

CORPORATE GOVERNANCE ALERT

22 January 2004

Forex trading losses and directors' duties revisited

It is just over a decade since the Supreme Court handed down Australia's landmark decision on directors' duties, *AWA Ltd v Daniels t/as Deloitte Haskins & Sells (AWA)*. That case involved foreign exchange trading losses.

*AWA Ltd v Daniels t/as
Deloitte Haskins & Sells*
7ACSR 759

The year in question was 1986 and AWA had no clear policies in place to manage foreign exchange risk. The executive director/chairman and auditors were held liable for the loss for failing to implement and maintain adequate controls and reporting lines. In AWA, the rogue trader was not subject to any controls and the company failed to obtain the appropriate expert advice to implement safeguards.

In case there was any doubt, the recent recommendations of the HIH Royal Commission reinforce the need for systems and procedures.

However, are company activities such as trading in foreign exchange options too complex for directors to effectively manage? Is there in reality, as suggested by the traders under scrutiny at National Australia Bank (NAB), a gap between the ideals set by formulaic risk management guidelines and practice which makes stringent, rule-driven risk management redundant and inapplicable?

NAB's suspended trader, David Bullen, says that assessing probabilities in a market comes from experience and is not something that can be taught (*Australian Financial Review*, 16 January 2004, p. 63). Hardly comforting for financial institutions that rely on risk management people and systems to scrutinise and maintain the internal systems of control effectively. Journalist Phillip Baker queries whether NAB should have obtained independent valuations of the volatility

of an option to keep its traders honest (*Australian Financial Review*, 20 January 2004, p. 36).

It is early days in the analysis of the NAB "unauthorised" options trading. Unlike the facts in AWA, there was a system of books and records and internal controls in place. Of course, the scope and appropriateness of NAB's systems and decisions cannot be discerned from press reports, but are likely to be the subject of the independent report that the bank has commissioned from PricewaterhouseCoopers.

Directors' duties & changes since AWA

Whatever the commercial outcome of the current forex loss circumstance, the question remains, what is the implication for officers of other companies?

Directors are subject to a common law duty to exercise reasonable care and skill in addition to any contractual, equitable or statutory obligations. This duty applies both to executive and non-executive directors. To determine whether directors are in breach of their duties, their conduct is measured against the objective standard of care (that is, was their conduct of such a standard that an ordinary person might be expected to take on their own behalf) and also against a standard of skill.

Since 1998 directors have had the benefit of a statutory defence to liability being the "business judgment rule". This rule provides that actions of directors will satisfy the tests of care and diligence if:

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- the decision is made in good faith and for a proper purpose, without the directors having a material interest in the subject matter of the decision;
- the directors inform themselves about the subject matter of the decision to the extent they reasonably believe to be appropriate; and
- the directors rationally believe the decision to be in the best interests of the company.

Delegation

There is statutory authority for directors to delegate any of their powers, subject to certain conditions. This might include, for example, delegation of authority to set and to enforce risk management systems in a particular line of business. The director remains responsible for the actions of the delegate unless:

- the director believed on reasonable grounds at all times that the delegate would exercise the power in conformity with the duties imposed on directors of the company by the Corporations Act and the company's constitution; and
- the director believed on reasonable grounds in good faith and after making proper inquiry (if the circumstances indicated the need for inquiry) that the delegate was reliable and competent in relation to the power delegated.

Directors in a situation like that of NAB can also rely on advice provided by experts if they can establish that they believed on reasonable grounds that the information and professional or expert advice given or prepared by an employee of the corporation (for example, the risk management officer) was reliable in relation to a subject such as foreign exchange options trading. To satisfy this test their reliance must have been in good faith after 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 their company).

Lesson learned

Press reports concerning the NAB forex trades provide us with a reminder of the need for continual review by all companies of their own risk management practices by reference to the legal liability framework described above, and contemporary market expectations of management and board level performance.

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LINKS & FURTHER READING

- [HIH Royal Commission Final Report](#)
- [Are you covered by your D&O policy? Implications of some recent decisions](#)
- [Intuitive intentions: no breach of director's duty – *E&E Insurance Review*, vol. 15, no. 2, November 2003](#)

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