

PAPUA NEW GUINEA INSTITUTE OF DIRECTORS

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YOUR DUTY OF CARE AND SKILL - IS IT DIFFERENT FROM THAT OF YOUR FELLOW DIRECTORS?

When you meet with others as a board of directors, do you all have the same level of responsibility? Do you have greater obligations than the person alongside you? Are you exposed to greater consequences if something goes wrong? The answer might surprise you!

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Introduction - Care, skill and diligence

One of the certain fiduciary duties of a director is to act with care, skill and diligence.

One of the hottest issues in company law today is: *How much* care, skill and diligence is required from a director?

To complicate the answer, it has become clearer recently that there is another question hidden inside the main one, namely: Is the level of required care, skill and diligence the same for all directors, or are some expected to exercise a greater degree of care, skill and diligence?

No definite, final answer can be given at this time. That is because this is a lively, volatile field of enquiry at present and also because the many court cases that are beginning to flow from recent corporate collapses in the USA and Australia have already, and will continue to, contribute to the answer.

So this article is somewhat premature. But it is written to focus attention on a current 'hot topic'.

There is a problem in imposing duties and either civil or criminal consequences for failure to fulfil those duties. Shareholders invest in companies in order to make profits. Directors are therefore elected to be entrepreneurial in pursuit of those profits. They are expected to take calculated business risks and, inevitably, sometimes the ventures will fail. If directors are made personally responsible for every failure - if the standard of care, skill and diligence is set too high - then directors will be defensive, they will not

be entrepreneurial, and the hoped-for profits will not eventuate. Either that, or no-one of substance will act as a director.

So the setting of a standard of care, skill and diligence is a balancing act - on the one hand, there must be scope for directors to exercise appropriate business judgement and considered business risks, on the other there must be a penalty if directors are reckless, inconsiderate or incompetent.

Sometimes directors are executive directors - that is, they are employed full-time in the management and operation of the company as well as in directing it, and they are paid handsomely for it. Other directors on the same board may be non-executive directors. Being, in effect, only 'part-time' directors, they cannot have the same detailed knowledge of the company. Are all those directors to be treated equally? What about the chairman? Directors appointed because of special professional or technical expertise? Those charged with special duties, such as those on an audit committee? Are they all to be treated as equal in expectations and consequences? The issue becomes tricky.

The law

The law requiring proper care, skill and diligence on the part of a director comes from three independent and overlapping sources.

First, the fiduciary duty to act with care, skill and diligence has long been in the general law as part of fiduciary duties generally, and was introduced into PNG as part of the general law adopted at independence.

Secondly, it is codified in section 115 of the Companies Act 1997 as follows:

DIRECTOR'S DUTY OF CARE.

(1) A director of a company, when exercising powers or performing duties as a director, shall exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation -

- (a) the nature of the company; and
- (b) the nature of the decision; and
- (c) the position of the director and the nature of the responsibilities undertaken by him.

(2) A director who acts in contravention of this section commits an offence and is liable on conviction to the penalty set out in Section 413(4).

Paragraph (1)(c) seems to acknowledge that different standards may apply to different directors

Thirdly, it has now been recognised in other jurisdictions that the law of negligence applies also. Thus in *AWA Ltd v Daniels* 7 ACSA 759, Rogers CJ adopts the majority judgement in *Castlereagh Motels Ltd v Davies-Rowe* 67 SR (NSW) 279 that "recognises that a director can be made liable at law for negligence".

These three sources of law approach the subject from different perspectives, have different tests of liability, and do not necessarily require the same standards!

Application of the law

How then is the law to be applied? For this we turn to court cases and to what happens in practice.

Executive and non-executive directors.

The leading Australian court cases to ask whether executive and non-executive directors have equal responsibility arise in litigation following the foreign exchange trading losses incurred by AWA Limited. In *AWA Ltd v Daniels*, the court found that the chief executive officer, Hooke (who was also the Chairman), and management were guilty of negligence but the non-executive directors were not. A percentage of the liability was apportioned to Hooke and ordered against him.

The appeal, *Daniels v Anderson* 16 ACSR 607, excused the non-executive directors of negligence and by treating Hooke as part of management attributed his default against the company rather than against him personally. But the court said (at 665): "the law of negligence can accommodate different degrees of duty owed by people with different skills ... "

That is the position in judgements of the courts. What about in practice? An indication that there may be, in practice, a distinction in Australia between the levels of accountability of executive and non-executive directors comes from recent court action initiated by the Australian Securities and Investment Commission (ASIC), the corporate 'watchdog'.

Following the collapse of One.Tel, ASIC has commenced court action against the two executive directors (who were also joint managing directors), namely Brad Keeling and Jodee Rich, and also the chairman (John Greaves who was a non-executive director, but also the chairman, as discussed below) whilst omitting from the action the other two non-executive directors, namely James Packer and Lachlan Murdoch. That is not to suggest that Packer and Murdoch will escape all liability, but they were not placed 'first in the firing line' by ASIC.

Similarly, the initial court proceedings brought by ASIC in respect of the collapse of HIH Insurance were against Ray Williams (at the relevant time, the CEO and executive director), Dominic Fodera (Chief Financial Officer and executive director) and 'Rocket' Rodney Adler (non-executive director of HIH but formerly executive director of FAI). Other non-executive directors were not targeted in those proceedings.

At no time has ASIC suggested that non-executive directors are excused from liability. But actions speak louder than words and do suggest that executive directors have to meet a higher standard of care, skill and diligence than non-executive directors.

Both in Australia and in New Zealand (*Deloitte, Haskins & Sells v National Mutual Life Nominees* (1991) 5 NZCLC 67,418 (CA) at 67,442), case law can be found to suggest that no distinction is drawn between executive and non-executive directors. So the position is not certain. However it appears that the law is moving in the direction of drawing that distinction. Executive directors beware.

On the other hand, this does not allow non-executive directors ('independent directors') to relax. They may have special responsibilities of a different type. For discussion of this, see the report in relation to comments from the ASX Corporate Governance Council on this site entitled: *ASX Report targets role of Independent Directors (6 Feb 03)*

The chairman

It can be said, with good legal authority, that the chairman stands apart from other directors in his or her responsibilities. Once the chairman was described as 'first among equals', but that description no longer seems valid.

In *ASIC v Rich & Ors* the Supreme Court of NSW in February 2003 endorsed the argument of ASIC that Chairmen have responsibilities beyond those of other directors. Generally, those responsibilities relate to overseeing adequate processes to enable the board to properly and effectively discharge its supervisory role.

ASIC's argument, accepted by the court, was that those responsibilities include such things as:

- the general performance of the board;
- the flow of financial information to the board;
- the establishment and maintenance of systems for information flow to the board;
- the public announcement of information;
- the maintenance of cash reserves and group solvency; and
- making recommendations to the board as to prudent management of the group.

This decision of the court is reviewed in notes elsewhere on this site entitled: *Company Chairmen Beware - You have special responsibilities (Mar 03)*

Advice to chairmen

Following that decision, Mr Greg Lay of White, Young & Williams, Lawyers, of Port Moresby has provided the following advice to chairmen. In making his advice available, Mr Lay accepts no responsibility for any other content in this article or on this website.

Chairman's statutory duties

There are very few mentions in the Companies Act concerning the duties of the Chairman of the Board, those that are mentioned are as follows:

1. At a meeting of shareholders, he:
 - (a) must allow shareholders reasonable time to ask questions and discuss issues;
 - (b) chairs all shareholders meetings;
 - (c) determines whether a vote will be on the voices or by show of hands;
 - (d) declares whether the motion is carried or not carried;
 - (e) signs minutes of the meeting as a prima facie record of what took place at the meeting.
2. He chairs the meetings of the Board at which he is present. The constitution of the company overrides the provisions of Schedule 4 of the Companies Act. Thus the constitution determines whether the Chairman has a second or casting vote where there is an equality of votes for and against a motion.

Generally accepted functions of the chairman

There is no law or text book which sets out precisely the role that a Chairman of a Board should play. Many larger companies, with today's emphasis on corporate governance, do take the trouble of having a general code of practise of corporate governance which does formally set out the role of the board, the role of its chairman, the relationship with the executive management etc. Some statements go to the extent of listing out the Board's work program for the year and indicating what reports the Board will require to be submitted by management each month for the Board's consideration.

Generally, the Chairman should ensure that the Board members, when taking up duties are briefed on the terms of their appointment and on their duties and responsibilities, that they are given other relevant materials such as the latest business plan and annual reports and accounts describing the company's organizational structure and basis of operation.

The Chairman should ensure that the Board meets at regular intervals in each year and that minutes of the meetings accurately record decisions taken and as appropriate, the views of individual board members.

The Chairman is responsible for leading the Board and for ensuring that it successfully discharges overall responsibility for the organization as a whole.

It is the Chairman's role to:

- * provide leadership to the Board;
- * enable all Board members to make a full contribution to the Board's affairs and to ensure that the Board acts as a team;
- * ensure that key and appropriate issues are discussed by the Board in a timely manner;
- * ensure that the Board has adequate support and is provided efficiently with all the necessary data on which to base informed decisions;
- * maintain a regular dialogue with the General Manager as Chief Executive to ensure that he is at all times fully informed of all major operational issues;
- * take key responsibility for the relationship between the Board and the shareholder;
- * be the public face of the company in respect of announcements in respect of policy matters, as distinct from operational matters which will normally be announced by the Chief Operating Officer (the General Manager);
- * advise the shareholder from time to time on the performance of the members of the Board;
- * ensure that, if appropriate, subcommittees of the Board are formed for roles which cannot be adequately or conveniently performed by the whole Board, such as review of the financial accounts and review of the audit report, normally performed by an audit subcommittee.

Members of an audit committee

This is a situation in which special tasks may bring special responsibilities. If an audit committee is established - a common recommendation - then the tasks of that committee should be defined. Different committees will be set different tasks. Flowing from those tasks may be the requirement of a higher level of care, skill and diligence - in respect of those tasks - from members of that committee. This is reinforced by section 115 set out above.

The same principle applies when some directors are charged with other specific tasks - in relation to those tasks, it may be that their level of care, skill and diligence will be judged against higher standards.

Directors with specific skills

What about those directors brought onto the board because of their specialised knowledge or professional expertise - for example lawyers or accountants?

The statute says that directors must exercise the care, skill and diligence that a reasonable director would exercise in the same circumstances, so it is commonly accepted that - in relation to their area of special expertise - such directors have a higher standard to meet than those without such skills.

Alternate directors

A person who acts on a board intermittently, only in the absence of his appointor, can hardly be expected to have the same knowledge of the company as the person he replaces. But if he must carry the same or similar responsibilities, he is in a very undesirable position.

For this reason, candidates are commonly advised against accepting the position of alternate director.

Small and large companies

Section 115 states that one of the considerations, in determining the standard to be met, is the nature of the company.

It is accepted, and there is judicial authority to confirm, that a large company, with more funds involved and the investments of more people involved, imposes a greater standard of care, skill and diligence on directors than does such a position in a small company or in a 'one family' company.

Further issues

As stated previously, this report is just a brief discussion of a volatile and developing area of law. A full discussion would also address these issues:

1. The extent to which a director may delegate his responsibilities, noting section 111 of the *Companies Act 1997*
2. The extent to which a director may rely on information given to him, noting section 116 of the Act
3. The scope of the 'business judgement rule' and the extent to which it applies in PNG, if at all.
4. The position of representative directors and nominee directors, noting section 123 of the Act.
5. The right of a director, against whom an award of damages or compensation has been made, to require contribution from his co-directors.
6. The relationship between the four different grounds on which action may be taken against directors for breach of the duty of care, skill and diligence - the different standards of performance required, the different tests of breach of that duty and the different measures of damages:
 - statute - criminal proceedings;
 - statute - civil proceedings for compensation;
 - general law - for breach of fiduciary duties; and
 - the law of negligence - for damages.

It is a dynamic field.

What do I do?

1. If you are a chairman, read carefully the expectations of company chairmen set out above, and the advice to chairmen. Assess your own performance in the light thereof. Make a list of things to do. Act on that list
2. If you are an executive director, realise that more is expected of you than from some of your fellow directors. This does not mean that you are right and they are wrong - it means that you must be more careful, skilled and diligent.
3. If you are on any sub-committee, particularly if you are the convenor or head of that committee, realise that you are particularly responsible to ensure that the sub-committee performs properly. Do not allow it to fail or reduce its performance because of slackness of others or because of indifference of other directors not on that sub-committee.

If you have any special role, the same applies.

4. If you are on the board because of special expertise or professional skill you should insist that, when dealing with a matter in that area of expertise, the board deals with it with professionalism and expertise. Do not permit non-professionalism to prevail.
5. If you are on a board as nominee or representative director, make sure you understand your obligations.
6. Beware of accepting the position of alternate director. Get professional advice before you do.
7. If in doubt, get professional advice.
8. Do all this in addition to your normal duties and responsibilities as a director!

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This is not a substitute for legal advice. Users should obtain professional advice.