

Directors Duties: Overview of the role of director

Directors are responsible for the overall management of the affairs of the company. Understandably, becoming a director carries a range of duties and legal obligations. These legal obligations are contained in, *inter alia*, the Corporations Act 2001 (Corporations Act).

As a director, you must be fully up to date on what your company is doing, including its financial position, question managers and staff about how the business is going and take an active part in directors' meetings.

Assuming a directorship is a serious undertaking and directors can be personally liable for failure to carry out their duties. The standard expected of directors is high.

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 keep up to date with changes to relevant legislation and review Regulatory and Industry commentary on the roles and responsibilities of directors.

Duties

You must not use your position as a director of a company – or information obtained because you are or have been a director, officer, or employee of a company – to cause detriment to the company or to gain an advantage for yourself or someone else.

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.

Other fiduciary duties are listed below:

- to avoid conflicts of interests;
- 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;
- to exercise his or her powers for a proper purpose; and
- to exercise discretion and not improperly limit their decision-making authority.

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.

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 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 are some of the exemptions that apply to the general obligation upon a director to give notice of his 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; or
- Where the interest arises in relation to the director’s remuneration as a director of the company; or
- 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; or
- 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 arises because the director has a right of subrogation in relation to the said guarantee or indemnity; or
- Where the interest relates to a contract that insures, or would insure, the director against liabilities that the director incurs as an officer of the company; or
- Where the interest relates to any payment under a contract of indemnity in favour of the director which is permitted by the company; or
- Where the interest relates to a contract or proposed contract with related body corporate and arises because the director is a director of the related body corporate; or
- Where the company is a proprietary company and the other directors are aware of the director’s interest and its relation 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 of the Corporations Act 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;

Unless:

- 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; or
- ASIC has provided a declaration or order under s 196 of the Corporations Act approving the director's presence in the meeting and ability to vote.

Substantial 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.

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.

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.

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 divert 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 (1) of the Corporations Act 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 (1) of the Corporations Act 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” in the contravention of s 182(1) and s 183(1). Sections 182 and 183 are also civil penalty provisions.

“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.

3. 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) of the Corporations Act, 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 of the Corporations Act is a civil penalty provision.

4. 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' is reflected in s 181 of the Corporations Act.

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. 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.

Stepping stones liability

A director who unreasonably exposes the company to sanctions, civil liability or reputational damage in allowing the company to contravene the Corporations Act or some other relevant law may be found to have breached their duties to the company, potentially giving rise to both civil penalties and disqualification as a director.

This process of finding secondary liability on the part of a director for allowing a primary breach by the company has been coined as "stepping stone liability" and has recently formed the basis of a number of successful actions brought by ASIC against company directors.

Directors must exercise reasonable care and take precautions 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: profits are accountable 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 over the asset on behalf of the company 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

If a director makes a decision on behalf of a company that leads to negative results for the company, the director may be personally responsible. If this is the case, the business judgment rule allows directors to protect themselves against such claims.

Directors can resort to the "business judgment" rule as a defence from personal liability in relation to the duty of care and diligence.

Under s 180(2) of the Corporations Act, 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.

The director's belief that the judgment is in the best interests of the company is a rational one unless the belief is one that no reasonable person in their position would hold.

Delegation and Reliance

Unless the company constitution provides otherwise, a director may delegate any of their powers to, inter-alia, a committee of directors, a director or an employee. A director is responsible for the exercise of power by the delegate except 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 Corporations 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(2) of the Corporations Act).

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

According to s 189 of the Corporations Act, a director's reliance on information or professional or expert advice prepared by certain people will be taken to be reasonable 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: and
- the reasonableness of the director's reliance on the information or advice arises in certain proceedings.

Directors must make an independent assessment of the reliability, validity and appropriateness of the information or advice.

Other Considerations

Appointment of directors

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

A public company must have at least three directors. At least two 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. A person who is disqualified from managing a company under Part 2D.6 of the Corporations Act may only be appointed as director if permitted by ASIC or leave is granted by the Court.

Execution of documents (including deeds)

It is essential that all documents signed by a company are executed properly to create legally binding agreements that are enforceable.

When executing documents a company must either execute them in accordance with the:

- Corporations Act; or
- Provisions for executing documents contained in its Constitution.

According to s 127 of the Corporations Act a company can execute a document 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.

If a company executes a document under s 127 of the Corporations Act, people will be able to rely on the protection in other sections of the Act for dealings in relation to the company.

A company may execute documents in accordance with the provisions in the company's constitution, which may vary the mode of execution on behalf of the company from the requirements under the Corporations Act.

A company could also authorise execution of documents by an alternate means by resolution of the board of directors.

Maintenance of financial records and accounts

Directors must take reasonable steps to ensure that the company complies with its obligations under the Corporations 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.

Misstatements in the context of fundraising

When securities are issued, the directors 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 or disclosure document was not defective.

Duty to prevent insolvent trading by the Company: s 588G of the Corporations Act

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; and
- the company was insolvent at the time of incurring the debt or becomes insolvent as a result of incurring that debt; and

- at that time, there were reasonable grounds for suspecting insolvency or would become insolvent; and
- the director failed to prevent the company from incurring the debt.

Other duties under the Corporations Act

The director(s) must:

- ensure that dividends are paid from profits and not out of capital;
- ensure that the company keeps the various statutory registers;
- provide, to their organisation, certain information relating to themselves
- call the general meeting within 21 days after a request is provided to do so 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); and
- ensure that if their position on a matter is different to that of other directors that their position be accurately recorded in minutes, letters or other memoranda and have a copy filed with the company records and keep a copy for yourself.

Important Note

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