



MEMO

To: Board of Directors
From: Company Secretary
Subject: **DIRECTORS AUTHORITY TO ACT ON BEHALF OF COMPANY**

You have advised that a non-executive director (“NED”) signed a contract with another party (“3rd party”) in July last year, to lease certain equipment from the 3rd party (“lease agreement”) for which the company is committed to pay [the 3rd party] up to \$1.2million over a 5 year period (ie, a contingent liability has been created), but that he did so without any authority of the board.

The question then arises: did the NED actually have authority and/or what is the validity of that contractual commitment?

In my opinion relevant areas to be addressed and considered by the board in relation to this matter include (not in any particular order):

A. Director’s role

One of the first issues to be considered is: is he really a NED?

My understanding is that he may have been inclined to purport in his day-to-day functioning that he was a company executive and was certainly ‘the face’ of the company in that state. So, perhaps there is a not unreasonable assumption by some parties that he was in fact fully authorized to act on the company’s behalf, including to enter into contractual arrangements.

On the other hand, you have advised that he only worked for the company on average 2 days per week and that was as a contractor paid through another corporate entity; he was never an employee other than as a director (and only to the extent, if any, that the law regards directors as employees).

B. Board approval

I understand that the board did not approve this lease agreement, nor did it in fact ever consider the matter (there is certainly nothing in any board minutes that I can see).

Normal protocol, whilst not specifically documented within our company, would be for a NED to consult with his fellow directors (ie, the board) and seek their concurrence to



such a commitment – even if the other directors' approval was not at a formal meeting (and could well be ratified at the next board meeting to complete the 'formalities').

Moreover, as I understand it, in this case the chairman had actually been approached some time beforehand and had specifically told the NED (before signing) not to commit to such contract because the other directors believe there is no perceived benefit to the company in entering into such contract, particularly as they cannot see any likelihood of needing the equipment for 5 years (the actual need at the time was seen to be only for the next 4 or 5 months, certainly not years).

C. Directors duties

In most public companies it is usual to confirm a director's appointment in a formal letter agreement or similar, such document detailing the director's role and responsibilities, powers and duties, obligations, etc, which might also be the place to set out any specific matters which he is authorized to handle.

We do not have that and no specific duties (other than those obliquely referenced in the company's constitution) have been documented or promulgated (and I have also checked previous board minutes, to no avail).

The usual general directors' duties that would be applicable to a NED are to:

- act bona fide in the company's interests
- exercise directorial powers for proper purpose
- avoid situations that might result in a conflict of interest.

However, beyond these, it would be unusual, in my experience, for a NED to be involved in negotiating/signing contracts, agreements and such-like, unless specifically authorized by the board.

The Corporations Act Part 2D.1 (ie, sections 179 ~ 199C) details the statutory provisions governing the duties and powers of directors.

D. Company policies

I can see no policies covering the signing of documents, agreements or similar for our company (again, I have checked previous board minutes).

However, as you are aware, most public companies have formally approved 'delegated authorities' (which might include some limited authority to contract on the company's behalf), but they usually relate to a managing directors and other executives, not to NED's. So, in this regard, notwithstanding the matter at hand, I recommend that we move to establish appropriate delegated authorities to guide executives in the future.



E. Authority of directors

In companies – public or proprietary – with more than 1 director, a director (especially a NED) acting individually usually has no authority to bind a company merely by virtue of that position (ref cases: *Northside Developments v. Registrar General* [1990] and *Brick & Pipe v. Occidental Life* [1992]).

In a company with several directors, a single director's involvement with binding the company usually only relates to participating in decision making by joining with other directors in a collective resolution of the board.

If a single director, especially a NED, is to have any power to bind the company on his own, such as executing a document (contract, agreement, etc) on behalf of the company, he must have been expressly given that authority by the board. And usually the method of execution will be as set out in the company's constitution, or failing that the Corporations Act.

On the other hand an executive director, especially a managing director, may have specific or ostensible or implied authority to execute certain documents and/or bind the company.

F. Lease documentation

The lease agreement documents you have shown me are certainly scant on detail and clarity and I have no idea of their legal validity. Questions arise like: what sort of lease is it (ie, from an accounting/tax perspective), what are the full terms, have they signed it?

In other words, is there really an agreement of any sort in place, let alone a proper lease agreement?

G. Accounting requirements/disclosure

As a provider of company secretarial services I am not really conversant with the accounting standards requirements in relation to recording/reporting material contracts, contingent liabilities, and the like. However, I do consider that a lease agreement of this magnitude would require disclosure in at least the annual accounts, if not also the half-yearly accounts.

Of course, you cannot account for something you are not aware of – which is the case here as I understand it (ie, that the board has only just found out about the matter and potential liability).



I suggest you clarify this aspect with the auditor, particularly if we have to re-state prior accounts and lodge any corrections with ASIC and/or the ASX.

H. Constitution

The company's constitution has a couple of sections that might be somewhat relevant to this matter (ie, in relation to a NED's authority to agree to the terms of and sign a contract without board knowledge):

6.6 Powers & Duties of Directors – provides power to do various things to 'the directors' (ie, collectively, one presumes), including delegation to individuals and/or appointment of agents and attorneys.

6.16 Delegation to Directors – allows 'the directors' to delegate specific powers to one director.

So, whilst there appears to be adequate board power to authorize a NED to approve and sign a contract, this process was not followed.

I. Corporations Act

Section 127(1) refers to the execution of documents including deeds) and says: *a company may execute a document if signed by 2 directors (or a director and company secretary)* and notes that if executed this way people can rely on the assumptions in section 129(5) when dealing with the company.

Section 129(5) says: *a person may assume that a document has been duly executed if signed in accordance with section 127(1).*

"Document" is not defined in the Act, but reference to a legal dictionary describes one as '*a formal piece of writing or printing that provides information or acts as a record of events or arrangements*', and it generally includes contracts and agreements (as well as deeds – which are specifically included in section 127).

So, on the face of it, as the contract has not been signed by the NED as per section 127(1) the 3rd party may not be able to rely on the Act to give them any 'protection'.

J. Indoor Management Rule

The so-called 'Indoor Management Rule' relates to the issue of a 3rd party dealing with a company, in the absence of actual or imputed knowledge to the contrary, making the assumptions set out in section 129.

These assumptions include:



- relevant provisions of the company's constitution (or the Replaceable Rules set out in the Act, if applicable) have been complied with
- that if a person appears – from information publicly available from the company or ASIC – to be a director (or company secretary) of the company, then it can be assumed that he is and has been duly appointed with relevant authority
- that the director (or other officer) is properly performing duties for which they are empowered by the company
- if a document appears to have been signed in accordance with section 127(1), then it can be assumed that it is
- if a document has been executed and sealed in accordance with section 127(6)

and the 3rd party dealing with the company is entitled to make those assumptions even if the company asserts that those matters are incorrect (section 128 and cases such as: *Nece v. Ritek* [1997]).

K. Normal commercial dealings

3rd parties relying on a document [signed by the company] should be concerned to ensure that it is properly executed.

And whilst section 129 has codified the common law principles in this regard, various court cases (eg, *Australian Capital Television v. Minister for Communication* [1989]) also follow and abide by the generalities of this rule.

L. Stock Exchange/Continuous Disclosure

The ASX rules have little to say on this situation, other than in relation to announcing to the market any material information (ie, under the 'continuous disclosure' provisions) – but is the magnitude of this lease agreement considered material in the context of the company's financial situation, business and operations.

Listing Rule 3.1 states: "*Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.*"

The rules further state that an entity becomes 'aware' of information if a director or executive officer has, or ought reasonably to have, come into possession of the information in the course of the performance of their duties as a director or executive officer of that entity.



So, now that the company has become 'aware' of the matter, the board will have to give consideration as to whether or not it should be announced (and, of course, if that is the case then in my opinion it should be done quickly).

Note: similar considerations would also be necessary even if the company was an unlisted disclosing entity, pursuant to section 675.

In summary, I have outlined above what I believe are the relevant areas for the board to consider in this matter. But, in my opinion, the issues appear somewhat complex and are not necessarily clear cut, so I would suggest that legal advice be sought before any action is taken.

DISCLAIMER

The comments in this memo reflect some commercial aspects and observations on the matter experienced or observed by the writer in practice as he understands them. The information is given as a guide only and does not represent a definitive or legal view of any of the issues raised, covered or referred to and the reader is urged to seek his own professional advice on all aspects of, or pertaining to, this and any related matter.