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Directors as a Curious Sentinel: Ignorance of a Breach of Duty is no Defence

Directors of companies are generally familiar with their duty to act with reasonable care and diligence. This well-known statutory duty finds its home in section 180 of the *Corporations Act 2001* (Cth) (**the Act**). It is well established that, in considering this duty, regard must be had to the surrounding circumstances. However, it is not unusual for section 180 to act as a form of “catch-all” against directors. That is to say, if a director has breached another duty, then they have almost certainly also breached section 180 by doing so. This has also led section 180 to be used where a director’s actions have exposed the company to a contravention of the law.

One species of breach of this duty of care and diligence can broadly be categorised as acting with *information deficiency*. That is, the director makes a decision or continues to act in a manner without the requisite information a reasonable person in their circumstances ought to require. If, in some circumstances, a director is required to have certain information in order to make a decision, then a question arises: does a director have a positive duty to make enquiries about their decisions?

Delegation

At first instance, company directors will be relieved to hear that there are special protections with respect to this duty where the director has delegated their responsibilities. At general law, because a director acts in a fiduciary manner towards the company, their duties cannot be delegated. However, the law now recognises that the exigencies of business place a great deal of demand on a director, and that commercial reality demands that directors rely on others.

Therefore, the general law rule is trumped by the operation of sections 198D and 190 of the Act. These sections provide that, barring anything contrary in the constitution of a private company, a director can delegate their powers to any other person, including another director or employee of the company. The delegating director is then responsible for all of the actions of the delegate, except in circumstances where the director, acting in good faith and after making the proper enquiries, has reasonable grounds to believe the delegate is competent and reliable. If the delegating director is able to satisfy the court that they had this belief and the requisite elements to support it, then it acts as a shield that a director can raise against a claim for breach of duty arising out of the actions of the delegate.

Making Enquiries

It is well established that a director must take reasonable steps to place themselves in a position to guide and monitor the management of the company. This will generally mean that the director must become familiar with the company, keep informed as to its activities, attend board meetings, and maintain familiarity with its financial status. However, as the NSW Court of Appeal held in *Daniels v Anderson* (1995) 37 NSWLR 438, a further duty to *make enquiries* can be enlivened in the following circumstances:

“if ... directors know, or by exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required and want of that care makes them responsible.”

Therefore, there is an objective test for the positive duty to make enquiries to be enlivened. The director must keep informed as to the affairs of the company, and if they know or should have known about facts that would have put a reasonable person on guard, then they should make enquiries into those facts. Further, the ability of a director to rely on information and advice of others are subject to this duty when enlivened. Therefore, once a director’s suspicions have been awakened, there is a positive duty on the director to satisfy themselves that no contraventions have occurred.

This test was recently considered by Robson J in the colourful case of *ASIC v Flugge & Geary* (2016) 342 ALR 1 (**Flugge**). This case considered whether two former directors of the Australian Wheat Board (**AWB**) had breached their duties regarding AWB’s contraventions of international law. The allegation was that the AWB had paid hard currency to the Iraqi government in response to sham fees for the delivery of wheat to Iraq. These payments were contrary to UN Resolutions in place at the time. ASIC brought proceedings against the directors, alleging that they knew about the contraventions, or if they did not know, they should have made enquiries that would have led them to stopping the contraventions.

Robson J, in a lengthy judgment, ultimately held that Mr Flugge, the former chairman of AWB, did not know that contraventions were occurring, but that he did breach section 180 of the Act by failing to make enquiries. His Honour quoted the words of Pollock J from the Supreme Court of New Jersey in the United States, saying:

“Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.”

His Honour found that Mr Flugge had breached his duty as he was aware of a complaint levied by the UN against the AWB, which should have been sufficient to awaken his suspicions, and he failed to make any enquiries as to the propriety of the payments which were the subject of the complaint. Mr Flugge was ultimately penalised \$50,000 and was disqualified from managing a corporation for five years.

Implications

Whilst the case of Flugge has an unusual factual matrix that many Australian companies would rarely find themselves in, the case stands out as a firm reminder as to scope of a director’s duty to positively make enquiries. Despite Mr Flugge not being aware of any contraventions, he was still in breach of his duty to act with reasonable care and diligence. It sends a message to company directors that, if they are aware that there may be a possible breach of the law taking place, or a breach of duty, it is not sufficient to shut their eyes or rely on the information of others. The sentinel must be alert and curious, ready to jump into the trenches and satisfy themselves that nothing improper is taking place. Anything short of this may result in a civil penalty being levied against the director who is asleep at their post.

Further Information

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