

Legal Alert

30 March 2020

Directors' Duties in Uncertain Financial Times

Summary

Following Australia's drought and bushfires, and in the face of COVID-19, the risks faced by a company are continuously evolving. Company directors need to be vigilant in understanding and satisfying their statutory and common law obligations. This legal alert provides a broad overview of directors' duties, including the Australian Government's temporary relief measures for directors which have been introduced as a result of the COVID-19 crisis.

Introduction

The impact of natural disasters and now COVID-19 on many, perhaps the majority of Australian companies, and their cashflow is significant.

In these circumstances, directors need to understand their obligations and be cognisant of their potential personal liability, as they face increased pressure to make difficult decisions about the company's future on a daily basis.

A company director has a raft of obligations, including directors' duties under the *Corporations Act 2001* (Cth) (**Corporations Act**) and fiduciary responsibilities owed under common law.

What are these directors' duties?

A director has the following duties:

- (1) to act in good faith and for a proper purpose;
- (2) to use care, due diligence and skill;
- (3) to avoid conflicts of interest and private profits; and
- (4) to prevent the company trading while insolvent.

Duty to act in good faith and for a proper purpose

Directors must act in good faith and in the best interests of the company (i.e. the shareholders collectively) and not act:

- (a) in their own interest;
- (b) in the interest of particular employees or shareholders; or
- (c) in the interest of third parties.

For example, directors have a duty to not use a company's resources for reasons other than to benefit the company, and directors should not act dishonestly or recklessly in dealing with shareholders.

Importantly in challenging times, if a company is facing financial distress or there is doubt about its ability to pay its debts, the duty to act in the best interests of the company includes an obligation to act in the interests of creditors. Whilst that obligation is not paramount, it does require directors to give greater weight to the interests of creditors, give consideration to the impact of their decisions on creditors and not act prejudicially to creditors' interests (either as a whole or to one creditor or group of creditors).

Duty to use care, due diligence and skill

Directors must exercise care in a way that a reasonable modern director would have in the circumstances.

Directors must (at an absolute minimum) adhere to the standards of a diligent director, including:

- (a) becoming familiar with the fundamentals of the business;
- (b) keeping informed about the company's activities (i.e. to not stop paying attention);
- (c) monitoring, generally, the company's affairs and asking relevant questions;
- (d) maintaining familiarity with the financial status of the company (i.e. reviewing financial statements); and
- (e) having the minimum skills of a skilful director including:
 - i. base level of financial competence; and
 - ii. base level knowledge of the business.

In times where restrictions on trading of businesses and movement are constantly changing, it is important to continuously monitor the operating environment of a company and its financial status.

There are certain defences available to an alleged breach of duty to use care, due diligence and skill, such as:

- (a) the decision was made in good faith as a matter of 'business judgment' having informed themselves of the subject matter and rationally believing it was in the best interests of the company;
- (b) the decision was made in reasonable reliance on professional / expert advice; or
- (c) the decision was made by the director's delegate and the director reasonably believed in good faith that the delegate was competent and reliable to make that decision.

As such, the engagement of an appropriately qualified advisor at an early stage should be looked to by directors when making difficult decisions about the company's operations and there should be adequate documentation of directors' decisions, outlining the circumstances of the time and the directors' reasoning.

Duty to avoid conflicts of interest and private profits

A director has a duty to:

- (a) disclose direct or indirect interests in a company contracting with the company;
- (b) not take bribes;
- (c) not misuse company funds for personal use;
- (d) avoid personally utilising a corporate opportunity that should have been taken on by the company (without disclosure or approval); and
- (e) not misuse confidential information for their own benefit i.e. trade secrets, client lists etc.

A director may have breached this duty if they:

- (a) have used their position to gain an advantage for themselves, for someone else, or to cause detriment to the company; or
- (b) have used the information they acquired in their role to gain a benefit for themselves or for someone else, or to cause detriment to the company.

Importantly, directors must give notice (to other directors) of matters with which they have a material personal interest. For a proprietary company, if the other directors have approved the conflict, it is unlikely to cause a breach of this directors' duty.

When there is pressure on cash flow, directors should be extra vigilant in ensuring company funds are quarantined within the company, rather than being utilised for other purposes.

Duty to prevent the company trading while insolvent

Of paramount importance during these difficult times, directors must be aware of their duty to prevent the company from trading while insolvent. A company

becomes insolvent at the point in which it cannot pay its debts when they become due and payable.

A director may be personally liable to the company for an amount equal to the loss or damage suffered by unsecured creditors if:

- (a) they were a director (or alternate, de facto, or shadow director) when a debt was incurred;
- (b) the company was insolvent (or became insolvent) by incurring that debt;
- (c) there were reasonable grounds to suspect the director knew of the insolvency, or a reasonable person in the director's position would have known; and
- (d) the director did not stop the company from trading.

COVID-19 (Coronavirus) temporary relief from directors' personal liability for trading while insolvent

As set out in our alert, [***Important Temporary Relief in Insolvency Law***](#), we discuss the temporary measures the Government introduced to curtail the impact of COVID-19 on Australian business, including to protect company directors from potential personal liability.

It is hoped that these reforms will incentivise continued trade through the COVID-19 health crisis, with the aim of returning to viability when the crisis has passed.

The measures introduced by the *Coronavirus Economic Response Package Omnibus Act 2020* provide a special safe harbour to relieve company directors from their duty to prevent insolvent trading. This only applies in relation to debts incurred in the ordinary course of the company's business.

The relief is designed to prevent directors who are concerned to avoid personal liability for insolvent trading from placing otherwise viable companies into external administration due to the cash flow restrictions arising from the COVID-19 crisis.

These measures will apply for six months: from 25 March 2020 to 25 September 2020, unless extended by the Government.

Importantly, the temporary relief measures do not affect the liability of a company to repay debts that it incurs, nor any liability of a director under a guarantee given in favour of a creditor off the company.

Penalties if non-compliant with directors' duties

A breach of a director's duty may result in various penalties, including a declaration of contravention of the Corporations Act's civil penalty provisions, a disqualification order against the director, a pecuniary penalty order of over \$1 million, or a compensation order made against the director in favour of the company (if there is actual loss).

If the breach is reckless, or dishonest by the standards of ordinary people, criminal sanctions including fines and imprisonment of up to 15 years may apply.

What do tough economic conditions mean for company directors?

As the situation with COVID-19 and the Government's response change so rapidly, a director's assessment of the company's financial position, performance and viability must be constant and thorough.

Directors should consider the long-term viability of the company and seek appropriate advice to protect not only the company, its shareholders and creditors, but directors themselves.

Decisions made in these trying times will no doubt be analysed and critiqued when the current crisis is over, and directors should be looking to ensure they are doing all they can now to protect their companies and themselves.

Directors' Key Duties & Obligations Handbook

If you would like a more comprehensive overview of the key directors' duties and obligations in Australia, we recommend you download our [free essential handbook \(The Directors' Handbook\)](#).

It is important to note, that this content is subject to change. By downloading The Directors' Handbook, when key amendments in the law transpire, we will update and redistribute The Directors' Handbook to you to ensure your handbook is always current.

For updated COVID-19 legal issues and considerations please access our website [here](#).

Contact details

If you have any queries regarding this alert, and ensuring directors' duties and obligations are complied with, please contact:

Lisa Calabrese Partner
lisa.calabrese@finlaysons.com.au
+61 8 8235 7479

Jeremy Schultz Partner
jeremy.schultz@finlaysons.com.au
+61 8 8235 7408

Andrew Dyda Partner
andrew.dyda@finlaysons.com.au
+61 8 8235 7706

George Femia Lawyer
george.femia@finlaysons.com.au
+61 8 8235 7613

This content is current as at 30 March 2020. The speed with which COVID-19 is spreading and the varied responses both internally within Australia and externally change on a daily basis. It is important that you regularly keep up to date with all relevant information and be prepared to respond as the landscape in which the virus is moving changes.

This Alert is intended as general information only. It does not purport to be comprehensive advice or legal advice. Readers must seek professional advice before acting in relation to these matters.