OVERVIEW OF DUTIES IMPOSED ON DIRECTORS OF PUBLIC COMPANIES

Introduction

Under common law principles, a director must act honestly; exercise reasonable care and skill; and be diligent, aware of and understand the fiduciary responsibilities of their position. This can be summarised as the duty to, among other things:

1. act bona fide in the interests of the company (act in good faith);
2. exercise care, skill and diligence;
3. exercise the powers for the purpose for which they were conferred;
4. retain their discretionary powers; and
5. avoid conflicts of interest.

There are extra statutory duties imposed under the Corporations Act. The statutory duties are in addition to, and in no way derogate from, the common law (s185 of the Corporations Act). However, the statutory defence (the so called "business judgment rule") in section 180(2) of the Corporations Act does apply to excuse a director from any liability that might otherwise arise under both statute and common law in relation to the duty of care, skill and diligence, provided the requirements of the rule are met (see further below).

As directors are in an accepted category of being in a fiduciary relationship, they also have obligations not to breach their fiduciary duties. It is reasonable for the company to rely on a director's trust, confidence and loyalty.

Duty to Act in Good Faith and For a Proper Purpose

Section 181(1) of the Corporations Act provides that a director of a corporation must exercise their powers and discharge their duties in good faith in the best interests of the corporation **and** for a proper purpose. These are two separate duties.

Duty to Act in Good Faith in the Best Interests of the Corporation

This duty is both a statutory and common law duty and is a civil penalty provision.

It is clear that a company director is required to act honestly in dealings with the shareholders and to ensure that the shareholders are not misled. When shareholders are approached for approval, they must receive all the information necessary to enable them to make a fully informed decision.

Although honesty is necessary it is not enough. The standard formulation of their duty is that directors must act "bona fide in what they consider – not what the court may consider – is in the best interests of the company". However, many cases have held that directors may breach their duty even if they are acting in what they genuinely consider to be an honest manner, because they have failed to give proper consideration to the interests of the company (including making a decision which no reasonable board could consider to be within those interests). Situations of this kind tend to arise when circumstances induce directors to believe that the company's interests correspond with their own interests or with the interests of some other person. In these circumstances, directors then act without considering the company's interests as a separate entity.

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Examples of a failure to pay proper regard to the company's separate interests include:

1. a director, who is also a controlling shareholder, causing the company to issue shares to his de facto wife with the object of ensuring that she would control the company after his death;
2. directors sanctioning the giving of a lease by the company on terms very favourable to two directors when the company is in financial difficulties; and
3. expenditure of company money by directors with the aim of preventing a rival panel of candidates being elected to the Board.

The appointment of nominee directors may raise issues as they may face conflicting duties. Nominee directors are appointed to act and represent the interests of their appointors. Therefore, potential conflicts may arise between the nominee director's duty to act in the interests of the appointor and the director's duty to act in the interests of the company as a whole. It has been held that a nominee director will not be in breach provided they honestly believed that the interest of their appointors and the company are the same. However, a company may draft its constitution so as to modify the directors' fiduciary duties, thus nominee directors may act in the interests of their appointor without breaching their duty to the company as a whole.

Another troublesome issue concerns what is meant by the words "the company"? Depending on the circumstances, various entities could be considered to be part of "the company", namely existing members, future members, creditors, employees, customers, contractors and the community. The basic principle is that the interests of a company are generally those of its members, especially the existing members. Typically however, difficult issues may arise when trying to balance the interests of members with the overall commercial interests of the company as well as interests of other stakeholders.

Duty to Act for a Proper Purpose

In exercising their powers, directors must be motivated to act in the company's interests, and not for any improper purpose nor in their own self-interest.

The following principles should be applied in determining whether directors have acted for an improper purpose:

1. powers under common law granted to directors must be exercised for the purposes for which they were given, not collateral purposes;
2. it must be shown that the substantial purpose of the directors was not improper nor in breach of their duties as a director. The issue is not whether the results of their rational business decisions proved to be good or bad; it is whether the directors have acted honestly and loyally so as not to be in breach of their fiduciary duties;
3. honest or altruistic behaviour does not prevent a finding of improper conduct. Whether acts were performed for the benefit of the company is objectively determined. However, evidence as to their subjective intentions or beliefs is always relevant; and
4. the courts must determine whether, but for the improper or collateral purpose, the directors' powers would not have been exercised.

Examples of situations where directors have been found to act for an improper purpose are:

1. exercising the Board's power to issue shares with the substantial motive of defeating the voting power of existing shareholders by creating a new majority (this is a frequent source of dispute);
2. failing to give proper full information in a notice of a general meeting;
3. using company funds to seek their re-election to the Board of directors;
4. refusing to register a share transfer when all transfer requirements have been complied with;
5. issuing shares to dilute the proprietary rights of shareholders, and for no demonstrable benefit to the company; and
6. causing the company to enter into a sale agreement to induce the purchaser to proceed with the purchase of an associated company where both the company and the related company were controlled by the directors who would personally benefit under the transactions – the

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potential benefit accruing to the controlling directors if the purchase of the related company went ahead was an impermissible purpose for the company to enter into the sale agreement.

Duty to Exercise Care, Skill and Diligence

There is an objective test for whether a director has met the standards of care and skill expected under the law. A director is expected to exercise a degree of care that is reasonable to expect from a director. Again, this area of the law is one where a combination of common law and statutory duties applies.

The statutory duty of care and diligence (section 180(1) of the Corporations Act) provides that a director of a company must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

1. were a director of a company in the company's circumstances; and
2. occupied the office held by, and had the same responsibilities within the company as, the director in question.

The wording of s180(1) makes it clear that while a director's performance is to be judged objectively, due consideration must be given to the position that the director holds in the company, and the company's particular circumstances.

The common law has also laid down a standard set of duties expected of directors, which includes the duty to act with reasonable care and diligence.

So, in determining whether a director has breached the statutory standard of care and diligence, the court will have regard to the company's circumstances, and the director's position and responsibilities within the company.

The duty of directors depends upon the size of the company and whether they are full-time senior managers or non-executive directors. While it is not always possible for directors of a large public company to have a hands-on approach to all the affairs of the company, they should have a good general understanding of the business of the company. In addition, directors should be aware that the developing complexities of modern commercial life have intensified what the community expects of them.

Non-executive directors are distinguished from executive directors in that they are not bound to give continuous attention to the affairs of a corporation, but rather, their duties are more of an intermittent nature to be performed at periodic board meetings and at meetings of any committee of the board they sit on.

The Corporations Act does not expressly set any required degree of skill and therefore the court decisions will determine this on a case by case basis. The word "diligence" imports application of skill where required, but says nothing as to the degree of skill required. Therefore, to understand the meaning of the statutory duty it is necessary to refer to the standards embodied in case law.

It has been held that the responsibilities of directors require that they take reasonable steps to place themselves in a position to guide and monitor the management of the company. The case law suggests that:

1. a director should acquire at least a working understanding of the business and finances of the corporation; accordingly, a director should become familiar with the fundamental operations in which the corporation is engaged;
2. directors are under a continuing obligation to keep informed about the activities of the corporation;
3. directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies; accordingly, a director should attend board meetings regularly; and
4. whilst directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of relevant financial statements.

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A director may be appointed to a company because of their special expertise in an area of the company's business, in which case, whether or not the director has breached their duties of care and diligence will be tested by reference to the knowledge and expertise possessed by persons with that same skill and expertise. Thus, if any director does possess special skills they will be expected to perform at that higher level in relation to the affairs of the company relevant to those skills, whilst still giving attention to the other affairs of the company that could reasonably be expected of any other director.

The following are examples of a director breaching their duty to exercise reasonable care and diligence:

1. convening a meeting of shareholders where the notice convening the meeting contains misleading and incorrect statements;
2. continuing to trade even when advised of insolvency;
3. taking high risks without attempting to assess the benefits which might be obtained in return for the risk;
4. failing to monitor and supervise the company's accountants;
5. failing to ensure that the company made loans in accordance with its authorised practices;
6. signing cheques carelessly without ensuring that the cheques were properly payable to the named payee and otherwise drawn and presented in accordance with the company's authorised business practices;
7. failing to ensure that the company had a proper system of controls and audit to avoid any defalcation by officers and employees; and
8. signing an insurance policy which had been completed by another person and which the director does not read.

Statutory Business Judgment Rule

A statutory business judgment rule is contained in section 180(2) of the Corporations Act. This section provides that a director of a corporation who makes a business judgment (any decision to take or not take action in respect of a matter relevant to the business operations of the corporation) is taken to meet the requirements of the statutory duty of care and diligence in section 180(1) of the Corporations Act and the equivalent duties at common law and in equity, in respect of the judgment if they:

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

Section 180(2) of the Corporations Act further provides that the director's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

The purpose of the business judgment rule is to provide directors with a “safe harbour” from personal liability for breaches of the statutory and general law duties of care and diligence in relation to “honest, informed and rational” business judgments. In one sense, this rule would seem to keep the courts away from the merits of a decision unless it can be shown that the decision making process was seriously flawed. Broadly speaking, so long as the process is not flawed, if the result turns out badly, the courts will have no right of review. Accordingly, one area where directors will continue to be exposed to litigation is in circumstances where it is alleged that there has been a failure to adequately monitor the affairs of the company.

Delegation and Reliance

In some cases it is necessary and acceptable for directors to rely on the advice and conduct of others within (or even outside) the company. But directors are expected to recognise situations in which it would be dangerous to rely on others.

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In terms of section 198D of the Corporations Act, unless the company's constitution provides otherwise, the directors of a company may delegate any of their powers to a committee of directors, a director, an employee of the company, or any other person. The delegation should be carefully minuted.

Section 190(1) provides that if the directors delegate a power under s198D, a director is responsible for the actions of the delegate. However, s190(2) provides that a director is not responsible under s190(1) if the director believed on reasonable grounds:

1. at all times that the delegate would exercise the power in conformity with the duties imposed on directors of the company by the Corporations Act and the company's constitution (if any); and
2. 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.

Section 189 Corporations Act provides a presumption that reliance by a director on information or advice is reasonable and not a breach of duty (unless it is proved that the reliance was not reasonable) where the reliance was made:

1. in good faith; and
2. after making an independent assessment of the information or advice having regard to the director's knowledge of the company and the complexity of the structure and operations of the company.

In order to obtain the benefit of the presumption in s189 (that there has been reasonable reliance and therefore no breach of duty), the information or advice must be given or prepared by:

1. an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;
2. a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence;
3. another director or officer in relation to matters within the director's or officer's authority; or
4. a committee of directors on which the director did not serve in relation to matters within the committee's authority.

Duty to Avoid a Conflict of Duty and Interest

There is a strict prohibition on directors (being fiduciaries) placing themselves in a position of conflict between their personal interests and their duty to the company, except where the director has the fully informed consent of the company. The obligation aims to prevent directors improperly making a profit from their office, but goes even further to prevent directors from putting themselves in a position where it appears that they may act in their own interests.

The case law confirms that equity recognises the following principal rules:

1. company directors must not, in any matter falling within the scope of their service, have a personal interest or inconsistent engagement with a third party, except with the company's fully informed consent. This is known as "the conflict rule";
2. company directors must not misuse their position for their own or a third party's possible advantage, except with the company's fully informed consent, and therefore they must account to the company for any gain which they make in connection with their fiduciary office. This is known as "the profit rule"; and
3. company directors must not misappropriate the company's property for their own or a third party's benefit. This is known as "the misappropriation rule".

The equitable principles regarding a director's obligations have been supplemented (not replaced) by provisions of the Corporations Act, including the following:

1. sections 182 and 183 deal with the improper use of position and information;

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2. section 191 imposes a statutory disclosure obligation on directors who have a material personal interest in a matter that relates to the affairs of the company;
3. section 195 prohibits a director of a public company who has a material personal interest from participating in the directors' decision;
4. Chapter 2E deals with a public company or its child entity giving financial benefits to related parties of the public company;
5. Part 2D.2 Div 2 deals with the giving of benefits to directors and officers on retirement or loss of office; and
6. Part 7.11 Div 2A deals with insider trading.

Conflict Rule

The conflict rule provides a general prohibition on directors placing themselves in a position of conflict whereby a personal interest or duty conflicts with their duty to the company. The courts have adopted a pragmatic approach to the scope of the conflict rule by requiring a "real sensible possibility of conflict" before a breach may be established.

The conflict rule has its most obvious application in cases where a director enters into a transaction, directly or indirectly, to which the company is a party. The clearest case of the director having a conflict is when a director enters into a transaction with the company under which the director stands to make a direct personal gain. Another category is where directors employ themselves to work for reward for the company.

Where a director of company A is engaged in a transaction with company B of which they are also a director, the director must make full disclosure of their interest and, in some cases, may be obliged to abstain from taking part in the negotiations or voting on the transaction. A conflict of duties may arise where a director owes a duty of honesty and loyalty to one company and a duty of confidentiality to another company, in a situation where the two companies are engaged in a transaction.

What action, beyond disclosure, the director must take varies from case to case depending on matters such as the degree to which the director has been involved in the transaction and the gravity of possible outcomes for the company. It may not be enough for the director to refrain from voting or absent themselves from the meeting. The circumstances may require the director to take some positive action to suggest a course of action to limit any possible harm to the company. The director may need to resign in order to avoid a breach of duty.

It is not necessary that the conflict between interest and duty or duty and duty cause either a loss to the company or a profit to the director.

As noted above, there are statutory provisions regarding interested directors. Section 191(1) of the Corporations Act provides that a director of a company who has a material personal interest in a matter that relates to the affairs of the company must give the other directors notice of the interest unless section 191(2) says otherwise.

Section 195(1) of the Corporations Act provides that 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 be present while the matter is being considered at the meeting or vote on the matter unless section 195 allows the director to be present or the interest does not need to be disclosed under section 191.

ASIC has power to make specific declarations under section 196 if matters require urgent attention and there are difficulties in maintaining a quorum.

Profit Rule

The profit rule states that a fiduciary is accountable for profits made in connection with their fiduciary office.

The profit rule attempts to ensure that when acting for the company, directors are not tempted by the prospect of deriving benefits for themselves. This equitable principle applies even where the company has not suffered any loss, indeed it may even have benefited. Further, there is a breach of duty even

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if the transaction was fair from the company's point of view. Directors must be seen to act in good faith and without self-interest – they cannot place themselves in a position where it may appear that they are motivated by considerations other than what is in the best interests of the company. Directors may be able to avail themselves of s1318 of the Corporations Act, which permits the court to relieve them from liability for breach of duty if it appears that they acted honestly, and, having regard to the circumstances of the case, ought fairly to be excused.

The application of the profit rule to company directors raises special problems because it seems to be acknowledged that directors may make profits through investments and sometimes through their own private businesses. There is no absolute duty on a director to abstain from engaging for their own benefit in the same kind of business as that carried on by the company where there is no likelihood of confidential company information being misused. Nevertheless:

1. directors are accountable to the company if they divert business opportunities away from the company and into their own business;
2. it is no answer to a breach of fiduciary duty that the profit made was of a kind that the company could not have obtained;
3. directors cannot avoid liability under the conflict or profit rules and retain the benefit of a transaction by proving that the transaction was fair to the company; and
4. a director who derives an undisclosed personal benefit is in breach of duty, irrespective of whether the company suffered loss as a result.

Though, there may be some instances where directors can exploit corporate opportunities that come to them in their private capacity.

Misappropriation Rule

A director may not apply company property either for the director's personal benefit, or for the benefit of any other person, without the authority of the company.

This restrains directors from taking remuneration or other benefits from the company's resources unless authorised by law, by the company's constitution or with the fully informed consent of the company in general meeting (Part 2D.2). For listed companies, the ASX Listing Rules require the approval of the general meeting in respect of fees payable to directors, employee incentive schemes benefiting directors and termination benefits exceeding a prescribed amount.

The equitable principles which prevent a director from misappropriating property of the company are supplemented by Chapter 2E of the Corporations Act, which prohibits a public company or its child entity from giving a financial benefit to a related party of the public company – directors of a public company are related parties of the public company – unless the approval of members in general meeting is obtained in the manner set out in the Corporations Act.

Statutory Provisions: Improper use of Office or Information

Misuse of Position

Section 182 of the Corporations Act (which is a civil penalty provisions) provides that a director or other officer of a corporation must not improperly use their position to gain an advantage for themselves or others or cause detriment to the corporation. Often this will overlap with the misuse of information provision because directors can misuse their position in order to gain information.

The following matters must be proved to establish a contravention of section 182:

1. the person in question was at the relevant time an officer or employee of the corporation;
2. the person made improper use of their position ('improper' is not defined but the High Court has stated that the test of impropriety is objective. In particular, the Court dictated that "impropriety consists in a breach of the standards of conduct that would be expected of a person in the position of the alleged offender by reasonable persons with knowledge of the duties, powers and authority of the position and the circumstances of the case".);

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3. the person made that improper use for the purpose of gaining an advantage or causing detriment to the corporation; and
4. such an advantage was either for the officer or some other person.

Misuse of information

Section 183(1) (which is a civil penalty provision) of the Corporations Act provides that a person who obtains information because they are or have been a director or other officer of a corporation must not improperly use the information to gain an advantage for themselves or someone else or cause detriment to the corporation.

The following matters must be proved to establish a contravention of section 183:

1. the person in question was at the relevant time an officer or employee of the corporation;
2. the person acquired the relevant information;
3. the person acquired that information by virtue of their position as officer or employee of the corporation;
4. the person made improper use of the information;
5. the person made that improper use for the purpose of gaining an advantage (as long as the purpose is there, it does not matter whether the advantage eventuates) or causing detriment to the corporation; and
6. that such advantage was either for the officer or for some other person.

Fiduciary Duties - Summary

There are two principal fiduciary duties owed by all fiduciaries to the person whose trust is present in their relationship:

1. a fiduciary must not place themselves in a position where there is or may be a conflict between their duty as a fiduciary to that person and their own interest or duty to a third party; and
2. a fiduciary must not make a profit by reason of their relationship with the party to whom the duties are owed.

These duties are dealt with more fully above. In general however, a director's fiduciary duties cannot be exhaustively listed as they are moulded and tailored to each circumstance. Furthermore, a director's contract or terms of employment as well as the company's constitution may also be relevant to the extent and content of a director's fiduciary duties.

Duty not to Fetter Discretions

Directors in the exercise of their powers and performance of their functions cannot act for their own benefit but must act for the benefit of the company. They have a duty to give adequate consideration and a duty to retain discretions. Directors are required to exercise an active discretion. They will be in breach of duty for letting things slide or for improperly acting blindly at the discretion of another person.

The Board can delegate to agents to carry out the Board's policy but delegation of the Board's functions must be in accordance with section 198D of the Corporations Act or an appropriate provision in the company's constitution. Section 198D is discussed above. This means delegation can occur but not to the extent of abdication of duties.

The duty to retain discretions does not however prevent directors from undertaking to exercise their powers in the future as a necessary and appropriate matter incidental to the implementation of prior decisions or contracts. When deciding to make the contract though they must give proper consideration to the desirability of entering the contract in the circumstances and make their decision on an informed and rational basis, and in what they believe in good faith to be the best interests of the company as a whole.

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Insolvent Trading

Under section 588(G) of the Corporations Act, a director has a duty to prevent insolvent trading. A director may commit an offence if a company incurs a debt while it is insolvent or there are reasonable grounds for suspecting the company would become insolvent as a result of incurring that debt or other debts. Subject to a number of defences, a director will be personally liable for the debts incurred by the company if there are reasonable grounds for suspecting that the company is insolvent and continues to trade.

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