Where DOES the buck stop?

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The legal liability of arts administrators and boards of management in South Australia.

In 1992 amendments were made to the *Associations Incorporation Act 1985* (SA) (the Act) which had the effect of increasing the legal liability of board of management members and administrators of associations incorporated under that Act.

Arts and other community organisations are generally established pursuant to the Act. The funding bodies which support arts organisations usually require that grants be held by an incorporated body. However, the board members of such organisations, particularly voluntary community board members, are often unaware of the legal duties attached to their positions. There has been some debate in the press and other forums about the extent of these duties and whether they will operate as a disincentive to people who voluntarily provide their services as board members of such organisations.[1]

The purpose of this article is to provide a clear outline of the main legal duties of administrators and members of boards of management under the Act and some guidelines on how these duties can be met. Other areas in which duties may arise will be mentioned and options for insuring administrators and boards of management will be considered.

Duties in the context of limited liability

The Act confers the benefits of limited liability on the members of arts and other non-profit organisations. This means that unless the rules of the association provide otherwise, the members of the association are not liable to contribute towards the payment of the debts and liabilities of the association or any winding up costs incurred by the association (s.21(2)). In return for this benefit, administrators and board members of such organisations are subjected to certain duties.

Some of these duties derive from the common law and equity; others are specifically set out in the Act and other legislation.

While it is beyond the scope of this article to consider the general law duties in any detail, for the sake of completeness they are mentioned below. The four main fiduciary duties include:

- the duty to act in good faith,
- the duty to exercise powers for proper purpose,
- the duty to avoid conflicts of interest, and
- the duty to retain discretions.

These duties arise from the fact that board members are *entrusted* with the general and financial management of the association and are therefore required to carry out their functions honestly and in the best interests of the association.

The main common law duty is the duty to exercise care, diligence and skill. This duty has been largely incorporated into the Act as has the duty not to prejudice creditors' interests where the association is

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suffering financial instability to such a degree that its creditors' money is at risk.[2] These duties will therefore feature in the discussion below.

As alluded to previously, the legislative duties that apply to administrators and board members are not necessarily confined to the Act. For example, duties may arise under various pieces of legislation dealing with specific subject matter such as occupational health safety and welfare, equal opportunity or environmental legislation. For the purpose of this article, I will confine my discussion to the duties arising under the Act.

Definition of officer (s.3)

Officer of an incorporated association means—

(a) any person who—

(i) occupies or acts in a position of—

(A) a member of the committee of the association; or

(B) the secretary, treasurer or public officer of the association; or

(ii) is concerned, or takes part in, the management of the affairs of the association,
by whatever name called and whether or not validly appointed to occupy or duly authorised to act in the position; or

(b) the holder of any other office established by the rules of the association (except a patron or the holder of some other honorary office that confers no right to participate in the management of the affairs of the association); or

(c) any person in accordance with whose directions or instructions the committee of the association is accustomed to act.

This new definition (effective from mid-1993) covers not only members of the committee, secretaries, treasurers, public officers and people taking part in the management of the association, but also people who act in any of those positions, regardless of title, and whether or not they are validly appointed or authorised to act in the position. Also included are people in accordance with whose directions or instructions the committee of the association is accustomed to act. Hence, it is clear that employees of an association as well as other people assisting in the management of the association can fall within this definition. This is a significant change because prior to the amendments most of the legal duties only applied to committee members whereas they now can extend to cover administrators.

Management of Incorporated Associations

Those people who have power to administer the affairs of the association pursuant to its rules constitute the committee of the association (s.29(1)) and, subject to those rules, employees may be appointed as committee members (s.29(2)).

The committee is usually referred to as the board of management. Insolvents under administration or people convicted of various offences of dishonesty or breach of duty are prohibited from taking part in the management of an association without leave of the State Business and Corporate Affairs Commission (s.30). Contravention of s.30 can result in a maximum fine of up to $4000.

Even if employees have not been appointed as committee members, they may still come within the definition of officer referred to earlier if they are concerned or take part in the management of the affairs of the association (s.3). Most administrators would fall within this category.

Some of the duties set out in the Act apply to committee members only. Others specifically apply to employees and, in at least one instance, former employees as well as officers.

Duties of officers and employees

Duty not to make improper use of information or position

Officers and employees must not make improper use of their position or of information acquired by virtue of their position so as to:

- gain any pecuniary benefit or material advantage for themselves or any other person, or
- cause detriment to the association (s.39A(2) and (3)).

The prohibition on misuse of inside information extends to *former* officers and employees. Breach of either duty can result in a maximum fine of up to $15,000 or imprisonment for up to four years. In addition, a person in breach is liable to the association for any profit made by that person or any damage suffered by the association as a result of the breach (s.39A(5)).

This duty is expressed in very broad terms. There is no need for the association to suffer detriment; it is sufficient if someone gains an advantage. Thus, the sorts of activities covered here would include using information for the purpose of securing jobs or contracts between the association and related people such as children or spouses; making personal profits as a result of knowledge derived in the position; using information gained in previous employment with the association in order to compete with the association; taking up opportunities which should have been taken up by the association; accepting bribes; and mixing association funds with personal funds; to name a few.

Although no cases have as yet been brought under the new provisions, the duty is expressed in almost identical terms to that set out in s.232(5) and (6) of the federal Corporations Law. Therefore, cases such as *Chew v R* (1992) 10 ACLC 816; *Cummings & Anor v Claremont Petroleum NL* (1993) 11 ACLC 125; *Grove v Flavel* (1986) 4 ACLC 654; *Jeffree v NCSC* (1989) 7 ACLC 556; and *R v Donald* (1993) 11 ACLC 712 will be relevant to interpreting these sub-sections.

Duties of officers

Duty to act honestly

An officer of an incorporated association must not commit any act with intent to deceive or defraud the association or its members or creditors (s.39A(1)).

Breach of this duty can result in a fine of up to $15,000 or imprisonment for up to four years. In addition, fraudulent officers are liable to the association for any profit made by them or damage suffered by the association (s.39A(5)).

This duty would cover situations where there has been intentional fraud such as misappropriation of grant moneys, membership subscriptions or other funds of the association.

Although the section does not cover employees who are not officers, such people would be covered by the false pretences and fraudulent misappropriation provisions contained in the South Australian *Criminal Law Consolidation Act 1935* (SA) (as amended). In addition, any officers who knew or should have known of the fraud or deceit may be personally liable to the organisation for having breached their duty to act with reasonable care and diligence.

Duty to act with reasonable care and diligence

The duties considered so far are mainly designed to prevent management self-dealing or dishonesty. On the other hand, the duty to act with reasonable care and diligence is directed toward the problem of shirking responsibility, laziness or plain ignorance.

Officers of *prescribed* associations, (currently defined in s.3 as associations with gross receipts in excess of $200,000 in the last financial year) must at all times act with reasonable care and diligence in the exercise of their powers and the discharge of their duties (s.39A(4)). 'Gross receipts' include grants and other subsidies from government but exclude subscriptions, bequests and proceeds from the sale of assets not originally purchased for resale (s.3).

This duty is similar to the common law duty owed by directors to their company and also embodied in s.232(4) of the Corporations Law. Thus, the cases dealing with the directors' duty to exercise care and diligence may be of assistance, particularly in relation to understanding the *standard* of care and diligence required.

One of the most frequently cited cases in this area is that of *AWA Ltd v Daniels t/a Deloitte Haskins & Sells & Ors* (1992) 10 ACLC 933 *(AWA)* which reaffirms to a large extent the principles laid down by Romer J in *Re City Equitable Fire Insurance Co. Ltd* (1925) 1 407 more than 70 years ago, albeit with some modifications. Although the principles in that case were expressed to apply to directors of corporations, they would arguably apply with equal weight to officers of incorporated associations. The main principles are:

- **A director need not exhibit a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience.**

In the context of incorporated associations, the implication here is that administrators or board members who are appointed for their special skills may bear a higher standard of care than ordinary board members. While skill is not referred to in s.39A(4), presumably this duty would still exist at common law.

- **A non-executive director (that is, a director who is not full-time) is not bound to give continuous attention to the affairs of the company whereas an executive director is (*AWA* at 1014).**

The Chairperson is responsible to a greater extent than any other director (except the managing director) for the performance of the board as a whole and each member of it due to the responsibilities of that position (*AWA* at 1015)

Arguably, the importance of the different roles is equally relevant in the context of incorporated associations, although the legislation is silent on this point. The trend in other areas of the law such as liability for insolvent trading is to eliminate such distinctions and it is likely that this will carry over into the duty of care and diligence.

An additional qualification on the above principles is that directors must take reasonable steps to place themselves in a position to guide and monitor the company. They are obliged to at least obtain a general understanding of the business of the company and the effect that a changing economy may have on that business and must bring an informed and independent judgment to bear on the various matters that come before the board for decision (*AWA* per Roger CJ at 1012-13 quoted with approval by the Full Court of WA in *ASC v Gallagher* (1993) 11 ACLC 286 at 295; confirmed in *Daniels v Anderson; Hooke v Daniels; Daniels v AWA* (1995) 13 ACLC 614).

- **If there has been a valid and reasonable delegation, then in the absence of grounds for suspicion, the director is justified in trusting the official to perform such duties honestly (*AWA* at 1015).**

This last principle again, may be subject to qualification where a director has been placed in the office specifically to make enquiries, thereby safeguarding the interests of those whom she or he represents. (See for example, *Permanent Building Society (in liq) v Wheeler* (1994) 12 ACLC 674.)

There has been debate in the legal community about whether the duty of care and diligence is and should be objective or subjective. It seems that the courts and legislature are both moving toward an objective standard, albeit fairly slowly. Under s.39A(4) of *the Associations Incorporation Act* an officer who breaches the duty of reasonable care and diligence may be liable to a maximum fine of $1000 and is liable to the association for any damage suffered as a result (s.39A(5)).

This duty is an all-embracing duty which applies to officers in carrying out all their functions. As such, whether the duty has been fulfilled will be a question which is relevant in many situations. For example, if an incorporated association enters into a contract which is not within its objects and therefore beyond its powers, s.27 of the Act provides that, unless the person contracting with the association had *actual* notice of the deficiency the contract must be honoured (see also s.28). Here, the question arises whether the officers involved, and any other officers who should have known about the contract, had acted with reasonable care and diligence. If they have not, then they may be liable to the association for any damage suffered as a result (s.39A(5)). Similarly, if officers of the association suspect fraud but fail to act, they may also be in breach of this duty.

Duty to assist auditors

An officer of a prescribed association must not refuse or fail to allow auditors access to accounting and other records of the association; refuse or fail to give explanations as and when required by the auditor or otherwise hinder an auditor in the exercise of his or her powers. Penalty for contravention of this provision is a maximum fine of $1000 (s.37(2)).

Officers are prevented from being appointed as auditors as are their partners, employers, employees (s.35(4)).

Duty to keep minutes and accounting records

All incorporated associations, whether prescribed or not, are under a duty to keep such accounting records as correctly record and explain the transactions and the financial position of the association (s.39C). They must also keep minutes of all proceedings of general meetings and of meetings of the committee. In addition, these minutes must be confirmed by members of the association present at a subsequent meeting and signed by the presiding member (s.51(1)).

If a prescribed association fails to comply with these requirements then the association and any officer in default are each guilty of an offence carrying a maximum penalty of $2000 (s.39C(3) and s51(1)). For other associations the maximum penalty is $1000 (s.39C(3)).

Minutes must be kept at the association's office or in the custody of an officer in accordance with the rules and that the minutes of any general meetings must be made available for inspection by members without charge. Failure to comply

with these requirements results in an offence being committed by the association and any officer in default, for which the penalties are $2000 in relation to prescribed associations and $1000 in any other case (s.51(5)-(7)).

Incorporated associations who have not been careful about keeping minutes should note these requirements.

Duty not to secure profits for members

Apart from reasonable remuneration for work performed, an incorporated association must not act so as to secure profit for members or their associates (s.55). An officer of an association who is knowingly concerned in or party to a breach of s.55 is guilty of an offence and liable to a fine of up to $4000 and/or imprisonment for one year (s.55(4)).

Duty to secure compliance with the Act

Section 57 of the Act provides that if an officer of an incorporated association fails to take all reasonable steps to secure compliance by the association with its obligations under the Act or conditions imposed by the Commission, the officer is guilty of an offence and liable to a maximum fine of $1000.

This is a catch-all provision which highlights the need for incorporated associations and their officers to be fully cognisant of their obligations under the Act.

Duties of committee members

In addition to all of the duties listed above, committee members are under the following obligations in relation to the association and, in some cases, its creditors.

Duty to disclose any interest in contracts with the association

Board members of an incorporated association who have any direct or indirect pecuniary interest in a contract, or proposed contract, with the association must, as soon as they become aware of their interest, disclose the nature and extent of their interest to the committee and at the next annual general meeting of the association. In addition, they must not take part in any decision of the committee with respect to that contract. Failure to comply with these requirements can result in a fine of up to $4000 (ss.31 and 32), avoidance of the contract by the association and/or an account of profits received by the member (s.62A(4)).

The disclosure requirements do not apply in respect of a pecuniary interest that exists only by virtue of the fact:

(a) that the member of the committee is an employee of the association; or

(b) that the member of the committee is a member of a class of people for whose benefit the association is established; or

(c) that the member of the committee has the pecuniary interest in common with all or a substantial proportion of the members of the association (s.31(2)).

The requirement not to vote applies in relation to (a) but does not apply in relation to (b) and (c) above. This means that administrators or other employees who are also board members *must not* take part in any decision of the committee with respect to their employment contracts.

Duty to keep proper accounting records (s.35)

A prescribed association must keep its accounting records in such a manner as will enable first, the preparation of accounts that present fairly the results of the operation of the association and second, the accounts of the association to be conveniently and properly audited (s.35(1)).

After the end of a financial year the association must have accounts for the financial year prepared and must attach a committee statement, signed by at least two committee members, to the accounts stating that:

(A) the accounts present fairly the results of the operations of the association for the financial year and the state of affairs of the association as at the end of the financial year; and

(B) the committee has reasonable grounds to believe that the association will be able to pay its debts as and when they fall due; and

giving particulars:

(A) of any body corporate that is a subsidiary of the association within the meaning of section 46 of the Corporations Law; and

(B) of any trust of which the association is a trustee.

The association must then have those accounts audited (s.35(2)).

Also, the committee must report on whether any officer of the association has, directly or indirectly, received or become entitled to receive any benefits from the association and if so the general nature and extent of those benefits (s.35(5)).

The committee of a prescribed association that has members must then ensure that the accounts, the committee statements and the audited reports are laid before members of the association at the annual general meeting of the association or, if an annual general meeting is not to be held, within five months of the end of the financial year to which the accounts relate (s.35(6)).

Committee members who fail to take all reasonable steps to comply with or secure compliance with the above requirements are guilty of an offence and liable to a penalty of $15,000 or imprisonment for four years where the offence is committed fraudulently. In any other case the penalty is $4000 (s.35(7)).

Duty not to incur debts where there are reasonable grounds to believe the association is insolvent

Section 41B of the Act incorporates ss.589 to 596 and s.1307 of the Corporations Law. In doing so, it creates a number of offences for which committee members may be liable (for the purpose of s.41B the provisions of the Corporations Law apply as if a reference to 'director' or 'officer' were a reference to a member of the committee of an incorporated association (reg.10)).

Section 41B came into operation on 1 June 1993. Most significantly, it incorporates s.592 (now s.588G) of the Corporations Law which imposes a duty not to incur debts when there are reasonable grounds to believe the association is insolvent. The Corporations Law was substantially amended by the *Corporate Law Reform Act 1992* which commenced operation on 23 June 1993. Section 592 was replaced by Part 5.7B and in particular, s.588G.

Therefore, s.592 of the Corporations Law will apply to debts incurred between 1 June 1993 (the date on which s.41B came into operation) and 23 June 1993 (the date on which the Corporations Law was amended) and Part 5.7B of the Corporations Law will apply to all debts incurred after 22 June 1993.

For the purposes of the Act s.588G of the Corporations Law will apply where—

- a person is a committee member of an association at the time when the association incurs a debt; and

- the association is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
- at that time, there are reasonable grounds for suspecting that the association is insolvent, or would so become insolvent; and
- the committee member is aware at that time that there are such grounds for so suspecting; *or* a reasonable person in a like position in an association in the association's circumstances would be so aware.

The last part of the above formulation contains an objective element. Even if the committee member was not aware at the relevant time that objectively, there were reasonable grounds for suspecting that the association was or would become insolvent, there will be liability if a reasonable person in a like position would be so aware.

Insolvent is defined to mean an inability to pay debts as and when they become due and payable (s.95A Corporations Law). In addition, s.588E contains certain presumptions of insolvency, for example, where there has been a failure to keep adequate accounting records.

There are a number of cases in this area mostly decided under the old s592 and its predecessor. Those cases indicate that the standard of care expected here is greater than that required in relation to the duty of care and diligence discussed above.

In *Commonwealth Bank of Australia v Friedrich & Others* (1991) 4 ASCR 115 at 126 Tadgell J of the Victorian Supreme Court said '. . . the stage has been reached when a director is expected to be capable of understanding his company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity'. Similarly, the Full Court of the Victorian Supreme Court in *Morley v Statewide Tobacco Services Ltd* (1992) 10 ACLC 1233 at 1245 said 'A director should not . . . be entitled to hide behind the ignorance of the company's affairs which is of his own making, or if not entirely of his own making, has been contributed to by his own failure to make further necessary enquiries'(See also *Group Four Industries v Brosnan* (1992) 10 ACLC 1437 at 1470 where the Supreme Court of South Australia held that it was no defence to a s.588G action for a passive director to say that she had left the running of the family business completely to her husband. Directors, including non-executive directors, must be aware of both the state of indebtedness of the company and the financial position of the company.)

There are certain defences which may be raised in relation to the duty to prevent insolvent trading, namely that:

- at the time when the debt was incurred, the director had reasonable grounds to expect and did expect that the company was solvent and at that time would remain solvent even if it incurred that debt;
- the director believed on reasonable grounds that a competent and reliable person was providing adequate information about the solvency of the company to the director and, on the basis of that information the director thought the company was solvent and would remain so;
- at the time the debt was incurred, because of illness or for some other good reason, the director did not take part in the management of the company; and/or
- the director took all reasonable steps to prevent the company incurring the debt (s.588H).

Under the Act the penalty for breach of this duty is a maximum fine of $4000 and/or imprisonment for one year (s.41B(2); Schedule 1). In addition, a liquidator, in the first instance, and thereafter creditors could recover compensation from the people in breach (ss.588J and 588M Corporations Law). In any event, the person in breach can be ordered to pay to the association the amount of any loss or damage (s.62A(4)).

So, we know the duties, what's the risk?

There has been some debate in the media and other circles about the amount of risk volunteer committee members of community organisations and other incorporated associations really face, particularly in relation to the insolvent trading provisions.[3]

It has been suggested that hundreds of volunteer directors or officials from community groups and sporting clubs are now at risk of personal bankruptcy from legal action against the groups and that volunteer directors should check with their board to ensure arrangements had been made to protect them before agreeing to continue serving on the board.[4] At least one writer has suggested, rather cynically, that this view has been promoted mainly by people who will benefit from increased litigation or from an increased demand for insurance.[5]

It is true that volunteer directors can now be sued personally if their organisation becomes insolvent due to their decisions. It is also true that there have been no reported cases of board member liability under the *Associations Incorporation Act* or similar legislation.[6] Although the duties owed by administrators and board members are expressed in similar and sometimes identical terms to the duties owed by managers and directors of companies incorporated under the Corporations Law, the question in this context is whether those duties will ultimately be interpreted in the same way.

This question does involve a degree of speculation. However, in my opinion, the courts *are* likely to treat directors of companies and board members of incorporated associations in the same way: after all, whether it's 500 dollars or five million, it is still public money we are talking about and the duties to act honestly, to exercise care and diligence and not to incur debts when there are reasonable grounds to believe they cannot be paid should apply with equal force.

There are some who might argue that these duties, if interpreted too strictly, will deter diligent volunteers from taking a role in the running of non-profit organisations. One response to such an argument could be that if they are truly diligent, they have nothing to fear. A board member or administrator who knows the state of affairs of the association, who makes properly informed decisions and who acts honestly and with care in all other respects cannot be held liable to the association or anyone else.

Risk minimisation

Ensuring the duties are met

One of the best strategies which can be used to avoid personal liability is to ensure that all board members, administrators and employees are aware of their duties and act in accordance with those duties. The standards of conduct expected in relation to specific duties have been discussed above, but there are also some general strategies which may be useful depending on the activities of the particular organisation. [7]

In all organisations where board members or administrators suspect that something is wrong or that an employee, administrator, or other board member has breached or is about to breach a duty, they must bring the matter to the attention of the board and ensure that their concerns are minuted in clear terms and that appropriate follow up action is taken.

In terms of the financial management of organisations, checks and balances and other controls should be put in place in order to ensure that budgets are not exceeded. All budgets should be monitored and evaluated by the board at regular intervals. There should be clear and accurate lines of authority so as to ensure that the board is consulted whenever circumstances which affect the financial position of the organisation change. Accurate job descriptions will also ensure that board members have a clear idea of who has responsibility for what and are able to get any information which they may require form time to time.

Some further strategies are:

- Schedules could be developed so as to ensure regular review of matters such as maintenance of premises, working conditions of employees, advertising, and other general management items.
- Effective investigation procedures can be formulated so as to ensure that when questions are asked they are dealt with fairly and effectively.
- There should be certain minimum reporting requirements from the administration to the board and the board to the members (where there are members).
- All new board members and employees should be made aware of their obligations and of the minimum knowledge requirements which they must have under the Act.
- If standard procedures are developed in order to ensure that the various duties are met, then those procedures should be followed.
- It may also be useful to develop checklists in relation to the various activities of the organisation. As one practitioner has noted, this procedure in itself is an activity which is consistent with the use of reasonable care and diligence in the management of an organisation.[8] Obviously, such checklists would have to be meaningful in that they should cover all the relevant issues.

Insurance

Another means of minimising risk is through insurance. Section 39B of the Act prohibits the indemnification of officers or auditors from any liability to the association for any negligence, default, breach of duty or breach of trust, unless the officer or auditor concerned receives a favourable judgment or acquittal. This provision, however, does not prevent the association taking out insurance.

Various types of insurance policies are available for incorporated associations, their board members and their administrators. Insurance can protect an organisation against losses incurred as a result of breach of duty by an administrator or board member including fraudulent or dishonest behaviour.[9] It can also protect individual administrators and board members against personal liability in certain circumstances.[10]

The problem is that such insurance policies are generally not widely available, are not standardised and can be very expensive, particularly for small organisations with limited funds. In addition, there is a question mark over whether the cost of such insurance can be considered part of an organisation's operating costs in accordance with funding body requirements.[11] There has been a suggestion that if arts organisations got together and formed an umbrella organisation, it might be possible to develop some standardised cover which would reduce the cost for everyone. However, it is thought that a significant number of organisations would need to participate before an insurance company would be prepared to get involved.[12]

Conclusion

The potential legal liability of arts administrators and members of boards of management in South Australia has increased as a result of amendments to the *Associations Incorporation Act 1985* (SA). This increased responsibility is not something to be feared but it is something to be conscious of so that proper procedures can be put in place to minimise the risk of personal liability. The greatest risk is in choosing to remain ignorant.

References

1. Male, A., 'Bankruptcy threat hangs over volunteer leaders', 15 February 1995 *Messenger Guardian,* p.1; Sarre, A., Letter to the editor, 8 March 1995 *Messenger Guardia.* p.2; Harley, G., 'Associations Duties and Liabilities of the Board' (1994) 16(10) *Bulletin* 20; Sinclair, A., 'Association members may be personally liable' (1995) 17(1) *Bulletin* 27; Eckert, W., ' Workshop on the Legal Duties of Administrators and Board Members', Artworkers Legal Service of South Australia Notes.
2. Burnett, B., *Australian Corporations Law Guide*, CCH, Sydney, 1995, para.860. An assumption has been made that the general law duties owed by members of incorporated associations are the same as those owed by company directors since they occupy similar positions of trust vis a vis the organisation and the writer is unaware of any authority to the contrary.
3. Above, ref. 1.
4. Male, A., above.
5. Eckert, W., above.
6. Sarre, R., Letter to the editor, above.
7. Adapted from notes by Eckert, W., above.
8. Adapted from notes by Eckert, W., above.
9. For example, fidelity insurance / directors and officers liability insurance.
10. For example, professional indemnity insurance.
11. Eckert, W., above.
12. Eckert, W., above, quoting Insurance Council of Australia.