
DIRECTORS' DUTIES

PREPARED FOR THE VICTORIAN COMMERCIAL TEACHERS' ASSOCIATION



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INTRODUCTION

The Victorian Commercial Teachers' Association Ltd ("VCTA") is a public company. Members of the VCTA Committee are company directors within the meaning of the *Corporations Act (Cth) 2001* ("the Corporations Act"). As directors, they are subject to the responsibilities imposed on them by the Constitution of the VCTA ("the Constitution"), the Corporations Act, other legislation and the common law.

There has been growing public demand for directors to be personally accountable for their actions. As a result, both the Government and the judiciary have been scrutinizing the recent company collapses and prolonged and expensive legal action has been taken against the individuals involved.

The purpose of this paper is to inform members of the VCTA, who are considering nominating themselves to the Committee, about directors' duties so that they are aware of the extent of the responsibility which such a position entails.

Sources of liability

There are various sources of a director's liability for a breach of a director's duty and several entities which have power to take action against a director.

1. The following are sources of director's legal duties:
 - Duties contained within the *Corporations Act (Cth) 2001*;
 - Duties contained within the *Trade Practices Act (Cth) 1974*;
 - Contract;
 - Common law duty of care, failure to exercise which may lead to an action in the tort of negligence;
 - Fiduciary duties to act in good faith and not to procure profit at the expense of the company; and
 - Duties contained within legislation other than the above-mentioned acts.

2. The following entities have the power to take action against directors' conduct:
 - Australian Securities and Investments Commission;
 - Commissioner of Taxation;
 - Trade Practices Commissioner;
 - Various Occupational Health & Safety authorities; and
 - Company liquidators; and
 - The VCTA, its members, creditors, employees, volunteers and fellow directors may directly commence legal action against a director since the director's duties are mainly owed to the company and its present and future members.

It is beyond the scope of this paper to discuss all of the above sources of directors' duties. Instead, the paper focuses on the specific duties contained within the Corporations Act.

Duties in the Corporations Act

Part 2D.1 of the Corporations Act is dedicated to the duties and powers of officers and employees.

Sections 180 to 183 contain the duties to:

- a. act with due care and diligence (s.180);
- b. act in good faith (s.181);
- c. act in the best interests of the company (s.181);
- d. act for a proper purpose (s.181);
- e. avoid improper use of position (s.182); and
- f. avoid improper use of information (s.183).

The duties in each of these sections are discussed below.

a. Duty to act with due care and diligence

s. 180(1) of the Corporations Act states:

“A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

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

Company directors are expected to have sufficient business and financial skills in order to understand and be aware of the financial affairs of the company. It is important to note that a lack of such necessary skills cannot reduce a director's duty of care and diligence below this minimal requirement. It therefore may not be prudent for someone who is not sure about one's skills in this area to nominate or accept an appointment as company director.

ASIC v Adler (2002) 41 ACSR 72 was a civil proceeding against former HIH directors, including Mr Adler, relating to a \$10 million payment made by a HIH subsidiary to a company in which Mr Adler had an interest. The payment was used to buy HIH shares and make unsecured loans to Adler's related entities. Justice Santow in that case made the following statements of principle about the duty to exercise care and diligence:

- In determining whether a director has exercised reasonable care and diligence, one must ask what an ordinary person, with the knowledge and experience of the defendant, might be expected to have done in the circumstances if he or she was acting on their own behalf;
- The Court will consider the company's circumstances and the director's position and responsibilities within the company;
- A director appointed because of special expertise in an area of the company's business is not relieved of the duty to pay attention to the company's affairs outside

that area of expertise, if they would reasonably be expected to attract this inquiry; and

- In general, a director can rely on the judgment, information and advice of management and appropriate officers, but that reliance may be unreasonable if the director knows, or by using ordinary care should have known, of any facts to the contrary.

All directors, whether executive or non-executive, are expected to achieve an objective minimal standard of care and diligence.

b. Duty to act in good faith

s.181(1)(a) of the Corporations Act states:

“A director or other officer of a corporation must exercise their powers and discharge their duties:

(a) in good faith ...”

In considering a breach of the duty to act in good faith, the court looks at the director’s actual intentions to determine whether they were honest. In addition, the Court considers whether a reasonable person would have made a similar decision in the circumstances. Thus, there are two tests, a subjective and an objective one to ascertain whether a director acted in good faith.

If, as was determined in Adler’s case, a director is found to have intentionally acted recklessly or dishonestly, he or she can be found guilty in criminal proceedings.

c. Duty to act in the best interests of the company

s.181(1)(a) of the Corporations Act states:

“A director or other officer of a corporation must exercise their powers and discharge their duties:

(a) ...in the best interests of the corporation”

Company directors have long been required to act in the best interests of the company.

One significant qualification within this duty is when the company is insolvent, in which case a director is also required to consider the creditors of the company: e.g. *Re Martco Engineering* (1999) 32 ACSR 487.

d. Duty to act for a proper purpose

s. 181(1)(b) of the Corporations Act states:

“A director or other officer of a corporation must exercise their powers and discharge their duties:

...

(b) for a proper purpose.”

The duty to act for a proper purpose is in some ways an interesting obligation. The Corporations Act does not define ‘proper purpose’, so it is necessary to refer to the case law in order to understand and comply with the legislative requirement.

In *Harlowe’s Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co N L* (1968) 121 CLR 483, the High Court of Australia dealt with a challenge to the allotment of shares by management which had the effect of blocking an attempt to secure control of the company. It was argued, unsuccessfully, that the power to allot shares had been used for an improper purpose and was therefore invalid. The court said that:

“[the] ultimate question must always be whether in truth the issue was made honestly in the interests of the company...Directors in whom are vested the right and the duty of deciding where the company’s interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.”

This reasoning also demonstrates that the duties to act in good faith, for a proper purpose, and in the best interests of the company necessarily overlap in many ways and often are considered together.

e. Duty to avoid improper use of position

s.182(1) of the Corporations Act states:

“A director, secretary, other officer or employee of a corporation must not improperly use their position to:

(a) gain an advantage for themselves or someone else; or

(b) cause detriment to the corporation.”

The obligation to avoid improper use of position is of particular relevance for directors who procure appointment to the VCTA Committee to represent particular interests of another institution. Essentially, such directors are required to keep information which they receive as a director of the corporation (in particular Board papers) strictly confidential. They are not entitled to pass confidential information concerning the corporation to those whom they represent, or to any outside party.

f. Duty to avoid improper use of information

s.183(1) of the Corporations Act states:

“A person who obtains information because they are, or have been, a director or other officer or employee of a corporation must not improperly use the information to:

- (a) gain an advantage for themselves or someone else; or
- (b) cause detriment to the corporation.”

This duty continues after the person stops being an officer or employee of the corporation.

In the recent case of *ASIC v Steve Vizard* (2005) 219 ALR 714 for breaches of this part of the Corporations Act, Mr Vizard was alleged to have used confidential price-sensitive information during his office as director of Telstra in order to obtain a benefit for himself by instructing a company associated with him to trade in Telstra shares. Even though no actual profit was found to have been made by these deals, Mr Vizard was fined \$130,000 for each contravention and disqualified from managing a company for 10 years.

Responsibility of director for delegated actions

Section 190 of the Corporations Act states:

- “(1) If the directors delegate a power under section 198D, a director is responsible for the exercise of the power by the delegate as if the power had been exercised by the directors themselves.
- (2) A director is not responsible under subsection (1) if:
 - (a) the director believed on reasonable grounds at all times that the delegate would exercise the power in conformity with the duties imposed on directors of the company by this Act and the company's constitution (if any); and
 - (b) the director believed:
 - (i) on reasonable grounds; and
 - (ii) in good faith; and
 - (iii) 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.”

Pursuant to the power given by Section 198D of the Corporations Act and Article 90 of the VCTA Constitution, the VCTA Committee may from time to time delegate its powers to the Executive Management Group (“EMG”).

Members of the Committee, who are not EMG members, will be subject to the operation of s.190 of the Corporations Act. For a director to be relieved from liability for a breach of this section, the director must hold a reasonable belief that the delegate was reliable and competent, as a result of having conducted proper enquiries.

Conflict of interest

Section 195(1) of the Corporations Act states:

“A director of a public company who has a material personal interest in a matter that is being considered at a directors' meeting must not:

- (a) be present while the matter is being considered at the meeting; or
- (b) vote on the matter.”

S. 195(2) provides that s. 195(1) does not apply if the Board has passed a resolution that the director may be present or that he or she may vote on the issue or where the interest is the kind of interest which may not need to be disclosed pursuant to Section 191.

Matters concerning conflict of interest may be complex, and independent legal advice should be sought in the event of uncertainty.

Insolvent trading

Section 588G(1) of the Corporations Act states:

“This section applies if:

- (a) a person is a director of a company at the time when the company incurs a debt; and
- (b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
- (c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
- (d) that time is at or after the commencement of this Act.”

The Section imposes a liability on a director of a company who fails to prevent a company from incurring a debt when the company is insolvent. It is a defence to establish that there was a reasonable ground at the time of the incurring of the debt, to believe that the company was, in fact, solvent, or may become so as a result of the debt in question. In determining whether there were reasonable grounds to hold the relevant belief under this section, the Court will take into account a standard of reasonableness expected from a director of reasonable competence and diligence.

In *ASIC v Plymin & Ors (2003) 46 ACSR 126*, ASIC was successful in establishing, that John Elliott contravened the insolvent trading provisions of the Corporations Act. The Court found that ASIC did not have to prove that Mr Elliott had a duty to make a certain step, but simply that he allowed the relevant debts to be incurred by the relevant companies.

Criminal Provisions

Section 184 of the Corporations Act provides that a dishonest or reckless contravention of sections 181 to 183 of the Corporations Act leads to criminal liability with maximum imprisonment up to 5 years, fines of up to \$200,000, or both.

Civil Provisions

The Corporations Act provides a number of avenues for various entities to impose pecuniary penalties on a director who has breached a civil provision of the Corporations Act. Fines of up to \$200,000 may be imposed, compensation may be ordered for the company or other plaintiffs, and disqualification from acting as director may be made.

Future developments

Following the HIH Royal Commission in 2006, the Federal Government has investigated whether directors' duties should be extended to include other management personnel and corporate officers, who currently are not covered by the legislation as they are not members of their company's board. The Government is now considering the necessary changes to legislation in this regard.

Furthermore, developments in personal responsibility in corporate fault and corporate social responsibility promise to extend directors' duties in the areas of occupational health and safety environmental, and ethical matters.

Conclusion

This paper provides a very brief summary of the various issues which may arise as a result of one's conduct as a director of a company in Australia.

A decision to become a director should not be taken lightly. And, more importantly, once in office, one should act in awareness of the various duties at all times.

If you require further information with respect to directors' duties, or any other commercial legal matter, Armstrong Lawyers are able to provide such professional legal advice.