

When is a director fit and proper?

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After the collapse of HIH Insurance Ltd (HIH), the HIH Royal Commission delivered a report which was critical of the conduct of the HIH Board but made no specific findings about the non-executive directors of HIH. In response to the criticisms of the Royal Commission, the Australian Prudential Regulation Authority (APRA) disqualified Mr Gardener (a non-executive director of HIH) from acting as a director or senior manager of an insurance company on the ground that he was not a fit and proper person to act in such a position.

Mr Gardener successfully appealed against his disqualification to the Victorian Administrative Appeals Tribunal.^[1] The Tribunal's decision provides interesting insight into the operations of the HIH Board and the degree of competence and diligence expected of non-executive directors.

Importantly, the Tribunal determined at the outset that the "fit and proper" test is a subjective one having regard to the background, qualifications, skill and experience of the director at the time of the relevant events – not with the benefit of hindsight. This was significant for Mr Gardener as the Tribunal stated that behaviour that may have been acceptable some 10 years ago (being the time in question) is unlikely to be well received by today's standards.

APRA claimed the following factors were evidence of a failure to act in a fit and proper manner. While APRA's arguments were unsuccessful, if today's standards were applied the claims may well have succeeded. For that reason the decision is instructive more of what not to do, rather than what to do.

1. Pre-appointment due diligence - APRA alleged that Mr Gardener did not undertake sufficient due diligence before accepting the Board position. HIH was Mr Gardener's first board appointment. The Tribunal acknowledged that Mr Gardener could have undertaken more extensive due diligence (e.g. he could have spoken to HIH's auditors), but that such shortcomings were not evidence of lack of competence or diligence on his part as a director.

It is interesting that APRA sought to attack the actions of Mr Gardener even before his appointment. Although unsuccessful in this instance, APRA's action foreshadows a proclivity of regulators to link the level of pre-appointment due diligence conducted by a director to his or her competence to act as a director.

2. Reliance on management - The Tribunal observed that providing non-executive directors with limited notice to consider significant and complex transactions reflected poorly on the HIH Board and demonstrated that it was not in control of the company. Despite this, the Tribunal did not consider it unreasonable, or that it indicated a lack of competence or diligence, for a non-executive director in such time-pressured circumstances not to review legal documents tabled but to rely upon the advice of management.

3. Failure to follow best practice - Where a Board needs to deliberate over a matter in the presence of directors with an interest in the outcome, it is not best practice for those interested directors to remain present throughout the deliberation. Yet the Tribunal determined that a failure by the HIH Board to follow best practice in such circumstances was insufficient to support a finding that Mr Gardener himself had not acted competently or diligently.

4. Reliance on auditors - Mr Gardener's failure to exercise appropriate professional scepticism of information provided by the auditors, was not considered sufficient to suggest that he did not act competently and diligently according to the standards of the time. Notwithstanding that conclusion, the Tribunal acknowledged that today a more proactive and questioning approach of auditors would be expected.

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5. Audit committees - There were several criticisms about the operation of the HIH Audit Committee, including:

- The Committee was chaired by chairman of Board.
- There were an inadequate number of meetings each year and insufficient time set aside for the meetings.
- Members of management were present during the whole of the meetings.
- The Committee did not review its terms of reference or its responsibilities or assess its own performance.

APRA argued that it was incumbent on Mr Gardener, as a member of the Audit Committee, to have addressed the above deficiencies and that his failure to do so indicated a lack of competence to act as a director. The Tribunal disagreed, and found that Mr Gardener was not in a position to influence the practice of the Audit Committee because he was new to the Committee and was not the Chairman of the Committee.

In summary, despite Mr Gardener's conduct failing short of today's standards in some important respects, the Tribunal was not satisfied that he was not a fit and proper person to be a director. Directors should not, however, take comfort in that decision. Had Mr Gardener been measured by today's standards of what is fit and proper, a different outcome would have been likely and the boardroom behaviours before the Tribunal are illustrative of those best avoided in today's environment.

[1] Gardener v APRA [2009] AATA 990 (24 December 2009).

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