



# Directors Duties: Explanatory Notes

Australian law imposes strict fiduciary, common law and statutory duties on company directors. Subject to its constitution, directors are responsible for the overall management of the company. Understandably, becoming a director carries a range of duties and obligations.

Whilst the law tends to be more accepting of errors of judgment in day-to-day business and commercial risk-taking, the standard expected of directors is high. Assuming directorship is a serious undertaking and directors can be personally liable for failure to carry out their duties.

The following overview is not intended to be exhaustive – the relevant system of laws is complex and it is recommended that you seek legal advice where the need arises.

Directors should also take an active interest in following current legislation.

## Fiduciary Duties

The nature of the relationship between director and company is fiduciary. This means that the director undertakes to act in the best interests of the company and only in its interests – otherwise known as the duty of undivided loyalty.

Other fiduciary duties are listed below:

- to avoid conflicts of interests and duty;
- not to obtain company property for his or her own benefit (or for the benefit of a third party) without the company's fully informed consent;
- to act in good faith and in the best interests of the company;
- to exercise his or her powers for a proper purpose; and
- to exercise discretion and not improperly limit their decision-making authority.

Given the courts' long-standing refusal to intervene the day-to-day management of business, the fiduciary relationship is interpreted in such a way to give directors the flexibility to manage the business and take appropriate risks but restricting them where they are in a position of self-interest or the interests of the primary conflict.

The duties that regulate directors' actions can be viewed in the context of the hypothetical bargain or "contract" between directors and shareholders. Shareholders invest in the company and grant directors a wide discretion as to how to manage a company. As quid pro quo for that discretion, shareholders insist that directors owe duties to not act in their own self-interest but in the interests of the company or, specifically, to maximise shareholder wealth hence also promoting investor confidence.



Such context has given rise to two notable “sub-rules”:

### **1. The “No Conflict” Rule**

*A director must not allow his/her personal interests (or engagement with a third party) to conflict with his/her duties to the company, except with the company’s fully informed consent.*

It is not necessary for the company to suffer any detriment or for the director to obtain an advantage in order to breach this duty – a director simply must not place themselves in a position where there is an actual or a real possibility of conflict.

Section 191(1) Corporations Act 2001 (Cth) supplements the civil law sanctions (see s 193) and requires a director with a material personal interest in a matter, that relates to the affairs of the company, to give notice to other directors of the interest.

The following exemptions apply to the general obligation upon a director to disclose her or her interest:

- Where the interest arises because the director is a member of the company and is held in common with the other members of the company;
- Where the interest arises in relation to the director’s remuneration as a director of the company;
- Where the interest relates to a contract the company is proposing to enter into that is subject to approval by the members and will not impose any obligation upon the company if not approved by the members;
- Where the interest arises merely because the director is a guarantor or has given an indemnity for all or part of a loan to the company or because the director has a right of subrogation in relation to the said guarantee or indemnity;
- Where the interest relates to a contract that insures, or would insure, the director against liabilities that the director incurs as an officer;
- Where the interest relates to any payment under a contract of indemnity in favour of the director which is permitted by the company;
- Where the interest arises because the director is a director of the related body corporate which is in, or proposed to be in, a contract with the company;
- Where the company is a proprietary company and the other directors are aware of the director’s interest and insulation to the affairs of the company; or



- Where all the following conditions are satisfied:
  - i. The director has already given notice of the nature and extent of the interest and its relation to the affairs of the company;
  - ii. Any new directors appointed after the fact are also given notice of the interest at the time of their appointment; and
  - iii. The nature and extent of the interest has not materially increased above that disclosed in the notice;
- Where the director has given a standing notice to the company of the interest - the notice must give details of the nature and extent of the actual or potential interest and be given either at a director's meeting or to the other directors individually in writing. A standing notice will cease to have effect where the nature and extent of the interest has materially increased above that disclosed in the notice.

In all other cases the interest must be declared to the directors' meeting as soon as practicable, and it must give details of:

- the nature and extent of the interest; and
- the relation of the interest to the affairs of the company.

### **Directors' meeting and vote**

Section 195(1) states that a director who has a material personal interest in a matter that is being considered at a directors' meeting must not:

- be present while the matter is being considered at the meeting; nor
- vote on the matter.

However, s 195(2) provides that the director may be present and vote if the other directors who do not have a material personal interest in the matter have passed a resolution stating that they are satisfied that the interest should not disqualify the director from voting or be present.

Under s 195(3), ASIC may also provide a declaration or order under s 196 that approves of the director's presence in the meeting and vote.

### **Interest**

It must clearly be disclosed if a director's personal interest is substantially affected by the outcome of the board's decision. Such interest does not need to be financial and can even exist where a relative of the director might benefit rather than the director personally.

An interest held as a company member that is in common with other members is not a personal interest, but an interest under an executive employee share option scheme will require disclosure.

Even if notice is given and the board allows the director to participate in any resolution on the matter,



the director may be legally prevented from exploiting the opportunity without shareholder approval. Subject to the company's constitution, fully informed shareholders can authorise a director to enter a transaction or exploit an opportunity that the company does not wish to exploit.

### Multiple Directorships

There is no absolute rule against a person being a director of two (or more) companies that are competing against each other. However, given the likelihood for a breach of duty to arise, the contract of employment will often forbid the director from holding directorship in competing companies or it may impose other restrictions e.g. restraint on the use of information.

### Corporate groups and wholly owned subsidiaries

Subject to the case of wholly owned subsidiaries, a director of a company owes duties to that company and not to any related companies in the corporate group. As for a director of a company that is a wholly owned subsidiary of a holding company, a director is considered to act in good faith in the best interests of the subsidiary if:

- the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company;
- the director acts in good faith in the best interests of the holding company; and
- the subsidiary is not insolvent at that time and does not become insolvent because of the director's actions.

## 2. The "No Profit" Rule

*A director must not misuse their position to advantage themselves or a third party, except with the company's fully informed consent.*

The leading authority on the rule strictly provides 'that a director must not make a profit out of property acquired by reason of his relationship to the company of which he is a director': *Regal (Hastings) Ltd v Gulliver* (1942) 1 All E R 378. However, it appears that the courts have since relaxed this formulation of the "no profit" rule and now refer along the lines of whether there is a 'real sensible possibility of conflict' (*Boardman v Phipps*) or 'significant possibility' of conflict (*Chan v Zacharia*).

This apparent relaxation of the rule has given rise to the following issues which the courts have yet settled on:

- what effect that resignation of the director will have on their fiduciary responsibility;
- whether directors can exploit opportunities of which they become aware in a "private" capacity; and
- whether a director can establish by way of defence that the transaction in question is fair to the company.



However, one key implication of this rule is that a director must not take remuneration or other benefits from the company's resources unless it is:

- authorised by law;
- authorised by the constitution; or
- with the fully informed consent of the company via general meeting.

Directors must not diverge opportunities (that the company is either actively pursuing or have the opportunity to pursue and might reasonably be expected to have an interest in pursuing) away from the company for their own interests or the interests of an engaged third party.

### **Use of position**

Section 182 provides that a director, secretary, other officer or employee of a corporation must not improperly use their position to:

- gain an advantage for themselves or someone else; or
- cause detriment to the corporation.

### **Use of information**

Section 183 provides that a person who obtains information because they are, or have been, a director or other officer or employee of a company must not improperly use the information to:

- gain an advantage for themselves or someone else; or
- cause detriment to the corporation.

Both duties under ss 182 and 183 apply further to anyone who is "involved" (s 182(2), "involved" defined in s 79) and is broader than the equivalent equitable concepts. Sections 182 and 183 are also civil penalty provisions.

Statutory duties sometimes apply to a "director" or an "officer". These terms are defined in s 9. "Director" includes shadow and de facto directors, and "officer" includes director or secretary, receiver, administrator, liquidator etc. or a person who makes or participates in making decisions that affect the whole or a substantial part of the business of the company or who has the capacity to affect the corporation's financial standing, or in accordance with whose instructions or wishes the directors of the company are accustomed to act.

Shadow directors and officers are subject to ss 180-183 duties, whilst the s 588G insolvent trading duty only extends to directors (including shadow and de facto).

Insider Trading Provisions – Part 7.10 Division 3



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Under these provisions, a person (the insider) is prohibited from dealing in financial products if they possess information that is not generally available or, if the information were generally available, a reasonable person would expect it to have a material effect on the price and value of securities. The prohibition also extends to procuring another person to deal in financial products and communicating the information or cause the information to be communicated to another person if the insider knows, or ought reasonably to know, that the other person would likely deal in the financial products or procure another third party to deal in the financial products.

Contravention of these provisions is an offence and may also attract civil penalties.

### **Duty to act in good faith in the interests of the company and for a proper purpose**

The common law rule that directors must act 'bona fide in what they consider – not what a court may consider – is in the best interests of the company, and not for any collateral purpose' (Re Smith and Fawcett Ltd [1942]) is reflected in s 181.

Directors must act in a way that they honestly believe to be in the company's best interests – but this is also assessed objectively by reference to what a reasonable director would do in the surrounding circumstances.

Furthermore, directors must exercise their powers and discharge their duties for a proper purpose. The company's constitution may expressly or impliedly indicate a "proper purpose", otherwise it would be determined against the surrounding circumstances and usual functions of a power. For example, a proper purpose for the issuing of shares is to raise capital. In contrast, issuing shares to retain control of the company and dilute the value of another shareholder's interest would be an improper exercise of power.

Recently, courts have looked to the "but for" test when contemplating the exercise of power by a director for "mixed purposes" (for a proper and improper purpose) i.e. whether the director would not have exercised the power "but for" the improper purpose (see *Whitehouse v Carlton Hotel* (1987)).

### **Duties of care, skill and diligence**

The common law and equitable duties of reasonable care and skill exist in addition to any contractual provisions.

As set out in s 180(1), a director or other officer of the company must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- were a director or officer of the company in the company's circumstances; and
- occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.



The objective “reasonable person” standard is mitigated or modified by considerations of the surrounding circumstances of the company and the skills or role of the director/officer in that company. For example, an executive director or other director with special skills, experience or responsibilities would be held to a higher standard.

Section 180 is a civil penalty provision.

### **Stepping stones liability**

ASIC has argued that a director who allows the company to contravene the law breaches their duty under s 180. This approach is known as the “stepping stones” approach to directors’ liability. The argument was accepted in some cases but more recently, the courts seem to have cautioned against such an approach (See *Mariner* [2015], *Cassimatis (No 8)* [2016]). Nonetheless, directors must exercise reasonable care and take precaution against foreseeable risks of harm to the company and its shareholders.

### **Civil Remedies**

ASIC can enforce directors’ duties by applying to the court for civil penalties and, in the most serious of cases, criminal sanctions. The company can also sue its directors under common law duties, bring an application for compensation for breach of the statutory duties (regardless of whether ASIC is pursuing an action) or, alternatively, plead both.

Some of the potential remedies include:

- Transaction void: the transaction can be voidable at the option of the company.
- Account of profits: account of profits to the company regardless of whether the company has suffered any loss.
- Equitable compensation: where actual loss has been incurred by the company, monetary compensation may be ordered.
- Constructive trust: directors may be liable as constructive trustee where a breach removes an item of the company’s property and the director retains an asset representing that item.
- Disqualification order: an order disqualifying a person from managing a company for a set period of time

### **The Business Judgment Rule**

Directors can resort to the “business judgment” rule as a safe harbour or defence from personal liability in relation to the duty of care and diligence.



Under s 180(2), a director or officer of a company who makes a business judgment is taken to meet the duties of care and diligence (in s 180(1)) if they:

- make the judgment in good faith for a proper purpose; and
- do not have a material personal interest in the subject matter of the judgment; and
- inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- rationally believe that the judgment is in the best interests of the company.

In balancing this “safe harbour” provision, which may allow directors to escape personal liability, the Act provides for the statutory derivative action.

The statutory derivative action is an avenue for enforcing company’s rights by allowing the directors or shareholders of a company to bring proceedings on behalf of the company for a wrong done. As for situations where a director’s statutory breach has been ratified by a general meeting resolution, the court may take it into account when considering relief under s 1317S but is not bound to accept it. Also, general meeting ratifications cannot prevent ASIC from beginning proceedings against the company in the public interest.

The statutory derivative action also permits the courts to allocate costs to the company, therefore encouraging members to pursue directors for breaching their duties and alleviating cost barriers.

## **Delegation and Reliance**

A director can delegate some of their responsibilities and that will absolve the director from liability for the exercise of power by the delegate if:

- they believed on reasonable grounds at all times that the delegate would exercise the power in conformity with the duties imposed on directors under the Act and the company’s constitution; and
- the director believed on reasonable grounds and in good faith and after making proper inquiry (if the circumstances indicated the need for inquiry) that the delegate was reliable and competent in relation to the power delegated: s 190.

So, although directors may delegate, they must still act reasonably and exercise some oversight.

A director may also be entitled to rely on information or professional or expert advice prepared by certain people if:

- the reliance was made in good faith; and
- after making an independent assessment of the information or advice, having regard to their knowledge of the corporation and the complexity of the structure and operations of the corporation: s 189.

Directors cannot simply “rubberstamp” information or advice. They must make an independent assessment of its reliability, validity and appropriateness.





## Other considerations

### Appointment of directors

A proprietary company must have at least one (1) director. That director must ordinarily reside in Australia.

A public company must have at least three (3) directors. At least two (2) of the directors must ordinarily reside in Australia.

An individual must be at least 18 years of age to be appointed as a director of a company. Furthermore, a person who is disqualified from managing a company under Part 2D.6 may only be appointed as director if permitted by ASIC under s 206GAB or leave is granted by the Court under s 206G.

### Execution of documents (including deeds)

A company may execute a document either by fixing a common seal (s 127(2)) or without a common seal if the document is signed by:

- 2 directors of the company; or
- a director and a company secretary of the company; or
- a sole director who is also the sole company secretary for a proprietary company (s 127(1)).

### Maintenance of financial records and accounts

Directors must take reasonable steps to ensure that the company complies with its obligations under the Act in relation to the maintenance of financial records and financial reporting.

Directors must also have the financial literacy to apply their own minds and understand the financial statements so as to satisfy themselves that it is consistent with their knowledge of the company's affairs and to make the directors' declaration required under s 295(4).

### Misstatements in the context of fundraising

When securities are issued, the director(s) must ensure that any prospectuses or disclosure documents issued do not contain any misstatements or misleading statements. A director will be personally liable for defective statements unless they can prove that they made all the relevant enquiries that were reasonable in the circumstances and believed on reasonable grounds that the prospectus was not defective.

### Duty to prevent insolvent trading: s 588G

Directors must prevent the company from trading whilst insolvent.



A director will breach this duty if:

- the director was a director at the time the company incurred a debt;
- the company was insolvent at the time of incurring the debt or as a result of incurring that debt;
- there were reasonable grounds for suspecting insolvency; and
- the director failed to prevent the company from incurring the debt.

### **Fair Trading Acts, Trade Practices Act**

Directors may be personally liable under the provisions of these Acts if they participate in anti-competitive behaviour or are engaged in making false and misleading statements.

### **Other duties under the Corporations Act**

The director(s) must:

- ensure that dividends are paid from profits and not out of capital (s 254T);
- ensure that the company keeps the various statutory registers;
- provide, to their organisation, certain information relating to themselves (Part 2D.5);
- call the general meeting within 21 days where a requisition is presented under s 249D and not later than 2 months after the request;
- assist auditors in finalising the company audits.

In order to minimise liability, the director(s) should:

- actively participate in the day-to-day running of the company's affairs;
- be actively interested in the behaviour and nuances of fellow directors and the company members (i.e. majority shareholders) – appreciate how they conduct business, their reaction time on legislative requirements and their attitude to the proper observance of their duties; and
- accurately record your position on matters whether it be in minutes, letters or other memoranda and have a copy filed with the company records and keep a copy for yourself.

### **Important Note**

This overview is intended to convey general information only in relation to its subject matter. It is not intended to be, nor should it be treated as, legal advice by the reader. Please direct any specific questions or issues to your accountant or a qualified legal practitioner. We do not provide legal, accounting, taxation, superannuation or investment advice.

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