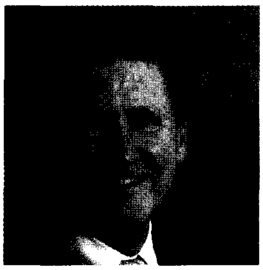
Balancing the director liability burden

As society re-appraises the risks posed by limited liability corporations, **Steven Cole** stresses the importance of balancing the liability burden faced by directors.



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In 1911, Nicholas Murray Butler, president of Columbia University, said: "The limited liability corporation is the greatest single discovery of modern times... Even steam and electricity are far less important than the limited liability corporation." If Nicholas Butler was alive today, his sentiment would surely extend to the computer chip and the internet, along with steam and electricity.

Corporations are conferred a statutory licence to operate with general acceptance that the "miracle" of the limited liability corporation has delivered profound benefit to mankind and its standard of living. Functionally, limited liability corporations have achieved their success by:

- Allowing the effective marshalling and deployment of resources;
- Enabling the orderly and efficient management of business, despite diversity of ownership;
- Attracting and empowering professional management expertise;
- Facilitating enterprise through the assumption and management of risk;
- Stimulating economic growth and employment;
- Limiting the liability risk of investors; and
- Sharing the fruits of the enterprise with a diverse stakeholder base.

However, as with any great concept, there can be unintended consequences, or undesirable side effects, the risks of which need to be managed. In the context of collective investments under a corporate structure, traditionally these risks were managerial abuse of position and malfeasance. Consequently, laws (legislated and court inspired) evolved to mitigate these risks, including the express imposition of obligations of honesty, care and diligence (subject to reasonable business judgement latitude) and fiduciary responsibility.

The success of the "miracle" of the limited liability corporation, particularly over recent decades, has resulted in:

- Concern as to the growing power of large (especially multi-national) corporations, potentially with influence beyond practical government and societal controls;
- Governments ceding to corporations the responsibility for providing and delivering public sector community infrastructure, including utilities, transport, health, education, communications and even security; and
- Society becoming financially exposed to, and dependent on, corporate performance (and non-performance) through direct, and indirect (through superannuation funds), investments in commercial corporations.

These factors, combined with other social shifts, especially in the areas of the environment and occupational health and safety (OH&S) have led to increasing demand for enhanced management practices and accountability to guard against adverse outcomes.

In response to these developments, society has been reappraising its risk profile to limited liability corporations, including re-evaluating the relatively open scope of a corporation's statutory licence to operate.

In addition to continuing to manage the traditional risks of managerial abuse of position and malfeasance, there is an emerging trend for society to also seek to better manage the risk of corporate non-performance or underperformance in the forms of assurances with respect to:

- Corporate social responsibility outcomes (especially in the areas of the environment and OH&S);
- Performance guarantees for corporations delivering public sector community infrastructure services; and
- Corporate investment performance outcomes.

Driven by these pressures, a plethora of prescriptive and proscriptive regulations (legislated and court inspired) have emerged, with continuing demands for tighter regulatory control of corporations and their governance in the aftermath of the global financial crisis.

Yet corporations pose special challenges for regulators seeking to deter aberrant behaviour:

- Corporations are notional statutory creations unable personally to be incarcerated;
- Financial penalties may pale into relative insignificance if economic rewards materially exceed the aggregate compliance and prospective "risk-weighted" penalty cost to the corporation of the relevant proscribed behaviour; and
- Ostensibly, it is the corporation's directors and officers who are the "heart and mind" of the corporation, rather than the corporation itself.

In these circumstances, the regulatory response, supported by society's desire for a "body to kick and a soul to damn" (to use the terminology of Neil Young QC from his ASIC Summer School address in February 2008), has been to impose personal responsibility and liability on the corporation's directors and officers, as well as to allow for compensation and retribution for society's "loss" arising from the corporation's performance non-delivery. This includes the full suite of deterrents including:

- Significant fines and/or compensation orders;
- Incarceration - for dishonesty and more extreme culpable behaviour;
- Banning orders - withdrawing a director's licence to ply his or her occupation; and
- "Naming and shaming" - with consequential severe reputational effects, especially in the context of heightened business media interest in, and reporting on, such matters.

Such penalties may be appropriate where it is proven that a director has materially transgressed accepted norms of behaviour, and is culpable, in which case society is entitled to its "soul to damn and body to kick". But contemporary regulatory practice with respect to director liability evidences disturbing discriminatory trends that should not be tolerated by society, particularly as around 2.1 million Australians (or about 10 per cent of the population) hold a directorship position and are directly personally affected by these discriminatory trends:

- Strict liability - where the director's intention when committing the offensive behaviour is not relevant in establishing the offence;
- "Ipso facto" liability - where culpability arises merely by the director holding the corporate office, without the need to establish accessorial involvement of the director in the offence;
- Reverse onus of proof - where the director has the burden to "prove" innocence by establishing all the elements of the available defence, which is often ill-defined in any event; and
- Severe penalties - be they financial or career-terminal banning orders, under the guise of a lesser civil standard of proof (balance of probabilities), rather than the more onerous criminal standard (beyond reasonable doubt).

If regulations of such a nature were to be imposed on other classes of society, cries for natural justice and unfair oppression would resound. Although perhaps true, it is cold comfort, and lazy jurisprudence, to suggest these laws are conservatively applied by our regulators who pursue only the more egregious cases of non-compliance.

So where does the balance lie between:

- Society's right to be protected against aberrant corporate behaviour;
- The desire for society to continue to enjoy the benefit of the "miracle" of the limited liability corporation; and
- The rights to natural justice, and a fair go, for directors and officers who honestly, and with reasonable acumen, exercise rational business judgement in good faith for the intended benefit of the corporation (and its stakeholders) to which they are appointed - often encapsulated in the call for a uniform "business judgement rule", or overarching protection, for directors and officers of corporations who act in this manner?

There must be no question that, in our mature society, laws imposing special duties and liabilities on those prepared to assume positions of responsibility and authority must be principled and reflect the basic tenets of natural justice as commonly understood within the Rule of Law. At the same time, those who accept, and then abuse, positions of responsibility and authority, either by dishonesty or culpable neglect or incompetence, deserve the damnation and retribution society is justly entitled to exact.

However, it must be remembered that many performance outcome risks (as opposed to more traditional managerial abuse and malfeasance risks) are inherent to commercial endeavour generally, and their management is the distinguishing competitive advantage differential between the more and the less successful business enterprises. The legitimacy of society's entitlement to require performance assurances for those risks, especially against directors and officers seeking to discharge their responsibilities with honesty, good faith and reasonable care and diligence, is questioned. In particular, the laws and regulations by which performance assurances are exacted against those prepared to take on the mantle of corporate management need to be appropriate if the managerially gifted, with ability to deliver the required performance, are not to be deterred by the journey's perils.

In seeking this balance, care needs to be taken not to rent the fabric of the "miracle" of the limited liability corporation, with the risk of the loss of its bounty. Emotionally assuaging retribution for corporate non-delivery must be tempered against broader potential unintended consequences of over-regulation.

In addition, if society is aggrieved by performance shortcomings of certain corporations, then in attributing culpability it may also wish to reflect on the role and responsibility of the corporation's shareholders in the selection and appointment of "the hearts and minds" of those corporations (that is, the boards and directors). Surely corporate owners must accept at least some responsibility for the selection and oversight of those they entrust to manage their affairs, although if they become too engaged personally in the corporation's management they may lose the benefit of the "limited liability" they treasure. Perhaps the inviolable protection of the "corporate veil" for shareholders has been at the expense, and on the sacrificial altar of those selected by the shareholders to represent their interests (the directors). The ethics of this sacrifice is open to debate.

At the end of the day, boards and their directors are not omniscient, nor are they infallible, even if the majority are honest, diligent and generally competent. Corporate governance structures and cultural practices are designed to ensure the prospect of sound decisions being made through due and proper process, and the application of reasonable acumen and rational business judgement, consistent with the information then reasonably available, advice taken (as appropriate), reasonable assessment of the potential risks and rewards involved and the corporation's strategic objectives and values.

Contemporary Australian corporate governance is the envy of other nations, with public corporate boards comprising a majority of independent non-executive directors (NEDs) who accept oversight responsibility for a corporation's actions, discrete from management and the executive team. At this fragile time of hopeful economic recovery, Australia's dependence on the corporate sector to deliver its "miracle" is heightened.

> **‘Care needs to be taken to afford this great majority reasonable protection when weeding out the few who have fallen short in the proper discharge of their responsibilities’**

It is not disputed that there have been a few examples of “extreme capitalism” (to adopt the terminology of Prime Minister Kevin Rudd) during the recent financial downturn that have resulted in economic and social loss to the community. None would argue too that as a consequence of the actions of a few, corporations and their directors need to regain the trust and respect of the community and earn the authority and legitimacy that will enable them to continue to deliver the fruits of sound corporate endeavour and governance practice, including shareholder returns, jobs growth and economic prosperity.

It is also not disputed that the great majority of independent NEDs who provide their services to commercial, governmental, not-for-profit and charitable organisations (often for no fee, or on a nominal basis, in the case of the latter two groups), are not only competent, diligent and professional in the discharge of their responsibilities, but also apply the highest ethical standards in doing so.

Care needs to be taken to afford this great majority reasonable protection when weeding out the few who have fallen short in the proper discharge of their responsibilities. Corporate performance assurance is more likely to be delivered by enhanced governance standards and director competency attributes than discriminatory regulation, which fosters a governance culture encumbered by procedure and reticent to make commercial business judgements for fear of liability and retribution.

Society also needs to reflect on its own role and responsibility in this debate, as well as the reasonableness of its expectations of those it delegates to deliver corporate outcomes, if it wants the “miracle” to continue to deliver its bounty.