

ISSUE

Taking into account given scenarios the following issues have to be considered in order to reach a conclusion on Tim's situation:

- 1) Can Tim be found liable for his actions associated with the management of Statewide Timber and if so what the liability would be?
- 2) Will Statewide Timber be found liable for the recovery of customers losses?

RELEVANT LEGISLATION

In *Hospital Product v United States Surgical Co* ((1984) 156 CLR 41 case the duty to act in a good faith was established, in accordance to which the companies' directors are in the position of trust towards the company meaning they must act in a good faith at all times. In essence, this concept incorporates fiduciary duties as follows (s 181,182 and 183 of CA):

- 1) Duty to act bona fide for best interests of Co
- 2) Duty to exercise powers for proper purpose
- 3) Duty not to fetter discretion
- 4) Duty to avoid conflict of interests with corporation

Also under the law of negligence the MD has duty to exercise reasonable care, skills and diligence (s 180).

The duty of care, skills and diligence

According to *Daniels v Anderson* (1995) 13 ACLCL 614 case directors cannot just rely on information provided by delegates – they must make inquiries if this is warranted by the situation.

Directors' Duty of care

s 180(2) of ITAA 97 states that a MD satisfies the duty of care under the following circumstances:

- 1) The judgment is made in good faith and for a proper purpose;
- 2) Managing director does not have a material personal interest in the subject matter of the judgment;
- 3) Rationally believe that the judgment is in the best interests of the corporation;

Duty to avoid conflict of interests

As fiduciaries, directors must avoid any situation where a conflict of interest might arise between them and Company (*Aberdeen Railway Ltd v Blaikie* (1854) 1 Macq 461 case).

The most obvious example of conflict of interest is where a director has an interest in a contract entered into by the Company and at the same time acts as the 3rd party with whom the contract was signed (*Transvaal Lands Co v new Belgium Land and Development Co*

[1914] 2 Ch 488 case). Furthermore, the Corporation Act imposes disclosure requirement on the directors in respect of material financial interest of the affairs of the corporation: under s 191 (1) director must disclose such an interest to the board when it arises.

Make a personal gain from one's position as a director

The requirement that there be no conflict of interest also applies where the director uses his position in the Company for his own benefits.

According to s 182 (improper use of position) of ITAA 97 improper use of position by director occurs under the following circumstances:

- 1) A personal gain, some advantages or benefits were obtained by the MD
- 2) MD harmed the Corporation
- 3) Information was used inappropriately by the MD for the purpose of obtaining an advantage or acting in the way which is detrimental for the Corporation (s 183(1) of ITAA 97).

As fiduciaries, directors must avoid any situation where a conflict of interest might arise between them and corporation (duty not to make profit from a position as a director).

Duty to act with a good faith

According to s 182(1) Managing Director must act with a good faith, in the interests of the company and for a proper purpose. This means that he must act honestly on behalf of corporation.

Directors are required to take into account the interests of creditors when make their decisions, in that if they permit the Corporation to become insolvent, the Corporation might be liquidated and creditors under s 588G can possibly recover losses from directors.

Disclosure of interests

According to s 191 (1) of CA directors are required to make disclosure to the Board of Directors at all times.

Liabilities

- 1) Under s 206C ASIC is able to obtain a disqualification order.

Corporation or ASIC can also apply for a s 1317H compensation order to recover damages on behalf of the Corporation.

- 2) Breaches of such duties as duty to act in a good faith, the duty to act in best interests of a company and duty to exercise power or information for a proper purpose will lead to criminal liability under s 184 - when court is able to prove that the director was acting recklessness or dishonesty deliberately.
- 3) Criminal proceedings may be initiated even if a civil penalty order has been obtained (s 1317P).

- 4) Company can sue director for being fraudulent and careless.
- 5) According to *Howard Smith v Ampol [1974] AC 821* case where the director improperly exercised the power, proceeds can be recovered

Person can also be prevented from running a business by automatic disqualification:

- Where a person is convicted of an offence which relates significantly to the business: s 206B of CA;
- For an offence relating to dishonesty with imprisonment of 3 month: s 206B of CA;

Relief from liability

Under the common law, director must disclose to the shareholders the breach of fiduciary duties and have GM ratification, as was held in *Furs v Tomkies (1936) 54 CLR 583* case. However, ratification by GM will prima facie not be effective if it is a fraud.

Also court can relieve MD from common law liability for negligence, default, breach of trust or duty where it appears that they acted honestly – s 1318(1) of CA.

In addition, if a director receives advance authorization to engage in conduct which would amount to a breach of s 181-183 of CA, their conduct would not constitute ‘improper’ use of information or position.

APPLICATION

Malfunction has occurred on the factory and the vital stage of the manufacturing process was omitted or neglected and the timbers involved in the manufacturing process were sent to the customers regardless. In fact, it is a responsibility of an Operation Manager to ensure that the timbers had been treated properly, otherwise they must have not been sent to the end users. Thus, it is a fault of the Operation Manager. However, he let Tim know that such an incident occurred and instead of rectifying the mistake Tim decided to act negligently due to being overwhelmed with other concerns. This means that Tim consciously breached the company’s policy and such an outcome causes director’s duty of care, skills and diligence being clearly breached. Consequently, s 180 of CA was breached as Tim failed to exercise reasonable care, skills and diligence, given that he has a position of trust towards the Statewide Timber Merchants. Also according to *Daniels v Anderson (1995) 13 ACLCL 614* case it was Tim’s responsibility to make a personal inquiry in order to check the credibility of the information (timber were not processed properly and subsequently sent to customers) as well as take some appropriate measures. Moreover, s 181 of Corporation act was breached as Tim did not act in the best interest of the company, he rather acted relying on his self-interest.

In the other words the duty of care was breached due to the following reasons:

- 1) The judgment (Ignoring the fact that timbers were not processed appropriately) was not made in good faith (because instead time was spent on settling the issue associated with customers credit limits) and not for a proper purpose. Especially it is important to emphasize that the value of timber was \$400,000 , which is a considerable amount of

money for the business and it must be Tim's priority number one. This means that duty to exercise proper skills and diligence was breached as Tim neglected such essential for businesses operation fact. Moreover, a director is under a duty to familiarize himself with what is happening in the company and to take an active interest (*AWA Ltd v Daniels (1992) 7ACSR 759* case).

Similarly, in case *Statewide tobacco Services v Morley (1990) 2 ACSR 405* the court held that a director should know company's affairs and the defense of the lack of the knowledge was rejected; MD could not hide behind ignorance.

2) Tim apparently has a material personal interest in the subject matter of the judgment

It is a fact that Tim had his own company which was carrying on a business with Statewide Timber Merchant and given that he spends a substantial amount of time on putting his efforts into changing the company's policy (extending credit limit for customers), it is obvious that he was concerned with how to obtain a loan for his personal company (Best Homes Ltd). Consequently, a material personal interest is involved when he made the decision to ignore the fact that timbers worth \$400,000 were not processed properly and he rather focused on how to improve the credit policy, which obviously was beneficial for Best Homes Ltd rather than for Statewide Timber Merchant.

3) Tim might rationally believes that the judgment is in the best interests of the corporation; however it is obvious that reasonable person wouldn't ignore any information related to the company's operations and would take reasonable steps to prevent the problem arisen or alternatively would take all reasonable steps to prevent timber from being sent to the customers. Moreover, it was reasonably foreseeable that by sending unprocessed timbers to customers there is a high possibility that they can be destroyed by termites. Thus, it is clear that the judgment was not made in the best interests of the corporation as corporation will be sued.

The above facts mean that sections 181 and 182 of CA were breached by Tim.

Also it should be mentioned that Tim uses his position as MD for his personal benefit (extending contract of his own company, whereby more money can be earned) by taking advantage of the position of power held (using information inappropriately). Moreover, no measures were taken to prevent conflict of interests arisen. Thus, Tim breaches s 183 by CA.

Apart from this, by extending credit to customers, Tim increases bad debts, which in turn decrease cash inflows. This can result in insolvent trading, which means Tim acts not in good faith.

Liability

Having his own company Best Trading, Tim must disclose his interest to the Board of Directors and let them know that he has an intention of making business with Statewide, otherwise s 191 will be breached. Given the fact that he takes advantage at the expense of the company and is not disclosing his interest to the shareholders and Board of Directors, he act

recklessly, fraudulently and dishonestly and he can be prevented from running the business immediately by ASIC disqualification order as well as he can be criminally liable as per s 184. On top of it, company can sue the director for recovering losses incurred (losses associated with termite activity, which worth \$2.5 million) and he will be found personally liable as well as he can be prosecuted and given a sentence.

In regards to bad debts that have raised dramatically to \$1.8 million it can be said that he will be liable as well, because he knew that company experiences difficulties associated with the turnover due to the downturn in the building industry and he must take reasonable steps and care in order to ensure that bad debts will not be maximized as it is obvious that customer might find it challenging to pay for their contracts. He cannot simply ignore this fact. This means that it is most likely that the self-interest was involved.

On the other hand, if Tim had got an authorization in advance to ignore the fact that timbers were not processed appropriately as well as authorization to change credit policy, he would have not been found liable as he would have not act 'improperly'. Also if he had disclosed his interest, he would have obtained the ratification of the shareholders and board of directors, which would have relieved him from the liability. However, that is not the case at all as he acted dishonestly, fraudulently and recklessly involving his personal material interest.

CONCLUSION

It is obvious that Tim had self-interest involved, because he was running 2 companies and he is most likely be found liable and prevented from running the business immediately with heavy penalties imposed along with imprisonment. Also Statewide Timber will not be liable to customers and they are most likely to recover losses from Tim.

In regards to Tim defense it can be said that it is less likely that he will be given any relief from the liability for breach of statutory duties.