

King's Own Institute

DUTIES AND RESPONSIBILITIES OF COMPANY DIRECTORS IN AUSTRALIA

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Course: Company and Securities Law

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Introduction

Critical pillars of good corporate governance, the adequacy of the provisions concerning the obligations and accountabilities required of directors of a company have been under increased scrutiny in the recent past (Mallesons Stephen Jaques, 2012, p. 5). According to Horrigan, the legal provisions concerning the duties of directors and the defences available to them is one area in Australian boardroom regulation that is increasingly under pressure (2012, p. 21). Golding notes that the trend emerging from recent cases concerning director duties and responsibilities exhibits a predisposition toward a finding of culpability of company directors (2012, p. 266). Therefore, it is imperative that those in corporate governance positions must be aware of the expectations placed on them. In considering these regulatory issues that have a bearing on the duties and responsibilities of company director's, this paper seeks out whether Karen and Lucy, through their conduct, have breached their directors' duties.

Sources of the Duties of a Director

Provisions governing the duties and responsibilities of directors derive from common law, statutory law and a corporation's constitution (PwC, 2011, p. 1). In this context, common law denotes the general law as developed by judges through judicial precedent. The *Corporations Act 2011* (Cth) is the principle statute providing for the duties of company directors. It codifies the common law duties of directors and equitable fiduciary duties and imposes further statutory duties (Barnes, 2013, p. 3). According to the *Corporations Act*, the activities of a company should be by or under the management of the directors (*Corporations Act*, 2001, s. 198A). It also recognizes that there are other sources of law concerning the duties of directors (*Corporations Act*, 2001, s. 179 (1)).The provisions of the Act add to and do not differ

from the duties of directors as stipulated under the common law (*Corporations Act*, 2001, s. 185). A corporation's constitution comprises a set of its rules on internal management and it may provide for directors' obligations. A constitution has an effect similar to that of a contract between the corporation and each director or employee (*Corporations Act*, 2001, s. 140(1) (b)). Suffice to note that breaches of the duties may lead to either personal (*Corporations Act*, 2001, s. 588G) or criminal liability (*Corporations Act*, 2001, s.184).

Duty of Care, Skill and Diligence

According to Section 180(1) of the *Corporations Act*, the company directors should act with care and diligence in the dispensation of their responsibilities. The provision requires all the directors and administrators of a company to observe the amount of care, skill and diligence that a rational person in similar circumstances would have exercised. Therefore, the objective test is applied in determining whether a director's actions are compliant with the law (*ASIC v Rich*, 2003). According to Golding, the adoption of the phrases 'degree of care and diligence that a reasonable person would exercise', 'the corporation's circumstances' and 'same responsibilities' are reflective of an independent minimum standard of behavior expected of a company director (2012, p. 269). Suffice to note that the standard of care may vary depending on the type and size of the company and the capacity and responsibilities of a particular director or official (Jones and Welsh, 2012, p. 374).

In *Commonwealth Bank of Australia v Friedrich* (1991), the court concluded that due to the complexities of modern commerce, it is expected that a director must have an adequate understanding of the affairs of the company such that can enable him to make an opinion that is reasonably informed concerning the financial capacity of the company. In *Daniels v Anderson*

(1995), the court also concluded that directors must take judicious measures to be at a plane upon which he or she can effectively control and observe the administration of the company. The court in *Daniels* extended the application of the objective standard from financial issues only to the general management of the company. Further, in *ASIC v Healey* [2011], the court concluded that directors are under an obligation to continuously make inquiries and stay informed about all aspects of the business and financial position of the company. In *AWA Ltd v Daniels* (1992), the court acknowledged that the subjective elements of a company officer's position as well as the particular circumstances of a company are also taken into consideration in making the determination on whether there has been a contravention of the duty of care and diligence. Accordingly, although there is a minimum objective standard, the standards expected of directors will differ according to the extent of their experience, the nature of the business judgment in question, the nature of the company in which they are directors and any other circumstances that are relevant to the case (Baxt, 2005, p. 106-7).

There are three defences available to a director who has been accused of a breach of the duty of care, skill and diligence. These are the business judgment rule, the defence of reliance and the defence of delegation. The business judgment rule is a creature of Section 180 (2) of the *Corporations Act*. The provision holds that the duty of care, skill and diligence imposed on directors of a company is deemed to be satisfactorily discharged if the director can prove that he has satisfied four requirements. First, they must have made the judgment in good faith and for a proper purpose; second, a manifestation of any personal interest that is material to the matter in question must be absent; third they must ensure that they adequately inform themselves on the subject matter to a level that is considered reasonable; and fourth, they must make the judgment with a rational belief that it is in the best interests of the company. A business judgment is

defined as any decision to act or to refrain from acting with regard to an issue that concerns operation of the business activities of the company (*Corporations Act, 2001, s.9*). In *ASIC v Adler & Others* (2002), the court concluded that for a director to qualify for immunity under the business judgment rule, he must have, at the first instance, made a business judgment. After establishing that the decision entailed a business judgment, it must then be scrutinized to establish whether it satisfies all the four conditions laid down under Section 180 (2) of the Act.

The Act allows directors to delegate their responsibilities in certain circumstances (*Corporations Act, 2001, s. 198D*). Whenever a director chooses to delegate his duties, the Act imposes parallel duties on the director for the activities of the person to whom the delegation has been made. Baxt asserts that as demonstrated by *ASIC v Rich* (2004) and *ASIC v Vines* (2003), the standard of duty of care expected of professional directors or of directors that hold a particular specialized position in the company is higher and that although delegation is allowed, a director has to be very careful whenever he chooses to go the delegation way (Baxt, 2005, p. 107). In *Statewide Tobacco Services Ltd v Morley* (1990), the court was of the opinion that the duty of care, skill and diligence cannot be weakened by delegating responsibility. In the same way, the court in *R v Williams* (2005) concluded that directors must not expect the court to be lenient on them just because there were other people in the board who were more senior and more experienced and that they had failed to act accordingly.

The reliance defence is also a creature of the Act. Section 189 allows directors and administrators to rely on information or guidance from administrators and managers in specified circumstances. Suffice to note that the degree and nature of reliance varies from case to case and is considered according to the circumstances of every case (Baxt, 2005, p. 108). The court in *AWA v Daniels* concluded that while reliance was allowed, the director has to be very careful in

such context. The verdict was similar in *ASIC v Rich* where the court emphasized that in specific circumstances, directors must take exceptional care in supervising the entrustment and ensuring that the delegated powers are used within their accepted limits. The court in *Sheehan (as liquidator of South Australian Service Stations) v Verco* (2001) was insistent that the era of ‘dummy directors’ was over. Therefore, while directors in non-executive positions do not have an obligation to perform a thorough examination of the daily operations of the business of the company, they had the obligation to be well informed of the true financial position of the company and its overall capability so that they could be able to act appropriately. For not being adequately involved in the affairs of the company, the court ruled that the non-executive directors of the company had violated their duty of care, skill and diligence. Baxt notes that although the *Sheehan* case was decided before the *Corporations Act* came into force, there is no doubt that it would have been decided in the same way under the Act (2005, 111).

Duty to Act in Good Faith and Proper Purpose

Directors and senior executives are obliged to act in good faith in the best interests of the company, and for a purpose that is proper (*Corporations Act*, 2001, s. 181 (1) (a)). Section 181(1) (b) further obliges them to exercise their powers for a purpose that is considered proper. A proper purpose is one that is for the wellbeing of the company and devoid of any personal or foreign interest (*ASIC v Adler*, 2003). To establish a violation of section 181(1) (b) there must be proof to the effect that the primary reasons for the director’s actions were unsuitable or not relevant to his responsibilities as a director. It does not matter if the decisions the director made were worthy or depraved. The issue of concern is whether the director’s conduct is in violation of his fiduciary duties owed to the company. The but-for-test is applied in determining whether there has been a contravention of section 181. Accordingly, the Court has to consider whether,

but for an unsuitable or irrelevant purpose, a director would have acted in the manner that he did (Redmond, 2012, p. 325).

At common law directors' duties required that their actions must be in good faith and for the benefit of the whole company (*Ngurli Ltd v McCann*, 1953). In *Whitehouse v Carlton Hotel Pty Ltd* (1987), the court concluded that to determine whether the duty of good faith in the interests of the company as a whole has been satisfied we should apply the subjective test of 'good faith and honesty.' Therefore, a breach will result where a director, in his own mind, fails to give proper consideration to the interests of the company (*Walker v Wimborne*, 1976). However, in *Chaterbridge Corporation Ltd v Lloyds Bank Ltd*, [1970], the court placed qualifications on this subjective test. The court concluded that the subjective test also imports an objective standard that questions whether a reasonable person in circumstances similar to that of the director would hold a reasonable conviction that the choice was in the best interest of the company.

Austin, Ford and Ramsay assert that this formulation comprises three distinct but related duties of company directors. First, there is a duty of good faith which is subjective and requires a director's conduct to be honest and in the interests of the company as he perceives them. Second, there is a duty to exercise the powers that have been bestowed on him for a purpose that is proper. Third, a director has a duty to consult and to act only in accordance to the interests that are recognized by law as the company's interests (2005, p. 264-308).

Application

As directors of the company, Karen and Lucy have an obligation to use care, diligence and skill in the discharge of any of their duties that pertains to the company. Therefore, they have

a basic duty to ensure that they are well informed of the affairs of the company, its business operations and its financial position. The duty of care, skill and diligence requires that as directors, they should be well informed of the company's status and abilities to enable them to make decisions on the affairs of the company from a point of knowledge. Karen and Lucy are directors in a non-executive capacity in the company because they do not deal with the daily operation of the company's affairs, a duty which they leave to Samantha. Although Lucy has no tertiary qualifications and arguably is not qualified to act as a director, her position as a director at Jolly Tots Pty Ltd requires that she takes minimum steps to ensure that she is well apprised of the status, affairs and capabilities of the company. Karen is seemingly well equipped to handle a director's affairs because of her experience in running her own office supplies undertaking.

By failing to take steps and get fully informed of the company status and financial position, they are in breach of the duty of care, skill in diligence. Although the standard of care expected of them as non-executive directors is relatively lower than that expected of Samantha who is the executive director, it does not negate the minimum responsibility placed on them to be well aware of the operations of the company. Accordingly, after listening to Samantha's input, they ought to have carried out separate and independent fact-finding analyses before accepting Samantha's proposal. Neither of the defences to a breach of the duty of care, skill and diligence is available to them. The condition of the business judgment rule that requires a director to adequately inform himself of the subject matter of the business judgment to a reasonable level is not satisfied in this case. Further, the reliance defence is not applicable because it requires that a director who relies on another must be sufficiently informed of the subject matter. In this case, that requirement is not satisfied because neither Karen nor Lucy undertook any discovery of the relevant facts.

Conclusion

By their conduct, Karen and Lucy are in breach of the two primary duties that company directors have. These are the duty of care, skill and diligence and the duty of good faith and to act in the best interests of the company. The breach of the duty of care, skill and diligence arises when they make the decision to purchase and move the company premises without being full informed of the company's financial status and fully reflecting on the consequences of their decision on the liquidity of the company. No defence is available to either Karen or Lucy for the breach of the duty of care, skill and diligence. Further, the manner in which they made the decision constitutes a violation of the duty to act in good faith and in the interests of the company. This is because making the decision without proper information resulted in an outcome that was detrimental to the interests of the company because the profits remain low.

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