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RESPONSIBLE SCHOOL GOVERNANCE



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Introduction

In the past 20 years statutory liabilities of directors of companies in Australia have expanded significantly.

Duties of directors are set out clearly in Chapter 2D of the *Corporations Act* 2001. Rather than discuss the detail of those duties, this paper will set them in a broader context.

We will give some colour and background to the advent of these additional liabilities so that boards of companies associated with schools and those responsible for the schools' administration can better understand how all the legal liabilities and responsibilities fit together. This will also give a clear view of likely future directions in this area.

Concept of the Corporation

A corporation can only be created by the act of a sovereign power.

Control over the property of groups is a source of revenue to the sovereign. Perpetual ownership by a group (or corporation) would deprive the sovereign of revenue otherwise gained through succession to property.

The earliest form of incorporation in English law was applied to those groups granted a "charter" by the sovereign.

The earliest corporate law cases dealt with cities, towns, monasteries and charitable organisations such as hospitals. They did not deal with business corporations. Although chartered guilds were connected to commerce, they essentially performed public purposes such as training and maintaining standards. It was also important politically for the sovereign to control the guilds and this was facilitated by the charter.

Expansion of Charters

Commercial practice is different from the public purposes of chartered organizations. Commercial practice is concerned with economic advantage and private gain. Commercial practice developed for economic reasons in parallel to the development of the corporations.

In the reign of Henry VII, trading groups were issued with charters that enabled them to trade in foreign countries. This approach was further developed by Elizabeth I as a means of bringing capital to England and modernizing its commerce. Under these charters, the organizations were granted monopolies within the English realm.

Charters were eventually found to be against the common law as being in restraint of trade. However, letters patent (similar to charters) were allowed for the protection of the “art or mystery” of a trade. For example, the company of soap makers paid £43,000 for letters patent plus sixpence per ton impost on soap in the seventeenth century. For that, their charter granted them a virtual monopoly over soap making.

Joint Stock Companies

The joint stock fund was a development from partnership. Overseas trade was lucrative and very risky. The joint stock company was developed to spread the risk and expense of that trade. They were not originally corporations. They became so with the *Joint Stock Companies Act 1840*.

Before incorporation was available, assets of a company were held by the company in trust for members according to the law. It was from this concept of the trust and the duties of trustees that directors' duties developed.

In 1844 the *Joint Stock Companies Act* allowed incorporation by deeds of settlement. It did not confer limited liability on members of the company.

The *Companies Acts* of 1856 and 1862 were designed to facilitate incorporation. There was minimal regulation so that investors and creditors would not see companies as having a government imprimatur or guarantee.

Australia

The English legislation was followed in Australia. Before the Companies legislation of the colonies in Australia, Australian companies were incorporated with limited liability on formation either by charter or private act. For example, the Bank of New South Wales (now Westpac) was formed in 1817 by charter.

The Australian equivalents of the 1862 English legislation were poorly administered but resulted in high revenue for the governments at a low cost.

54 out of 64 banks in Australia closed their doors between 1891 and 1893. These collapses of the 1890s fuelled debate on the powers of the coming Commonwealth of Australia.

Section 51(xx) of the Constitution gives power to make company law for the whole of the Commonwealth. However, the power in this section was limited by judicial interpretation. The qualification of the power resulted from a concern about the prospect of the rising labour movement controlling corporations and commerce at the Commonwealth level.

Australian corporations legislation continued to be administered by the States. It remained administrative rather than regulatory until the 1960s.

Regulation v Administration

There was a move for governments to take a more regulatory approach after the crashes of the 1960s of companies such as the Reid Murray Group and the Korman Group.

There was considerable debate as to whether government should adopt a positive regulatory role. The argument was that shareholders had powers to control directors for fraud or negligence and

could ultimately exercise their power of voting at general meetings. The contrary argument is that this theoretical control by shareholders does not work, especially in large public companies. The failures following the stock market correction of 1987 undermined confidence in unregulated management of corporations.

The 1990s saw greater impositions by government, particularly of public companies, following collapses of the late 1980s such as Qintex.

The major issues with regard to the legislation are the regulation of group structures and the need for less regulation of small companies. Small companies are treated differently in some respects in the current *Companies Act 2001*.

Directors

The term “director” was first used generally at the end of the seventeenth century. It was used by the Bank of England and the Bank of Scotland.

It is said that management, in the absence of a countervailing power, have a tendency to pursue their own self interest at the expense of the corporation. There is a need to monitor management to prevent shirking and other opportunistic behavior. One way is through the law, especially by fiduciary restraints, and by legislation. Another way is through economic forces or markets.

For independent schools, indirect regulation can be effected through accreditation and funding agreements.

Themes

Various themes can be drawn from the development of the limited liability corporation. They include:

- the difference between corporations formed for public purposes and those formed for commercial endeavours and the desire of government to keep them separate;
- directors' duties have developed from the law of trust;
- the crown has traditionally derived revenue from granting concessions to organisations;
- the legislation relating to corporations has historically been more concerned with administration than regulation;
- the political mood has changed so that governments have been compelled to take a closer interest in the regulation of corporations;
- corporations and the concept of limited liability have been an essential component of the development of successful capitalist economies; and
- each time there is a chill in the stock market there is a shiver in government.

Current Controls on Directors and Officers of Companies

Obligations for directors of companies may be found in the following sources:

- corporations legislation;
- the general law regarding directors' duties including contract, tort and fiduciary duties;
- legislation not directly concerned with corporations but which places vicarious liability upon directors for the obligations of the corporation; and
- indirect sources such as regulations under legislation and funding agreements.

Contract

An executive director will have a contract of employment with the company. It will set standards of behaviour, expressly or impliedly. ¹

Tort

A director owes a duty of care to the company. ²

Fiduciary Duties

The following is a list of fiduciary duties with references to their statutory restatements:

- duty of care and diligence (*Corporations Act 2001, Section 180*);
- the duty of good faith (*Section 181*);
- the duty to avoid situations where there is a conflict between the interest of the director and the interest of the company (*Section 182 – 184*);
- the duty to exercise powers conferred on a director as a result of his or her office for proper purposes; and
- the duty to maintain accounting records (*Section 286, 295 to 297, 344*).

¹ *Lister – v – Romford Ice and Cold Storage Co Ltd* [1957] AC 555

² *Daniels t/as Deloitte Hoskin Sells – v – AWA Ltd* (1995) 37 NSWLR 438; *ASIC – v – Maxwell* [2006] NSWSC 1052, (2006) 59 ACSR 373, (2006) 24 ACLC 1308

ASIC's Attitude

In an address by Mr Jeffrey Lucy, Chairman of ASIC, to the Australian Institute of Company Directors on 17 August 2006, Mr Lucy said:

"We do not take enforcement action against those who make honest and reasonable efforts to comply with their legal duties as directors."

He also said ASIC does not take action on trivial issues. On the matter of reckless behaviour, he said:

"Where recklessness or intentional dishonesty is involved and we have enough evidence to mount criminal proceedings, we will refer the matter to the Commonwealth Director of Public Prosecutions for prosecution. ... In our view you will be reckless where you are aware of substantial risk that a transaction is not for a proper purpose or to be entered into in good faith or not otherwise justifiable, but you are determined to proceed indifferent to the consequences."

You can take the lessons from these cases to enhance your own contributions to corporate activity, including:

- *ensuring company financial reports and audits are reliable;*
- *acting against corporate fraud, breach of continuous disclosure and misconduct by other directors and officers;*
- *pursuing and achieving corporate compliance;*
- *encouraging directors and officers of financially troubled corporations to act promptly;*
- *ensuring you have read and properly understood documentation upon which you are asked to make a decision, or which you are asked to execute; and*

- *asking questions of management when documentation presented to you is not readily comprehensible or, by reason of your past knowledge and experience, questions arise as to the veracity of the decision you are asked to take. This final point includes your duty as directors to make further enquiries when appropriate so that you are able to come to independent views on matters and not merely act as a “rubber stamp” on decisions that have wider ramifications.*

James Hardie Prosecution ³

This case set out the duties of directors and officers by reference to existing law. In that sense, it did not break new ground. What was unusual was that the Judge was prepared to find a state of affairs which the directors either could not recollect or swore had not existed. The judge found they were all ‘mistaken’ in their evidence.

The case emphasises the heightened responsibilities of directors and officers under the general law and the *Corporations Act* 2001 when they are dealing with any issue likely to have a serious effect on others. Their primary duty is always to the company and they must be aware of the damage they may cause to their company if they do not act with proper care and diligence.

James Hardie was a very large, listed trading company and the particular issue was unusually sensitive in the Australian community.

ASIC took civil penalty proceedings against seven directors, the CEO, the general counsel, the CFO and two companies from the James Hardie group of companies. The proceedings alleged breaches of sections 180(1), 181(1), 995 and 999 of the *Corporations Law*. Sections 180 and 181 appear in the same form in the current *Corporations Act* 2001. The current equivalent of section 995 is section 1041H and the equivalent of section 999 is section 1041E in the *Corporations Act*.

³ *ASIC -v- MacDonald* (No. 11) [2009] NSWSC 287

The facts were extensive because there were 12 defendants and the allegations against each of them needed to be worked through carefully. The matter lasted 45 sitting days. There were 30 barristers representing various parties and 3237 pages of final submissions were handed to Mr Justice Gzell who heard the matter.

Briefly, the sections are concerned with the following:

Section 180: care and diligence – directors and other officers

Section 181: good faith – directors and other officers

Section 1041E: false or misleading statements

Section 1041H: misleading or deceptive conduct.

Two companies in the James Hardie group were exposed to claims for compensation for asbestos-related injuries. The management of the company devised a plan to separate the group from these two tainted companies so as to quarantine the rest of the group from future asbestos claims. The group was to set up a fund which would be used to meet the claims.

The proceedings relate essentially to announcements and presentations made by the company and its officers in relation to the extent of the fund, whether it was likely to cover all claims into the future and the manner in which the fund was to be financed.

ASIC alleged that a draft ASX announcement was approved at a meeting of the board of directors on 15 February 2001 and that it contained a number of statements to the effect that the foundation would have sufficient funds to meet all legitimate asbestos claims, that it was fully funded and provided certainty for people with legitimate asbestos claims. ASIC alleged that those statements were false or misleading and that the directors were in breach of section 180(1) of the *Corporations Law*. They could not have been satisfied the company had a proper basis for making the assertions of sufficient funding.

ASIC made its case under s.180 but failed in relation to section 181. It was successful in making its case for breach of sections 1041E and 1041H.

Sections 180 and 181 of the *Corporations Act* are of wider application than section 1041E and 1041H which relate to financial products and services.

Section 180(1) was in the following terms in February 2001:

A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- (a) were a director or officer of a corporation in the corporation's circumstances; and*
- (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.*

Justice Gzell described the formation of the foundation and the separation of the two asbestos companies from the James Hardie group as “potentially explosive steps”. Many people were interested in the manner in which the company dealt with the asbestos claims. Interested parties included the people injured, unions, creditors of James Hardie group companies, shareholders in the group companies and investors generally.

One or more of the defendants has said they are likely to appeal the decision. Even if the appeals are upheld, the case remains as a caution to directors of all companies. They should ensure they have proper governance regimes in place and that they have proper indemnities from the company and insurance of their liabilities to the extent permitted by law. They should always act honestly and diligently.

Future Directions

This brief exploration of the legal development of corporations has shown that:

- the position of companies existing for public purposes is intertwined with regulation of companies incorporated for commercial purpose;
- it is inevitable that government will take an approach to corporations more regulatory than administrative;
- the limited liability corporation is an essential component of a capitalist economy;
- in adopting their regulatory position, governments cannot take such an extreme role as to deter commerce or the willingness of people to volunteer to conduct corporations for public purposes; and
- as more regulation is imposed, government is likely to treat different kinds of corporations differently – not-for-profits are likely to be treated differently from listed companies.

Essential Corporate Governance Principles

The ASX corporate governance council has published essential corporate governance principles and best practice recommendations for corporations. There are eight principles with recommendations as to how to fulfill them.

The principles are primarily directed towards public companies listed on the ASX but they are readily adaptable to any other kind of corporation. They are the product of a great deal of thought and experience in running companies. The principles and recommendations are published on the internet – look for “corporate governance principles and recommendations second edition August 2007” at the ASX interactive investor website.

The following is a recitation of the principles with a brief note as to how they might be applied for a not-for-profit corporation running a school.

Principle No.	Principle	Recommendation
1	Lay solid foundations for management and oversight	Companies should establish and disclose the respective roles and responsibilities of board and management
2	Structure the board to add value	Companies should have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties
3	Promote ethical and responsible decision-making	Companies should actively promote ethical and responsible decision-making
4	Safeguard integrity in financial reporting	Companies should have a structure to independently verify and safeguard the integrity of their financial reporting (audit committee)
5	Make timely and balanced disclosure	<p>Companies should promote timely and balanced disclosure of all material matters concerning the company.</p> <p>This is primarily intended to satisfy continuous disclosure requirements of the ASX listing rules and will not apply to unlisted companies.</p>
6	Respect the rights of shareholders	<p>Companies should respect the rights of shareholders and facilitate the effective exercise of those rights.</p> <p>The importance of this principle will depend on the nature of the members of the school company. The more members there are, the greater the need to communicate effectively with them. There is obviously a different imperative for members of a not-for-profit organisation.</p>

7	Recognise and manage risk	Companies should establish a sound system of risk oversight and management and internal control
8	Remunerate fairly and responsibly	Companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear. This is more of an issue for commercial organisations than schools.

Corporate Social Responsibility

The term “corporate social responsibility” (“CSR”) lacks a universally accepted definition. However, it can be described as a company’s management of the economic, social and environmental impacts of its activities (Department of Treasury submission 134 to Parliamentary Joint Committee on corporations and financial services June 2006).

CSR is essentially a proposition that companies ought to be concerned with the broader effects of their activities rather than concentrating narrowly on the interests of shareholders. Discussion of the point commonly refers to “stakeholders”. In the school context, a ‘stakeholder’ might be an employee, a pupil, a parent, a board member, a supplier or a member of the local community around the school.

There is no legal obligation for companies to act in the best interests of non-members. In the commercial world, there is an argument that the directors must focus on the interest of the shareholders rather than others such as creditors. This is a controversial argument surrounding the James Hardie prosecutions.

Corporate social responsibility requires companies to take into account whatever matters are topical within society at any time. It is advocated at the present time that companies should report on measures they take to alleviate environmental damage.

There is no legislative coercion for directors to adopt a policy of corporate social responsibility. It is suggested that companies should make some attempt at it if for no other reason than for “enlightened self-interest”. Under this argument, it is for the benefit of a company to take into account issues beyond those narrow issues directly affecting the company and its members.

Conclusions for Directors of Independent Schools

If directors adopt a common-sense approach, acting with honesty, diligence and the utmost integrity, they will usually meet their legal obligations as directors.

Directors of not-for-profit companies should always bear in mind the interests of third parties such as creditors and government and in particular, the way in which the company’s dealings with interested parties may affect the company’s interests.

Provided their intentions are honourable, directors have most to fear from insolvent trading.

It is the responsibility of directors to ensure that the administration of their school is complying with the legal responsibilities of the school. Failure to take steps to ensure this is happening may lead to personal liability of directors.

Directors should ensure that there is a satisfactory directors and officers liability policy of insurance and that there are no conditions or exclusions on the policy which require particular attention.

They should also consider obtaining an indemnity from the company of which they are a director.