Module 8: Directors’ and officers’ duties

Key duties of directors and officers:
- Act with care and diligence;
- For directors only, avoid allowing the company to trade while the company is insolvent;
- Be a fiduciary, that is, be loyal and faithful to the company first, and avoid conflicts of interest.

a. Officers’ duties (owners and managers (2 distinct groups))

Managers are obliged to manage the company to benefit the owner, maximize the value of the company.

An officer’s duties must be understood to be both:
- a positive act-what officers should do/ a negative act- what officers should not do;

1. Duties under common law and equity

drs. have 2 liability regarding their activities, first liability is to the company ( agency theory) as a whole

General law duties- Common law duties and equitable (officers have duty to)
- the duty of care skill and diligence (act with reasonable care and diligence)

Establish in common law  *Daniels v Anderson (1995) 12 AGLC 614// 191*

Officers required to:
- be familiar with the company’s business and financial position
- be aware of other areas of the company outside your own area and expertise
- enquire and seek info by attending meetings and asking questions
- not ignore corporate misconduct;
- the duty to act in good faith for the benefit of the company ( be fiduciary)
- avoid conflicts of interests
act in good faith in the interests of the company
- use their powers for a proper purpose.
- retain discretions: where officers have a duty to act in the interest of the company they should not limit that power by acting in the interest of a controlling or influential shareholders.

2. Duties under the corporations Act

Statutory duties under the Corporations Act.

- The company takes action in relation to breaches of general law duties.
- **Primarily ASIC** enforces statutory duties. ASIC would take actions.
- the regulators will take actions if the breach comes to their notice.

Statutory duties are:

- Act with reasonable care and diligence- s 180;
- prevent insolvent trading- s 588G;
- act in good faith in the best interests of the company and for a proper purpose- s 181;
- not misuse position- s 182;
- not misuse information- s 183;
- disclose certain interests- s 191;
- disclose to other officers and vote (proprietary companies)- s 194;
- disclose and not able to vote (public companies)- s 195;
- avoid related party transactions- Chapter 2E;

3. The interaction of general law and statutory duties

- There is some overlap between the two sets of duties.

Because general law is still used by company or the members to take actions against on officers, but statute law is definitely used by the regulator, ASIC, against the officer where actions and behaviour of the officer is deemed to regulatory intervention for a breach of the rules.

4. Penalties and Remedies
When the company has suffered a loss because the actions of director or officer, then the company can seek:

- compensation, or
- damages;

If the actions of the director or officer breach the statutory duties such that ASIC feels it should take actions, then the penalties are:

- fine (either a criminal fine and a civil penalty)
- disqualification, and/or
- imprisonment;

ASIC as a regulator, the function and justification for imposing penalties is to:

- protect (shareholders)
- punish (those who breach their statutory duties)
- deter (others from breaching their statutory duties);

b. The duty of care and diligence

The duty of care and diligence arise from:

- a contract between director and the company - s 140(1)(b)
- the common law
- s 180 of the Corporations Act

Common law and statutory duty are similar, because the Corporations Act sought to legislate the duties that had established in common law.

s 180

Care and diligence–directors and other officers

(1) 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.

Note: This subsection is a civil penalty provision (see section 1317E).

Business judgment rule

(2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they: (a-d)

Note: This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (including the duty of care that arises under the common law principles governing liability for negligence)--it does not operate in relation to duties under any other provision of this Act or under any other laws.

(3) In this section:

*"business judgment"* means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.

1. who owes the duty of care and diligence?

s 180- under statute, the duty of care and diligence applies to the company’s directors
and other officers.

under common law, the duty is owned by the officers and senior executives.

Note: duty apply not only to directors but also to other officers of the company.

2. To whom is the duty of care and diligence owned?

- To the company as whole (Greenhalg v Arderne Cinemas Ltd [1946] 1 All ER 512) ie the shareholders (Percival v Wright [1902] 2 Ch 421)
- Generally not to employees, the community or even creditors (although creditors’ interests are relevant if the company is insolvent or facing insolvency)
- But duty may be owed to individual shareholders in some circumstances (sh is so reliant on the director for info and advice, and where the dr is in a position of particular advantage on the member and special circumstance)

Brunninghausen v Glavanics (1999) 17 ACLC 1247 text 194- B’s possession of special knowledge and the fact that he was effectively sole dr placed a duty on him not to prefer his own interest.

3. Determining whether a director has breached their duty of care

Statutory duty s 180- Court will look at the actual amount of care and diligence exercised by the director, and compare this with the degree of care and diligence that a reasonable person would exercise if they were directors of a similar company and have the same responsibilities as a director.

Difference is the application of penalties: by regulator(ASIC) OR by the company( general law)

Consider s 180(1)(a)

A defence against a breach of duty is available- the business judgement rule.

4. The consequences of breaching the duty

Common law: company can ask for damages. The company will want to be put back into the position it would have been if the officers not breach.( undo consequences of the breach of duty)

s 180: ASIC can seek to enforce civil penalty provisions by asking the court to:
- disqualify the person from managing companies;
- impose a penalty of up to $200 000
- ordering compensation to the company for loss or damage because of the breach of duty, even if the company did not seek compensation.

Note the criminal penalty under the Act do not apply for a breach of the statutory duty of care.

c. The standard of care

   Re City Equitable Fire Insurance Co Ltd [1925] Ch 407-traditional formulation of the duty

   “a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience”

1. Acquire a basic understanding of the business and be familiar with the fundamentals of the business
   - Know the business’s strengths.
   - Know the business’s weaknesses.
   - Know the business’s competitors.
   - Know the industry.

2. Stay informed about the activities of the company
   - Attend board meetings.
   - Question everything.
   - Do not rely solely on rubber stamp resolutions.
   - Monitor the company’s business affairs (but there is no need to closely inspect the day-to-day activities).

3. Delegate only to capable, experienced, qualified and reliable persons
   - Delegation can be to the managing director.
   - Delegation to staff must only be to staff capable of the responsibilities.

4. Be familiar with the financial status of the company by reviewing financial statements
   - Understand the income statement and the statement of financial position.
   - Understand the impact of numbers on ratios and covenants and do comparisons to the previous years’ results.

5. Make sufficient enquiries to inform business decisions
   - Ask questions and obtain advice.
   - Ignorance cannot be used as a defence for business decisions.
   - A failure to enquire is no defence.

6. Do not ignore any misconduct of the company
   - Do not ignore knowledge or suspicion that the company is engaged in misconduct.

7. Pay attention to all areas of the company
   - Even if an officer is engaged for a particular skill, they must also pay attention to other areas of the company.

- Drs must become familiar with company’s business
- Director is not an ornament but an essential component of corporate governance
- Directors must keep themselves informed of the company’s financial position
- Directors who have special skills and experience must use those but also pay attention to all areas of the company’s business
- Directors can exercise business judgment and take commercial risks but ignorance and a failure to inquire is no protection against liability for negligence
- Dr cannot shut their eyes to corporate misconduct – they have a duty to look.

To illustrate the applications of this minimum standards:

**ASIC v Healey (2011) 83 ACSR 484 text p 196** - the court found that the officers had breached their duty of care and diligence under s 180 (1) of the Corporations Act.

- The financial statements failed to disclose significant matters including
  - $1.5 billion of short term liabilities (they were classified as non-current liabilities)
  - Guarantees of short term liability of an associated company of US$1.75 billion.
- The directors were found not to have reviewed the financial statements with the degree of care and diligence which the law requires.

**ASIC v Adler [2002] NSWSC 171 approved in ASIC v Adler [2003] NSWSCA 131** - In relation to this transaction Adler breached s 180(1). A reasonably careful and diligent director of HIH or HIHC would not have caused this payment which was not in the
interests of HIH or HIHC/ Further Adler failed to ensure that the company followed its own investment practices with which he was familiar

*ASIC v Hellicar [2012]HCA 17* and related James Hardie cases see text p196- the court found that the potential liability was 1 billion. The executive and seven non-executive officers of JHL were held to have breached s 180(1) of the Corporations Act.

- The trial judge found that the draft announcement was misleading and that 7 non-executive directors and 3 executives had breached their duty of care in s 180 in approving it. (Directors denied the draft announcement was considered by the board but their evidence was not accepted by the trial judge or the High Court.)
- Two drs based in the USA who attended the meeting by telephone did not even see the draft announcement but the trial judge and the High Court found that they breached their duty of care in not calling to see it.
- The CEO (also a dr) breached his duty by voting to approve the announcement but also by
  - Failing to advise the board that the announcement was too emphatic concerning the adequacy of funding
  - In making comments at press conferences that were also false and misleading
- Two other persons, the CFO and a person who was company secretary and general counsel were also held to have breached s 180 by failing to advise the board of certain information that was relevant to the draft ASX announcement

2. **The standards of care by types of officer**

- Executive director: high level of skill given they involve in the day-to-day running of the company; higher standards
  
  The test of standard of care of an executive director is what reasonable person in the same position would do.

  *ASIC v Vines (2006) 24 ACLC 165*- Mr Vines’ failure to drawing matters to the attention of the board providing the profit forecast was breach of his duty of care.

- Non-executive directors: for some particular expertise, but they are not related in the day-to-day operations.
  
  Test: is refer to the knowledge and expertise possessed by other people with the same skill and expertise.

- The chair: higher degree of standard of care


- The managing director/chief executive officer: overall responsible and relatively high standard of care

  *ASIC v Adler (2002) 20 ACLC 1,146*

2. **Diligence:** all officers should be diligent when looking at affairs- understanding the affairs of the business.

1. **Attending board meeting**

   s 300(10): require the officers’ report of a public company to set out how many board meetings each director attended.

2. **Delegation**

   s 189D: allow officers to delegate tasks and responsibilities to: a committee of officers,
a director, an employee, or any other person.

2.1 Responsibility of the actions of delegates:

s 190 (1)

- S 198D provides that directors may delegate powers but they remain responsible for actions of delegates unless directors believed on reasonable grounds that delegate would act in compliance with law and was reliable and competent s190. However, s 190 (2) allows directors to escape this responsibility if certain conditions satisfy.

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.

1. Is the function delegated of a type that can be properly left to such officers?
2. To what extent should the director be put on notice?
3. What is the relationship the director and the delegate?
4. Does the director honestly believe that the delegate is trustworthy and competent and can be relied on?
5. If the delegate is dishonest or incompetent then the reliance is unreasonable. How do you check?
6. What is the nature and risk in the transaction?
7. What steps were taken by the director (i.e what enquiries did they make)?
8. Is the director an executive or non-executive?

Sheahan v Verco (2001) 37 ACSR 117- Held that they had breached general law and statutory duties in failing to play any role in monitoring the activities of the managing director. They were not justified in relying on the company’s solicitor and accountant to monitor the managing dr.

2.2 Information and active provided by others

s 189 allows officers to rely on others if:

Drs can reasonably rely on information or advice provided by others only if:

- the dr believes that a professional expert has the skills required
- the dr has reasonable grounds to believe that the employee is reliable and
competent
bullet the dr believe another director has the skill, or
bullet a committee on which the dr does not serve has the required skills
  • Reliance is made in good faith
  • Dr made an independent assessment of the information or advice
  • Categories of person who might be relied upon
  • Employee (reliable and competent), professional advisor (within area of expertise), other director or committee of directors.

e. Defences against a breach of duty of care and diligence
bullet Business judgment rule s 180(2)
bullet Reliance upon others s 189
bullet Delegation of responsibility s 198D and s 190.

1. Business judgment rule s 180(2) – arise from the fact that the courts will not review the merits of a business decision. Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821 – provides protection for directors (rebuttable presumption) in relation to fulfilment of the duty of care and diligence where
a) The judgment was made in good faith and for a proper purpose
b) they do not have a material personal interest in the subject matter and
c) they inform themselves about the subject matter to the extent they reasonably believe to be appropriate and
d) rationally believe that the judgment is in the best interest of the corporation

ASIC v Rich (2009) ACLC 2,139 – a rational belief exists if the director believes that his judgement was in the best interest of the company and that belief is supported by a reasoning process that is rational.

General law duties in relation to creditors
Duties are owed to the company as a whole and under the general law the interests of creditors are not considered except where the company is insolvent or facing insolvency. The interests of creditors then overtake the interests of shareholders as they will rank ahead of shareholders in a liquidation.

Kinsela v Russell Kinsela Pty Ltd (in liq) (1986) 137 CLR 1
  • Funeral business company insolvent
  • Leased business premises to 2 drs on uncommercial terms
  • interests of creditors had to be taken into account

Today you would also consider the insolvent trading provisions and the voidable transaction provisions.


f. The duty to prevent insolvent trading

1. the duty to prevent insolvent trading under s 588G of the corporations Act

  • Statutory duty to prevent insolvent trading
    • A positive duty is placed on directors (only on directors – including de facto and shadow directors - but not other officers) to prevent the company from trading while insolvent as this unfairly places creditors at risk.
The corporate veil is effectively lifted by placing liability on directors personally.

**S 588G**
- Director at the time company incurred the debt
- Company was insolvent or became insolvent by incurring the debt
- Reasonable grounds for suspecting insolvency
- Director was aware of those grounds or reasonable person in like position would have been so aware

### 2. When is a debt incurred? —timing depends on the type of debts

#### 2.1 Debts related to the supply of goods and service
Debt incurred when the goods and services are ordered.

#### 2.2 deemed debts s 588G(1A)

### 3. Other requirements as to incurring debts
What constitutes the incurring of a debt?
- Deemed debts s 588G(1A) eg paying a dividend, buying back shares
- Specific amount of money
- Can be a contingent liability eg guarantee
- Does not include an obligation to pay unliquidated damages (not voluntarily incurred)
- Debts owed to ATO

### 4. The time at which a company becomes insolvent
**s 95A** adopts a cash flow definition of insolvency – insolvent if company cannot pay its debts as and when they become due for payment
- cash flow test
- However the courts recognise that the real question is whether the company is able to pay its debts whether the funds are derived from cash reserves or other sources
  - **Presumptions of insolvency**
- **S 588E**
In winding up if it is proved that a co was insolvent at some point during the past 12 months it is presumed (rebuttable presumption) to have continued to be insolvent since that time s 588E (3)

Failure to keep or retain financial records s 588E (4)

5. **Reasonable grounds for suspecting insolvency**
   Court will look at whether a director has a basic understanding of the company’s financial status and ask whether the director was aware at the time the debt was incurred that there were reasonable grounds to suspect the company is insolvent.

6. **Defences to a breach of s 588G**
   The defences to a breach of s 588G are combined within s 588H
   - Reasonable grounds to expect that the company was solvent see Metropolitan Fire Systems Pty Ltd v Miller, Hall v Poolman and ASIC v Plymin below
   - Reasonable reliance on someone else to provide information about the company’s solvency see Metropolitan Fire Systems Pty Ltd v Miller and ASIC v Plymin below
   - Absence from management due to illness or other good reason see DCT v Clark
   - Director took reasonable steps to prevent incurring the debt
     - Reasonable steps includes any action the dr took to appoint an administrator

**ASIC v Plymin, Elliott and Harrison [2003] VSC 123**
- Therefore no reasonable grounds to expect that the company was solvent
- Couldn’t rely on defence of info supplied by others – some info suggested insolvency and other info was unreliable and Elliott admitted concerns about the quality of the information
- Elliott argued that he was unable to prevent insolvent trading because he was a non-executive dr – if that is the case then the dr should resign.
- Plymin banned from being a dr 10 years (reduced to 7 on appeal) and fined $25,000 and Elliott banned for 4 years and fined $15,000.

**Metropolitan Fire Systems Pty Ltd v Miller (1997) 23 ACSR 699** Raydar undertook to do work for Reed. Miller, dr of Raydar, then arranged to sub-contract some of that work in order to meet deadlines./Raydar had creditors demanding payment
- Other drs sought to say that they had relied on Miller
- They were unsuccessful in this – they had a positive duty to take an active part in the affairs of the company – they should have known what was going on.
- An expectation of solvency requires something more than mere hope or possibility.

7. **Penalties and Remedies**
   - Compensation
     Compensation can be given in conjunction with an application for civil penalty order or as part of proceedings for criminal offence ss 588J and 588K (and see s 1317H)
     Liquidator can bring proceedings s 588M
     Creditor initiated proceedings ss 588R – 588U – subject to liquidator’s consent
   - Civil penalty- a civil penalty provision under Pt 9.4B. For breach of s 588G
     the court, on application of ASIC, can make
- An order disqualifying the dr from managing cos for a specified period s 206C
- An order to pay a pecuniary penalty of up to $200,000 s 1317G
- An order to pay compensation to the company (loss or damage suffered by the creditor whose debt was incurred when the company was insolvent) s 588J
- Criminal offence under s 588G (3)- serious enough and dishonesty in involved
  - Fine of up to $360,000 and/or
  - Imprisonment for up to 5 years Schedule 3
  - (Schedule 3 is at the back of the Act before the Regulations and contains the penalties for breach of specified sections. Note that a penalty unit is currently $180 under s 4AA of the Crimes Act 1914 (Cth))
- disqualification of directors
- Note that holding companies may also be liable for insolvent trading of subsidiary companies under s 588V although there have been few actions under this provision

g. Employee entitlements
- Under s 596AB a person must not enter into an agreement with the intention of preventing the recovery of the entitlements of employees (wages etc) or significantly reducing their entitlements.
- There were a number of well publicised cases including Patricks where employees stood to lose their entitlements. This led to the introduction of this provision.

Insolvent trading:
S 596 AC – provides for payment of compensation in the event of breach of s596AB (liquidator or employee can sue