AUSTRALIAN INSTITUTE *of* COMPANY DIRECTORS

DIRECTOR TOOLS

Types of directors

Board composition

There are a number of different types of directors, known by a variety of names. All directors generally have the same duties and responsibilities regardless of their title. The following types of directors will be discussed: alternate director, chair, de facto director, executive director, non-executive director, independent director, lead director, managing director, nominee director and shadow director.

What is an alternate director?

An alternate director is appointed by a director to exercise some or all of the appointing director's powers for a specified period. Appointing an alternate is the most useful way that directors can fulfil their duties and responsibilities if they know they will be absent for one or more board meetings, for example due to illness, jury duty, long holiday, etc.

Section 201K of the *Corporations Act 2001* ('Act'), a replaceable rule, covers alternate directors. This section may be replaced by specific provisions in the company's constitution. Some organisations do not allow alternate directors in their constitutions.

Appointment of an alternate director is subject to the board's approval and must be given in writing.

ASIC must be notified within 28 days of the appointment in accordance with section 205B (2) of the Act, which is done through ASIC's alternate directors online services.

At law, alternate directors have the same rights, powers, duties and responsibilities as other directors. Specific roles, duties and responsibilities of an alternate director will usually be specified in the constitution or other formal company documentation. If the appointor requests it, the alternate must be given notice of meetings (s 201K (2) of the Act). Alternate directors may, if appointed to do so, act in their own right and do not have to act on the wishes of the appointor.

Where the appointing director has a conflict of interest, the alternate director is still able to vote if appointed to act in their own right. Where the alternate director has a conflict of interest, they are unable to vote regardless of whether acting as an agent or in their own right.

The appointor may terminate the appointment of an alternate director at any time provided it is done in writing (s 201K (5) of the Act). However, if the appointing director resigns or if either the appointing director or the alternate director is disqualified from managing a company, the alternate director's appointment ceases automatically. ASIC must be notified within 28 days of the alternate director ceasing their appointment for any reason using the ASIC alternate director web page (s205B (5) of the Act).

What is the role of the chair?

A chair is a director appointed to chair the meetings of directors. Often they will also chair meetings of members.

The position of chair is covered by section 248E of the Act, which is a replaceable rule. Section 248E states:

(1) The directors may elect a director to chair their meetings. The directors may determine the period for which the director is to be the chair.

(2) The directors must elect a director present to chair a meeting, or part of it, if:

- (a) A director has not already been elected to chair the meeting; or
- (b) A previously elected chair is not available or declines to act, for the meeting or the part of the meeting.

Consequently, under this replaceable rule, a chair is only technically required on a meeting by meeting basis, but a more permanent chair can be appointed. Consequently, to understand how chairs are appointed and whether they have any special powers or responsibilities it is necessary to refer to the company's constitution.

In some companies, especially those with only one or very few shareholders, the constitution may give the owner the power to appoint the chair. This is common in many government-owned corporations, wholly-owned subsidiaries and is sometimes observed in organisations owned by religious based entities. Having a chair who is not elected by the other directors can, at times, lead to friction in the boardroom.

The more common situation is for the constitution to allow the existing directors to elect one of their number as the chair. The period for which a person is appointed chair can be set out in the constitution; however, this is not advised. A common practice is for the directors, as the first item of business at the first board meeting following the annual general meeting, which is when any new directors are usually appointed, to elect a chair for the year. In this way, any new directors get to have a say in who is chair. As this is a resolution of directors, if the chair loses the support of the board, they can be replaced by resolution at any time throughout the year.

The Act is virtually silent on any powers or expectations of chairs outside of chairing board meetings. However, contemporary thinking on corporate governance suggests that chairs play a very important role in ensuring the organisation functions effectively.

The role of the chair:

- Chairs board meetings
- Has final say on the agenda for each board meeting, guiding the board to address each item on the agenda and building a consensus so that decisive action can be taken
- Arranges with management to provide the information the board needs
- Leads the board in creating the governance structure for the company, often acting as chair of a governance or nomination committee
- Acts as the board's primary channel of communication with the CEO between board meetings
- Often leads the process by which the board motivates and evaluates the CEO and potentially decides to replace him or her
- Chairs general meetings of shareholders
- Supports the external communications of the company

A director who is a chair currently owes the same duties as other directors, although this is being challenged by recent court decisions, which suggest that a chair may carry additional responsibilities.[1]

The chair acts as the link between the board, the organisation and the CEO. Governance codes including Recommendation 2.5 of ASX Corporate Governance Council's Corporate Governance Principles and Recommendations (ASX Principles) recommend the chair to be independent.

What is a de facto director?

A de facto director is usually a person who has not been formally or properly appointed as a director, but who acts as a director, for example a person may call themselves a consultant, but be carrying out tasks associated with being a director. The term can also refer to a person formally appointed to the position of a director regardless of the position, title or job description they use in practice.

Where a person is not formally appointed as a director, whether a person is a de facto director depends on the nature of the activities or work they perform in a context of the operations and circumstances of the company concerned. There is no general test to determine whether a person has acted as a director. Factors that are considered relevant in this determination include: size of the company; internal practices and structure of the company, and the perception of outsiders. In *Grimaldi v Chameleon Mining NL (No 2)* (2012), the Full Court of the Federal Court found that a consultant was a de facto director, saying:

> *"We accept that the Board members seem only to have allowed Mr Grimaldi's attendance at Board meetings by invitation and did not appear to regard him as a director as such. However, while they did not hold him out as a director eo nomine [by that name], they clearly authorised him on occasion to perform functions such as would lead a reasonable third party dealing with him to believe he was acting as a director of Chameleon. His authorisations to negotiate the acquisitions of the Fijian mining interests and of the Chilean copper mine, instance this and demonstrate that in these matters he stood on an equal footing with them in directing the affairs of the company. More, generally, Mr Grimaldi was allowed either to perform functions, for example fund raising and share placements, or to arrogate to himself functions in which at least either or both of the executive directors acquiesced with knowledge...Mr Grimaldi was obviously a resourceful and experienced person and the extent of his participation and intrusion into Chameleon's affairs could hardly have gone unnoticed. There is little room for doubt that the executive directors knowingly and willingly utilised his skills and experience over a diverse range of matters, acquiescing in, if not always authorising, what he did."*

De facto directors have the same duties and responsibilities as other directors, as has been demonstrated in case law.[2]

What is an executive director?

Executive directors wear two hats – that of senior executive in a company, that is an employee, and that of a director. Hence, in the United States they are usually referred to as "inside directors". Today's governance codes in Australia and overseas emphasise the importance of having a majority of independent directors as well as any executive directors. This is usually only possible in larger organisations.

The value of executive directors to a board lies with their depth of knowledge of the business and with their technical business skills.

Some court decisions suggest that executive directors might have a greater responsibility than other directors because of their inside knowledge and other specific qualifications (in which case a greater standard of care applies).[3] The distinction is not reflected in the Act.

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[1] *ASIC v Rich* (2003) 44 ACSR 341; 21 ACLC 450.

[2] Relevant cases include Grimaldi v Chameleon Mining NL (No 2) (2012) FCAFC 6; *Deputy Commissioner of Taxation v Austin* (1998) 16 ACLC 1,555; *Forkserve Pty Ltd v Jack and Aussie Forklift Repairs* (2001) 19 ACLC 299; *Re Canadian Land Reclaiming and Colonizing Co* (1880) 14 Ch D 660, 670; *Ultraframe UK Ltd v Fielding* [2004] RPC 24 at 39.

[3] *Geoffrey William Vines v Australian Securities & Investments Commission* [2007] NSWCA 75.

What is a non-executive director?

A non-executive director, by definition, is any director who is not an executive of the company. They are sometimes referred to as "outside directors" or as an "NED". As explained below, a director may be a non-executive director, but not necessarily an independent director.

Non-executive directors, like all directors, are elected by shareholders/members to act on their behalf in overseeing and governing an organisation. However, as distinct from executive directors, non-executive directors are not employees of the organisation. The advantage of non-executive directors is that they bring objectivity and independence to act in the best interests of the organisation.

They rely on information from management to guide their decision-making. Therefore, they have a responsibility to ensure they receive appropriate and necessary information from the executive team.

What is an independent director?

An independent director can be broadly defined as a non-executive director who is not a member of management and who is free from any business or other relationship that could materially interfere (or could reasonably be perceived to materially interfere) with the independent exercise of that director's judgment. Recommendation 2.4 of the ASX Principles states that there should be a majority of independent directors on a board.

The ASX Corporate Governance Council provides the following guidance in *Box 2.3: Factors relevant to assessing the independence of a director,* in its *Corporate Governance Principles and Recommendations 3e*.

"Examples of interests, positions, associations and relationships that might cause doubts about the independence of a director include if the director:

- *Is, or has been, employed in an executive capacity by the entity or any of its child entities and there has not been a period of at least three years between ceasing such employment and serving on the board;*
- *Is, or has within the last three years been, a partner, director or senior employee of a provider of material professional services to the entity or any of its child entities;*
- *Is, or has been within the last three years, in a material business relationship (for example as a supplier or customer) with the entity or any of its child entities, or an officer of, or otherwise associated with, someone with such a relationship;*
- *Is a substantial security holder of the entity or an officer of, or otherwise associated with, a substantial security holder of the entity;*
- *Has a material contractual relationship with the entity or its child entities other than as a director;*
- *Has close family ties with any person who falls*

In each case, the materiality of the interest, position, association or relationship needs to be assessed to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally."

Family ties and cross-directorships may be relevant in considering interests and relationships that may affect independence, and should be disclosed by directors to the board.

The term is often used interchangeably with non-executive director, although this is not correct. A director can be a non-executive director, but not an independent director. An executive director can never be independent.

[5] *ASX Corporate Governance Council*, op cit, Box 2.3, p 16.

What is a lead director?

This is a term mainly used in the US, but also in a handful of Australian companies. In the US, the roles of chair and CEO are often combined and held by the one person. A lead director is a non-executive director, and preferably an independent director, who undertakes some of the roles of the chair which the chair is unable to perform given that they are an executive of the company. Appointing a lead director allows more independent oversight and assessment of the CEO and senior executives.

The lead director should be chosen by other non-executive directors. The role includes presiding over meetings of non-executive directors, assisting in the preparation of the board agenda, acting as the contact point for other directors to raise concerns about the management, liaising between the board and management, ensuring a CEO succession plan is in place and leading the evaluation of the chair/CEO and senior management.

What is the role of a managing director?

A managing director (MD) is an executive director who sits on the board, but also has the ultimate authority to manage the organisation on a day-to-day basis. Often the terms chief executive officer (CEO) and MD are used interchangeably. It is not compulsory to have a managing director. However, it is a usual practice for larger proprietary and for listed companies. There may be joint MDs, but normally there are no more than two.

The MD is the most senior executive in the organisation. They manage the day-to-day operations of the organisation, its people and resources. They supervise the work of other executives, implement strategy and create an appropriate corporate culture.

Section 198C of the Act, a replaceable rule, covers the MD. This section may be replaced by specific provisions in the company's constitution. Under this section, the board is given the power to confer to an MD any of the powers the directors can exercise and to revoke or vary any such conferral.

What is a nominee director?

A nominee director is a director who is appointed by a shareholder, creditor or interest group and who has a continuing loyalty to the nominator or some interest other than the interest of the company.

Nominee directors should act in the best interests of the company to which they are appointed and not in the interests of the nominator. Nominee directors should be aware of conflicts of interests they have towards the company and the loyalties they hold towards their nominators. In Australia, the nominee directors can, however, pay regard to the interests of the nominator if they genuinely believe they are acting in the best interests of the company.[4]

If an actual conflict of interest occurs, the nominee must either obey their duty to the company, not to the nominator, or resign from the company's board.

A company may in its constitution allow nominee directors to have different duties (apart from statutory ones) to other directors that may otherwise be considered to be a conflict of interests for that nominee director (for example, a duty for a nominee appointed by a creditor to secure a loan facility for the company).[5] Any such provisions must be subject to limitation imposed by section 199A of the Act, which states the situations in which the company will not exempt or indemnify or reimburse the costs incurred by a director.

Under section 187 of the Act, directors appointed to the board of a wholly-owned subsidiary may take the interests of the holding company into consideration if:

1. the company constitution allows the director to do so;
2. the director acts in good faith in the best interests of the holding company; and
3. the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

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[5] *Re Broadcasting Station 2GB Pty Ltd* [1964-65] NSWL 1648.

[5] *Levin v Clark* [1962] NSWR 686.

What is a shadow director?

A shadow director is a person not formally appointed as a director, but on whose instructions or wishes a company's board members are accustomed to act. Those who appoint nominee directors may be considered shadow directors in certain circumstances. Shadow directors owe the same duties to the company and may face the same penalties and fines as validly appointed directors.

A body corporate can be a shadow director, despite section 201B of the Act, which provides that only an individual is eligible to be appointed a director of a company. For example, in New Zealand, the Privy Council held in the context of a corporate group, a parent became a shadow director of a subsidiary.[6] In Australia, similarly, a parent company was held by the Supreme Court to be a shadow director of another company due to the parent company:[7]

- Having effective control of its subsidiary;
- Exercising management and financial control over its subsidiary; and
- Imposing on its subsidiary requirements for financial reporting consistent with its own financial reporting requirements.

This may expose holding companies and other corporate shareholders to additional liabilities under the provisions of the Act dealing with insolvent trading and breaches of directors' duties, as well, of course, as liability for breaches of fiduciary duties.

Shadow directors were dealt with in detail in *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd (2011) NSWCA 109* where Justice Young said that the following principles emerge from the leading cases:[8]

- *"Not every person whose advice is in fact heeded as a general rule by the board is to be classed as a de facto or shadow director*
- *If a person has a genuine interest of his or her or its own in giving advice to the board, such as a bank or mortgagee, the mere fact that the board will tend to take that advice to preserve it from the mortgagee's wrath will not make the mortgagee, etc. a shadow director*
- *The vital factor is that the shadow director has the potentiality to control. The fact that he or she does not seek to control every facet of the company or the fact that from time to time the board disregards advice is of little moment*
- *Millett J's proposition that the evidence must show "something more" than just being in a position of control must be shown. The whole of the facts of the case must be shown to see whether that power to control was put into practice. The emphasis that one must judge on the whole of facts and circumstances is made many times over in the leading cases...*
- *Although there are problems with cases where the board of the company splits into a majority and minority faction, so long as the influence controls the real decision makers, the person providing the influence may be a shadow director."*

[6] *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] AC 187; [1990] BCLC 868.

[7] *Standard Chartered Bank v Antico* (1995) 13 ACLC 1, 381.

[8] Relevant case law in relation to shadow directors includes: *Australian Securities Commission v AS Nominees Ltd & Ors* (1995) 13 ACLC 1,822; *David Hill v David Hill Electrical Discounts* (2001) 19 ACLC 1,000 *Forge & Ors v ASIC* (2005) 23 ACLC 1,010; *Australian Securities Commission v AS Nominees Ltd & Ors* (1995) 13 ACLC 1,822; *Harris v S* (1976-1977) 2 ACLR 51; *Ho v Akai Pty Ltd* (2006) 24 ACLC 1, 526; *Standard Chartered Bank v Antico* (1995) 13 ACLC 1,381; *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] AC 187; [1990] BCLC 868; *ASIC v Adler* (No 3) (2002) 20 ACLC 576].

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