that directors have been and are entitled to rely upon specialist advice" and that the directors should not have done it all themselves, nor do they have to become familiar with the complexities of various accounting standards. He acknowledged that the individual circumstances of a case may lead to different conclusions. What is encompassed by taking all reasonable steps will differ depending upon the company, the nature of its business and its complexity. What the Centro judge appears to have placed more emphasis on is the prior knowledge of the directors from earlier board papers that should have alerted them to the incorrect accounting classification of current liabilities as non-current: "The significant matters not disclosed were well known to the directors, or if not well known to them, were matters that should have been well known to them".

CONCLUDING COMMENT

To a non-lawyer, these two judgements appear quite contradictory. The Feltex judgement is strong in its finding that directors are entitled to rely on experts such as finance staff in the company, external accountants and external auditors. The judgement concludes that it would be unreasonable and unworkable to expect directors to be experts in accounting standards which are lengthy and highly technical. Conversely, the Centro judgement concludes that directors cannot rely on the advice of management in place of attending to and examining themselves on important matters such as their financial reporting obligations which fall firmly within their board responsibilities.

> "THE SIGNIFICANT MATTERS NOT DISCLOSED WERE WELL KNOWN TO THE DIRECTORS OR, IF NOT WELL KNOWN TO THEM, WERE MATTERS THAT SHOULD HAVE BEEN WELL KNOWN TO THEM."

These legal conflicts leave company directors in a confusing and unsatisfactory position. What is clear from these two cases is that the expectations of directors on the execution of their duties is all the time increasing. No person should take on a directorship without understanding the very significant risks of such a position. Once appointed by the shareholders, directors cannot afford to leave any stones unturned in terms of understanding the business right down to the small print and technical knowledge of fine details.

Notes:

[1] The Feltex judgement is available at http://www.courtsofnz.govt.nz/cases/ministry-of-economic-development-v-feeney/ (accessed 22 September 2011); the Centro judgement is available at http://www.austlii.edu.au/au/cases/cth/FCA/2011/717.html (accessed 22 September 2011)

[2] *ACIS v Adler & Ors* [2002] NSWSC 171; [2003] 179 FLR 1; 46 ACSR 504; [2003] NSWCA 131

[3] *Jagwar Holdings Limited v Julian Holdings High Court Auckland* CO 691/91, 24 July 1992.

[4] *Francis v United Jersey Bank* [1981] 432 A 2d 814

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