COMMONWEALTH BANK OF AUSTRALIA v FRIEDRICH & ORS

SUPREME COURT OF VICTORIA

TADGELL J

30-31 January, 1, 4-8, 11-15, 18-22, 25-28 February, 4-8, 12-15, 18-22, 25-27 March, 4, 5, 8-11, 22-24, 29, 30 April, 1 May, 3 July 1991 — Melbourne

Directors — Liability — Debts — Directors liability for company's debts — Whether reason to believe company unable to pay debts — Defence — Obligations of directors in respect of accounts — Duties owed by honorary directors — Companies (Vic) Code ss 535, 556.

Accounts — Audited — Qualified — Obligation of directors to sign accounts — Duty of directors to inquire into auditor's qualifications — Companies (Vic) Code ss 269, 275.

A bank which was owed $97m by a company in liquidation claimed under s 556 of the Companies (Vic) Code against 10 officers of the company. After the trial commenced a compromise was reached with all but one director of the company.

The evidence showed that the directors had signed the 1986 and 1987 accounts as showing a true and fair view of the company's financial affairs. Reports by the auditors on both sets of accounts were qualified. The directors had not been provided with the qualified auditor's reports, and had not properly considered the accounts.

Held, finding the director liable for the whole sum:

(i) In determining whether there were reasonable grounds for believing a company would not be able to pay its debts as and when they fell due, it is necessary to prove facts which give a person seeking properly to perform the duties of a non-executive director of a company reasonable grounds to say that they expect the company will not be able to pay all its debts as and when they fall due.

(ii) In determining whether a director had no reasonable cause to expect, for a defence under s 556(2), an objective standard applied to the facts as known to the defendant.

Statewide Tobacco Services Ltd v Morley (1990) 2 ACSR 405; 8 ACLC 827; *Metal Manufacturers v Lewis* (1986) 11 ACLR 122; 4 ACLC 739, followed.

(iii) As s 556 imposes criminal as well as civil liability it is to be construed strictly. *Hussein v Good* (1990) 1 ACSR 710; 8 ACLC 390; *Metal Manufacturers v Lewis* (1986) 11 ACLR 122; 4 ACLC 739, applied.

(iv) A director ought usually to know, in general terms at least, at the time of the annual general meeting what the accounts and auditor's report contain.

(v) On the balance of probabilities a person seeking to perform the duties of a non-executive director would on 31 May 1988 have reasonable grounds to expect that the company would not be able to pay its debts as and when they become due. The plaintiff had established its case under s 556(1).

(vi) In these circumstances the defendant could not rely on the assertions of the chief executive, and his own assumption that the company was financially sound did not entitle him to say that he would not have reasonable cause to expect that the company would be unable to pay its debts.

(vii) No defence is available under s 535 of the Code from an action under s 556. Section 535 applied only to an action for negligence, default, breach of trust and breach of duty. None of these applied to s 556.

Lawson v Mitchell [1975] VR 579; *Customs and Excise Commissioners v Hedon Alpha Ltd* [1981] 1 QB 818, applied.

(viii) Even if a defence were available under s 535 it would not be available in the circumstances of this case.

Action

This was an action for recovery of a debt owed by a company from a director of the company.

A J Myers QC and *Mr S A Rosenzweig* for the plaintiff.

No appearance for the first-named defendant.

I F Turley and *Mr R W McGarvie* for the second-named defendant.

D Collins for the third-named defendant.

D Collins for the fourth-named defendant.

R S Randall for the fifth-named defendant.

H Jolson for the sixth-named defendant.

The seventh-named defendant appeared in person.

P H Clarke for the eighth-named defendant.

P B Murdoch QC and *A R McNab* for the ninth-named defendant.

M D G Heaton for the tenth-named defendant.

L M F Watts for the eleventh-named defendant.

Cur. adv. vult.

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Tadgell J. The division of these reasons for judgment into sections is intended to make them more digestible; but the headings are only guides because their subjects tend to overlap.

The general nature of the litigation

This proceeding stems from the ruin by fraud of a company called The National Safety Council of Australia Victorian Division. The fraud was vast and its perpetrator was the first-named defendant, John Friedrich, formerly a full-time employee as chief executive officer of the company. His dupes included the State Bank of Victoria — of which the plaintiff is the lawful successor — and the other 10 defendants, of whom the second to the tenth-named were non-executive directors of the company and the eleventh-named was a senior full-time manager. The company was ordered on 24 April 1989 to be wound up on the ground that it could not pay its debts. There is said to be a deficiency of assets of some $258m.

The plaintiff alleges that the defendants are liable to it pursuant to the provisions of s 556(1) of the Companies (Vic) Code for the payment of certain debts incurred by the company to the State Bank of Victoria at times when there were reasonable grounds to expect that the company would not be able to pay all its debts as and when they became due.

The plaintiff's claim is unusual not least because of its immense size — nearly $97m having been claimed against each defendant individually — but also because it was made against directors each of whom served in an honorary and part-time capacity. Some of the defendant directors were nominees of members of the company, which was one limited by guarantee and having no share capital. The range and size of the activities of the company, including its borrowings, are also remarkable given that it was without equity capital.

The plaintiff's case, in a few sentences, is this. The State Bank of Victoria became the company's principal source of finance in May 1988 and it remained so until the company was placed in provisional liquidation on 22 March 1989. Throughout that period the State Bank provided finance for

the company and the plaintiff alleges that an amount well in excess of $100m remained owing to it by the company at the commencement of the winding up. At relevant times the company represented to the State Bank of Victoria that it was solvent and profitable whereas in fact it was irretrievably insolvent and carrying on its business at a huge and increasing loss. The statutory accounts and the various other items of accounting information provided to the State Bank of Victoria were bogus and misleading to an astonishing degree. The plaintiff has sued the defendants not for the whole of what it claims to be its provable debt but for portion of it under three distinct classes of debts incurred by the company during periods throughout which the plaintiff alleges that there were reasonable grounds to expect that the company would not be able to pay all its debts. The classes of debts are these:

cash advances from 31 May 1988 to 22 March 1989	$16,003,148
bills of exchange accepted and discounted from 2 June 1988 to 22 March 1989	$52,291,517
overdraft on current account from 1 January 1989 to 21 March 1989	$28,410,333
	$96,704,998

This last sum is the sum for which the plaintiff sued each defendant.

Friedrich failed to file an appearance and judgment was entered against him on 21 June 1990 for the amount claimed. The other defendants resisted the plaintiff's claim on the footing, in effect, that because of Friedrich's deception they were as ignorant of the true position as the State Bank of Victoria was. They relied on the defences contemplated by s 556(2) of the Companies Code and in any event they sought to be relieved from liability under s 535.

The trial as between the plaintiff and the defendants other than Friedrich began before me on 30 January 1991. All save one, Mrs Hobson, were represented by counsel, although not all counsel were present throughout. On 11 April 1991, the forty-fifth day of the trial, after the conclusion of the evidence called for the ninth of the 11 defendants, I was told that the plaintiff had reached a compromise upon all the outstanding claims save that against the second defendant, Mr M W Eise. I accordingly ordered by consent that the claims against the third to the eleventh-named defendants inclusive be dismissed. The plaintiff's claim against Mr Eise remains and it is upon it alone that I am now to give judgment.

I must say at once that there is no question of fraud on the part of any defendant other than John Friedrich. The detail and magnitude of Friedrich's deceit are not readily grasped but a broad appreciation of it is afforded by a comparison of the following salient figures taken from the accounts prepared by or for the company for the financial years ended 30 June 1986, 1987 and 1988, on the one hand, and the liquidator's assessment of the true position for those years on the other. I have rounded off the figures to the nearest million.

	Company's Accounts $m	*Liquidator's assessment* $m
1986		
assets	99	47
liabilities	76	91
net assets (liabilities)	23	(44)
1987		
assets	155	51
liabilities	131	145
net assets (liabilities)	24	(94)
1988		
assets	296	113
liabilities	269	273
net assets (liabilities)	27	(160)

The liquidator's assessed figures given in evidence on behalf of the plaintiff were not seriously contested by any defendant. There was evidence, indeed, that the company had been insolvent ever since the end of the 1983 financial year. That evidence, too, went substantially unchallenged. The provisional liquidator's assessment of the company's financial state at the date of the winding up order, according to the statement of affairs prepared and signed by him, showed an estimated net deficiency of $258,211,000. The figures provide a singular commentary not only on the conduct of the company but on the lending procedures of those who furnished its working capital during the eight years before its collapse. Upon the evidence before me the company sustained an operating loss, in the period of not quite 9 months from 1 July 1988 to 22 March 1989, in the order of $98m.

The issues

The issues in the case are in strictness quite narrow. The first is whether the plaintiff has proved the application of the provisions of subs (1) of s 556 of the Code, which reads thus:

"556(1) If—

(a) a company incurs a debt, whether within or outside the State;

(b) immediately before the time when the debt is incurred—

(i) there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or

(ii) there are reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and

(c) the company is, at the time when the debt is incurred, or becomes at a later time, a company to which this section applies,

any person who was a director of the company, or took part in the management of the company, at the time when the debt was incurred is guilty of an offence and the company and that person or, if there are 2 or more such persons, those persons are jointly and severally liable for the payment of the debt.

"Penalty: $5,000 or imprisonment for 1 year, or both."

In fact the plaintiff relies on para (b)(i) of subs (1) and does not rely on para (b)(ii). If the plaintiff demonstrates the application of s 556(1) then Mr Eise, who is the sole remaining defendant with whose liability I am directly concerned, is made liable to the plaintiff by force of the subsection, unless he can make out one or more of his defences, for payment of each of the debts the incurrence of which attracted the subsection's application.

In order to make out its case the plaintiff has undertaken to prove the following:

(a) The company incurred debts to the State Bank of Victoria that are the subject of the plaintiff's claim.

It is common ground that the alleged debts were incurred but I treat the quantum as being, to some extent at least, in issue.

(b) Mr Eise was at the time when the debts were incurred a director of the company.

This is common ground.

(c) The company became, in terms of s 556(1)(c), "a company to which this section applies".

This is also common ground for, while the relevant debts were still owing, the company went into liquidation and it is now in the course of being wound up: s 553(1)(a) of the Code.

(d) Immediately before the time when each of the debts was incurred there were reasonable grounds to expect that the company would not be able to pay all its debts as and when they became due.

This ingredient of the plaintiff's proof is much in issue and was vigorously contested as to the debts incurred and as to each one of them.

If the plaintiff proves the application of s 556(1) of the Code as against Mr Eise in respect of any of the debts in question he relies by way of defence upon s 556(2), which reads thus:

"(2) In any proceedings against a person under sub-section (1), it is a defence if the defendant proves—

(a) that the debt was incurred without his express or implied authority or consent; or

(b) that at the time when the debt was incurred, he did not have reasonable cause to expect—

(i) that the company would not be able to pay all its debts as and when they became due; or

(ii) that, if the company incurred that debt, it would not be able to pay all its debts as and when they became due.

Specifically, Mr Eise relies only on para (c)(i) of s 556(2) and he accordingly undertakes to prove in relation to any relevant debt the facts which that provision sets out. The question of that proof is again very much in issue.

Mr Eise also seeks relief under s 535(1) of the Code, which provides as follows:

"535(1) If, in any civil proceeding against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity by virtue of which he is such a person, it appears to the court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default or breach but that he has acted honestly and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default or breach, the court may relieve him either wholly or partly from his liability on such terms as the court thinks fit."

All defendants are persons to whom s 535 applies: s 535(4)(a) and (5)(a). The plaintiff, however, disputes the availability of s 535(1) as a basis for relief in any case when the claim depends upon s 556(1). Moreover the plaintiff contends that, even if s 535(1) is capable of being applied in favour of the defendant Eise, it should not be applied in his favour having regard to the facts of this case.

Although the issues are capable of succinct statement the evidence I received was wide ranging, touching upon numerous and diverse aspects of the company's activities. To some extent that was inevitable. The plaintiff was concerned to reveal all the circumstances tending to demonstrate the existence of the "reasonable grounds to expect" referred to in s 556(1)(b)(i), whereas the defendants sought to demonstrate the opposite. The defendants, for their part, were concerned also to reveal all the circumstances tending to show that they did not have the "reasonable cause to expect" referred to in subs (2)(b)(i), whereas the plaintiff sought to demonstrate the contrary. The defendants strove also to emphasise the high order of deceit practised by John Friedrich as chief executive officer of the company with a view to showing that they were his unwitting victims to whom no want of reasonable conduct or reasonable appreciation of the facts could be attributed. The plaintiff, on the other hand, sought to ascribe to the defendants a large measure of incompetence, combined with a want of due care, diligence and astuteness, and an abrogation of their duties as directors.

The pleadings no doubt left room for considerable evidence of the kind I have described. I am obliged nevertheless to point out, in case anyone reading these reasons might suppose otherwise, that the case does not involve a thoroughgoing examination of the whole of the affairs of the National Safety Council of Australia Victorian Division. Such an examination is not called for by the pleadings and would in any event be impossible having regard to the limited sources of the evidence I received. Those giving oral evidence were eight of the nine defendant directors, a partner of the liquidator, an agent of the State Bank of Victoria as mortgagee of the company's book debts, three officers of the plaintiff (two of them confined largely to formal proofs) and a member of the firm of Ernst & Whinney, chartered accountants, engaged by the directors during the three months immediately preceding the company's final collapse. I mention in particular that I received no evidence from any full-time or part-time employee of the company or from any representative of its auditors, and that there was but slight evidence of any technical kind — and none at all from any expert source — about the operational activities of the company.

Before attempting to summarise the mass of evidence, and in order to focus attention upon those aspects of it that really matter, it is as well to consider the provisions of s 556 of the Code which must be applied to the facts as found.

Interpretation of s 556 of the Companies (Vic) Code

It is common ground that s 556 of the Code continues to apply in relation to the company notwithstanding the enactment of the Corporations Law, which came into force on 1 January 1991. In any event s 592 of the Corporations Law is identical to s 556 of the Code in every material respect.

Section 556(1)

A contested issue of interpretation of s 556(1)(b)(i) arises: what is meant by the words "there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due . . ."? Plainly enough subs (1) imposes liability by reference to a series of objective circumstances, set forth in subparas (a), (b)(i) or (ii) and (c) and the remaining part of the subsection, which it is incumbent on the plaintiff to prove. Several questions are presented. What objective facts must the plaintiff prove in order to establish that "there are reasonable grounds to expect . . ."? Whose expectation is relevant? What is meant by "expect"? What exactly is it that is to be expected?

"Reasonable grounds"

Counsel for the plaintiff submitted, first, that he needed only to prove facts sufficient to satisfy the court that as an objective circumstance there were reasonable grounds to expect what subs (1)(b)(i) sets out. The submission was that, having regard to the unchallenged fact that the company was insolvent when it incurred the relevant debts, there must have been reasonable grounds to expect that it could not pay all its debts as and when they became due. I do not accept the argument for it offers no criterion by which to judge the reasonableness of grounds other than the court's own judgment. Reasonableness is a relative concept: *Opera House Investment Pty Ltd v Devon Buildings Pty Ltd* (1936) 55 CLR 110 at 117 per Starke J. In general, what is reasonable cannot be judged except by reference to a standard; and I do not agree that the subsection contemplates only that the court is to form its own judgment by reference to what it thinks constituted reasonable grounds to expect that which the subsection sets out.

Alternatively, counsel for the plaintiff submitted that the plaintiff establishes the application of s 556(1)(b)(i) if it satisfies the court by reference to facts in evidence that at the relevant time a director, had he known those facts, should have formed the expectation that the company would be unable to pay all its debts as and when they became due. For the defendant Eise it was submitted that even such a test as that gives insufficient effect to the words "there are reasonable grounds to expect" and practically means that the plaintiff could make its case by proving that, as a matter of fact, the company could not at the relevant time pay all its debts as and when they became due. It is necessary, so counsel for the defendant argued, that the plaintiff prove that a director of ordinary competence would have actually discovered facts upon which to form an expectation at the relevant time that the company would not be able to pay all its debts as and when they became due. The argument was that, in the

circumstances of this case, no director of ordinary competence and acting reasonably could have formed the necessary expectation at any relevant time. The words "there are reasonable grounds to expect" serve, it was said, to avoid fixing a director with liability by reference to a retrospective analysis of the company's affairs revealing facts which he had no reason to expect and no reasonable means of discovering. Thus, it was said, in this case Friedrich had so comprehensively deceived everyone who had been involved with the company that no director of ordinary competence, acting reasonably, would or could have had the necessary expectation until 21 March 1989, which was the day before a provisional liquidator was appointed. According to the argument for the defendant Eise the real question relates to the facts to be considered in determining whether Eise had reasonable grounds to expect that the company was unable to pay its debts; whereas for the plaintiff it was argued that, if one needs to consider the expectation of a director at all, it is not Eise's expectation that matters but that of a director in his position, acting reasonably.

The existence of reasonable grounds for the purpose of s 566(1) is to be determined by a wholly objective test. I respectfully adopt in that connection the following statements in the judgment of Forster J in *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371:

"It will be seen that [s 556] subs (1)(b)(i) makes no provision for the person or class of persons who are to have the relevant expectation. Clearly, material that could provide 'reasonable grounds' for expectation by a person with the qualifications of an auditor could be very different from material that would provide such grounds for an office boy. . . . It is to be noted that subs (1)(b)(i) does not speak of the accused, or the defendant, as the case may be, as having the relevant expectation. The expectation of the accused and/or the defendant, is brought into consideration only by subs (2)(b)(i)." (at 372-3)

. . .

"Clearly, s 556(1) creates two offences, and corresponding heads of civil liability, in relation to the company's incurring of the relevant debt, without regard to the presence or absence of personal involvement of the defendant in the incurring of that debt or to his knowledge or lack of knowledge of matters indicating the company's ability or otherwise to meet all its debts. I have already indicated my view that the sub-section, when it speaks of 'reasonable grounds' is not speaking of grounds personal to the defendant." (at 376)

After having referred to earlier cognate legislation (to which I shall also refer below) Foster J remarked: "The inquiry as to the establishment, prima facie, of an offence or head of civil liability is, therefore, very different from the inquiry called for under the old section. No elements personal to the defendant are involved at all."

Faced with these statements, counsel for the defendant Eise referred to a passage from the judgment of O'Bryan J in *Heide Pty Ltd v Lester* (1990) 3 ACSR 159 which was said to allow some matters subjective to the defendant to be considered. In the course of discussing s 556(1)(b) his Honour said: "To succeed, the plaintiff must prove on the balance of probabilities that at the relevant time a reasonable and prudent person, in the position occupied by each defendant as a director, *with their state of knowledge of the company,*

would not have reasonable grounds of expectation of the company being able to pay all its debts as and when they became due, if the company incurred the debt." (my emphasis)

This, and in particular the phrase I have emphasised, was said to support the view that the existence of reasonable grounds to expect for the purpose of subs (1)(b) is to be judged by reference to a reasonable and prudent person fixed with the defendant's state of knowledge of the company. If that is what the passage intends to convey it appears to me, with respect, not to be supported by the language of the subsection. The subsection does not require proof that anyone would *not* have reasonable grounds to expect and it does not refer to the defendant's state of knowledge.

Counsel for the defendant Eise also relied on passages in the judgment in *Kemish's* case to the effect that under s 556(1) "the reasonableness of the grounds relied on by the ... plaintiff must be judged by the standard appropriate to a director or manager of ordinary competence". (at 373) This thesis was summarised by Foster J at 378 as follows: "I have come to the conclusion that, as a matter of construction, it lies upon a plaintiff, in establishing the head of liability constituted by s 556(1)(a) and (b)(i) and (c) to prove the existence of facts at the time of the incurring of the subject debt which would reasonably induce a director or manager of ordinary competence to anticipate or predict that the company would clearly be unable to pay all its debts as and when they became due. Nothing short of this will satisfy the section."

I have, I believe, considered all the reported decisions, and all the unreported decisions to which I have been referred, which bear on the interpretation of subss (1) and (2) of s 556. These are, in chronological order: *3M Australia Pty Ltd v Watt* (1984) 9 ACLR 203 (Rogers J); 9 ACLR 524 (CA); *Pioneer Concrete Pty Ltd v Ellston* (1985) 10 ACLR 289; *3M Australia Pty Ltd v Kemish, supra; Russell Halpern Nominees Pty Ltd v Martin* (1986) 10 ACLR 539; 4 ACLC 393; *Metal Manufactures Ltd v Lewis* (1986) 11 ACLR 122; 4 ACLC 739 (Hodgson J), (1988) 13 NSWLR 315; 13 ACLR 357 (CA); *John Graham Reprographics Pty Ltd v Steffens* (1987) 12 ACLR 779; 5 ACLC 904; *Grimm v Roy Galvin & Co Pty Ltd* (1988) 13 ACLR 745; 6 ACLC 852; *Hussein v Good* (1990) 1 ACSR 710; 8 ACLC 390; *Heide Pty Ltd v Lester, supra; Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405; 8 ACLC 827. Several of these decisions preceding *Morley's* case were analysed in that case by Ormiston J and it would not be profitable to repeat the exercise here. With the assistance of those authorities however, but not necessarily adopting the language used in them, I venture to state my own understanding of the proof required of a plaintiff by s 556(1)(b)(i) upon a claim made against a non-executive director under s 556(1). It is this: the plaintiff must prove facts which, immediately before the time when the company incurred the relevant debt, gave a person seeking properly to perform the duties of a non-executive director of that company reasonable grounds to say: "I expect that the company will not be able to pay all its debts as and when they become due."

With respect, I prefer this to the formulation stated by Foster J in *Kemish's* case at 378, and set out above, which counsel for the defendant Eise invited me to adopt. I believe that the formulation I have attempted follows faithfully the words of the subsection, giving due weight to each without either glossing or obscuring any of them; and it gives appropriate

value to time and tense as expressed in the legislation. In particular it avoids, as does the subsection itself, inserting words such as "reasonably" and "clearly" and notions such as inducement and ordinary competence, anticipation and prediction.

My formulation does refer to a person seeking properly to perform the duties of a director of the company, and that criterion is to be understood and applied against the background of the whole of the Code and the principles of common law and equity which govern a director's duties and their discharge. Of course, it may be said in a general way that the law requires a director only to act reasonably and to attain to standards of no more than ordinary competence and to behave with only average prudence, but it is in my opinion unwarrantable and unhelpful to limit the interpretation of s 556(1) by these concepts alone. Section 556 is to be taken to have been drafted on the assumption that a director would comply with the requirements of the law with respect to directors, and especially the requirements imposed upon directors by the Code of which the section is part. What constitutes the proper performance of the duties of a director of a particular company will be dictated by a host of circumstances, including no doubt the type of company, the size and nature of its enterprise, the provisions of its articles of association, the composition of its board and the distribution of work between the board and other officers: *Byrne v Baker* [1964] VR 443 at 450. To speak of a director of ordinary, reasonable or average competence or prudence, or indeed of an ordinary reasonable or average director, is to give no very useful description, whereas a person seeking properly to perform the duties of a director of a particular company can be identified by reference to more specific criteria of which ordinariness, reasonableness and averageness are, or may be, merely ingredients.

Counsel for the defendant Eise submitted that the duties of directors imposed by the Code, other than duties to act honestly (s 229(1)) and to exercise a reasonable degree of care and diligence (s 229(2)) in the capacity of a director, are irrelevant to the definition of a director of "ordinary competence" by reference to whom s 556(1) should be construed. Whether that is right or not, it will be evident that I reject the view that the duties imposed by law upon a director are not relevant *as a whole* for the purpose of considering whether there are reasonable grounds in terms of s 556(1).

Ormiston J in *Morley's* case (at ACSR 410; ACLC 832) expressed the view that s 556 is to be interpreted in the light of the obligations placed on directors by the Code including those which, before its enactment, they did not bear. He referred by way of example to the obligation imposed by s 269(9)(a)(iii) that directors cause a statement to be attached to any accounts of the company required to be laid before its annual general meeting stating, among other things, whether in the opinion of the directors at the date of the statement there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due. The provision imposing that requirement began its life in the Code with s 556. Moreover, as his Honour pointed out, s 564(2) penalises the furnishing by directors of such a statement "without having taken reasonable steps to ensure that the information ... was not false or misleading". Ormiston J continued: "It is thus apparent, without considering the effects of s 556, that a director is obliged to inform himself or herself as to the financial affairs of

the company to the extent necessary to form each year the opinion required for the directors' statements. Although that is only an annual obligation, it presupposes sufficient knowledge and understanding of the company's affairs and its financial records to permit the opinion of solvency to be formed."

With that opinion I respectfully agree. Sir Douglas Menzies, in a paper entitled "Company Directors" delivered over 30 years ago ((1959) 33 *ALJ* 156), suggested that what would in general be expected of directors would tend to become the measure of what the law required of them by way of diligence and capability. That has surely been borne out over the succeeding years. As the complexity of commerce has gradually intensified (for better or for worse) the community has of necessity come to expect more than formerly from directors whose task it is to govern the affairs of companies to which large sums of money are committed by way of equity capital or loan. In response, the parliaments and the courts have found it necessary in legislation and litigation to refer to the demands made on directors in more exacting terms than formerly; and the standard of capability required of them has correspondingly increased. In particular, the stage has been reached when a director is expected to be capable of understanding his company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity. Moreover, he is under a statutory obligation to express such an opinion annually. I think it follows that he is required by law to be capable of keeping abreast of the company's affairs, and sufficiently abreast of them to act appropriately if there are reasonable grounds to expect that the company will not be able to pay all its debts in due course and he has reasonable cause to expect it.

"Expect"

I was pressed by counsel for Mr Eise to give proper effect to the word "expect" in s 556(1)(b)(i): it is not to be equated with "suspect". Evidence of a director's mere suspicion will not afford evidence of his expectation. Foster J, in the passage from his judgment in *Kemish's* case, supra, at 378, set out above, seems to have equated "expect" with "anticipate" or "predict". In doing so he relied on the definition of "expect" in the *Shorter Oxford English Dictionary* and on what Mahoney JA had said in *Dunn v Shapowloff* [1978] 2 NSWLR 235 at 249, of the expression "reasonable or probable expectation" in s 303(3) of the Companies Act 1961, viz that "'expectation' . . . goes beyond a mere hope or possibility. It requires, in a sense, a prediction as to the future ability of the company, and the measure of the reliability of that prediction is in the words 'reasonable or probable'".

Certainly, "I expect" does not mean "I suspect", but I offer the view that the verb "expect" – a part of the vocabulary of ordinary English – requires no substitute to explain it. In an idiomatic form it may need a little expansion in order to be completely understood in a given context, but supposed synonyms may serve to confuse rather than to explain.

Many would say that the verb "anticipate", when accurately used, is no substitute for "expect". I accept the dictum of Sir Ernest Gowers in *The Complete Plain Words* that the use of *anticipate* as a dignified synonym for *expect* is "a gross example of the way in which the vocabulary is impoverished by what Fowler called 'slip-shod extension'"; and that it should not be used "except to convey the sense peculiar to it of being

beforehand with something, of forestalling". He continued "If we write 'It is anticipated that a circular on this and other matters will be issued at an early date' when all we mean is that this is what we expect, we take the virtue out of *anticipate* and are parties to what Professor C S Lewis has called the crime of verbicide".

Again, the suggestion that *expectation* "requires, in a sense, a prediction" leads one to ask: in *what* sense? Rather than attempting the task of assigning a sense to a word that s 556 does not use it is preferable, because it is necessary and the only sure guide, to take the word the section does use and assign a sense to that. In its extended idiomatic form "expect" is often used to convey the sense of "expect to find", or "expect that it will turn out that": cf Fowler's *Modern English Usage.* A measure of confidence is built in. I take it to mean neither no more nor less in s 556. Lord Nelson presumably meant to convey much the same by his signal at Trafalgar. What result in the battle might he have achieved with "England anticipates . . ."?

What is it that is to be expected?

In *Morley's* case, supra, Ormiston J inferred, at ACLR 422; ACLC 843-4, that the reference in s 556 to the company's inability "to pay all its debts as and when they become [or became] due" can conveniently be treated as a reference to the company's commercial insolvency. That is a convenient shorthand way of compressing a long-winded flow of words in the section. It was adopted as such during the course of the trial, but it is important not to be diverted by the compression.

In *Dunn v Shapowloff,* supra, the court was concerned with s 303(3) of the Companies Act 1961 (NSW) (which was the same as s 303(3) of the Companies Act 1961 (Vic). That provision referred to an officer of a company who had, at the time of the company's contracting a debt, "no reasonable or probable ground of expectation . . . of the company being able to pay the debt . . .". I shall refer below in another context to the differences between s 303(3) of the 1961 Act and s 556(1) of the Code, but concentrate at present on their similarity – viz that each involves the concept of the inability of a company *to pay* a debt or debts. In that connection Reynolds JA said in *Shapowloff's* case at 240:

"I am not prepared to accept as a proposition of law that, in order to succeed in a prosecution under this section, it is incumbent on the prosecution to prove that, at the date in question, the liabilities of the company exceeded its assets . . . the section is not directly concerned with the question of whether, if a creditor pursued his legal right to judgment and some form of execution, satisfaction would have ensued, but it is concerned with the question of the company *paying* the debt. It surely cannot be a satisfactory answer to a charge under this section that on a winding-up there would be a probability that the creditor would receive dividends amounting to 100c in the dollar. Creditors do not do business with a company on this basis."

At 244 Mahoney JA said:

"Next, it is necessary to determine what is meant by ability to pay. That which is in question is not whether the company, at the relevant time, will be solvent or whether it will, on an assumed and instant liquidation, have a surplus sufficient to meet the debt, though these may be relevant in considering the statutory question. What will constitute ability to pay must

be determined, in a realistic way, by reference to the facts of the particular case, after taking into consideration, inter alia, the company's assets and liabilities and the nature of them, and the nature and circumstances of the company's activities . . ."

So here, I consider that reasonable grounds to expect that there was an excess of liabilities over assets need not be demonstrated by the plaintiff. What the plaintiff must show is that at the relevant time there were reasonable grounds to expect (in the sense I have indicated) that the company would not be able to meet its current financial obligations.

Section 556(2)

Subsection (2)(b)(i) of s 556 contemplates that a defendant against whom a case has been established under subs (1)(b)(i) in respect of a debt may prove, as a sufficient defence, that at the time when the debt was incurred *he* did not have reasonable cause to expect that the company would not be able to pay all its debts as and when they became due. Plainly enough it is open to such a defendant to rely on his own state of knowledge at the relevant time with a view to establishing the application of subs (2)(b)(i). He can prove what he actually knew and believed, and he can point to facts and prove that he did not know them or had no belief of their existence at the relevant time. It does not follow, however, that his subjective state of knowledge will necessarily establish that he did not have *reasonable cause* to expect that the company would not be able to pay all its debts as and when they became due.

In *Morley's* case Ormiston J concluded that, in order to determine whether a defendant has established a want of reasonable cause to expect, regard can be had to facts that he ought reasonably to have known (even if he did not actually know them) as well as to those which he actually knew. His Honour applied and expanded on the reasoning of Hodgson J in the *Metal Manufactures* case (in preference to that of Carruthers J in *Ellston's* case) when holding that the interpretation by the High Court in *Shapowloff v Dunn* (1981) 148 CLR 72 of s 303(3) of the Companies Act 1961 was not applicable to s 556(2) of the Companies Code. In *Shapowloff's* case Wilson J, with whom the other members of the court agreed, had said, at 85, that: "The test of reason imports an objective standard, but it is to be applied to the facts as known to the defendant."

Having reviewed the authorities to which I have earlier referred, Ormiston J, speaking of s 556(2), said, at 846-7:

". . . because the defendant must prove a negative and one related to the ability of the company generally to pay its debts as and when they become due, the question of the director's reasonable cause of expectation is not related to a specific debt but to the financial position of the company generally. Thus the issue is directed to what the director might reasonably know and understand of the company's general financial position at the relevant time. In the light of the various duties now imposed upon the directors, it would not appear unreasonable that they should apply their minds to the overall position of the company. In other words, the defendant is not entitled to say that he or she was told a minimal number of facts about the company's financial affairs but chose to ignore the possibility of other facts, or at least failed to enquire further as to other relevant facts.

"What is reasonable, therefore, is related in part to the extent of the inquiries that the director has made and should have made about the company's solvency. A director should not in those circumstances be entitled to hide behind ignorance of the company's affairs which is of his own making or, if not entirely of his own making, has been contributed to by his own failure to make further necessary inquiries. On the other hand directors are not required to have omniscience. It is not yet assumed that directors shall apply themselves full-time to the company's business. There is still a place for part-time and advisory directors. Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information either available to him or which he might with fairness demand from the executives or other employees and agents of the company."

I was invited by counsel for the defendant Eise to decline to follow the approach adopted by Ormiston J, which was said to strip s 556(2)(b) of its subjective element, and to apply to s 566(2) the High Court's interpretation of s 303(3) of the Companies Act 1961. This was said to mean that, in determining whether the defendant had negated reasonable cause to expect on his part that the company would not be able to pay all its debts as and when they became due, any fact not known to him should be ignored. There seems to me to be no warrant for such an interpretation in the language of s 556(2), which is very different from that of s 303(3) of the Companies Act 1961. The proof that was laid on the prosecution by s 303(3) was that the defendant was "knowingly a party to the contracting of a debt . . ." and "had, at the time the debt was contracted, no reasonable or probable ground of expectation . . . of the company being able to pay the debt . . .". The proof therefore depended on what the defendant knew, and the question was whether his expectation by reference to that was not objectively reasonable or probable. That is far from the proof contemplated by s 556(2) of the Code to provide a defence, which is that the defendant did not have reasonable cause to expect that the company would not be able to pay all its debts as and when they became due. I therefore propose to follow the decisions of Hodgson J and Ormiston J because, with respect, I think they were correct to say that *Shapowloff v Dunn* does not govern the interpretation of s 556(2). So to decide does not, I think, strip s 556(2) of its subjective element, as counsel for the defendant contended. The defendant can rely, with a view to making his proof, on anything he wishes, but a want of reasonable cause on his part to expect that the company would not be able to pay all its debts as and when they became due is nevertheless to be demonstrated objectively. Full weight is to be given in subs(2)(b) to the word "reasonable", just as it is in subs (1)(b). What the defendant actually knew is to be considered, for the purpose of deciding whether he did not have reasonable cause to expect, in terms of subs (2)(b), together with what he ought reasonably to have known.

In *Kemish's* case Foster J appears to have taken the view, at 377, that there are two steps involved in the defendant's establishing that he "did not have reasonable cause to expect . . .". The first is that the defendant must prove that he had in fact no "cause to expect"; and, having done so, he must prove that that was objectively reasonable. Hodgson J in the *Metal Manufactures* case, at ACLR 133; ACLC 750, did not accept that approach.

He said: "To require a defendant to prove that he had no cause whatsoever to expect something seems to me to go further than to require him to prove that he did not have reasonable cause to expect it: conceivably a defendant might have some cause to expect something which falls short of being a reasonable cause."

With respect I agree with Hodgson J, and indeed counsel for Mr Eise did not contend that I should embrace the two-step approach. I adopt the view expressed by Hodgson J (at ACLR 133; ACLC 750) that: ". . . it is best to approach the question in s 556(2)(b) as a single question, namely has the defendant proved that he did not have reasonable cause to expect that the company would be unable to pay its debts as they fell due. In considering that question, one may have regard to facts and circumstances known to the defendant and also facts and circumstances which by reason of the defendant's duties ought to have been known to the defendant."

In applying this test matters personal to the defendant can of course be taken into account. In particular, it would appear to be proper to consider, in deciding whether the defendant did not have reasonable cause to expect, etc, all the circumstances in which he found himself at the time when the debt in question was incurred by the company.

The earlier history of the company

The company was incorporated in 1928 under the provisions of the Companies Act 1915 as a company limited by guarantee and having no share capital. The concept of the organisation apparently derived from a public meeting convened on 23 May 1927 following efforts of the president at the time of the Royal Automobile Club of Victoria. Three themes were pursued – safety in the workplace, safety on the road and safety in the home. The objects of the company as set out in its memorandum of association assented to on 5 November 1986 (no earlier version having been put in evidence) included these:

"3.

(a) To devise provide advocate and promote the provision of services which may seem to the association calculated to prevent accidents and minimise the consequences thereof.

(b) To promote and foster the consideration and free discussion of all matters and questions relating to precautionary measures as aforesaid . . ."

It appears that the company's operations, although they did gradually grow from small beginnings, remained comparatively modest until the 1970s. There was at first a concentration upon the provision of services and education to promote occupational safety, child and home safety and, until 1972, road safety. Water safety, and for a time air safety, later became areas of interest. Although it became affiliated with the Federal Secretariat of the National Safety Council of Australia in about 1962 the company remained autonomous in all respects. Despite its name it has never been a division of any other organisation. Until about the early 1970s the staff was small and operations depended substantially on volunteers. The company has never operated under government aegis, although some federal and State government departments and instrumentalities – along with community, professional and business organisations – have invariably nominated representatives to its State Council.

The company has always been largely self-funding although it did until the 1980s accept some relatively modest government grants. As a measure of the company's earlier activities it may be noted that in the 1973 financial year its income was $230,889, including government grants of some $24,000, and its expenditure was $211,089. By 1982 its so called turnover was $2.8m. The company's expansion in the intervening decade had generally coincided with the term of office of Mr F Y Turley as chief executive, who was styled "the Director" although not a member of the board. During that period the company had established an Emergency Services Division which undertook firefighting and search and rescue operations for which it charged fees. This departure from its previous less spectacular operations paved the way for what was, or appeared to, an enormous expansion in the activities of the company following Friedrich's appointment as chief executive, in succession to Mr Turley, in 1982.

Great though the expansion was during Friedrich's regime in terms of staff employed, work done, property acquired and fees earned, its reflection in the company's financial statements was very largely illusory. The balance sheets and profit and loss statements from 1982 to 1987 and the drafts for 1988 purported to show what can now be seen as a fanciful rate of expansion.

The company throughout generally promoted itself as a non-profit making community service organisation. Indeed its memorandum of association prohibited the distribution of any of its income or property to its members, this being a condition of its having received a licence from the Attorney General pursuant to s 27 of the Companies Act 1915 for its registration as a company with limited liability without the addition of the word "limited" to its name. As an organisation avowedly dedicated to community service (if not a charity in the strict legal sense) the company enjoyed a respectable reputation. It was accorded or claimed vice-regal patronage, so far as the evidence discloses, during the 1970s and at least until 1985. It was, or claimed to be, exempt from income tax and filed no income tax returns. Moreover, it seems never to have filed an annual return with the Corporate Affairs Commission or any other regulatory body, although the basis for its exemption from an obligation to do so, if there was one after the commencement of the Companies (Vic) Code in 1982, did not precisely emerge in the evidence.

The structure and management of the company

I refer as briefly as may be to the formal structure of the company and I do so by reference to the memorandum and articles of association authorised at the annual general meeting of members held on 26 February 1988. Except in some instances that I shall specifically mention, the articles previously in force during the period now relevant were not for present purposes materially very different. Membership within any one of a number of stipulated classes — corporate members, nominee members, individual members and State Council members — was open to "any corporate body, association, public body, firm, club, governmental or quasi-governmental department or person ...": reg 2.1. In accordance with cl 7 of the memorandum the members were liable by way of guarantee to contribute to the company's assets upon a winding up to the extent only of one guinea.

The "oversight of the business and general affairs" of the company was placed by reg 9.1 under the management of the State Council, all members of which were required to be members of the company. Regulation 9.3 provided:

"9.3 Subject to subparagraph 9.1 of this article the State Council shall consist of:

A representative nominated by each advisory panel created by the board.

A representative nominated by the Ministry of Labour in the State of Victoria.

A representative nominated by the Department of Health of the State of Victoria.

A representative nominated by the Department of Education for the State of Victoria.

A representative nominated by the Chief Commissioner of the Victoria Police.

A representative nominated by the Victorian Accident Compensation Commission.

A representative from the Trades Hall Council.

A representative nominated by the National Council of Women of Victoria.

A representative from each of such further appropriate technical bodies and other organisations as may be decided upon by the State Council."

Regulation 9.4 (it seems) allowed the State Council to appoint an unlimited number of other persons to its membership; and reg 9.2 nominated the then present State Council members. Regulation 10.1 provided that "It shall be the function of the State Council to supervise the carrying out of the objectives of this company".

Regulations 13 to 17 dealt with the board of directors and the following provisions are of present relevance:

"13.1 The State Council shall elect from among its members a board of directors, numbering not more than nine persons, according to the procedures set out in these articles.

"13.2 It shall be a primary function of the board to act as the controlling body of this company. All rights and powers which are not specifically vested in any other body or person hereunder are hereby declared to be vested in the board.

"13.3 The board and officers authorised from time to time by the board shall be entitled to enter into all such negotiations and contracts as this company may lawfully enter and rescind or vary the same and to execute and do all such acts, deeds and things in the name of and on behalf of this company as it may consider expedient for the purposes of this company.

"13.4 The board shall meet and adjourn as often as it shall decide and shall also make such reports and give such information to the State Council from time to time as the board shall decide.

. . .

"13.6 The board may appoint such permanent officers to service it as hereinafter provided and further upon such terms and conditions as it shall from time to time determine."

Regulation 15.1 provided for the appointment by the board from among its members of a president, one or more vice-presidents and an honorary treasurer, each of whom was required to be a member of the company.

Regulation 16.1 provided that "A meeting of the board at which a quorum is present shall be competent to exercise all of the authorities, powers and discretions for the time being vested in or exercisable by this company". Regulation 16.3 fixed a quorum of three. Regulation 17.1 provided that "The board may subject to the Code delegate any of its powers or duties to a person, special committee or committees consisting of such persons whether members of the board or not as it may think fit".

Regulation 20.1 provided that "The honorary treasurer shall be responsible to ensure that the financial and accounting obligations of the company are carried out"; and reg 20.3 provided that "No person shall be elected or remain honorary treasurer unless he is a member of the board".

Accounts were dealt with by reg 23, of which para 23.1 was as follows:

"23.1 The board shall cause proper accounts to be kept in proper books in accordance with normal accounting practices. Such accounts shall be kept at the registered office of this company or at such other place as the board thinks fit and shall always be open to the inspection of members of the board and the financial affairs of this company shall at all times be attended to in accordance with the provisions of the Code."

Regulation 24 provided for the appointment of an auditor or auditors in accordance with the Companies (Vic) Code. Regulation 25.1 provided that "The board shall be entitled to borrow moneys on behalf of this company by way of overdraft, mortgage or otherwise as it deems fit in the interests of this company".

Regulation 27 read as follows:

"27. NON-MEMBER OFFICE BEARERS:

CHIEF EXECUTIVE

"27.1 The chief executive shall be appointed by the board for such term and at such remuneration and upon such conditions as the board may think fit and the chief executive so appointed may be removed by a resolution of the board.

"27.2 The chief executive shall be responsible to the board and shall oversee and manage all operations of this company and shall be responsible for the appointment of all non-member positions in this company (excepting the secretary) and shall report to the State Council and its board as may be required from time to time concerning the operations of this company.

SECRETARY

"27.3 The secretary shall be appointed by the board for such term and at such remuneration and upon such conditions as the board may think fit and any secretary so appointed may be removed by the board.

"27.4 The secretary shall be responsible for the custody of the books, documents and records save for those books, documents and records relating to financial matters which shall be the responsibility of the financial controller as set out in subart 27.7 herein and shall cause correct entries to be made in the books of all matters required therein in the ordinary course of proceedings of this company and shall when required by the chief executive or the board report details of all transactions, matters and things relating to this company and the affairs over which the secretary may have control or have knowledge. The secretary shall be responsible for the custody of the company seal and the safe keeping of all documents under seal and shall properly maintain all statutory registers.

"27.5 The secretary shall convene as required by the board or State Council all meetings of members of this company including all meetings of the State Council and board and shall keep proper minutes of such meetings. The secretary shall carry out such other and further duties which may properly be and as are usually required of a secretary as and when called upon to do so by the board or the chief executive.

FINANCIAL CONTROLLER

"27.6 The financial controller shall be appointed by the chief executive upon such terms and conditions as shall be approved by the board upon the recommendation of the chief executive and the financial controller shall be subject to the direction of the chief executive.

"27.7 The financial controller shall be responsible for maintaining the accounts of this company under the direction of the chief executive and when called upon to do so shall report to the chief executive, the honorary treasurer and the board concerning the accounts of this company.

At relevant times, as I understand the evidence, there were generally at least two meetings of the State Council each year, one towards the middle of the calendar year and one on the same day as the company's annual general meeting and preceding it. These meetings in general transacted little more than formal and routine business. It is unnecessary to discuss the nature of that business except to say that at times relevant to this litigation it appears to have involved no financial matters at all.

The members of the State Council last in office appear to have been between 30 and 40 in number and included representatives of such entities as the following: Australian Chamber of Manufactures, Australian Institute of Management, Australian Medical Association, Country Fire Authority, the Commonwealth Departments of Aviation and Transport, the Victorian Departments of Conservation Forests and Lands, and Health and Transport, Gas and Fuel Corporation of Victoria, Melbourne and Metropolitan Board of Works, Metropolitan Fire Brigade, Municipal Association of Victoria, Royal Australasian College of Surgeons, Royal Australian College of General Practitioners, Royal Automobile Club of Victoria, State Electricity Commission of Victoria, State Insurance Office, Victoria Police and Victorian Employers' Federation. There were also non-representative individual members, including some of the present defendants. The composition of the State Council seems to have followed that pattern for a number of years.

No member of the State Council or director was remunerated by the company for the office.

The board of directors (which was until an alteration of the articles on 5 November 1986 called "the executive committee") met nominally monthly but in practice sometimes rather less regularly during the period with which I am concerned. The directors of the company last in office were the second to the tenth-named defendants in these procedings, namely:

Mr Maxwell Walter Eise MBE — an individual member, a member of the executive committee or a director since 1968 and president since 1972;

Mr Frank Thomas James Cook — an individual member, a member of the executive committee or a director since 1970 and honorary treasurer since 1984;

Mr James Sydney Guthrie – a nominee of the Water Safety and Boating Advisory Panel and a member of the executive committee or a director since 1968;

Dr Edward William Brentnall MBE – a nominee of The Royal Australian College of General Practitioners and a member of the executive committee or a director since 1985;

Mr Raymon Murray Greenwood – a nominee of the Country Fire Authority and a director from 26 February 1988;

Mrs Dorothy Gertrude Hobson, BEM – an individual member, a member of the executive committee or a director since 1979 and a vice-president from 1974 to 1976;

Mr William Thomas Lloyd Jinkins MBE – an individual member, and a member of the executive committee or a director and a vice-president since 1974;

Mr John Barry Johnston – a nominee of the Department of Conservation Forests and Lands and a director since August 1987;

Mr Robert Landells Mills Summerbell – a nominee of The Victorian Employers' Federation and a director since 26 February 1988.

It is evident that each of the defendant directors, without exception, is honest and public-spirited and that each had talents to offer to The National Safety Council. Some of their talents were of an expert kind. It is fair to say, however, that with one possible exception their talents did not extend to the field of corporate financial management. Mr Johnston and Mr Greenwood had been senior Victorian public servants and indeed the latter remains chairman of the Country Fire Authority. Mr Johnston, formerly chief fire officer of the Department of Conservation Forests and Lands, holds the degree of Master of Business Administration from Monash University but his expertise is not in finance. Mr Summerbell is the only defendant director from whom I did not receive oral evidence and I can express no informed opinion about his expertise. His contribution to debate at meetings during the 13 months he was a director suggests, however, that he was better versed in financial matters than the other directors.

In the circumstances the only director whose background I need to mention in closer detail is Mr Eise. He is a former manufacturer of plumbing fittings and the like, now 75 years of age, whose successful business was bought out in about 1964, after which he appears to have devoted himself enthusiastically to community service. Over a period of 20 or more years he held office in a wide range of charitable and other community organisations, was a councillor of the City of Brighton for some 12 or 13 years, and mayor in 1971 and 1972. He achieved no post-secondary qualifications save a plumber's licence and claims in particular to have only a passing acquaintanceship with commercial principles. He denied on oath that he had ever learned how to read a balance sheet or a profit and loss statement. Whether that is correct or not he gave me the very clear impression that, throughout his involvement with the company, he was never much disposed to concern himself with financial detail. Plainly enough, whatever the reason, he was not in the habit of studying such financial statements as he received. By and large, he confined himself to the bottom line and was content with a balance sheet that showed an excess of assets over liabilities and a profit and loss statement that showed an excess of revenue over expenditure.

John Friedrich

The brooding omnipresence of John Friedrich pervaded this trial. I should say only sufficient of him to attempt to explain his peculiar influence upon the company, its board and those who advanced the company money. He, of course, gave no evidence but he was to be heard in several tape-recordings of board meetings that were in evidence, of which there were also transcripts. His curriculum vitae, apparently provided to the company in about 1982, described him as having been born at Mount Davis (or Mount Davies) in South Australia on 7 September 1945; to have been married with three children; and to have been educated at a Lutheran boarding school in Adelaide until 1960 when his family resettled in Germany. He was said to have completed high school in Munich in 1962, to have obtained various engineering qualifications in Germany and thereafter to have worked as an engineer in New Zealand and in Queensland from 1968 to 1977. In June 1977 he joined the National Safety Council of Australia Victorian Division as a regional consultant and safety officer in the Latrobe Valley in connection with the company's fire protection service provided to the State Electricity Commission. When Mr Turley retired as the director of the company in 1982 his recommendation that Friedrich succeed him as chief executive was accepted by the board and the appointment was made. According to Mr Eise, Friedrich claimed upon his appointment that he had a first-class knowledge of the company's operations. He requested a free hand in the conduct of those operations, and the board agreed.

Until some time in 1988, at least, Friedrich gave the board the general impression of being an ideal chief executive of exceptional industry and ability to which the company's remarkable expansion since his appointment had been largely due. He did, it seems, drive the Board along with an almost euphoric sense of high achievement, a sensation which the board greatly appreciated and enjoyed. Friedrich was awarded the Medal of the Order of Australia in the Australia Day Honours List in January 1988. The evidence does demonstrate that he combined a dominating and indeed overbearing personality with unusually capable organising skills, which he applied to both the business and operational aspects of the company's affairs.

Notwithstanding these qualities Friedrich was, I should judge, manipulative and deceitful; and he made himself extremely plausible by dint of being an accomplished liar. Particulars of this assessment appear throughout the remainder of these reasons for judgment.

The company's activities in 1985 and after

Some appreciation of the nature and scale of the activities of the company during the last three or four years of its operation can be derived from its sixtieth and last annual report, nominally for the 1987 financial year, which was received at its last annual general meeting held on 26 February 1988. There were then some 300 full-time employees and others were employed on a part-time basis. The company's principal business premises in Victoria were then at 470 St Kilda Road, Melbourne and at a major operations centre at West Sale, with an aerodrome and associated installations. There was also a substantial establishment in the Latrobe Valley and there were, it seems, some smaller installations in other Victorian country centres. The company had bases of some kind (some in

association with Commonwealth defence establishments) at Sydney, Williamtown and Illawarra in New South Wales, at Cairns, Townsville and Coolangatta in Queensland, at Darwin and Tindal in the Northern Territory, and at the Royal Adelaide Hospital. The company had, or was said to have, a representation in Canada, France and Spain and in parts of South East Asia. Some of the overseas activities were apparently carried on through wholly or partly-owned subsidiaries. By way of equipment the company had available a body of fixed and rotary wing aircraft, motor vehicles and marine vessels. There was, it was said, a mass of expensive and high-quality engineering, maintenance, medical, communications and training equipment.

The company's principal classes of activity were described in the 1987 annual report in these terms:

"OCCUPATIONAL HEALTH AND SAFETY

Primarily within the State of Victoria a consultancy and training service is provided to industry, government and semi-government organisations advising employers and employees how they may reduce injury and disease in the workplace.

"COMMUNITY AND WATER SAFETY

Organisations and individuals are provided with material and advice to encourage safety in the community across the range of child and home safety, water and boating safety, and recreational safety.

"INDUSTRIAL EMERGENCY SERVICE

Fire prevention and protection, emergency rescue and first-aid services are provided up to 24 hours per day to a wide range of organisations at their work sites. The Industrial Emergency Service group has also developed an extensive range of training sources in all of these areas.

"AERIAL FIRE FIGHTING

Facilities such as medium size helicopters specifically equipped for dropping water or fire retardant accurately onto bushfire fronts, or property in the path of bushfires, are deployed each summer throughout South Eastern Australia. The service is also exported to Canada and Europe.

"HYPERBARIC EMERGENCY

Transportation to and between major recompression chambers from Adelaide to Townsville is provided in our portable chambers. Three of the major treatment chambers are managed by NSCA.

"REMOTE SENSING

Airborne fire and pollution mapping is available throughout Australia and overseas. Sophisticated software has been developed to enable detailed research of bushfire behaviour.

"AIR AMBULANCE

In conjunction with the Victorian South Eastern Ambulance Service the NSCA provides both primary and secondary patient transportation across Eastern Victoria.

"SEARCH AND RESCUE

A rapid response capability with fixed and rotary wing aircraft is provided along the Eastern seaboard of Australia to complement airline and general aviation resources.

"DIVER EMERGENCY SERVICES

Through the Hyperbaric Medicine Unit at the Royal Adelaide Hospital the NSCA is involved in the 24 hour per day provision of information to deal

with diving emergencies. The work of the Unit includes research treatment and training associated with hyperbaric medicine.

"TRAINING

Programs from one hour to full residential courses are conducted across the range of services provided by the organisation. The ongoing proficiency and currency training for pararescue, aircrew and emergency personnel stimulates our high standards. Specialised courses are run by the Underwater Training Centre. The audio-visual group provides course support, including video and projected aids."

Some of the more esoteric of the company's projects were described as follows by Mr Eise in his remarks as president made in the 1987 annual report:

- Project Seahunt involving the use of pigeons which are carried on board search aircraft to detect missing aircraft and marine vessels, as well as survivors
- worldwide investigation of available flight data recorder retrieval systems for the recover of aircraft 'Black Boxes'
- designing and constructing a portable helicopter underwater escape trainer which can be carried on board our vessel 'Blue Nabilla' for operation around Australia and overseas
- feasibility study into the use of foam for aerial bushfire fighting (in conjunction with the Department of Conservation Forests and Lands)."

The company undoubtedly had, or had the use of, a great deal of the plant and equipment to which the 1987 annual report laid claim. Unlike most of the so called "containerised safety equipment", to which I shall have to refer more particularly below, much high-quality plant and equipment said to be owned or leased by the company actually existed. An example of the sophistication of some of the equipment operated by the company was its so called flagship, the "Blue Nabilla", a 34.7 metre multi-purpose ocean-going vessel which was apparently commissioned in 1985. According to the 1987 annual report the vessel was "converted primarily for diver training purposes but is also extremely well-equipped for other specialist work in the emergency and safety fields. The 'Blue Nabilla' functions efficiently as a search vessel with sonar, radar and radio homing instrumentation; as an on-scene command vessel with full radio, telex and facsimile facilities; as a base for emergency hyperbaric retrievals and treatment; and plays a vital role in many other emergencies". The "Blue Nabilla" was said in the 1987 annual report to have a range of features including the following:

"• a helicopter pad capable of accommodating helicopters weighing up to 12,500 lbs
- the capability to refuel aircraft with Jet A1 aviation fuel
- a 12 t/m crane used in helicopter and diving operations, and for lifting support vessels back to main deck
- an eight man hyperbaric chamber located on the main deck, with associated equipment. This chamber has transfer under pressure capability: portable chambers can be attached to it and patients transferred to the larger chamber whilst still under pressure
- a transportable hyperbaric chamber
- a 7 metre inflatable jet propelled rescue vessel with a rigid hull

- both air and heliox deep diving equipment to service up to eight divers, together with recharging facilities."

The company's air ambulance, search and recue and firefighting activities (to select only three among several aspects) appear to have been very efficiently conducted from an operational point of view and to have provided a valuable community service. The company received fulsome and grateful commendations from defence and police forces and a range of community service organisations. To outside observers the company was a highly competent and thriving organisation providing useful community facilities, some of which were otherwise unobtainable in Australia. Since it paid no income tax the company was of course placed in a position of advantage over any commercial competitors — an advantage it was always anxious to exploit. In truth the company had by 1985 at the latest developed a markedly commercial and entrepreneurial outlook.

The operational activities of the company were, it seems, subjects of close interest to and detailed attention by the directors, who viewed them with pride and great satisfaction. The board was led to believe, too, that the company was prosperous and successful in all respects.

The financing of the company's operations, unfortunately, received very different attention from the board than the physical operations themselves. The operations — carried out with modern and sophisticated equipment and highly-trained personnel, all apparently abundantly available — were exceedingly expensive; but the financial devices used to support them were most imperfectly understood during the last five years of the company's existence by the board and the State Council. The board was content to allow the company to carry on financially by force of its own momentum. It is striking that the 1987 annual report — an elaborate public relations exercise including a history of the company and consisting of some 66 illustrated pages — contained no financial information whatsoever except a meaningless pie chart (on p 4) headed "Income Percentage Breakdown 1986-7". The chart stated the sources of the company's income as follows:

Government grant	0.1%
Overseas	19%
Aviation	18%
Training	12%
Remote Sensing	19%
Consultancy	4.7%
Industrial	27.2%

With fine irony the board resolved on 15 September 1987, on Friedrich's recommendation, to forgo the government grant that year with a view to bettering the company's image as a successful and truly independent organisation.

Arrangements for the financing of the company's operations from 1985 onwards (at least) were left by the board to Friedrich and many of the arrangements he made were fraudulent.

The company's accounting system

According to the audited accounts for the year ended 30 June 1985 the company's annual turnover exceeded $25m. The accounts were at that time, it seems, kept by the company's auditors, Horwath & Horwath, and nominal responsibility for them was vested in the company secretary, then Mrs Pratt,

at West Sale. Towards the end of 1985 the auditors suggested the appointment of a financial controller to the company's staff and provided a job specification for the position, making the appointee responsible to the honorary treasurer. Such an appointment was made early in 1986 but the appointee was after only a few weeks given other duties by Friedrich and sent to Canada. He did not ever report to the board. No permanent replacement for him was ever appointed, notwithstanding that the company's articles were amended in November 1986 to require such an appointment, albeit (curiously) by the chief executive: see reg 27.6 and 27.7 set out above. There was never afterwards any employee whose distinct task it was to oversee the company's financial affairs. Friedrich protested that he could not induce a suitable person to accept an appointment and, as it turned out, probably he alone in the company's organisation knew during the last 3 years of its life what its financial position was.

Friedrich suggested early in 1987 that a member of the auditor's staff should be permanently located at the company's base at West Sale. That was done, from about February 1987, and the arrangement lasted until the so called resident auditor (one Dixon) resigned in January 1989. The function he performed during that period was left unexplained by the evidence before me.

According to the evidence of Mr A L Whitear, a partner of the liquidator who has closely analysed the company's accounts and accounting system on the liquidator's behalf, the company operated a "fairly simplistic" accounting system. Initially, most accounting records were kept manually although the general ledger was maintained on the inhouse computer of Messrs Horwath & Horwath. In about 1984 the company installed its own computer system for keeping its general ledger, accounts payable ledger and accounts receivable ledger. The company's computer base was broadened early in 1987 and Friedrich told the board that it was giving some difficulty.

Distortion of the company's accounts

The company's audited accounts for the financial years 1982 to 1987 and its final draft accounts for the 1988 financial year suggested a dramatic expansion in its affairs as the following table indicates:

	Receivables	*Property plant and equipment*	*Turnover*	*Operating surplus*
1982	$1,073,194	$393,507	$2,800,000	$69,474
1983	$925,770	$2,372,487	$6,580,000	$300,558
1984	$1,928,114	$13,414,137	$11,607,599	$695,290
1985	$8,019,677	$38,053,416	$25,185,232	$832,074
1986	$28,270,911	$70,927,461	$42,781,336	$2,449,250
1987	$47,471,393	$103,965,125	$60,423,700	$783,351
1988	$76,488,081	$212,222,522	$88,693,694	$544,331

A mere comparison of these figures from any one year to the next, let alone a comparison over a broader period, is enough to occasion surprise. One is naturally led to seek the reasons for the large annual increases from 1984 onwards in the amounts for receivables (ie debtors and contract work in progress) and property, plant and equipment. The progressive increase in turnover also excites interest. The largest single component of the balance sheet item "property, plant and equipment" was "containers" or "containerised safety equipment".

The fact is that at least from 1984 onwards the items referable to trade debtors, work in progress and containers or containerised safety equipment were invariably vastly overstated in the company's balance sheet, and the item of current liabilities was much understated. The measure of distortion for the year 1986 and those following is shown by the simplified table below extracted from the 1986 and 1987 audited accounts and the company's last draft 1988 accounts, compared with the liquidator's assessment.

	(1) *Company's accounts* $	(2) *Liquidator's assessment* $	(3) *Discrepancy between (1) & (2)* $
1986			
Trade debtors	23,861,824	567,529	23,294,295
Work in progress	3,021,465	630,241	2,391,224
Containerised safety equipment	29,234,161*	2,474,980	26,759,181
Current liabilities	31,486,024	46,443,702	14,957,678
1987			
Trade debtors	38,562,859	944,297	37,618,562
Work in progress	8,917,068	278,100	8,638,968
Containerised safety equipment	59,843,388*	3,691,855	56,151,533
Current liabilities	50,517,034	65,083,034	14,566,000
1988			
Trade debtors	62,480,224	839,085	61,641,139
Work in progress	14,015,863	395,788	13,620,075
Containerised safety equipment	109,596,694	3,309,880	106,286,814
Current liabilities	81,133,571	85,242,571	4,109,000

(* written-down value)

In each of the years 1986, 1987 and 1988 the effect of overstating trade debtors and work in progress was to overstate in the profit and loss statement of the company the operating income and to indicate an operating profit, whereas in truth there was an operating loss, as follows:

	Company's accounts $000	*Liquidator's estimate* $000	*Estimated overstatement* $000
1986			
Turnover	42,781	5,084	37,697
Profit (Loss)	2,449	(33,416)	35,865
1987			
Turnover	60,424	6,544	53,880
Profit (Loss)	783	(50,435)	51,218
1988			
Turnover	88,694	6,197	82,497
Profit (Loss)	544	(65,644)	66,188

Delegation to Friedrich

At a meeting of the board held on 21 October 1985 Friedrich sought to overcome what he called "present difficulties" in getting documents signed under the company's seal. The articles then required that the company's seal should be used only by the authority of a resolution of the State Council and that every instrument to which the seal was affixed should be "signed by at least two members of the State Council and counter-signed by the secretary or by some other persons appointed by the State Council for that purpose". In practice the State Council members who attested the use of the seal were directors, most of whom lived in or around Melbourne and did not often visit West Sale where the seal was kept by the secretary. Friedrich proposed that, once a project had been approved by the board, the affixing of the seal might be attested by three senior members of the company's staff. The proposal was purportedly approved by the State Council at a meeting held on 21 October 1985. The holders of any three of nine designated senior executive offices of the company were purportedly authorised to attest the affixation of the seal. The resolution was no doubt contrary to the articles as they then stood but, by amendment of the articles on 5 November 1986, the attestation of the seal was authorised by "at least two members of the board or by such officers in the employ of this company who may from time to time be authorised by the board to sign such documents on which the seal is affixed". On the same day the board resolved:

". . . that the following officers of the company be authorised to enter into negotiations and contracts etc in accordance with art 13.3 of the articles of association: chief executive, general manager, assistant general manager (operations), assistant general manager (administration), executive officer, occupational health and safety manager – authorisation limited to contracts regarding occupational health and safety";

and:

"that any two of the following officers of the company be authorised to sign documents on which the company seal as is affixed in accordance with art 26.1 of the articles of association: chief executive, general manager, executive officer, assistant general manager (operations), assistant general manager (administration)".

The directors therefore effectively put out of their hands their sighting of any document before it was executed under the company's seal.

Until the articles were altered on 5 November 1986 they provided that all cheques and other negotiable instruments drawn on the company's bank account should be signed by at least two members of the State Council or by one member of the State Council and the secretary. This was said in his evidence by Mr Eise to have been inconvenient after the larger part of the company's accounts department was moved to the West Sale base. The amended articles required cheques and other negotiable instruments to be signed "by at last two authorised officers": reg 23.3. On the day the articles were amended the board by resolution authorised any two of the holders of 14 designated offices (without naming any person) to sign cheques and negotiable instruments in accordance with reg 23.3. By this step the directors not only lost the right to sign the company's cheques and negotiable instruments but also greatly reduced the company's ability to supervise and control the signing of these documents. Furthermore the board on 5 November 1986 resolved to "authorise the chief executive to make payments by or on behalf of this organization by bank draft, telegraphic transfer, periodical payments or direct debits in accordance with art 23.3 of the articles of association". This appears to have purported to give Friedrich sole discretion to authorise payments for the company. That, at all events, is a discretion he assumed.

Friedrich's fraudulent technique

In each of the financial years 1986, 1987 and 1988 (and before) the overstatement of trade debtors and contract work in progress derived from the raising of fictitious invoices. These were raised against various government and government-associated bodies and other institutions which were already customers of the company but related to services much beyond those which the customers had sought or received. The stratagem had the effect of artificially increasing in the company's accounts the amount of both its apparent income and its assets. The effect was exacerbated by treating as the results of cash sales some of the funds raised from financiers. The large overstatement of the amount of containerised safety equipment derived from the issue to the company of false invoices for equipment and services that were not supplied and the making in the company's accounts of entries as though they had been supplied.

False invoices issued by the company to debtors

The company maintained both a general ledger and an accounts receivable ledger. From the commencement of the 1987 financial year the accounts receivable ledger was divided into two sections, a general section and a section termed "Z accounts" filed under the letter Z. Thenceforth all fictitious sales invoices raised by the company were posted to the Z accounts section, which was operated under the direct control of the chief executive officer's department rather than by the accounts receivable department. Other functions of the chief executive officer's department in relation to accounts receivable included the authorisation and making of all invoices and statements to customers, and a determination of the allocation to debtors' accounts of large unidentified cash amounts received by telegraphic transfer. The evidence of Mr Whitear is that all accounts maintained in the Z section of the ledger related to fictitious debts arising

from false invoicing. Sales invoices were typically raised periodically – quarterly, monthly or randomly – for services not provided, under headings such as emergency services, standby charges and decompression charges. Upon being raised the invoices were recorded as evidencing either sales income or accounts receivable. It seems probable that in many instances the invoices were not even sent to the customers concerned.

Illusory containerised safety equipment

The overstatement in the company's accounts of containerised safety equipment as assets stemmed from false invoices issued to the company from at least two sources, including Centurion Transport Pty Ltd and Hodges Nominees Pty Ltd. These invoices purported to charge the company for the supply of containers fully equipped with elaborate-sounding and expensive technical equipment such as high-pressure turbine pumps, underwater rescue apparatus and the like. The invoiced equipment was brought to account in the company's books as fixed assets. According to the evidence of Mr Whitear he had concluded from his investigation that no safety equipment at all was supplied to the company as so invoiced to it, although empty industrial containers (of low quality) were supplied by those rendering the invoices. These containers, similar in appearance to conventional shipping containers, were ostensibly – and were generally represented by Friedrich to be – available to store safety equipment, fuel and other supplies for use wherever these were required by the company to provide its emergency services to customers.

The containers supplied by Centurion and Hodges, according to Mr Whitear's evidence, cost the company on average about $16,000 each, for that is what it paid. The invoices for them, however, referred to containers complete with safety equipment and valued in the order of $250,000 for each container. The liquidator has found 245 such containers but, being of inferior quality, they were said by Mr Whitear to be fit only for purposes such as garden sheds and were realised by the liquidator at an average of some $1592 each. Banks and other financiers were approached by Friedrich to finance the acquisition by the company of containerised safety equipment and purported to do. The financing was by way either of loans, believed by the lenders to be secured over safety equipment as invoiced, or by the supposed purchase of such equipment by a financier and its lease back to the company on the faith of the supplier's invoice, or some similar financing arrangement.

According to Mr Whitear's evidence Centurion and Hodges each operated a clearing account in which were recorded transactions purportedly occurring with the company. Hodges also opened a special bank account with Westpac at its Glenroy branch for transactions with the company. Funds raised by the company from financial institutions were remitted to Centurion or Hodges, as a purported supplier to the company of containers and equipment, or directly to the company. Where remitted to Centurion or Hodges, the funds were passed on to the company after the deduction by the supplier of the cost charged to the company for the empty container supplied and any charges incurred or payments made on behalf of Friedrich for extraneous matters.

By means of ruses such as these the company actually received tens of millions of dollars from financiers procured by base fraud. The money so

obtained was recorded as unidentified cash receipts from customers and was sometimes purportedly placed in a so called "suspense account". Allocations were thereafter made by Friedrich to credit specific amounts as payments received of individual (but fictitious) debts. The remainder was treated as the product of cash sales.

The following passage from the evidence of Mr Whitear is striking: "The magnitude of the 'non-existent' containerised safety equipment to be excluded from the assets shown in the balance sheets is on its own sufficient to render the NSC insolvent as at 30 June 1986, with ever increasing impact on the total deficiency thereafter as the magnitude of the financing of the non existent assets increased in each succeeding financial year. Likewise the amount of the fictitious debtors was, by itself, sufficient in each of those years to render the NSC insolvent."

That passage was unchallenged. Its correctness seems to me to be entirely probable and I feel obliged to accept it.

The company's major source of funds throughout the period from 1 July 1985 until its demise was from fraudulent borrowings from banks and other financiers. The funds so derived were described in the company's books of account as receipts from customers. In that way the company's turnover year by year was exceedingly distorted; its statements of its assets were ridiculously excessive and its statements of its liabilities were correspondingly minimised.

Board approval of finance facilities

The broad authority given by the board to Friedrich to enter into contracts on behalf of the company and to sign documents was used by him particularly to negotiate and execute agreements with financiers for the provision of working capital. Minutes of board meetings from November 1985 to September 1988 indicate that, during the last 4 years of its operation, the company had the benefit of financial facilities of one kind or another by contracts made with no less than 27 different banks or finance institutions. Friedrich commonly sought the board's approval of these arrangements by asserting orally at board meetings that they were necessary and without providing any documents by way of explanation either in advance of the meeting or at all. Sometimes the board's approval was sought in advance of the making of a finance contract but it was not unusual for Friedrich to seek and obtain the endorsement of a fait accompli. The thrust of the evidence was that he used to explain, sometimes using a white board, the purpose to which particular finance would be put and the board gave its approval to obtain or continue financial accommodation on the faith of Friedrich's say so. It was very rare for the board to see or to seek or be offered inspection of any correspondence or other documents evidencing a transaction for financial accommodation. According to the minutes of meetings the board's approval of Friedrich's proposals was habitually given in the broadest and vaguest of terms. The following extracts from board minutes are fairly typical.

29 November 1985

"Approval was given to extend the current overdraft with the ANZ Bank or enter into a factoring agreement (an accounts receivable loan) on a non-notification basis through an appropriate financial institution.

"Confirmation of approval for the following financial facilities was agreed:
Samwa
Scandinavian Pacific
Rothschilds
Custom Credit."

18 April 1986

"*Toronto Dominion Aust Ltd*: The facility available from Toronto Dominion for the last 2 years has again been rolled over and extended."

20 May 1986

"The facilities available from the Hong Kong Bank, Toronto Dominion and ABN Finance were approved."

16 September 1986

"Rollovers and new facilities were approved for Rothschilds; AGC; Custom Credit; ABN; Kuwait; Kleinwort Benson; BBL Australia; Midland.

"Mr Friedrich reported that the Toronto Dominion facility had been completely paid out on 25 August 1986 and that the Barclays facility would be paid out in October. This will leave the ANZ as the only provider of a working capital facility."

[This last sentence appears to have been quite inaccurate.]

21 October 1986

"Finance Facilities

"*Motion:* Standard Chartered and BBL Australia facilities to be approved.

"Moved Mr Cook, seconded Mr Jinkins.

"Carried."

18 November 1986

"Mr Friedrich reported that finance facilities have been put in place with Standard Chartered, Barclays, BBL Australia and ABN Australia and sought the board's approval to accept, reject or rollover these facilities as required. The board granted this approval."

20 January 1987

"The board approved rollovers and facilities for Standard Chartered, ABN, CIBC Australia, Partnership Pacific, AGC, Barclays, Rothschilds and Macquarie Bank."

17 February 1987

"Rollovers of facilities with the following financial institutions were approved: BOT Bulletin; Standard Chartered; Partnership Pacific; Macquarie Bank; Toronto Dominion; Scandinavian Pacific; Elders Rural Finance."

16 June 1987

"The board approved finance facilities and rollovers for: CIBC; State Bank; Custom Credit; Elders Finance; Macquarie Bank; Bank of New York; Barclays Bank."

15 September 1987

"Mr Friedrich sought approval for rollovers and finance facilities.

"Motion: That approval be given for the chief executive to accept rollovers and finance facilities from the Bank of Hong Kong, Partnership Pacific and the Australian Industry Development Corporation.

"Moved Mr Cook, seconded Mr Johnston. Carried."

20 October 1987

"The board approved a finance facility with the Hong Kong Bank."

19 January 1988

"The board gave approval for rollovers of existing facilities with Credit Commercial de France and Partnership Pacific."

Plainly enough the result of this procedure was that the board was led to approve the making of arrangements for financial facilities without any records, for the board's purposes, of the nature of the arrangements, the capital amounts of money involved, the interest or other charges payable, the duration of the borrowings, the securities granted (if any) or the terms of repayment. Nor, in many cases, was the board aware, at the time of giving approval or later, whether what had been approved was a new borrowing or a rollover of an existing facility. It is true that, according to the evidence of several of the directors, including Mr Eise, Friedrich used to explain orally at board meetings the implications of any given transaction. The financial transactions were, however, so frequent, numerous and diverse, and the amounts involved so large, that it was scarcely possible for board members to obtain or retain a useful appreciation at any given time of the nature or total dimension of the company's borrowings.

A further striking but different illustration of the laxity of the board's control of its approval of borrowings is afforded by an incident at the board meeting held on 19 January 1988. The board by resolution retrospectively altered the minutes of the last preceding meeting, held on 14 December 1987, to make it appear that the raising of a loan account for $10m had been approved at the earlier meeting. The minutes of the meeting on 19 January 1988 record the matter thus:

"Mr Friedrich noted that notification of the rollover of a finance facility with BNY Australia Ltd should have taken place at the previous meeting. The board agreed to the inclusion of the following motion in the minutes of the previous meeting.

"Motion: 'It is hereby resolved that the National Safety Council of Australia Victorian Division, pursuant to its memorandum and articles of association and by and through its authorised officers is hereby empowered to raise a ten million dollar ($10m) loan facility with BNY Australia Ltd and to secure such loan funds with appropriate chattel securities and to sign all such things as are necessary to execute the appropriate documentation.'

"Moved Mr Cook, seconded Mr Guthrie. CARRIED."

There was no evidence to explain or suggest why this was done but I would infer that it was probably done simply because Friedrich asked for it. Mr Guthrie was not even present at the January 1988 meeting when his name was used as a seconder of the motion supposed to have been retrospectively created.

The directors' understanding of the company's financial position was further restricted by the unrevealing nature of the management accounts provided to them.

Board agenda papers and management accounts

The quality of decisions made by the directors was naturally much influenced by the type of information provided to them. Friedrich seems to

have been responsible for determining the form of the agenda papers the directors received, including management accounting information, and the time at which it was provided. The period now relevant can be conveniently divided into four phases.

A. 1986 to mid 1987

During this period management accounts were provided to the board at exceedingly irregular intervals, and then almost invariably at board meetings rather than in advance of them. Indeed, of the 18 board meetings held in the period January 1986 to May 1987, there were at least 11 meetings at which no accounts of any kind were provided to the board or considered. At the remaining board meetings during that period the management accounts that were provided were generally unhelpful in form and misleading in substance. It is difficult to avoid the conclusion upon the evidence that, with the exception of annual accounts for the year ended 30 June 1986 tabled at the board meeting on 16 December 1986, the board had no useful accounts at all between the board meetings of 20 May 1986 and 16 June 1987. The stark reality of the position can be illustrated in summary form as follows.

Board meeting

21 January 1986 An income and expenditure summary for November 1985 and a balance sheet expressed to be "for period ending November 1985" were presented to the meeting. According to the minutes Friedrich indicated that "the current surplus had been adversely affected in the short term by the lack of bushfires in Victoria this summer" [sic]. In response to an inquiry about the item "Containers" listed (at $22.7m) in the balance sheet under "Fixed Assets" Friedrich explained that "The Emergency Equipment Containers were located from Cape York to Portland. Their values ranged from $400,000 for gas monitoring equipment through to $25,000 for aviation fuel. The average value is $200,000".

18 February 1986 No accounts or financial documents were presented to the meeting.

18 March 1986 According to the minutes "The unaudited balance sheet and statement of income and expenditure for the period ending December 1986 [an error for 1985] prepared by the auditors was presented to the meeting. It was noted that depreciation of fixed assets is $3.6m for the 6 months, that leasehold improvements have increased and that secured loans have also increased as the company shifts from leases to secured loans." That is all that appears in the minutes under "Finance". There were in evidence two documents tendered on behalf of Mr Eise purporting to be the company's "Balance sheet for period ending [sic] December 1985" although one was erroneously headed "for period ending December 1986". They were substantially different from each other in that there were discrepancies between them of $5m in the item for "Containers" and of $1.4m in the item for "Net Assets" but it is not clear from the evidence which of them was relied on by the board.

18 April 1986 The minutes record that "The accounts had been received from Horwath & Horwath on the morning of the meeting, however a cumulative error had been found which meant they were distorted throughout. The accounts will be tabled at the next meeting."

20 May 1986 The minutes record that accounts were tabled but that they were distorted as to expenditure by approximately $4m. The accounts were not in evidence and it is not possible to make an assessment of their utility.

17 June 1986 The minutes record under the heading "Finance" that Friedrich "apologised for having nothing to report due to the recent administration relocation".

There was no board meeting in July or August 1986.

16 September 1986 The minutes record that Friedrich "presented the prepared income/expenditure statement for the period 1 July 1985 to 30 June 1986. A list of individual cost centres was also distributed and in future separate accounts will be prepared for each of these cost centres". The income and expenditure statement showed an apparent income for the 1986 financial year of $34m and expenditure of $33.2m, leaving a surplus of $0.8m. The list of so called "individual cost centres" was without figures.

30 September 1986 No accounts were presented.

21 October 1986 No accounts were presented.

5 November 1986 No accounts were presented.

18 November 1986 Under the heading "Finance" the minutes record only the following: "Mr Friedrich reported a total turnover of $15,619,350 for the period 1 July 1986 – 17 November 1986. The surplus for the financial year 1985/1986 is $840,000, however, there is still some depreciation to be deducted from this figure". No financial documents of any kind were presented to the meeting.

16 December 1986 The minutes record that "Mr Friedrich tabled the annual accounts [ie for the year ended 30 June 1986] and reported a $2.4m operating surplus". The accounts were not provided to the directors before the meeting. The stated increase in surplus from $840,000 (orally reported to the meeting on 18 November) was apparently greeted without query and the minutes record that "The Board agreed that this was an excellent result and that these funds were necessary to ensure the continued development of the organisation". The 1986 accounts so tabled were later on the same day presented to the 59th annual general meeting of the company in circumstances that I shall have to consider in detail below.

20 January 1987 Under the heading "Finance" the minutes record merely "Nothing to report'.

17 February 1987 No accounts or financial documents of any kind were before the meeting, save that the minutes record:

"The following information was tabled:

1/7/86-21/12/86	Income $17,953,902.00
	Surplus 880,587.00"

If that implies that a document was provided there is no evidence to indicate what it was.

17 March 1987 No accounts or financial documents of any kind were before the meeting.

There was no board meeting in April 1987.

1 May 1987 No financial documents were presented to the meeting. The minutes record that Mr Gomm (described as general manager/company secretary) "reported that the forecast of income and expenditure for the

next 5 years indicates an estimated increase of 5-10% per annum. Income and expenditure to the end of January 1987 produced a surplus of approximately $280,000 on a turnover of $29.25m. The cash flow budget for 1987 indicates that the surplus is on "target". Friedrich did not attend this meeting, which was held at Wollongong. The oral report by Mr Gomm apparently contained the entirety of the financial information provided to the board by way of report in respect of the first 10 months of the financial year ending on 30 June 1987. The minutes record that Mr Cook, the honorary treasurer, noted that "the change to the computerised accounting system is presenting some problems, but a summary sheet will be provided for board meetings in future".

Mr Eise was overseas on behalf of the company from May 1987 until August 1987, during which period Mr Jinkins acted as chairman at board meetings.

19 May 1987 The minutes record that "Copies of the finance summary sheet were distributed", but the evidence does not disclose what the summary contained. It was resolved "That the board be provided with summary sheets on a monthly basis and quarterly statements in the form of extended print-outs of (i) individual items and (ii) cost centre breakdowns, be provided four times a year". A motion proposed by Dr Brentnall "That the situation be reviewed in 6 months time" was withdrawn and it was resolved "That the financial report be accepted as presented".

B. June 1987 to February 1988

During this period summaries of income and expenditure by reference to cost centres were fairly regularly provided at board meetings – not before them – but they were not very revealing because there was no definition or common understanding by the board of the operations of the company that were comprehended within each so called "cost centre". Moreover, the summaries did not indicate whether the "income" shown referred to receipts or accruals, and the directors did not know. The management accounts (if they may be so called) for the period consisted largely of these summaries, which were usually presented 3 or 4 months in arrear. No conventional accounts for the year ended 30 June 1987 were provided to the directors until the meeting on 15 September 1987. Those then produced showed a surplus of $1.19m for the year and net assets of $24.8m. Fixed assets included containers, plant and equipment at $33.2m and current assets included trade debtors of $30.5m. These figures are to be contrasted with those in the final 1987 annual accounts, referred to in more detail below, in which net assets were shown at $24.3m, containers, plant and equipment at $65.7m and trade debtors at $38m. At the board meetings held in October, November and December 1987 and January and February 1988 no balance sheet was provided. There were merely summaries by major cost centres which provided little detail and were invariably at least 3 months in arrear.

No annual general meeting was held in 1987 and one was fixed for 26 February 1988. At the board meeting on 16 February 1988 no final accounts for the year ended 30 June 1987 were available. According to the minutes Mr Gomm confirmed that "the annual audited accounts for

1986/1987 will be tabled at the annual general meeting on 26 February 1988". I shall deal separately below with the events on 16 and 26 February 1988.

C. Management accounts after February 1988 for the 1988 financial year

A balance sheet as at the end of the first 6 months of the financial year ending 30 June 1988 was provided for the board meeting held on 15 March 1988. The balance sheet as at 31 December 1987 showed trade debtors of $52.5m and containers, plant and equipment of $65m. Mr Summerbell had on 26 February 1988 been appointed to the board by resolution of the State Council. The board meeting on 15 March 1988 was the first he attended and he and others drew attention to the unsatisfactory management accounts and to the fact that they were provided at the meeting and not before it so that directors might first study them. The board requested that in future the income and expenditure statement should include comparative figures for the previous year and the current budget. It was also resolved that the finance documents — a monthly income and expenditure statement and a quarterly balance sheet — be sent to the board prior to each meeting. Thereafter, from April 1988 onwards, the form of management accounts temporarily improved and they were sent to directors in advance of meetings, along with other agenda papers.

Monthly balance sheets were provided as follows:

Board meeting

19 April 1988 Balance sheet at 31 January 1988, showing:

Containers, plant & equipment	$63.7m
Trade debtors	$57.6m
Suspense	$21.3m

17 May 1988 Balance sheet at 31 March 1988, showing:

Containers, plant & equipment	$63.7m
Trade debtors	$80.4m
Suspense	$23.8m

21 June 1988 Balance sheet at 30 April 1988, showing:

Containers, plant & equipment	$63.7m
Trade debtors	$51.2m
Suspense	$0.614m

19 July 1988 Balance sheet at 30 May 1988, showing:

Containers, plant & equipment	$63.7m
Trade debtors	$53.1m
Suspense	$0.703m

At the board meeting on 19 August 1988 no balance sheet as at the end of the 1988 financial year was available and none became available for several months. An income and expenditure summary showed a surplus for the 1988 year of $109,795 as against a budgeted surplus of $6.1m.

D. Management accounts for the year ending 30 June 1989

In September 1988 Eise asked Friedrich to give him a list of the company's debtors. Friedrich complied literally with the request, sending by messenger lists of debtors' names, but without amounts. It was not until February 1989 that Friedrich provided Eise with a list of debtors' names and amounts, marked "Confidential, Part 1". It was incomplete, containing

reference to only a few of the larger supposed debts. Eise asked Friedrich to give him Part 2 as well, but it seems never to have been provided to him.

At the board meeting on 20 September 1988 no balance sheet was provided but there was an income and expenditure statement for July 1988 showing total income for that month of $4.4m and a surplus of $14,982. According to the minutes Mr Summerbell pointed to a number of items where expenditure had exceeded budget, and "Mr Friedrich explained that the budget still needed to be revised and will hopefully be presented to the next meeting. Some explanations lay in the unexpected expenses in Spain and Darwin". The minutes also recorded that "It is anticipated that the annual accounts [ie for the year ending 30 June 1988] will be presented to the next meeting for consideration and signature".

A board meeting was due to be held on 18 October 1988 but it was cancelled at Mr Friedrich's request on the ground that he was ill.

The next meeting was held on 2 November 1988. No accounts for the current (1989) financial year were presented save for budgeted and actual income and expenditure to August 1988. That item was, however, overshadowed by a consideration of the draft 1988 accounts which had been provided. This was an important meeting which I shall have to consider below in the context of the 1988 accounts.

At the board meeting held on 15 November 1988 there were available only an income and expenditure statement for September 1988 and comparisons of budget and actual figures to September 1988. The board was advised that the complete 1988 accounts would not be available until 29 November.

The next board meeting was due to be held on 13 December 1988 and the auditors were due to attend to explain the 1988 accounts. The meeting was cancelled on account of Friedrich's supposed indisposition. The agenda papers forwarded for the meeting included, however, an income and expenditure statement for October 1988 which showed, for that month, expenditure of $5.6m and income of $3.9m, producing a monthly deficit of $1.7m, and a deficit for the financial year to October of nearly $600,000.

The next board meeting on 21 December 1988 was devoted largely to a consideration of the accounts for the 1988 financial year. No management accounts for the 1989 financial year were available then or at any subsequent meeting of the board until the company expired.

The 1986 audited annual accounts

The audited accounts for the year ended 30 June 1986 were presented and accepted at the 59th annual general meeting of the company held on 16 December 1986. According to the Companies (Vic) Code *the directors* had the following obligations in relation to the 1986 accounts:

1. not less than 14 days before the annual general meeting to cause to be made out:
   (a) a profit and loss account for the 1986 financial year giving a true and fair view of the profit or loss of the company for that financial year: s 269(1);
   (b) a balance sheet as at the end of the 1986 financial year giving a true and fair view of the state of affairs of the company as at the end of that financial year: s 269(2);

(c) group accounts dealing with the profit and loss of the company and its subsidiaries for their respective last financial years, and the state of affairs of the company and its subsidiaries at the end of their respective last financial years and giving a true and fair view of the profit or loss and state of affairs so far as they concerned members of the holding company: s 269(3).

2. to take reasonable steps to ensure that the accounts of the company and any necessary group accounts were audited as required by the Code not less than 14 days before the annual general meeting: s 269(4).

3. to cause to be attached to or endorsed on the accounts or group accounts the auditor's report relating to the accounts that was furnished to the directors in accordance with s 285(2): s 269(5).

4. to ensure that the accounts complied with the prescribed requirements relevant to them and, if necessary, to add such information and explanations as might be necessary beyond what was prescribed as would give a true and fair view: s 269(8).

5. to cause to be attached to the accounts to be laid before the annual general meeting pursuant to s 275, before the auditor reported on them, a statement made not more than 56 days before the date of the annual general meeting, in accordance with a resolution of the directors and signed by at least two of them, stating whether, in the opinion of the directors:

(a) the profit and loss account was drawn up so as to give a true and fair view of the profit or loss of the company for the 1986 financial year: s 269(9)(a)(i); and

(b) the balance sheet was drawn up so as to give a true and fair view of the state of affairs of the company as at the end of the 1986 financial year: s 269(9)(a)(ii); and

(c) at the date of the statement, there were reasonable funds to believe that the company would be able to pay its debts as and when they fell due: s 269(9)(a)(iii) and s 269(9A).

6. to cause a comparable statement to be attached to the group accounts to be laid before the annual general meeting pursuant to s 275: s 269(10) and (10A).

7. to take into account, when forming an opinion for the purposes of a statement under s 269(9) as to the matters specified in 5(a) and (b) above matters that had arisen and information that had become available since the end of the 1986 financial year: s 269(11).

8. not less than 14 days or more than 56 days before the annual general meeting to cause reports to be made out in accordance with a resolution of the directors and signed by at least two of them, in accordance with s 270(1) and (2).

9. to cause to be laid before the annual general meeting a copy of the accounts made out in accordance with s 269, of the directors' report made out under s 270(2) and of the auditor's report and of the directors' statement made under s 269(10): s 275.

In addition to the above *the company itself* was required at least 14 days before the annual general meeting held on 16 December 1986 to send a copy of all accounts that were to be laid before the meeting, and of the reports and statements referred to above, to all persons entitled to receive notice of general meetings of the company: s 274(1).

Most, if not all, of these statutory requirements were breached in relation to the 1986 accounts and the annual general meeting held on 16 December 1986. As I have described, the management accounts for the 1986 financial year were grossly inadequate as a means of enabling the directors to form a useful view of the company's financial affairs during the course of the financial year ending on 30 June 1986. The only financial information received by the directors between 30 June 1986 and 16 December 1986 relating to the 1986 financial year was that contained in the income and expenditure statement placed before them on 16 September 1986, to which I have referred, and Friedrich's oral announcement made to the meeting on 18 November 1986 of an annual surplus of $840,000. Then, at a directors' meeting beginning at 11.30 am on 16 December 1986 the directors were provided for the first time with the 1986 accounts. The directors' ostensible purpose was to consider the accounts and approve them preparatory to their presentation to the 59th annual general meeting of the company called for 2 pm on the same day. It was a futile procedure, no doubt designed by Friedrich to deprive the directors of any reasonable opportunity to give proper consideration to the accounts, and plainly that is what it did. There is no evidence suggesting that any member of the board objected to being so easily used – indeed abused. Moreover, as I have indicated, no director remarked upon the discrepancies between the accounts then placed before the board and the figures contained in the document that was before the board on 16 September and the surplus orally reported on 18 November. Instead, the directors expressed their satisfaction with the "excellent result" and adopted the accounts. The meeting adjourned at 12.30 pm in order that, following a State Council meeting, the annual general meeting might be held, as it was, commencing at 2 pm. In the meantime Mr Eise as president and Mr Cook as vice-president signed a statement on behalf of the board in purported compliance with s 269(9) of the Code.

Mr Eise swore before me that when he signed the directors' statement there was bound in with the accounts which it accompanied a "clear" and unqualified unsigned auditors' certificate. In this I think he was mistaken. It is contrary to evidence he gave upon his earlier examination before a Master pursuant to s 541 of the Code and contrary also to the evidence given to me by Mr Cook. Moreover, the whole of the rest of the evidence is opposed to any probability that a "clear" report issued by the auditors ever existed. The accounts as adopted by the board – or parts of them – were placed before the annual general meeting and, although the minutes do not say so, they were evidently accepted. The minutes do record that Mr Summerbell, (who was then a member of the State Council but not a director) made two points at the annual general meeting. The first was that the auditors' certificate was not attached to the accounts. The second was that no notes were attached to the accounts. Friedrich responded to the first point by asserting that the accounts had been audited and he held up a document, claiming that it was the auditors' report and stating that it was available for inspection if anyone wanted to see it. Mr Eise swore that he observed it to be a single sheet signed by Price Williams, who was a partner of the firm of Horwath & Horwath, but there is no evidence that he read its contents. No one, it seems, sought to inspect it and it was not read out. As to Mr Summerbell's second point Friedrich replied that there had been no

time to attach the notes to the accounts before the meeting and said, according to the minutes, that "a full set of accounts would be forwarded in due course".

The procedural irregularity in connection with the 1986 accounts and their presentation to the 1986 annual general meeting was extreme. Irrespective of the inherent inaccuracy of the accounts, the auditors' report had not been attached to or endorsed on them; the directors' statement under s 269(9) had not been provided until the very day of the annual general meeting; and the accounts and associated reports and statements had not been sent to those entitled to receive them within the time prescribed by s 274(1) or at all. Moreover, only the balance sheet and profit and loss account were laid before the annual general meeting, without the 13 pages of notes that formed part of them and should have been attached and without which the accounts were rendered substantially meaningless.

Another grievous irregularity consisted in the non-disclosure to the annual general meeting of the auditors' qualified report upon the 1986 accounts. The report, which bears date 16 December 1986, read, in part, as follows:

"We have audited the accounts contained in pages 4 to 21, in accordance with Australian Auditing Standards.

"In determining the operating surplus for the year ended 30 June 1986, the holding company has brought to account contract income received and receivable of $25,712,925 for services rendered to government and semi-government authorities for fire, rescue and emergency services during the year ended 30 June 1986. We have confirmed the general basis of these contracts and written variations, telexes and correspondence with these authorities relating to the contract fees rendered. We have also verified that throughout the period of each contract that services were rendered by the holding company to ensure a reasonable right of recovery against contract debtors. However, at the date of this report we have been unable to confirm directly with the statutory authorities either the total amount outstanding at 30 June 1986 or the total contract income for the year then ended, save that $16,920,644 has since the balance date been received as part confirmation of these balances. In this regard, it should be noted that contract debts become payable within the 180 days terms of credit allowed under the respective contracts.

"Subject to the foregoing:

"In our opinion, . . ." etc.

The nub of the auditors' qualifications was that they could not confirm outstanding debts of nearly $27m or the turnover from trading activities which had purportedly risen from about $25m in 1985 to over $42m.

There was an issue at the trial whether the directors, or at least Messrs Eise and Cook, knew of the qualified auditors' report at the time of the 1986 annual general meeting. Counsel for the plaintiff did not ultimately press the point and I am satisfied that no director did then know of the qualified report and that none learned of it until December 1988. It must be said, however, that if there had been compliance with the fundamental provisions of the Code in relation to the accounts, including the sending of copies of accounts and associated reports and statements to members before the meeting, this litigation would probably have not arisen. It is commonly expedient to include a company's accounts in its annual report, although

strictly the Code does not require it if the accounts are otherwise sent to those entitled to attend meetings. The National Safety Council of Australia Victorian Division had not for many years before 1986 included any accounts in its annual reports. Mr Eise suggested in evidence that the reason lay in the highly confidential nature of the accounts. He also suggested, curiously, that that explained the practice, also apparently followed for many years and adopted at the 1986 annual general meeting, of laying before the meeting only what were called "abbreviated" accounts, without the notes and associated reports and directors' statements. The practice seems scarcely to square with the requirements of the Code. However that may be, the printed 1986 annual report of the company, distributed at the annual general meeting on 16 December 1986, did in that connection contain an especially objectionable statement. Under the heading "Finance" (the only reference in the report to financial matters) it was said:

"The organisation has generated a small surplus from the fees for services rendered. All persons who have a formal entitlement have received detailed audited copies of the accounts."

The statement that persons entitled "have received" audited copies of the accounts was false; and both that statement and the statement that the company had "generated a small surplus" were obviously composed and printed in the annual report before the directors had seen the accounts to which it purported to refer. The report, under the name of Mr Eise as president and chairman of the board, was seriously misleading in that it implied that the accounts and the result of the audit were known to the board when the report was compiled. In fact, the surplus of $2,449,250 recorded in the final accounts was nearly three times greater than anything the directors had contemplated before 16 December 1986.

The 1987 audited annual accounts

The audited accounts for the year ending 30 June 1987 were presented and accepted at the 60th annual general meeting of the company held on 26 February 1988 at 470 St Kilda Road. The same requirements of the Code existed in relation to them as had existed in relation to the 1986 accounts but the procedural irregularities were even greater than those in 1986.

No balance sheet or profit and loss statement relating to the 1987 financial year had been before the board during the course of that financial year. As I indicated above the first documents of that description relating to the 1987 financial year were produced to the board at its meeting on 15 September 1987. They were then unaudited. At the board meeting held on 20 October 1987 Friedrich stated that the pending production of the elaborate 1987 annual report, containing a history of the company, necessitated the postponement of the next annual general meeting. According to Mr Eise the board was also told that the final 1987 accounts would be delayed because of a change in accounting procedures. Mr Cook, the honorary treasurer, swore that he was led to believe that the audited accounts would be ready for the November 1987 board meeting. The 1987 accounts were not, however, available at the November or the December board meetings, even though by 14 December 1987 it had been decided that the overdue annual general meeting was to be held on 26 February 1988.

The board was told by Friedrich that the audited accounts were being delayed either by the company's staff or by the auditors – it is not clear which.

On 12 January 1988 Mr Eise was at the West Sale base and took the opportunity to speak there to the resident auditor, Dixon, and to Mr E D Farquhar, a partner of Horwath & Horwath responsible for the audit. According to Mr Eise he asked Farquhar whether he had anything he would like to discuss about the activities of the company or any concerns of the company and, according to Eise's evidence, Farquhar replied "that he had no concerns at all about the operation or the finances of the company. As far as he was concerned everything was 'fine, fine, fine'".

At the board meeting on 19 January 1988 the 1987 accounts were again not available but the directors were told, apparently by Friedrich, as the minutes record, that "Audited balance sheet and income and expenditure documentation for the 1986/87 financial year will be presented to the State Council at the annual general meeting". There is no indication that this remarkable statement occasioned any comment but, according to Eise's evidence, he assumed that the accounts would be considered by the board at its next meeting on 16 February. Even if the final accounts had been available for the board's consideration at the 16 February meeting they would have been too late for compliance by the board or the company with the requirements of the Code relating to them, given that the annual general meeting had been called for 26 February. On 16 February the accounts were still not available and the minutes of the board meeting on that date record that "Mr Gomm confirmed the annual audited accounts for 1986/1987 will be tabled at the annual general meeting on 26 February 1988". There is no evidence that there was any expression of concern or dissatisfaction about the further delay in the production of the accounts, although Mr Eise in his evidence said "We did expect them to be there".

Arrangements were made for a meeting of the board at 12 noon on 26 February, as Mr Eise swore, "to accept the financial statements and approve of them, if the board thought that was the right thing to do, and we all arrived at the meeting at 12 o'clock and Friedrich came in and said that he was sorry, that the auditors were late in getting the accounts out and we wouldn't receive them until just before the annual general meeting, or the State Council meeeting". The board meeting was then abandoned and the directors attended the State Council meeting at 12.30 pm (which dealt with no financial business) and the annual general meeting which, according to the minutes, began at 2.35 pm.

In the meantime Friedrich had produced the audited 1987 accounts to Messrs Eise and Cook, together with a statement of the directors upon them and a pro forma directors' report, both of which they signed just before the annual general meeting began. Mr Eise swore before me that there was a clear, unsigned audit certificate with the bundle containing the documents he signed. That evidence is inconsistent with what he swore before the Master on his examination pursuant to 542 of the Code and I feel unable to rely on it. Irrespective of that, the signature of the statement of the directors and the directors' report on 26 February was highly irregular. The directors' report purported to be made in accordance with a resolution of the board and was dated 12 February 1988. There had been, of course, no resolution of directors on any of the matters the subject of the report on or before

12 February or at all. The statement of the opinion of the directors upon the accounts, signed by Eise and Cook, purportedly on behalf of all, was also dated 12 February 1988. The directors had expressed no such opinion on or before 12 February or at all. It is plain upon the evidence that no director either gave or had any opportunity to give even the most cursory consideration to the accounts which were laid before the annual general meeting on 26 February 1988. Most had not even sighted them before the meeting.

The minutes of the annual general meeting record that Mr Cook presented his treasurer's report, but there is no written record or any other evidence of what it contained. Again, as at the December 1986 annual general meeting, only so called "abbreviated accounts" were distributed — a two-page balance sheet and a document headed "Profit and Loss Account" of four lines, showing an operating surplus of $783,351, without accompanying notes or other documents. One member (not a director of the company) complained of the procedure and is recorded in the minutes as having requested that in future the accounts be incorporated with the agenda and circulated prior to the meeting. Another asked why there was not a detailed list of expenditure, to which Friedrich replied, according to the minutes, "that a detailed expenditure and balance sheet were presented to the board each month". Yet another member queried the description of "containerised safety equipment" listed under fixed assets in the balance sheet. The minutes record that Friedrich "explained that this item collects assets used by the NSCA which cannot move under their own power". Mr Summerbell — in the capacity of a member but not as a director, for he had been appointed to the board only that day at the State Council meeting — inquired whether the accounts had been audited. Friedrich repeated his performance at the 1986 annual general meeting, replying that the accounts had been audited, and he held up a document, saying that the audit report was available for inspection. Apparently no person present sought to inspect the document, and it was not read out. Mr Eise swore that he did not read it but that it bore the signature of Price Williams, and that "it was a very, one page similar type of document that auditors give when they give a clear certificate". The meeting resolved (one abstention by the member who objected to the failure to provide accounts in advance being noted) "that the balance sheet as at 30 June 1987 and the profit and loss account for the year ending on that date, together with the reports of the directors and the auditors thereon, be received, approved and adopted". The motion was moved by Mr Cook, the honorary treasurer, and seconded by Dr Brentnall, a director, neither of whom had read the accounts or the auditors' report, and of course no other person voting at the meeting had read them.

The auditors' report which, be it noted, was dated 12 February 1988 — a fortnight before the meeting — in fact contained important qualifications and they were stated more trenchantly than the qualification to the 1986 accounts. In part the auditors' report read as follows:

"We have audited the accounts contained in pages 4 to 21 [sic], in accordance with Australian auditing standards, except as explained in the following paragraphs.

"The trade debtors of the holding company at 30 June 1987 are stated at a value of $38,562,859 after crediting as receipts direct bank deposits of $26,710,613. These receipts are from an accounts receivable facility

provided by a merchant bank pending the collection by that bank from primary contract debtors. The holding company has been unable to determine either at 30 June 1987 or to the date of this report which invoices have been paid or the balance of invoices outstanding awaiting collection. We have received confirmation from government primary contract debtors confirming that the 1986 and 1987 invoiced income was properly brought to account.

"Work in progress as stated in the accounts at a value of $8,917,068 has been brought to account as income for the year ended 30 June 1987 based on services rendered to that date. We have confirmed subsequently that invoices to this value have been raised by the company.

"Because we were unable to determine the timing of trade receipts paid to the bank and the offset against the accounts receivable facility, we were unable to confirm either the valuation of contract debtors, contract work in progress, or the bank liability outstanding under the accounts receivable facility to the holding company at 30 June 1987.

"Included in the accounts of the holding company at 30 June 1987 is containerised safety equipment at a written down value of $73,106,388. This figure comprises containerised equipment in the balance sheet of $59,843,388 and leased equipment subject to finance lease purchase arrangements and not capitalised in the balance sheet but included in note 12 to the accounts at a present value of minimum lease payments of $13,263,000. The company did not perform a physical inventory of these fixed assets as the majority of containerised assets are located in geographically inaccessible areas of Australia, and are in the custody of the end users and therefore, not subject to the company's control. Efforts to confirm directly with the contract users concerning the physical existence and valuation of these fixed assets has been unsuccessful. The company's records do not permit the application of satisfactory alternative audit procedures for the determination of existence of such fixed assets and the degree of security held by financiers.

"Accordingly, we are not in a position to and do not express an opinion on either the physical existence, the valuation, or the security of these assets held by financiers.

"Subject to the foregoing:

"In our opinion, the accounts of NATIONAL SAFETY COUNCIL OF AUSTRALIA — VICTORIAN DIVISION and group accounts, of the company and it's [sic] subsidiary companies are properly drawn up . . ." etc.

The accuracy of the curious statement in the second paragraph that "We have received confirmation from government primary contract debtors confirming that the 1986 and 1987 invoiced income was properly brought to account" is to be doubted. Putting that aside, the report may be said to have left the state of debtors and work in progress obscure, saying that the auditors were unable to confirm the valuation of contract debtors or work in progress. The report also said without equivocation that the auditors did not and could not express an opinion on the *existence or value* of the containerised safety equipment. The written-down value of this item had increased in the balance sheet from $29.2m in 1986 to $59.8m in 1987.

Again I am satisfied that no director actually learned of that qualified auditors' report until December 1988 in circumstances that I shall describe in some detail. Nevertheless the comments I have made above about

non-compliance with the Code in relation to the 1986 accounts apply with even more force here. Apart from anything else, had the accounts and the auditors' report thereon been sent to members before the annual general meeting, as s 274(1) of the Code required, it is scarcely conceivable that the company would have continued as it did. Moreover, by proposing and supporting a motion that accounts they had never considered and an auditors' report they had never seen be received, approved and adopted, the directors of the time (ie all the defendant directors save Mr Johnston, Mr Greenwood and Mr Summerbell) most seriously misled the annual general meeting. In explanation of the farce which followed after the directors had allowed Friedrich to foist the accounts upon them at the last moment before the meeting, Eise said in his evidence, with perhaps more piercing accuracy than he intended: ". . . it was really out of our control, at that stage, as far as what we could do when he said that the papers weren't ready; we couldn't cancel the annual meeting, at that stage, with everybody there."

The truth was that the whole of the company's financial affairs were then out of the control of the directors and they were never to regain it.

Most regrettably, having failed to consider the company's 1987 accounts before the annual general meeting on 26 February 1988, none of the directors obtained a copy at or after the meeting. They all remained ignorant of the accounts (quite apart from the auditors' report) for months afterwards, most until after this litigation began. Had any of the directors troubled to compare the 1987 accounts that were adopted at the annual general meeting with the draft 1987 accounts that had been presented at the meeting on 15 September 1987 (the only pretended 1987 accounts they had seen), and with the final 1986 accounts, the following figures, for example, would have been evident:

	(1) *Final 1987 Accounts* $	(2) *Draft 1987 Accounts* $	(3) *Final 1986 Accounts* $
(a) Total Assets	155,588,936	121,037,031	99,661,449
(b) Net Assets	24,392,831	24,803,730	23,593,393
(c) Current Assets	51,623,811	37,192,169	28,653,976
(d) Containerised Safety Equipment (before depreciation)	65,768,326	33,270,045	32,049,852
(e) Trade Debtors	38,562,859	30,571,264	23,861,823
(f) Current Liabilities	50,517,034	29,525,693	31,486,024
(g) Turnover	60,423,700	54,470,002	42,781,336
(h) Operating Surplus	783,351	1,194,250	2,449,250

These items are only examples. The huge discrepancies between columns (1) and (2) for items (a), (c), (d), (e), (f) and (g), along with the relative constancy in columns (1), (2) and (3) for item (b), cried out for explanation. Yet no director who gave evidence ever noticed the discrepancies, much less inquired about or investigated them.

Volume Two

The relationship between Friedrich and Eise

There is evidence that after Eise's return from overseas in August 1987 his relationship with Friedrich deteriorated.

Eise had prepared a long written report about his overseas trip and had made arrangements direct with some of the company's public relations staff, apparently to Friedrich's dissatisfaction, to have it produced and published. At the board meeting on 20 October 1987 Friedrich requested that directors refrain from direct contact with staff members. According to the minutes he "advised that the president of this company holds no special rights" and "respectfully requested that contact with staff be made either through himself or Mr Gomm, as they are responsble for the day-to-day activities of the company".

On 10 November 1987 Mr Eise went down to West Sale to speak to Friedrich about developments in the company while he had been abroad. Mr Jinkins, the vice-president who had stood in for him in his absence, went with him and on the way down wrote out a list of questions that Friedrich should be asked. Eise began to ask Friedrich some fairly elementary questions designed to elicit information about the company's financial and other affairs but was promptly rebuffed by Friedrich, who declined to answer any of them. Friedrich expressed the view, in effect, that in accordance with the company's articles Eise was entitled to no more information than that available to any other director and that any information required should be sought at board meetings or that Eise should be otherwise specifically authorised by the board to receive it. Eise accepted the humiliation and went home.

At the next board meeting, on 17 November 1987, there was extensive discussion about the role of the president. A motion was proposed to authorise a close working relationship between the president and the chief executive officer and to entitle the former to oversee all decisions of the board. Friedrich purported to produce an opinion from counsel (apparently unsigned), dated only 4 days previously, to the effect that the company's articles would need amendment if the president's role were to be more extensive than Friedrich maintained it then was. After this the discussion was inconclusive and the motion was withdrawn. The motion was reinstated and passed at the next board meeting on 14 December 1987. The minutes record, rather curiously, that Friedrich "agreed" that the motion be implemented immediately but the evidence does not suggest that thereafter the atmosphere was much changed.

During the second half of the 1988 calendar year relations between Friedrich and Eise, and indeed the whole board, seem to have further deteriorated, although perhaps no director fully recognised it at the time. The directors were told in general only what Friedrich wanted them to know. In July 1988 Eise incurred Friedrich's further displeasure by visiting a shipyard in Cairns, without first telling Friedrich, where he discovered that some repairs or extensions to the "Blue Nabilla" had gone awry.

On 6 September 1988 Horwath & Horwath sent Friedrich an important report of 13 pages, together with flow charts, headed "Review of Administrative Procedures and Information Flows". The report recited a litany of "major problems in office administration at West Sale". These

included a lack of "written procedures to identify responsibility levels within the organisation to indicate who should receive mail and who should be provided copies of documents on a 'need to know basis'"; an inefficient filing system; a lack of administrative procedures for routine maintenance of major contracts and of administrative accounting procedures for purchasing fixed assets. By way of conclusion the auditors said: ". . . weaknesses exist at West Sale for the administration of all contracts and finance documentation which we believe is due to a combination of lack of delegation, poorly defined accountability and responsibility levels at all hierarchy levels in the organisation."

The report made a series of detailed recommendations designed to rectify the stated defects. The probability is that the report was not brought to the attention of the board. Eise swore that he did not see it before 21 December 1988. It was particularly important that the board should have been aware of the auditors' concerns at about the time of the report because, at a board meeting on 19 August 1988, it had been decided that Friedrich, in conjunction with Messrs Johnston and Greenwood, should prepare a draft policy statement dealing with aims, objectives and strategies of the company. That group of three met on several occasions and a so called "strategy plan" was generally approved at a board meeting on 20 September 1988.

On Sunday, 2 October 1988 there was published in the Sydney *Sun-Herald* a long article by one Wendy Bacon making unfavourable insinuations about the company, especially in relation to some of its financial affairs. Having read the article with considerable concern, Eise began and painstakingly pursued an elaborate series of inquiries about Friedrich's curriculum vitae and formed the view that some of the information in it was suspect. He suspected in particular that Friedrich might be an illegal immigrant. He unsuccessfully sent interstate and overseas for a copy of Friedrich's birth certificate, but did obtain a copy of his marriage certificate, and explored suggestions in the newspaper article that illegal payments had been made to or by Friedrich out of the company's money. He even went so far as to consult the Chief Commissioner of Police with a view to pursuing a rumour that Friedrich was a foreign agent. Although the inquiries were inconclusive, and Eise kept the results of them largely to himself, it seems plain enough that in his mind Friedrich was under a cloud of suspicion from early October 1988 onwards. Eise denied in evidence, however, that he had any reservations about Friedrich's competence or honesty until many months later.

Arrangements with the State Bank of Victoria

Being without equity captal, and having no means of capital growth, the company was financed almost entirely by debt. Its use of borrowed funds was always necessarily a critical characteristic of its economy but, unlike most other highly-geared companies, it had no need to satisfy any expectations of financial dividends. All these elements of the company's make-up were exploited by Friedrich but their significance seems sometimes to have escaped the directors.

Until May 1988 the company's principal bank was the ANZ but it had dealings with several others as well. In June 1987 the company obtained from the State Bank of Victoria an overdraft facility of $2.5m and a cash

advance facility of $6.5m. Copies held by the State Bank of what purport to be minutes of board resolutions (signed only by Friedrich) dated 16 June 1987 approving the arrangement bear scant relation to the company's official minutes and were presumably bogus. The amount of the cash advance facility was increased in July 1987 to $8m, apparently without reference to the company's board. Thereafter the State Bank of Victoria pursued a determined strategy, as the bank's internal memoranda record, to "ease out" the ANZ Bank from its position as the company's principal bank. A file memorandum dated 11 September 1987, made by Mr M Palmer, the senior manager, Corporate Banking, Frankston Region, is eloquent testimony of the State Bank's anxious struggle for custom: "It is felt that should we be successful in wresting this facility from ANZ then we will become NSCA's principal banker transacting all day to day banking business. With an annual turnover of $50m + this is seen as attractive. The exposure for the bank in the Latrobe Valley would be excellent as a result and could only be beneficial to the bank's marketing efforts in that area."

By way of enticement the State Bank ultimately allowed the overdraft facility to the company without security.

Arrant propaganda by Friedrich secured the confidence of officers of the State Bank of Victoria, who were led to regard loans to the company as virtually without risk. In particular the bank was influenced by the composition of the State Council of the company (which included nominees of government departments), the calibre of its supposed debtors, its supposedly indispensable place in the community and invulnerable position in an almost competitor-free market. Friedrich angled disarmingly for his catch, rejecting an offer of a bill of exchange facility of $27.5m made by the State Bank in October 1987, and holding out for a larger facility. By April 1988 he played upon the supposed need for a huge working capital facility because of the stated imposition by government departments of 180 day terms that he claimed were not being honoured. This led Mr Palmer to remark in a sanguine internal memorandum that: "In effect government liquidity problems are being shouldered by the NSCA which is comforting from a lender's viewpoint. NSCA's status (non profit-making and tax exempt) and its role as a provider of community service in the fields of health, safety and emergency services render it for practical purposes a quasi government body. It has developed and grown to such an extent that it has in my view become indispensable."

By 12 May 1988 Friedrich led the State Bank of Victoria to believe that "ANZ is becoming increasingly suspicious" and thus to make an offer, as a matter of supposed urgency, of a number of facilities by letter dated 16 May 1988. At the company's board meeting held the next day (part of which was recorded on a tape in evidence) Friedrich announced that "We have a formal facility letter from State Bank which allows us to place all of it [meaning, it seems, all the company's banking business] with the State Bank if we choose". Some rambling and unguided discussion followed about that (which was not an agenda item) in the course of which Friedrich said he had brought the Bank's letter along in case anyone should want to see it. No one did. There was some associated discussion about acceptance of another offer by the State Bank of a performance guarantee (which was an agenda

item) in connection with a lease to be executed by the company. It is far from clear what the board approved or understood but the minutes of the meeting contain this garbled passage:

"Motion: Whereas a letter of offer, dated 16 May 1988 of Victoria to this company to provide additional credit facilities totalling $57,846,800.00 to refinance credit facilities in place with other lending institutions and to provide a performance guarantee it was resolved to accept the same and sign the form of acceptance and return it to the State Bank.

"It was further resolved that the directors present be authorised to execute documentation in accordance with cll 15, 32 and 47 of the letter of offer.

"Moved Mr Cook, seconded Mr Johnston. Carried unanimously.

"Confirmed that this minute be accepted as a true record of the proceedings of this meeting.

"Moved Mr Jinkins, seconded Mr Johnston."

The three lines at the end of this passage are unusually puzzling.

On the very day of the meeting — 17 May 1988 — Friedrich and another employee of the company signed on the company's behalf an acceptance of the facility offered by the State Bank's letter of 16 May. Whether or not the directors understood at the meeting that they had authorised what the minute set out, it was confirmed without recorded comment at the next meeting of the board on 21 June. In these unpropitious circumstances the contract for a very substantial finance facility was made between the company and the State Bank of Victoria. Within a fortnight of 17 May Friedrich had drawn upon the bill facility for some $41m, apparently without the board's knowledge.

The "additional credit facilities" of $57,846,800 referred to in the minute brought the company's agreed accommodation by the State Bank to this:

overdraft at the Traralgon Branch of the bank	$ 2,250,000
cash advance facility with bill option	$ 8,250,000
bill of exchange acceptance and discount facility with cash advance option	$50,000,000
bill of exchange acceptance and discount facility	$ 7,200,000
	$67,700,000

By letter dated 11 July 1988 the State Bank of Victoria offered, at Friedrich's instigation, to add to the existing facilities an unsecured standby bill facility with a cash option of $10m. On 19 July 1988 the board resolved that the company accept that addition. Friedrich and another employee had, however, already accepted it on the very day it was offered — 11 July. Internal memoranda of the State Bank suggest that the bank did not wait upon the board's resolution before allowing the newly-offered extension to be used. The entire range of facilities provided by the State Bank of Victoria was fully drawn down by 14 July 1988 to the extent of over $77m.

The overdraft accommodation provided by the State Bank to the company was not specifically supported by security. As to the rest of the facilities the bank supposed that it held securities over real property and registered first fixed debenture charges over containerised safety equipment and motor vehicles and a registered first fixed and floating debenture charge

over debtors. The evidence indicates that at no stage, either before granting the facilities or until the company's collapse, did the State Bank of Victoria make any useful investigation to ascertain the existence or value of the containerised safety equipment or of the debtors over which it assumed it held security. The fact was that these securities were practically worthless having regard to the enormous debt that they were intended to secure.

The overdraft facility was temporarily increased to $9.75m in September 1988, and this without any authorisation by the board of the company or, it seems, any attempt on the part of the State Bank to ensure that there was such an authorisation. By 6 October 1988 the bank had allowed the overdraft, without any formal authorisation, to exceed $12m and by 13 October to exceed $14.5m. By November the overdraft exceeded $23m, although it had reduced by 3 January 1989 to $10.3m. By 26 January it had extended again to some $22m. This debt was not only unsecured but its incurrence was unauthorised except by implication in that the State Bank simply allowed it to happen. On 26 January 1989 the company's total liability to the bank exceeded $103m. To the bank, Friedrich pleaded default by government departments in making payment of debts as necessitating the excesses on overdraft.

The 1988 end-of-year accounts

I have referred briefly to the management accounts that were from time to time provided to the board, up to its meeting on 19 July 1988, in respect of the year ending 30 June 1988. At the board meeting on 17 May 1988, according to a tape-recording and its transcript in evidence, Mr Eise as chairman asked the honorary treasurer, Mr Cook, whether he wished to speak to the item "Finance Report". The honorary treasurer's entire recorded response was: "No, all I can say about the finance report is to generally continue to make a profit and everything seems to be fair and above board." [sic]

If that was not typical there is practically no evidence of any reliable kind to indicate a different quality of discussion by the board during the financial year ending 30 June 1988 of the company's financial position.

At the board meeting held on 19 August 1988 Friedrich stated that financial accounts for the 1988 year would be "available for the October meeting" and he made a similar announcement at the September board meeting. The October meeting, as I have stated, was not held. In October the company secretary had tentatively arranged that the next annual general meeting be held on 18 November.

With the agenda papers for the next board meeting, held on 2 November 1988, there were included a balance sheet "for period ending June 1988" together with a so called profit and loss account for the 1988 financial year, and a so called summary profit and loss statement showing an operating surplus for the year of $626,818. By memorandum to the board dated 24 October 1988, also sent with the agenda papers for 2 November, Friedrich proposed that these accounts be approved. For a variety of reasons, on which it is unnecessary to dwell, the accounts sent with the agenda papers for the 2 November meeting were in no state to receive board approval. At the meeting Mr Summerbell expressed some concern about their format, as appears from the minutes and from the tape-recording of part of the meeting that is in evidence. Friedrich pleaded that

the auditors needed more information, after receiving guidance from the board about the form of the accounts to be laid before the forthcoming annual general meeting, but in truth what he had served up to the board was a lamentable concoction. The board did not realise this at the time, even though the surplus for the year was then said to be over five times what the surplus for the same year had been reported to be at the meeting on 19 August. Not only were the 1988 figures distorted in the balance sheet but many of the 1987 figures (shown in the 1988 balance sheet ostensibly for comparison with the 1988 year) did not equate with the actual audited 1987 figures. As an example the 1987 figure for sundry creditors, as shown in the 1988 balance sheet for comparison with the current year's figure, was $2,040,338 whereas the 1987 audited figure had been more than double that — $4,140,663. There were many other such discrepancies which the directors did not pick up because, for one reason, none of them ever studied, and most did not even obtain, a copy of the 1987 balance sheet.

After the board meeting of 2 November Friedrich went away professedly to give further information to the auditors and to arrange that they attend the next board meeting to explain the accounts. The projected annual general meeting was put off.

By memorandum dated 11 November 1988, sent with the agenda papers for the next board meeting on 15 November, Friedrich advised that "Following a meeting with a partner of our audit firm, complete annual accounts in a form requested at the last meeting will be available, complete with all notes etc by 29 November 1988. A consolidated statement, including subsidiaries will be included in these accounts". The meeting on 15 November therefore did not advance the matter of the 1988 accounts save that the board agreed that it must give itself sufficient time to consider them properly and that they should be presented to the next meeting. No representative of the auditors attended. The annual general meeting was put off again.

The next board meeting was due to be held on Tuesday 13 December. With the agenda papers Friedrich sent a memorandum to the directors advising that the 1988 accounts had been bound and forwarded separately and that a partner of Horwath & Horwath would attend the meeting to answer questions about them. Some accounts, marked "Draft", and showing an annual surplus of $526,597, were forwarded to the directors a few days before 13 December together with an unsigned draft unqualified auditors' report. On 9 December Friedrich telephoned Eise and asked whether, as a favour to him, the meeting of 13 December might be postponed so that he could keep an appointment on that day to go to hospital for an operation. With some reluctance Eise agreed and the meeting was re-fixed for 31 January 1989. On the morning of 13 December Eise telephoned Mr Farquhar to tell him of the postponement of the meeting (of which it seems Farquhar already knew) and remarked that it was a pity the auditors had not been able to get the papers out earlier because the board would have liked to have had the meeting weeks ago. Farquhar thereupon, according to Eise's evidence, referred to three pages of "papers of explanation" which he assumed the directors would have received. Having received no such thing Eise was surprised to hear what Farquhar had to say and arranged to call on him the next day, 14 December, to pursue the matter. Eise's evidence suggests that Farquhar advised

Friedrich of Eise's intended visit and Friedrich (who apparently had not gone to hospital after all) telephoned Eise asking to accompany him to the auditors, but Eise refused to allow it: he wanted to talk to the auditor without Friedrich. Shortly afterwards, as Eise swore, Farquhar telephoned Eise (no doubt at Friedrich's instigation) seeking to postpone a discussion between them until 31 January at the next board meeting, and saying that he had only been referring to working papers. Eise, however, insisted that the consultation go ahead.

So it was that on 14 December 1988 Mr Eise went with Mr Summerbell to the offices of Horwath & Horwath where the two spoke with Farquhar and his senior partner, Mr P M Williams. Eise surreptitiously made a tape-recording of part at least of the conversation, a transcript of which, prepared by Eise, was in evidence. I have no reason to doubt Eise's evidence about this episode or the correctness of the transcript. In the course of the meeting Williams stated that the audit of the company's 1988 accounts had not been completed and that no audit report had been issued. When Summerbell expostulated at this revelation Farquhar said in effect that if the audit report were then signed it would have to contain three pages of qualifications. The two auditors explained that a principal difficulty was to confirm the allegedly outstanding debtors and that half of the letters requesting customers to confirm their debts had not yet been dispatched by the company in accordance with the audit program. They made it very plain that there was a critical problem about verification of amounts of trade debtors, which they said stood in the draft 1988 accounts at $45m. Eise asked (as the transcript of his tape reveals): "Is there a possibility that the recorded income we have been told we will get is incorrect?"

Williams answered: "I can't say yea or nay. I cannot categorically state that all the income has been properly brought to account, or that some income has not been brought to account, or overstated."

Surprisingly, the auditors seem to have dissuaded Eise from taking away with him, or even sighting, a copy of the "papers of explanation" to which Farquhar had referred on the telephone the previous day. Overnight, however, Eise had second thoughts and sent to Farquhar for them on 15 December. He received by hand from Farquhar on the same day a draft auditors' report for 1988 containing not only a series of qualifications but a disclaimer, together with copies of the qualified auditors' reports for 1986 and 1987. Eise promptly convened an extraordinary meeting of the board for 21 December 1988.

The draft auditors' report for 1988 was copied by Eise to the other directors. It read as follows:

"To the members of NATIONAL SAFETY COUNCIL OF AUSTRALIA — VICTORIAN DIVISION

"We have audited the accounts contained in pp 4 to 29, in accordance with Australian auditing standards, except as explained in the following paragraphs.

"The trade debtors of the Council at 30 June 1988 are stated at a value of $71,006,573 after crediting as debtor receipts direct bank deposits of $25,020,418. While the Council believes that these deposits represent income collections from primary contract debtors by various banks

providing temporary account receivable loan facilities, no documentation has been made available to substantiate the validity of these receipts as income received during the year.

"In our audit report for the year ended 30 June 1987 we referred to unreconciled bank deposits of $26,710,613 paid by a merchant bank and credited against trade debtors under a temporary accounts receivable loan facility. As at 30 June 1988 and to the date of this report the council has not received a reconciliation from this bank of 1987 and 1988 income collected against [sic] trade debtors.

"The Council has therefore been unable to determine at 30 June 1988 or to the date of this report which sales invoices have been paid or the balance of outstanding invoices awaiting collection.

"At the date of this report we have been unable to obtain audit confirmations from either the government primary contract users confirming the 1988 income or the banks confirming the loan facility balances and validity of income receipts credited against trade debtors. We have been unable to employ alternative audit procedures to prove contract income such as verification of contracts and assets in use.

"Accordingly, we are unable to determine whether the valuation of trade debtors, contract work in progress recorded in the accounts at $85,014,431 or the 1988 turnover income of $70,286,182 which has been brought to account as income for the year ended 30 June 1988.

"Included in prepayments are recoverable rotary maintenance costs by an overseas unrelated corporation relating to a helicopter exchange program and amounting to $3,394,248. These costs reflect excess engine and airframe maintenance costs of the Council's helicopters used in the program by the overseas corporation and are recoverable in the form of flying hour credits available to the Council by the use of exchange aircraft in Australia. The Council has valued these flying hours at $1320 per hour while the exchange lease agreement states an agreed maintenance rate of $300 per hour. The Council has not confirmed with the overseas corporation the higher $1320 rate. Consequently we believe that prepayments and the operating surplus are overstated by $2,662,828 representing the unconfirmed rate increase in prepaid maintenance recovery.

"Included in current assets are loans to subsidiary corporations of $1,198,793. These loans represent unsecured advances to a subsidiary corporation to enable it to purchase an overseas investment in Nova Scotia. Because the subsidiary company is economically dependent on the Council and currently unable to pay [sic] loan account within 12 months, we believe that the advance should be disclosed as a non-current asset, the recovery of which should be reviewed annually.

"Included in creditors and borrowings are trade creditors amounting to $2,355,437. We have not been provided with a listing of creditors balances or a control account reconciliation of the purchases ledger to the general ledger creditors control account at 30 June 1988. We are therefore unable to comment on the completeness of these trade accounts at 30 June 1988.

"During the year the Council rescheduled a significant proportion of [sic] bank debts with a major bank. This included the transfer of an accounts receivable facility and a consolidation of a significant number of chattel mortgages and finance leases with the bank. Material transactions on this bank account have not been recorded or reconciled in the books of account

of the Council. We have not received all the bank confirmations, information and explanations that we require at the date of this report. Bank confirmations of secured or unsecured debt that have been received to the date of this report disclose material unreconciled differences with the accounts. The Council has requested bank statements from the primary bank to record the transactions into [sic] books of account and to enable a reconciliation of [sic] other finance debts.

"The Council has not disclosed a lease commitments note disclosing its liabilities under finance and operating leases over a prescribed 5 year period and reconciled to the liabilities in the accounts. The Council has partially adopted the provisions of the standard by capitalising the current and non current portions of finance liabilities in the accounts, but is unable to provide a further breakdown of [sic] non current liabilities over their lease terms. This is a departure of an approved accounting standard ASRB 1008 Accounting for Leases. We do not agree with the departure from the standard.

"The Council has not conducted a comprehensive physical inventory of [sic] containerised safety equipment to confirm the physical existence and valuation of these assets either at balance date or to the date of this report. The Council has not been able to provide an accurate listing of either the location or number of physical units so as to enable us to sight a limited sample of containers or confirm their existence directly with the contract users. The company's records do not permit the application of satisfactory alternative audit procedures for the determination of the existence and valuation of these assets. We have therefore been unable to confirm the existence of these assets.

"The Council has not provided us a fixed assets and depreciation movements listing reconciling material movements and depreciation charges of its leased and owned fixed assets. We are therefore unable to comment on either the completeness or valuation of these assets at the balance date.

"In our opinion:

"We have not obtained all the information and explanations that we have required. Because of the existence of material uncertainties referred to above, and because the possible effects of the ultimate resolution of those uncertainties on the state of affairs of the Council and of the group, and on the loss of company and group for the year ended on that date could, in our opinion, significantly affect the overall truth and fairness of the matters dealt with in the accounts, we are unable to express an opinion on the accounts for the year ended 30 June 1988.

"Proper accounting records and other records (with the exception of the registers) have not been kept in accordance with the provisions of the Code, and

"We are unable to report in respect of the other matters required by s 285(3) of the Companies (Vic) Code.

HORWATH & HORWATH
Chartered Accountants
Price M Williams – Partner
500 Collins Street
MELBOURNE, VICTORIA"

The report drew attention to the following areas of concern, among others.

- Problems relating to trade debtors that had been referred to in the previous year's audit report remained unresolved and the amounts for trade debtors and work in progress could not be verified for the 1988 year.
- Income for the 1988 year, said to be $70.2m, could not be verified.
- The amount of $2,355,437 for trade creditors could not be verified.
- Material transactions with the State Bank of Victoria had not been recorded or reconciled in the company's books.
- The existence and valuation of containerised safety equipment again could not be verified.

It is to be noted that the draft auditors' report, in the third-last paragraph, referred to "the loss of company and group for the year". The draft 1988 accounts that the directors had received for the meeting of 13 December showed, as I have said, not a loss for the year but a surplus of $526,597. There is no evidence that any director adverted to the auditors' reference to a loss, or to the possibility that the accounts provided to the board differed from those provided to the auditors.

Meanwhile, on 20 December, Messrs Eise, Summerbell, Cook and Jinkins had another meeting at the offices of Horwath & Horwath with Williams and Farquhar. The auditors reiterated the points they had made at the meeting on 14 December, emphasised that the company's accounts had not been kept in accordance with the Companies Code, suggested that consulting accountants be engaged to advise upon rectification of the accounting problems and arranged to attend the board meeting to be held the next day. Farquhar provided Eise with a discussion paper of some five pages and attachments, dated 19 December 1988, dealing with outstanding audit and accounting matters.

The board meeting of 21 December 1988

The board meeting held on 21 December at St Kilda Road was of high importance in the company's history for what it revealed, then and there, to the directors present — all save Dr Brentnall. The meeting lasted some 3 hours and a tape-recording of much of it, together with a transcript, were in evidence. The history of the two recent meetings with the auditors was rehearsed. Eise and Summerbell expressed their consternation at having discovered the past qualified auditors' reports and the uncompleted current audit. Friedrich asseverated, "categorically, absolutely categorically" that Eise had been aware that the 1986 accounts were qualified, thus flatly contradicting Eise's word. There followed various allegations against, and counter allegations by, Friedrich which it would be both tedious and unrewarding to canvass here. What emerged from the free-ranging discussion was that the directors present were made well aware that the company's financial administration was a shambles. Blame for it was laid in various quarters but again I shall not canvass the detail of that.

Farquhar went through his discussion paper of 19 December, paragraph by paragraph. He pointed out to the directors present in simple terms, and explained with unmistakeable directness, the grave shortcomings of the company's accounting procedures and the problems they had produced. He explained that the auditors could not determine in the previous (1987) year

the amount of outstanding trade debtors and that they were in the same position for the current (1988) year. The item had risen in the company's accounts, according to Farquhar, from $38m in 1987 to $71m (according to the version of the accounts he had) and Farquhar said "We can't account for the income". He discussed in elaborate detail the procedures that had been attempted, without result, to obtain confirmation from debtors of their indebtedness as stated in the company's accounts. Friedrich was asked to explain why it was that half of the letters seeking confirmation from debtors had not been sent. His answers were nonsense, often contradicting Farquhar's statements of fact but providing no sensible explanation of the position. Farquhar also stated that, as matters stood unexplained, the subsidiary Conair would show a loss for the 1988 financial year of $2.1m. He pointed out that a number of bank statements relating to transactions with the State Bank of Victoria were missing from the company's records, that other material transactions had not been recorded or reconciled in the company's books of account and in particular that the Project Account with the bank had not been recorded in the company's books at all, Friedrich evaded explanations and his excuses were fatuous.

Farquhar gave his opinion that "probably the most disturbing feature of the whole thing" was the auditors' inability to verify the existence or value of the containerised safety equipment stated in the accounts at some $65m – about half the value of the company's fixed assets. Friedrich's attempted explanations were essentially puerile. Farquhar made the point that not only the existence of the containers (supposedly some 278 in number) could not be verified but that the alleged income from their use could not be accounted for. Manifestly, as the board was made aware, the problem was not new. Farquhar stated that he had been concerned about the containers for 2 or 3 years: the point had been made in the 1987 audit report and it remained unresolved. Friedrich protested that it could be cleared up but when asked how long it would take to do so – weeks or months – he replied "I couldn't tell you". He said, with bland effrontery, "Mr Chairman there are containers from empty through to $500,000 worth of value and above, and we will provide Mr Farquhar on our return to Sale with the list – which does at the moment not match all the finance contracts, however the – at the same time I am sure that it can be relatively readily by telex obtained from the major users as to – that they have got control of them as has been done last year." Eise was well alive to the point and expressed his concern, although in a not very sophisticated way. He said: "I would say it is very serious to the extent if the people who are financing us were to inquire and see this report here that you have got in front of you about the containers, and it got around the traps, it might be very difficult to get finance. And we could be in hell of a lot of trouble." Farquhar mentioned again the need for a qualified finance controller. He agreed with Mr Johnston's assessment that the audit qualification had been made on the basis that the auditors had not received information and not because they had information that anything was wrong. Nevertheless, the mood of the meeting was to accept Mr Summerbell's proposition that ". . . quite frankly we have to do something about this and we have to do something very quickly Mr Chairman, because we are in a very nasty situation . . ."

Another remarkable revelation at the meeting was made by Mr Gomm who was then, it seems, the general manager of the company and the

executive officer second-in-command to Friedrich, and had from May 1986 until May 1988 been the company secretary. When asked what he had to say about the qualified auditors' report for the 1987 financial year he said at first that he did not recollect the qualifications. Farquhar asserted that he and Williams had discussed the qualifications in the report in detail with Friedrich and Gomm in February 1988. After that Gomm conceded that Farquhar might be correct and said "I may have been there and I may have had these things brought to my attention. The only excuse that I can give for it is my understanding at the time that financial matters were not the responsibility of the company secretary – so that it may have eluded me . . ."

I have no sworn evidence at the trial from Mr Gomm.

According to the minutes Farquhar summarised his requirements as auditor to be the confirmation from financiers of their advances, the return of reconciliations from financiers, the provision of bank statements from the State Bank of Victoria and production of an inventory of containerised assets. The board passed a series of resolutions noting various matters "with the gravest concern" and in particular resolved:

(a) to require an opinion and recommendations from its solicitors upon the board's obligation to disclose to the State Council the qualified auditors' reports for 1986 and 1987;

(b) ". . . that in the best interests of the efficient and effective operation of the [company's] financial affairs, it should appoint an independent firm of accountants . . . to examine the [company's] financial procedures and recommend to the board what steps should be taken to ensure that proper accounting records and systems are in place in accordance with the Code. This report to be in our hands within 90 days if possible but certainly prior to the end of the financial year. A subcommittee comprising the president, Mr Greenwood, Mr Johnston and Mr Cook to make the appointment . . .";

(c) to note "with the gravest concern our auditors' Horwath & Horwath reports in 1987 and again in 1988, their inability to conduct an appropriate audit of the Council's containerised safety equipment valued in excess of $53m"; and to instruct the chief executive and the financial controller "to take immediate steps to conduct a physical inventory of these containers. This inventory to be undertaken in conjunction with Horwath & Horwath and an appropriate independent agency as expeditiously as possible and a progress report made to this board by 31 January 1989."

On 22 December 1988 Farquhar wrote to Eise expressing his concern that the board meeting on the previous day had not considered the timing and dispatch of audit confirmation letters that he had indicated he required to be sent forthwith on company letterhead. He again set out his requirements in detail, but they were never met.

The advent of Ernst & Whinney

On 28 December 1988 Eise consulted Messrs Graeme Richardson and D N Balcombe of Ernst & Whinney, chartered accountants, at home and outlined to them the board's areas of concern as discussed at the meeting on 21 December. He also referred to the contents of the article in the

Sun-Herald by Wendy Bacon, to difficulties between Friedrich and some of the directors and to his own reservations about the truth of some of the statements in Friedrich's curriculum vitae. On the strength of what Eise told him Mr Richardson prepared a written proposal to conduct an investigation into certain of the financial and accounting issues that had arisen within the company. The proposal was designed to review the procedures and accounting practices of the company and to consider a selection of types of transactions with a view to determining whether the procedures and accounting practices adopted had been effective and complete. If they were found not to comply with the requirements of the Code recommendations were to be made with a view to achieving compliance. Richardson's proposal was approved on 30 December by the subcommittee of the board that had been appointed on 21 December. Eise confirmed the appointment of Ernst & Whinney by letter dated 4 January 1989 and on 6 January he and Cook introduced Balcombe at West Sale to Friedrich and other employees of the company. Balcombe and other staff of Ernst & Whinney spent much of the rest of January conducting the review, making a number of further visits to West Sale, consulting Friedrich and other company staff and studying the company's accounting and other records. Balcombe and Richardson prepared a comprehensive report of some 55 pages dated 27 January which was distributed to the directors and later considered at a board meeting on 31 January.

I shall do no more then refer to some of the essential features of the report. It was then no part of the brief given to Ernst & Whinney to become involved in the completion of the current financial statements and their review was in no sense an audit. They reported that attention, and in some cases immediate attention, was required to improve the basic procedures within the company's accounting system. They said "No irregular transactions or impropriety was detected in the course of our review, but it should be emphasised that such detection was not the primary objective of this review". They referred to the failure, due to slow transmission of data to the accounts section, to record several liabilities, including the State Bank of Victoria overdraft account styled "Project Account". They found that the State Bank of Victoria overdraft liability had varied after its commencement from up to $10m to a then present balance of approximately $4m (as the report said, though the debit balance was then close to $23m) without being recorded in the company's accounting records. They found also a large unreconciled difference between debtors as recorded in the debtors' ledger and in the general ledger: at 4 January 1989 the general ledger showed accounts receivable at approximately $65m whereas the detailed debtors' ledger showed a balance for accounts receivable of approximately $108m. A similar difference had existed at 30 June 1988. The report indicated that there were "several areas where we believe that controls and procedures have broken down to such an extent that financial data produced to (and potentially to be produced) to the board is inaccurate". Having referred to the shortcomings in general terms, the report made a series of recommendations for rectification.

In the meantime, during January 1989, the auditors had been pressing for the information they required but they made little headway. The reported their difficulties in writing twice in January to the honorary treasurer but he

did not respond. In a memorandum to the board dated 19 January 1989 Friedrich reported that the balance sheet at 31 December 1988 was "not yet available".

The board meeting of 31 January 1989

The tape-recording (with transcript) in evidence of proceedings at this meeting reveals understandable tension between the board and Friedrich and between some of the directors themselves. There was unedifying recrimination but little positive fact finding. Williams and Farquhar reported that there was still much information required before an audit could be satisfactorily completed for the 1988 financial year. Balcombe and Richardson spoke to their report of 27 January and summarised their findings in simple terms. The report gave the directors little if any indication of the financial position of the company and certainly no support for a supposition, let alone a conclusion, that the company was financially sound. On the contrary it served to reinforce an already obvious conclusion that the accounts and accounting procedures were in a deplorable state of disarray. While it is true that no irregular transactions or improprieties were said to have been detected, that was scarcely a comfort to the board having regard to the terms of Ernst & Whinney's instructions and the object of the report. The report, as Mr Balcombe was at pains to explain in his evidence, was an attempt to express a point of view formed by reference to generalities rather than examination of particular transactions or balances or receipts. As a result the report mentioned very few specific transactions. It contained few figures and, in so far as there were any, they tended to be disturbing. For example, Mr Summerbell at the meeting of 31 January described the difference of $43m for debtors at 4 January 1989 between the debtors' ledger and the general ledger as "frightening". He was well justified in saying so.

Notwithstanding the assurances that Friedrich had given at the last board meeting, the company was no further forward at the meeting on 31 January in the resolution of the matters of containers, trade debtors and the State Bank of Victoria Project Account. Moreover, the accounts for 1988 were still nowhere near ready for audit. The state of accounts for the 1989 year – already more than half-spent – was largely unknown. The gravity of the position was well appreciated by Mr Eise. Responding to one of Friedrich's lame explanations for the failure to enter the Project Account into the company's books he exclaimed that "There could be millions of dollars – we don't know yet – that we are behind".

There was at the meeting on 31 January a particularly vivid demonstration of Friedrich's intransigence. Eise described to the meeting a visit he had made on 27 January to the Frankston branch of the State Bank, which was not far from where he lived. He had gone, as he said, to make himself known as president to the bank staff and to seek information upon the company's accounts and finance facilities with the bank of which (as a matter of fact) he knew practically nothing. He was told at the bank that the trading account was $21m overdrawn, although the approved limit (as he was also told) was $2.25m. Nevertheless, as he reported to the meeting, the bank staff expressed themselves to be satisfied with the operation of the account because of what Friedrich had told them. He asked for some further information but, after having been kept waiting for a quarter of an

hour, was told that he could not have it without a written request, and he left the bank without it. Mr Greenwood disclosed at the board meeting that he had been in Friedrich's office at West Sale at the time of Eise's visit to the bank, when a bank officer had telephoned through to ask Friedrich whether Eise might have the information he sought and that Friedrich had in effect forbidden it. The revelation was eloquent evidence of Friedrich's willingness to obstruct Eise's simple, if naive, inquiries even at a time when — as Mr Greenwood aptly said at the meeting ". . . we need to find out what our financial liability is, and then we need to pick this organisation up from its knees, where I believe it has fallen, and get it going". Eise expressed himself in forthright terms at the meeting about Friedrich's loyalty, saying:

"I haven't got confidence in the chief executive that he will give me the things that I ask for. That's the reason why I go direct — I haven't got confidence in the chief executive because the accounts have been qualified, we know nothing about it. We have got a banking account where there could be millions in interest that has never been entered — now that's the reason why I believe if I can't get things from the chief executive and when I do ask here this morning — the reason why we have got Ernst & Whinney up there, and you read these reports, as the chairman, I believe that it is my responsibility to go down to that bank, talk to them, tell them nothing about our business, and in our conversation when they talk about leases they talk about money, they talk about interest, which they give me copies of, [sic] my responsbility as the chairman to say whether I would like a copy of the leases if you have got them, just so that I can show them to the board. That's the way I spoke to them."

Friedrich spoke dismissively and insolently about the episode; but, despite the expressed and obvious ill will, he was allowed to continue as chief executive at a time when he was demonstrably impeding the board and the auditors. A conclusion to be drawn from the evidence is that the board did not get rid of Friedrich because it was obvious that if it did so the whole house of cards would fall.

The board received and considered a letter of opinion dated 13 January 1989 that had been sought from its solicitors, Messrs Westgarth Middletons, pursuant to the first of its resolutions of 21 December set out above. Referring to the auditors' reports for the 1986 and 1987 financial years, the letter advised, among other things, that: ". . . there is no specific obligation on the directors to now report to members of the company that they were unaware of the qualified nature of the auditor's report . . . provided the directors have met their primary duty of ensuring that the accounts for those years were properly made out, no liability can attach to them for being unaware of the nature of the auditor's reports. Accordingly we do not believe it is necessary for the board to raise the issue of past audit reports at the forthcoming annual general meeting." Not surprisingly, some of the directors expressed themselves to be uncomfortable with that advice.

After long discussion the report from Ernst & Whinney was received and it was resolved, among other things, that that firm be requested to take steps with the object of producing unqualified financial statements for the period ending 30 June 1988, to prepare accounts for the current financial year up to 31 January 1989 as soon as possible and to provide progress reports to each successive board meeting. A further subcommittee consisting of

Messrs Eise, Cook and Summerbell was appointed to discuss with Ernst & Whinney matters which might arise between board meetings.

Thereafter Ernst & Whinney's brief somewhat altered.

The events of February 1989

Early in February 1989 there was a suggestion from one of the company's employees – a former director, Mr Athol Hodgson – that the company should consider purchasing the undertaking of Conair, in which it already had some interest and with which it had previously been working fighting fires in Canada. A meeting of the board had been convened for 7 February to discuss the notion. On 2 February Eise sent a memorandum to Friedrich. He said:

"To help the board evaluate the feasibility or discuss the possibility of submitting a bid for the purchase of CONAIR it needs to have complete understanding of our current financial position.

"Please include with the paper to be sent to directors for the forthcoming meeting at 10.30 am on Tuesday 7 February 1989 a summary statement of the following:

1 list of all banks, and their locations, which are currently providing facilities for us listing the "account names", the number, current status of the account (amount of the credit balance or overdraft or whatever) and the limit to which we can overdraw on the account if necessary;
2 list of all other facilities provided by banks including "factoring" etc;
3 financial planning schedule of dates on which overdrafts will be paid off, what amounts of interest are or will will [sic] be incurred, and by what means these accounts will be cleared;
4 financial plan outlining the proposed measures you would use to finance the purchase of CONAIR, what would be the proposed limit of our offer and the cost involved."

The memorandum, it may fairly be observed, gives some further indication, if any be needed, of the extent of the board's and Eise's want of understanding of the basic financial affairs of the company as late as February 1989. Friedrich responded to Eise in a memorandum of 3 February strongly recommending that the proposal with respect to Conair be indefinitely postponed. The board meeting called for 7 February was accordingly cancelled. Eise nevertheless pressed Friedrich in a telephone conversation on about 3 February to provide the financial information sought by his memorandum of 2 February. Eise received another rebuff in astonishing circumstances, particularly in the light of the preceding month's revelations. According to Eise's evidence Friedrich, when so pressed, said to him: "Max, if I jump over the cliff, you will follow." Eise swore that initially he treated this as a joke but that Friedrich told him he was "very serious". Eise's evidence was that he then became concerned because he associated the remark with others Friedrich had made months before to the effect that he did not want to see Eise hurt. Eise's concern was sufficient to induce him to report the matter to the Federal and State police. Nothing further came of it and it remains to say that Eise did not receive the financial information he had sought and that Friedrich was allowed to continue in office as chief executive with undiminished authority.

Ernst & Whinney prepared a further proposal designed to implement the board's resolution of 31 January. The subcommittee approved it on 7 February at a meeting at which Richardson recommended that Friedrich be stood down. After a further fortnight's work Ernst & Whinney made a progress report dated 20 February which was discussed at a board meeting on 21 February.

The report of 20 February recited that an initial priority was to conclude the June 1988 financial statements to a position where the auditors would be able to issue an audit opinion which was as unqualified as possible. The work was not in the nature of an audit or indeed a check of the audit procedures being undertaken by Horwath & Horwath. The report noted that the State Bank Project Account, previously unrecorded, had now been accurately recorded and was $10,042,725 in overdraft. $28,127,512 had been paid from it, including unrecorded expenses of $1,542,401. The report noted that "this fact brings into severe doubt the validity of financial data supplied by management to the board in the period until now". The report told also of deficiencies in fixed asset identification and valuation and indicated that no significant progress had been made by staff in the area of identification and reconciliation of debtors and provision for doubtful debts, thus causing concern. The report also dealt in a little detail with the Hodges account and noted that within the last 2 weeks entries had been raised to create four invoices and debtors of approximately $14.5m as at 30 June 1988. The four invoices related to four payments received *by* the company from J Hodges Nominees Pty Ltd over the 1988 financial year. The report said that "We have requested that full details be provided to us to support the bona fides of the invoices and sums received from Hodges". By way of conclusion the report said that "It was disturbing to note the magnitude of unrecorded transactions which emerged from the analysis of the State Bank 'Project Account'".

At the board meeting on 21 February Mr Cook advised that he had been told by the auditors that they agreed with Ernst & Whinney's assessment of the condition of the accounts and were "proceeding and getting the debtors into line". The matter of containers remained wholly unresolved — and this notwithstanding Friedrich's undertaking given at the board meeting held 2 months previously to "provide Mr Farquhar on our return to Sale with the list . . ."

Two representatives of the company's solicitors were present at the meeting and discussed a long letter of advice, dated 21 February and tabled, dealing with the directors' duties and other matters concerning the next annual general meeting, the date for which had, it seems, by now become indefinite: the Commissioner for Corporate Affairs had refused an application for an extension of time for holding it, the application having been made out of time. According to the minutes the solicitors explained that "A qualified audit was not fatal and that auditors have a duty to report to the members. There is a duty on the directors to act reasonably and the qualifications to the audit should be looked at factually and in light of what corrective procedures have been taken." Messrs Richardson and Balcombe spoke to their report of 20 February. Mr Summerbell remarked that the board was not getting any progress reports on the company's present financial state and asked how long that situation was likely to continue having regard to the fact that Ernst & Whinney had reported, in effect, that

the past management accounts were (as he said) "hardly worth the paper they were written on". The minutes record that the report was received but no course of action seems to have been resolved upon save to allow Ernst & Whinney to continue their existing task. Mr Balcombe's evidence was that to the best of his recollection the board decided to give Friedrich another week to satisfy the requests that had been made of him.

The events of March 1989

By the end of the first week in March Balcombe was little further advanced in his quest to obtain information. To that time he had pursued a policy of cautious assiduity but now he began to assert himself. He recognised that he was encountering not merely passive resistance from Friedrich, but active obstruction, and advised the subcommittee accordingly at detailed and intensive meetings on 9 and 10 March at which Mr Eise was present. These meetings were apparently precipitated by a memorandum to Eise from Mrs Pollard, the company secretary, dated 9 March. She referred in it to continuous delay in the completion of the 1988 accounts and audit, thus delaying the convening of the annual general meeting. She expressed concern that insufficient attention had been given by the board and officers of the company, as the responsible parties, to the timely completion of accounts in accordance with the Companies Code and legal and professional advice received. She continued:

"This situation cannot be allowed to continue and it is my strong advice to you that the problem must be addressed immediately.

"It has also become evident that this company's major financiers are concerned in not being able to receive updated management accounting and the board's attention must be directed to the consequences of further delays in the transmission of this vital information."

The memorandum combined urgency with frustration and in writing it the company secretary went over the head of Friedrich, as Mr Eise must have realised.

The meetings of 9 and 10 March were of importance but I shall not dwell on their description for they apparently covered, although with emphasis, the shortcomings in the company's accounts and accounting system which had already been drawn consistently to the board's attention. Contemporaneous notes made by Mr Cook and put in evidence indicate, together with his and Mr Balcombe's oral testimony, that the matter of the Hodges account was much discussed, as were the difficulties in reconciling against debtors' balances the amounts that had been received, or purportedly received, from Rothschild Australia Ltd. The inability of Ernst & Whinney to make headway in their attempted verification of containers was also discussed at length. The meetings considered the matter of invoices raised by the company at 30 June 1988 to cover the $14.5m paid to Hodges, there being no evident contract to support them. Balcombe told the subcommittee that his investigation suggested that some $46m had passed through the Hodges account in 12 months. Trade debtors of $76m at 30 June 1988 – an increase of some $40m in 12 months – could not be reconciled. Balcombe pointed out that the books showed outstanding debts of $17m to be owed by the State Electricity Commission at the end of the 1988 financial year, and that no agreement to support those debts had been found. (In fact none existed.) Balcombe also told the subcommittee that no

real effort seemed to have been made to collect the debts. The possibilities were raised that assets were being "double financed", that there were undisclosed bank accounts and that certain customers' invoices might not be enforceable. There were also questions raised whether advances received from Rothschild Australia Ltd were in truth payments on account of debtors or whether they were loans.

These revelations and queries did not provoke any immediate action by the board but on 14 March Balcombe presented a further written report to the subcommittee. The report referred to the matters which had been discussed at length at the meetings on 9 and 10 March, expressed extreme concern about them and gave detailed particulars of the concern, with supporting figures. Balcombe told the subcommittee, as he swore, that he had "found it totally unsatisfactory dealing with the chief executive and had spent some hours with him on 7 and 8 March 1989 without getting any meaningful response from him, that I did not trust what the chief executive told me and that I had told the chief executive just that".

At a board meeting held on 15 March 1989 Balcombe spoke to his written report of the previous day and orally expanded it. He said that he had not been able to obtain any confirmation or verification of the nature of the amounts in the suspense account. He pointed out that at 30 June 1988 uncollected invoices for sales had been outstanding for an average of 13 months, which he described as "preposterous". He was asked whether there was evidence of fraud but answered that it was too early yet to say. There were contributions by directors to the debate to the effect that in the last 3 months no progress had been made to resolve the company's difficulties and that, although it was initially thought that this could be done within a reasonable time, a reasonable time had passed. The minutes record that Mr Richardson indicated a sound basis for these expressions of concern. According to the minutes he said, "There are some fundamental questions [answers to] which have not been provided and there is an element of gross uncertainty in massive terms relating to forms of debtors, assets and creditors. No accurate accounting records have been kept."

Mr Dixon, of the company's solicitors, was present at the meeting and spoke to a letter of advice dated 14 March. According to the minutes he advised that the board should carry out the recommendations of Ernst & Whinney, relieve the chief executive of his duties and require him to account for his conduct to date and take steps to ensure the continued operation of the organisation.

On 15 March 1989 the board resolved that Friedrich be stood down, but not dismissed. He was directed to provide all the information that Ernst & Whinney had sought in the past and which they might seek in the future and to present a written report to the board by 21 March containing a full explanation of his management. The board also resolved that Friedrich in the meantime be relieved from all his other duties and that Mr Gomm carry out all the normal duties of the chief executive, subject to the direction of the board.

On 17 March Mr Balcombe spoke with Mr Wayne Sommerville, who had been in charge of stores at the West Sale base, and learned from him that he had supplied about three generators and one pump for containers and not the quantities of 50 generators and 25 pumps referred to in the company's documents for 1988-1989. Sommerville was unable to verify the existence of

the containers. From 17 March onwards Balcombe commenced to gather further information from direct inquiries to debtors. By 20 March he was satisfied that the figures for actual debtors to the company did not in any way correlate with the company's records. His review of the records showed a pattern, over a period, of misdescribing loan receipts from financial institutions as collections from trade debtors. He concluded late on 20 March that supposed debts of at least $50m, if not all the amounts shown for trade debtors, with the exception of about $1.2m, were fictitious and uncollectable.

On 21 March Friedrich suddenly resigned as chief executive. On the same day Richardson and Balcombe advised the directors that it was possible that $106m of trade debtors could not be collected and that they doubted the existence of containers said to be valued at $86.8m which the company purported to have obtained. They told the board that fictitious invoices to financiers had been used to finance the company, that the company appeared to be insolvent, that it should not incur further debts and that steps should be taken immediately to place it in liquidation. The board took immediate steps for the appointment of a provisional liquidator and an appointment was made the next day.

Quantification of the plaintiff's claim

Cash advances

Reduced to simple terms the plaintiff's claim in respect of cash advances by the State Bank of Victoria to the company is made up as follows:

1988	*Advance* $	*Repayment* $	*Balance* $
31 May	41,547,458		41,547,458
2 Jun		21,547,458	20,000,000
14 Jun	7,903,148		27,903,148
21 Jun	3,000,000		30,903,148
22 Jun		23,000,000	7,903,148
27 Jun	1,187,000		9,090,148
29 Jun	2,500,000		11,590,148
30 Jun	2,500,000		14,090,148
5 Jul		5,000,000	9,090,148
8 Jul		1,187,000	7,903,148
13 Jul	8,100,000		16,003,148
	66,737,606	50,734,458	

Although each cash advance was initially made for a short period of days, each was in general rolled over, ie re-advanced, until (except for the advances made on 14 June and 13 July 1988) it was repaid. The advance of $7,903,148 first made on 14 June and the advance of $8,100,000 first made on 13 July were not repaid and, having been rolled over from time to time, together constitute the outstanding balance of $16,003,148 for which the plaintiff claims under this head.

Bills of exchange

Each of the four repayments made by the company to the State Bank of Victoria in respect of cash advances to it, referred to in the table above, was

made by the application of the discounted net proceeds of bills of exchange drawn by the company and accepted and discounted by the State Bank of Victoria, and later rolled over, thus:

Bills drawn	*Face value of Bills*	*Maturity date*	*Dates of rollovers*
2 Jun 88	$22,245,832	1 Sep 88	1/9/88 to 3/3/89 3/3/89 to 3/4/89
22 Jun 88	$23,724,130	14 Sep 88)	14/9/88 to 14/10/88) 14/10/88 to 7/12/88
5 Jul 88	$ 5,134,555	14 Sep 88)	7/12/88 to 6/2/89) 6/2/89 to 8/3/89
8 Jul 88	$ 1,187,000	14 Sep 88)	8/3/89 to 6/6/89
	$52,291,517		

At the date of the appointment of the provisional liquidator of the company — 22 March 1989 — the face values of bills of exchange drawn by the company and accepted by the State Bank of Victoria were $22,245,832 maturing on 3 April 1989 and $30,045,685 maturing on 6 June 1989. At their maturity dates the bills were paid by the State Bank of Victoria to the third parties to whom it was liable in the capacity of acceptor. The plaintiff's claim under this head is calculated accordingly.

Overdraft account

The company's indebtedness to the State Bank of Victoria on 21 March 1989 upon a trading account numbered 721-7107-6153 was $28,410,333.13. The company drew cheques on the account and used it also for effecting telegraphic transfers and making other payments that were directly debited. The account was established in (it seems) 1988 following which innumerable debits and credits were posted to it as a running account. The plaintiff limits its claim, however, so as to exclude the debts incurred on the account before 1 January 1989. The aggregate amount of the debits to the account after 1 January 1989 was $31,652,171.22. There were net credits to the account during the period from 1 January 1989 of $3,241,838.09 which, when applied to the debts incurred during the same period, reduced the latter, thus:

debits	$31,652,171.22
credits	3,241,838.09
	$28,410,333.13

The gross aggregate of the credits to the account in the period from 1 January was $15,843,889.82 and there was some debate (although the point was but faintly pressed for the defendant Eise) whether those credits ought to be offset against the debits of $31,652,171.22 incurred during that period. What the plaintiff has done in its calculations is to apply the deposits to the account of $15,843,889.82 in the period from 1 January 1989 first in reduction of the opening debit balance on 1 January 1989 and also against fees, interest and tax etc incurred by the company in the period from 1 January 1989, thus:

aggregate credits		$15,843,889.82
opening debit balance	$10,044,225.22	
fees, interest, tax, etc	$ 2,557,826.51	
		$12,602,051.73
leaving a net credit of		$ 3,241,838.09

In my opinion the plaintiff's calculation appropriately reflects the amount of the debts incurred by the company to the State Bank of Victoria for advances made to it after 1 January 1989 upon its current account by the debit to the account of the amounts of cheques drawn by and direct payments made for the company. In the absence of agreement to the contrary, accepted practice in accordance with the rule in *Clayton's* case (1816) 1 Mer 572 requires that credits to the account during the period from 1 January 1989 be applied successively to meet debts existing at 1 January before being applied to those incurred after 1 January 1989. It is also appropriate that credits to the account after 1 January be appropriated to bank fees, tax and interest incurred by the company in respect of the account during that period. If they were not so appropriated the aggregate net debits of $31,652,171.22 would be correspondingly increased so that the ultimate debit balance of the account would remain the same — $28,410,333.13, which is the sum the plaintiff claims under this head.

Evidence of the plaintiff's proof under s 556(1)

The company's admitted insolvency cannot by itself get the plaintiff home. Yet, in order to succeed, the plaintiff need not prove the company's insolvency. What the plaintiff must prove in order to put the defendant Eise to proof of a defence is that, immediately before the incurrence of the relevant debts to the State Bank of Victoria, there were "reasonable grounds to expect", in the sense I have indicated, that the company would not be able to pay all its debts as and when they should become due.

I turn now to analyse the evidence bearing upon the question whether there were reasonable grounds so to expect. In doing so I remind myself that counsel for the defendant Eise invited attention to two principles to be particularly considered in the construction and application of s 556. The first is that, because the section contemplates potential criminal liability as well as potential civil liability, it is to be construed and applied with a strictness appropriate to provisions of that kind. I note, without setting it out, what Southwell J said about that in *Hussein v Good,* supra, at ACLR 717; ACLC 397, and to what Hodgson J had to say about it in the *Metal Manufactures* case, at ACLR 130; ACLC 746-7, especially in reliance on the dictum of Isaacs J in *Scott v Cawsey* (1907) 5 CLR 132 at 154-5. I believe the interpretation I have adopted obeys the precept, which is essentially one of statutory construction. It is, however, not out of place to bear it in mind when considering the application of the statute to the facts, and then in association with the second principle on which counsel relied referable to the degree of persuasion: *Helton v Allen* (1940) 63 CLR 691. The plaintiff's proof should be "clear and cogent, such as to induce, in a balance of probabilities, an actual persuasion of the mind" as to the existence of the facts that the statute requires as a prerequisite to liability: cf *Rejfek v McElroy* (1965) 112 CLR 515 at 521; *Brigginshaw v Brigginshaw* (1938) 60 CLR 336 at 361-2. The nature and gravity of the findings that the plaintiff

seeks to establish, and their potential effect on the defendant Eise, demand that the principle should be borne steadily in mind here.

I am of course concerned principally with the question whether there were "reasonable grounds to expect" immediately before the time of the incurrence by the company of the relevant debts, the earliest of which was incurred on 31 May 1988. Obviously, however, evidence referable to earlier times may bear upon the answer to that question in order to provide a proper context.

The significance of the board's and the company's failures to comply with the requirements laid upon them respectively by the Code in relation to the 1987 accounts and the annual general meeting held on 26 February 1988, and the circumstances of the failures, cannot be overemphasised. The management accounts provided to the board up to mid-1987 had been insufficient to enable the board to form any reliable view of the company's financial position at 30 June 1987. The only balance sheet and profit and loss statement the board had ever had before it in respect of the 1987 financial year were those distributed at the meeting on 15 September 1987. The board never considered at a board meeting before the annual general meeting held on 26 February 1988, or at any time thereafter, the final accounts for the year ended 30 June 1987. Most of the directors never even saw them before this litigation began.

It is difficult, although perhaps possible, to imagine that a director properly doing his job would not have known at the annual general meeting on 26 February 1988 of the contents of the auditors' report on the 1987 accounts. After all, the auditors were required by s 285(2) of the Code to furnish their report *to the directors* in time to enable them to cause the company to attach it to or endorse it on the accounts to which it related; and it was the obligation of *the directors* pursuant to s 275 to cause copies of the accounts, together with copies of their own report pursuant to s 270, their statement required by s 269(10) and the auditors' report, to be laid before the meeting for consideration. Mr Eise told me, in effect, that he was unaware at the time of the trial of these requirements laid upon the directors. There was evidence that Mr Cook and Mr Jinkins each took steps to provide the directors with elementary but practical textbooks describing the duties of company directors. Some of the texts were put in evidence but the extent of their digestion by the directors was not made evident.

The requirement of s 275 of the Code that a copy of the auditors' report be laid before the annual general meeting of the company is no mere formality. In my opinion a director ought usually to know, in general terms at least, at the time of the annual general meeting what the report contains. In England, to emphasise the importance of an auditor's report, there has for the whole of this century been a statutory requirement that the report be read, ie read aloud, at a general meeting: see, now, Companies Act 1985 s 241(2). The same requirement obtained in Victoria until the enactment of the Companies Act 1910: Companies Act 1896 s 33(3). By the 1910 Act it was provided that the auditor's report should be read before the company in general meeting if any member so desired and that it should be open to inspection by a member at any reasonable time: s 121(4). That has remained the position ever since: Companies (Vic) Code s 285(7); and the Corporations Law s 332(7). The relaxation of the requirement in this State that the auditor's report should inevitably be read at a general meeting

(whether any member required it or not) did not in any way diminish the importance of the report. In the present case s 274(1) of the Code and the company's articles of association combined to assume that each director, being necessarily a member of the company, should receive a copy of the auditor's report before the holding of the annual general meeting.

Let it be assumed that, for some sensible reason, a director properly performing his duty did not actually know at the time of the 1988 annual general meeting what the 1987 accounts and the auditors' report contained. In that case he would, if properly doing his job, and using no more than common sense, have called for and considered both the accounts and the report within a relatively short time after the holding of the meeting that had purportedly received, approved and adopted them. He would have done so in order to keep himself abreast of the company's affairs for the purpose of carrying out his director's duties. I cannot countenance the notion that a director should be heard legitimately to say that he carried on as a director, and involved himself in the company's affairs in that capacity, for any appreciable time after an annual general meeting had received, approved and adopted annual accounts and an auditors' report thereon and yet did not know the substance of what both the accounts and the auditors' report had to say. It is of the essence of the responsibilities of the directors of a company such as the National Safety Council Victorian Division that they should take reasonable steps to place themselves in a position to guide and monitor the management of the company by reference to information appropriate for the purpose. Considering simply the directors' responsibilities during the 1988 calendar year, a knowledge of the 1987 audited accounts and of the auditors' report thereon were part of that information. Upon considering the 1987 accounts and the auditors' report thereon the director seeking to do his duty would have found without difficulty (if he did not already know it):

- that the company's stated total current assets ($51.6m) at 30 June 1987 were not greatly in excess of its current liabilities ($50.5m); and (again if he did not previously know it) he would have seen also from the 1987 balance sheet that in the previous year (1986) the stated current liabilities ($31.5m) had exceeded its current assets ($28.6m);
- that stated trade debtors and work in progress together at 30 June 1987 ($47.4m) had increased in the year (from $26.8m) by some 77%, and that the auditors had not been able to confirm the valuation of contract debtors or work in progress at 30 June 1987;
- that reported turnover for the 1987 financial year of $60.4m exceeded reported expenses (of $59.6m) by merely 1.3%, producing a reported surplus of $.783m; and that the reported receivables equalled nearly 80% of the year's turnover;
- that the balance sheet item for containerised safety equipment (before depreciation) was stated at $65.7m, being 63% of the stated non-current assets and 42% of stated total assets; that the item had increased in the year (from $32m) by 105%; and that the auditors were not in a position to verify the existence or value of any of these assets;
- that advances and loans to the company reported in the balance sheet were approximately $115m, $91m being secured and $24m

being unsecured, and equalled some 74% of the stated total assets of which some 73% could not be verified — ie the unverifiable assets nearly equalled the reported advances and loans.

These figures, and the calculations I have indicated, are not complicated. They could, I think, be fairly easily appreciated by any adult person of normal intelligence who had a general knowledge of the company's activities and an inclination to consider the accounts and the auditor's report for half an hour. A non-executive director of a company whose figures they were should, in my judgment, have been able to derive from the documents at least the simple propositions I have set out. The company was not an elementary organisation operating in a back yard, but one with a stated annual turnover of $60m, having stated liabilities of at least $131m and the use of very substantial resources and some hundreds of employees: its affairs demanded an appreciable degree of diligent application by its directors if they were to attempt to do their duty. The deserved degree of application should have enabled an appreciation by a director of its 1987 accounts and the audit report thereon at least to the extent I have indicated.

The state of the company's affairs disclosed by its 1987 audited accounts and the audit report was in my view well sufficient to occasion anxious inquiry by a director properly performing his task as a director.

The figures disclosed in the 1987 accounts were, of course, those at or up to 30 June 1987. The director properly performing his duty at, say, the beginning of March 1988, and having previously been put on inquiry, would surely want to know the up-to-date position about verification of amounts of receivables and the existence and value of containerised safety equipment. He would have received no balance sheet at all at any date beyond 30 June 1987 — over a period of 8 months. Had he made inquiries of Friedrich he would no doubt have been rebuffed as Mr Eise had been in November 1987. In short he would have been no further advanced in his quest for knowledge. The balance sheet at 31 December 1987, provided at the board meeting on 15 March 1988, showed trade debtors and work in progress (called renderables) as having increased to $73.6m (as against $26.6m at 31 December 1986 and $47.4m at 30 June 1987); and revenue for the half year to 31 December 1987 was said to be $29m. The balance sheet as at 31 March 1988, received for the meeting on 17 May 1988, showed trade debtors and renderables as having increased together to $90m and income for the 9 months from 30 June 1987 was said in an income and expenditure statement to be $47.6m. There was still no evidence of verification of these balance sheet items or of the existence or value of containerised safety equipment.

On 31 May 1988 the directors of the company did not know what the company's debts were at that date. The best they knew was that according to the balance sheet at 31 March 1988 the company had liabilities of $174m, and that it had assets of $193m of which trade debtors and renderables ($90m) and containerised safety equipment ($63.7m) constituted about 79% which, for all the board knew, could not be verified. A question now arising is whether the facts I have described gave a person properly seeking to perform the duties of a non-executive director of the company on 31 May 1988 reasonable grounds to say: "I expect that the company will not be able to pay all its debts as and when they become due." I am of the clear opinion, upon the balance of probabilities, that the answer to that question must be

yes. Such a person would not have been able to say, upon those facts, that the company's liabilities exceeded its assets, but that is not the point. There were in my opinion such reasonable grounds immediately before 31 May 1988 and they would then have been evident to any director who had conscientiously turned his mind to the question. The sheer size of the company's loan liabilities, considered in combination with the rate of their increase during the 1988 financial year and the circumstances, including the duration, of the auditors' and the company's failure *and inability* to verify the only possible means of meeting them, strikingly demonstrated reasonable grounds to expect that the company would not be able to meet them. The company had no equity capital, it was funded almost entirely by debt and its cash flow was parlous. According to the latest balance sheet (as at 31 March 1988) the company purportedly had current liabilities of $56.1m, and current assets of $78.3m of which some 92% could not be verified by its auditors; and it purportedly had non-current liabilities of $80.6m, and fixed assets of $104m of which some 63% could not be verified by its auditors. The inability of the auditors to verify receivables had continued since 30 June 1986 – a period of 23 months; and their inability to verify the existence or value of containers and containerised equipment had continued for 11 months. Of course, the auditors had not made a report since that dated 12 February 1988, but there was a resident auditor from whom in the meantime the directors had not heard, or sought, a word.

The supposed liabilities of debtors were to pay huge sums to the company, said largely to have been outstanding long beyond soundly imaginable commercial limits. These were not supported by any contracts that the directors had seen, or knew of, or even authorised beyond giving Friedrich blanket authority to negotiate. Most of these debts depended, so far as the directors knew, purely on Friedrich's say so. It was, in short, a fantasy, and by May 1988 there were reasonable grounds for its recognition as such by the directors.

To suggest that the existence and valuation of containerised safety equipment could not be verified during a period of 11 months was absurd. All of the equipment was supposed to have been under lease or some other form of finance arrangement. If it existed its existence and identity should have been readily ascertainable from finance or insurance documents, even if its whereabouts could not. Moreover, the very nature and purpose of the supposed equipment – safety equipment and the like for use in emergencies – were such that the company's capacity to locate and use it at short notice was surely imperative. If it could not be readily found and used the company had no legitimate business to have it at all; and if it could have been readily found and used its existence and description should have been verifiable with equal readiness.

These facts alone were in my opinion sufficient in May 1988 to constitute "reasonable grounds" for the expectation referred to in s 556(1)(b)(i), but they cannot be regarded in isolation from a body of other facts that, in association with what was to be learned from the 1987 accounts and the auditors' report thereon, considerably strengthened the grounds for the expectation. For at least the last 2 years there had been serious breaches of the Companies Code with respect to the preparation of the annual accounts and reports thereon by the directors; the accounts and reports had not been provided to the members; there had been no financial controller appointed,

as the articles had required since November 1986 and as the auditors had more than once seriously urged. The requirement of the articles that the honorary treasurer should be "responsible to ensure that the financial and accounting obligations of the company are carried out" had been practically ignored. Dominion over the company's financial affairs had reposed with Friedrich, to whom the board had delegated a huge, unfathomable task. Moreover Friedrich had been given unsupervised power to make payments and contracts on behalf of the company, so that the directors were quite out of touch with the company's contractual arrangements, such as they were. The making of the contract with the State Bank of Victoria on 17 May 1988 was itself an example of the way in which the power was exercised by Friedrich. Although the board approved it on 17 May, in the circumstances I have described, the directors and each of them remained wholly unaware for at least 6 months of even the broad nature of the contract save for what the unsatisfactory minutes indicated. When on 31 May Friedrich drew down $41m under the facility, reasonable grounds existed in terms of s 556(1)(b)(i) of the Code; and, in my opinion, such reasonable grounds existed thereafter, immediately before each succeeding debt was incurred by the company to the State Bank.

The knowledge available to the board of the company's financial position did not much alter between 17 May and the end of October 1988, but by the meeting of 2 November it should have been evident to every director giving reasonable attention to the matter that the 1988 end of year accounts of which Friedrich sought board approval were unreliable — and indeed the board did realise it. The figures in those accounts were then over 4 months old. The management accounts relating to the period after 30 June 1988 gave the board no jot of information — at any time — about the company's assets and liabilities.

When Mr Eise learned on 15 December 1988 that the 1986 and 1987 audit reports had been qualified he had actual knowledge of their contents, although it seems that he still did not refer to the 1986 and 1987 accounts. Because he had such actual knowledge it is not necessary to attribute to him at that stage the knowledge of a director seeking properly to perform his duties. This actual knowledge, together with what was revealed at the meetings with the auditors on 14 and 20 December, and at the board meeting on 21 December, a fortiori gave any director seeking properly to perform his duties reasonable grounds in terms of s 556(1)(b)(i). In addition there was the substantial body of facts pointing to Friedrich's untrustworthiness including the fact, that had by then become obvious, that he had misled the board and two annual general meetings about the auditors' reports. If Eise believed he had seen signed and unqualified auditors' reports at the annual general meetings held in December 1986 and February 1988 he must now have known that they were bogus.

Eise insisted throughout his evidence, when this body of facts was drawn to his attention, that at no time before 21 March 1989 did it occur to him either that Friedrich was in any material respect untrustworthy in his financial management or that the company was unable to pay its debts. In my opinion Mr Eise's expressed appreciation of the facts was unrealistic, to say the least. It does not square with what he said, for example, at the board meeting on 21 December or with his answers upon his examination before the Master pursuant to s 541 of the Code. Notwithstanding his sworn

evidence at the trial I am satisfied that there were reasonable grounds to expect, in terms of s 556(1)(b)(i), in May 1988. By December 1988 they were much stronger, and as time went on they strengthened further. The plaintiff needs to demonstrate no more than that there were reasonable grounds to expect, but it is perhaps appropriate to say that, in my opinion, by 21 February 1989 the basis for an expectation of the company's inability to pay its debts had gone beyond one fairly described as providing merely reasonable grounds. Yet the company continued to incur debts of many millions of dollars in the succeeding month.

For these reasons I conclude that the plaintiff establishes its case under s 556(1).

Evidence of the defendants' proof under s 556(2)

In my opinion the defendant Eise has not made out the defence raised under s 556(2)(b)(i).

It was properly pointed out by counsel for Eise that the present case is a far cry from, for example, *Morley's* case, where the defendant director took no substantial interest at all in the affairs of the company of which she was a director. Here, by comparison, it was submitted, Eise took an active and lively interest in the company and did all that could be reasonably expected of him to keep abreast of its affairs. It was said that for years he had no reason to suspect, and had no reasonable means of discovering, Friedrich's misfeasance as chief executive officer. It was further submitted that the 1987 accounts that the directors had certified – albeit without considering them at a board meeting – on their face showed the company to be in a position in which it would have been able to pay all its debts. The same was said of the draft accounts for the 1988 year. Both the 1987 final accounts and the draft 1988 accounts, it was submitted, concealed rather than revealed the true position, and this because of Friedrich's deceit. As to the financial information given to the directors for the period after 30 June 1988, it was submitted that it should be considered in the light of the circumstances in which it was presented – with oral explanations and a treasurer's report to the effect that all was well. In short, it was submitted that the directors at no relevant time until late in 1988 had any cause to go behind the information they were given, for the circumstances were such that no director acting reasonably was likely to expect that anything was amiss; when, towards the end of 1988, Eise's suspicions were aroused he diligently pursued his inquiries; and when real doubts arose about the company's finances he summoned the aid of the auditors, independent investigating accountants and solicitors, and sedulously followed their advice; even after the discovery of the qualified auditors' reports for 1986 and 1987, Farquhar assuaged doubts, making no suggestion of fraud or insolvency. The argument was that Eise could not reasonably have been expected to do more than he did, and that what he did involved no falling short of his duties as a director. His only mistake, it was said, was the same mistake as that of the State Bank of Victoria: he fell to the audacious and fraudulent deception of the chief executive officer.

It is true enough that the directors, including Eise, did not know or suspect in May 1988 what the company's financial position was. For that they blame Friedrich's fraudulent conduct. Mr Eise said more than once in his evidence that the matter of the company's financial difficulty never

crossed his mind before December 1988 and even after that. He merely assumed that all was well and had never had occasion to think otherwise.

It is to be steadily remembered, however, that the board was the controlling body of the company and that the directors, including Eise, did not take reasonable steps that were open to them, and should have been taken by them, to obtain proper financial information. That was so for at least 2 years before May 1988. The management accounts in each of the 1986 and 1987 financial years were insufficient to keep the directors in touch with the company's financial affairs from time to time. Moreover, the fact is that the board did not during the company's lifetime properly consider the final 1986 accounts and it did not consider the 1987 accounts at all. Yet in each of those years the accounts bore a statement signed by Eise purporting to be made in accordance with a resolution of the directors pursuant to s 269(9)(a) of the Code. That was in direct contravention of the Code. It was also contrary to common sense, as was Eise's failure personally to inform himself of the contents of the 1986 and 1987 accounts, and the auditors' reports thereon, that were received at annual general meetings and accepted by the members on the faith of the directors' assurance. Having regard to what the 1986 and 1987 accounts and the auditors' reports contained, I consider that Mr Eise falls far short of proving that, at 31 May 1988, he did not have reasonable cause to expect in accordance with s 556(2)(b)(i). In the circumstances his reliance on Friedrich's assertions, express or implied, and his own assumption that the company was financially sound, did not entitle him to say that he did not have reasonable cause to expect. Eise claimed also to have relied on the company's staff and auditors but he did not take the trouble to ascertain and read what the final accounts and the auditors' reports thereon had said. Indeed, I have difficulty in appreciating how Mr Eise can rely on the 1986 and 1987 final accounts as part of the proof of his case — irrespective of what they said — because he did not read them. However that is, the contents of the accounts and of the auditors' reports go far to negate his proof of his want of reasonable cause to expect, even if he did read them.

It is fair to say that the nature and strength of the plaintiff's proof in this case under s 556(1) make Mr Eise's task under s 556(2) a difficult one. This is so because the material adduced by the plaintiff to show that, objectively, there were *reasonable grounds* to expect under s 556(1) included a great deal of evidence that tends to negate an absence of *reasonable cause* to expect on the part of any individual director. I shall not repeat what I said above by way of review of the evidence of the plaintiff's proof, although much of it is equally relevant here. It is worth emphasising, however, that by 21 December 1988 there was so much information actually available to Mr Eise about the company's financial position, and he expressed such reservations about Friedrich's honesty and management, that the difficulty of proof of an absence on his part of reasonable cause to expect at that date is compounded. I refer in particular to the very appreciable doubt that the evidence available by 21 December 1988 to Mr Eise, when objectively considered, cast upon the existence at 30 June 1988 of considerably more than half of the company's assets. This evidence is of the utmost importance. He continued, in the face of this evidence, as he swore, to have

no qualms about the company's continuing ability to pay its debts. Evidence of the company's financial position after 30 June 1988 was, as I have said, almost nil.

It is true again that none of the professional advisers of the board at or after 21 December 1988 expressed a positive finding of fraud or commercial insolvency for another three months. Section 556, however, does not in my opinion depend for its operation on positive proof of insolvency or the absence of such positive proof. A director does not prove that he did not have reasonable cause to expect etc at a particular time by calling evidence that expert advisers had not advised him by that time that insolvency was proved to their satisfaction.

Counsel for Mr Eise relied upon the evidence of Mr Balcombe of Ernst & Whinney, who was the only witness called on behalf of the defendants apart from eight of the nine defendants themselves and Mr Palmer of the State Bank of Victoria. In accordance with principle I think it is reasonably to be inferred that no employee of the company – leaving aside Mr Gomm – could have assisted the defendants in making a case under s 556(2) or negating the plaintiff's case under s 556(1): *O'Donnell v Reichard* [1975] VR 916 at 929. Mr Balcombe swore in effect that until 20 March 1989 or thereabouts there was a range of explanations for the company's financial position and the state of its accounts, of which commercial insolvency was only one. Balcombe's evidence was said to corroborate the advice he gave to the board, and on which the board reasonably acted, and to show the skill of Friedrich's operation, because he deceived Balcombe, too, until the end. If Balcombe's evidence is offered as a basis for a conclusion that there were no reasonable grounds to expect etc (in terms of s 556(1)), or that Eise did not have reasonable cause to expect etc (in terms of s 556(2)), I do not accept it as providing such a basis. Mr Balcombe initially adopted a very cautious approach to his task, and no doubt properly so having regard to his interpretation of the terms of the instructions given to Ernst & Whinney. He was not until early in March 1989 inquiring about fraud or insolvency. He came to his task with very little background knowledge of the company, and is to be contrasted with Mr Eise who had been a director of the company for 20 years and president for about 18. Realistically, it is fair to suppose that, having learned on 21 December what they did, the directors could and should have been taking immediate steps to verify the amounts of trade debtors and containerised safety equipment in the company's books. Had Friedrich not had dominion over the accounts, contrary to the company's articles of association, the necessity to obtain such verification would presumably not have arisen. Given, however, that there was a necessity, verification could and should have been attempted, and the results known, within quite a short time. What in fact ultimately happened was that Balcombe satisfied himself within 3 or 4 days, after beginning an inquiry directed to the point on 17 March 1989, that most of the figures in the company's accounts for trade debtors were bogus. The inquiry, apparently, was made by the simple and obvious expedient of telephoning a number of the supposed debtors. Evidence of a more durable kind, by letters, was obtained by Mr C T Daly, as agent for the State Bank of Victoria, generally inside a fortnight, following the appointment of a provisional liquidator. Mr Daly learned within that period that about 98% of all debtors in the company's books were spurious. As to the existence of containerised safety

equipment, Balcombe made a simple inquiry of Somerville, the stores officer, on 17 March which promptly exposed the fraud. I refer also to my comments above as to the absurdity of the idea that emergency safety equipment could not be readily found and identified if it existed.

It is fanciful to suggest that the supposedly huge assets of receivables and containerised safety equipment, which stood between the company's solvency and its insolvency, could not have been promptly verified if they had existed at any time from May 1988 and onwards. Having regard to the 1987 accounts and the auditors' report thereon of which Mr Eise should in my opinion have known – taking a generous view – at latest by the end of the first quarter in the 1988 calendar year, it is not possible fairly to conclude that he did not have *reasonable cause* to expect at 31 May 1988 that the company would not be able to pay all its debts as and when they became due. A simple and prompt check could and should have been made which would have revealed that those assets were largely illusory. If I am wrong to say that such a check should have been made before 31 May 1988 I nevertheless think it clear that such a check could and should have been made within a short time of 21 December 1988, which would have exposed Friedrich's fraud and the insolvency of the company.

For these reasons I consider that the defendant Eise fails in his defence under s 556(2)(b)(i).

The defence under s 535 of the Code

The first question here is whether s 535(1) is capable of affording a defence to a claim made under s 556(1) by a creditor of a company against one of its directors. It can do so only if a claim so made is "for negligence, default, breach of trust or breach of duty". A claim made by a creditor under s 556(1) is plainly not one for negligence or breach of trust, but it was argued for the defendant Eise that it is a claim for either "default" or "breach of duty" in terms of s 535(1). Counsel for the plaintiff contended that the claim was for neither of these.

In *Lawson v Mitchell* [1975] VR 579 at 594, Kaye J, referring to s 365 of the Companies Act 1961, an ancestor of s 535 of the Code, said that "The words 'default' and 'breach of duty' refer to the performance or omission to perform some act required or forbidden by the statute". At 599 his Honour said that the introduction of the words "default" and "breach of duty" into the section by s 372 of the Companies Act 1929 "... made the section applicable to those provisions in the Act imposing liability on persons to pay compensation to persons who had suffered loss, in consequence of an irregular allotment of shares or a false prospectus". Founding himself on these dicta, counsel for the defendant Eise argued that s 535 confers a jurisdiction to allow the court to relieve a defendant from liability upon a civil claim under s 556(1). The argument was that, if it is right in interpreting s 556(1) to take into account the various obligations imposed on directors by the Code, it is sensible to suppose that s 535 applies directly to claims brought under s 556(1). Granted all this, it remains necessary to discern the imposition by s 556(1) of a liability to the plaintiff for a default or breach of duty by the defendant. I have difficulty in seeing that s 556 imposes by its terms a liability for an act or omission in contravention of the Code or for the breach of any duty imposed by the Code or otherwise.

Section 556(1) imposes a liability upon a particular defendant if, and only if, the facts specified in paras (a), (b)(i) or (ii) and (c) are proved and if the defendant happens at the relevant time to have been a director or person who took part in the management of the company. The liability under s 556(1) does not arise on account of (to adapt the words of Kaye J, and expand them in the sense I think his Honour intended) the performance of some act forbidden, or the omission of some act required, by s 556(1) or indeed any other provision of the Code. The only prerequisite to the defendant's liability under s 556(1) over which he has any necessary control is simply that he was a director or took part in the management of the company. This cannot by itself have involved him in any default or breach of duty to the plaintiff. It is true that he may have been in default under, or have breached a duty imposed upon him by, any of a number of other provisions of the Code and that these shortcomings may have provided objectively "reasonable grounds to expect" under s 556(1)(b). The section does not, however, impose liability upon the defendant to a creditor for any such default or breach. Putting it another way, liability under s 556(1) is not made to depend on breach by the defendant of any provison of the Code: a case to answer may be made against him under s 556(1) whether or not any breach by him of a provision of the Code is demonstrated; and equally the plaintiff may fail to make a case to answer against him under s 556(1) even though there are breaches by him of other provisions of the Code.

It is true that, upon the view I have taken of s 556(1), it presupposes that directors have obligations under the Code, and that they will be complied with, but the section does not impose any obligation on a director for breach of which or default by reference to which a claim may be made under the section by a creditor. The liability under the sub-section is simply a liability for the payment of a debt that was incurred by the company.

There seem to be no authorities directly in point but counsel for the plaintiff referred to two English decisions which raised questions in some respects similar to the question I have to decide. The first was *Customs and Excise Commissioners v Hedon Alpha Ltd* [1981] 1 QB 818, a decision of the Court of Appeal. The question there was whether s 448 of the Companies Act 1948 (similar to s 535 of the Code) could be relied on to grant relief to a director who had been made personally liable in that capacity under a taxing Act for betting tax incurred but not paid by a company that was a bookmaker. Section 448 was held to be unavailable to allow a grant of relief, and this for several reasons. One, now relevant, was that the taxing Act imposed no obligation for which the director could be liable by way of default or breach of duty within the meaning of s 448 of the Companies Act 1948. Stephenson LJ, summarising the successful argument, said at 823:

". . . the commissioners' action was not a proceeding for default, which in its context of negligence, breach of duty and breach of trust involved some fault or guilt or misconduct, but for debt; if there was any default it was by the defendant company on whom alone rested a duty to pay imposed by s 2(1)(a) and not by the director against whom s 2(2)(d) provided the commissioners with a right to recover the company's unpaid debt; and the proceedings in which relief could be granted [scil under s 448 of the Companies Act] must be proceedings for the negligence, default etc of the director . . .".

At 825 Ackner LJ said:

"Assuming that the word 'default' should be given its ordinary meaning not in any way limited by the context in which it appears in s 448, I would nevertheless take the view, as did the judge, that it was the company, as bookmaker, which was in default, by failing to comply with the obligation imposed on it by s 2(1). Since s 2(2) imposed no duty on the third defendant, but merely gave the commissioners the right to sue in debt, there was no default by him.

"I do not, however, take the view that an unrestricted construction should be given to the word 'default'. In the context in which it appears in s 448, it signifies a species of misconduct by an officer of a company or a person employed by a company as auditor, against a liability for which a court may relieve him either wholly or in part. It is common ground that no element of misconduct is to be found in the foundation of a claim brought by virtue of s 2(2) of the Act. Accordingly the question of default does not arise."

At 827 Griffiths LJ said:

"In my judgment s 448 has no application to the present claim. Although the section is expressed in wide language it is in my view clearly intended to enable the court to give relief to a director who, although he has behaved reasonably and honestly, has nevertheless failed in some way in the discharge of his obligations to his company or their shareholders or who has infringed one of the numerous provisions in the Companies Acts that regulate the conduct of directors . . . The word 'default', where it appears in the section, is to be construed as a failure to conduct himself properly as a director of the company in discharge of his obligations pursuant to the provisions of the 1948 Act."

Those passages appear to be consistent with and to lend support to the conclusions I have expressed above.

In the present case the defendant becomes liable to the plaintiff under s 556(1), if at all, "for payment of the debt" incurred by the company to the plaintiff. There is no liability to the plaintiff imposed upon the defendant by s 556(1) for any default or breach by the defendant. Counsel for the defendant Eise sought to distinguish the *Hedon Alpha* case on the ground that here, unlike liability under the taxing statute with which that case was concerned, liability under s 556(1) presupposes a breach of duty by the defendant of the kind to which s 535 refers in the same legislation. On that basis the position referred to in the dictum of Griffiths LJ, quoted above, may be reached because the defendant had "failed in some way in the discharge of his obligations to his company or their shareholders . . .". The answer, I think, is simply that liability under s 556(1) does not depend on a breach of any duty owed by the defendant to the plaintiff; and a claim under s 556(1) is not *for* any such breach or any default in terms of s 535(1). This is so, in my opinion, even if by virtue of comparatively recent dicta it may be said that the company (at least when its solvency is suspect) owes a duty to creditors, or that the directors owe a duty to the company, or to the creditors directly, to consider the creditors: *Walker v Wimborne* (1976) 137 CLR 1 at 7 per Mason J; *Nicholson v Permakraft (NZ) Ltd (in liq)* [1985] 1 NZLR 242 at 249-50, per Cooke J; *Kinsella v Russell Kinsella Pty Ltd (in liq)* (1986) 4 NSWLR 722 at 733, per Street CJ; *Winkworth v Edward Baron Development Co Ltd* [1986] 1 WLR 1512 at 1516 per Lord Templeman; *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30; *Jeffree v NCSC* (1989) 15 ACLR 217; 7 ACLC 556; and see Sievers, "The honorary

director: The obligations of directors and committee members of non-profit companies and associations" (1990) *C & SLJ* 87, 102-5.

The other case referred to was *Re Produce Marketing Consortium Ltd* [1989] 1 WLR 745, a decision of Knox J. The question there was whether s 727(1) of the Companies Act 1985 (the successor of s 448 of the Companies Act 1948) could provide a basis for excusing liability otherwise established under s 214(1) of the Insolvency Act 1986. The latter provided in effect (and so far as is now relevant) that the court might on the application of the liquidator of a company declare in certain circumstances that a director of the company "is to be liable to make such contribution (if any) to the company's assets as the court thinks proper". The relevant circumstance was that the company had gone into insolvent liquidation and that at some time before the commencement of the winding up the director "knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation". Knox J found indications in s 214 of the Insolvency Act that s 727(1) of the Companies Act was not intended to be available as a defence. One argument he considered was dealt with in the following passage of his judgment, at 751, which might be thought to be of present relevance: "[Counsel for the liquidator] relied on the absence of any specific duty being imposed in the section in question.

"I find that argument less impressive. It is correct in the sense that there is no duty in terms imposed. On the other hand I feel that there is considerable force [in the submission of counsel for the first respondent] that a duty in fact exists at the back in the shape of a director's obligations in relation to which s 214 imposes a sanction for not having discharged it in the way which the law requires. However, it is not necessary for me to come to a concluded decision on that aspect of the matter because I accept the first way that I have quoted [counsel for the liquidator] as putting the case . . .".

It might be suggested, consistently with the argument of counsel for the defendant Eise in this case, that that passage allows an interpretation of s 556(1) of the Code whereby "a duty in effect exists at the back in the shape of the director's obligations in relation to which [s 556(1)] imposes a sanction for not having discharged it in the way which the law requires". I mention the point only lest I might be thought to have overlooked it, for I think it does not avail the defendant Eise here. Section 214 of the Insolvency Act 1986 gives the court a discretion to make a declaration after taking into account a defendant's conduct as director by reference, no doubt, to his duties as director. The greater a departure from his duties as a director, the greater would be the prospect of a declaration against him. In that sense s 214 might be applied as a sanction against a director for not having discharged his duties as the law requires. There is no similar sanction to be imposed under s 556(1) which either applies, or not, irrespective of a particular defendant director's acts or omissions. Section 556(2) is of course another matter, but I do not think it can properly be said that in the case of s 556(1) "a duty in fact exists at the back" in relation to which a sanction is imposed for not having discharged the director's obligations in a way in which the law requires.

Counsel for the plaintiff relied on another aspect of the decision in the *Produce Marketing Consortium* case for the conclusion that s 535 is not available as a defence to a claim under s 556(1). Knox J held that s 214 of

the Insolvency Act required an objective test in the determination of its application "which is very difficult indeed to marry with the essentially subjective approach that s 727 requires": at 750. So, here, counsel for the plaintiff submitted that it is not reasonably possible to apply s 535, which requires an essentially subjective approach, to a situation where a case under s 556(1) has been made out upon objective facts. I can not accept the point in that form. There must be many breaches of duty under the Code, determined on objective considerations, to which s 535, having regard to subjective considerations, may be an ultimate defence. The point in the *Produce Marketing* case, as it seems to me, was that s 214 of the Insolvency Act was to be applied or not *in the court's discretion* having regard to objective considerations, and s 727 of the Companies Act 1985 was to be applied or not, also in the court's discretion, having regard to subjective considerations. The discretionary application of the two provisions together was therefore logically difficult, if not impossible. If s 535 applies at all in the case of a claim under s 556(1), I can not see the same difficulty in its application as that to which Knox J referred, the court having had no discretion as to whether s 556(1) applied or not. I therefore think that, in this respect, *The Produce Marketing* case is distinguishable and that the plaintiff derives no assistance from it.

More attractive is the alternative argument advanced by counsel for the plaintiff to show an inconsistency between s 535 and s 556(1). It was in effect that the existence of sub-s (2) of s 556, providing for a specific defence to a claim under s 556(1), showed that it was unlikely that s 535 was intended to afford a means of defence in circumstances where s 556(2) did not avail the defendant. It would be difficult to apply s 535 if the defendant had not been able to prove, for the purposes of s 556(2), that he did not have "reasonable cause to expect". Having noted the argument, I do not find it necessary to pursue it.

Counsel for the plaintiff also relied on the *Hedon Alpha* case for a conclusion that s 535 is not available upon a claim not made by the company or on its behalf as against an officer or other person for breach of duty owed to the company. The *Hedon Alpha* case is, I think, authority for that proposition. It is cited as such without reservation in Ford's *Principles of Company Law,* 5th ed, para 1534. Stephenson LJ, at 824, held that s 448 of the Companies Act 1948: ". . . is inapplicable to any claim by third parties to enforce any liability except a director's liability to his company or his director's duties under the Companies Acts. Wide and general though the opening words of s 448 are, read in their context they do not allow an officer or auditor of a company to claim relief in 'any' legal proceedings which may be brought against him in his capacity as an officer or auditor of a company by the rest of the world".

Ackner LJ, at 826, said that: ". . . the true ambit of s 448, with one limited exception, is restricted to claims by or on behalf of the company or its liquidator against the officer or auditor for their personal breaches of duty. The only exception relates to the criminal process for the enforcement of certain specific duties imposed by the 1948 Act on the company's officers . . ."

I was referred also to *Dimond Manufacturing Co Ltd v Hamilton* [1969] NZLR 609, at 629-30 per McCarthy J, at 640 per Turner J and and at 645, where North P, referring to s 468 of the Companies Act (NZ), which was

similar to s 535 of the Code, said: "The width of this section which is common to both the English Act and the Australian Act has never, so far as I am aware, been considered in any reported case, and undoubtedly presents difficulty in the way of interpretation. To begin with it is difficult to understand how a negligent officer or auditor could nevertheless be held to have acted 'reasonably' but there it is, for the section undoubtedly recognises that in some circumstances an auditor or other officer of the company, though guilty of negligence, may be held nevertheless to have acted reasonably. But however that may be, in my opinion, in an action brought by a member of the public against an officer of the company or an auditor for a negligent representation the section affords no defence."

With all respect to these opinions, which I was invited by counsel for Mr Eise to reject, they do seem to be somewhat arbitrarily expressed. Moreover, s 535, unlike its English, New Zealand and Victorian predecessors, no longer requires (in terms) that a person seeking to rely on it should be seen to have acted "reasonably". It is not immediately apparent to me why, for example, an honest but admittedly negligent company secretary, sued by a debenture holder who alleged and proved loss on account of the negligence, could never in any circumstances rely on s 535.

In *Lawson v Mitchell,* supra, the Full Court departed from English authority upon the forerunners of what is now s 535 of the Code, to the extent of holding that the section in the Victorian legislation has no application to proceedings for an offence: cf the passage from the judgment of Ackner LJ in the *Hedon Alpha* case, at 826, cited above. Young CJ and Newton J at 582-3, while acknowledging that the section confers power on the court to relieve from civil liability, left open the question whether it was applicable to civil claims brought against a company's officers, not by the company or its liquidator, but by "somebody else such as a shareholder or debenture holder seeking personal relief for himself". It would be odd, but nevertheless possible, that s 535 was intended to be available as a defence to a civil claim under s 556(1) but not a defence to a criminal proceeding under that subsection. Perhaps the necessity will arise to consider whether the approach stated in the *Hedon Alpha* case, expressed in the passages from it I have last quoted, should be followed here in the context of civil liability. Having found for another reason that s 535 does not apply in this case, I have no such necessity and I think I should not attempt the task.

Even assuming that s 535 of the Code is capable of affording a defence to the defendant Eise, I have concluded that it should not avail him in the circumstances of this case.

It was submitted for Mr Eise that in the application of s 535(1) there are but two areas of inquiry: whether the defendant has acted honestly, ie without moral turpitude, and whether, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused. The court has a discretionary jurisdiction, having regard to those criteria, to relieve the defendant either wholly or partly of his liability. As I have already noticed, the section does not now specify, whereas previous corresponding legislation did specify, that it is to appear to the court exercising the jurisdiction that the defendant acted reasonably, as well as honestly. In my opinion, however, in having regard to all the circumstances of the case, it will be permissible and appropriate, and

usually necessary, to consider whether the defendant had acted reasonably in those circumstances: cf also s 229(2).

The principal circumstances of the case relied on by counsel for the defendant Eise for an exercise of the jurisdiction under s 535(1) were these. The defendants all served in a non-executive, part-time and honorary capacity and were performing a public or community service in acting as directors. Mr Eise was said in particular to have been devoted to the company and was plainly as much a victim of Friedrich's fraud as was the State Bank of Victoria. It was said to be inequitable that the bank, having presumably far greater resources to investigate the financial position of the company than Eise had, and not having used them, should be allowed to recover the company's debts from an individual director. Counsel argued in particular that Mr Palmer, the senior manager, Corporate Banking, Frankston Region, who had been chiefly responsible for recommending the bank's loans to the company, had been deceived by Friedrich just as Eise had been. Palmer acted on Friedrich's blandishments and on his assurances of the company's invulnerability and its indispensable role in the community. Palmer relied also, apparently, on the 1986 accounts and the audit report thereon, and also on the 1987 accounts, although it was not proved that he received the 1987 audit report. It was submitted on Eise's behalf that in these circumstances it was unfair that one victim of the fraud should be required to make recompense for it to another. Counsel submitted that the bank presumably regarded Palmer's conduct as reasonable and yet it seeks to impugn Eise's reliance on the same matters as those on which Palmer relied in circumstances where no reasonable attempt was made by the bank to protect itself. Moreover, it was submitted, the bank on 27 January 1989, when Eise visited the Frankston branch, fed his assumption that the bank was satisfied with the company's financial arrangements. Finally, it was submitted on Eise's behalf that it is inequitable that he, as a victim of fraud, should in all the circumstances be made liable for debts of such magnitude as those for which the plaintiff makes its claim, and that the court should accordingly exercise a discretion against the bank.

The Code does not in terms distinguish between executive and non-executive directors, or between paid and honorary directors. Again, the obligations cast by the Code on companies having the benefit of limited liability are in general applicable alike to companies not for profit and profit-making companies. There is nothing in the Code to suggest that the standard to be expected of a part-time non-executive director of a company not for profit is different from the standard expected of any other director of a profit-making company: both are required by s 229(2) to exercise a reasonable degree of care and diligence in the exercise of their powers and the discharge of their duties. Notwithstanding that, conduct that will be held to involve a departure from the required standard of reasonableness will vary infinitely from case to case according to the circumstances.

The present question is not one calling for a decision whether Mr Eise is liable for a default or breach of his duty as a director. A detailed examination of the duties of an unpaid non-executive director of a company not for profit is therefore not required. On the contrary, in considering whether relief under s 535 should be granted, I am to assume, ex hypothesi, that Mr Eise *has* been guilty of a default or breach of duty. Making that

assumption, I should think it legitimate to take into account Mr Eise's position as a non-executive and part-time director, that he was unpaid, that as a director of the company he was motivated by a desire to involve himself in a useful community service, and that he did so involve himself. I should think it right that the courts should use the jurisdiction conferred by s 535 in an appropriate case to provide a flexible form of relief to voluntary, non-executive directors of companies not for profit. It is in the public interest that, while directors should be held accountable for their conduct, able people should not be deterred from offering their voluntary services for want of appropriate protection. It would also be right, in the exercise of the jurisdiction under s 535, to take account of the fact that Eise was duped by Friedrich's fraud.

Assuming all that, it is to be remembered that s 556(1) is designed to facilitate the recovery by a creditor from a director of a debt incurred by the company in the circumstances to which it refers; and it is to be further remembered that the defendant has (on the assumption I am now making that s 535 is available to him) been guilty of default or breach of duty and has not been able to make out a defence under subs (2) of s 556. In the circumstances I should not think it right to take into account the fact, if it be the fact, that the State Bank of Victoria lent to the company imprudently. The notion that a director of a company should be entitled to rely on a lender not to make an imprudent loan to the company of which he is a director seems to me to involve an inversion of reality. The fact is that the bank *did* rely for information on the company, and the ultimate responsibility for the company's conduct lay with the directors. I do not regard the bank's attitude to Eise upon his visit of 27 January 1989 as having given him any reasonable ground for a belief that nothing was untoward. By then the stage had long been set and the greater part of the damage had been done, although more remained to be done.

Central to Mr Eise's downfall was his signing on 26 February 1988 a statement of the directors and a directors' report. In doing so he represented that the directors had both considered the 1987 accounts and expressed an opinion on them conformably with s 269(a) of the Code, when in truth they had done nothing of the kind. He thus falsely represented to those present at the annual general meeting, and to every member and every creditor who cared to refer to the accounts, that the board had complied with its obligations under the Code in relation to the accounts. Worse than that, Mr Eise himself had not had any opportunity to look at the accounts and yet he represented that he had done so and that they were accounts on which members and creditors could rely. Even in the face of criticism by a member at the annual general meeting, the directors present — of which Mr Eise was one — persisted in the falsity. If he or any other director had had the honest resolve to say that the accounts had been produced only minutes before the commencement of the annual general meeting, and that the board had not considered them what would the result have been? Friedrich's fraud would in all probability have been readily exposed. If Mr Eise's conduct at and immediately before the annual general meeting was not dishonest — involving some moral turpitude — it was surely conduct of the utmost folly; and it involved clear and flagrant breaches of both the letter and the intent of the Code. It was conduct that led in an important way to the company's reaching, *and remaining in,* the

state of financial disarray in which it was when it began to make the relevant borrowings from the State Bank of Victoria in May 1988. That conduct, along with the conduct of the board during the 3 or 4 months following it, is in my opinon part of the "circumstances of the case" to which it is necessary to have regard in deciding whether s 535 should be applied. Fraudulent though Friedrich's conduct was, it appears to me probable that he would not have been able to achieve his purpose in obtaining for the company the very large advances from the State Bank if Mr Eise had not compromised so seriously his performance of his own obligations. If, in the face of Mr Eise's conduct, I were to apply s 535 in his favour, I should do a serious disservice to the administration of the Code and to the commercial community.

Quantification of the award to be made to the plaintiff

My primary conclusion on the question of liability is that the plaintiff has made out its case upon all the debts in respect of which it claims. That is to say, the plaintiff has proved that on and after 31 May 1988, immediately before the time when each relevant debt was incurred, s 556(1) was satisfied; and the defendant Eise has not proved that, at the time when any such debt was incurred, s 556(2) was satisfied. The liability of the defendant Eise on that basis is $96,704,998.

If I am wrong to conclude that the plaintiff has proved the application of s 556(1) immediately before the incurrence by the company of the debt of $41,547,458 by way of cash advances on 31 May 1988, or that the defendant Eise has not made out a defence under s 556(2) in respect of that debt incurred on 31 May 1988, I think it follows that he should not be liable in respect of any debt incurred by the company to the State Bank before 21 December 1988. If the plaintiff has not made out its case under s 556(1), or if the defendant Eise has made out his defence under s 556(2), in respect of the debt incurred on 31 May 1988, the evidence would probably not sustain the plaintiff in respect of any debt incurred by the company to the State Bank before 21 December 1988. That would mean that the plaintiff would fail in respect of each of the cash advances made on 31 May 1988 and up to 13 July 1988. The reason is that the evidence is not substantially different, as to a claim under s 556(1) and as to a defence under s 556(2), for the period from 31 May 1988 to 21 December 1988. That being so, the plaintiff would also fail in respect of the claim for the debt incurred by *the drawing* of each of the bills of exchange drawn on 2 and 22 June and 5 and 8 July 1988. Each of those bills, however, was rolled over at least once, and rolled over finally in March 1989, at a time when on any view, in my opinion, the plaintiff sustained its proof under s 556(1) and the defendant Eise could not sustain a defence under s 556(2). If the final rollover of each bill (on either 3 March 1989 or 8 March 1989) involved the incurrence by the company of a fresh debt at the time of the final rollover it is plain, in my opinion, that immediately before the date of the final rollover the plaintiff makes its case under s 556(1) and the defendant fails to make his defence under s 556(2). If, however, the final rollover merely involved the continuance of a debt that had already been incurred upon each bill when the bill was originally drawn, the plaintiff would not make its case unless it did so at 2 and 22 June and 5 and 8 July 1988 and the defendant failed to make a defence under s 556(2) at each of those dates respectively. The point is a technical one, depending upon the terms of the bill facility granted by

the State Bank of Victoria to the company and, perhaps, on an analysis of such authorities as *K D Morris & Sons Pty Ltd (in liq) v Bank of Queensland Ltd* (1980) 146 CLR 165 and *Coles Myer Finance Ltd v FCT* (1991) ATC 4087.

Since I am satisfied that the plaintiff makes out its case as at a time immediately before the drawing of each of the bills in question, and that the defendant Eise does not make out his defence under s 556(2) at any of those times, I shall not add unnecessarily to these reasons by canvassing the point.

The plaintiff's claim upon the overdraft account is for $28,410,333.30 incurred after 1 January 1989. On any view, in my opinion, the plaintiff makes out its case at and after 1 January 1989 and the defendant Eise does not make out his defence under s 556(2) at or after that date.

In the result there will be judgment for the plaintiff against the second-named defendant, Maxwell Walter Eise, in the sum of $96,704,998.

* * * *

If the result of this judgment seems severe, the severity will probably be perceived for three main reasons. The first lies in the size of the award to the plaintiff, but that is no more than a reflection of the size of the debt actually incurred by the company. The second is that Mr Eise was a victim of Friedrich's extensive fraud. That is a matter which arouses sympathy. But, if the fraud was extensive so also was the directors' failure to monitor the company's financial position, thus allowing the fraudulent borrowing of enormous sums that the company could not possibly repay. The Companies Code has sought to make a director ultimately responsible to pay the loss, rather than the creditor, if s 556(1) is shown to apply and the director cannot make out a defence under s 556(2). If that is thought to be too harsh or disproportionate a result, it is a product of the legislation and only the parliament can soften or reproportion it. The third reason is that there are or may be grounds to think that the State Bank of Victoria was imprudent in making advances to the company in the circumstances that it did. The fact remains that the company had the benefit of the advances and it thus incurred the debts. Section 556(1) does not draw a distinction between a wise and a foolish lender to whom the company incurs a debt in the circumstances it describes. Again, if that is an unacceptable feature of the section, only the parliament can remove or vary it.

In conclusion I offer this observation. The whole case is to be viewed in the light of the clear fact that, over the last 5 years or more of its life, the National Safety Council Victorian Division was inherently unsuitable as an organisation for the conduct of the business it had developed. The company purported to conduct itself as a commercial entrepreneur. The use for that purpose of a company limited by guarantee and having no share capital is altogether inappropriate.

Solicitors for the plaintiff: *Phillips Fox.*

Solicitors for the first-named defendant: No appearance.

Solicitors for the second-named defendant: *Macpherson & Kelley.*

Solicitors for the third-named defendant: *Thos Burke & Assoc.*

Solicitors for the fourth-named defendant: *E L Richards & Co.*

Solicitors for the fifth-named defendant: *Strongman & Crouch.*

Solicitors for the sixth-named defendant: *Gadens Ridgeway.*

Solicitors for the seventh-named defendant: in person.

Solicitors for the eighth-named defendant: *Best Hooper.*

Solicitors for the ninth-named defendant: *Anderson Rice.*

Solicitors for the tenth-named defendant: *Read Kelly.*

Solicitors for the eleventh-named defendant: *Henty Jepson & Kelly.*

R WEBB
SOLICITOR