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## COMMERCIAL LITIGATION

### Inside:

The limits of privilege:  
how to protect  
yourself when  
retaining external  
experts

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## Special responsibilities of the chairman

Partner, John Warde and lawyer, Andrew Byrne consider a recent case which arguably expands the duties of a company director who is also the company chairman.

The New South Wales Supreme Court has handed down a significant decision which recognises that, in particular circumstances, the chairman of the board of directors may have special responsibilities above and beyond those of other non-executive directors. In *ASIC v Rich & Ors*<sup>1</sup>, Justice Austin held that the *Corporations Act 2001* imposed a duty of care and diligence on the chairman of a listed public company which could lead to the imposition of a series of more specific duties which reflect contemporary community expectations.

Historically, the role of the company chairman was viewed as being procedural and ceremonial in nature. Until recently, it was often assumed that the chairman's statutory duties, in her capacity as a director of the company, were no more onerous than the duties imposed on directors generally. *ASIC v Rich* serves as a warning to chairmen that they need to ensure that they are fulfilling additional responsibilities (and accordingly enhanced legal duties) which the law may place on them, above and beyond the duties owed by the other directors, having regard to their experience, their expertise and the circumstances of their company.

This decision arose from an application by the chairman (Mr Greaves) of the failed telecommunications company One.Tel Limited (in liquidation) for an order striking out before trial the Australian Securities and Investment Commission's (**ASIC**) claim against him for an alleged breach of s180(1) of the *Corporations Act*.

### The duty of care and diligence

Section 180(1) of the Act states that:

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:

1. [2003] NSWSC 85

- (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.

## Meaning of 'responsibilities'

ASIC argued that the reference to 'same responsibilities' in s180(1) should be interpreted to mean that Mr Greaves had special responsibilities by virtue of his various positions within the company, particularly his position as chairman of One.Tel's Board of Directors and chairman of its Finance and Audit Committee. ASIC also argued that the special responsibilities arose by reason of Mr Greaves' high qualifications, experience and expertise relative to the other directors.

*ASIC v Rich serves as a warning to chairmen that they need to ensure that they are fulfilling additional responsibilities (and accordingly enhanced legal duties) which the law may place on them, above and beyond the duties owed by the other directors*

Mr Greaves argued that the word 'responsibilities' in s180(1) refers to the specific tasks delegated to the relevant director (including the chairman) as part of the distribution of functions of the corporation, as identified in the articles of the company, through resolution or otherwise. Mr Greaves argued that, notwithstanding his roles as chairman of the board and of a committee, he was in essentially the same position as three other non-executive directors of One.Tel who were not sued by ASIC.

The Court accepted ASIC's argument and concluded that the word 'responsibilities' refers to:

the acquisition of responsibilities not only through specific delegation but also through the way in which work is distributed within the corporation in fact, and the expectations placed by those arrangements on the shoulders of the individual director.

## What are these 'responsibilities'?

The evidence submitted by ASIC, accepted by the Court as disclosing a reasonable cause of action against Mr Greaves, provides an insight into the possible obligations in particular circumstances of the chairman of a board in light of s180(1). ASIC tendered affidavits from two prominent chairmen of listed public companies as expert opinion evidence, describing the role of a reasonably careful and diligent chairman of a listed company as follows:

- the chairman must adopt a **leadership role** in the conduct of the board's responsibilities and lead and manage the board in the discharge of its duties;
- this role includes setting the agenda for the performance of the board's responsibilities, taking steps to ensure board meetings take place with sufficient frequency, for a sufficient length of time and with adequate information and **ensuring that the board is kept properly informed** of the financial position and performance of the company;
- the chairman leads the board in the **monitoring of management**, the assessment of the company's financial position and performance and the detection and assessment of any material adverse developments;
- this involves directing, if so advised by the audit committee, and requiring, the provision of **material financial information** to enable the board to discharge its responsibilities;
- it also involves taking steps to ensure that he or she and the board are informed as to the adequacy of the cash reserves of the company, including, especially where debtors outstanding are very substantial, an **analysis of debtors** including an aged listing;
- if the chairman has an experienced financial background, the chairman should ensure that the person appointed as **finance director** has appropriate qualifications, expertise and experience;
- the chairman will be concerned to be personally satisfied about the **accuracy of public statements** made on a company's behalf, and the company's compliance with the ASX Listing Rules;
- where the business of the company is being established, and expenditure exceeds and is expected to continue to exceed income, the

chairman will take a close and active interest in the **cash reserves** of the company, including the steps that should be taken to ensure that cash reserves are maintained so as to enable the company to pay its debts as and when they fall due;

- if the company is in start-up phase, the chairman should also take steps to ensure that systems are implemented to properly monitor the **cash flow** in and out of the company and that he or she is promptly informed of any matters materially affecting the company's cash flow;
- the chairman will take steps to ensure that there is an active and functioning **audit committee**, among other things to assess the general standards of performance of the financial system and management;
- the chairman will take steps to ensure that the company has a process of ongoing internal audit review by an internal auditor.

Justice Austin noted that ASIC's evidence did not purport to establish that Mr Greaves had specific duties on particular occasions. Rather, it sought to establish Mr Greaves' 'responsibilities' having regard to usual practice. Justice Austin concluded that ASIC's evidence provided a reasonably arguable case for the view that Mr Greaves had the responsibilities alleged by ASIC, sufficient to allow the case to proceed to trial.

## Reasonable steps

ASIC's amended pleadings alleged Mr Greaves needed to take 'reasonable steps to ensure' that each of his responsibilities were met. ASIC had originally asserted that Mr Greaves had 'to ensure' that the responsibilities were met, an obligation carrying a much heavier burden. The change in wording represents an acknowledgment that Mr Greaves did not have an unqualified obligation to produce the outcomes originally alleged in ASIC's claim.

## Community expectations and corporate governance

The type of evidence submitted to, and accepted by, the Court is of interest. As mentioned above, the primary evidence submitted by ASIC consisted of the affidavits of two prominent Australian company chairmen. The opinions of these chairmen were then substantiated by reference to various reports and academic writings from Australia and elsewhere. The Court stated in relation to this evidence:

Much of the literature of corporate governance is in the form of exhortations and voluntary codes of conduct, not suitable to constitute legal duties. It is sometimes vague and less than compelling, and must always be used with caution. Nevertheless, in my opinion this literature is relevant to the ascertainment of the responsibilities to which Mr Greaves was subject during the period from January to March 2001.

Furthermore, Justice Austin held that courts must perform the difficult task of articulating a standard of care by reference to community expectations in relation to corporate governance and that it is preferable that such a task be undertaken with the assistance of the type of evidence submitted by ASIC rather than by the reliance of a judge on 'unassisted armchair reflection'.

## Reliance on management

Mr Greaves submitted that imposition of extra duties on a chairman would be inconsistent with other law concerning the extent to which directors can rely on others. In particular, Mr Greaves argued that the law permitted a director to rely on the honesty and integrity of his or her subordinates unless something occurs to put him or her on suspicion, and that a director did not have a responsibility to supervise co-directors or to acquaint himself or herself with all of the details of the running of a company.

*...a chairman may have a responsibility, above that of the other directors, to take additional appropriate action where financial problems emerge in a company.*

While acknowledging that it is sometimes permissible for a director to leave matters to management or even to other directors, Justice Austin noted that this does not prevent a conclusion that, in particular circumstances, a director could not safely trust subordinates. Directors are under a continuing obligation to keep informed about the activities of the corporation and, in particular, its financial status. As this duty exists for all company directors, the Court held, it must therefore apply to the chairman whose responsibilities may be 'enhanced'.

## Conclusion

The decision points to an expanded operation of s180(1) of the *Corporations Act 2001*, whereby it is now recognised that chairmen (and other directors such as those holding special positions on audit committees) may hold special responsibilities when discharging their duty of care and diligence to the company, depending on an individual's particular responsibilities and expertise and the particular circumstances of the company. Those responsibilities, defined against evolving standards of corporate governance and the qualifications, expertise and experience of the particular individual, are likely to require that a chairman must take reasonable steps to ensure, amongst other things, that a company has an effective reporting system to enable the board of directors to effectively monitor the financial health of the company. Furthermore, a chairman may have a responsibility, above that of the other directors, to take additional appropriate action where financial problems emerge in a company.

Given these increased responsibilities, the company chair may lose its lustre for some directors, and remuneration for company chairmen may well increase to reflect the increased work and risk attached to the role.

# The limits of privilege: how to protect yourself when retaining external experts

Partner, Andrea Martignoni and lawyer, Lucas Shipway, consider the steps a company can take to ensure the maximum application of legal professional privilege to its communications with non-legal experts.

Companies often retain external non-legal experts to assist them in major projects with a legal dimension, such as corporate restructuring. The protection available for confidential communications with such

experts under the law of privilege is limited, but there are steps companies can take to ensure they get the best protection. A recent decision of the Federal Court is a reminder of these steps and a pointer to possible future reform in this area.<sup>1</sup>

## Legal professional privilege

Legal professional privilege is an important common law immunity. It protects documents that contain or refer to confidential communications made for the dominant purpose of obtaining legal advice. Such documents are generally exempt from disclosure and use in court proceedings or prosecutions by bodies such as the Australian Taxation Office or the Australian Competition & Consumer Commission.

Given that privilege protects communications made for the purpose of obtaining legal advice, communications between clients and their lawyers are a clear category of communications that will often be privileged. However in certain circumstances, such as when court proceedings are underway or imminent, communications with third parties such as witnesses or experts will also be privileged.

Where litigation is not involved communications with third parties will only be privileged when certain circumstances are met. These are discussed below.

## The case

In *Commissioner of Taxation v Pratt Holdings*, the Commonwealth Tax Commissioner sought access to documents held by PriceWaterhouseCoopers relating to its former client, Pratt Holdings. Pratt Holdings claimed privilege over the documents.

During a corporate restructuring, Pratt Holdings' lawyers had suggested that Pratt Holdings engage Price Waterhouse (as it was then known) to value certain assets. That valuation was to be used by the lawyers to prepare tax advice for Pratt Holdings in connection with the restructuring. No court proceedings were involved.

Pratt Holdings engaged Price Waterhouse and passed information between Price Waterhouse and its own lawyers as necessary to allow the lawyers to prepare the advice. Price Waterhouse never communicated directly with the lawyers. Rather, according to a witness, Price Waterhouse was instructed only on a 'need to know' basis - to the extent that information flowed from Price Waterhouse to the lawyers, it did so via Pratt Holdings.

*Commissioner of Taxation v Pratt Holdings Pty Ltd* [2003] FCA 6



## Agency argument

As noted above, where litigation is not involved, privilege will only attach to communications with third parties in certain circumstances. Provided the communication is made for the dominant purpose of obtaining legal advice for the client, if the third party is acting as agent of the client or the lawyer, the third party will be treated as standing in the shoes of the client or the lawyer and privilege will apply.

Pratt Holdings attempted to rely on this principle by arguing that Price Waterhouse was acting as its agent in preparing the valuation for the lawyers. However, the judge held that Price Waterhouse was not relevantly Pratt Holdings' 'representative' because it was not retained to act as agent for the purpose of communicating with the lawyers but only to prepare the valuation. Price Waterhouse never communicated directly with the lawyers. The fact that the valuation it prepared was used by the lawyers to give legal advice was not sufficient.

Pratt Holdings would have been in a better position had Price Waterhouse communicated directly with the lawyers. In these circumstances:

- Price Waterhouse may have been treated as Pratt Holdings' agent, at least for the purposes of some of the communications between Price Waterhouse and the lawyers; or, alternatively,
- Pratt Holdings may have been able to take advantage of a separate rule that documents that tend to disclose legal advice are allowed to be kept confidential. Clearly, where communications between a lawyer and an external expert are made to assist the lawyer to give legal advice to the client, disclosing the communications with the expert will often tend to disclose the communications with the client.

## Possible reform?

In her reasons in Pratt Holdings the judge suggested that the law in the United States and Canada on the issue of privilege over third-party communications 'may produce a more rational, less artificial result' than

the law in Australia. In those jurisdictions, a party is treated as an agent for privilege purposes if the party made a communication while not acting entirely independently and 'under its own steam'. In other words, the agent need only act at the direction or request of the lawyer in some way. As the US courts have recognised:

Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. Hence, the presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege.

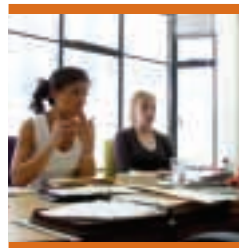
Similarly, the Canadian courts have recognised that a strict treatment of communications with external experts such as accountants may be unfair because smaller companies that are forced to obtain external accounting advice would be disadvantaged compared to large corporations with internal accounting departments that do not need to use external experts. It will generally be easier to keep in-house communications privileged. The judge in the Pratt Holdings case agreed that for that reason 'too much may turn' under the Australian test on whether a report or other communication is prepared internally or externally.

## Steps to take

In light of the concerns expressed by the judge in Pratt Holdings, it may be that in future courts in Australia will move toward the position adopted in the US and Canada.

In the meantime, to ensure the maximum application of privilege to their communications outside litigation, companies should:

- where a project or transaction contains a significant legal dimension, speak to their lawyers about the non-legal expert advice that might be required; and
- if possible, have their lawyers retain any external experts on their behalf, and communicate with the experts via the lawyers rather than directly.



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