



# Précis Paper

## Duties of Directors

An insightful and comprehensive overview of directors' duties

### Discussion Includes

- Who can bring a legal action against a director?
- To whom do directors owe a duty?
- What are the legal duties that directors owe to their companies?
- Common law duties
- Equitable fiduciary duties
- Statutory duties
- Financial literacy of directors
- What questions should be asked, and things considered, before accepting a directorship

# Précis Paper

## Duties of Directors

1. In this edition of BenchTV, Professor Michael Adams (Special Counsel, Coleman Grieg, Sydney) and Ms Grace Borsellino (Academic, Western Sydney University, Sydney) discuss in detail the law as it relates to directors' duties.

### Introduction

2. There are 2.2 million companies registered in Australia. By law, every company - public or private - is required to have a director. So there are at least 2.2 million directors in Australia, all of whom have a whole series of legal rights and responsibilities.
3. Companies range in size, from small family businesses with a single director, to the largest companies in Australia, which have large boards, and are listed on the stock exchange.
4. It is advised that directors of small companies with few shareholders consider whether or not to have directors or officers insurance.
5. A director has to consent to be a director. A form must be signed, and that has to be registered with the regulator ASIC (the Australian Securities Investment Commission). The qualifications to be a director are surprisingly minimal. A person must be 18 years old, and must not be banned by the regulator. Banning can occur by way of a Court order, or involvement in phoenix companies.
6. 'Directors' and 'officers' are confusing terms. 'Officer' is an umbrella term. All directors are by default officers. An officer is defined to include all directors and the company secretary. Nowadays, it is only required that public companies have a company secretary.
7. Proprietary companies (private companies) are not required to have a company secretary, but may nevertheless have one. The definition of officer stretches to a broader group. Originally they were called executive officers.
8. The HIH Royal Commission inquiry examined Australia's largest corporate collapse, and made recommendations subsequent to its findings that would change our laws. One of those recommendations was to move away from the term 'executive officer' to the term 'senior manager'.
9. Senior managers can make significant decisions, decisions capable of binding a company. In practice, about 99% of officers are directors.

### Who can bring a legal action against a director?

10. The most famous case in corporate law is the English case *Salomon v Salomon & Co Ltd* [1897] AC 22. In this case, Salomon decided to sue his own company.
11. Although he was the director and major shareholder, he had also lent money to the company, which the company had failed to repay, so he sued the company as a creditor.
12. The House of Lords found that Salomon & Co Ltd was a separate legal entity, and that Mr Salomon, in his personal capacity as a creditor, was able to sue the company. This case created the principle that a corporation is a separate legal entity. It established that a corporation is a distinct person with its own personality separate from the persons who formed it, who invest money in it, and who direct and manage its operations; it established that a company is a juristic person.
13. In Australia, that common law principle was encapsulated in s 124 of the Corporations Act. S 124 states that a company has the powers of an individual, both in this jurisdiction, and outside this jurisdiction. So, in effect, anything a human can legally do, a company is able to do too.
14. Usually, the main party suing a director will be the company.
15. The principle that emerged out of *Foss v Harbottle* (1843) states that the majority of shareholders, through the company, can bring a legal action against the company. But with all rules, come exceptions. In some circumstances, a company may be very reluctant to bring an action against one of its own directors.
16. If it is a civil matter, ASIC has the ability, if it is in the public interest, to bring a case on behalf of the company against the directors. Creditors can also sue directors to recover money, often on the grounds of insolvent tradings.
17. Shareholders themselves can apply to the Court to bring a case against the directors in two ways:
  - firstly, by relying on the oppression of minority provisions
  - secondly, by way of a statutory derivative action

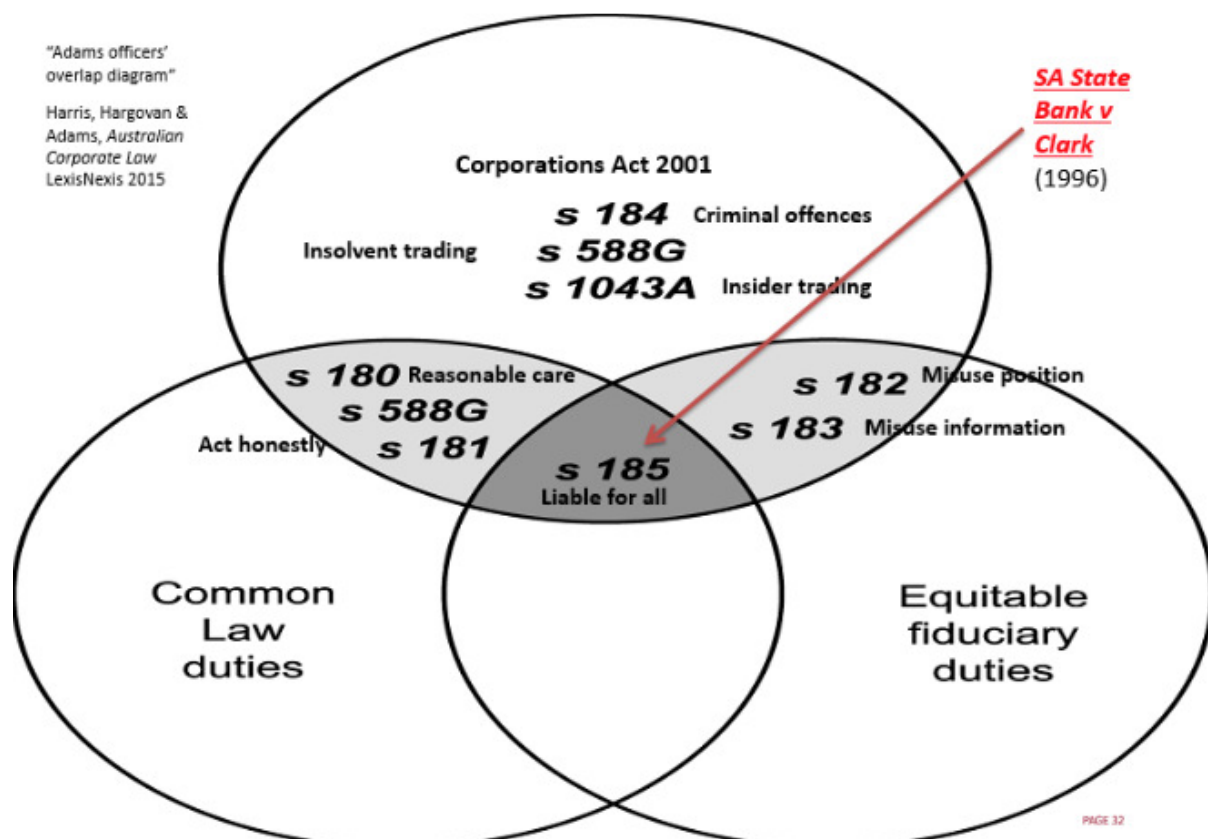
18. There are of course also criminal actions in corporate law. Criminal actions in corporate law are always brought by the Commonwealth Director of Public Prosecutions, usually on the instructions of ASIC.
19. For more minor crimes, ASIC does have some authority to bring criminal actions. In the last 10 years, 305 directors have been sent to jail in Australia. The jail sentence is up to 5 years for each breach, and there can also be a criminal fine imposed, which is currently set at a maximum of \$945,000 per breach.
20. Directors and officers insurance will not cover any pecuniary penalty, it can only help to cover the costs of litigation. In relation to civil actions, however, director and officer insurance can provide some level of cover.
21. S 588G of the Corporations Act is an interesting section, because it finds the duty to prevent insolvent trading by company to be on directors, not on officers. So only directors can be held liable for insolvent trading by a company, but they are only liable for the debts incurred from the date of insolvency. So an insolvency practitioner, or a Court, must determine when a company was actually insolvent – that is, when it could not meet its debts as they fell due. Directors are personally liable for these debts.
22. What is interesting about s 588G is that there is a civil action so that the liquidator can recover money. It is a civil penalty provision whereby ASIC can bring an action to recover a pecuniary penalty of up to \$200,000, or ban the person for up to five years and order unlimited damages.
23. If there is dishonesty (whereby a director recklessly or deliberately engaged in insolvent tradings and failed to pay the company's debts), a director can be sent to jail. So s 588G has some very serious consequences.
24. In most cases in directors' duties, a company is trying to recover money from the directors who have broken the law. The major remedy in a civil case is therefore going to be damages. So a practitioner needs to calculate how much financial loss a director has caused its company. This can cover a whole range of things, against which there are some defences for directors, for example, the business judgment rule.
25. Damages are calculated through statute, common law, and equity. Courts can also be asked for other remedies. A common one is an injunction. Rarely, an order for specific performance will be made. Another unusual Court order, which has become popular both with ASIC and companies, is a declaration.

### To whom do directors owe a duty?

26. The law itself on this is reasonably clear and straightforward. The law, right from the beginning, has always stated that directors owe their legal duty to the company – they must act in the best interests of the company. The practical problem with this concept arises from the question, 'who is the company?'
27. The company is made up of its shareholders. In Australia, we have the shareholder primacy rule. Fundamentally, the legal duty is owed just to the company, and only the company can sue the directors for breach of that duty. So the duty is always to the company, but in practice, the majority are the shareholders.

### What are the legal duties that directors owe to their companies?

28. The three major groupings of legal duties owed by a director to a company are:
- common law duties
  - equitable fiduciary duties
  - statutory duties



29. There is a clear overlap between the common law duties and the statutory duties, and between the equitable duties and the statutory duties. The basic common law duty of a director is to act honestly, and in the best interests of the company.
30. The one that has become most actionable has been the tort of negligence. It is expected of a director that they will apply reasonable care and diligence in carrying out their work. When directors make decisions that are so grossly negligent, they can then be held liable for those decisions.

#### *Common law duties*

31. The common law actions were traditionally subjective, which meant that if a director said that he or she honestly believed their decision to have been reasonable, and there was no evidence to the contrary, it would be virtually impossible to make out a case against the director. But the Courts and Parliament decided to change that subjective test to an objective test. The change is found in s 180 of the Corporations Act.
32. The change also came about because of the decision in *ASIC v Adler and 4 Ors* [2002] NSWSC 171. The Court found in this case that the non-executive director, the chairman, and the chief financial officer, were all in breach of the common law duty of negligence – that is, they failed to take reasonable care and diligence in the performance of their respective jobs. This decision mirrored s 180, which is the statutory provision on reasonable care and diligence.

#### *Equitable fiduciary duties*

33. The common law duty needs to be contrasted with the equitable fiduciary duty.
34. In the famous High Court decision in *Hospital Products Ltd v United States Surgical Corporation* [1984], it was determined that directors are fiduciaries (they are like trustees/agents).
35. Directors have a fiduciary duty to the shareholders, which means they must avoid conflicts of interest, and making secret profits, and must act in the best interests of the company. Those fiduciary duties are imposed by the Courts, but they are also reflected again in statute – they are found in s 182 and s 183 of the Corporations Act as follows:
  - s 182 states that a director must not misuse his or her position
  - s 183 states that a director must not misuse information through his or her position

These sections are mirrors of the equitable case law on fiduciary duties of directors.

36. The difference between common law and equity when it comes to directors' duties lies in the remedies available, and the parties that are able to bring an action. For example, ASIC would bring a statutory action to enforce the Corporations Act, whereas a company might just bring a common law or equitable action.
37. As a matter of general principle, disclosure is the best way forward for a director dealing with a potential conflict of interest. The Corporations Act does have some specific provisions dealing with certain types of transactions where directors have to make disclosures.
38. It is important to remember that this is not in the realm of criminal law - rather, it is in the realm of civil law - which means it can be resolved by parties discussing it. Issues tend to occur where directors fail to disclose their potential conflicts of interest.
39. In the case of *Green & Clara Pty Ltd v Bestobell Industries Pty Ltd* [1982] WAR 1, Bestobell Industries was tendering to build a hospital in Western Australia. Mr Green was a state manager, responsible for putting the tenders together. Mr Green had decided to set up his own construction company, and decided to tender for that same contract.
40. Interestingly, neither Mr Green nor Bestobell Industries actually won the tender. But somehow, the government indicated to Bestobell Industries that their senior manager (who was not actually a director, just an officer) had potentially breached its equitable fiduciary duty, because of a conflict of interest (misusing information through the position), and also because of the statutory provision in s 182 and s 183.
41. The Court held that Mr Green was an officer of the company, and was in breach of both his statutory duty and his equitable fiduciary duty. Mr Green was ordered to pay damages. There is a degree of irony in this case because of the fact that neither party won the tender, so there were no profits made. The damages were calculated on what the potential profits might have been.

### *Statutory duties*

42. Although we have been focusing thus far on the civil actions under s 180 - s 183 of the Corporations Act, if any of those sections are caught up with dishonesty, or even recklessness, ASIC, through the DPP, can bring a criminal action against a director for that dishonesty under s 184, Corporations Act. s 184 of the Corporations Act criminalises the directors' duties.
43. Mr Adler in *ASIC v Adler and 4 Ors* [2002] had been held liable for breach of directors' duties. The Court found Mr Adler in breach of s 184, and applied criminal penalties.
44. Our civil and criminal processes are quite different. The first case was a civil case against the three officers, Mr Adler, Mr Williams, and Mr Fodera. It was then decided that the DPP would bring a criminal case against Mr Adler and Mr Williams.
45. The three officers were originally charged with breaches of s 184 (the criminal provisions of directors' duties). Due to the plea bargaining process, Mr Adler ended up instead pleading guilty to misleading and deceptive conduct. So it was decided not to pursue action against Mr Adler under s 184.
46. Mr Adler and Mr Williams served over two years in jail, which obviously had a huge impact on their reputation, and ability to work in the future.

#### Financial literacy of directors

47. The directors in the case of *ASIC v Healey* [2011] FCA 717 relied on the advice provided to them by the management of the company, and external financial auditors – advice which subsequently turned out to be significantly erroneous.
48. The directors defended themselves by saying that they were not financial experts, and that they relied upon expert financial advice.
49. The Court held that one of the primary responsibilities of the directors is to understand the financial statements, and that these mistakes were large enough that they were reasonable to be seen. The directors were held in breach. Since this case, a lot of directors have signed up for courses on financial literacy.



50. The James Hardie litigation involved the company taking legal action through its shareholders against the directors. In the NSW Supreme Court, it was decided that there was no criminality on the part of the directors. So the focus was then on a civil action for breach of directors' duties.
51. There was an appeal in the NSW Court of Appeal, and then, quite unusually in corporate law, this case went to the High Court. The High Court held that the directors had breached their duties of reasonable care and diligence. A pecuniary penalty of \$20,000 was imposed, and the directors were prohibited from being directors or managers for the next two years. The reputational damage suffered by all the directors was huge.
52. In the case of *Shafron v ASIC* [2012] HCA 18, Mr Shafron was both company secretary and general counsel.
53. Mr Shafron put up a strong defence that he was not an officer of the company when he was providing advice to the board (he was doing it as general counsel).
54. The Court determined that Shafron was an officer (his role as general counsel and company secretary could not be split). The Court held that Shafron had fallen short of his duty under s 180, and had therefore been negligent. Shafron was fined \$75,000 as a pecuniary penalty, and banned for 7 years from being a senior manager and/or officer of another company.

What questions should be asked, and things considered, before accepting a directorship

55. Being a director comes with great responsibility, and many questions should be asked, and things considered, before accepting a directorship, including:
  - first question: to ask the company whether they have directors and officers insurance
  - second question: to ask the company for a copy of that policy
  - third question: what the company's constitution is like, and if there is a shareholder agreement in place
  - fourth question: to ask to see a set of audited accounts showing that the company is solvent, that it has assets, and that those assets will cover all liabilities in the foreseeable future

- other things to be considered as expected of a director: basic honesty, basic competence, good corporate governance, good risk management system, board diversity, personal integrity, good management of work flow

56. Much depends on the size of a company. But interestingly, and importantly, all directors of all companies owe the same common law, equitable, and statutory duties.

## **BIOGRAPHY**

### Michael Adams

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Professor Michael Adams is an internationally recognised specialist in corporate law, governance, securities markets regulation, and legal education (especially e-learning). Michael has been writing, teaching and regularly presenting on all these topics for over 20 years. He is a Fellow of the Australian College of Educators (FACE), as well as the Australian Academy of Law (FAAL), and is also a Fellow of the Governance Institute of Australia (FGIA & UK FCIS). Professor Adams has been the former President of the Australasian Law Teachers Association, the Corporate Law Teachers Association and Chartered Secretaries Australia (now Governance Institute of Australia). He is the co-author of ten books and 30 chapters, 50 articles and over 250 conference/seminar presentations. In 2000 he was the recipient of the Australian University Teacher of the Year, for Law and Legal Studies, as well as 2005 CSA President's Award.

### Grace Borsellino

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Grace Borsellino teaches and researches in Corporate Law. Prior to joining Western Sydney University, Grace taught in the area of corporate and commercial law for 5 years at other tertiary and educational institutions. Grace graduated law at Western Sydney University and was admitted to practice law in 2005. Grace is currently undertaking post graduate studies at Western Sydney University in the School of Law. Her research interests are corporate law and corporate governance. Grace has co-authored, researched and edited in a number of publications in relation to corporate governance. Grace is an active participant in community engagement and appears on behalf of the school of law as an Academic and Professional Speaker in Schools. Grace is the Course Administrator for the Master of Laws (International Governance).

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