LEGALVISION®

DIRECTORS' DUTIES

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ABOUT THIS GUIDE

As a director, you are responsible for many of the decisions that chart a company's course, including overseeing management affairs, deciding who should be the CEO and maintaining proper company records.

Directors hold a unique position of power and trust. They make decisions that affect the company's share value. And shareholders in turn, rely on directors to act in their interest.

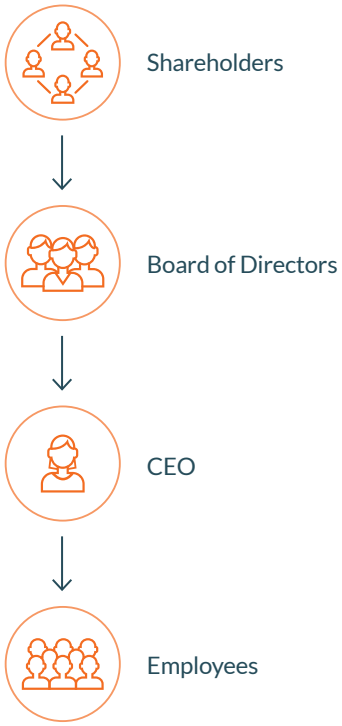
Shareholders are the owners of the company and the directors are their agents. Directors run the company for the benefit of the shareholders. Typically, directors are also shareholders of the company.

Whether you are the sole director of a startup or you sit on the board of an ASX-listed company, you must comply with these legal duties. If you do not comply, you could face serious penalties, including disqualification from acting as a director of a company, fines and jail time. The business could also suffer reputational damage. To help you understand your position as a director, this guide will outline:

- the role and the core duties;
- the importance of record-keeping and preparing reports; and
- how to manage risk, should a breach occur; and
- whether directors are responsible for company debts, including how to respond to a director penalty notice.

Company Corporate Structure

The corporate structure of a typical company with power and authority flowing from the shareholders to the board of directors to the company's officers.



WHO IS A DIRECTOR?

The company will appoint its first director(s) when it registers the company with the Australian Securities and Investments Commission (ASIC). But a company can appoint a director at any time in its life. After the company is set up, existing directors or shareholders may appoint new directors. In some cases, even if you are not formally appointed, you may be considered to be acting in the role (i.e. a shadow director).

APPOINTING DIRECTORS

The process for appointing directors depends on the company's size, the company constitution and which role is being filled.

How a Company Appoints a Director

New companies

Individuals who set up the company will often be its first directors.

Existing, smaller companies

Existing directors or shareholders nominate someone to be a director based on attributes such as:

- industry expertise;
- relevant boardroom experience (e.g. financial governance); and
- personality traits (e.g. curiosity and vision).

Large and publicly listed companies

Existing directors recommend the appointment of a director who is interviewed for the position, or recruited specifically to fill a vacancy.

The company will appoint you to the position after you have agreed to act as a director. The company constitution, shareholders agreement or the *Corporations Act* sets out the process to follow.

1. **The director writes and signs a consent to act.** This form sets out your first name, date of birth and address, and that you agree to be a director of the company.
2. **The director delivers the signed form to the company.** We recommend that you deliver the form either in-person or via post. But you can also scan and email the form to the company.
3. **The company approves the director's appointment, often by passing a directors' resolution.** Depending on the company constitution and shareholders agreement, the directors usually approve the appointment by passing a directors' resolution.
4. **The company updates ASIC about the appointment and its *Directors' Register.***

SHADOW DIRECTORS

If a company has not formally appointed you as a director, you might be a *de facto* or *shadow director* if you:

- can make important decisions on behalf of the company without directors' approval;
- control the business of the company (i.e. you make management decisions like hiring and firing team members and approving payroll); or
- deal with third parties on behalf of the company.

So, if a Chief Financial Officer (CFO) regularly signs off on business deals on behalf of the company without any prior approval from the directors, the CFO could be considered a shadow director. Shadow directors must still comply with directors' duties.

Delegating Authority

If you ***are*** or believe you ***could be*** acting as a shadow director, you should obtain legal advice.

The company should then take one of the following actions:

- change your role or responsibilities so that you are not directing the company (e.g. introduce reporting lines). We recommend that you also record your position and duties in a written agreement (e.g. a *contractor's agreement*); or
- formally appoint you as a director; or
- formally delegate to you specific decision-making authority.

A delegation of authority could, for example, empower the CFO to make financial decisions on behalf of the company up to a certain threshold (e.g. $10,000). But the directors must approve and record this delegation through a directors' resolution at a directors' meeting.

OFFICERS

The Corporations Act also requires *officers* to comply with directors' duties. An officer is someone who makes decisions, or instructs directors to make decisions, that affect the business of the company (for example, a company secretary or CFO). This definition does not cover professional advisers, such as lawyers and accountants.

WHAT ARE DIRECTORS' DUTIES?

Directors' duties are prescribed behaviours and rules that a person must follow when they are acting as a director (or shadow director) of a company. They come from both common law (i.e. judges' decisions in court cases) and statute (legislation).

Directors' Duties

1. **Perform their role with care, diligence and skill**
   Stay informed of what is going on in the company.
2. **Prevent insolvent trading**
   Make sure that the company does not trade if it cannot pay its debts on time.
3. **Act in good faith in the best interests of the company**
   Make decisions that benefit the company even if they do not benefit you.
4. **Do not use the position or access to information to gain a personal advantage**
   Prioritise the company's interests over your own where the two might conflict. For example, choose a supplier on merit and not because they are a friend or a family member.
5. **Maintain records and prepare financial reports**
   Keep written records such as minutes of directors' meetings, contracts, and profit and loss statements that explain the company's financial position.

PERFORM THE ROLE WITH CARE, DILIGENCE AND SKILL

A director is in charge of the business' day-to-day operations and makes decisions on behalf of the shareholders who own the company. A director must perform their role with a degree of care, diligence and skill that you would expect of an *ordinary person* in their position. What the law expects of an ordinary person in this position depends on:

- the company's circumstances (e.g. the size of the company); and
- the director's position and responsibilities.

For instance, an *executive director* of a large company who is involved in day-to-day management decisions will be held to a higher standard than a *non-executive director* of a small company who sits on the board to help with decision-making.

Dealing with Advisors

Whether you are an executive or non-executive director, you cannot outsource key decisions to others, including consultants, financial advisors and lawyers.

If you follow the instructions of advisors without making your own inquiries, you may breach your duty. For example, if an advisor recommends you sell a critical piece of machinery for significantly less than it is worth — and you did not research the market rate — you may have breached your duty of care, skill and diligence. In some cases, you will have to pay the company the difference in price.

When dealing with advisors, you should:

- carefully select and appoint advisors that you trust; and
- do your own research and ask questions to make sure you understand the advice they are providing.

Business Judgment Rule

Directors often make decisions with imperfect information, which will sometimes result in a financial loss. If you make a business decision that turns out to be wrong, you usually will not breach your directors' duties. This is true even if another director would have made a different decision.

But sometimes, a director who makes a poor decision that results in a financial loss for the company may have breached their duty of care, skill and diligence. To protect yourself in this situation, you must demonstrate that you:

- researched and asked questions about the decision's impact beforehand;
- believed that the decision was in the company's best interests; and
- were not influenced by a personal benefit that you would have received from the decision.

For example, you want to acquire a competitor because you believe the acquisition will have a positive return. But there are risks associated with the purchase. Before making a decision, you should:

- research the business, do your due diligence and create financial models;
- document why you think the acquisition is a good idea for your company; and
- avoid acquiring businesses that you have a personal interest in.

DUTY TO PREVENT INSOLVENT TRADING

As a director, you must prevent your company from doing business when it is *insolvent*. A company is insolvent when it cannot pay its debts on time.

If your company trades while it is insolvent, you will breach your duty if:

- you were a director at the time that the company incurred the debt;
- the company was insolvent or became insolvent because of that debt; and
- there were reasonable grounds for suspecting that the company was insolvent, or would become insolvent (i.e. you knew, or should have known, that the company had debts which were due and that it could not pay them on time).

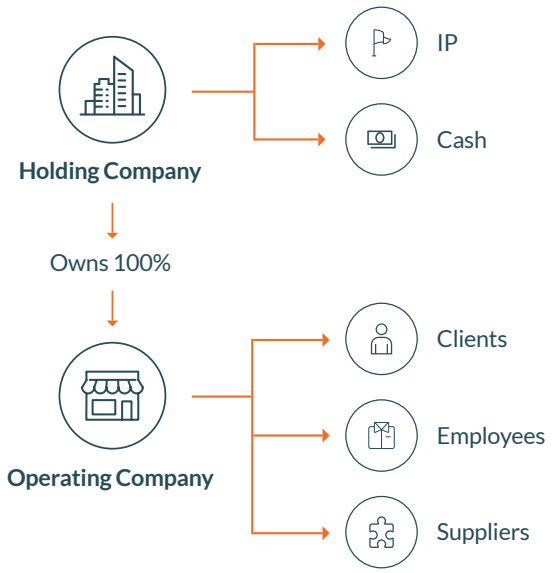
When assessing whether a company is insolvent, you should look at the business' overall financial position and whether the company can make repayments as required. If you believe that your company is likely to become insolvent, you should stop trading until you have strengthened your financial position.

Dual Company Structure

Some businesses operate under a dual company structure. Under this arrangement, a holding company owns 100% of shares in a subsidiary operating company.

This structure protects the financial assets and intellectual property that the holding company owns from the liabilities of the operating company, which deals with customers, suppliers and employees.

The holding company can be sued if the operating company trades while insolvent.



A director in breach of their duty to prevent insolvent trading faces serious consequences and may:

- have to compensate creditors, including suppliers, lenders and employees;
- have to personally compensate the company for debts incurred after it became insolvent; and
- be disqualified from managing a company.

Criminal penalties, such as further fines or imprisonment, may also apply where a director has acted dishonestly. An example of dishonest conduct may be lying about the company's financial position to a supplier who then provided the company with goods that the company could not pay for.

Safe Harbour Exception

Usually, if a company is insolvent, the directors must appoint either:

- an *administrator*, who recommends whether to restructure the company to implement cost saving measures; or
- a *liquidator*, who winds up the company.

The *safe harbour exception* allows a director to develop a course of action that is reasonably likely to put creditors and shareholders in a better position than if the company was immediately wound up. When assessing whether their course of action will succeed, a director should carefully consider the company's financial situation and seek professional advice.

This exception might be suitable where a company is facing a short period of financial trouble and where the path to solvency is clear and likely.

DEFENCES

There are defences to insolvent trading. These include:

- whether you had reasonable grounds to expect the company was solvent at the time the company incurred the debt and would continue to be solvent;
- whether you took reasonable steps to prevent the company from incurring the debt; and
- you did not participate in the company's management at the time the company incurred the debt due to illness or another legitimate reason.

What steps you need to take

Stay informed of the company's financial position. If the company misses the due date for making a payment, take note and act accordingly.

Maintain adequate financial records, and make sure that you understand them.

Obtain professional accounting and legal advice to help understand or address the company's financial difficulties.

DUTY TO ACT IN GOOD FAITH IN THE BEST INTERESTS OF THE COMPANY

As a director, you must act for the benefit of the company and its shareholders. You must avoid situations where conflicts of interest may exist, as well as manage conflicts of interest if they arise.

For example, your company should not enter into a contract with your relative's manufacturing business without exploring alternatives. But, if your company must deal with your relative's company because it is the only manufacturer of a certain product, you should ask another director or executive to negotiate the deal.

Sole Director and Majority Shareholder

If you are a sole director and sole or majority shareholder of your company, it is important to remember that the company is a separate legal entity.

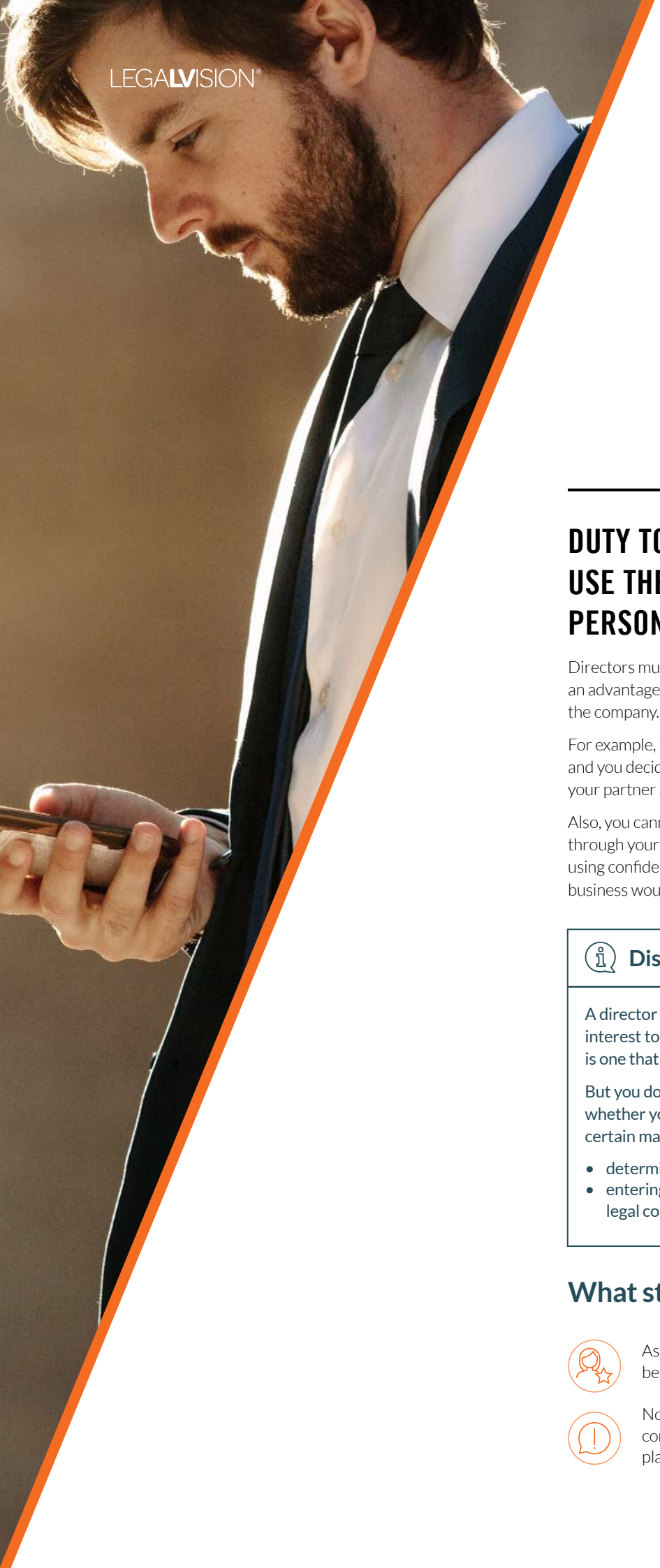
As the director, **you need to act in the company's best interests**, not your own or anyone else's.

A breach of this duty is usually a *civil offence*. This means you will have to pay a fine and may be disqualified from acting as a director. But, if you were reckless or intentionally dishonest when failing to act in the company's best interests, you may have committed a criminal offence. For example, misleading other directors to choose a particular supplier that you have personally invested in could lead to criminal penalties.

What steps you need to take

When making a decision, ask yourself:

- Have you considered how the decision will impact the company?
- Have you disclosed any personal interest in the decision to your shareholders and directors?
- Will this benefit you or someone close to you personally?
- Have you considered alternate options?



DUTY TO NOT IMPROPERLY USE THE ROLE TO GAIN A PERSONAL ADVANTAGE

Directors must not improperly use their position to gain an advantage for themselves or someone else, or harm the company.

For example, if your company needs new office furniture, and you decide to purchase furniture from a business run by your partner at an inflated price, you would breach this duty.

Also, you cannot use the information you have received through your position to make a personal gain. For instance, using confidential client information to set up a competing business would be a clear breach of this duty.

Disclosing Information

A director must also disclose a material personal interest to other directors. A material personal interest is one that influences a director's decisions.

But you do not need to disclose to other directors whether you have a material personal interest in certain matters, including when:

- determining your own compensation; or
- entering into a contract that insures you against legal costs and liabilities.

What steps you need to take

Ask whether your actions will personally benefit you and not the company.

Notify the other directors when you have a connection with somebody whom the company plans to do business with.

KEEPING PROPER RECORDS AND PREPARING REPORTS

Directors must keep accurate records explaining the company's transactions, financial position and performance. The company must keep its records for seven years, stored electronically. Records can include:

- invoices;
- receipts;
- cheques; and
- a document that explains how the company's financial reports are prepared.

This duty will apply to you even if you outsource the company's financial matters to an accountant or financial advisor.

Large private companies must also prepare a financial report and directors' report each financial year.

Small private companies must prepare these reports if directed by:

- a shareholder holding 5% or more of the company; or
- ASIC.

What is a large private company?

A large private company has **two** of the following three features:

- consolidated annual revenue;
- gross asset of $12.5 million or more; or
- 50 or more employees.

What steps you need to take

Make sure that the company has appropriate accounting policies and processes, such as an expenditure approvals policy.

Understand how your finance team, accountant or financial advisor prepares and audits your reports.

Ask questions about the company's financial position where something is unclear (e.g. clarify with your CFO why they have not paid).

Ensure that you have a level of financial knowledge to understand the company's business and transactions.

MANAGING RISK IN THE EVENT OF A BREACH

Even a diligent director can inadvertently breach their duties. To minimise the impact of a claim against a director, the company should enter into a *Deed of Access, Indemnity and Insurance* (Deed of Access) with each director.

A Deed of Access protects you against liability for breaching a duty in three ways:

1. **Access to company records:** It ensures you can access the company's books and records to defend yourself against a claim.
2. **Indemnity for personal liability:** It requires the company to reimburse you for personal liabilities (such as travel costs) and legal fees arising from a claim.
3. **Insurance:** It requires the company to maintain *directors and officers insurance* with a reputable insurer. This allows the insurer to reimburse you for a liability arising from the claim, even if the company is insolvent.

LIMITS OF A DEED OF ACCESS

Each Deed of Access is different and the scope of indemnities will vary. Also, companies cannot indemnify directors for certain liabilities resulting from a breach of directors' duties, including:

- a liability owed to the company itself (for example, if the company has loaned you money);
- pecuniary penalties (i.e. fines) imposed by a court for a serious breach; and
- liabilities that arise due to a breach of good faith (for example, if you enter into a transaction on the company's behalf without proper authorisation).

The company cannot indemnify a director for the legal costs of defending certain claims, in particular, criminal claims against a director who is found guilty.

PERSONAL LIABILITY FOR A COMPANY'S DEBTS

There are some circumstances in which a director is personally responsible for its company debts and liabilities. One of the core duties of a director is not to trade after the company has become insolvent. If this is the case, you may need to use your personal assets and finances to pay the company's debts.

Avoid Engaging in Phoenix Activity

The term 'phoenix activity' refers to fraudulent activity which involves a director transferring company assets to another entity. Following this, a director puts the old company into administration or liquidation to avoid paying creditors or employees.

If you engage in phoenix activity, you can be personally liable for a breach of the director's duties. You may then be disqualified from managing corporations in the future.

The Director Identification Number (**DIN**) aims to combat illegal phoenix activity. The Australian Government implemented the steps to ensure that all Australian company directors are responsible for their actions. The tracking system means that each director receives a unique DIN which they will keep permanently. Therefore, if you act as a director of multiple companies, it will be easy to identify you across those companies.

Before consenting to act as a director, it is essential to understand how long you owe obligations to the company. Once a company is registered, the rights and liabilities of each director will continue. They will continue until, and in some circumstances after, the company has finished trading or has been deregistered.

As a director, you will have liability under statutory regimes and guarantees.

1. LIABILITY UNDER STATUTORY REGIMES

A statutory regime includes written laws that formally detail your legal obligations and consequences for non-compliance. Specifically, there are some statutory regimes under which a director can be personally liable for a debt. This can be either directly, or, as an accessory to an infringement. For example, as a director, you have personal liability for unpaid 'Pay As You Go' (**PAYG**) tax or Superannuation Guarantee Charge (**SGC**) amounts the company has not paid under the Australian Tax Office's Director Penalty Regime. In such a case, a director may receive a **director penalty notice** from the ATO.

You may receive a penalty notice if you are a:

- current director of the company;
- director who has resigned;
- newly-appointed director, provided they have been in office for more than 30 days; or
- de facto or shadow director.

Types of Notices

There are two types of director penalty notices: a traditional notice or a lockdown penalty notice.

Traditional Notice

A director may receive a 21-day traditional director penalty notice where the company has outstanding PAYG or SGC liabilities. As soon as the ATO sends the penalty notice, the director has 21 days to act. They can either:

- pay the debt;
- place the company into liquidation or voluntary administration; or
- come to an arrangement with the ATO.

Further, where the company appoints a liquidator or an administrator within 21 days, the director may escape personal liability for the debt.

Lockdown Penalty Notice

A director may receive a lockdown penalty notice where PAYG or superannuation amounts are unpaid, and fails to lodge their company returns within three months.

Where a director gets a lockdown penalty notice, they must pay the debt in full unless they have a valid defence. They cannot avoid liability by placing the company into voluntary administration or liquidation.

Options for Directors

If a director is served with a director penalty notice, there are only limited options to discharge the penalty. For companies that have not reported the unpaid debts within three months of the due date, the only option to discharge the penalty is to pay the debt.

If, however, the company has reported the unpaid amounts within three months of the due date, there are more options:

1. payment of the debt in full;
2. have a liquidator appointed to wind up the company; or
3. appoint an administrator to the company.

Take Action

Your company must undertake action within 21 days of the issue of the notice. The clock starts ticking on the director penalty notice from when it is posted, not when you receive it.

There are some defences a director may rely on, for example, illness. Even so, the ATO will consider whether the director took all reasonable steps to comply with their PAYG and superannuation obligations. As a consequence of non-compliance, the ATO may recover the unpaid amounts directly from the director and the director's assets.

2. LIABILITY UNDER A GUARANTEE

As a director, you can be personally liable if you have signed a director's guarantee. This is also the case if you have provided security over your personal assets for a:

- loan;
- credit facility; or
- other agreement in the interest of your company.

Additionally, a guarantee against a director cannot be enforced without leave of the court during a period of voluntary administration. The purpose of voluntary administration is to investigate the company's affairs and decide what strategy is in the best interests of the company's creditors. However, the voluntary administration process does not halt proceedings already on foot. Nor does it stop a creditor from enforcing a judgment that the court has already handed down.

CHECKLIST

As a director, you are responsible for significant decisions that impact your company's success and shareholders' financial interests. This position of power and trust is balanced by legal obligations called directors' duties. Failing to comply with your directors' duties can expose you to fines, disqualification from acting as a director, and in the most severe cases, jail.

To help ensure that you comply with your duties, you should:

- ☐ Sign a consent form and confirm that the company has formally appointed you as a director.
- ☐ Organise to receive regular updates about the company's financial position.
- ☐ Schedule regular meetings to check that anyone you have delegated decision-making authority to is fulfilling their role as expected.
- ☐ Prioritise the interests of the company above your own when making a business decision.
- ☐ Avoid conflicts of interest and disclose any conflicts that arise.
- ☐ Communicate regularly with your fellow directors, and be transparent about your reasons for making any decisions relating to the company.
- ☐ Stay informed of any key decisions that your employees are making by having proper safeguards in place, for example, employment agreements.
- ☐ Implement clear processes setting limits on employees' decision-making powers. You should supervise those employees and their actions to monitor compliance.
- ☐ If you are unsure whether you might be in breach of your duty, or have concerns about the company's financial stability, speak with your lawyer or other professional advisors.

HOW CAN LEGALVISION HELP?

LegalVision is a market disruptor in the commercial legal services industry. Our innovative business model and custom-built technology assist our lawyers to provide a faster, better quality and more cost-effective client experience. LegalVision is a leader in delivering legal services in Australia and has assisted more than 110,000 businesses.

Our experienced corporate team can assist you with drafting legal documents for your company and advise you on your directors' duties. If you have any questions, get in touch with our lawyers today by calling us on **1300 544 755.**

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