Duties of Governors

of Not-for-Profits and Charities

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What is this paper about?

With more than 55,000 registered charities in Australia employing over 1,200,000 people and having a total income well over $135 billion, there is a real need for proper accountability and good governance. In this paper, we focus on the duties of the governors of not-for-profits and charities in Australia.[1]

The discussion begins by considering the overriding duty on governors to pursue their organisation's purposes. We then consider both common law duties and statutory duties. The statutory duties are found in the *Corporations Act 2001* (Cth) and *Associations Incorporation Act 2009* (NSW), which apply to incorporated non-charitable not-for-profits, and the *Australian Charities and Not-for-profits Commission Act 2012* (Cth) (ACNC Act) which applies to charities.

The paper concludes by briefly considering other duties such as those under the legislation covering work health and safety, taxation and discrimination.

Overriding duty: the organisation's purpose

All not-for-profits and charities are established for a purpose which is set out in their constitutions. Their governors must ensure that the assets and income of the organisation are only used for that purpose.

For charities, the first Governance Standard under the ACNC Act sets out this obligation quite clearly. It requires charities to be 'not-for-profit' and to

[1] All charities are not-for-profits. However, in this paper, when we use "not-for-profit", we mean a not-for-profit that is not a registered charity, and when we use "charity" we mean a registered charity. We use "governor" to mean a person on the governing body of a not-for-profit or charity, whether or not incorporated.

work towards their charitable purpose. They must also be able to demonstrate this.

The Charity Commission for England and Wales fulfils a similar purpose to the Australian Charities and Not-for-profits Commission (ACNC) in the United Kingdom. In late 2016, the Charity Commission published a report[2] of its inquiry into a charity whose objects were:

(a) the advancement of the Islamic religion;

(b) to advance the education of the public in the ways of Islam;

(c) to promote research into the Islamic faith and to publically disseminate the useful results of that research.

The charity attracted media attention as a result of an event it organised. This led to an investigation by the Charity Commission which examined:

(a) the decision making of the governing body regarding due diligence and monitoring of guest speakers; and

(b) the financial management of the charity, specifically payments to trustees and/or former trustees.

The Charity Commission said that a charity's governing body must ensure, when organising events or distributing literature, that the message of the event and the literature is consistent with the charitable objects. There is also a duty to be vigilant to ensure that the charity's premises, assets, staff, volunteers or other resources are not used for activities inappropriate for a charity.

The investigation found that a number of the charity's governors had received payments from the charity which were considered more than reasonable costs for travelling expenses for board meetings and for the fulfilment of their duties. More than half of the governors had received

[2] Inquiry Report: Islamic Education and Research Academy www.gov.uk/government/uploads/system/uploads/attachment_data/file/565354/islamic_education_and_research_academy_iera.pdf

payments for services which were in breach of the charity's constitution and legal duties.

The lessons are clear. Charities and their governors must comply with the law. There are clear obligations on governors always to act in the best interest of their charity. They must ensure that its funds, assets and reputation are not placed at undue risk. The governors must not use their charity's name to promote views or activities inappropriate for a charity.

The governors are under a legal duty to ensure that their charity's funds are applied solely and reasonably in furtherance of its purpose. They must also be able to demonstrate that this is the case. Accordingly, they must keep records and an adequate audit trail to show that the charity's money has been properly spent on furthering the charity's purpose for the public benefit.

In addition, governors must not misuse a charity's funds or assets and must ensure that its finances and property are used appropriately and in accordance with its charitable purpose.

Common law duties

Duty of loyalty

It is well established that there is a relationship of trust and confidence between director and company.[3] This is referred to as a fiduciary relationship. In *Hospital Products Ltd v United States Surgical Corp*, Mason J defined a fiduciary relationship:

> *The critical feature of these relationships is that the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense.*[4]

[3] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 96-97 per Mason J; *Elders Trustee and Executor Co Ltd v EG Reeves Pty Ltd* (1987) 78 ALR 193
[4] (1984) 156 CLR 41 at 96-97

Because a director is said to be in a fiduciary relationship with the company, equity demands a high standard of loyalty from directors. This standard of loyalty is reflected in a number of positive obligations, as well as in some negative ones.

The positive duties of loyalty owed by a director of a company include the duties:

(a) to act in good faith in the best interests of the company;

(b) to act for proper purposes; and

(c) to give adequate consideration to matters for decision and to keep discretions unfettered.

The negative aspects of the duty of loyalty are those which require directors to avoid conflicts of interest of various kinds. This includes the prohibition against directors improperly using information and/or their position.[5]

Duty of care

The duty of loyalty is only one aspect of the duties of directors. In addition, directors owe a duty of care to their company. This is a common law duty arising out of the close relationship between a company and its directors.[6] It requires directors to act with sufficient care, skill and diligence in relation to the affairs of the company. In our opinion, the same applies to the governors of an incorporated association under the *Associations Incorporation Act*.

Where a not-for-profit or charity is unincorporated, neither a member nor a governor owes a duty of care to other members of the association by virtue of being a member or a governor.[7] For there to be a duty of care, it needs to be established on ordinary principles of negligence.[8]

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[5] Austin and Ramsay in *Ford's Principles of Corporations Law* (LexisNexis, 14th ed, 2010) at 364 [8.010] draw the helpful distinction between positive and negative duties.
[6] *Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438
[7] *Hrykynyuk v Mazur* [2004] NSWCA 374 at [9]
[8] Ibid, at [21]

Statutory duties

Prior to 1 July 2013, the *Corporations Act* and the *Associations Incorporation Act* imposed duties on those governing not-for-profits including charities incorporated under those Acts. After that date, while the provisions in these Acts still apply to those governing not-for-profits incorporated under them, if a not-for-profit is also registered as a charity under the ACNC Act, the relevant provisions of that Act apply instead.

Corporations Act

The *Corporations Ac*t applies to companies limited by guarantee,[9] which is one type of incorporated legal structure suitable for not-for-profits. Pursuant to the relevant sections of the Act, the directors of these not-for-profits are required to:

(a) exercise their powers and duties with the care and diligence that a reasonable person would have, including taking steps to ensure they are properly informed about the not-for-profit's financial position (section 180);

(b) exercise their powers and duties in good faith in the best interests of the not-for-profit and for a proper purpose (section 181);

(c) not use their position at the not-for-profit improperly to gain an advantage for themselves or someone else or cause detriment to the not-for-profit (section 182);

(d) not use information obtained through their position at the not-for-profit improperly to gain an advantage for themselves or someone else or cause detriment to the not-for-profit (section 183); and

(e) prevent insolvent trading by the not-for-profit (section 588G(2)).

Associations Incorporation Act

The *Associations Incorporation Act* applies to incorporated associations, which is another type of legal structure appropriate for not-for-profits. With

[9] *Corporations Act 2001* (Cth) section 112(1)

the exception of some specific provisions relating to financial management,[10] the directors' duties set out in the *Corporations Act* do not apply to "committee members" of not-for-profits incorporated under the State Act.[11] However, the duties set out in the State legislation are very similar in content, requiring committee members to:

(a) carry out their functions for the benefit, so far as practicable, of the association and with due care and diligence (section 30A);

(b) do all things (or abstain from doing all things) in good faith and exercise their functions for a proper purpose (section 30B);

(c) disclose an interest in a matter that conflicts with the performance of their duties (section 31);

(d) ensure information obtained as a committee member is not used dishonestly (section 32);

(e) ensure their position as a committee member is not used dishonestly (section 33); and

(f) ensure that the association does not incur debts that are not expected to be repaid (section 91).

In addition, members of the committee should ensure that appropriate internal financial controls are implemented for all payments made on behalf of the association.[12]

ACNC Act and Governance Standards

Since 1 July 2013, charities must meet a set of Governance Standards to be registered and remain registered with the ACNC. The Governance Standards

[10] See *Associations Incorporation Act 2009* section 95. For example, "subsection (1) does not operate to exclude the operation of" Chapter 2F (Members' rights and remedies), 2L (Debentures), 5C (Managed investment schemes), 6D (Fundraising) or 7 (Financial services and markets) of the *Corporations Act 2001* (Cth).
[11] *Associations Incorporation Act 2009* section 95(1)
[12] Fair Trading, *Management Committee: Incorporated Associations* (September 2016) New South Wales Government, 2 <http://www.fairtrading.nsw.gov.au/Factsheet_print/Cooperatives_and_associations/Running_an_association/_Management_committee.pdf>

are a set of core, minimum standards that deal with how charities are run (including their processes, activities and relationships) – their governance.

Governance Standard 5 sets out the duties that apply to a charity's governors.[13] Under Governance Standard 5, the governors must:

(a) act with reasonable care and diligence;

(b) act honestly and fairly in the best interests of the charity and for its charitable purposes;

(c) not misuse their position or information they gain as a governor;

(d) disclose conflicts of interest;

(e) ensure that the charity's financial affairs are managed responsibly; and

(f) not allow the charity to operate while it is insolvent.

Key to meeting this Standard is understanding that governors have a duty to act in their charity's best interest. We now deal with each of these duties.

Reasonable care and diligence

The first of these duties is that governors must act with reasonable care and diligence. To meet this duty, governors should:

(a) prepare for and attend meetings

Governors must do their best to participate. They must attend board meetings whenever they are reasonably able to do so. Before the meetings, they should read and try to comprehend the materials they have been given about the topics on the board's agenda.

James Hardie board members failed to do this is as *Gillfillan v Australian Securities & Investments Commission*[14] revealed. In this case, the board

[13] Australian Charities and Not-for-profits Commission, *Governance Standard 5: Duties of Responsible Persons* (July 2013) Australian Government, 14-15 <http://www.acnc.gov.au/ACNC/Manage/Governance/GovStds_5/ACNC/Edu/GovStandard_5.aspx>

[14] [2012] NSWCA 370; see also *Australian Securities and Investments Commission (ASIC) v Hellicar* (2012) 247 CLR 345 (French CJ, Gummow, Hayne, Heydon, Crennan, Kiefel and Bell JJ)

considered a draft announcement to the ASX. Two directors were at the meeting by telephone. They had not seen copies of the draft and did not ask to see a copy. Yet they voted in favour of making the announcement.

The Supreme Court of New South Wales found that the board members appreciated that a significant announcement was to be made on the controversial subject of whether funding, which had been set aside for victims of asbestosis, could be guaranteed. The onus was on them to be cautious when voting on the making of the announcement – either by seeking further information or by explicitly abstaining. They gave evidence that they would not have voted for the announcement had they known its terms. Consequently, the Court made a declaration that each of the directors had contravened their duty of reasonable care and diligence and made orders disqualifying each director from managing corporations for five years and imposing on each a financial penalty of $30,000.[15]

The directors appealed to the New South Wales Court of Appeal, which set aside the declarations and orders made against them by the Supreme Court.[16] ASIC then appealed to the High Court, which reinstated the Supreme Court's declarations and orders and sent the case back to the Court of Appeal for it to remake its decision about how severe its disqualification and penalty orders should be.[17]

Barrett JA for the Court of Appeal offered some advice to board members participating in board meetings by telephone, audio-visual link or other like means of communication. His Honour said that, as a bare minimum, each participating director must be able to hear and be heard by every other participating director for the duration of the meeting.[18] However, he went on

[15] *Australian Securities Investments Commission (ASIC) v McDonald (No 11)* [2009] NSWSC 287 (Gzell J) (Liability Judgment); *Australian Securities Investments Commission (ASIC) v McDonald (No 12)* [2009] NSWSC 714 (Gzell J) (Penalty Judgment)
[16] *Morley v Australian Securities and Investments Commission (ASIC)* [2010] NSWCA 331 (Spigelman CJ, Beazley and Giles JJA)
[17] *Australian Securities and Investments Commission (ASIC) v Hellicar* (2012) 247 CLR 345 (French CJ, Gummow, Hayne, Heydon, Crennan, Kiefel and Bell JJ)
[18] *Gillfillan v Australian Securities & Investments Commission (ASIC)* [2012] NSWCA 370, [15]; see also *Re GIGA Investments Pty Ltd* (1995) 17 ACSR 472 (Branson J)

to say "more may be required in a given case".[19] He gave the following examples:

(i) where the directors discuss the content of a particular document in the course of a meeting and that document is not already in the possession of every director entitled to participate, the technology being used to "hold" the meeting must be such as to enable each participating director to see the document's content at the relevant point during the meeting; and

(ii) where a document is to be "tabled" at a meeting of directors, the technology being used must be such as to allow the full content of the document to be placed before every participating director.[20]

It follows that governors participating in board meetings remotely must:

(i) be aware of each other governor's contributions to the meeting;

(ii) be able to contribute to the meeting without impediment; and

(iii)see the content of any document discussed or tabled.

(b) become familiar with the charity's business

All governors, irrespective of their professional qualifications, are expected to keep themselves properly informed of the charity's business and to apply sound judgment based on proper information. Therefore, a minimum degree of skill and competence is required of governors. This excludes the possibility that governors could escape liability by pleading that they have insufficient education or experience to understand the complexity of the charity's affairs.

This is precisely what the board members failed to do in *Commonwealth Bank of Australia v Friedrich*.[21] This case stemmed from the ruin by fraud of a company called The National Safety Council of Australia Victorian Division. The fraud was vast and its perpetrator was Mr Friedrich, the Chief

[19] *Gillfillan v Australian Securities & Investments Commission (ASIC)* [2012] NSWCA 370, [15]
[20] Ibid
[21] [1991] 5 ACSR 115 (Tadgell J)

Executive Officer of the company. He duped his fellow directors and the Commonwealth Bank of Australia, the company's principal source of finance, into believing that the company was solvent and profitable. In fact, the company was insolvent and carrying on its business at a huge and increasing loss. There was said to be a deficiency of assets of some $258 million. When the company was placed in provisional liquidation and ordered to be wound up in 1989, the CBA was owed nearly $97 million.[22]

This case is unusual and of particular interest for not-for-profits and charities because the company was one limited by guarantee and had no share capital. In 1928, the founding members guaranteed £1.1.0 – clearly, an inadequate amount to cover its debts! Consequently, the CBA brought a claim against the directors personally, each of whom served in an honorary and part-time capacity. All but one of the directors, Mr Eise, reached a compromise with the CBA. [23]

Mr Eise argued that he was an unwitting victim of Mr Friedrich's deceit and that he should, therefore, be exonerated from any suggestion of unreasonable conduct or unreasonable appreciation of the facts.[24] Conversely, the CBA argued that Mr Eise was incompetent and this, combined with a lack of due care, diligence and astuteness, meant he had failed in his duties as a director.[25]

When examining the company's structure and management, Tadgell J discussed the directors' professional qualifications. His Honour observed "that with one possible exception their talents did not extend to the field of corporate financial management".[26] His Honour then turned his attention to Mr Eise specifically, commenting:

[22] Ibid, 117-118
[23] Ibid
[24] Ibid, 121
[25] Ibid
[26] Ibid, 135

> *He claims in particular to have only a passing acquaintanceship with commercial principles. He denied on oath that he had ever learned how to read a balance sheet or a profit and loss statement… He gave me the very clear impression that, throughout his involvement with the company, he was never much disposed to concern himself with financial detail. Plainly enough, for whatever reason, he was not in the habit of studying such financial statements as he received. By and large, he confined himself to the bottom line and was content with a balance sheet that showed an excess of assets over liabilities and a profit and loss statement that showed an excess of revenue over expenditure.*[27]

Although Tadgell J expressed sympathy for Mr Eise, a 75 year old former plumber who had devoted himself enthusiastically to community service over a period of 20 or more years, his lack of education and experience and subsequent failure to understand the complexity of the company's financial affairs did not absolve him from liability.[28]

However, Tadgell J went on to observe that Mr Eise did not have to be professionally qualified in financial affairs to suspect that something was amiss. Originally, the company's objects were the provision of services and education to promote workplace, child and home, road, water and air safety.[29] However, after Mr Friedrich was appointed as CEO, there was an enormous expansion in the activities of the company in terms of staff employed, work done, property acquired (or that Mr Friedrich said had been acquired) (e.g. a mass of expensive and high-quality engineering, maintenance, medical, communications and training equipment) and fees earned (e.g. from fire fighting and search and rescue operations).[30]

Notwithstanding Mr Friedrich's dramatic expansion, the rate of it as reflected in the balance sheets and profit and loss statements was "largely illusory" and "fanciful".[31] Tadgell J said a mere comparison with other years

[27] Ibid
[28] Ibid
[29] Ibid, 130
[30] Ibid, 131, 137
[31] Ibid, 131, 140-141

would have been "enough to occasion surprise" and "naturally lead one to seek reasons".[32]

Finances aside, His Honour said that the directors should have known that the very nature of the business had moved away from not-for-profit to for-profit:

> *The whole case is to be viewed in the light of the clear fact that, over the last 5 years or more of its life, the [company] was inherently unsuitable as an organisation for the conduct of the business it had developed. The company purported to conduct itself as a commercial entrepreneur. The use for that purpose of a company limited by guarantee and having no share capital is altogether inappropriate.*[33]

Consequently, Tadgell J found in favour of the CBA, holding that the directors, including Mr Eise, did not take reasonable steps that could and should have been taken by them to obtain proper financial information.[34]

One of the lessons from this case is that governors must hone in on financial information but, at the same time, interpret that information and monitor the general direction and objects of the company by adopting a broad perspective.

(c) ask questions

It follows that if governors have any questions about any of the board's business they should:

(i) seek additional information;

(ii) obtain external advice if necessary; and

(iii)question the CEO or other person who is putting a proposal.

In *Friedrich*, the fraud was discovered when the auditor took the "simple, obvious and expedient" step of telephoning a number of the company's

[32] Ibid, 140
[33] Ibid, 200, see also 131, 139
[34] Ibid, 189

supposed trade debtors, only to find out that they were "bogus".[35] The non-existence of the supposedly newly acquired safety equipment stored in shipping containers was exposed when the auditor made a simple inquiry with the company's stores officer.[36] Tadgell J concluded that "a simple and prompt check could and should have been made which would have revealed that those assets were largely illusory".[37]

This analysis suggests that it is good practice for governors to seek additional information by telephoning and talking to debtors and workers and by conducting a physical inspection of goods if need be.

Mr Eise, together with his fellow directors, also failed to question Mr Friedrich, the CEO, when he put the following two proposals, to which the board agreed:

(i) that once a project had been approved by the board, the affixing of the seal might be attested by three senior members of the company's staff, including the CEO, general manager and the like;[38] and

(ii) that the CEO be authorised to make payments by or on behalf of the company by bank draft, telegraphic transfer, periodical payments or direct debits.[39]

The practical effect of the first resolution was that the directors put out of their hands their sighting of any document before it was executed under the company's seal. The result of the second resolution was that the directors gave Mr Friedrich sole discretion to authorise payments for the company and, conversely, they not only lost the right to sign the company's cheques and negotiable instruments, but also the ability to supervise and control the signing of these documents.[40]

[35] Ibid, 190
[36] Ibid, 190-191
[37] Ibid, 191
[38] Ibid, 142
[39] Ibid, 143
[40] Ibid

This was characteristic of Mr Friedrich's tenure as CEO: he requested a free hand in the conduct and financing of the company's operations. The board readily agreed and left many of the arrangements to him.[41]

At least two lessons can be drawn from these events. Governors should question the CEO or a person putting a proposal if:

(i) it is contrary to the company's constitution such that the constitution requires amendment for the proposal to take effect (as it did in Friedrich's case); and

(ii) it takes power away from some and puts it into the hands of one.

(d) make considered and independent decisions

While seeking out and accepting the advice of others can be an important step in reaching a decision, governors cannot wholly rely on the judgment of another governor. They must exercise their own judgment.

One of the problems in *Friedrich* was that the board members wholly relied on Mr Friedrich's judgment. For example, the company, like many charities, was partly reliant on government grants. When Mr Friedrich recommended that the company forgo government grants to improve its "image as a successful and truly independent organisation", the board unquestioningly agreed.[42]

In this situation, the board members should have asked themselves:

> *Would someone who was observing me think that I am being careful and conscientious in my duties by forgoing government grants?*
>
> *Would that person question why I support the charity developing a markedly commercial and entrepreneurial outlook?*
>
> *Would I be able to justify such a development?*

Tadgell J acknowledged that the board members' task of making considered decisions was made more difficult by the fact that Mr Friedrich

[41] Ibid, 136, 139
[42] Ibid, 139

manipulated, deceived and lied to them. However, Tadgell J found that the board was so impressed by Mr Friedrich and so caught up in all the excitement surrounding the company's "remarkable expansion" that they did not make independent decisions.[43] As His Honour put it, the board "greatly appreciated and enjoyed" the "almost euphoric sense of high achievement" that Mr Friedrich perpetuated,[44] they took "pride and great satisfaction" from the company's operational activities and they were "content" to watch the company "carry on financially by the force of its own momentum."[45]

In the James Hardie litigation, Barrett JA gave some practical advice on what it looks like when board members make considered and independent decisions. His Honour emphasised the importance of each director communicating their vote and having it taken into account:

> *Value is often attached to collegiate conduct leading to consensual decision-making, with a chair saying, after discussion of a particular proposal, "I think we are all agreed on that", intending thereby to indicate that the proposal has been approved by the votes of all present.*
>
> *Such practices are dangerous unless supplemented by appropriate formality.*
>
> *The aim is not to consult together with a view to reaching some consensus, although it may well be, as a practical matter, that such consultation facilitates the making of the decision that is ultimately required. The aim is rather that the members of the board should consult together so that individual views may be formed and the individual will of each member may be made known in a clearly communicated way.*

[43] Ibid, 136
[44] Ibid
[45] Ibid, 139

> *The culmination of the process must be such that it is possible to see (and to record) that each member, by a process of voting, actively supports the proposition before the meeting or actively opposes that proposition; or that the member refrains from both support and opposition. And it is the responsibility of an individual member to take steps to ensure that his or her will is expressed in one of those ways.*[46]

There is some protection afforded to governors by the broad common law business judgment rule, which says that the courts will normally respect the judgment of governors in business matters (that is, their decision to take or not take action in respect of a matter relevant to the business operations of the not-for-profit or charity).

This rule has since been enshrined in section 180(2) of the *Corporations Act*.[47] Although this section does not apply to charities, since it is virtually identical to the common law rule, it is prudent for governors to be mindful of its contents. It states that directors who make a business judgment are taken to meet the requirements of reasonable care and diligence and, therefore, courts will not review their decisions if they:

(i) make a judgment in good faith for a proper purpose; and

(ii) do not have a material personal interest in the subject matter of the judgment; and

(iii) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(iv) rationally believe that the judgment is in the best interests of the company. The belief that the judgment is in its best interests of the company is a rational one unless the belief is one that no reasonable person in that position would hold.

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[46] *Gilfillan v Australian Securities & Investments Commission* [2012] NSWCA 370, [8]-[11]. Note that His Honour's observations were made after the case was remitted by the High Court of Australia to the New South Wales Court of Appeal, and they have not been disturbed subsequently.

[47] There is also a similar rule in section 30B of the *Associations Incorporation Act 2009*.

In practice, this means that if a governor prepares for and attends meetings, becomes familiar with the charity's business, asks questions and makes independent and considered decisions, the courts will respect the judgment of governors. However, a failure to turn one's mind to a matter will not constitute a business judgment.[48]

Act honestly and fairly and to further the charity's purposes

The second of these governors' duties in Governance Standards 5 is actually expressed to require governors to "act in good faith in the registered entity's best interests, and to further the purposes of the registered entity". This duty is a two-part duty, which includes the duty to act in good faith and the duty to act for a proper purpose.

(a) Good Faith

There is much debate about the meaning of good faith. One school of thought is that it means that governors must act honestly or have a bona fide belief that their decision or action is in the interests of the charity.[49] That is, governors can be said to act in good faith unless they consciously and deliberately engage in conduct knowing that it is not in the interests of the charity.[50]

The second school of thought, which has received more judicial and academic support,[51] holds governors to a higher standard of behaviour. This says that it is irrelevant if governors exercise their powers according to their

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[48] *Gold Ribbon (Accountants) Pty Ltd (in liq) v Sheers* [2006] QCA 335

[49] *Meehan v Jones* (1982) 149 CLR 571, 581 (Gibbs CJ), 588 (Mason J), 597 (Wilson J); *United Group Rail Services v Rail Corp New South Wales* [2009] NSWCA 177, [70] (Allsop P)

[50] *Marchesi v Barnes* [1970] VR 434, 437 (Gowans J); *Forge v Australian Securities and Investments Commission (ASIC)* [2004] NSWCA 448, [247] (McColl JA); *Australian Securities and Investments Commission (ASIC) v Maxwell* [2006] NSWSC 1052, [109] (Brereton J); *Australian Securities and Investments Commission(ASIC) v MacDonald (No 11)* [2009] NSWSC 287, [659], [661]-[663], [665], [669]-[670] (Gzell J)

[51] *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* [2002] 41 ACSR 72, 234 [738]-[739] (Santow J); cited with approval in *Australian Securities and Investments Commission (ASIC) v Rich* [2009] NSWSC 1229, [7213] (Austin J). See also *Renard (1992)* 26 NSWLR 234, 258, 266; *Burger King Corporation v Hungry Jack's Pty Ltd* [2001] NSWCA 187, [149]; *Commonwealth Bank of Australia v Barker* (2014) 253 CLR 169, 213 [104] (Kiefel J)

personal moral compass or their "own lights" for acting honestly.[52] Otherwise, as Bowen LJ put it, you might have a "lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly *bona fide* yet perfectly irrational".[53] Rather, governors cannot be said to act in good faith if their decision is shown to be one which no reasonable board could consider to be within the interests of the charity.[54]

For example, a governor on a not-for-profit or charity board as a representative or nominee of another organisation may tell the board about the concerns of the nominee organisation. However, the governor's ultimate duty is to make decisions that are in the best interests of the not-for-profit or charity. In other words, the governor ought not to make decisions that are in the best interest of the nominee organisation.

(b) Proper Purpose

Acting for a proper purpose means that a governor must make decisions that help the charity to achieve its purpose or objective. Governors must ask themselves, "What has the charity been set up to do?"

To ensure the charity is making decisions for the right purpose, governors must not only be familiar with the aims and purposes set out in the charity's governing documents, but they must also act within the bounds of the powers conferred upon them. This generally means governors should be concerned with long-term planning rather than day-to-day administration issues, such as staffing.

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[52] *Australian Growth Resources Corporation Pty Ltd v Van Reesema* (1988) 13 ACLR 261, 272 (King CJ)
[53] *Hutton v West Cork Railway Co* [1883] 23 Ch D 654, 671; cited with approval in *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* [2002] 41 ACSR 72, 234 [738] (Santow J)
[54] *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* [2002] 41 ACSR 72, 234 [739] (Santow J)

Misuse of position or information

While serving on a board, it is likely that governors will come across information that could be used for their personal gain or to further other interests. Any such information, and any special knowledge that governors gain while serving in that position, must only be used for the benefit of the charity. Although misuse of position often goes hand in hand with misuse of information, since the Governance Standards distinguish between the two, we set out some separate examples below.

"Position" examples

If governors use their position for personal gain or to benefit a family member or friend, this would be improper conduct. Examples include:

(i) Governors actively encouraging or "causing"[55] their charity to enter into a contract, perhaps for strategic planning services, where the contract confers benefits on or gains advantages for themselves, their relatives or their friends. This includes any companies they, their relatives or their friends own or have an interest in. It is irrelevant whether the benefit or advantage is actually achieved.[56]

(ii) Governors using their position to get services that their charity provides for a friend (e.g. who suffers from a disability) who does not quite meet the charity's guidelines and purposes (e.g. prevention of homelessness).

(iii) School governors using their position to get their friend's child enrolled ahead of others on the waiting list at the school.

In all these instances, governors would be in breach of their duty.

"Information" examples

Similarly, if governors use information they have obtained through their position for personal gain or to benefit a family member or friend, they will

[55] *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* [2002] 41 ACSR 72, 234 [458] (Santow J)
[56] *Chew v R* (1992) 173 CLR 626, 633 (Mason CJ, Brennan, Gaudron and McHugh JJ)

also be in breach of their duty. For example, governors may hear about the details of a tendering process and know what quotes have been given. If they or their relative or friend operates a business that offers the services for which the charity is seeking tenders and if they use or pass on that information to undercut other quotes, this would be improper conduct.

It follows that one of the responsibilities of governors is to keep information they are privy to confidential. The information can and must only be used in the interests of their charity.

Conflict of interest

When do conflicts of interest occur?

Conflicts of interest occur when the governors' duty to act in the best interests of their charity is or may be in conflict with the opportunity or potential to get a personal benefit (or a benefit for a person or organisation with whom they have a relationship).

Actual and perceived conflicts of interest

An actual conflict of interest exists where, for example, governors decide to contract personally with the not-for-profit or charity to provide a service or to supply goods. In that situation, the governors want to do the best by themselves but at the same time have a duty to act in the best interests of their charity.

A perceived conflict of interest exists where, for example, governors are reviewing quotes for a service and one of the potential providers is the employer of a governor's sibling. While the governor might believe that an impartial decision can be made in the best interests of the charity, it could be perceived as being made in their own interest.[57]

For these reasons, the law generally prohibits payments to governors and their companies, relatives and friends for goods and services unless the

[57] Australian Charities and Not-for-profits Commission, *Managing conflicts of interest guide – About conflicts of interest* (July 2013) Australian Government <http://www.acnc.gov.au/ACNC/Pblctns/Guides/ACNC/Publications/COIguide/COIGuide3.aspx>

terms are not more favourable than could be obtained at arm's length from a third party. The Returned & Services League of Australia (South Australia Branch) Incorporated (RSL SA) learnt this the hard way when, in early 2017, the ACNC commenced an investigation into its governance.

In its August 2017 report of the investigation, the ACNC criticised the failure of the RSL SA to manage actual and potential conflicts of interest, in particular its use of firms of lawyers and accountants, two of whose partners were former board members. The specific failures of the RSL SA included:

(i) it did not have a competitive tendering process before hiring both firms;

(ii) no quotes had been obtained before their appointment;

(iii) there was no agreement or contract with the firms; and

(iv) the invoices from each firm were signed by the governors associated with those firms.

Although the then president, Mr Hanna, said that the relationship between the RSL and the firms was based on a "very clear understanding… [and] on a very long course of conduct", the ACNC said that it did not consider this explanation to be a "sufficient and transparent agreement".[58] It follows that it is not enough to engage a governor's company on the basis that there is a long running association or because it has charged reasonably in the past.

As a consequence of the ACNC's investigation into the RSL SA's activities and operations, on 23 August 2017, the charity entered into a Compliance Agreement with the ACNC to resolve its governance issues.[59]

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[58] Renato Castello, 'Investigation into RSL SA branch finds former boss Tim Hanna received $8769 on the day charity was placed into administration', *The Advertiser* (Adelaide), 19 August 2017 <http://www.adelaidenow.com.au/business/investigation-into-rsl-sa-branch-finds-former-boss-tim-hanna-received-8769-on-the-day-charity-was-placed-into-administration/news-story/b591fcea1b495e7128899187bd7b5fc7>

[59] Australian Charities and not-for-profits Commission, *ACNC charity compliance decisions* (23 August 2017) Australian Government <http://www.acnc.gov.au/ACNC/About_ACNC/Regulatory_app/ComplianceDecisions/ACNC/Regulatory/ComplianceDecisions.aspx>

What should board members do?

If governors have a conflict of interest, or even if they perceive that they might have a conflict, they should:

(i) inform their board as soon as possible; and

(ii) not take part in any discussion or decision-making where they have a conflict – this is not only a good idea but it is often required by the board's rules or the legislation applying to charities.

Conflicts of interest are common and do not have to be a serious problem. It is important to manage conflicts of interest properly to avoid damaging a charity's reputation and, in serious cases, even breaking the law.

A good way for governors to gauge whether they need to disclose and manage a conflict of interest is for them to ask themselves:

> *Would an independent observer be sure that I was only acting in the best interests of my charity? Or might they think I was acting in some way for my own interest?"*

Financial management and insolvency

Donations and financial management

Most charities receive donations from the general public and may also receive government funding and taxation concessions or exemptions. This is one reason why charities must have sound financial management practices in place. Such practices are designed to ensure that a charity's resources are used effectively and protected from misuse.

Examples of financial controls

But what do such management practices look like? Charities should have appropriate and tailored financial systems and processes in place, which are suitable for their size, their circumstances and the complexity of their financial affairs. Some financial controls available are:

(i) requiring multiple signatures to authorise and complete payments and receipts;

(ii) establishing an annual budget and tracking performance against it throughout the year;

(iii) providing up-to-date financial reports to the board at regular intervals – it is also worth considering establishing a board sub-committee (which could include one or two people who are not board members to provide an extra level of accountability) with responsibility for reviewing financial reports in greater detail and providing advice to the board on financial matters;

(iv) establishing clear financial delegations; for example, a board might decide that the CEO can spend up to $5,000 before requiring its approval for any expenditure; and

(v) keeping information about bank accounts safe by making sure any passwords to online banking are kept secure and that there is limited access to them.[60]

Payment of Governors

While most charity governors are not paid, serving as volunteers, all charities are different and there are different views about the appropriateness of paying governors. The ultimate test is: *Is paying governors in the best interests of the charity?*

The answers will vary depending on the nature and complexity of the charity and the skills and time required of governors.

Governors may be paid as long as doing so furthers the charity's purpose, is allowed under its governing rules, is properly authorised, and is conducted in a transparent and robust way. This is consistent with the obligations of governors under the ACNC's Governance Standards.[61] Governors must act

[60] Australian Charities and Not-for-profits Commission, *Managing Charity Money: Guide for board members on managing finances and meeting ACNC duties* (January 2016) Australian Government, 6 <http://www.acnc.gov.au/ACNC/Publications/Charity_money/Managing_charity_money_-_guide_for_board_members.aspx>.

[61] The ACNC published guidance on 12 July 2017 aimed at providing charities with practical advice on paying their board members. www.acnc.gov.au/ACNC/Edu/Remunerating.aspx

in the best interests of their charity and manage its finances in a responsible way.

Solvency and insolvency

Governors must ensure that their charity can pay its debts when they are due. This is a simple test of solvency. If the charity is unable to do this, it will probably be insolvent. Governors must not allow their charity to continue to take on new debts (for example, wages, rent and equipment lease payments) if they know the charity will not be able to pay those bills when they are due.

In its recent investigation into the RSL SA, the ACNC found that the president, Mr Hanna, sought and received payments of $8,769 for his president's allowance and phone expenses on the day the charity was placed in administration. Although Mr Hanna was entitled to the payments, the ACNC said that he "would have known" of the RSL SA's financial situation and, therefore, attempted to benefit himself ahead of the creditors (the RSL SA owed its lawyers $92,410 and its accountants $322,332, although the later waived its debt).[62]

On a much larger scale, in *Friedrich*, the National Safety Council of Australia Victorian Division represented to major Australian banks that "it was solvent and profitable".[63] In fact, it was insolvent and "carrying on its business at a huge and increasing loss",[64] owing $258 million to the banks. As previously stated, one of the directors, Mr Eise, was found to be personally liable for almost $100 million.

These situations reinforce the importance of not allowing a charity to operate while insolvent.

[62] Castello, above note 58
[63] [1991] 5 ACSR 115, 118 (Tadgell J)
[64] Ibid

Other duties

As with for-profit entities, not-for-profits and charities must meet a range of legal requirements imposed by state and federal laws. Sometimes this regulation is specific to charities (for example, charitable fundraising); sometimes to charities and other not-for-profits (for example, legal structures); and sometimes to not-for-profits, charities and for-profits (for example, work health and safety and employment). Often there will be different requirements depending on the type of activities the charity does (such as working with children or providing aged care services). We deal with just a few of these areas now.

Work health and safety

The *Work Health and Safety Act 2011* (NSW) imposes duties on everyone at a workplace. However, the duties vary depending on a person's level of responsibility. The most significant duties are imposed on the persons conducting the business or undertaking[65] and on the officers of such persons.[66] Officers include governors.[67]

Section 5 explains what is meant by a "person conducting a business or undertaking" and makes it clear that a volunteer association does not conduct a business or undertaking. In this context, a volunteer association means a group of volunteers working together for one or more community purposes when none of the volunteers, whether alone or jointly with any other volunteers, employs any person to carry out work for the volunteer association. A volunteer is a person who is acting on a voluntary basis (irrespective of whether the person receives out-of-pocket expenses).[68]

Therefore, the Act does not apply to a typically small not-for-profit or charity whose committee members and supporters are all volunteers and which does not employ anyone. On the other hand, the Act does apply to all other not-for-profits and charities, which conduct a business or undertaking.

[65] Section 19
[66] Section 27
[67] See the definition in section 4
[68] See the definition in section 4

A volunteer is still a worker for the purposes of the Act if the person carries out any work in a voluntary capacity for a person conducting a business or undertaking.[69] This means that volunteers carrying out work for not-for-profits and charities, which are not volunteer associations, do receive the benefit of the protection afforded by the Act.

As noted earlier, the governors of not-for-profits and charities are often volunteers. Such unpaid governors are expected to exercise due diligence to ensure that their not-for-profit or charity complies with its obligations under the Act.[70] However, the governors are exempt from prosecution under the Act for failing to comply with the duty to exercise due diligence.[71] Essentially, the governors cannot be prosecuted because of the decisions they make in their meetings.

However, the governors are not exempt from all offences under the Act. They may still be prosecuted if they breach their duties as "workers"[72] and "other persons at the workplace".[73] These duties include taking reasonable care for their own safety and the safety of others and complying with reasonable instructions given by the person conducting the business or undertaking. Governors may be prosecuted for breaching these duties, just as an employee or someone else at the workplace could be.

There are some other offences under the Act for which volunteers are not exempt. For example, it is an offence to hinder or obstruct a SafeWork investigation.[74] The governors could be prosecuted if they obstruct an investigation.

There are also other enforcement measures in the Act[75], which may be enforced against governors personally if they breach the Act. These other enforcement measures include improvement notices, prohibition notices,

[69] Section 7(1)
[70] Section 27. It is beyond the scope of this paper to explore in detail what is required to fulfil the duty to exercise due diligence.
[71] Section 34(1)
[72] Section 28
[73] Section 29
[74] Section 188
[75] Part 10

non-disturbance notices, remedial action and injunctions. SafeWork NSW is more likely to enforce these measures against the not-for-profit or charity or its Chief Executive Officer but it could enforce them against a governor in some circumstances.

Taxation

Directors of all companies, not-for-profit or for-profit, that fail to meet a Pay As You Go withholding or Superannuation Guarantee Charge liability by the due date are personally liable for a penalty equal to the unpaid amount. The Commissioner of Taxation may issue not-for-profit and charity directors with a "director penalty notice" for a penalty which is equal to the not-for-profit's or charity's unpaid PAYG and SGC liabilities. If the director fails to take appropriate steps within 21 days, the Commissioner may take recovery action against the director personally to recover that penalty.

Discrimination

The anti-discrimination legislation in Australia, federal and state, contains no universal exemption for charities and not-for-profits. Some not-for-profits are exempt from certain provisions of the anti-discrimination legislation. For example, nothing in Division 1 or 2 of the *Sex Discrimination Act 1984* (Cth) renders it unlawful for a voluntary body to discriminate against a person, on the ground of the person's sex, sexual orientation, gender identity, intersex status, marital or relationship status, pregnancy, breastfeeding or family responsibilities, in connection with:

(a) the admission of persons as members of the body; or

(b) the provision of benefits, facilities or services to members of the body.[76]

A voluntary body is an association or other body (whether incorporated or unincorporated) the activities of which are not engaged in for the purpose of making a profit but does not include:

[76] Section 39 *Sex Discrimination Act 1984*

(a) a club with at least 30 members that, amongst other things, sells or supplies liquor for consumption on its premises;

(b) an employer or employee association;

(c) a body established by a law of the Commonwealth, of a State or of a Territory; or

(d) an association that provides grants, loans, credit or finance to its members.[77]

There are similar but different provisions in the *Disability Discrimination Act 1984* (Cth).

There are some specific exemptions; for example, the exemption for religious bodies in section 37 of the *Sex Discrimination Act 1984* (Cth).

Most anti-discrimination legislation contains provisions that can make a governor liable where the governor has caused, instructed, induced, aided or permitted another person to do an act that is unlawful.[78]

A prerequisite for such accessorial liability is that someone has engaged in unlawful conduct. If that someone is the not-for-profit or charity, it could be that the unlawful conduct is actually of a third party to whom the not-for-profit or charity is vicariously liable.[79] Accordingly, if the not-for-profit or charity is exempt because of one or more of the provisions referred to above, a governor of that not-for-profit or charity cannot have accessorial liability.

Not all not-for-profits or charities are exempt. In those cases, governors may have accessorial liability. This could be the case where a governor permitted an employee or volunteer to discriminate against another person on a prohibited ground (for example, race, sex, gender, sexual orientation and so on) knowing or having "reasonable grounds for believing that there

[77] Section 4 *Sex Discrimination Act 1984*
[78] For example, section 105 *Sex Discrimination Act 1984*, section 122 *Disability Discrimination Act 1992*
[79] For example, section 106 *Sex Discrimination Act 1984*

was a material chance that the [other person] was at risk of being discriminated against" on a prohibited ground.[80]

Conclusion

As Rob Elliott, a former Executive Director and General Counsel of the Australian Institute of Company Directors, once said:

> *It is no longer a case of being able to join a board and have it be a nice, happy place to go, without there being much chance of things going wrong, or being held accountable if things do go wrong. Those days are gone.*

As outlined in this paper, those who joined the board of a charity or not-for-profit have significant duties. Breaching these duties can have serious consequences. Accordingly, governors must become aware of their duties and the practical implications of fulfilling them.

However, even though being a governor carries these duties, they are manageable and the reward for taking on the governor's role is great as the furtherance of the charitable and other objects of the charity or not-for-profit will often make a special difference in the lives of people or otherwise bring about improvement in our society and our world.

[80] *Elliott v Nanda & Commonwealth* [2001] FCA 418 at [169]