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The new horizons of directors' liability

As the dust settles after the corporate governance-related storms over the past year, new horizons have emerged for director and officer responsibility and liability.

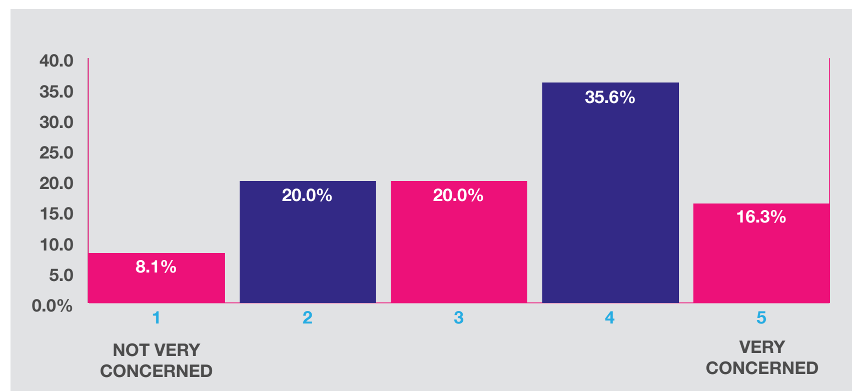
Although none of:

- the rapidly changing legislative environment;
- ASIC's continued pursuit of directors and officers based on 'stepping stones' liability; or
- increasing environmental, social and governance (**"ESG"**) activism,

were cited as key concerns for Boards according to our 2019 *Directions* Survey, they each can have a major bearing on at least two of the top three concerns – protecting brand and reputation and maintaining an appropriate corporate culture.

In this article, we reflect on the implications of these emerging liability issues on those key priorities.

How concerned are you about the risk of potential litigation or enforcement action against a director personally, based on an alleged breach of their duty to exercise care and diligence where their organisation has contravened the law?



1. Legislative change at lighting speed

Governments have recently enacted a wide range of legislation that directly or indirectly raises the bar for companies and directors.

Particularly noteworthy changes to directors' responsibilities (and exposure to risk of liability) have arisen out of:

- The BEAR
- Whistleblowing laws
- Modern slavery
- Increased statutory penalties for corporate misconduct

Directors who have not familiarised themselves with these legislative changes should do so urgently – ignorance of the law continues to be no excuse as the new laws are regulated and enforced.

Further, directors should not hope for a lighter legislative load in 2020 or beyond. Ongoing work into corporate criminal responsibility by the Australian Law Reform Commission (**"ALRC"**) is likely to spark calls for further legislative change.

2. The onward march of 'stepping stones' liability for directors and officers: Another ASIC win in the *Vocation* case

Over the last two decades, ASIC has succeeded in over 80% of cases brought against directors and officers for breaches of their statutory duty of care.[1]

A key reason for ASIC's success is its use of 'stepping stones' claims. The 'stepping stones' claim asserts that a director or officer who exposes a company to a breach of the law has breached their statutory duty of care and diligence under section 180 of the Corporations Act. Liability results from the failure to prevent a reasonably foreseeable risk of harm to the company's interests from that breach of law.

This year, the Vocation case *(Australian Securities and Investments Commission v Vocation Limited (in liquidation)* [2019] FCA 807) reaffirmed ASIC's approach in prosecuting 'stepping stones' claims, and the case's facts and circumstances illustrate how 'stepping stones' claims continue to expand the horizon for director and officer liability.

[1] See Ian M Ramsay and Benjamin B Saunders, "An Analysis of the Enforcement of the Statutory Duty of Care by ASIC" (2019) 36 *Company and Securities Law Journal* 497, 511.

In Vocation, directors and officers were found to have breached their statutory duty of care and diligence in two key aspects.

- The Chairman and CEO (who was also an Executive Director) failed to prevent the company breaching continuous disclosure obligations under the Corporations Act.
- The CEO and CFO were found to have breached their duties of care and diligence by allowing the company to provide a misleading due diligence questionnaire to an underwriter of a capital raising.

As we have previously noted, the continuous disclosure rules in section 674(2) of the Corporations Act contain their own regime for pursuing directors and other persons who are involved in a company breaching that section, with a 'reasonable steps' defence applying. However, in the *Vocation* case, ASIC chose not to rely on that section and instead pursued certain directors and officers for a breach of their duties of care and diligence under section 180, which does not have a 'reasonable steps' defence.

The only defence available to a claim for breach of duty under section 180 is the business judgment rule. The Court in *Vocation* affirmed the narrowness of that defence, holding that the defence would not apply to decisions in relation to continuous disclosure obligations because those decisions were not decisions in respect of the company's 'business operations' (as required by section 180(3)), but were instead considered compliance matters.

Finally, the *Vocation* case illustrates that potential liability for misleading and deceptive statements goes beyond material released on ASX. ASIC successfully argued that the company's CEO and CFO had breached their duties under section 180 by allowing the company to provide a misleading due diligence questionnaire to its underwriter. The Court held that a reasonable person in the position of the CEO and CFO would have appreciated that a due diligence questionnaire was likely to be relied on by an underwriter in deciding whether or not to underwrite a capital raising and, in that context, it was important to ensure that answers given in that questionnaire were, to the best of their knowledge and belief, not likely to mislead or deceive. This underscores that care and diligence needs to be applied by directors and senior executives not only to the preparation of ASX releases, but also to the key documents used in transaction processes.

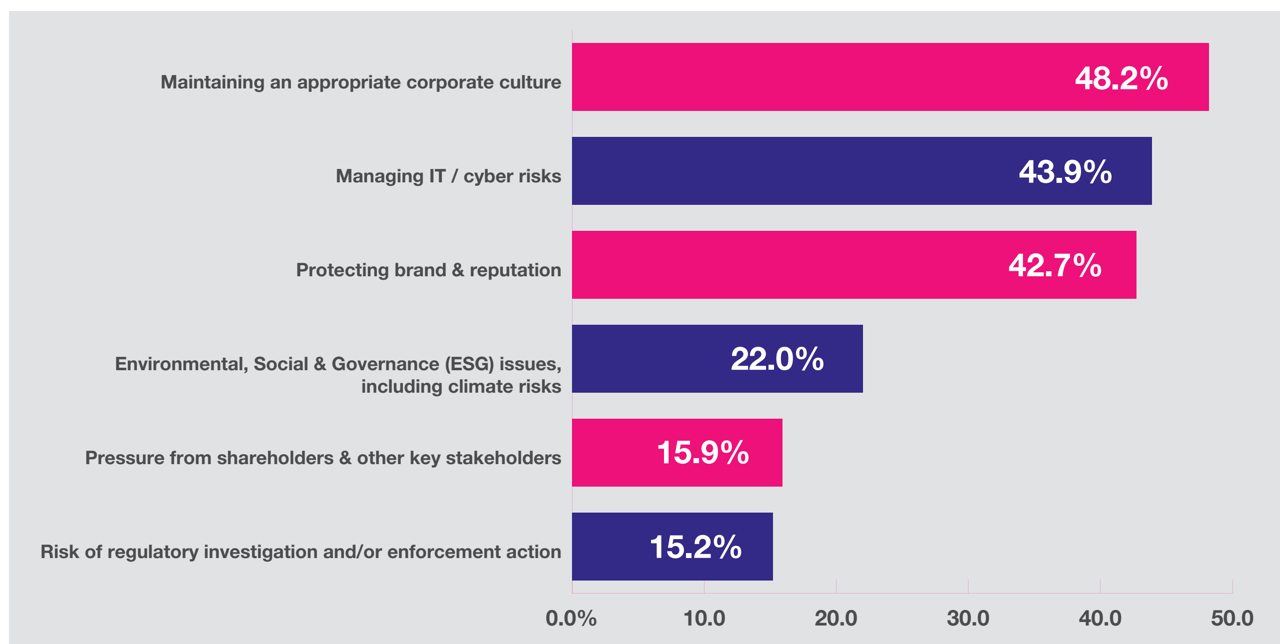
3. Exposure to actions for environmental, social and governance risk – are Directors connecting the dots?

The increasing horizon for director and officer liability is not only shaped by new legislation and increasing regulatory action - it is also expanded by the range of stakeholders and commentators who wish to see greater accountability for ESG-related misconduct, actual and perceived.

While no Australian Court has properly considered the issue yet, ASIC has endorsed the view that many climate-related risks would be regarded by a Court as reasonably foreseeable and that directors who fail to consider climate change risks could be found liable for breaching their duty of care and diligence. The Hon. Mr Kenneth Hayne AC QC has also stated in his 21 November 2019 address at the Centre for Policy Development that "a director acting in the best interests of the company must take account of, and the board must report publicly on, climate-related risks and issues relevant to the entity". Meanwhile, ASIC has released the first report from its new supervisory initiative, the ASIC Corporate Governance Taskforce, which scrutinized governance practices relating to director and officer oversight of financial and non-financial risks, while other ASIC publications emphasise that it is monitoring climate-related disclosure.

This is a salient reminder that directors and senior executives should pay attention to increasing risks around companies (and their senior leaders) being exposed to actions for ESG-related matters. Interestingly, while nearly 50% of respondents to our 2019 *Directions* Survey stated that

Key concerns for directors - compared with the top three topics, what percentage are worried about regulatory & shareholder issues?



"protecting brand and reputation" and "maintaining an appropriate corporate culture" were key concerns for their Boards, less than 25% of survey respondents stated that ESG-related issues (including climate risks) represented material areas of concern for their Boards.

Globally, companies have been under increasing pressure to take notice of – and in some cases, responsibility for – the risks posed by climate change. Charges brought by the New York State Attorney General against Exxon Mobil[2] (ostensibly over alleged false and misleading assurances it made to investors about the economic risks posed to its business connected to climate change) have opened the door for other lawsuits, including a derivative action against the Exxon Mobil directors brought by investors claiming directors failed in their duties to protect the company from the risks of climate change, and a consumer lawsuit[3] involving alleged misleading conduct by Exxon Mobil.

As at 10 December 2019, the Supreme Court of New York has found that the New York AG failed to prove Exxon Mobil had made material misstatements or omissions, or that any alleged misrepresentations in its climate risk disclosures were 'false and material' in the context of all the information available to the public. However, even when these lawsuits are unsuccessful, companies and their boards are faced with the costs and potential adverse reputational impacts of protected litigation.

The prospect of ESG-related litigation against companies and directors in Australia may seem remote to some, but others have already ranked Australia No. 2 in the world (behind the US) for climate change-related litigation cases.[4]

Further, the Australian regulatory landscape is shifting, as companies and Boards face greater scrutiny in respect of ESG-related risks. These changes (directly or indirectly) raise the bar in terms of ESG-related disclosures and duties. Key changes in 2019 included:

- **ASIC's updates to its Regulatory Guides for prospectuses and operating and financial reviews in August 2019 to include guidance on climate change risk disclosure.** This follows ASIC's release of its report on climate risk disclosure by listed companies in late 2018, which noted that directors and officers of listed companies need to understand and continually reassess existing and emerging risks, including climate risk, and that listed companies should provide "meaningful and useful" risk disclosure to enable investors to make fully informed decisions.
- **The 4th edition of the ASX Corporate Governance Principles and Recommendations includes measures to encourage improvements to disclosure in respect of ESG-related risks.** More specifically, the 4th edition recommends that listed entities should disclose whether they have material exposure to environmental or social risks, and if so, how they will manage those risks, and that Boards should consider whether they have the necessary skills to deal with business and governance issues, including sustainability and climate change.

As the public's attitude and regulators' opinions shift in respect of ESG-related matters, there is every chance that activist stakeholders will increasingly seek to bring companies and Boards to account for perceived failures to disclose and/or address climate change and other ESG-related risks.

Directors beware!

[2] *People of the State of New York v. Exxon Mobil Corporation* (filed 24 October 2018; see also pre-trial memorandum filed 10 July 2019).

[3] *Commonwealth of Massachusetts v. Exxon Mobil Corporation* (filed 24 October 2019).

[4] https://apps.law.unimelb.edu.au/climate-change/index.php.

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