

Fact sheet: Duties of directors of a company limited by guarantee

Overview

This fact sheet concerns the legal duties of directors and other officers of not-for-profit organisations that are incorporated as a company limited by guarantee.

These duties or responsibilities are owed by directors (officers and possibly other people involved in the organisation - see further below) to the organisation itself. In some cases they may be owed to the members of the organisation as well. You will need to be aware of these duties in carrying out your role as a director or officer of a company limited by guarantee. If you breach these duties you may be personally liable to pay penalties (that is, from your own money or assets).

These duties derive both from general law (common law) and from statute, in particular the *Corporations Act 2001* (Cth). This legislation is administered by the Australian Securities and Investments Commission (ASIC).

The basic duties owed by directors of a not-for-profit organisation that is a company limited by guarantee are:

- ▶ a duty of good faith and loyalty to the company (organisation);
- ▶ a duty to exercise reasonable care and skill in carrying out the role of director; and
- ▶ a duty to prevent insolvent trading by the company (organisation).

In addition, a director or office bearer is required to comply with the constituent document(s) of the organisation. In the case of a company limited by guarantee this is usually called a constitution (although in older companies these can be called a 'Memorandum and Articles of Association').

Penalties apply for breaches of directors' duties.

Our focus in this fact sheet is on not-for-profit community organisations that are incorporated as a company limited by guarantee. If your organisation is an incorporated association registered under the *Associations Incorporation Act 1981* (Vic), please see the Related Resources section at the end of this document for separate fact sheets on these issues.

Note: The information contained in this fact sheet is intended as a guide only, and is not legal advice. If you or your organisation has a legal problem you should talk to a lawyer before making a decision about what to do. The information in this fact sheet is written for people and organisations resident in, or affected by, the laws that apply in Victoria, Australia and is current at 1 October 2008.

The role of directors/ office bearers and the Board

Incorporating a company with ASIC creates an independent entity that is legally separate from its members, directors and employees (if any). The Board of Directors governs the entity (organisation) and is ultimately accountable for its performance.

It is therefore very important that directors recognise and keep separate their own personal interests from those of the organisation. This applies even where your group is very small and the directors are also the only members.

Who is a Director?

Broad definition of 'director'

Even if you do not have the title 'director', the duties may still apply to you. Directors' duties will apply to:

- ▶ 'officers' of the organisation, like a company secretary (even where they are not on the Board);
- ▶ any person who is occupying or acting in the position of a director, even if they have not been formally appointed as a director or if they have some other title in the organisation;
- ▶ any person who gives instructions or direction on which the directors of the organisation usually act. For example, if the directors of your organisation always consult with and act on the instructions of a particular person, that person (for example, the founder of the organisation) may also be considered a director; and
- ▶ any person who makes, or participates in making, decisions that affect the whole or a substantial part of the work of the organisation. This person - for example the chief executive or most senior manager of your organisation - may be held to be an 'officer' of the company, and will also be required to act in accordance with directors' duties.

There is no such thing as a 'silent' director.

All directors have duties under the common law and the *Corporations Act*. There is no such thing as a 'silent' or non-participating director, even where (as is usually the case) directors of not-for-profit organisations are not paid for their role and act in a voluntary capacity. All directors must comply with the legal duties imposed on them by the *Corporations Act* and common law.

What about delegation to a chief executive or other employee of the organisation?

In some organisations the directors will also do the work of the organisation and make all decisions themselves as a Board. In others, some authority will be delegated to a chief executive or other employee.

While it is reasonable to rely on information and advice from others to whom you have delegated powers, as a director you should reasonably believe that person to be reliable and competent. You should also understand and assess the information and advice that they provide you. If you are not satisfied with information provided by the organisation's managers or employees you should make further investigations.

This obligation to understand and assess information for yourself (rather than just rely on the advice of the treasurer or manager, for example) applies to financial reports as well as more general information about the organisation's activities.

What are the legal duties of Directors?

As noted above, the three basic directors' duties are

- ▶ a duty of good faith and loyalty to the organisation;
- ▶ a duty to exercise reasonable care and skill in carrying out the role of director; and
- ▶ a duty to prevent insolvent trading by the company (organisation).

Duty of good faith and loyalty to the organisation

As a director, you stand in a special relationship to your organisation, and you should ensure that you always act honestly and carefully in carrying out your role, putting the interests of the organisation first.

There are several aspects to this duty of good faith and loyalty:

- ▶ you must act in good faith in the best interests of your organisation, even if this is not in your own best interests;
- ▶ you must act for a proper purpose, and never take advantage of your position as an office bearer or information you have gained in the role for personal advantage; and
- ▶ you must avoid conflicts of interest between your own personal interests and the interests of the organisation.

The duties of good faith and loyalty to the company derive from the common law and are sometimes called 'fiduciary duties'. A 'fiduciary' is someone who stands in a position of trust and power over another. The law imposes fiduciary duties on directors because they are considered to stand in such a position of trust and power in relation to their organisation.

Example 1: If an organisation enters into a contract with a director, or company controlled by a director, or a member of the director's family, on terms very favourable to that director this may amount to a breach of the duty to act in good faith in the best interests of the organisation.

An example of this might be entering into a cleaning contract with a director at above market rates. The decision to enter the contract would probably not be in the best interests of the company (because it is at above market rates) and would likely involve a conflict of interest for that director between her role as office bearer of the organisation and her outside/personal interest in the cleaning company.

Example 2: It would be a breach of the duty of good faith and loyalty to the organisation for a director or office bearer to use information that the organisation holds about its members for an unrelated personal reason.

For example, if a director on the Board of a child care centre (company) used the personal details of families using the service to approach them about the director's own personal business (whether this was a child care-related business or completely unrelated), this would be an improper use of the director's position and an improper use of information gained in the position. (Although not the subject of this fact sheet, such behaviour may also breach privacy laws).

What should you do if a conflict of interest arises?

If an actual or potential material conflict of interest arises, you must disclose this to the rest of the Board (the other office bearers). You should not participate in discussions or decisions of the Board in which you have this kind of material personal interest. Example 1 above is an example of a 'material personal interest', in that the director stands to profit if the cleaning contract is entered into.

If the conflict or potential conflict does not involve a material personal interest on the part of the director then it may be permissible for the director to participate in Board discussions and decision-making on the issue, providing full disclosure of the conflict has been made.

Tip: It is a good idea to have all directors or office bearers declare any ongoing conflicts of interest when they join the Board (refer section 192 of the *Corporations Act*). As a Board you can also encourage openness about declaring conflicts and make it a normal occurrence for directors to step out of meetings when they have a conflict.

Duty to exercise reasonable care and skill

As a director you are required to act with the skill and careful attention that a reasonable person in a similar position to you would bring to the role.

While you do not have to have special qualifications to be a director, if you do have a particular qualification or skill you are expected to make use of it. For example, if you are qualified as an accountant you will be expected to utilise that skill in your role on the Board.

The test of reasonable care and skill also recognises that decisions must be made, and judged, on the basis of circumstances known at the time and without the benefit of hindsight.

You should take care to ensure that you understand what the organisation is doing and inform yourself properly about any decisions that need to be made, and then make the decision that you rationally believe to be in the best interests of the organisation.

If you are relying on information or advice from a manager or employee of your organisation you should make sure you are satisfied that it is reasonable to rely on the information.

Tip: Read the Board papers and ask questions if anything is unclear! As a director you should make sure you take reasonable steps to place yourself in a position to monitor the activities and management of your organisation.

Duty to prevent insolvent trading by the organisation

As a director, you have a legal obligation to make sure that the organisation is able to pay its debts on time.

An organisation (company) is 'insolvent' if it cannot pay all of its debts as they become due and payable. By law, you must prevent the organisation from incurring a debt when it is insolvent or when you suspect it might become so. This means you should consider whether you have reasonable grounds to believe that the organisation will be able to pay a new debt when it becomes due, as well as pay its existing debts.

What if an organisation can't pay its debts?

If the directors allow the organisation (company) to trade while it is insolvent they may expose themselves to legal action to recover amounts lost by creditors. They may be personally liable for these amounts even though the organisation is incorporated and even if they are voluntary (unpaid) directors.

Tip: Read the financial reports and ask questions of the Treasurer and the auditor if you are not sure about anything. If you do not understand financial documents generally, you may wish to arrange training for the directors of your organisation on reading financial reports.

Get further help

If your organisation is facing financial difficulty or in danger of being insolvent you should seek immediate advice. There are links to further resources about obtaining help if your organisation is in danger of insolvency in the 'Related Links' section at the end of this fact sheet.

What happens if you breach these directors' duties?

Both civil and criminal penalties can apply for a breach of the duty to act in good faith or a failure to exercise reasonable care and skill. As a director you can be personally liable (that is, you may have to pay the fine from your own personal assets) for some breaches.

While you are likely to comply with your duties if you are honest and careful, you should be aware that both ASIC and the courts regard breaches of directors duties seriously. Generally, the penalties for contravention of directors' duties under the *Corporations Act* are more serious than the penalties which apply to organisations incorporated in Victoria under the *Associations Incorporation Act*.

Even if not resulting in prosecution, such behavior can seriously undermine the credibility of your organisation with funders, your members and the general public.

Civil penalties under the *Corporations Act* include a fine of up to \$200,000 for an individual, compensation and damages to the company (organisation). A court may also make orders prohibiting a person from being a director or managing a company in the future if the breach of duty is 'serious'.

Criminal penalties may be imposed if a person knowingly, intentionally or recklessly breaches any of the duties and does so dishonestly and intending to gain an advantage or deceive or defraud someone.

How do I comply?

While you should be aware of the directors duties set out above you should not let them prevent you contributing to the work of your organisation by serving on the Board of Management as a director or office holder.

Generally you will fulfil your duties if you:

✓	act honestly and diligently
✓	act with reasonable care in the best interests of your organisation
✓	never take advantage of your position for personal advantage
✓	never use information gained to benefit yourself, your family, an associate or another organisation
✓	always disclose any conflict
✓	comply with the terms of your organisation's constitution (constituent documents)

Related Resources

Related PilchConnect fact sheets

PilchConnect fact sheet: Duties of Committee of Management members in Vic. incorporated associations

Related legislation

Corporations Act 2001 (Cth)

Associations Incorporation Act 1981 (Vic)

Related links

For online legal information resources for Victorian community organisations about:

- ▶ the people involved in a company limited by guarantee see www.pilch.org.au/positionsclg
- ▶ the people involved in an incorporated association see www.pilch.org.au/positionsia
- ▶ information about financial insolvency see www.pilch.org.au/financial