Centro and the Monitoring Board – Legal Duties Versus Aspirational Ideals in Corporate Governance

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Abstract

Pothers about liability risks for company directors and officers are nothing new in corporate law. The global financial crisis, however, created a unique and unfamiliar commercial matrix in which such concerns were played out. Although Australia fared better than many jurisdictions during the global financial crisis, nonetheless, the crisis had some significant commercial and legal effects, including in the area of directors' liability. One decision highlighting the potential dangers for directors in this regard is ASIC v Healey (2011) 196 FCR 291) ('Centro liability decision'), an Australian decision concerning financial disclosure and breach of directors' duties, which has been described in the US as a 'wake-up call from down under'. This article explores an apparent incongruity between the Centro liability decision, which has been criticized for its stringency, and the subsequent penalty decision ('Centro penalty decision'), which some have considered far too lenient. This article argues that, rather than signifying inconsistency, the Centro liability and penalty decisions form vital complementary parts, which reflect an underlying tension in the area of directors' duties between legal rules and aspirational standards. The same tension also underpins the law in this area in the United States. The article examines the Centro litigation through a comparative law lens, contrasting it with some leading US case law on directors' duties, including Smith v Van Gorkom, In re Caremark International Inc. Derivative Litigation, and the Disney litigation.

Keywords: global financial crisis, corporate governance, directors, boards, monitoring, directors' duties, directors' liability, duty of care, business judgment rule, duty of oversight, Centro litigation, financial disclosure

JEL Classifications: G18, G28, G30, G32, G38, K20, K22, O16

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CENTRO AND THE MONITORING BOARD – LEGAL DUTIES VERSUS ASPIRATIONAL IDEALS IN CORPORATE GOVERNANCE

JENNIFER G HILL*

I INTRODUCTION

Pothers about liability risks for company directors and officers are nothing new in corporate law.[1] The global financial crisis ('GFC'), however, created a unique and unfamiliar commercial matrix in which such concerns were played out. Although Australia fared much better than many jurisdictions during the GFC,[2] that is not to say it was unaffected. The crisis had an array of significant commercial and legal effects in Australia, including in the area of directors' liability.[3] Against the backdrop of Australia's stringent insolvent trading regime,[4] the crisis increased the risk of business failure and complicated the task of assessing a company's solvency.[5] These factors also affected potential liability of directors for breach of the duty of care and diligence.

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1 Joseph W Bishop Jr once famously stated: 'a vast pother has arisen in corporate circles over the dreadful plight of officers and directors': Joseph W Bishop Jr, 'Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers' (1968) 77 *Yale Law Journal* 1078, 1078.

2 See generally Jennifer G Hill, 'Why Did Australia Fare so Well in the Global Financial Crisis?' in Eilís Ferran et al, *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press, 2012) (forthcoming).

3 See, eg, J J Spigelman, 'The Global Financial Crisis and Australian Courts' (Speech delivered at the Inter-Pacific Bar Association Conference, Singapore, 4 May 2010).

4 See, eg, Wayne Martin, 'Official Opening Address' (Speech delivered at the Insolvency Practitioners' Association of Australia 16th National Conference, Burswood Entertainment Complex, Perth, 28 May 2009). He describes Australia's insolvent trading laws as 'arguably the strictest in the world': at 14.

5 See generally Corporations and Financial Services Division, The Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (Commonwealth of Australia, 2010); R P Austin, 'Introductory Essay' in R P Austin and Fady J G Aoun (eds), *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (Sydney University Press, 2012) 5, 26–8.

One decision highlighting the potential dangers for directors in this regard is *ASIC v Healey*[6] ('*Centro Liability Decision*'), which was delivered in June 2011. In that case, Middleton J in the Federal Court of Australia held that the defendants, including executive and non-executive directors, had breached their duty of care and diligence in relation to financial reporting obligations during the GFC. Many commentators viewed the *Centro Liability Decision* as unduly harsh.[7] In the United States ('US'), it has been described as a 'wake-up call from down under'.[8]

Only a few months after delivering his wake-up call, however, Middleton J came to consider the appropriate penalties to apply in relation to the relevant breaches in *ASIC v Healey [No 2]*[9] ('*Centro Penalty Decision*'). In contrast to the *Centro Liability Decision*, which had been criticised for its stringency, the *Centro Penalty Decision* was widely greeted in the press as being too lenient.[10]

An intriguing aspect of the Centro litigation is the apparent incongruity between the liability decision and the later penalty judgment.[11] This article argues that the *Centro Liability Decision* and *Centro Penalty Decision* form vital complementary parts of the overall doctrinal message of the Centro litigation. The article suggests that, rather than signifying inconsistency, the two decisions reflect an underlying tension in the area of directors' duties between legal rules and aspirational standards.

This tension also underpins the law in this area in the US. The article examines the Centro litigation through a comparative law lens, contrasting it with some leading US case law on the duty of care and the duty of oversight, where the friction between legal rules and aspirational standards is apparent. US case law discussed in this article, which serves to elucidate the tension between legal rules and aspirational standards, includes the famous decision in *Smith v Van Gorkom*,[12] and the Disney litigation.[13] The article argues that although, viewed in

6 (2011) 196 FCR 291.

7 See, eg, Richard Gluyas, 'Centro Ruling Leaves Boards Battling with Legal Burden', *The Australian* (Canberra), 23 July 2011, 32.

8 David A Katz, 'For Directors, a Wake-Up Call from Down Under' on *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (4 October 2011) <http://blogs.law.harvard.edu/corpgov/2011/10/04/for-directors-a-wake-up-call-from-down-under/>. See also Charles M Elson and Robert B Thompson, '*Van Gorkom*'s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives' (2002) 96 *Northwestern University Law Review* 579, where the authors describe *Smith v Van Gorkom*, 488 A 2d 858 (Del, 1985) as a 'wake-up call to passive boards': at 583.

9 (2011) 196 FCR 430.

10 See, eg, Nick Lenaghan and Patrick Durkin, 'A Fine, a Ban and Off the Hook', *The Australian Financial Review* (Canberra), 1 September 2011, 9; Patrick Durkin, 'Centro Investors Vent Anger at "Injustice"', *The Australian Financial Review* (Canberra), 1 September 2011, 9; Michael West, 'Off the Hook, With Barely a Slap', *Sydney Morning Herald* (Sydney), 3 September 2011, 2.

11 See generally Jennifer Hill and Robert Austin, 'Balancing the Scales on Centro', *Business Spectator* (online), 6 September 2011 <http://www.businessspectator.com.au/bs.nsf/Article/Centro-directors-legal-ruling-Justice-Middleton-pe-pd20110905-LE8ZD?OpenDocument&src=sph>.

12 488 A 2d 858 (Del, 1985).

isolation, the *Centro Liability Decision* strongly resembles *Smith v Van Gorkom*, when the complementary *Centro Penalty Decision* is taken into account, the overall message of the Centro litigation becomes more closely aligned with more recent US case law on the duty of care, such as the Disney litigation.

II BACKGROUND TO THE CENTRO LITIGATION

The *Centro Liability Decision* has been frequently described as a 'landmark' decision,[14] and its genesis lay in the GFC. Like many other highly leveraged firms, the Centro Group[15] suffered extreme liquidity problems during the crisis. The Group came near to collapse in December 2007, when an announcement was made that signalled the Group's difficulty in refinancing A$3.9 billion in short-term debt.[16] The Centro Group, which owned around 650 shopping malls in America, was only one of several high profile commercial real estate operators in the US to be hard hit by the credit freeze[17] and exposed to the plummeting US property and retail sales at this time.[18]

In October 2009, two years after this crisis period, the Australian Securities and Investments Commission ('ASIC') commenced civil penalty proceedings

13 *In re The Walt Disney Company Derivative Litigation*, 907 A 2d 693 (Del Ch, 2005) *('In re The Walt Disney')*; *Brehm v Eisner (In re Walt Disney Company Derivative Litigation)*, 906 A 2d 27 (Del, 2006) ('*Brehm v Eisner*').

14 See Tim Leung and Jon Webster, 'Directors' Duties, Financial Literacy and Financial Reporting After Centro' (2012) 30 *Company and Securities Law Journal* 100, 100; Australian Securities and Investments Commission, 'Decision in Centro Civil Penalty Case' (Media Release, 11-125MR, 27 June 2011); Leonie Wood, 'Centro Loses Landmark Decision: Courts', *Sydney Morning Herald* (Sydney), 28 June 2011, 1; Pia Akerman, 'Landmark Centro Case Could Trigger Director Exodus – Buck Stops with the Board: Judge', *The Australian* (Canberra), 28 June 2011, 21.

15 The Centro Group comprised Centro Properties Ltd ('CPL'); Centro Property Trust ('CPT'); and Centro Retail Trust ('CRT'): *Centro Liability Decision* (2011) 196 FCR 291, 296 [2].

16 See Centro Properties Group, 'Centro Earnings Revision and Refinancing Update' (ASX Media Release, 17 December 2007). See also Robert Harley and Mathew Dunckley, 'Credit Crisis Savages Centro', *The Australian Financial Review* (Canberra), 18 December 2007, 1; 'Tread Carefully in Volatile Times', *The Australian Financial Review* (Canberra), 18 December 2007, 46; Karen Maley, 'The Year the Financial System Snapped', *The Australian Financial Review* (Canberra), 21 December 2007, 32.

17 See Kris Hudson, 'Mall Owners Sent Reeling by Spiraling Credit Woes', *The Wall Street Journal* (New York), 16 December 2008, B.1.

18 General Growth Properties, which was one of America's biggest commercial real estate operators, had entered a 'death spiral' period, as a result of inability to refinance massive amounts of debt. See Kris Hudson, 'General Growth Chief Exits Amid Loan Flap', *The Wall Street Journal* (New York), 28 October 2008, B.1. General Growth Properties filed for Chapter 11 bankruptcy on 16 April 2009. See Glenn Dyer, 'Centro, Westfield Hearing Grim Tales from US Mall Owner', *Crikey.com* (online), 13 November 2008 <http://www.crikey.com.au/2008/11/13/centro-westfield-hearing-grim-tales-from-us-mall-owner/>; Michael J de la Merced, 'General Growth Properties Files for Bankruptcy', *The DealBook Column*, *The New York Times* (online), 16 April 2009 <http://dealbook.nytimes.com/2009/04/16/general-growth-properties-files-for-bankruptcy/>.

against the directors and chief financial officer ('CFO')[19] of the Centro Group.[20] The action related to the defendants' approval of consolidated financial statements of the Centro Group for the financial year ended 30 June 2007.[21] ASIC claimed that the financial reports for the Centro Group did not comply with the relevant accounting standards and regulations,[22] and failed to give a true and fair view of the financial position and performance of Centro Group entities. This was on the basis that the reports wrongly classified around A$2 billion of debt as non-current liabilities[23] and failed to disclose guarantees of short-term liabilities amounting to approximately US$1.75 billion that were provided after the balance date.[24]

Defective financial disclosure and non-disclosure of guarantees relating to short-term liabilities were also crucial issues in the US during the GFC, and provide an important point of cross-jurisdictional comparison. Balance sheet manipulation and inadequate financial disclosure were also central features of Enron Corporation's collapse ('Enron'). The US legislative response to Enron, the *Sarbanes-Oxley Act of 2002* attempted to fix the problem by introducing a requirement of CEO and CFO financial statement certification under section 302.[25] Yet, ultimately, section 302, and many other provisions of the *Sarbanes-Oxley Act of 2002*,[26] merely demonstrated the gap between 'law on the books'

19 The defendants included former Centro Chief Executive Officer ('CEO') and Managing Director, Andrew Thomas; former CFO, Mr Romano Nenna; and former Chairman and non-executive director, Mr Brian Healey: ASIC, 'ASIC Commences Proceedings against Current and Former Officers of Centro' (Media Release, 09-202AD, 21 October 2009). See generally Philip Crutchfield and Catherine Button, 'Men Over Board: The Burden of Directors' Duties in the Wake of the Centro Case' (2012) 30 *Company and Securities Law Journal* 83, 86–9.

20 ASIC, above n 19.

21 The consolidated financial statements of the Centro Group were approved in a board meeting, which the defendant directors attended on 6 September 2007: Crutchfield and Button, above n 19, 88.

22 Section 296(1) of the *Corporations Act 2001* (Cth) requires that financial reports must comply with the accounting standards. The relevant accounting standard for the purposes of Centro was Australian Accounting Standards Board ('AASB') 101, 'Presentation of Financial Statements', which related to the classification of liabilities as current in a corporation's financial reports: *Centro Liability Decision* (2011) 196 FCR 291, 302 [40] ff.

23 ASIC, above n 19.

24 See *Centro Liability Decision* (2011) 196 FCR 291, 297 [9].

25 See also *Sarbanes-Oxley Act of 2002* § 906. An analogous certification requirement was introduced in Australia in response to Enron under *Corporations Act 2001* (Cth) s 295A.

26 The *Sarbanes-Oxley Act of 2002* also included a statutory clawback provision, permitting recovery of bonuses, incentive-based, or equity-based compensation received by the CEO or CFO if the corporation is required to restate earnings because of material non-compliance with financial reporting requirements as a result of misconduct: § 304 *Sarbanes-Oxley Act of 2002*. In spite of the multiplicity of financial restatements by US corporations since the introduction of § 304, successful clawback actions have been very rare: see generally Jennifer G Hill, Ronald W Masulis and Randall S Thomas, 'Comparing CEO Employment Contract Provisions: Differences Between Australia and the United States' (2011) 64 *Vanderbilt Law Review* 559, 574 nn 93–4. The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* ('*Dodd-Frank Act of 2010*'), the major US regulatory response to the GFC, expands the scope of the earlier clawback provision under the *Sarbanes-Oxley Act of 2002*: see § 954 *Dodd-Frank Act of 2010*.

and 'law in action' in this regard.[27] There has not been a single case of enforcement of section 302, in spite of many examples of accounting manipulation and fraud in the period between Enron and the GFC.[28] It is, therefore, hardly surprising that only a few years after Enron Corporation's problematic use of special purpose entities,[29] major US banks again found ways, through structured investment vehicles and other mechanisms, to conceal liabilities off their balance sheets in the lead-up to the GFC.[30] Enron and the GFC both highlighted the crucial role, as well as the limits,[31] of financial disclosure as a regulatory technique.[32]

The Centro litigation merges issues relating to financial disclosure and directors' duties. It should be noted that this would be precluded under US law due to the longstanding structural divide between the disclosure regime under federal securities law,[33] and regulation of fiduciary duties under state corporation law.[34] Given the Centro Group's misclassification of debt and failure to disclose guarantees of short-term liabilities in its financial reports, ASIC alleged that the defendant directors and CFO had failed to take all reasonable steps to ensure compliance with the Centro Group's reporting obligations under the

27 See, eg, David A Skeel Jr, 'Book Review: Corporate Anatomy Lessons' (2004) 113 *Yale Law Journal* 1519, 1543; John C Coffee Jr, 'Law and the Market: The Impact of Enforcement' (2007) 156 *University of Pennsylvania Law Review* 229, 243–5; Howell E Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications' (2007) 24 *Yale Journal on Regulation* 253.

28 See Francine McKenna, 'Accounting Failure: What Sarbanes-Oxley Teaches Us about Dodd-Frank', *Essays, Boston Review* (online), 22 August 2011 <http://www.bostonreview.net/BR36.5/francine_mckenna_dodd-frank_sarbanes-oxley_wall_street_financial_reform.php>, stating that this is remarkable given the fact that, in many companies, such as Lehman Brothers Holdings Inc and Citigroup, evidence emerged showing that CEOs and CFOs had knowingly signed false certifications.

29 See Steven L Schwarcz, 'Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures' (2002) 70 *University of Cincinnati Law Review* 1309.

30 See John C Coffee Jr, 'Systemic Risk after *Dodd-Frank*: Contingent Capital and the Need for Regulatory Strategies beyond Oversight' (2011) 111 *Columbia Law Review* 795, 820, stating that '[w]hat is essentially the same accounting subterfuge worked twice, only a few years apart.' It appears that the same subterfuge had also been employed in the early 20th century. See generally Frank Partnoy, 'Historical Perspectives on the Financial Crisis: Ivar Krueger and the Credit-Rating Agencies, and Two Theories about the Function, and Dysfunction, of Markets' (2009) 26 *Yale Journal on Regulation* 431.

31 See Tony D'Aloisio, 'Regulatory Response to the Financial Crisis' (Speech delivered at the Asia Securities Forum, Sydney, 12 October 2009 and CPA Congress, Sydney, 15 October 2009) 11 ff.

32 See generally John Lowry, 'The Irreducible Core of the Duty of Care, Skill and Diligence of Company Directors: *Australian Securities and Investments Commission v Healey*' (2012) 75 *Modern Law Review* 249.

33 See generally Jesse H Choper, John C Coffee Jr and Ronald J Gilson, *Cases and Materials on Corporations* (Aspen, 7th ed, 2008) 300 ff.

34 There has, however, been much recent controversy concerning possible encroachment by federal law into the traditionally state-based arena of corporate law and governance, as a result of legislation such as the *Sarbanes-Oxley Act of 2002* and *Dodd-Frank Act of 2010*. See, eg, Martin Lipton, 'Some Thoughts for Boards of Directors in 2011' on *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (18 January 2011) <http://blogs.law.harvard.edu/corpgov/2011/01/18/some-thoughts-for-boards-of-directors-in-2011/> ; Steven M Bainbridge, '*Dodd-Frank*: Quack Federal Corporate Governance Round II' (2011) 95 *Minnesota Law Review* 1779; E Norman Veasey, 'What Would Madison Think? The Irony of the Twists and Turns of Federalism' (2009) 34 *Delaware Journal of Corporate Law* 35.

Corporations Act 2001 (Cth) ('*Corporations Act*'),[35] and had breached their statutory duty of care and diligence under section 180(1)[36] by failing to detect the critical errors in the accounts.[37]

Justice Middleton agreed with this analysis of the directors' conduct in the *Centro Liability Decision*.[38] Although noting that the directors were 'intelligent, experienced and conscientious people' and that there was no suggestion that they had carried out their responsibilities otherwise than honestly,[39] the Judge found them liable for breach of the statutory duty of care and diligence. This was on the basis that the directors had: 'failed to take all reasonable steps required of them, and acted in the performance of their duties as directors without exercising the degree of care and diligence the law requires of them'.[40]

The *Centro Liability Decision* took the issue of financial disclosure seriously indeed,[41] and the Centro directors were held liable for breach of duty, in spite of the presence of an audit committee, and in spite of the fact that a major accounting firm had audited the accounts.[42] The decision has elicited controversy and disagreement as to whether it altered the law, and whether it 'raised the bar', particularly in terms of financial literacy, for Australian directors.[43] Some commentators view the decision as part of a general trend in Australia towards greater accountability of directors in discharging their duty of care and diligence.[44] Others, however, including, it seems, the former Chairman of ASIC, Tony D'Aloisio, have suggested that the law may be too onerous, particularly in

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35 Section 344(1) of the *Corporations Act 2001* (Cth) requires a director 'to comply with, or to secure compliance with, Part 2M.2 or 2M.3.' Part 2M.2 of the *Corporations Act 2001* (Cth) relates to financial records, which the corporation is obliged to keep. Part 2M.3 deals with financial reports, including the annual directors' report and audit. See generally *Centro Liability Decision* (2011) 196 FCR 291, 321 [125] ff.

36 Section 180(1) of the *Corporations Act 2001* (Cth) states:

> A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
> (a) were a director or officer of a corporation in the corporation's circumstances; and
> (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

See generally *ASIC v Rich* (2009) 236 FLR 1, 127–41 [7185]–[7242]; Joanna Bird and Jennifer Hill, 'Regulatory Rooms in Australian Corporate Law' (1999) 25 *Brooklyn Journal of International Law* 555, 560–74.

37 See Matthew Stevens, 'Centro in Line to Become Ultimate Testbed for Board Behaviour', *The Australian* (Canberra), 22 October 2009, 21; James Eyers and Patrick Durkin, 'ASIC's Centro Case Rattles Boards,' *The Australian Financial Review* (Canberra), 24 October 2009, 22.

38 See generally Robert Austin and Carolyn Reynolds, 'All Reasonable Steps to be in a Position to Guide and Monitor – The Impact of the Centro Decision' (Minter Ellison Alert, 1 July 2011) <http://www.minterellison.com/NA_20110701_centroDecision/>.

39 *Centro Liability Decision* (2011) 196 FCR 291, 296 [8].

40 *Centro Liability Decision* (2011) 196 FCR 291, 296–7 [8].

41 According to Lowry, the *Centro Liability Decision* emphasises 'the fundamental importance of financial disclosure both as a regulatory tool and as a key component for ensuring that the markets can effectively monitor the performance of corporate management': above n 32, 249.

42 See generally Crutchfield and Button, above n 19.

43 See, eg, Leung and Webster, above n 14, 104–5.

44 See Lowry, above n 32, who argues that this trend exists in both Australia and the United Kingdom.

its application to non-executive directors.[45] It has, for example, been said that the *Centro Liability Decision* may lead to an 'exodus' of directors,[46] and an undesirable fixation with corporate procedure over strategy in Australian companies.[47]

III THE DUTY OF CARE IN THE US: FROM VAN GORKOM TO DISNEY

Corporate law in both Australia and the US provides numerous safe havens, which may enable directors to escape liability for breach of the duty of care and diligence. The most familiar of these is the business judgment rule. Reasonable reliance and delegation provide other useful safe havens in this regard.

These legal principles have traditionally provided a powerful protection to directors in the US. They reflect a gap between stringent standards of conduct and more lenient liability standards with regard to US legal regulation.[48] Nonetheless, one case, which clearly demonstrated the limits of this protection was the famous 1985 Delaware Supreme Court decision in *Smith v Van Gorkom*, which sent a collective – though, admittedly, short-lived[49] – chill down the spine of corporate America.

Smith v Van Gorkom examined US directors' duties in a transactional setting. The case involved a cash-out merger between Trans Union Corporation ('Trans Union') and a subsidiary of the Marmon Group. Jerome Van Gorkom, Trans Union's CEO and Chairman, was the driving force behind the merger. Although Trans Union's shareholders approved the transaction, they subsequently brought a class action alleging that the directors, including Mr Van Gorkom, had acted negligently in recommending the merger. The shareholders argued that the merger price of US$55 per share was lower than the 'intrinsic value' of Trans Union,[50] and that directors had breached both the duty of care and the duty of candour in relation to the merger.

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45 See Damon Kitney, 'Go Easy on Directors: ASIC Chairman Raises Fear Laws May be Too Tough – Exclusive', *The Australian* (Canberra), 30 March 2011, 19; Crutchfield and Button, above n 19, 84. See also Gluyas, above n 7.

46 See Samantha Bowers and Jason Murphy, 'Centro Case Makes Directors Sit Up', *The Australian Financial Review* (Canberra), 29 July 2011, 23, citing Bob Baxt.

47 See Patrick Durkin, John Kehoe and Nick Lenaghan, 'ASIC Pumped on Centro Win', *The Australian Financial Review* (Canberra), 29 June 2011, 8, citing David Gonski.

48 See also Jennifer G Hill, 'Recent Developments in Directors' Duties in the Common Law World' in A Paolini (ed), *Research Handbook on Directors' Duties* (Edward Elgar, 2012) (forthcoming). See generally D Gordon Smith, 'A Proposal to Eliminate Director Standards from the Model Business Corporation Act' (1999) 67 *University of Cincinnati Law Review* 1201, 1203 ff; Meir Dan-Cohen, 'Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law' (1984) 97 *Harvard Law Review* 625; Melvin Aron Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993) 62 *Fordham Law Review* 437.

49 See below, nn 62–3, relating to the introduction post *Smith v Van Gorkom* of *Delaware General Corporation Law*, 8 Del C ch 1 § 102(b)(7) (2012).

50 See, eg, *Smith v Van Gorkom*, 488 A 2d 858, 866 (Del, 1985).

At first instance, the Delaware Court of Chancery granted judgment for the directors, on the basis that they were protected by the business judgment rule.[51] The Delaware Supreme Court, however, reversed this decision, and held that the directors had indeed breached their duty of care in approving the merger.[52] The majority judges stressed that, although the business judgment rule constitutes a potent presumption in favour of the directors in the context of the duty of care, it can be rebutted where the plaintiff demonstrates that the business judgment was not an informed one. According to the Court, the business judgment rule provides no protection for an 'unintelligent or unadvised judgment'.[53] Specifically, the Court stated that:

> fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.[54]

The majority judges in *Smith v Van Gorkom* identified an array of factors which indicated that the directors' decision to enter into the transaction was not an informed one.[55] These included: the absence of any valuation study to assess whether US$55 per share was a fair value in a cash-out merger context;[56] the fact that no director had made further inquiries of the CFO as to the issue of fair value;[57] and the fact that the directors effectively approved the sale of the entire company at a board meeting, which lacked proper notice and lasted only around two hours.[58]

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51 See *Smith v Pritzker* (Del Ch, No 6342, 6 July 1982).

52 *Smith v Van Gorkom*, 488 A 2d 858, 866 (Del, 1985). Justice Horsey delivered the majority judgment (joined by Herrmann CJ and Moore J). Justice McNeilly (joined by Christie J) filed what can only be described as an excoriating dissenting judgment: at 893 ff. Justice McNeilly derided the majority judgment as reading 'like an advocate's closing address to a hostile jury', marked by a 'comedy of errors': at 893–4. The minority judgment focused on the calibre and credentials of the Trans Union Board members. The outside directors included, eg, a professor of economics at Yale University and other directors, who were graduates of distinguished academic institutions, such as the University of Pennsylvania Law School, University of Chicago Business School and Harvard Business School: at 894. According to McNeilly J, it was highly unlikely that directors of this calibre could be 'taken in by a "fast shuffle"': at 894.

53 Ibid 872 (Horsey J). Where the plaintiffs are successful in rebutting the presumption of propriety under the business judgment rule, the burden then shifts to the defendants to justify the transaction on an 'entire fairness' test: see *Cede & Co v Technicolor Inc*, 634 A 2d 345, 371 (Horsey J) (Del, 1993); *In re The Walt Disney*, 907 A 2d 693, 747 (Del Ch, 2005). See also *Cinerama Inc v Technicolor Inc*, 663 A 2d 1156, 1166 (Holland J) (Del, 1995), explaining that the combination of breach of the duty of care and the duty of candour in *Smith v Van Gorkom* made it possible for the defendants to satisfy the 'entire fairness' standard.

54 *Smith v Van Gorkom*, 488 A 2d 858, 872 (Horsey J) (Del, 1985).

55 According to the majority judges, the proper standard for determining whether the directors had reached an informed business judgment was the concept of 'gross negligence' from *Aronson v Lewis*, 473 A 2d 805 (Del, 1984): ibid 873 (Horsey J).

56 *Smith v Van Gorkom*, 488 A 2d 858, 876 (Horsey J).

57 Ibid 877 (Horsey J).

58 Ibid 869, 874 (Horsey J).

The main focus of *Smith v Van Gorkom* was the process of decision-making,[59] and the case has been described as 'a recital of explicit and implicit do's and don'ts' for directors.[60] Nonetheless, the liability implications of the decision were subverted shortly afterwards by Delaware's rapid enactment of section 102(b)(7) of the *Delaware General Corporation Law*, 8 Del C ch 1 (2012) ('*DGCL*'),[61] which provided statutory authorisation for inclusion in the corporate charter of exculpation provisions for this kind of breach.[62]

Twenty years after the Delaware Supreme Court exploded its momentary *Van Gorkom* 'bomb',[63] equally high profile litigation relating to The Walt Disney Company ('Disney') also considered the 'do's and don'ts' of director conduct. The Disney litigation presented an interesting contrast to *Smith v Van Gorkom*. The 2005 Delaware Court of Chancery decision, *In re The Walt Disney Company* formed part of a judicial saga, involving a shareholders' derivative action for breach of directors' duty and corporate waste against Disney directors and officers, who approved an executive contract resulting in payment of a US$140 million severance package to former President, Michael Ovitz, for 15 months of lacklustre work.[64]

Notwithstanding earlier obiter dictum suggesting that the Disney directors might lose the protection of the business judgment rule if their conduct in approving Mr Ovitz's remuneration package could be characterised as reckless,[65] Chancellor Chandler was ultimately deferential to the Disney directors in his determination that they had not breached their duties to the corporation.[66] Focusing predominantly on the duty of care,[67] he assessed breach by reference to whether the directors had acted in a grossly negligent manner or failed

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59 See Lynn A Stout, 'In Praise of Procedure: An Economic and Behavioral Defense of *Smith v. Van Gorkom* and the Business Judgment Rule' (2002) 96 *Northwestern University Law Review* 675. She describes *Smith v Van Gorkom* as providing the classic example of the procedural focus embedded in the business judgment rule: at 696. See also Elson and Thompson, above n 8, 582–7.

60 Bayless Manning, 'Reflections and Practical Tips on Life in the Boardroom after *Van Gorkom*' (1985) 41 *Business Law* 1. Manning gives a list of the relevant do's and don'ts for directors in the context of the *Smith v Van Gorkom* decision: at 7.

61 The equivalent provision under the *Model Business Corporation Act* is § 2.02(b) 4.

62 See Elson and Thompson, above n 8, 583, noting that following the enactment of *DGCL* § 102(b)(7), directors replicating the acts of the Trans Union directors in *Smith v Van Gorkom* today would no longer be personally liable in damages. See, eg, *Malpiede v Townson*, 780 A 2d 1075 (Del, 2001).

63 Manning, above n 60.

64 907 A 2d 693 (Del Ch, 2005). See generally Note, 'Recent Cases' (2006) 119 *Harvard Law Review* 923, 923–6.

65 According to Chancellor Chandler, the defendant directors could lose the benefit of the business judgment rule if they had '*consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude': *In re The Walt Disney Company Derivative Litigation*, 825 A 2d 275, 289 (2003) (emphasis in original). Such characterisation of the directors' conduct would also deprive them of the protection of exoneration clauses in corporate charters: see, eg, *DGCL* § 102(b)(7).

66 See, eg, Theodor Baums and Kenneth E Scott, 'Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany' (2005) 53 *American Journal of Comparative Law* 31, criticising what the authors describe as Delaware's 'elaborate theology of deference to board decisions': at 32.

67 See Note, above n 64, 926–7, arguing that this focus on the duty of care precluded examination of the facts through the lens of the duty of loyalty.

adequately to inform themselves. In spite of many procedural lapses, Chancellor Chandler concluded that the directors 'did not intentionally shirk or ignore their duty, but acted in good faith, believing they were acting in the best interests of the Company'.[68] He therefore held that the presumptive protection of the business judgment rule was unimpaired.[69]

In re The Walt Disney, which was subsequently approved in 2006 by the Delaware Supreme Court,[70] sits somewhat uncomfortably with *Smith v Van Gorkom*, which held that mere absence of bad faith or fraud was insufficient to satisfy the duty of care.[71] It has sometimes been suggested that the cases can be easily reconciled by recognising that *Smith v Van Gorkom* was essentially a takeover case, where directors' conflicts of interest are particularly acute.[72] Nonetheless, Chancellor Chandler went to considerable lengths in *In re The Walt Disney* to distinguish the two cases. Some of his points of distinction were transactional, others were not.[73] They included the nature and magnitude of the relevant transaction in each case;[74] the fact that the directors in *Smith v Van Gorkom* were required by Delaware law to take certain actions in relation to the merger;[75] differences in the two cases regarding the level of notice provided for the relevant meetings,[76] and the amount of time devoted to discussion of the key issues;[77] documentation aspects;[78] and, finally, the financial implications of the relevant transactions in each case.[79]

Chancellor Chandler considered that the actions of Disney's directors provided 'many lessons of what not to do',[80] and that there were serious procedural flaws in the process of determining Mr Ovitz's pay and termination

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68 *In re The Walt Disney*, 907 A 2d 693, 772 (Del Ch, 2005).

69 For a detailed comparison of the US business judgment rule with Australia's statutory business judgment rule under *Corporations Act 2001* (Cth) s 180(2), see *ASIC v Rich* (2009) 236 FLR 1, 144–55 [7248]–[7295].

70 *Brehm v Eisner*, 906 A 2d 27 (Jacobs J) (Del, 2006). Justice Jacobs considered that there were rational commercial justifications for the Disney directors agreeing to the enormous termination payment to Michael Ovitz: at 58.

71 *Smith v Van Gorkom* 488 A 2d 858, 872 (Del, 1985).

72 See, eg, Jonathan R Macey and Geoffrey P Miller, '*Trans Union* Reconsidered' (1988) 98 *Yale Law Journal* 127, who state '*Trans Union* is not, at bottom, a business judgment case. It is a takeover case': at 128.

73 *In re The Walt Disney*, 907 A 2d 693, 767 (Del Ch, 2005).

74 Ibid.

75 See *DGCL* § 251(b). Chancellor Chandler stated that, by way of contrast, there was no statutory requirement for the board to take particular action in relation to the hiring of Mr Ovitz at Disney: *In re The Walt Disney*, 907 A 2d 693, 767 (Del Ch, 2005).

76 *In re The Walt Disney*, 907 A 2d 693, 767 (Del Ch, 2005).

77 Ibid 768–9.

78 Ibid 769.

79 Ibid 767–8. Another distinction noted by Chancellor Chandler was that, in *Smith v Van Gorkom*, Trans Union's senior management opposed the merger, whereas Disney's senior management were generally in favour of the Ovitz hiring: at 769–70.

80 Ibid 760.

package.[81] Nonetheless, he held that the directors did not act in bad faith and that the business judgment rule therefore applied.[82]

In reaching this conclusion, Chancellor Chandler drew a sharp distinction between corporate law and corporate governance,[83] and between legal rules and aspirational standards.[84] Although he characterised the conduct of Disney's directors as falling well short of corporate governance best practice, that conduct did not constitute a breach of fiduciary standards under Delaware law.[85] The Judge stated: 'Delaware law does not – indeed, the common law cannot – hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices'.[86]

The safe havens of reasonable reliance and delegation also made an appearance in both *Smith v Van Gorkom* and the Disney litigation. The majority judgment in *Smith v Van Gorkom*, for example, denied the Trans Union directors not only the protection of the business judgment rule, but also access to the defence of reasonable reliance. Section 141(e) of the *DGCL*, as it stood at the time of the decision, protected a director who relied in good faith on 'reports' made by company officers.[87] The Court held that the provision did not protect the Trans Union directors, since no 'report' had ever been provided to them. An oral presentation by Mr Van Gorkom and a brief statement by the CFO did not qualify.[88]

The protection offered by section 141(e) of the *DGCL* was greatly expanded in 1987 following *Smith v Van Gorkom*, ostensibly in order to modernise the provision.[89] Protection was no longer restricted to 'reports' only, but applied to a much broader range of information. Section 141(e) of the *DGCL* currently

81 Ibid 734 ff. He also noted that an 'unwholesome boardroom culture' existed at Disney: at 741 n 373.

82 Ibid 760, 745, 767, 772.

83 Ibid 697–8, 772.

84 A leading proponent of the aspirational theory of fiduciary duties in the United States was Chancellor Allen of the Delaware Court of Chancery, who stated that the US duty of care was 'essentially aspirational: informing well-intentioned persons of what they should be doing in a general way': William T Allen, 'The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule' in Klaus J Hopt et al (eds), *Comparative Corporate Governance: The State of the Art and Emerging Research* (Clarendon Press, 1998) 307, 329. See also William T Allen, Jack B Jacobs and Leo F Strine Jr, 'Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of *Van Gorkom* and its Progeny as a Standard of Review Problem' (2002) 96 *Northwestern University Law* Review 449; William T Allen, Jack B Jacobs and Leo F Strine Jr, 'Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law' (2001) 56 *Business Lawyer* 1287.

85 *In re The Walt Disney*, 907 A 2d 693, 697 (Del Ch, 2005). *Gantler v Stephens*, 965 A 2d 695 (Del, 2009), which recognises that corporate officers have the same fiduciary duties as directors, could provide an alternative judicial route to challenging executive compensation by allowing courts to examine a CEO's conduct during the negotiation process. See generally Randall S Thomas and Harwell Wells, 'Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties' (2011) 95 *Minnesota Law Review* 846, 880–97.

86 *In re The Walt Disney*, 907 A 2d 693, 697 (Del Ch, 2005).

87 *Smith v Van Gorkom*, 488 A 2d 858, 874–5 (Del, 1985).

88 Ibid 875.

89 See R Franklin Balotti and Megan W Shaner, 'Safe Harbor for Officer Reliance: Comparing the Approaches of the Model Business Corporation Act and Delaware's General Corporation Law' (2011) 74 *Law and Contemporary Problems* 161, 167.

provides that a director is 'fully protected' in the performance of corporate duties:

> in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

This reasonable reliance protection, although very broad, is not absolute under Delaware law. It can still be lost if the directors have relied blindly on another person, or if they did not reasonably believe that the relevant advice was within an expert's competence.[90] The provision was effective, however, to insulate directors on the Disney compensation committee.[91]

A final protective mechanism, which was relevant in the Disney litigation, involves delegation to a board committee. In the 2006 Delaware Supreme Court Disney decision, Jacobs J rejected an argument that the full board should have considered and approved Mr Ovitz's employment agreement independently of the compensation committee.[92] Justice Jacobs held that the compensation committee had exclusive responsibility for the employment contract. He noted that delegation of powers and responsibilities to board committees is expressly permitted under the *DGCL*, observing that '[n]othing in the DGCL mandates that the entire board must make those decisions'.[93] The somewhat idiosyncratic interpretation of delegation adopted by Jacobs J[94] effectively provides a technique by which the board as a whole can quarantine responsibility for certain decisions to particular committees.

Smith v Van Gorkom is arguably an outlier in US corporate law.[95] Liability for breach of duty of care has always been rare in the US and tends to be limited to egregious conduct that also implicates the duty of loyalty.[96] Recent US case law continues this trend, under which the duty of care has become anaemic to say the least.[97] The business judgment rule, delegation and reasonable reliance, in

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90 See *Brehm v Eisner*, 746 A 2d 244, 261–2 (Veasey J) (Del, 2000).

91 See *Brehm v Eisner*, 906 A 2d 27, 38 (Jacobs J) (Del, 2006) in relation to the Disney compensation committee's reliance on Graef Crystal, who was a noted executive compensation consultant.

92 *Brehm v Eisner*, 906 A 2d 27, 53 (Del, 2006).

93 Ibid 54.

94 See Jennifer G Hill, 'Regulating Executive Remuneration: International Developments in the Post-Scandal Era' [2006] *ICFAI Journal of Corporate and Securities Law* 32–3 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=922299>.

95 Cf Macey and Miller, above n 72.

96 See Lyman Johnson, 'Rethinking Judicial Review of Director Care' (1999) 24 *Delaware Journal of Corporate Law* 787, 801; William L Cary and Sam Harris, 'Standards of Conduct under Common Law, Present Day Statutes and the Model Act' (1972) 27 *Business Law* 61; John Armour et al, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States' (2009) 6 *Journal of Empirical Legal Studies* 687; Clark W Furlow, 'Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware' [2009] *Utah Law Review* 1061.

97 In relation to derivative litigation pleadings see, eg, *In re Citigroup Inc Shareholder Derivative Litigation*, 964 A 2d 106 (Del Ch, 2009). Cf *American International Group Inc v Greenberg*, 965 A 2d 763 (Del Ch, 2009).

addition to other factors, such as exculpation clauses in the corporate charter and insurance, have effectively insulated US directors, particularly non-executive directors, either from liability, or the financial consequences of liability, for breach of the duty of care.[98]

IV THE *CENTRO LIABILITY DECISION* AND *CENTRO PENALTY DECISION* AGAINST THE BACKDROP OF US CORPORATE LAW

The *Centro Liability Decision* clearly reflects the upward trajectory of the duty of care and diligence in Australia since the early 1990s,[99] when a series of cases in the areas of insolvent trading[100] and the duty of care[101] provided the first judicial indication that legislative changes and increasing community expectations meant that more would be required of Australian directors than had historically been the case.[102] These cases stressed that the law would no longer tolerate the passive or incompetent director, and that directors must have sufficient financial competence and knowledge of the company's affairs to enable them to reach an informed opinion as to the company's financial capacity.[103] This longstanding requirement lies at the heart of the *Centro Liability Decision*.[104]

A former judge of the High Court of Australia once stated, 'what is in general expected of directors will tend to become the measure of what is required of them'.[105] The *Centro Liability Decision* continues the trend of the 1990s case law in responding to this prediction. Nonetheless, the context of the judgment differed markedly from some of the earlier case law that first signalled this shift in the 1990s. Two important decisions at that time, *Statewide Tobacco Services Ltd v Morley* and *Friedrich*, were both extreme cases which involved misfeasance through egregious failure to become acquainted with the most basic

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98 Bernard Black, Brian Cheffins and Michael Klausner, 'Outside Director Liability' (2006) 58 *Stanford Law Review* 1055, 1090–5.

99 See generally Bird and Hill, above n 36, 560–72.

100 See, eg, *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405, affd *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 ('*Friedrich*').

101 Cf *AWA Ltd v Daniels* (1992) 7 ACSR 759; *Daniels v Anderson* (1995) 37 NSWLR 438.

102 Historically, the standard of the duty of care and diligence had been set at a surprisingly low and undemanding level. The definitive exposition of the duty of care traditionally imposed on directors was set out in *In re City Equitable Fire Insurance Co* [1925] Ch 407. In that case, Romer J held that a director is required to exercise 'the care an ordinary man might be expected to take in the circumstances on his own behalf': at 428. Other early case law, such as *In re Cardiff Savings Bank (Marquis of Bute's Case)* [1892] 2 Ch 100, confirmed that, from a historical perspective, directors had little to fear from this branch of the law.

103 See, eg, *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405, 412–13; *Friedrich* (1991) 5 ACSR 115, 126.

104 See Leung and Webster, above n 14, 108.

105 Sir Douglas Menzies, 'Company Directors' (1959) 33 *Australian Law Journal* 156, 164.

elements of the corporation's affairs. *Friedrich* also involved financial illiteracy, raising the element of failure to follow up leads of impropriety. The Centro litigation, involving as it did, 'intelligent, experienced and conscientious'[106] directors who were also 'sufficiently financially literate',[107] was quite different and was, therefore, a more difficult and interesting case.

At a theoretical level, the *Centro Liability Decision* demonstrates strong adherence to a 'monitoring' model of the board of directors. Such a paradigm views the board as responsible for monitoring, rather than directing, the corporation's affairs.[108] One interpretation of this model is that it casts the board in the role of 'shareholders' champion',[109] with prime responsibility for ensuring 'the existence, integrity, and efficacy of the corporation's internal control'.[110]

There are many indications that such a vision of the board underpins the legal analysis in the *Centro Liability Decision*. For example, Middleton J cites the US decision, *Francis v United Jersey Bank*,[111] as authority for the proposition that more is required for directors to satisfy their duty than merely 'going through the paces'.[112] Like Pollack J in *Francis v United Jersey Bank*,[113] Middleton J in the *Centro Liability Decision* stressed that 'a director is not an ornament, but an essential component of corporate governance'.[114] Justice Middleton also stated that a 'core, irreducible requirement of directors [is] to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor'.[115]

By focusing on the monitoring function of directors, Middleton J was able to examine, not only what the directors knew, but what they 'ought to have known', to discharge their duty properly. Delegation and reliance, although permissible, have limits, and the *Centro Liability Decision* emphasised the fact that that directors must maintain 'an inquiring mind' and critically analyse material presented to them.[116] According to Middleton J, this had not occurred on the facts of the case. Rather, there had been wholesale reliance on management and external advisors in relation to the financial statements,[117] which constituted a

106 *Centro Liability Decision* (2011) 196 FCR 291, 296 [8].

107 Ibid 426 [566].

108 See generally Edward B Rock, 'America's Shifting Fascination with Comparative Corporate Governance' (1996) 74 *Washington University Law Quarterly* 367, 370–3.

109 Ibid 370.

110 Melvin A Eisenberg, 'The Board of Directors and Internal Control' (1997) 19 *Cardozo Law Review* 237, 240. See also James D Cox, 'Changing Perceptions into Reality: Fiduciary Standards to Match the American Directors' Monitoring Function' (1989) 1 *Bond Law Review* 218.

111 432 A 2d 814 (NJ, 1981).

112 *Centro Liability Decision* (2011) 196 FCR 291, 298 [19].

113 432 A 2d 814, 823 (NJ, 1981).

114 *Centro Liability Decision* (2011) 196 FCR 291, 298 [19].

115 Ibid 298 [16].

116 Ibid 298 [20]. See also Leung and Webster, above n 14, 106–7. This requirement of independent scrutiny is consistent with *Corporations Act 2001* (Cth) s 189(b)(ii), which requires that reliance be made 'after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation'.

117 *Centro Liability Decision* (2011) 196 FCR 291, 427 [582].

vital aspect of their responsibilities to the company.[118] Justice Middleton suggests that if the directors had taken care to read and understand the final accounts, the errors might have come to light earlier.[119] Justice Middleton also stated that it was not possible for directors to delegate ultimate responsibility for their declaration regarding the annual financial report under section 295(4) of the *Corporations Act*.[120]

The *Centro Liability Decision* is much closer to the reasoning in *Smith v Van Gorkom* than the Disney litigation. As in *Smith v Van Gorkom*, 'mere absence of bad faith'[121] was insufficient to save the Centro directors from breach of duty. Both *Smith v Van Gorkom* and the *Centro Liability Decision* criticised the directors for having effectively delegated all decision-making to management, when they should have assessed information with 'a critical eye'[122] and 'an inquiring mind'.[123] Unlike in the Disney litigation, the safe havens of the business judgment rule, reasonable reliance and delegation, were ineffective to protect the directors in both *Smith v Van Gorkom* and the *Centro Liability Decision*.

However, the overall doctrinal message of the *Centro Liability Decision* changes significantly when viewed in combination with the *Centro Penalty Decision*. Whereas the *Centro Liability Decision* found that the executive officers and non-executive directors had all breached their duties of care and diligence, the later decision distinguished between the defendants in terms of the penalty outcomes of those contraventions. In the *Centro Penalty Decision*, Middleton J made detailed declarations of contravention against all defendants. He imposed a fine of A$30 000 on Centro's former CEO, and a two year managerial disqualification order on its former CFO.[124] However, no penalties were imposed on the six non-executive directors.

Once Middleton J had determined breach of the duty of care and diligence in the *Centro Liability Decision*, the focus shifted, in the *Centro Penalty Decision*, to consideration of a different set of mitigation techniques, including exoneration provisions in the *Corporations Act*,[125] which assumed centre stage. These provisions grant the court power to excuse a person from breach where the person acted honestly and ought to be excused, having regard to all the circumstances of the case. The provisions are classic 'mud' (as opposed to 'crystal') rules, in that they are vague and open-ended, and allow for considerable judicial discretion in assessing specific factual and contextual matters.[126]

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118 Justice Middleton states that '[w]hilst there are many matters a director must focus upon, the financial statements must be regarded as one of the most important': ibid 426 [567]. See generally Lowry, above n 32.

119 *Centro Liability Decision* (2011) 196 FCR 291, 427 [582].

120 Ibid 321 [125].

121 *Smith v Van Gorkom* 488 A 2d 858, 872 (Del, 1985).

122 Ibid.

123 *Centro Liability Decision* (2011) 196 FCR 291, 298 [20].

124 *Centro Penalty Decision* (2011) 196 FCR 430, 433.

125 *Corporations Act 2001* (Cth) ss 1317S, 1318.

126 See Carol M Rose, 'Crystals and Mud in Property Law' (1988) 40 *Stanford Law Review* 577.

Justice Middleton could have decided that Centro's non-executive directors were exonerated from liability by virtue of these provisions. Yet he did not. Rather, he held that the non-executive directors had contravened the *Corporations Act* and, accordingly, the Court should make declarations of contravention, but that no further penalty would be imposed upon them.[127]

Justice Middleton's decision concerning the exoneration provisions of the *Corporations Act* accords with the general judicial approach to date. Australian courts, in spite of the breadth of judicial discretion, have not been particularly generous in their interpretation of these exoneration provisions,[128] often on the basis that the granting of relief would be contrary to public policy and the goal of encouraging directors to comply with their duties. However, *McLellan v Carroll*[129] is a recent exception to this approach. In that case, the Court exonerated the relevant director for contravention of the insolvent trading provisions of the *Corporations Act* on the basis that he had acted honestly and reasonably relied on a third party's assessment of the company's financial position.

Justice Middleton justified his refusal to exonerate the non-executive directors from liability in the *Centro Penalty Decision* on discretionary grounds, principally relating to the seriousness of the contraventions. By the same token, he held that declarations of contravention, without disqualification or pecuniary penalty orders, were sufficient 'to indicate the Court's disapproval of the actions of each of the defendants, and to satisfy the requirements of the principle of general deterrence'.[130] He considered a range of factors to 'militate very strongly against more excessive penalties',[131] which could be contrary to public interest.[132]

Justice Middleton's approach in regard to penalties may appear puzzling, given some strong statements in his earlier judgment about the extent to which directors can be protected by reliance on others. The *Centro Liability Decision*, for example, stressed the fact that reliance on the financial staff and auditors did not protect the directors from breach of duty because of their failure to make an independent assessment in light of their knowledge about the Group's debt position. In the *Centro Penalty Decision*, on the other hand, a factor influencing Middleton J towards leniency was that the non-executive directors reasonably expected that the accounts produced by the accounting staff of the Centro Group would comply with the relevant financial reporting standards.[133]

What can explain the apparent mismatch between the *Centro Liability Decision* and *Centro Penalty Decision* in this regard? One possible explanation is the distinction, discussed earlier in the US context, between legal duties and

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127 *Centro Penalty Decision* (2011) 196 FCR 430, 433.

128 See especially Elizabeth Boros and John Duns, *Corporate Law* (Oxford University Press, 2nd ed, 2010) 258.

129 (2009) 76 ACSR 67.

130 *Centro Penalty Decision* (2011) 196 FCR 430, 433 [6].

131 Ibid.

132 Ibid.

133 Ibid 437.

aspirational standards.[134] When viewed in isolation, the *Centro Liability Decision* bears a strong resemblance to the legal reasoning in *Smith v Van Gorkom*. However, when the liability and penalty decisions are combined, the *Centro* doctrinal message shifts to become more akin to that in the 2005 Disney decision, *In re The Walt Disney*, where strong aspirational rhetoric was ultimately unmatched by liability and sanctions. To be sure, the Centro litigation can be distinguished from the Disney litigation by virtue of the fact that Centro's non-executive directors were actually held to have breached their duty of care, and did not receive absolution via the exoneration provisions of the *Corporations Act*. Nonetheless, the final outcome of the *Centro Penalty Decision* is not dissimilar from the Disney litigation in terms of the lack of legal consequences from a liability perspective.

The combined *Centro Liability Decision* and *Centro Penalty Decision* also resemble another important US case regarding directors' oversight duty, *In re Caremark International Inc Derivative Litigation*,[135] ('*Caremark*').[136] *Caremark* reassessed directors' duties of oversight thirty years after the former leading case, *Graham v Allis-Chalmers Manufacturing Company*,[137] mapped out the contours of a 'red flag test'. This test, like many of the early United Kingdom decisions relating to the duty of care, was relatively undemanding and highly protective of directors.[138] In spite of rhetoric in *Caremark* suggesting an expansion of the duty of oversight, ultimately, this was neutralised in the case by a number of procedural limitations and presumptions, which protected the board. In *Caremark*, Chancellor Allen, held, for example, that directors' actions would be examined through the lens of the business judgment rule;[139] that good faith attempts to monitor management would not result in liability; and that lack of good faith would not be established through isolated examples of oversight failure.[140]

Thus, *Caremark*, *In re The Walt Disney*, and the Centro litigation as a whole reveal a divide between legally enforceable rules and aspirational standards

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134 See above n 84.

135 698 A 2d 959 (Del Ch, 1996).

136 See generally Jennifer Arlen, 'The Story of Allis-Chalmers, Caremark, and Stone: The Director's Evolving Duty to Monitor' in J Mark Ramseyer (ed), *Corporate Law Stories* (Foundation Press, 2009) 323.

137 188 A 2d 125 (Del, 1963).

138 According to the decision in *Graham v Allis-Chalmers Manufacturing Company*, the directors were entitled to rely upon the integrity of their subordinates in the absence of grounds for suspicion, and were not required 'to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists': ibid 130. The decision parallels early United Kingdom case law, such as *In Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407; *In re Cardiff Savings Bank (Marquis of Bute's Case)* [1892] 2 Ch 100. See generally M J Trebilcock, 'The Liability of Company Directors for Negligence' (1969) 32 *Modern Law Review* 499.

139 698 A 2d 959, 970 (Del Ch, 1996).

140 Ibid 970–1. See generally Alec Orenstein, 'A Modified *Caremark* Standard to Protect Shareholders of Financial Firms from Poor Risk Management' (2011) 86 *New York University Law Review* 766, 769 ff. See also *Stone v Ritter*, 911 A 2d 362 (Del, 2006), confirming Chancellor Allen's ruling in *Caremark* that directors could only be liable if they had acted in bad faith. See generally Jennifer Arlen, above n 136.

concerning directors' duties.[141] In spite of the strong normative pronouncements in the *Centro Liability Decision* on the issue of directors' duty of care and diligence, the *Centro Penalty Decision* ultimately rendered this rhetoric aspirational only. At the penalty stage, Middleton J was prepared to consider a broader range of matters in the exercise of his discretion, including the fact that the non-executive directors were 'intelligent, experienced and conscientious people'.[142] The Judge also took the view that there was a reduced need to impose penalties for reasons of general deterrence, in view of the damage that the directors had already experienced to their reputations.[143] However, in the upper echelons of the US business world at least, the GFC has raised crucial questions as to whether aspirational standards and public shaming are ever truly effective regulatory techniques.

An exclusive focus on the *Centro Liability Decision* might suggest that Australia is considerably ahead of the US in holding directors accountable for defective financial disclosure during the GFC. Yet, the combined effect of the *Centro Liability Decision* and *Centro Penalty Decision* is that the jurisdictional difference in this regard is not as stark as it first appears.

V CONCLUSION

The *Centro Liability Decision* undoubtedly created a 'pother' in Australian corporate law, in spite of the fact that the judgment has been described by one US commentator as 'not out of line with common sense expectations'.[144] Although the *Centro Liability Decision* arguably broke no new legal ground, the case is interesting in its examination of directors' duties in the context of the difficult commercial environment created by the GFC. It is also a timely reminder of the shift that occurred in Australia in relation to the duty of care and diligence from the 1990s onwards, namely that directors are expected to take an active, rather than passive, role in guiding and monitoring the corporation, and that there is a distinction between delegation and abrogation of responsibilities.

This article, however, argues that the *Centro Penalty Decision* is critical to understanding Centro's doctrinal message. The article examines an apparent tension between the *Centro Liability Decision* and *Centro Penalty Judgment* from a comparative law perspective, and suggests that the distinction between legal rules and aspirational standards which plays such an important role in US law relating to directors' duties of care and oversight, may provide a basis for understanding this tension.

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141 See Jennifer G Hill, 'Deconstructing Sunbeam – Contemporary Issues in Corporate Governance' (1999) 67 *University of Cincinnati Law Review* 1099, 1114–17; Anne Tucker Nees, 'Who's the Boss? Unmasking Oversight Liability within the Corporate Power Puzzle' (2010) 35 *Delaware Journal of Corporate Law* 199.

142 *Centro Penalty Decision* (2011) 196 FCR 430, 434.

143 Ibid 454.

144 Katz, above n 8.

The article explores parallels between the Centro litigation and some leading US case law on directors' duty of care and the duty of oversight. It argues that although, when viewed in isolation, the *Centro Liability Decision* strongly resembles *Smith v Van Gorkom*, when combined with the *Centro Penalty Decision*, its overall message becomes more closely aligned with subsequent US cases on the duty of care, such as the Disney litigation and *Caremark*. These cases rely strongly on a distinction between legal rules and aspirational standards, a distinction that may be ripe for review in light of the GFC.

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