

FACT SHEET

Companies Limited by Guarantee

Director's Duties

Who is this fact sheet for?

This factsheet is for board directors of a not-for-profit company limited by guarantee (a 'CLG') elected by the company's members to manage the company. As a director, you have many management duties that will only be held accountable by your company. However you also have legal duties that are governed by corporation law that require you to act in a responsible way and will penalise you if you don't, even if the CLG might just be a really big charity or a relatively small non-profit organisation that runs on a national scale. These legal duties are at times quite similar to that of the management committee of an incorporated association but can be more stringent than those duties and are more likely to be litigated. However, never fear, many of these legal duties are just common sense and encourage good management.

Traditionally, companies are run by a board of directors. In fact, a company limited by guarantee must have at least three directors and one secretary under the *Corporations Act 2001* (Cth) (the Act). But if you are a company limited by guarantee, it doesn't matter what you call the group of people running the organisation – they will have the same responsibilities as directors when they are put in similar positions of power. Notably the terms of board directors, committee member and officer are used interchangeably in this factsheet.

Who has to comply with the legal duties?

Anyone elected to a committee or board including part time, 'honorary', 'shadow' or 'de facto' directors has to comply with legal duties under the Act. For example, an organisation's founder who still attends meetings, whose opinion is commonly sought and whose consultation is always a prerequisite to the organisation making a decision can be considered a driving force of the organisation, and therefore, should be made responsible for their actions and subject to legal duties. Even senior officers such as a manager, coordinator, chief executive officer, an executive director a non executive director should obey these duties.¹

Why do Boards generally have legal duties?

Directors of companies have positions of great power that can be readily abused without government regulation. The common law, which is the law that courts make, has been regulating companies in English courts for approximately 150 years. In Australia and elsewhere, we now have legislation that has developed many of these common law ideas to make up the current company law regime. What this means is that you should go to the legislation first (the written down law passed by parliament) then go to case law to fill in the gaps of knowledge that parliament did not fill. Legislation is available online.

On top of the obligations restraining your power there are obligations arising out of the trust that the organisation's members have in you. In law, we call these trust based relationships

¹ PilchConnect, *Guide to legal duties of Committee or Board Members* (September 2011), 9 <http://www.pilch.org.au/Assets/Files/GovGuide_September11_v1.3.pdf>.

'fiduciary' relationships. This type of relationship pops up in many different contexts such as the relationship between a doctor and their patient.

Why are CLG Board members also subject to these legal duties?

Companies limited by guarantee are formed under the rules of the Act and are subject to those rules. Since the organisation is just large enough to become a company (although this may not always be the case), people running the company have a responsibility not to take advantage of public trust and the donations which the public entrusts to the organisation. These duties were not always seen as necessary to regulate charities and nonprofits.

In fact, many CLGs were not required to lodge annual returns, report changes to the returns of directors and officers² and had little government regulation to follow until the 1980s.³ It was understood that many CLGs were relatively small or should not be burdened with regulations due to their charitable or nonprofit purposes. However in 1991, the *National safety council case* brought public outcry and media attention to fraudsters who use nonprofit organisations for their own purposes and fly under the radar. In that case, the organisation had become bankrupt due to the mismanagement of its executive director. More information about this case is shown in detail below.

While you may be running a legitimate charitable or nonprofit organisation, the courts must balance the possibility of fraud and mismanagement occurring again without burdening organisations with too many rules and too many consequences. This balancing act can be seen in the defences that can be used in court mentioned later.

How tough will the courts be on board members of nonprofit organisations?

The answer is simply: as tough as a director of any other company. There are not many cases on this subject apart from the *National Safety Council case* and it decided that there is no difference between how a court will treat a volunteer executive director and how it will treat a non-voluntary one. What might make a difference to the outcome of a case is the court's freedom to take into account your circumstances and excuse your behaviour. However the court is free to judge you as harshly as an executive director and has indicated at least one instance (the National Safety Council case) that it will do so.

One special instance to consider is that of passive board member, see the case study below.

² Sally Sievers, 'Incorporation and regulation of non-profit associations in Australia and other common law jurisdictions' (2001) 13 *Australian Journal of Corporate Law* 124.

³ Myles McGregor-Lowndes, 'Nonprofit Corporations — Reflections on Australia's Largest Insolvency' (1995) 5 *Australian Journal of Corporate Law* 417.

Case study: the case of a passive board member

Commonwealth bank of Australia v Friedrich – **The National Safety Council Case**

In this case, the executive director had falsified his experience, mismanaged funds and hid his mismanagement. The question is: how should the court treat the other directors who did not discover the mismanagement? Mr Eise was one such passive board member.

What the court considered:

- The court was deciding if Mr Eise should be excused.
- The court took into account Mr Eise's position as a non-executive and part-time director, that he was unpaid, that as a director of the company he was motivated by a desire to involve himself in a useful community service, and that he did so involve himself.
- The judges decided that behaviour to be legally wrong does not need to be dishonest, that is, it does not have to be morally wrong, but lazy and frivolous.
- The intent of the legislation (the Corporations Act), at the time, is to prevent unreasonable management.

Action/Behaviour:

Mr Eise signed a statement of the directors and a directors' report without verifying it. Even though the director had not had any opportunity to look at the accounts, he acted to others on the board as if he had done so and that they were accounts on which members and creditors could rely. Even when one member at the annual general meeting made a criticism, the directors present — including Mr Eise— insisted the report was okay.

On whether it was reasonable:

The court considered that if Mr Eise did not act the way he did, the fraud of the executive director may have been exposed. This fraud led to the company taking out more loans they could not afford. Considering the consequences and the difficulty of verifying such records the court found the action to be unreasonable.

What are the legal duties that board members of CLGs have to comply with?

There are many duties which board members have to comply with, however the first four mentioned in the list below are the main duties to keep in mind. The other duties listed either fall into one of the four major categories but are more specific or are simply rare in its occurrence:

- **Duty to act in good faith and act for a proper purpose**
- **Duty to act with due care, skill and diligence**
- **Duty to avoid conflicts of interests**
- **Duty not to misuse position or information**
- Duty not to disclose confidential information
- Duty not to take opportunities for the company for yourself
- Duty to retain discretion
- Reasonable reliance on information or advice provided by others when appropriate
- Being responsible of actions when you have delegated

These duties exist separately from financial reporting duties, duties that relate to annual general meetings and the ban on paying dividends to members.

For more information on these other obligations see:

<http://www.asic.gov.au/asic/asic.nsf/byheadline/Companies+limited+by+guarantee-simplified+obligations>

In describing director's duties, it is useful to think of what the court would consider in hindsight, should your actions ever be judged in court. Don't let this thought exercise scare you though, common sense and good management go hand in hand with being judged in court and it is simply useful to think to yourself, 'what would a court think of me when I do this' before you take action. The director's duties will be explained in detail below.

Duty to act in good faith in the best interests of the company⁴

Generally, directors have to act with "honesty or good faith" in the interests of the company.⁵ The duty to act in good faith is a duty with deep historical roots and simply means not being dishonest, reckless and not committing acts as a board member for any other reason. It overlaps with many other duties such as avoiding conflicts of interest but also cover acts that do not fall into any other category. One technical thing to note when fulfilling this duty is that usually you are considering the best interests of the organisation; however you will have to start acting in the interests of creditors when the company becomes insolvent,⁶ that is, doing everything not to lose money.

Duty to act for a proper purpose

Every act you do in your capacity as a board member should correlate with something the organisation needs or wants done to achieve its purpose. The ability to continue operating for a long time may also be one of the interests of the organisation, the exception being those organisations which will only continue for a limited time. One such example is community financing groups for Aboriginal social enterprises which aim to make Aboriginal groups financially self-sufficient and eventually directly liaison with other financial providers themselves. In the Act, the duty to act for a proper purpose is linked with the duty to act in good faith⁷ however, it should be noted that both need to be fulfilled. It is possible that you act for an improper purpose even if you're being honest. There must be a reason you can point to as to why you make a certain decision which relates to the purpose of the organisation.

What is a 'proper purpose'?

Anything that aims to achieve what your organisation was set up to do and serve the viability of the organisation's existence. It may even include making decisions that is prudent for the organisation but may be detrimental yourself or someone you know. This is an objective test which means the court will ignore your gender, race, religion, personality and political persuasions and try to figure out what the most reasonable, universal person would do. Your acts must also be within your powers, as given to you by the organisation to act on this purpose.

In order to define what a proper purpose is, it is helpful to describe what an improper purpose is.

⁴ *Corporations Act 1968* (Cth) s 181.

⁵ *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

⁶ *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.

⁷ *Corporations Act 1968* (Cth) s 181.

What is an 'improper purpose'?

Improper purposes include:

- Doing things in the best interest of yourself⁸ - however you can indirectly pursue your interests as long as it does not conflict with the company's interest.⁹
- Doing things in the best interest of sponsors or employers
- Doing things in the best interest of whoever elected you into the organisation
- Doing things on behalf of some region or sector within the group (especially in the case of peak bodies)
- Doing things for other charities to the detriment of your own charity
- Excluding others from participating or joining the organisation due to personal dislike¹⁰

What you can do to avoid breaching this duty

To fulfil this duty – you must do two things before committing any act:

- 1) You must give proper consideration to the interests of the company before doing the act.¹¹ This act is decided subjectively which means the court will consider what actions could be justified from your unique point of view. For instance, you may have discussed with another board member or with others at a meeting what you considered the best interests of the company before making the decision. This can be used as evidence.
- 2) You must also consider whether an intelligent and honest person in your position, as a director of your company, in the whole of the relevant circumstances, would have reasonably believed that the transactions were for the benefit of the company.¹² That is, the act is also decided objectively.

With the second test – you cannot let your own bias cloud your judgment as a court will be as objective as possible and only let you justify what you thought was proper in the first part of the test.

Some helpful hints include creating a statement of purpose or objective for the organisation as an official document and reading it at every meeting. Also, consider whether you need to disclose any of your interests at a meeting with members of the organisation before you take action – this measure coincides with fulfilling the duty to avoid conflicts of interests.

What is the consequence of pursuing an improper purpose?

A decision may be later invalidated if it would not have been made if it wasn't for the improper purpose. This means two things: firstly, improper purposes can be one of many reasons and not be a problem unless it is the cause of the decision made.¹³ Secondly, the court will ignore the effect of the decision and let the organisation act as if the decision was never made. For other consequences see the information on civil and criminal penalties set out below.

⁸ *Mills v Mills* (1938) 60 CLR 150 at 185.

⁹ *Mills v Mills* (1938) 60 CLR 150 at 163.

¹⁰ This list was compiled with the help of PilchConnect above n 1, 10 – 13.

¹¹ *Walker v Wimborne* (1976) 137 CLR 1.

¹² *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62; *Farrow Finance Company Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* (1997) 26 ACSR 544.

¹³ *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

Duty to avoid conflicts of interests

As a director, you cannot put yourself in a position where a **potential** conflict may arise.¹⁴ There only needs to be a real possibility of a conflict occurring for this duty to be breached.¹⁵ Therefore, potential conflicts of interests' should be managed in such a way as to prevent coincidence – you need to take precaution and remove yourself from potential disasters.

You should not be present while a matter that affects a personal interest of yours is being considered at the meeting, or vote on the matter, unless participation is approved in accordance with relevant provisions of the *Corporations Act 2001 (Cth)*, see *details below*. These bars to participation are more stringent than requirements of incorporated associations where the committee member may still be allowed to participate in deliberations. Governing a company limited by guarantee, it is recommended that you do not take part in any deliberations.

What is a 'material personal interest'?

Material personal interests can be financial or simply personal in nature where a benefit is given to you or someone else connected to you. It may also include preventing something bad happen to you or somebody you know. Financial interests are the most obvious examples, for instance, where you own a business and you decide your business should take advantage of an investment opportunity which is appropriate for your CLG and which you found out about in your capacity as a board member.

Other material personal interests include:

- Acts of nepotism – giving benefits to family and friends such as jobs, investment opportunities, award nominations or sponsorships.
- Being part of two different organisations interested in the same contracts, bids, leases and investment opportunities.

One example of there being no conflict of interest is the situation where you are part of the interest group which the organisation supports. For example, if you are disabled and are a board member of an organisation that supports disability service there is no automatic conflict of interest.

There are two circumstances where this duty is modified:

Internal rules

The constitution, which is the CLG's governing document, or the rules which members promise to adhere to as an organisation, may modify this duty and allow you to have a personal interest in a contract with the company.¹⁶ You can also stipulate in your constitution that there be full disclosure of a personal interest in a contract at a general meeting before the contract can be entered into unless the directors have full knowledge of the facts or context of that personal interest.¹⁷

However, it is recommended that you fully disclose your interest and avoid participating in deliberation and voting on any resolution.

¹⁴ *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461 at 471.

¹⁵ *Phipps v Boardman* [1967] 2 AC 46 at 124.

¹⁶ *Woolworths Ltd v Kelly* [1991] 22 NSWLR 189.

¹⁷ *Ibid*.

Full disclosure and approval by the company

According to section 195(2) of the *Corporations Act 2001* (Cth), which applies to public companies (companies limited by guarantee are public companies) the director with the conflict of interest may be present and vote at a meeting if directors who do not have a material personal interest in the matter have passed a resolution that:

- (a) identifies the director, the nature and extent of the director's interest in the matter and its relation to the affairs of the company; and
- (b) states that those directors are satisfied that the interest should not disqualify the director from voting or being present.

The full nature of the interest must be fully disclosed at a general meeting. An ordinary resolution, that is one by majority and not $\frac{3}{4}$ of the vote, is adequate.¹⁸

What you can do to avoid breaching this duty:

- 1) Disclose the full nature and extent of the interest at a meeting before any action is taken
- 2) Do not take part in decision making or meetings
- 3) Refrain from discussing or voicing an opinion

Sometimes you may have to remove yourself from the board if your interests as an employee or as a member to another organisation overwhelm your responsibility to the board.

Some laws require committees to keep registers on interests of the committees and boards,¹⁹ you should also think about doing this.

A model conflict of interest policy can be accessed here:

<https://wiki.qut.edu.au/display/CPNS/Conflict+of+interest+policy>

Duty to act with due care, skill and diligence

This duty, unlike the duty to avoid conflict of interests which may arise from time to time, means a constant monitoring of your own actions. Simply put, the duty to act with due care, skill and diligence prevents laziness or recklessness when fulfilling your role.

It includes:

- The use of your skills and knowledge to contribute information to meetings and decision making and give sufficient time and energy to decision making;
- preparing for meetings and following up tasks, after delegating tasks, take responsibility for what you have decided;
- making reasonable decisions – this does not mean perfect decision making but responsible and objective decision making;
- having constant awareness of the organisation's financial position – this is not just the treasurer's job but your job, see the case study above;
- asking questions;²⁰ and
- knowing when to consult an expert (this duty will be examined later, as its requirements are quite specific).

¹⁸ Ibid.

¹⁹ *Associations Incorporation Act 1981* (Vic)

²⁰ This list was compiled with the help of PilchConnect, above n.1, 20.

Under section 180 of the Act, the court will consider if how you acted was reasonable as:

- 1) a director or officer of a corporation in the corporation's circumstances;
- 2) who occupied the office held by, and had the same responsibilities within the corporation as a director or officer.

The test is objective as it considers what a reasonable person would do but is also subjective in the sense that the court will place a reasonable person in the director's shoes and consider the choices and circumstance you had to face.²¹

What to do to fulfil this duty:

You should do your best to fulfil the list of actions above and more specifically:

- Attend and pay attention to meetings
- Do not release inadequate media releases
- Do not approve bank loans without verifying them first
- Do not depend on other directors
- Investigate the continued repair of premises
- Get legal advice when committing to a contract²²

However, sometimes, deciding whether your act or decision was reasonable at the time without the benefit of hindsight can be very hard. As a director you may have to take risks from time to time in order to get more donations, keep the organisation afloat or promote the cause you are supporting. This is where the business judgement rule may protect you when you make a decision that turns out to not be so successful. It is a rule used in the defence of profit-making companies which will have to take on many risks to compete in the market environment. Remember that nonprofit organisations do not face the exact same risks and courts will take this into account, so take more precaution than a profit-making company would when making business decisions. However the rule does apply to all decisions that have some future outcome that may be hard to predict.

The Business Judgement Rule (or Reasonable Judgement Rule)²³

This rule is stated by the Act in section 180. A director or other officer fulfils the duty to act with due care, skill and diligence when making a business judgment that fulfils the following requirements²⁴:

- where the business judgment is made in good faith for a proper purpose; and
- there is no material personal interest in the subject matter of the judgment; and
- the director or other officer inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- they rationally believe that the judgment is in the best interests of the organisation.

However, the Business Judgement Rule will not be available when you trade during insolvency.

²¹ *AWA Ltd v Daniels* (1992) 7 ACSR 759.

²² This list was compiled with the help of PilchConnect, above n 1, 20.

²³ PilchConnect, above n 1, 40.

²⁴ Department of Families, Housing, Community Services and Indigenous Affairs, Australian Government *Corporate Governance: Handbook for the board* (7 February 2011), 3.1.1

<<http://www.fahcsia.gov.au/sa/disability/pubs/general/CorporateGovernanceHandbook/Pages/RolesResponsibilities.aspx#311>>.

Duty to not trade whilst insolvent

This duty overlaps with several of the duties mentioned above. For instance, the duty to act with care and due diligence includes constant awareness of the company's financial position. More specifically it means that every time you are about to commit to a bank loan or some sort of financial liability, you must check your records to see if it's okay to do so. Depending on information presented in annual financial reports alone is not sufficient to fulfil this duty.

For more information see this factsheet by ASIC:

[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Insolvency_guide_for_directors.pdf/\\$file/Insolvency_guide_for_directors.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Insolvency_guide_for_directors.pdf/$file/Insolvency_guide_for_directors.pdf).

What to do to prevent trading while insolvent:

- Incorporate financial accounting transparency internally
- Take action as soon as possible once there is an indication of insolvency
- Investigate and gather information
- Seek professional advice, legal and/or financial
- Do not approve of further debts, free any motion or action to do so
- Arrange an urgent meeting and create a strategy²⁵

Duty not misuse position or information to gain an advantage

This duty is all about loyalty and prevents you from gaining any extra benefits from your position even when there is no loss to the organisation. The duty incorporates the idea of a 'fiduciary' relationship where the law considers the amount of power that is put into your hands that can potentially be abused and binds you to be loyal to the group or person who allowed you to have this power. Other examples include lawyers and their clients and Trustees and beneficiaries

These duties are negative duties so be aware about what you must not do, and when in doubt, analyse the range of consequences and go back to the basic concept – what is in the best interests of the company?

Duty not misuse position

Under section 182 of the Act, you have a duty not to make improper use of your position as a board member. Misusing your position includes receiving bribes or receiving benefits, acting without authority, pulling strings, intimidating others and 'throwing your weight around'.²⁶ The duty to not misuse your position overlaps with the duty to avoid conflicts of interests, for example, acts of nepotism that give jobs, investment opportunities, award nominations or sponsorships to friends or family are also instances of misusing your position

Duty not misuse information

According to section 183 of the Act, any information obtained through the course of the organisation's activities should not be used for give advantage to yourself or someone connected to you or cause detriment to the organisation. This duty will be breached despite nothing happening in actual fact.²⁷

Acts that misuse information include:

²⁵ PilchConnect, above n 1, 17.

²⁶ PilchConnect, above n 1, 22.

²⁷ *R v Byrnes* (1995) 130 ALR 529.

- Sharing sensitive information about contracts, tenders or financial struggle, to any other organisation or employer
- Obtaining information about the Government that is confidential and sharing it with any other organisation
- Sharing details obtained from membership or client databases, employee information, minutes from meetings or any financial information
- Taking advantage of an opportunity or diverting it to yourself – for instance a lease or an investment opportunity²⁸

What to do to avoid breaching this duty:

Some negative duties include avoiding gossiping about confidential and sensitive matters, especially with other organisations and always retain client confidentiality. Some positive duties include continually maintaining proper protocol, with informative inductions to new volunteers and a well circulated code of conduct.²⁹

Duty not to disclose confidential information

This duty is more likely to occur to directors of profit-making companies which are competing in the marketplace, but may occur in limited circumstances in regards to social enterprises, if they have products or initiatives that they wish to protect. Otherwise it overlaps with the duty to not misuse information. The duty occurs when the person, to whom the information relates, 'reasonably' believes that:

- the disclosure of the information would have a negative impact on them or a give someone else an advantage, and
- the information is confidential and not publicly known and the 'in light of the usage or practice of the particular industry or trade,

and the court must decide that the information would be regarded as worthy of protection.³⁰

One example which applies to profit-making companies is insider trading³¹ where investors have access to private information that could affect share prices of a company and gives them an advantage over other investors.

Duty not to take opportunities for the company for yourself

You must also not take opportunities intended for the company for yourself. One limit to the duty is that there must also be some nexus between this duty and the opportunity, it must be apparent that the opportunity was meant for the company.³² For example, if you are invited to purchase property which you could sell for a profit later and you were invited in your capacity as a board member, you should not buy the property for yourself even if the company did not have the funds to take advantage of buying the property in the first place.³³ However you will not be held responsible for this duty if you get informed consent from the organisation, which you can do at a meeting before you take any action.³⁴

²⁸ PilchConnect, above n 1, 23.

²⁹ PilchConnect, above n 1, 26 - 28.

³⁰ *Thomas Marshall (Exports) Ltd v Guinle* [1979] Ch 227 (Megarry VC).

³¹ *Commissioner for Corporate Affairs v Green* [1978] VR 505.

³² *SEA Food International Pty Ltd v Lam* (1998) 16 ACLC 552.

³³ *Regal (Hastings) Ltd v Gulliver* [1942] UKHL 1.

³⁴ *Ibid.*

What may happen if you do breach this duty is whatever profit you make or property you gained will be given to the organisation, you will not be allowed to keep it.³⁵

Duty to retain discretion

This duty is breached if you place yourself in a position where you are unable to make a decision in the best interests of the company,³⁶ for instance, where you restrictively contract how you will vote at board meetings. This has rarely gone to court for even profit making companies.³⁷

Reasonable reliance³⁸ on information or advice provided by others

Relying on the advice of experts and professionals can act as a defence to a breach of one of your duties. However it is better to think of taking these actions regularly; you should ask for information or advice when you do not have expertise, double check information where you can and act on your suspicions.

Relying on professional or expert advice is reasonable where:

- the advice is from a reliable and competent employee or professional expert;
- or you are relying on another board member or officer for matters within their authority;
- or you are relying on the advice of a Committee of Directors that is within the Committee's authority (if you were not a part of that Committee); and
- the reliance is made in good faith and after making an independent assessment of the information or advice. Your subjective knowledge of the corporation and the complexity of the structure and operations of the corporation is the benchmark of decision making.³⁹

This means that you should be honest and diligent, reconsider whether you think the advice is sound and how a court will judge the actions of someone in your position, considering the needs of your organisation.

Responsibility of action when you delegate

You may delegate your powers when it is reasonable to do so, and when you have done your research. Strictly speaking, you can rely on the actions of a delegate if:

- at all times you believed on reasonable grounds that the delegate would exercise the power your delegated abiding by all the Director's Duties and the constitution; and
- if the circumstances indicated the need to investigate, you believed on reasonable grounds and in good faith and after making proper inquiry that the delegate was **reliable** and **competent** in relation to the power delegated.⁴⁰

³⁵ Ibid.

³⁶ *ANZ Executors & Trustee Co Ltd v Qintex Australia Ltd (recs and mgrsapptd)* [1991] 2 Qd R 360.

³⁷ Harris, Hargovan & Adams, *Australian Corporate Law* (2008) LexisNexis, 6.

http://www.lexisnexis.com.au/aus/academic/text_updater/documents/harrisch16.pdf.

³⁸ *Corporations Act 1968* (Cth) s 189

³⁹ Department of Families, Housing, Community Services and Indigenous Affairs, Australian Government, above n 24, 3.1.6.

⁴⁰ Department of Families, Housing, Community Services and Indigenous Affairs, Australian Government, above n 24, 3.1.7.

How and when does the court intervene?

The court will intervene when the following interested parties:

- ASIC – the national regulator;
- a creditor;
- administrator or liquidator;
- former committee member or;
- the organisation as a group petitions the court (that is, applies to the court, by the proper procedure).

However, they must have some legal basis to do so; the court does not take to time-wasters lightly.

Defences:

Aside from reasonable reliance on another's advice, delegation and the business judgement rule, the most relevant defence to nonprofit companies is the power of the court to exercise their discretion as to whether they will excuse a company from liability. That is, the court is free to make up its own mind on whether to hold you legally responsible for your actions.

Excuse by Court from liability

The court has the discretion to excuse a company from liability under sections 1318 and 1317s if that person **acted honestly** and having regard to **all the circumstances of the case**, including those connected with the person's appointment, the person ought **fairly** to be excused for the act.

It should be noted that if a person acted honestly, a director may get some consideration for being a volunteer in applying this defence. For instance Tadgell J stated in *National Safety Council*⁴¹ case that:

“I should think it right that the courts should use the jurisdiction conferred by s 535 [Corporations Law s 1318] in an appropriate case to provide a flexible form of relief to voluntary non-executive directors of companies not for profit. It is in the public interest that, while directors should be held accountable for their conduct, able people should not be deterred from offering their voluntary services for want of adequate protection.”⁴²

That is, the court will take into account the fact that CLGs provide a benefit to society for free and shouldn't have to face extreme obstacles. However, if a person is dishonest, this defence offers no protection. Further, the court is not bound to give leniency; it can do whatever it wishes.

Civil Penalties

Civil penalties are the most common remedies provided by the court and may consist of a pecuniary penalty or compensation. These consist of a fine to punish you or a sum of money given to the CLG to help undo the damage you caused.

⁴¹ *Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946

⁴² *Ibid* 1012.

Pecuniary penalty or compensation

According to section 1317J of the Act, ASIC can apply to the court for a declaration of contravention, pecuniary penalty order and/or a compensation order.

A pecuniary penalty may also be made, up to the amount of \$200,000⁴³ where an act materially prejudices the interests to the company, its members or the ability of the company to pay of its creditors. Pecuniary penalties are like fines, they are amounts of money, intended to punish people for their bad behaviour. For example, it does not cover the amount of loss.

Under section 1317H you may have to compensate a corporation if this remedy is asked for by ASIC or the person wronged. For example, when you trade when the company was insolvent, you may be held personally financially liable for compensation equal to the amount of that loss or damage to the CLG, where at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent.

Criminal Penalties

If you breach the duties of good faith, misuse of position and/or information – you may have to face a criminal penalty. Facing such a penalty depends on the nature of your act. For example, a criminal penalty will be imposed if you breach the duty of acting in good faith and you are intentionally dishonest or reckless. You may also face a criminal penalty if you misuse your position or information:

- dishonestly with the intention of directly or indirectly gaining an advantage for yourself, or someone else, or causing detriment to the company; or
- recklessly as to whether the use may result in you or someone else directly or indirectly gaining an advantage, or in causing detriment to the company.⁴⁴

These are awarded for **extreme** breaches of these duties, for instance, a large sum being lost or fraud being committed. In most cases the court will simply give you a heavier fine instead of imprisonment.⁴⁵

Disqualification

You may also be disqualified from managing corporations for 5 years if you do something wrong. This disqualification includes managing all kinds of companies. However, this penalty occurs in only a limited amount of cases, you have to be either making crucial decisions that jeopardise the viability of the organisation, affects at least a substantial part of the business of the corporation or significantly impacts the company's financial standing.

Other duties

According to the Department of Families, housing, Community Services and Indigenous Affairs website,⁴⁶ the practical duties you also have to keep in mind, include the following;

⁴³ *Corporations Act 1968* (Cth) s 1317G.

⁴⁴ Department of Families, Housing, Community Services and Indigenous Affairs, Australian Government above n 24, 3.1.5

⁴⁵ PilchConnect, above n 1, 42.

⁴⁶ List taken from: Department of Families, Housing, Community Services and Indigenous Affairs, Australian Government *Corporate Governance: Handbook for the board* (7 February 2011), 3.1.14
<http://www.fahcsia.gov.au/sa/disability/pubs/general/CorporateGovernanceHandbook/Pages/RolesResponsibilities.aspx#3_1_1>.

- Appointment of Company Directors, including the Chairperson;
- Appointment of the Company Secretary;
- Appointment of alternate Company Directors;
- Use of a Common Seal (where applicable);
- Conduct of Board Meetings, and General and Special Meetings;
- Recording of Minutes and Resolutions, and members' access to Minutes;
- Delegations;
- Maintaining a Registered Office within Australia that is open and accessible to the public;
- The articulation and use of the company name including the inclusion or exclusion of the word 'Limited';
- Maintaining a Register of Members;
- Adoption of a Constitution, Replaceable Rules or a combination of each one;
- Related parties and financial benefits;
- Receipt, review and lodgement of an Annual Statement with the Australian Securities and Investment Commission (ASIC);
- Appointment of a Company Auditor;
- Provision of a copy of Financial Statements and Reports to members, unless a member has waived that right; and
- Lodgement of notices of changes to officeholders, the Constitution or Rules etc to ASIC.

List taken from: Department of Families, Housing, Community Services and Indigenous Affairs, Australian Government *Corporate Governance: Handbook for the board* (7 February 2011), 3.1.14 <http://www.fahcsia.gov.au/sa/disability/pubs/general/CorporateGovernanceHandbook/Pages/RolesResponsibilities.aspx#3_1_1>

Protection

Considering the variety of things that can go wrong when running a company (not to ignore all the things that can go right with running a company), it is prudent that the company explores options of self-protection.

Two main ways an organisation can protect itself are the following. Firstly it can take out Directors and Officers insurance to cover a director's liability. Directors and Officers insurance can cover the costs of litigation and provide financial protection for directors and officers of an organisation when they have allegedly breached their duties. However it should be noted that such insurance is subject to certain terms and conditions with many acts such as insolvent trading or acts of fraud or dishonesty not covered.

Secondly, the company's constitution can include a clause whereby the organisation agrees to indemnify the Board members. However there are also limits to the clause's application as liability is subject to the amount the organisation has, will often only reimburse the board member after the action has been completed and will not cover recklessness or fraud.

Glossary

Annual general meeting – a meeting occurring every year, required by law, often used to put financial and management affairs in order as well as hold elections for board members.

Board Members – often called directors, but whatever they are named, are the people who make up the governing body of an organisation who make the crucial decisions affecting the organisation's activities.

Business Judgement Rule - A defence that can be used to justify taking reasonable actions that seemed good at the time but had bad outcomes. Loosely, it applies when you:

- honestly and sensibly thought about what was in the best interests of the company; and
- did not have any conflicting personal interests; and
- educated yourself on the matter; and
- was rational in your belief.

Breach – When a legal responsibility is not kept or adhered to, you do something you're not supposed to, or fail to do something you should do.

Confidential information – secret or sensitive information that is not accessible to the general public and may not be disclosed at will.

Constitution – the internal rules governing the organisation, which the members of the organisations agree to be regulated by.

Common law – the body of cases developed by courts over hundreds of years.

Company Law – the body of cases by the courts and statutes passed by parliament regulating and ruling over companies.

Compensation – a monetary sum given to a person or organisation that is wronged by the wrongdoer, usually to the amount of the damage or loss.

Defence – a legal justification which negates legal responsibility and may excuse certain behaviour in certain circumstances.

Delegate – passing your role and its responsibilities and duties to somebody else.

Directors – see 'Board Members'. Also includes 'honorary', 'shadow' or 'de facto' directors. 'Honorary' directors are those directors who may not have an official position, cannot vote or have limited responsibility, but are given a special role or unofficial title. Shadow directors are those individuals whose orders are generally obeyed by official directors of an organisation. De facto directors are simply people who act as if they are a director, even if they are not elected to that position. The legal duties of any of these 'directors' depend on the circumstances, the extent of their control or what functions they exercise.

Director's And Officers (D&O) Liability Insurance – Insurance that can cover the costs of litigation and provide financial protection for directors and officers of an organisation when they have allegedly breached their duties or for any wrongful act committed by them in their role as a director and officer of the organisation.

Discretion – a margin of freedom to decide and judge cases, however the judge likes. This is subject to some principles and safeguards but not as much as directly applying rules to facts.

Due care, skill and diligence – acting responsibly, monitoring your own actions as you fulfil your role, using your skills and experience as necessary and taking precautions.

Fiduciary duty - a relationship of trust recognised in law where the law considers the amount of power that is put into your hands that can potentially be abused and binds you to be loyal to the group or person who allowed you to have this power.

Fraudster – a person who falsifies their identity, quality of their goods, work experience or anything else in a transaction or activity, often to the detriment of others.

Frivolous – without seriousness or with self-indulgence.

Good faith – honesty and good intention.

Insider trading - where people trade in stocks using private information, giving them an advantage over other investors.

Insolvent – in common usage, it is the inability of the organisation to pay their debts. Under legislation, being insolvent has a particular meaning. See the *Corporations Act 2001* (Cth).

Legal duty – a responsibility imposed by law due to your role as a board member. You may also have legal duties in your capacity as a normal citizen.

Legislation – the law passed by parliament, in the form of statutes.

Liability – legal responsibility, what the court will hold you accountable for.

Material Personal Interest - where a benefit is given to you or someone else connected to you. It can be financial or in some other form.

Management – the running of day to day tasks and operations to achieve the aims of the organisation.

Mismanagement – the reckless, dishonest or negligent running of day to day tasks and operations which often damages the organisation in some way.

National Safety Council Case – the case of *Commonwealth bank of Australia v Friedrich*, (1991) 9 ACLC 946 where an organisation became bankrupt due to the mismanagement of its executive director.

Negative duties – actions you must avoid in order to fulfil your duties – what you must not do.

Objectively – if the court is thinking objectively, the court will ignore your gender, race, religion, personality, opinions, political persuasions and what you say you thought was the right thing to do and try to figure out what the most reasonable, universal person would do.

Obligations – what you are required to do, whether morally or legally. In this factsheet we are concerned with legal duties.

Officer – positions within the organisation with power or responsibilities in the running of the organisation such as managers, coordinators, chief executive officers, an executive director or non executive directors.

Passive board member – a board member which may fulfil all negative duties, but not positive ones such as acting with due care.

Pecuniary penalty - orders by the court to punish for bad behaviour.

Petition - applying to the court for a remedy or a lawsuit, following the proper procedure

Positive duties – duties that require you to act a certain way, or to fulfil a certain standard in order to fulfil that duty.

Proper purpose - doing things in the interest of your company, achieving what your organisation was set up to do and serving the viability of the organisation's existence.

Prudent – behaving sensibly and cautiously, thinking ahead and taking precautionary measures.

Register of Interests – an information system (it can simply be a document) recording all relevant interests, personal or financial, of the board members in detail.

Reasonable – an objective standard, what would be the most universal, sound and appropriate thing to do in the circumstances.

Subjectively – if the court is thinking subjectively, the court will consider what actions could be justified from your unique point of view. It will step into your shoes and consider the circumstances in which you acted.

Resources

ACPNS:

<https://wiki.qut.edu.au/display/CPNS/DYB+Home>

QCOSS:

<http://www.communitydoor.org.au/establish-a-community-service-organisation/company-limited-by-guarantee>

ASIC:

<http://www.asic.gov.au/asic/asic.nsf/byheadline/Companies+limited+by+guarantee-simplified+obligations>

Federal government:

http://www.fahcsia.gov.au/sa/disability/pubs/general/CorporateGovernanceHandbook/Pages/RolesResponsibilities.aspx#3_1_1

Our community:

http://www.ourcommunity.com.au/boards/boards_article.jsp?articleId=1305

Useful PilchConnect guide:

<http://www.pilch.org.au/govguide/>

Australian Institute of Company Directors:

<http://www.companydirectors.com.au/Director-Resource-Centre/Director-QA/Director-tools>

For empirical studies:

The University of Melbourne, Centre for Corporate Law and Securities Regulation:

<http://cclsr.law.unimelb.edu.au/go/centre-activities/research/research-reports-and-research-papers/>

<http://cclsr.law.unimelb.edu.au/go/centre-activities/research/reforming-not-for-profit-regulation-project/index.cfm>

The Liability of Directors and Committee Members of Non-profit Associations in the 1990's

http://eprints.gut.edu.au/12047/1/7R_Sievers.pdf

Other useful links on directors duties:

http://www.pwc.com.au/legal/assets/GuideDirectors_Apr08.pdf

<http://www.lawhandbook.sa.gov.au/ch04s01s03s02.php>

For more information on financial reporting frameworks:

The Institute of Chartered Accountants in Australia:

<http://www.charteredaccountants.com.au/Industry-Topics/Reporting/News-and-guidance-on-regulatory-matters/Corporation-Act/Companies-limited-by-guarantee.aspx>

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