



How to Avoid a

FALL *from*

GRACE



Legal Lessons for Directors

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CHAPTER 1

Directors' 101

Before you even utter the word *director* when talking about your job, it is essential to understand the Act. It includes important legal definitions and terms you need to fully understand your legal obligations. These terms include *director*, *senior manager*, and *officer*. The Act imposes requirements on each of these categories of individuals.

What exactly is the Act? In short, it is the principal legislation that regulates companies in Australia. If you really want to get detailed, you could read all five volumes and ten chapters that comprise the Act. Or I can just give you a brief overview:

WHO ARE THESE PEOPLE?

The Act refers to *officers* of the corporation. This can mean many things, including:

- **A company director.** This includes both executive and non-executive officers.
- **A company secretary.** This is mandatory for public companies. A company secretary has several important duties, including signing contracts, supervising and managing board policies and procedures, and keeping diligent and accurate minutes during meetings.
- **Any significant decision maker.** This is a person who participates in making substantial or significant decisions for the company.
- **Employees of the company.** In the context of directors' duties under the Act, the term *employees* refers to senior managers who are involved in decision making for the company. It normally does not mean all of the company employees; this would be quite rare. However, keep in mind there may be other legislation in place that imposes obligations on employees within specific industries, organisations, or areas of responsibility.

WHAT'S YOUR TYPE?

There are different types of directors. It all depends on the level of involvement they have in the company. These types include:

- **Executive director.** These directors are involved in the daily running of the business and are responsible for the decisions they make on day-to-day business.
- **Non-executive director.** These directors are not involved in the daily running of the business. Non-executive directors normally bring an independent perspective to the company decision making and sometimes bring knowledge and expertise from specific fields.
- **Managing director.** These directors are also known as the chief executive officer (CEO). Other directors typically appoint the CEO. The CEO is a type of executive director and is solely responsible for daily decisions and company operations.
- **De facto director.** This person is not an official or validly appointed director but is acting in place of a director. He or she has the same obligations, duties, and liabilities as an official director.
- **Shadow director.** Similar to the de facto director, the shadow director does not have an official title. He or she exercises some degree of control or influence on the board's decisions. The board of directors is accustomed to acting in accordance with this person's instructions or wishes.

The Act also considers the company secretary to be an officer of the company. However, the secretary is not held to the same high standards as the directors listed above, because he or she does not participate in decision making in the same way that directors do.



CHAPTER 2

The Legal Landscape

It's a legal jungle out there.

Understanding the legal landscape of the corporate jungle is crucial to understanding where your duties as a director fit in. If you don't know much about the basics of law, don't worry. I've got you covered. In this chapter, I explain the legal structure in the context of your duties as a director.

If you feel overwhelmed when you read about the law, know that you are not alone. People from all kinds of professions and disciplines often complain that reading the law is like reading another language. I'm sure you have heard the term *legalese*. I know that sometimes it seems as though it is not even English!

SOURCES OF LAW

You are likely familiar with terms such as *statute*, *common law*, *equity*, and *fiduciary duties*. These are what make up the *sources of law*. Basically, these terms describe different types of laws and where the authority to enforce them originates. How is this relevant to you as a director? There is some overlap in the source of the various duties imposed by law on directors.

Many people find the overlap in the sources of the law confusing. The easiest way to understand the legal landscape is to isolate the sources of law and look at each of them under a magnifying glass.

1. Statute. A statute is a law that a parliament has made.

These are the types of laws most people think of when they think of ‘the law’. A statute is normally a written piece of legislation that clearly states what the law is. Both state parliaments and the Federal Parliament in Australia create statutes.

The main statute that applies to you and your directorial duties is the Act. On the other hand, there are some state laws that apply to directors. For example, each state has its own environmental protection laws, which may differ. I’ll talk more about this later.

2. Common law. This is also known as case law and judge-made law. Common law is created and developed by judges through court decisions, also known as court judgements. There are directors’ duties that are imposed by existing case law. While the Act largely codifies, or overrides, common law, there are instances in which

judges interpret the Act. Sometimes judges will use reasoning from previous cases to help them determine whether there has been a breach of directors' duties.

3. **Equity.** This type of law runs alongside statutes and common law. Many people think of equity as a type of law that promotes 'fairness' and equality. However, equity is much more complex than this.
4. **Fiduciary duties.** These are the laws directors need to be aware of the most. Simply put, fiduciary duties are the legal obligations imposed on directors to ensure they always act in the interests of another person (in this case, the company) and not their own self-interests. It is important to note that there are unique consequences for breaching fiduciary duties. One example is if a director makes a profit from his or her position, another person may claim entitlement to that profit by way of a 'constructive trust'.

OVERLAP BETWEEN SOURCES OF LAW

Are you confused yet? Just in case you're not, let me help you out by explaining how these sources of law overlap. Equity and the common law are collectively known as the general law. While their origins differ, both types of law are legally binding and enforceable. Statute, common law, and equity are interrelated and may work independently of one another or together.

Be aware as you read about your directorial duties that often there will be an overlap of general law and statutory duties. Some common law duties imposed on directors are now covered by statute. In many instances, the statute will simply replicate the common law—that is, the statute says the same thing that the case law says. Other times, the two laws might be a bit different. When there is an inconsistency between common law and statute, the statute will prevail. The importance of this is that there may be different consequences (civil, criminal penalties, and/or remedies available to others) for breaching different directorial duties.

Look in the Appendix for a table that gives you an overview of all of the directors' duties we discuss in this book. The table shows how there are different kinds of duties based on different sources of law.



LEGAL LESSONS

Do you understand:

- from which sources your directorial duties stem?
- the differences between a statute, equity, and the common law?
- the importance of fiduciary duties?
- the overlap between the different sources of law?



CHAPTER 3

Directors' Duties: An Overview

It does not matter how great a person you are, whether you have a good business sense, or how much money you make. If you do not fully understand your directorial obligations, you could lose a whole lot more than just your job. I'm talking about credibility, respect, social standing, and more.

Take my client Mr Rogers, for example. He purchased a fast food franchise, and for a while, everything was going quite well. Cash was flowing, business was good, everybody was happy. Naturally, Mr Rogers decided to open another franchise, where, surely, things would go just as well. His business's expansion continued rapidly—

so much so that the bank became nervous and asked Mr Rogers if he could personally guarantee the company's financial obligations to the bank. Mr Rogers then became personally liable for all the debt the company owed to the bank. However, Mr Rogers's good fortune ran out, and soon he found himself having to personally pay back all the loans the bank had given him after he placed his company into voluntary liquidation. He became bankrupt, which meant, among other things, that he could not enter any more business ventures, as a director, until the bankruptcy ended.

The takeaway here? Only sign a personal guarantee on behalf of your company once you have all the facts, including what you will be liable for in the worst-case scenario.

Practical tips! Keep track of your personal guarantees. Explore options for security you might be able to provide to banks other than personal guarantees.

Know your personal exposure. Say a business-savvy friend of yours approaches you, asking you to become a director in his organisation. 'I promise, you won't have to do anything,' he assures you. 'Just sign here and you'll be a part of this amazing business opportunity.' I cannot stress this enough: *Just say no*. This 'friend' could be roping you into a situation that exposes you to many legal liabilities. You must be aware of your directorial responsibilities. Now that you have a basic understanding of the legal framework—from the previous

chapter—it's time to become familiar with some of those legal obligations and responsibilities.

On the other hand, if you're interested in becoming a star on *Today Tonight* or *60 Minutes*, note the following case of my client Mr Sanders.

Mr Sanders was a director (and shareholder) of a major corporation. Mr Nathan served as the general manager. At some point Mr Nathan began to withhold information about the operations of the company. Because he was not confident in the way the business was being operated, Mr Sanders resigned from his directorial position when, in fact, he was aware that:

- The company had not paid a number of employees their superannuation, and he thought Mr Nathan intended to abandon the company without paying those employee entitlements.
- Mr Nathan was benefiting personally via financial gain and using the company cash flow to pay for personal expenses and holidays.
- The company had been trading insolvent for the last 12 months, with client funds being misappropriated.

The lesson? Do your homework before you agree to be a director of a company. Make sure you are well informed about the company and its employees before going into business with them.

Here's a basic overview of some very general things that directors must do regularly. Directors must:

- ensure the company's compliance with the Act
- observe and comply with the company's constitution and its by-laws

- inform the Australian Securities and Investments Commission (ASIC) of any changes that are made to the company
- be an active participant in board meetings
- make decisions for the company and not allow someone else to make them
- seek professional advice when needed
- disclose any material conflicts of interest
- give the interests of the company, its shareholders, and its creditors top priority

The official duties of a director include the following, which I expand on in this chapter:

- the duty to act bona fide (in good faith)
- the duty to not act for an improper purpose
- the duty of care, skill, and diligence
- the duty to avoid conflicts of interest
- the duty to not make improper use of the position
- the duty to not make improper use of information
- the duty to avoid insolvent trading