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Legal obligations of directors of Australian companies

Introduction

This publication aims to outline certain legal obligations of a director of an Australian company when making decisions in relation to the company.

The legal obligations summarised below represent a non-exhaustive list of legal requirements, which directors must comply with. As directors can become personally liable for decisions made in their capacity as director of a company, it is critical that directors understand all obligations imposed on them.

For more information regarding the establishment of an Australian Company, please refer to our publication titled *Guide for Setting up a Business in Australia*.

Appointment as a director

In Australia, every person from the age of 18 years or older who has not been disqualified from becoming a director of an Australian company may be appointed as a director of a company. It is irrelevant if the director resides in Australia or not (as long as the company has at least one local director).

In order to be appointed as a director, the director must sign a notice consenting in writing to be appointed as a director of the company. The director must also provide the company with certain personal information about themselves.

Resignation as a director

If no special circumstances apply, a director may resign from his or her directorship at any time by giving written notice to the company.

Fiduciary duties owed to the Company

Once the director is appointed, the director owes various fiduciary duties to his or her company which, if breached, may lead to personal liability of the director including civil and criminal penalties and liability for damages.

Duty to act honestly

The director must act in good faith, in the best interests of the company and for a proper purpose.

This duty demands more than a general sense of honesty; it requires directors to exercise independent judgment in light of relevant facts, materials and other views when assessing the best interests of the company.

Importantly, a breach of this duty that involves fraud, dishonesty and even recklessness may attract criminal penalties.

Duty not to improperly use inside information or position

A director must not make improper use of his or her position or information acquired through that position, to gain an advantage for themselves or any other person or to cause detriment to the company.

A director's improper use of his or her position may arise irrespective of whether the director intended the impropriety to have a certain outcome.

Additionally, where a director uses information acquired because of his or her position for their own benefit instead or for the benefit of the company, a breach of this duty is likely.

Duty to avoid a conflict of interest and to disclose material personal interests

All directors must disclose all material of personal interests that the directors have in relation to the affairs of the company.

All directors must, as soon as he/she becomes aware of a conflict of interest, notify the board of such conflict.

Directors of proprietary companies, however, need not give notice as to the conflict, provided the other directors are fully aware of the nature and extent of the director's conflicting interests.

The necessary procedures to follow when dealing with conflicts of interest depend on the circumstances and usually require specialist advice. In some instances, it may be appropriate for a director to disclose a conflict and refrain from voting on the issue, while in other instances, the director's resignation may be required.

Duty not to abuse a corporate opportunity

Similar to the duty to disclose material personal interests, a director has a duty not to take advantage of a corporate opportunity for personal gain and at the expense of the company.

Only where such an opportunity is properly considered and rejected by the company can a director pursue the opportunity personally, pending the necessary disclosure requirements.

Duty of care and diligence

A director is required to discharge its duties with the same degree of care and diligence that a reasonable person in a similar position would exercise. Factors such as the size of the company and experience, position and responsibilities of the director are taken into account in establishing this objective standard of care.

A director may not be liable for breach of the duty to exercise care and diligence if the director:

- ◆ made the decision in good faith for a proper purpose;
- ◆ rationally believed the decision was in the best interests of the company after having made all reasonable inquiries necessary to inform themselves about the subject matter of the decision; and
- ◆ made the decision while having had no personal interest in the matter.

Duties owed to third parties

Once appointed, and for as long as the director is appointed, a director owes the following duties to third parties which, if breached, may lead to personal liability of the director.

Duty not to engage in insolvent trading

Each director has a duty to prevent the company from trading while insolvent and also to prevent the company from trading in a way that will make it insolvent.

When a company debt is incurred, if a director is aware that, or has reasonable grounds to suspect that the company is or may become unable to pay its debts as and when they fall due, the director will be in breach of this duty. The director may become personally liable for the debt and/or be ordered to pay compensation to the company or its creditors.

A director will be deemed to have been aware of the company's insolvency if a reasonable person in the position of the director would have been so aware.

Other than being ill or otherwise incapacitated, a director will only have a defence if they can demonstrate there were reasonable grounds on which to expect the company was, and would remain, solvent.

Duty to keep proper accounts and records

Each director is required to ensure the company prepares a financial report and a directors' report each financial year.

While small proprietary companies may be exempt from lodging all the information required of larger companies, each director must inform themselves of accounting and recording obligations. Specialist accounting advice is usually necessary.

Vicarious liability

A director may personally become liable in certain circumstances for breaches of the law by the company. If the director was a director of the company at the time the company breached the law in question such liability is called 'vicarious liability'. The following lists some of the instances where directors of Australian companies may personally become liable if the company they are a director of, breaches certain laws.

Competition and Consumer Act

The *Competition and Consumer Act 2010* (**CCA**) affects almost every aspect of the day to day running of a company and regulates such areas as product liability, consumer protection and competition policy.

Depending on the circumstances, where a company has contravened a provision of the CCA, directors of that company may be found to be personally liable.

Penalties for breaches of the CCA may be millions of dollars and/or jail, depending on the circumstances.

Occupational health and safety laws

Each Australian State and Territory has occupational health and safety (**OHS**) legislation which imposes certain obligations on companies with employees. The main obligation is to meet minimum standards of health and safety in a number of areas. It is typically required that all companies with employees ensure the health, safety and welfare at work of their employees,

contractors and other persons. Breaches of the relevant OHS Act attract large fines.

In some States, where a company violates one of the OHS Acts, directors will be deemed to also be in breach of the OHS Acts, unless they are able to satisfy a court that the director could not influence relevant conduct of the company or the director used all due diligence to prevent the contravention by the company.

Directors can protect themselves by:

- ◆ exercising and showing due diligence in fulfilling their roles (demonstrate obligations are identified and responsibilities allocated);
- ◆ having a proper basis for believing that OHS is being properly attended to by appropriate people (reporting, auditing and accountability); and
- ◆ having an understanding of OHS and information to be able to do this.

Environmental protection laws

All Australian States and Territories have enacted environmental protection legislation. Serious offences, like the disposal of waste without lawful authority, causing leakage or spillage of a harmful substance and emission of ozone depleting substances can carry penalties of in excess of \$1 million in the case of a company.

Where an offence is proved against a company, the directors of the company risk being held liable for the ancillary offence of aiding, abetting, attempting or conspiring to commit such an offence (which carries a maximum penalty of \$290,000 or 7 years imprisonment or both).

Where a company has a supervised and effectively implemented environmental compliance program in place at the time of a pollution offence, evidence of the program and its implementation may mitigate the risk of penalty if the company and/or its directors are successfully prosecuted.

Taxation

Directors may be prosecuted personally for tax offences committed by the company. It is a defence to liability if the director can prove that he or she did not aid, abet, counsel or procure the act or omission of the company and was not in any way knowingly involved in or a party to that act or omission.

As a matter of policy, the Australian Taxation Office (**ATO**) will usually prosecute the company rather than the individuals who manage it. However, this may not be the case where the company has insufficient assets, where the directors were deliberately using the company to defeat the operation of tax laws or where the company has already been prosecuted for a tax offence and it is apparent that the prosecution has not deterred the company from re-offending.

If a company fails to provide to the ATO certain tax instalment deductions, the directors may be personally liable for an amount equal to the unremitted or unpaid amounts. A director may be personally liable for director penalties. The ATO generally gives the director 14 days to respond to a penalty notice.

When a penalty notice is issued, directors have four options to avoid personal liability. Directors can:

- ◆ have the company pay the amount owing to the tax department;
- ◆ enter into a payment agreement with respect to the amount owing to the tax department;
- ◆ appoint a voluntary administrator to the company; or
- ◆ appoint a liquidator to the company.

Failure to do one of the above things within the 14 day notice period will result in each director automatically incurring a penalty equal to the company's outstanding tax liability.

Practical tips for directors

Steps to limit liability

Directors should try to take the following steps in order to limit their potential exposure to personal liability:

- ◆ obtain proper advice in respect of the primary legislation that applies to the activities of the company and the obligations that are imposed by the legislation on both the company and the directors; and
- ◆ ensure that proper procedures exist and are followed in order to minimise the risk of the company breaching any of its liabilities to minimise the risk of the directors becoming vicarious liable.

Protections to be obtained from the company

To protect themselves from potential personal liability, a director should consider the following:

- ◆ Require the relevant company to obtain Directors' and Officers' Insurance (**D&O Insurance**) to provide some protection to the director. Due to the general law rule prohibiting individuals from insuring themselves against criminal allegations, the coverage of D&O Insurance is not unlimited and will not cover certain conduct of the director (for example, breaches of duties owed to the company and conduct in bad faith).
- ◆ Require the relevant company to indemnify the director for any loss suffered by the director in connection with acting as a director for the company. Such an indemnity may be set out in the constitution of the company or in a separate Deed of Indemnity and Access.

Please contact us to discuss these matters further.

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