General duties of directors

Boards of directors are responsible for the overall governance and strategic direction of an organisation. They provide “overall superintendence” of a company, overseeing both performance and compliance in accordance with the organisation’s purpose and objectives.

The relationship between a director and a company is fiduciary in nature, meaning that a director undertakes to act in the interests of the company and not in his or her own interests.

The overriding duty of a fiduciary is the obligation of undivided loyalty. This obliges the director to act honestly, in good faith and to the best of his or her ability in the company’s interests. A director must not allow conflicting interests or personal advantages to override the company’s interests. Nor should a director participate in deliberations of the board if the director has personal interests or duties that may conflict with those of the company. The company to which the director has been appointed must always come first.

While boards are often said to make collegiate decisions for which they take collegiate responsibility, the law imposes individual duties on directors.

This document provides an overview of core legal duties that apply to directors under the Corporations Act 2001 (Cth) (Corporations Act) and common law, and touches on other statutory duties, but is not exhaustive.

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Who are considered to be directors?

A director includes:

- a person validly appointed as a director or an alternate director;
- a person who, even though not validly appointed as a director, acts in the position of a director (also known as a ‘de facto director’); and
- a person about whom, even though not validly appointed as a director, the directors are accustomed to act in accordance with that person’s instructions or wishes (also known as a ‘shadow director’).

It is important to remember that directors’ duties apply to a person who exercises directors’ power and control in the company even if they may not be validly appointed.

What are the core directors’ duties?

Directors are subject to a range of legal duties including those outlined below. The core duties contained in sections 180-183 of the Corporations Act largely codify the common law on directors’ duties.

Act with care and diligence

Directors must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if he or she were a director in the company’s circumstances and had the same responsibilities of that director.

Whether a director has exercised a reasonable degree of care and diligence is determined by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to flow to the company from the conduct in question.

In making decisions, directors must apply an enquiring mind, consider the overall position of the company, test information put before them by management and proactively consider what other information they require.

In practice, the duty requires each director to:

- become familiar (and maintain familiarity) with the fundamentals of the business or businesses of the organisation;
- stay informed and make appropriate inquiries about the organisation’s activities;
- monitor, generally, the organisation’s affairs and policies;
- maintain familiarity with the organisation’s financial status by appropriate means, including review of its financial statements and board papers and make further inquiries into matters revealed by those documents where appropriate; and
- have an informed opinion of the organisation’s financial capacity and solvency.

The business judgment rule provides a defence for a director in relation to an alleged breach of the duty to act with care and diligence.

What is the business judgment rule?

This rule seeks to avoid unnecessary restrictions on proper entrepreneurial activity. Section 180(2) of the Corporations Act provides that a director who makes a ‘business judgment’ (that is, any decision to take or not take action in respect of matters relevant to the business operations of the company) is taken to meet the care and due diligence requirements in respect of the judgment if they:

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

It is important to note it does not apply to other duties contained in the Corporations Act.

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2 Section 180, Corporations Act 2001 (Cth).
4 This demands an ability to understand financial statements, and a basic knowledge of accounting practice and standards. Refer to S. Dianne Azoor Hughes, 2019, Financial Fundamentals For Directors, 2nd Edition, Australian Institute of Company Directors.
Act in good faith in the best interests of the company and for a proper purpose. Directors must exercise their powers and discharge their duties in good faith in the best interests of the corporation, and for a proper purpose.

It is clear that the corporation (as a distinct legal and commercial entity) is the focus of this duty, and that it requires consideration of more than financial returns or profitability over a particular period.

Boards operate in a complex environment and must have sufficient flexibility to consider what the best interests of the company are in the context of specific decisions, exercising appropriate judgment. This is fundamental to the role of the board. Accordingly, directors' judgment as to what is in the best interests of the corporation, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.6

In practical terms, acting in a responsible and ethical manner towards stakeholders (such as customers, employees, community and the environment) is necessary for the promotion of the interests of the company and its sustainability, and builds long-term value for shareholders.

Of course, this does not mean that all stakeholders will be satisfied with every decision taken, given stakeholder interests will be diverse.

There will also be certain circumstances where the interests of specific groups may be paramount – such as the interests of creditors where the company is insolvent or approaching insolvency, or the interests of shareholders in the context of a change of control scenario.

The duty to act in the best interests of the corporation came under scrutiny in the context of the Banking Royal Commission.

In his final report, Commissioner Hayne discusses the consideration by boards of stakeholder impacts when acting in the best interests of the corporation:

“The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation’s continued long-term financial advantage. And long-term financial advantage will more likely follow if the entity conducts its business according to proper standards, treats its employees well and seeks to provide financial results to shareholders that, in the long run, are better than other investments of broadly similar risk... Regardless of the period of reference, the best interests of a company cannot be reduced to a binary choice…”7

Not improperly use information or position. Directors must not improperly use their position, or information they obtain because they are or have been a director, to gain an advantage for themselves or someone else, or cause detriment to the company.

These prohibitions stem from a director’s fiduciary duty to prevent conflicts of interests, and the obligation to act only in the best interests of the company.

Manage conflicts of interest. Directors must avoid or appropriately manage conflicts between personal interests and the company’s best interests.9

The first step to managing conflicts of interest is identification. Recording conflicts of interest can help to ensure appropriate oversight and transparency.

Once a conflict has been identified, the board must decide if it can be managed, and how. For example, it may be required that the conflicted director:

• refrain from participating in any discussion about related matters;
• remove themselves from the room; or
• abstain from voting on any matter related to the conflict.

5 Section 181, Corporations Act 2001 (Cth).
6 United Petroleum Australia Pty Ltd v Herbert SmithFreehills [2018] VSC 347 at [627-629]
7 Ibid, p 403.
8 Sections 182-183, Corporations Act 2001 (Cth).
9 Organisational conflicts of interest often take on ethical decision-making dimensions. Refer to Australian Institute of Company Directors and The Ethics Centre, 2019, Ethics in the Boardroom: A decision-making guide for directors, Australian Institute of Company Directors.
GENERAL DUTIES OF DIRECTORS

Disclosing directors’ interests

A director must disclose – to other directors of their company – the nature and extent of matters relating to the affairs of the company in which he/she has a material personal interest.\(^{10}\)

Disclosing directors’ interests is also a requirement in the context of public companies obtaining shareholder approval for related party transactions\(^{11}\), and public companies notifying the market\(^{12}\).

Prevent insolvent trading\(^{13}\)

Directors have a duty to ensure that a company does not trade whilst insolvent or where they suspect it might be insolvent. Directors will be personally liable for certain debts which are incurred if:

- they are a director at the time when the company incurs the debt;
- the company is insolvent at that time, or becomes insolvent by incurring that debt; and
- at that time, there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.

What is an insolvency safe harbour?\(^{14}\)

An insolvency ‘safe harbour’ protection is available to directors if:

- at a particular time after a person starts to suspect a company may become or already be insolvent, he or she starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and
- the debt is incurred directly or indirectly in connection with that course of action and during a specified time period.

Statutory duties in relation to financial record keeping and reporting

Directors have an obligation to take reasonable steps to ensure that their company complies with its obligations under the Corporations Act in relation to the keeping of financial records and financial reporting.\(^{15}\)

They must apply their own minds (rather than rely solely on advice) when reviewing financial statements, and they must satisfy themselves that this information is consistent with their knowledge of the company’s affairs.

Provision of director information

Directors have an obligation to provide, to their organisation, certain information relating to themselves.\(^{16}\)

In certain circumstances, directors of proprietary companies will have responsibilities to lodge information with the Australian Securities and Investments Commission (ASIC).\(^{17}\)

Do directors have obligations under other laws?

There are a significant number of laws (federal, state and territory) under which a director can be found to be personally liable in the event of a contravention. Examples of these laws include competition and consumer law, workplace health and safety, privacy law, environmental law and taxation.

For an overview of some of the key legal, regulatory and compliance environments in which organisations operate – and accordingly, key areas requiring director oversight – refer to the AICD Director Tool Directors’ legal and regulatory environments.\(^{18}\)

Some specific industries also have very specialised laws (for example, aviation, financial services, schools, mining). There are also special responsibilities and directors’ liabilities associated with different organisational activities such as takeovers, joint ventures and floats. If a company has operations in a foreign country, directors should also ensure their duties and responsibilities comply with and fulfil any local legislation and requirements.

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10 Section 191, Corporations Act 2001 (Cth).
11 Section 208, Corporations Act 2001 (Cth).
12 Section 205G, Corporations Act 2001 (Cth).
13 Section 588G(1), Corporations Act 2001 (Cth).
14 Refer to the AICD Director Tool The insolvency safe harbour.
15 Section 344, Corporations Act 2001 (Cth).
16 RePart 2D.5, Corporations Act 2001 (Cth).
17 Section 188(2), Corporations Act 2001 (Cth).
18 For practical guidance on more specific areas of regulatory oversight, also refer to AICD Director Tools: Work health and safety, Modern slavery risk oversight and Data and privacy governance.
What are the consequences of breaching directors’ duties?

Criminal sanctions
Contravention of certain duties under the Corporations Act or other laws constitutes a criminal offence. For example, under the Corporations Act, contravention of the duty of good faith or improper use of information or position, if it involves dishonesty or recklessness, is punishable by substantial fines and potential imprisonment for up to 15 years (s 184). It is also illegal for a corporation to indemnify its officers against legal costs and any financial penalty for this behaviour.

Civil sanctions
A contravention of the duties under the Corporations Act can make a director liable to a substantial fine. Shareholders or others (for example, creditors) may also take action against directors who have failed to comply with their duties.

Disqualification
Both ASIC and the courts have the power to disqualify directors for long periods of time for failure to comply with their duties under the Corporations Act (Part 2D.6). Directors are automatically disqualified on conviction of certain serious offences or an undischarged bankruptcy (s 206B).

For directors of charities registered with the Australian Charities and Not-for-profit Commission (ACNC), the ACNC Commissioner has the regulatory power to suspend or remove a director upon failure to comply with the Australian Charities and Not-for-profits Commission Act 2012. The ACNC Commissioner may also prevent a director from governing any other ACNC registered charities (see the Australian Charities and Not-for-profits Commission Act 2012 Chapter 4 Division 100).

Disqualification in a foreign jurisdiction, such as New Zealand, may also lead to disqualification in Australia.

Director appointments
The Corporations Act requires public companies to have at least three directors, at least two of whom must ordinarily reside in Australia. Proprietary companies must have at least one director who must ordinarily reside in Australia. For proprietary companies with a sole director who is also sole shareholder, a second director can be appointed by the original director recording the appointment and signing the record. A director may not resign if the resignation would leave the company without a director. A single director may resign or be removed if the company is being wound up at the time.

Commercial consequences
The most serious consequences of breaching directors’ duties are often not the legal ones but the commercial ones. A corporation’s most valuable asset is its reputation. The company will likely be subjected to much greater scrutiny, both by investors and regulators, where directors breach duties. At worst, market and stakeholder reaction may mean the company will cease to exist.

These commercial consequences likely occur before any court judgement is handed down. Media reporting on the misconduct of financial institutions disclosed during the Banking Royal Commission caused drastic falls in share prices and loss of public trust. Significant public scrutiny and pressure on board performance also saw the resignation of board chairs and directors of a number of organisations.

19 Section 201A, Corporations Act 2001 (Cth).
20 Section 201F, Corporations Act 2001 (Cth).
What duties exist in organisations not governed by the Corporations Act?

Examples of organisations not governed by the Corporations Act include:

- Incorporated associations such as cooperatives (governed by state legislation, called the Associations Incorporation Act in most states);
- Organisations operating under a royal charter;
- Charities (governed by the Australian Charities and Not-for-profits Commission Act 2012);
- Organisations incorporated by their own Act of State or Federal Parliament (for example, Anglican Church of Australia Constitution Act 1961 (NSW), University of New England Act 1993 (NSW));
- Government bodies (regulated by their own legislation: for example, the Commonwealth Authorities and Companies Act 1997, State Owned Corporations Act 1989 (NSW)).

Essentially the same directors’ duties and responsibilities found in the Corporations Act apply to these organisations by virtue of their own legislation or the common law.

Currently, directors of charities that are structured as companies that are limited by guarantee are not subject to the individual duties under the Corporations Act as they are replaced by the ACNC Governance Standards. This position is currently under consideration by the Government as part of its response to the ACNC review. However, they remain subject to equivalent individual duties under the common law.