

GENERAL DUTIES OF DIRECTORS

Q&A



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DIRECTORS GOVERN A COMPANY ON BEHALF OF THE STAKEHOLDER OF THAT COMPANY. THE CORPORATIONS ACT 2001 STATES IN S 198A (1) THAT 'THE BUSINESS OF A COMPANY IS TO BE MANAGED BY OR UNDER THE DIRECTION OF THE DIRECTORS'. ALL DIRECTORS HAVE CERTAIN BASIC LEGAL DUTIES AND RESPONSIBILITIES. THE DUTIES AND RESPONSIBILITIES IMPOSED ON DIRECTORS UNDER THE CORPORATIONS ACT 2001 APPLY TO MANY DIFFERENT ORGANISATIONAL STRUCTURES, SUCH AS PUBLIC COMPANIES, PROPRIETARY COMPANIES, ETC. AS THE OWNER OF YOUR OWN BUSINESS YOU ARE A DIRECTOR AND ARE SUBJECT TO THE MANY OF THE SAME DUTIES AS DIRECTORS OF OTHER TYPES OF ORGANISATIONS.

Who are considered to be directors?

The term "director" is defined in s9 of the Corporations Act 2001 to mean:

- A person validly appointed as a director or an alternate director.
- A person, even though not validly appointed as a director, if that person acts in the position of a director ('de facto' director).
- A person, even though not validly appointed as a director, if the directors are accustomed to act in accordance with that person's instructions or wishes ('shadow director'). For simplicity, the term 'director' will be used in this Director Q&A to refer to all those who are considered to be directors.

What are the four basic directors' duties?

The Corporations Act 2001 specifies four main duties for directors:

- Care and diligence - to act with the degree of care and diligence that a reasonable person might be expected to show in the role (s 180). The same duty is imposed on directors at common law. Recent court cases have emphasised this duty in relation to the approval of financial statements (Centro case) and board approval of statements issued by a company (James Hardie cases). There can also be a breach of this duty by causing a company to enter into risky transactions without any prospect of producing a benefit or where a managing director fails to inform the board of matters which clearly should have been brought to the board's attention. The

business judgment rule (discussed below) provides a "safe harbour" for a director in relation to a claim at common law or under s 180.

- Good faith - to act in good faith in the best interests of the company and for a proper purpose (s 181), including to avoid conflicts of interest, and to reveal and manage conflicts if they arise. This is both a duty of fidelity and trust, known as a 'fiduciary duty' imposed by general law and a duty required in legislation.
- Improper use of position - to not improperly use their position to gain an advantage for themselves or someone else or to the detriment to the company (s 182).
- Improper use of information - to not improperly use the information they gain in the course of their director duties to gain an advantage for themselves or someone else or to the detriment to the company (s 183).

As a general guide to fulfilling these duties, reference should be made to the words of Professor Baxt in Duties and Responsibilities of Directors and Officers (2012) at p 66: 'The yardstick by which a director may safely judge their own actions at times of difficulty and conflict is this:

Taking account of all the circumstances, is what I propose to do in my honest belief in the best interests of all the shareholders (present and future) of the particular company of which I am a director. In the case of financial difficulty, 'creditors' could and perhaps should be substituted for 'shareholders'. If the answer to the question is 'yes', then the director need not fear an action for breach of duty under either the statute or common law.'

Are there additional directors' duties under the Corporations Act?

In addition to the four basic duties discussed above, other significant duties and responsibilities under the Corporations Act 2001 include:

- **Insolvent trading** - directors have a duty to ensure that a company not trade whilst insolvent or where they suspect it might be insolvent (s 588G).
- **Financial information** - taking reasonable steps to ensure that a company complies with its obligations in the Corporations Act 2001 related to the keeping of financial records and financial reporting (s 344).
- **Disclosing directors' interests** - disclosing matters relating to the affairs of the company in which he/she has a material personal interest (s191), particularly in the context of the requirement that public companies obtain shareholder approval for related party transactions (s 208), and disclosure of director's interests to the market (s 205G).
- **Lodging information with ASIC** (s 188).
- **Continuous disclosure** - for listed companies, continuous disclosure to the market of information which is not generally available and which may affect the company's share price (s 674).

Are there directors' responsibilities under other laws?

Every company is involved in activities which are regulated by other laws (e.g. hiring and firing people, renting an office, marketing). There are over 600 of these laws (Federal, State and Territory) under which a director can be personally liable. Examples of these laws include competition law, occupational health and safety, environmental law and taxation. There will also be specific industries which have very specialised laws (e.g. aviation).

What are the consequences of breaching directors' duties laws?

Criminal sanctions - There can be very severe penalties for failure to comply with either duties under the Corporations Act 2001 or other laws governing a company's activities. For example, 'cartel conduct' under the competition laws can lead to imprisonment for 10 years. Under the Corporations Act 2001, contraventions of the duty of good faith or improper use of information or position, if they involve dishonesty or recklessness, can be punished by imprisonment for five years (s 184).

Civil sanctions - A contravention of the duties under the Corporations Act 2001 can make a director liable to a substantial fine. Shareholders or others (e.g. creditors) may also take action against directors who have failed to comply with their duties.

Disqualification - Both the Australian Securities and Investments Commission and the courts have the power to disqualify directors for long periods of time for failure to comply with their duties under the Corporations Act 2001 (Part 2D.6)

Commercial consequences - The most serious consequences of breaching directors' duties are often not the legal ones but the commercial ones. A corporation's most valuable asset is its reputation. The company will likely be subjected to much greater scrutiny, both by investors and regulators, where directors breach duties. At worst, market reaction may mean the company will cease to exist.

What is the business judgment rule?

The Business Judgment Rule applies to the duty to act with care and diligence (s 180) and not other sections of the Corporations Act 2001. This rule seeks to avoid unnecessary restrictions on proper entrepreneurial activity. Section 180 (2) of the Corporations Act 2001 provides that a director who makes a business judgment is taken to meet the care and diligence requirements in respect of the judgment if they:

- Make the judgment in good faith for a proper purpose.
- Do not have a material personal interest in the subject matter of the judgment.
- Inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate.
- Rationally believe that the judgment is in the best interests of the corporation.

The business judgment rule, according to Professor Baxt, has proved to be a rather illusory safety net for directors:

'There has been no decided case reported in the law reports (to my knowledge) in which the business judgment rule has been successfully relied upon by a director or officer. There have been many cases in which it has been argued.'

The Australian Institute of Company Directors advocates an extension of the business judgment rule to other areas of the Corporations Act 2001 – for example, in relation to insolvent trading.

Is there a duty to consider broader 'stakeholder' interests?

In Australia, a director owes a fiduciary duty to the company, i.e. he or she must "act honestly, in good faith and to the best of his or her ability in the interests of the company." Section 181(1) requires that directors act 'in good faith in the best interests of the corporation'. In practice, this means in the interests of the shareholders or members of the company as a whole. This is not the case in some other countries (e.g. Germany, France) where directors' duties are owed to a wider range of stakeholders (e.g. shareholders, customers, creditors, the local community).

There have been two Australian Government reviews on whether Australia should adopt the 'stakeholder' approach of somewhere like Germany. In both cases, the review considered that the law in Australia should remain the same. The view was taken that, in considering what is in the best interests of the shareholders, Australian directors will consider broader interests (e.g. employees, creditors) in so far as these things are relevant to the shareholders' interests.

What duties exist in organisations not governed by the Corporations Act 2001?

Not all organisations are governed by the Corporations Act 2001. Examples of organisations not covered by the Corporations Act 2001 include:

- Incorporated associations such as cooperatives – governed by State legislation, called the Associations Incorporation Act in most States;
- Organisations operating under a royal charter;
- Charities – to be governed by the Australian Charities and Not-for-profits Commission Act 2012;
- Organisations incorporated by their own Act of State or Federal Parliament, eg. Anglican Church of Australia Constitution Act 1961 (NSW), University of New England Act 1993 (NSW);
- Government bodies – regulated by their own legislation (e.g. the Commonwealth Authorities and Companies Act 1997, State Owned Corporations Act 1989 (NSW)).

Most of the directors' duties and responsibilities found in the Corporations Act 2001 apply to these organisations by virtue of their own legislation or the common law.

There is some debate amongst directors as to whether directors of not-for-profits should be subject to less onerous duties and responsibilities. We believe that all directors should be subject to the same duties and responsibilities.

How many directors are needed?

The Corporations Act 2001 requires public companies to have at least three directors, two of whom must ordinarily reside in Australia. Proprietary companies must have at least one director who must ordinarily reside in Australia (s 201A).

For proprietary companies with a sole director who is also sole shareholder, a second director can be appointed by the original director recording the appointment and signing the record (s 201F).

What titles do directors have?

There are a number of types of directors. Commonly used terms include non-executive director, executive director, managing director, independent directors, shadow directors, alternate directors, de facto directors, nominee directors, amongst others.

What time commitment should a director expect?

To effectively perform the duties and responsibilities of a director, sufficient time must be devoted to the role. Chairmen will need to give extra time. The actual time commitment will vary according to the organisation. Factors influencing the necessary time commitment include the company size, complexity of structure and operations, whether it is listed or unlisted, the company's stage of growth or expansion, and whether it is undergoing significant change.

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