OXFORD LAW GUIDEBOOKS

# BUSINESS LAW GUIDEBOOK

## SECOND EDITION

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## CHAPTER 11: DUTIES OF COMPANY DIRECTORS

### TEST YOUR KNOWLEDGE

**1. Explain what is meant by saying that directors have a duty to act in the best interests of the company.**

**ANSWER**

Section 181 (1) (a) sets out the duty of directors to act in good faith and in the best interests of the company. The good faith aspect puts directors under an obligation to genuinely believe that they are acting in the best interests of the company. Although a company is regarded as a legal entity separate and distinct from its shareholders, it has been held that the duty to act in the best interests of the company means that the directors must act in the best interests of the shareholders as a group: *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286. In this sense, as long as the company is solvent, the interests of the company and the interests of the shareholders coincide.

**2. To whom do directors of a company owe their duties?**

**(a) most of the shareholders**

**(b) the company itself**

**(c) the creditors of the company**

**(d) the employees of the company**

**(e) the agents of the company**

**(f) the officers of the company.**

ANSWER

(b) The directors of a company owe their duties to the company itself.

### 3. Explain what is meant by the duty to act with due care, skill and diligence.

ANSWER

Section 180 (1) of the *Corporations Act 2001* provides that it is the duty of company directors to exercise their power and discharge their duties with the degree of care and diligence that a reasonable person would exercise. The section imposes an objective standard of a 'reasonable person'—that is what an ordinary person, with the knowledge and experience of the defendant, might be expected to have done in the circumstances if the defendant were acting on his or her own behalf. The duty takes into account the director's position and responsibilities, such as whether the person was an executive or non-executive director and whether they had been given any special committee responsibilities. In large companies, directors are unlikely to have involvement in the day-to-day management of the company. They will more than likely be non-executive directors whose function is to bring an independent view to, and a broader outlook on, the company's decision-making processes. In small and medium-sized proprietary companies, the directors may have a more hands-on role where they will be involved in the day-to-day management of the company.

### 4. Discuss the operation of the business judgment rule.

ANSWER

The business judgment rule in s 180 (2) provides that directors will be shielded from liability in relation to decisions made in the best interests of the company. More specifically, it is a defence for actions that may otherwise be in breach of s 180 (1) which imposes an obligation on directors to exercise care and diligence when discharging their decision-making responsibilities. The effect of the business judgment rule is to acknowledge that directors should not be responsible for business decisions that may have turned out badly but were made in an honest, informed and rational way. So under this rule, directors are assumed to have acted with appropriate care and diligence if all the factors contained in s 180 (2) are satisfied. This statutory rule is the equivalent of the similar obligation at common law and in equity.

The rule ensures that risk-taking and entrepreneurial activities will be encouraged because directors are assured by legislation that if they acted honestly, they will not be personally liable as a result of making errors of judgment.

### 5. Is the care owed by a non-executive director the same as that owed by an executive director?

ANSWER

Courts have rejected the view that a lower standard of care should be applied to a non-executive director as compared to that of an executive director. In other words both types of directors owe the same duty of care: *Daniels v Anderson* (1995) 13 ACLC 614.

### 6. Explain the purpose of s 588 G of the *Corporations Act*? If directors contravene s 588 G what defences are available to them?

ANSWER

The purpose of s 588 G of the *Corporations Act* is to impose a duty on the director of a company to prevent his or her company from trading while insolvent. A director contravenes the section if, when the company incurs a debt, there are reasonable grounds for suspecting that the company is insolvent and would become insolvent.

There are four defences to s 588G and these are set out in s 588 H. The defences are:

- At the time when the debt was incurred, it could be proved that the director had reasonable grounds to expect, and did expect, that the company was solvent at that time: s 588 H (2).
- The director could prove that he or she had reasonable grounds to rely on information provided by a competent and reliable person that the company was solvent: s 588 (3).
- A director did not take part in the management of the company because of illness or for some other good reason at the time when the company incurs the debt in question: s 588 H (4).
- The director could prove that he or she took all reasonable steps to prevent the company from incurring the debt: s 588G H (5).

**7. Why does an insolvent company or a company nearing insolvency have to consider the interests of creditors when making decisions concerning the allocation of resources?**

ANSWER

An insolvent company or a company nearing insolvency owes a duty to take account of the interests of creditors because these creditors have a right to be fully informed. The interests of the creditors in respect of the allocation of resources would be related to the ability of the company to realise the company's current assets and the effect of its contingent liabilities. These interests of the creditors would oblige the company through the directors to declare whether or not there are reasonable grounds to believe that it will be able to pay its debts when they become due and payable: s 295 (4) (c). Such interests would also be served in the duty to prevent a company from trading while insolvent under s 588 G as discussed in the answer to Question 6.

**8. What consequences exist for breaches of directors' duties?**

ANSWER

If directors' duties are breached, ASIC or the company can apply to the court for a declaration of contravention (s 1317E). A court may order a director to pay a civil penalty involving a pecuniary penalty order or a fine of up to $200,000 if the contravention adversely affects the interests of the company or its ability to pay its creditors: s 1317G. The court may also order the director to compensate the company for damage (which included profits made) suffered as a result of the contravention: s 1317 H.

Directors would be liable for a criminal offence if they contravene a civil provision knowingly, intentionally or recklessly; and intending to deceive or defraud. The penalty here is a $200,000 fine or imprisonment for five years or both: s 1317P.

More specifically, s 184 of the *Corporations Act* 2001 provides that if directors fail to exercise their powers in good faith in the best interests of the company, the director would be guilty of a criminal offence. The penalty for such an offence is a $220,000 fine or imprisonment for five years or both.

**9. Explain what is meant by insider trading.**

ANSWER

A director or other officer is prohibited under s 183 of the Corporations Act from trading with informational advantage, that is, improperly using insider information in an activity commonly known as insider trading. This kind of trading occurs where a director or other officer trades in shares or other financial products while in possession of price-sensitive information not generally available. It is important to note here that the information acquired or created in the course of someone's role as director or other officer within the company belongs to the company and cannot be used for personal gain, for gain of a third party, or to harm the company. The person with whom the 'insider' deals is entitled to recover compensation. Contraventions of the insider trading provisions attract the civil penalty provisions.

Insider information covers a wide range of material, including a wide range of financial products such as derivatives, superannuation, and others which are able to be traded on a financial market. Even where the director created the information, this information still belongs to the company if it was created in the course of carrying out his or her duties as a director, or other officer.

### 10. Discuss the indoor management rule.

ANSWER

Section 129 (1) is a clarification and partial codification of the '*rule in Turquand's case'* *(Royal British Bank v Turquand* (1856) 6 E &B 327) which says, in effect, that outsiders transacting with a company in good faith are entitled to assume that the internal company rules, and the acts done within the company's constitution and powers have been complied with. Outsiders do not have to check whether the acts of internal management have been regular. The rule in *Turquand's* case, also known as the 'indoor management rule' is applicable in most of the common law world.

### 11. What is the rule in *Foss v Harbottle*?

ANSWER

At common law, the right of a member to bring a legal action in the name of the company to remedy a wrong committed against the company came from the old rule in *Foss v Harbottle* (1843) 2 Hare 461. This rule was based on the philosophy that it was generally proper for disputes to be resolved in accordance with the constitution and the majority vote of the members.

The rule in *Foss v Harbottle* says that for breaches of common law duties, the company may seek redress in its own right. The duties are owed to the company and not to the shareholders. The company as opposed to individual shareholders, must sue. That is to say, the proper plaintiff is the company.

 

However, it must be pointed out that where directors, who have breached their duties to the company also constitute a majority of the board and therefore control the company, it is not likely that these directors will decide to bring an action against themselves. So the proper plaintiff rule which provides that it is only the company that can bring a legal action for breaches of duties owed to the company can be a disadvantage for the company and its shareholders or members.

There are exceptions to the rule in *Foss v Harbottle*. In respect of one class of exceptions, a member could complain of an infringement of personal rights as a member. Other exceptions to the rule allowed a member to bring a legal action in the name of the company to enforce a right of the company. This normally comes about where the company's directors breached their duty to the detriment of the company, but because they controlled the company they would not wish the company to remedy the breach.

Part 2F.1A of the Corporations Act contains, in effect, provisions that are exceptions to the proper plaintiff rule in *Foss v Harbottle*. For example, to make sure that the company management is not overwhelmed by vexatious and frivolous litigation, s 236 (1) (b) of Part 2F.1A provides that members, directors and officers can apply to the court to obtain leave before commencing a proceeding on behalf of a company or intervening in proceedings to which a company is a party.

 