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# DOING BUSINESS IN AUSTRALIA

CORPORATE GOVERNANCE





## Chapter 4

# Corporate Governance

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In Australia, the regulators expect company directors to conform to high standards of conduct in the performance of their duties to the company. Directors are generally required to apply their particular skills and experience relevant to the matter being considered and to always act in the best interests of the company, prioritising those interests over any external interests. If a director breaches their duties, they individually, as well as the company, could be subject to sanctions, including financial penalties and imprisonment.

The law recognises that directors can delegate their powers and responsibilities to the company's executive officers to manage on their behalf. However, some responsibilities cannot be delegated, including responsibility for the accounts.

Shareholders do not have a right to be involved directly with the affairs of the company or to interfere with management. However, they do have the right to elect or remove the directors, and in the case of public companies this right cannot be restrained.

## Directors duties

### Overview

In Australia, high standards of business conduct are required of company directors and officers in the performance of their duties to the company. Directors are generally required to apply their particular skills and experience relevant to the matter being considered. If a director breaches their duties, they individually, as well as the company, could be subject to sanctions, including financial penalties and imprisonment. The range of duties directors owe to their company under both statutory and common law are described below.

### Common law duties

Under the common law, directors have duties to:

- **act in good faith** and exercise their discretion in what they consider to be the best

interests of the company as a whole and not for a collateral purpose;

- **not to act for an improper purpose**, that is not to exercise their powers to obtain some private advantage or for any purpose for which the power was not granted;
- **maintain, as a board, any discretions** they have and not to limit themselves in the future from acting in the best interests of the company;
- **avoid conflicts of interest**, that is not enter into engagements in which a director has a personal interest conflicting, or possibly conflicting, with the interests of the company; and
- **act with care and diligence**, meaning that directors apply their minds to considering the overall position of the company. Directors cannot hide behind ignorance of the company's affairs (where this results from a failure to make necessary enquiries) but must test information put before them and consider what other information they might require in their decision-making.

## Statutory law duties

The statutory duties of directors are contained in Part 2D.1 of the *Corporations Act 2001* (Cth) (**Corporations Act**). These statutory duties apply in addition to the common law directors' duties set out above, although the two sets of duties are broadly consistent. The Corporations Act may impose other, more specific obligations, in the context of a particular sector (for example, the duty imposed on a holder of an Australian Financial Services Licence to have an appropriate conflicts management policy).

Under the Corporations Act, directors are required to:

- **act with a degree of care and diligence** which 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;
- **act in good faith in the best interests of the company** and for a proper purpose; and
- **not improperly use information or their position** to gain an advantage for themselves or someone else or to cause detriment to the company.

# Other duties

Under the Corporations Act, there is a positive duty on directors to prevent the company from trading while insolvent. A director breaches this obligation if he or she fails to prevent the company from incurring a debt at a time when:

- the company is insolvent or becomes insolvent by incurring that debt (or by incurring debts including that debt);
- there are reasonable grounds for suspecting the company is (or would become) insolvent; and
- the director was subjectively aware of those grounds, or a reasonable person in a like position in a company in the company's circumstance would be so aware.

There are certain defences a director may rely on, including that the director:

- believed on reasonable grounds that the company was solvent;
- relied on information from a competent and reliable person whom the director believed on reasonable grounds to be responsible for providing such information;
- the director did not take part in the management of the company at the time because of illness or some other good reason; or
- the director took all reasonable steps to prevent the company from incurring the debt.

In 2017, the Corporations Act was amended to provide directors with a defence to civil action for insolvent trading. Directors will be afforded an exception from liability for insolvent trading where the debt that the liquidator alleges had been incurred whilst the company was insolvent was incurred in connection with a course of action that is reasonably likely to provide a better outcome for the company than the immediate liquidation or administration.

Directors also have duties which are found in other pieces of legislation and which may impose personal liability on directors for non-compliance. The primary areas where these duties arise can be found in financial services legislation, environmental legislation, workplace health and safety laws and trade practices regulations. These and other statutory duties may be owed to the company's shareholders, its employees and relevant third parties.

# Legal protections available to directors

There are several legal protections or defences available to directors, as set out below.

## **Business judgment rule**

Directors will meet the requirement to exercise due care and diligence both under the Corporations Act and the common law if, when making 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), they:

- act in good faith and for a proper purpose;
- do not have a material personal interest in the matter;
- inform themselves to the extent they reasonably believe to be appropriate; and
- rationally believe that the judgment is in the best interests of the company (which will be deemed to be the case unless no reasonable person in the position of the director would hold that belief).

The business judgment rule provides directors with a safe harbour from personal liability in relation to honest, informed and rational business judgments.

Directors will not be able to take advantage of the business judgment rule where they are discharging their general oversight and monitoring duties, as these duties do not involve any decision to take or not take an action. Similarly, failure to consider a matter does not constitute a business judgment.

## **Reliance on information and advice**

In practice, directors will not always be in a position to independently verify and assess every piece of information upon which they must base their decisions.

Accordingly, the law recognises that directors are entitled to rely on information or professional or expert advice from an employee, professional adviser or expert, another director or officer, or a board committee, provided the reliance was made in good faith, and after the director has made an independent assessment of the information or advice having regard to the director's knowledge of the company and the complexity of the structure and operations of the company. In certain cases, directors' duties will positively require directors to obtain this type of expert

advice.

The key qualifications on the capacity of directors to rely on information and advice of others are where:

- the director has knowledge of deficiencies or inaccuracies in the information which has been provided to him or her;
- in all the circumstances there are sufficient 'warning signals' regarding the reliability of the information such that a reasonable person in the director's position would take steps to verify or otherwise test the information; or
- the information is proved to be unreliable.

Further, directors cannot substitute the advice of management for their own attention and examination of an important matter that falls specifically within the scope of each director's individual responsibilities (including responsibilities that legislation places on directors personally, such as the approval of the financial reports).

This principle applies to all directors, including the managing director. In practice, however, the managing director is likely to be in a better position than non-executive directors to assess the reliability of information flowing from employees of the company to the board and this factor would be taken into account in determining whether a managing director has acted reasonably in the circumstances.

#### Indemnity and insurance

A company can indemnify directors (for example, under its constitution or by entering into an indemnity deed with directors). The Corporations Act, however, prohibits a company from indemnifying a director against:

- liabilities owed to the company or related bodies corporate;
- liabilities for pecuniary penalties or compensation orders under the Corporations Act for certain breaches of duties; and
- liabilities owed to a third party and not arising out of conduct in good faith.

A company can also take out and maintain insurance for its directors. A company or a related

body corporate must not, however, pay, or agree to pay, a premium for a contract insuring a person who is, or has been, an officer of the company against a liability (other than one for legal costs) arising out of conduct involving a wilful breach of duty in relation to the company or arising out of improper use of position or information.

## Potential consequences of breaching directors' duties

If directors breach any of the duties mentioned above or fail to meet any of their obligations they may have proceedings brought against them by:

- the company;
- shareholders under the statutory derivative action provisions (provided the court in its discretion grants leave to the applicant);
- creditors, insolvency administrators and trustees in bankruptcy in the context of insolvent trading;
- third parties in the context of misleading and deceptive conduct or anti-competitive behaviour; and/or
- regulatory authorities such as the Australian Securities and Investments Commission (**ASIC**) and the Australian Competition and Consumer Commission (**ACCC**).

As a general rule, enforcement action by ASIC will only be taken where there has been a failure of honesty, due care, diligence or proper purpose. Nonetheless, directors should equally remember ASIC's high expectations of directors generally.

In addition, any breach or alleged breach of directors' duties could have a significant impact on a director's personal reputation and the reputation of the company.

### Nominee directors

## Duties owed by nominee directors

As a matter of Australian law, a nominee director is appointed in his or her personal capacity (rather than a representative capacity) and is subject to the usual array of directors' duties applicable to any director of a company.

All directors, including nominee directors, have a duty to exercise their powers and discharge their duties in good faith in the best interests of the company, which means that they must act in the best interests of shareholders as a general or collective body. The law remains unclear as to the extent to which a nominee director can take into account the interests of their appointing shareholder. However, the generally accepted guiding principles are as follows:

- **alignment of interests of the appointer and the company** – nominee directors may act in the interests of their appointer if they have a bona fide belief that they are also acting in the best interests of the company;
- **interests of the company** – irrespective of what the constitution says, the fact that a director has been nominated to the office of director of a company by a particular shareholder does not permit the director to act in disregard of the interests of the company as a whole; and
- **direct conflict** – when the interests of the appointer and the company conflict, absent special circumstances, the nominee director must act in the best interests of the company (in preference to the best interests of the appointing shareholder).

## Ability of nominee directors to pass information to their appointer

Australian law prohibits directors, including nominee directors, from using information that they have obtained in their capacity as a director to gain an advantage for themselves or someone else (including their appointing shareholder) or to cause detriment to the company. The obligation attaches to information obtained because a person is or was a director and continues after the director is no longer in office.

A director also owes a duty of confidentiality to the company. Ultimately, this duty of confidentiality overrides any obligation that a nominee director might otherwise owe to the major shareholder who appointed them to the board.

A nominee director must not disclose confidential information that they have obtained in their capacity as a nominee director to their appointer, unless there is a provision in the company's constitution or in an agreement between the company and the appointing shareholder to the contrary, board consent or other special circumstances. However, there are a variety of ways to handle these obligations including formal protocols, and provisions in shareholder agreements.

## Delegation

# Power to delegate

A non-executive director is not expected to be involved in the day-to-day management of the company. The law recognises that all directors can delegate some of their powers and responsibilities to the company's executive officers to manage on their behalf, with the exception of some non-delegable responsibilities (see 'Non-delegable responsibilities' section below). The Corporations Act also permits directors to delegate any of their powers to a committee of the board, another director, an employee of the company or any other person (unless the company's constitution provides otherwise).

# Non-delegable responsibilities

Australian common law, legislation and regulatory standards have also had the effect of mandating that certain responsibilities of directors cannot be delegated and must be fulfilled by directors themselves.

In order to discharge their duties all directors must:

- become familiar with the fundamentals of the business or businesses of the company;
- keep informed about the company's activities;
- monitor, generally, the company's affairs and policies by way of regular attendance at board meetings;
- maintain familiarity with the financial status of the company, including review of the company's financial statements and board papers and to make further inquiries where appropriate; and
- have a reasonably informed opinion of the company's financial capacity.

Where a particular responsibility is expressly imposed as a 'director responsibility' under the Corporations Act, it must remain in the board's domain and delegations cannot remove liability. While steps that will assist in meeting the responsibility can be delegated to management, the ultimate responsibility and oversight cannot be shifted from the board. For example, the Corporations Act imposes a responsibility on the directors to approve and adopt the company's financial statements.

# Higher standard for executive directors

Both non-executive and executive directors have legal duties, responsibilities and potential liabilities. In practice, executive directors are held to a higher standard by virtue of their executive role, even though the wording of the directors' duties are the same. A court will apply an objective standard when considering the conduct of executive officers and executive directors and will consider the role and expected expertise of persons in the same recognised calling or office. It is important that executive directors consider issues raised in board and committee meetings through the 'director lens', as well as the 'management lens' (which may be slightly different).

## Shareholder rights

Shareholders do not have the right to manage the affairs of the company. The Constitution typically vests all powers of management in the board and authorises the board to delegate those powers to one or more executives. While the board retains ultimate responsibility for the strategy and performance of the company, the day-to-day operation of the company is typically conducted by, or under the supervision of, the chief executive officer as directed by the board.

Of course, the primary right of shareholders is to elect or remove the directors. A shareholder or shareholders holding more than 5% of the voting shares can requisition that a shareholders meeting be held or, at their own cost, can convene a shareholders meeting to consider any resolution validly within the power of shareholders (for example, to remove a director, amend the Constitution or resolve to wind the company up). 100 shareholders together or any one or more shareholders holding more than 5% of the voting shares can also requisition that a resolution be put to the next general meeting convened by the board (more than 2 months after the requisition). General meetings of the company provide an opportunity for shareholders to engage with management and the board. Further information about general meetings is set out below.

Shareholders do not have a right to demand access to information under the Corporations Act. Shareholders may apply to the court for an order to inspect the books of the company. Shareholders have limited rights at common law to inspect the books of a company unless that inspection is necessary with reference to some specific dispute or question and it is only then granted to such an extent as may be necessary for that dispute or question.

Major shareholders by virtue of the size of their shareholding are often able to engage further with management and the board. By way of example, major shareholders often seek to appoint directors to the board of a company to effectively act as their spokesperson and to represent and protect their interests in the company.

## General meetings

A public company must hold an annual general meeting (**AGM**) at least once every calendar year within 5 months after the end of its financial year. Proprietary companies must hold such meetings if they are required by their constitution. Meetings involving shareholders are subject to rules (generally set out in the company's constitution) on the giving of notice and the time and place where the meeting can be held.

A shareholders' meeting may be called:

- at any director's own initiative; or
- at the request of shareholders holding at least 5% of the voting shares.

The court may also call a meeting if it is impractical to call one in any other way.

There are two types of resolutions that can be passed at a shareholders' meeting. Ordinary resolutions require a simple majority to succeed. However, a special resolution must be passed by at least 75% of the votes cast by shareholders entitled to vote on the resolution. The Corporations Act requires that certain decisions are only made by special resolution. Where this is the case, there are additional notice requirements. The company's constitution may also set out certain requirements relating to the meeting of shareholders or the voting requirements in respect of certain resolutions.

## Additional guidance for ASX listed companies

The Australian Securities Exchange (**ASX**) Corporate Governance Council Principles and Recommendations (**ASX Principles**) set out recommended corporate governance practices for ASX listed entities that are likely to achieve good governance outcomes and meet the reasonable expectations of most investors in most situations.

The ASX Principles are in general not formally binding but any departure from them must be disclosed and explained by the Company in its annual reporting. The ASX Principles regulate (amongst other matters):

- Board composition and director independence; and
- Board Committees, Charters and Corporate Codes of Conduct.

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