

9-21-2012

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## Recommended Citation

John Lessing, David Morrison, and Maria Nicolae. (2012) "Educational institutions, corporate governance and not-for-profits" *Corporate Governance e-Journal*, 1-22: ISSN 1836-1110.

<http://epublications.bond.edu.au/cgej/26>

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## **Disciplines**

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# EDUCATIONAL INSTITUTIONS, CORPORATE GOVERNANCE AND NOT-FOR-PROFITS

Maria Nicolae

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# EDUCATIONAL INSTITUTIONS, CORPORATE GOVERNANCE AND NOT-FOR-PROFITS<sup>1</sup>

JOHN LESSING<sup>†</sup> DAVID MORRISON<sup>‡</sup> AND MARIA NICOLAE<sup>\*</sup>

Schools are a big part of the not-for-profit ('NFP') sector in Australia. This article considers the choice as operating structure of NFPs and recommends a uniform operating structure that might be used for all. The company limited by guarantee is a useful structure since the provisions of the *Corporations Act 2001 (Cth)* ('*Corporations Act*') offer day-to-day operating rules and law. This article suggests that a new chapter be inserted into the *Corporations Act* specifically to account for NFP activities. The recommendations draw upon the recent English inquiry and legislative amendments. We also refer to the January 2011 Australian Government consultation paper, *Scoping Study for a National Not-for-Profit Regulator*, that considers the feasibility of a nation-wide regulator.

The goals for the introduction of a nation-wide regulator of not-for-profit or NFPs are to increase efficiency and transparency in the sector, minimise individual organisational costs and improve public confidence. Within the for-profit sector, these goals are adequately achieved by Australia's regime of corporate regulation. Accordingly, this article recommends that NFPs generally be structured as corporate entities, allowing for the *Corporations Act* amendments to account for the inherent differences between the NFP and for-profit sector, including surplus versus profit motivations and the wider range of NFP stakeholders.

## 1.0 INTRODUCTION

The role of the board of directors is to manage the business of the company.<sup>2</sup> This role remains unchanged, irrespective of whether the company is small or large, public serving or member serving, for-profit or NFP.<sup>3</sup> However, the statutory and general law<sup>4</sup> duties owed

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<sup>1</sup> This article is dedicated to the memory of Professor John Lessing, a scholar, a gentleman and our friend. This paper is based upon a presentation: Lessing J, 'Corporate Law and School boards' Accountability', paper presented at the National Principals' Conference, Bond University, May 2009; and a draft paper: Lessing J and Nicolae M, 'School Board Responsibilities' (2010). An earlier version of this paper, 'Corporate governance and non-profits: issues with respect to educational institutions', was presented at 2011 Corporate Law Teachers' Association Conference, QUT, Brisbane. We are grateful for the kind support of Emeritus Professor John Farrar. The usual caveats as to accuracy and completeness apply.

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<sup>2</sup> *Corporations Act 2001 (Cth)* s 198A.

<sup>3</sup> Sally Sievers, 'The Honorary Director: The Obligations of Directors and Committee Members of NFP Companies and Associations' (1990) 8 *Companies & Securities Law Journal* 87, 88.

<sup>4</sup> The authors use the term 'general law' to denote the legal principles derived from both common law and equity.

by directors do vary with the particularity of the organisation, notwithstanding the kind of enterprise involved.<sup>5</sup>

Differences in statutes as between business structures impose divergent duties upon those serving on boards.<sup>6</sup> In the context of a company, where companies are governed by the same statute (primarily, the *Corporations Act*) whether the company is public or proprietary in nature will affect the scope of the duties imposed. Specifically, where the circumstances warrant it, the duties imposed upon directors of public companies are more onerous than those imposed upon directors of proprietary companies. Financial reporting and disclosure requirements differ, for example.<sup>7</sup>

An investigation of the use of the term 'board', the types of business structures and their governance mechanisms is beyond the scope of this article. The focus of this paper is on the NFP corporate, particularly **the school**. It is concerned with the governance aspects of a school and focuses on policy rather than requisite differences in legislative requirements.

Although board governance is much researched (modern discourse on corporate governance dates back to the 1930s),<sup>8</sup> Hough, McGregor-Lowndes and Ryan<sup>9</sup> (2005) note that there is much less scholarship devoted to the governance of NFP boards.<sup>10</sup> Six years later

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<sup>5</sup> *Corporations Act 2001* (Cth) s 112. The *Corporations Act* has concurrent operation with State or territory legislation. This means that companies limited by shares or guarantee, and no liability public companies, have to comply with the State or territory legislation where they operate, in addition to the federal legislation as outlined in the *Corporations Act*. For example, companies limited by shares or guarantee, and no liability public companies are regulated by the *Corporations Act*. Whereas other incorporated associations are governed by Associations Incorporation Acts: *Associations Incorporation Act 1991* (ACT); *Associations Incorporation Act 2009* (NSW); *Associations Act 2003* (NT); *Associations Incorporation Act 1981* (Qld); *Associations Incorporation Act 1985* (SA); *Associations Incorporation Act 1964* (Tas); *Associations Incorporation Act 1981* (Vic); *Associations Incorporation Act 1987* (WA).

<sup>6</sup> There is no legal definition of 'board' that is particular to a for-profit or NFP organisation, although governing statutes or regulations may so define for their own purposes. The term is used more generally than its particular use for the organisation of the management of a company.

<sup>7</sup> For example, s 292 of the *Corporations Act* requires that all public and large proprietary companies prepare an annual and directors' report; whereas small proprietary companies and small companies limited by guarantee are required to prepare an annual report only if so directed by either their shareholders or members, or ASIC. A proprietary company is deemed to be a small proprietary company if the consolidated revenue for a financial year is less than \$25 million, or if the value of the consolidated gross assets at the end of the financial year is less than \$12.5 million, or the company has less than 50 members (s 45A of *Corporations Act*).

<sup>8</sup> Thomas J Moloy, 'Charity, Truth and Corporate Governance' (Research Paper No 2010-05, Elon University School of Law, 24 May 2010) 7.

<sup>9</sup> Alan Hough, Myles McGregor-Lowndes and Christine M Ryan, 'Theorizing about board governance of nonprofit organizations: surveying the landscape' (Paper presented at 34<sup>th</sup> Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action, Washington DC, 17-19 November 2005) 2. Peter D Steane and Michael Christie, 'Nonprofit Boards in Australia: a distinctive governance approach' (2001) 9(1) *Corporate Governance: An International Review* 48, 49.

<sup>10</sup> In support of this conclusion, the authors note that a simple search of the words 'board of directors' on the ProQuest databases alone produced over 14,000 references. When the same search was performed, in relation to NFP companies, far fewer references were produced: specifically only 300 references. In his article 'Incorporation of NFP Associations: The Way Ahead?' Sally Sievers similarly concludes, that except in cases where serious scandals occur, the regulation of the NFP sector receives little attention as compared to regulation of companies generally (A Sally Sievers, 'Incorporation of NFP Associations: The Way Ahead?' (2000) 18 *Company and Securities Law Journal* 311, 320).

their 2005 findings remain, by and large, unchallenged.<sup>11</sup> Given the paucity of literature specifically devoted to the governance of NFP companies, this paper seeks to ascertain the extent that the existing scholarship devoted to board governance in the for-profit sector is equally applicable to the NFP sector, particularly schools. Further, the paper considers whether the scope of the duties imposed are dependent upon the profit seeking objectives of the organisation, and whether recommendations might be made to enhance the operation of NFP boards to take account of important differences between NFP and for-profit organisations.

## 2.0 WHY SCHOOL BOARDS?

The NFP sector does not comprise 'a uniform mass'.<sup>12</sup> Instead, NFPs may be large or small, public serving or member serving and consisting of volunteers or staff. NFPs may also be funded in a variety of ways including by commercial activity or through donations and charitable activity.<sup>13</sup>

Compared with commercial organisations operating in the traditional company limited by shares structure, these are significant differences. The diverse range of stakeholders of those NFP organisations that choose the company structure for their operation makes it very difficult to make generalisations, such as the ones that might be made for commercial businesses using the same business structure. We are able to assume, for example, that for-profit companies will have a board of directors, be interested in maximising their profit and value and be reasonably diligent with respect to their reporting obligations; generalisations that are not necessarily able to be made or indeed applicable to NFP entities. Farrar states that:<sup>14</sup> 'NFP organisations are many and varied, but together they constitute a separate, distinct class of organisations, neither government nor business, with their own distinctive rules and characteristics.'

An analysis made around the governance of NFP boards must be context specific,<sup>15</sup> so this article is confined to a specific type of NFP organisation, namely schools. The impetus to do so is twofold. First, there is very little available scholarship in this area. The liability of school boards and their members has been primarily explored in the areas of freedom of

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<sup>11</sup> A similar search of the words 'governance' on the ProQuest databases produced over 16,000 references. In relation to NFP companies, approximately 450 references were produced. Generally: John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3<sup>rd</sup> ed, 2008).

<sup>12</sup> Alan Hough, Myles McGregor-Lowndes and Christine M Ryan, 'Theorizing about board governance of nonprofit organizations: surveying the landscape' (Paper presented at 34<sup>th</sup> Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action, Washington DC, 17-19 November 2005) 3.

<sup>13</sup> Alan Hough, Myles McGregor-Lowndes and Christine M Ryan, 'Theorizing about board governance of nonprofit organizations: surveying the landscape' (Paper presented at 34<sup>th</sup> Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action, Washington DC, 17-19 November 2005) 3. See also Mark Lyons, *Third Sector* (Allen & Unwin, 2001) 12-16.

<sup>14</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3<sup>rd</sup> ed, 2008) 441; and citing Mark Lyons, *Third Sector* (Allen & Unwin 2001) 5-7, sets out typical indicia of NFPs including having their own set of rules, being private, involving volunteers, having complex financial arrangements and being 'owned' by community, social, or welfare groups.

<sup>15</sup> Alan Hough, Myles McGregor-Lowndes and Christine M Ryan, 'Theorizing about board governance of nonprofit organizations: surveying the landscape' (Paper presented at 34<sup>th</sup> Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action, Washington DC, 17-19 November 2005) 3.

information, criminal law, family law, negligence and anti-discrimination.<sup>16</sup> There is considerably less literature addressing the liability of school boards and their members for decisions made on the financial administration and planning of the school.<sup>17</sup>

Secondly, scholarly scrutiny is needed on governance of school boards. In 2009 the Australian Bureau of Statistics announced that the number of Australian students attending independent, non-governmental, schools has increased eightfold in the past decade.<sup>18</sup> This will lead to an increase in the establishment of independent schools and, implicitly, an increase in the number of boards serving those schools.

Many independent schools are structured as incorporated entities.<sup>19</sup> The boards of such schools and their members are therefore subject to specific common law, equitable and statutory obligations. However, in a study published in 2005 by David Gamage,<sup>20</sup> 66% of the participating school principals indicated that they received no training prior to undertaking their position and were largely unaware of their duties and potential liability. Although the study did not address the level of management training undertaken by members of school boards other than principals, it is anticipated that the results are equally applicable.<sup>21</sup>

This article outlines the obligations incurred by members of school boards in the course of discharging their duties. This is completed by describing the organisational structure of schools' governing bodies in Australia and addressing the directors' duties of non-governmental school boards. In addition to outlining the existing legal framework within which members of school boards must operate, this paper analyses the appropriateness of the current framework. It also aims to provide board members with practical guidance on best governance practice to minimise personal liability, and to better promote the objectives of the schools on whose boards they sit.

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<sup>16</sup> Douglas J Stewart, 'Principals' Knowledge of Law Affecting Schools' (1996) 1(1) *Australia New Zealand Journal of Law Education* 111, 119.

<sup>17</sup> Following the methodology adopted by Alan Hough, Myles McGregor-Lowndes and Christine M Ryan, a search of the words 'governance' in relation to school boards on the ProQuest databases produced approximately 100 references.

<sup>18</sup> Australian Bureau of Statistics (Cth), 'Private School Student Numbers Boom' (Media Release, 4221.0- Schools Australia 2009, 16 March 2010). The significance of the NFP sector to the Australian economy provides additional impetus for further research. In 2006/07 the NFP sector accounted for 4.1% of total GDP (Productivity Commission Research Report, Commonwealth Government, *Contribution of the Not-for-Profit Sector* (2010) 53. During the same year, Education and Research organisations made up 27% of the gross value added (GVA) of the NFP sector. The GVA is the value a producer adds to the raw materials it uses in producing its own output (Productivity Commission Research Report, Commonwealth Government, *Contribution of the Not-for-Profit Sector* (2010) 66).

<sup>19</sup> This assertion is based on the anecdotal evidence collected in the writing of this and the related papers to date. One further research objective is to collect more data on schools and their structures to enable an in-depth analysis following on from this position paper.

<sup>20</sup> David Gamage, 'It's Time to Listen: Principals' Views on the Principalship' (2005) *Principal Matters* 26.

<sup>21</sup> The lack of sufficient training is not limited to principals or the education sector; it appears to be an endemic problem within the NFP sector. See The Productivity Commission Research Report, Commonwealth Government, *Contribution of the Not-for-Profit Sector* (2010) at p 272 where it noted that participants in the study had concerns about the limited opportunities available to management and board members to undertake training. It is also noted that the *Corporations Act 2001* (Cth) does not impose any qualification or training requirements on directors prior to their appointment. The only requirements imposed by the Act are that directors must be at least 18 years of age (s 201B) and cannot become bankrupt, be an undischarged bankrupt or convicted of particular offences, such as fraud or offences under company law (Part 2D.6).

### 3.0 SCHOOL GOVERNING BODIES AND THEIR CONSTITUENTS

The Australian school system commenced as a centralised effort, with State and territory legislation vesting significant control with respect to administrative functions in the Education Department. Decentralisation of the school system commenced during the 1970s, allowing some distribution of power to individual schools and principals led to the establishment of school boards.<sup>22</sup> Today, the organisational structure of the school (governmental, Catholic systemic or independent) determines the role and liability of the board and its members.

In 2005, two-thirds of school children in Australia attended governmental schools.<sup>23</sup> 20% of children attended religious schools, such as Roman Catholic schools, while 12% attended non-governmental, independent schools.<sup>24</sup> There has been a significant shift in the proportion of children attending independent schools, with attendance increasing by more than 20% in the past decade.<sup>25</sup>

#### 3.1 GOVERNMENTAL AND CATHOLIC SYSTEMIC SCHOOLS

The Education Acts<sup>26</sup> of each State and territory provide for the establishment of various organisations to assist Education Ministers in their administration of governmental schools.<sup>27</sup> The legislation in each jurisdiction also prescribes the role of these organisations and their member composition, including the level of parental and community involvement.<sup>28</sup> Generally, these organisations and governmental schools do not have the status of a separate legal entity.<sup>29</sup>

Catholic systemic schools are non-governmental schools administered by a Roman Catholic education authority for the State.<sup>30</sup> They are governed by rules and regulations imposed by their diocese and are accountable to the Catholic Education Office for financial expenditure

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<sup>22</sup> David T Gamage, 'School Councils and Community Participation in Australia and Overseas' (1996) 23 (1) *Education Research and Perspectives* 46, 47.

<sup>23</sup> Governmental schools are also known as public schools.

<sup>24</sup> John McCormick et al, 'Board governance of Independent Schools' (2006) 44(5) *Journal of Educational Administration* 429, 429.

<sup>25</sup> Between 1998 and 2008 the proportion of students enrolled in independent schools increased by 21.9% (Australian Bureau of Statistics (Cth), 'Schools Australia' (Media Release, 4221.0 – 2008 Reissue, 7 May 2009). Also Australian Bureau of Statistics (Cth), 'Private School Student Numbers Boom' (Media Release, 4221.0-Schools Australia 2009, 16 March 2010). By comparison, between 1998 and 2008 the proportion of children attending governmental schools has decreased from 70% to 65.9% (Australian Bureau of Statistics (Cth), 'Schools Australia' (Media Release, 4221.0 – 2008 Reissue, 7 May 2009)).

<sup>26</sup> *Education Act 1990* (NSW); *Education and Training Reform Act 2006* (Vic); *Education (General Provisions) Act 2006* (Qld); *School Education Act 1999* (WA); *Education Act 1972* (SA); *Education Act 1994* (Tas); *Education Act 2004* (ACT); and *Education Act 1979* (NT).

<sup>27</sup> Jim Jackson and Sally Varnham, *Law for Educators: School and University Law in Australia* (LexisNexis Butterworths 2007) 6.

<sup>28</sup> Depending on the jurisdiction of operation, these organisations may be called school boards, school councils, Parents or Citizens' Associations.

<sup>29</sup> Jim Jackson and Sally Varnham, *Law for Educators: School and University Law in Australia* (LexisNexis Butterworths 2007) 6. However, the *Education and Training Reform Act 2006* (Vic) s 2.3.2 allows the Education Minister to create school councils as bodies corporate.

<sup>30</sup> *States Grants (Schools) Act 1973* (Cth) s 3.



and school organisation.<sup>31</sup> Catholic schools are generally not incorporated and do not have a separate legal status. The contracting power of these institutions rests with a church representative or with a board of church trustees. An exception to this general rule occurs in Queensland, where pursuant to the *Roman Catholic Church (Incorporation of Church Entities) Act 1994*, Catholic schools have the right to incorporate under specific church legislation.<sup>32</sup>

Generally, governmental and Catholic systemic schools have school boards with advisory roles only. The boards of these schools are created pursuant to statute, and are therefore subject to the administrative requirements of each State and territory.<sup>33</sup> As these school boards are not incorporated and do not have separate legal status, board members are personally liable for their conduct. However, a question remains about the function of a so-called board that is only 'advisory' and which might be distinguishable from one that makes decisions. Each board member must comply with the Education Act in the State or territory where the school board operates and must perform their stated legislative duties with due care and diligence.<sup>34</sup> Importantly, the Education Act in each jurisdiction protects board members by granting them conditional immunity from liability. Immunity is typically conditional upon the board member acting within the power prescribed by the legislation and acting honestly,<sup>35</sup> in good faith,<sup>36</sup> and without negligence<sup>37</sup> in the discharge of their duties.

In addition to the statutory requirement to act honestly, in good faith and without negligence, members of an advisory school board owe a general law duty of care in their conduct.<sup>38</sup>

### 3.2 INDEPENDENT SCHOOLS

Independent schools are defined as non-governmental, non-Catholic systemic schools. These schools are governed by individual constitutions specifying the objects of the school, election procedures, requisite qualifications of their members and the manner of exercising the schools' administrative functions. The schools are structured either as incorporated associations (established and regulated by the Associations Incorporation Acts in the respective States and territories),<sup>39</sup> companies limited by guarantee (established and

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<sup>31</sup> Behnaz Mohajeran, *An Investigation of the relationship between governance, decision-making and school effectiveness: a case study of four high schools* ( PhD Thesis, Faculty of Education, University of Wollongong, 2006 ) <<http://ro.uow.edu.au/theses/173>> 18.

<sup>32</sup> Jim Jackson and Sally Varnham, *Law for Educators: School and University Law in Australia* (LexisNexis Butterworths 2007) 10-11.

<sup>33</sup> D J Duncan and J W Duncan, 'Rights and duties of school boards' in Jane Edwards, Andrew Knott and Dan Riley (ed), *Australian Schools and the Law* (North Ryde, 1997) 261, 263.

<sup>34</sup> *Idem*.

<sup>35</sup> *Education (General Provisions) Act 2006* (Qld) s 117; *Education Act 2004* (ACT) s 49A; *Education Act 1994* (Tas) s 86.

<sup>36</sup> *Education and Training Reform Act 2006* (Vic) s 2.3.32; *School Education Act 1999* (WA) s 137; *Education Act 1972* (SA) s 100; *Education Act 1979* (NT) ss 13B, 71M; *Education Act 1990* (NSW) s 120.

<sup>37</sup> *Education (General Provisions) Act 2006* (Qld) ss 117, 141.

<sup>38</sup> DJ Duncan and JW Duncan, 'Rights and duties of school boards' in Jane Edwards, Andrew Knott and Dan Riley (ed), *Australian Schools and the Law* (North Ryde, 1997) 261, 264.

<sup>39</sup> See for example *Associations Incorporation Act 1991* (ACT) s 14; *Associations Incorporation Act 1984* (NSW) s 7; *Associations Incorporation Act 1981* (Qld) s 5; *Associations Incorporation Act 1985* (SA) s 18; *Associations Incorporation Act 1987* (WA) s 4. For an educational institution to be eligible for incorporation under these Acts, it must not operate with a view to make a profit; additionally, in Queensland, it cannot be a School Council or Parents and Citizens Association under the *Education (General Provisions) Act 2006* (Qld).

regulated by the *Corporations Act*),<sup>40</sup> or by a deed of trust (established and regulated by the *Corporations Act*).<sup>41</sup>

Some independent schools, such as Seven Day Adventist schools, Lutheran schools and a number of Anglican schools, have a governance structure similar to that of systemic schools.<sup>42</sup> More specifically, the organisational structure of these schools consists of a central board of directors and management committees acting as school councils for individual schools. With respect to financial decisions, the management committees advance proposals for approval to the central board of directors. In all other matters the management committees act in a manner similar to that of other independent school boards.<sup>43</sup>

Independent schools structured as incorporated associations and governed by State legislation, and independent schools with a governance structure similar to that of systemic schools, are not the focus of this paper.

Most independent schools are structured as companies limited by guarantee.<sup>44</sup> These types of companies do not have share capital. Instead, their members agree to contribute a specified amount ('guarantee') in the event that the company is wound up.<sup>45</sup> These incorporated entities are public companies governed by a board of directors. Within the school context, the board of directors is also known as the school board.<sup>46</sup>

#### 4.0 OBLIGATIONS OF BOARD MEMBERS

Schools structured as companies<sup>47</sup> require natural persons to act on their behalf. With incorporated companies this function is fulfilled by the board of directors. The board, and by extension the school board, is legally responsible and accountable for the overall conduct of the school.<sup>48</sup> However, the school board is not liable as an entity alone; each member of the board bears personal responsibility as well. All company directors have legal obligations to the companies they manage and owe them specific duties in the discharge of

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<sup>40</sup> Section 9 of the *Corporations Act 2001* (Cth) defines a school operated as a company limited by guarantee as one whose members' liability is limited to the amount they have each undertaken to contribute to the assets of the company in the event that the company is wound up.

<sup>41</sup> A school limited by way of a deed of trust is administered through a trust with either human or corporate trustees. Under s 64B(4) of the *Corporations Act 2001* (Cth) a company is limited by way of a deed of trust where a corporation is the settlor or the trustee of the trust.

<sup>42</sup> John McCormick et al, 'Board governance of Independent Schools' (2006) 44(5) *Journal of Educational Administration* 429, 429.

<sup>43</sup> *Ibid* 430.

<sup>44</sup> D J Duncan and J W Duncan, 'Rights and duties of school boards' in Jane Edwards, Andrew Knott and Dan Riley (ed), *Australian Schools and the Law* (North Ryde, 1997) 261, 265; John McCormick et al, 'Board governance of Independent Schools' (2006) 44(5) *Journal of Educational Administration* 429, 429.

<sup>45</sup> A S Sievers, 'Incorporation of NFP Associations: The Way Ahead?' (2000) 18 *Company & Securities Law Journal* 311, 313.

<sup>46</sup> John McCormick et al, 'Board governance of Independent Schools' (2006) 44(5) *Journal of Educational Administration* 429, 429.

<sup>47</sup> Including those incorporated as companies limited by guarantee; the company limited by guarantee being the more popular entity choice for private independent school operating structure.

<sup>48</sup> John McCormick et al, above n 46, 430.

their responsibilities.<sup>49</sup> These duties come from common law equity, as well as the *Corporations Act*.<sup>50</sup> A précis of these obligations is set out below.

#### 4.1 GENERAL LAW OBLIGATIONS

At common law, directors owe a duty of care, diligence and skill to the company in the course of their conduct.<sup>51</sup> Initially, the Courts have held that the level of skill a director must exhibit is one that can reasonably be expected of someone with similar knowledge and experience.<sup>52</sup> That principle was qualified by *AWA Ltd v Daniels*<sup>53</sup> and *Daniels v Anderson* ('*Daniels*'),<sup>54</sup> confirming that although the obligations imposed will vary depending on the size and business of the particular company, a person accepting the position of director of a company is taken to have understood the nature and duties inherent to such an appointment.

One of the main management differences between corporate boards and NFP boards, is that generally, NFP boards consist of members who do not have the same level of expertise as that required by law of corporate directors.<sup>55</sup> Does that mean that the degree of skill and diligence expected of a board member in a NFP institution is lower than that of a corporate board member? We do not believe so.<sup>56</sup>

The minimum standard of care required of board members according to *Daniels* case is that directors are expected to become familiar with the business organisation of the companies on whose boards they sit. Although the Courts recognised that not all members of the board

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<sup>49</sup> Phillip Lipton and Abe Herzberg, *Understanding Company Law* (Thompson Legal, 14<sup>th</sup> ed, 2008) 282. Note that these duties apply whether the person is called 'director' or something else such as 'Council member'. Anyone who occupies the position of a director falls within the definition of 'director' in s 9 of the *Corporations Act 2001* (Cth).

<sup>50</sup> *Corporations Act 2001* (Cth) ss 180-4.

<sup>51</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford UP, 3<sup>rd</sup> ed, 2008) 108.

<sup>52</sup> *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407.

<sup>53</sup> (1992) 7 ACSR 759; 10 ACLC 933.

<sup>54</sup> (1995) 37 NSWLR 438.

<sup>55</sup> Klaus J Hopt, 'The Board of Nonprofit Organisation: Some Corporate Governance Thoughts from Europe' (Law Working Paper No 125/2009, Max Planck Institute, 2009) 5.

<sup>56</sup> The NSW Court of Appeal in *Daniels v Anderson* (1995) 13 ACLC 614 held that the duty of directors 'will vary according to ... the experience or skills that the director held himself or herself out to have in support of appointment to the office.' In *Dorchester Finance Co Ltd v Stebbing* (1980) 1 Co Law 38 and *Gold Ribbon (Accountants) Pty Ltd v Sheers* (2005) 23 ACLC 1288, the Courts found that directors with more extensive business experience owed a higher standard of care than their less experienced colleagues; in those cases the directors were found to have breached their duty of care when they failed to check the activities of the less knowledgeable and experienced directors. Note, eg, that Scotch College in Melbourne is overseen by BHP Billiton and Foster's director David Crawford, investment banker Craig Drummond and retired National Australia Bank executive Bob Prowse; Ascham School in Sydney is chaired by Diane Grady, a director at Woolworths, Goodman Group and BlueScope Steel, and its governing Council includes Steven Harker, chief at Morgan Stanley, David Feetham of Gresham Advisory Partners and Tim Burroughs, a vice-chairman at Goldman Sachs JB (as reported by Rebecca Urban, 'How to work those old school ties', *The Weekend Australian* (Sydney), 7-8 November 2009). We believe that, given the impressive board membership of some schools, the degree of skill and diligence expected of a NFP board member will, if tested, be the same as a person of similar skill and experience of a for-profit board; and moreover, that the more experienced board members may be held liable for not checking the activities of the less experienced board members.

will have the same level of skill and experience, nonetheless directors are under a continuing obligation to make inquiries and keep themselves apprised of the activities of the business. Specifically, the *Daniels'* case looked at the liability of executive and non-executive directors in the context of a for-profit enterprise. More generally however, the Court noted the broadening of the duties expected of directors as a consequence of modern commercial realities, irrespective of the directors' level of involvement in the day to day management of the business:

[I]t would be unreasonable to expect every director to have equal knowledge and experience of every aspect of the company's activities. Furthermore traditionally non-executive directors have been appointed for perceived commercial advantage such as attracting customers or adding to the prestige and status of the company. (at 501)

A non-executive director does not have to turn him or herself into an auditor, managing director, chairman or other officer to find out whether management is deceiving him or her. These are the words uttered in 1872 by Lord Hatherley LC in *Overend & Gurney Co v Gibb* (at 487) in describing *crassa negligentia*. In our respectful opinion it does not accurately state the extent of the duty of directors whether non-executive or not in modern company law. (at 502)

It appears that the duties imposed by the common law and their scope do not vary with the profit seeking objective of the company. Impliedly then, the common law obligations of care, diligence and skill are similarly imposed on members of school boards. Serving members, in the discharge of their duties, must meet the objective standard of reasonableness.

In further support of the above, is the practical reality that in recent years, educational institutions have formed commercial alliances with various for-profit companies, some even listed on the London Stock Exchange.<sup>57</sup> As school budgets have steadily increased, we anticipate that the level of due diligence now expected of a school board member is the same as for a board member of a publicly traded company.<sup>58</sup>

Equity has long since recognised the existence of a fiduciary relationship between directors and the company they serve.<sup>59</sup> This relationship arises because directors act as agents for their company;<sup>60</sup> and in so acting directors have power and discretion to adversely affect the company's interests.<sup>61</sup> Once the fiduciary relationship is established, directors are subject to strict fiduciary duties arising from stewardship obligations and loyalty. More specifically, directors are under a duty:

- (1) not to use their position to obtain a private advantage; and

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<sup>57</sup> Jane Nicholls 'Commonwealth Funding Programs for Private Schools 1996-2004' (Paper prepared for the Australian Education Union, 2004) 6-9.

<sup>58</sup> Audrey Jackson, 'Governance - When push comes to shove' (2005) *Teacher* 15, 15. See also John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3<sup>rd</sup> ed, 2008) 453, citing Peter Coaldrake and Lawrence R Stedman, *On the brink : Australia's universities confronting their future* (University of Queensland Press, 1998) 172, states that universities (in their capacity as NFP educational institutions, are 'no different from either the corporate or public sector in their need for direction and monitoring, and their obligation to satisfy the community at large that they are operating effectively'.

<sup>59</sup> *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41, [69]; *Elders Trustee and Executor Co Ltd v E G Reeves Pty Ltd* (1987) 78 ALR 193.

<sup>60</sup> *Breen v Williams* (1996) 186 CLR 71, [82].

<sup>61</sup> *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41, [97].

(2) not to enter into any agreement that the directors' personal interest conflicts, or may possibly conflict with their duties.<sup>62</sup>

The imposition of such duties applies to all directors and their companies and is therefore not affected by the size of the company or whether or not it has a profit making objective. In the school context, this means that school board members owe fiduciary obligations to their respective educational institutions at general law unless those duties are altered by statute.<sup>63</sup>

## 4.2 STATUTORY OBLIGATIONS

The statutory directors' duties in the *Corporations Act* complement the obligations developed by the general law. The *Corporations Act* reiterates the directors' common law duty of care and diligence in s 180, by stating that directors of a company must discharge their duties with the degree of care and diligence reasonably expected of a person undertaking such a position, in the company's specific circumstances.<sup>64</sup> Unlike the duties imposed by the general law, it is noted that s 180 does not impose a standard of skill on company directors. Although, this may lead to the conclusion that there is no objective statutory standard of skill,<sup>65</sup> such a conclusion would be erroneous. Courts have, in fact, inferred a minimum objective standard of skill in the context of financial competence from other parts of the *Corporations Act*, such as the provisions relating to directors' liability for insolvent trading.<sup>66</sup>

Directors also have a duty not to fetter their discretion when making decisions on behalf of the company.<sup>67</sup> This means that directors cannot decide in advance how they will vote at a meeting prior to giving the pending decision adequate consideration. Directors may not act solely on the influence or advice of others; they must always make their own inquiries and act in the best interests of the company. This duty is not specifically legislated for<sup>68</sup> in the *Corporations Act*; however the *Corporations Act* does state under what circumstances and to what degree directors may delegate their decision making power to another director or

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<sup>62</sup> *Moss v Moss (No 2)* (1900) 21 LR (NSW) Eq 253, 258.

<sup>63</sup> Such an alteration might arise where for example, a school is established by its own act of parliament, the latter containing either an adoption of the common law duties with alteration or a code that precisely articulates the nature and limits of the duties.

<sup>64</sup> *Corporations Act 2001* (Cth) s 180. The ability of the Court to have regards to the company's subjective circumstances and the individual director's responsibilities within the organisation in determining whether the statutory duty was breached is endorsed by the Explanatory Memorandum to the Corporate Law Economic Reform Bill 1999 at [6.75]. The standard of care and diligence imposed by the section are essentially the same as the standards imposed by the common law, as evidenced by the decisions of *Re HIH Insurance Ltd (in prov liq)*; *ASIC v Adler* (2002) 41 ACSR 72.

<sup>65</sup> R P Austin, H A J Ford and I M Ramsay, *Company Directors: Principles of Law and Corporate Governance* (LexisNexis Butterworths, 2005) 231.

<sup>66</sup> R P Austin, H A J Ford and I M Ramsay, *Company Directors: Principles of Law and Corporate Governance* (LexisNexis Butterworths, 2005) 231. The authors conclusion is supported by a number of judicial decisions, including *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115, 126. In that case the Court examined the liability of the company's directors under the predecessor of s 588G and held that directors are obliged to inform themselves of the financial affairs of the company to the extent necessary to ascertain its financial solvency and cannot avoid liability by stating that they lack the skill necessary to read financial statements. The Court's decision was later affirmed in *Statewide Tobacco Services Ltd v Morkey* [1993] 1 VR 423.

<sup>67</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3<sup>rd</sup> ed, 2008) 109.

<sup>68</sup> The duty not to fetter their discretion still holds at common law (*Thorby v Goldberg* (1965) 112 CLR 597, 605, 617-618). The duty states that directors cannot reach some prior agreement or contract as to how they will vote at board meetings.

expert.<sup>69</sup> Even in circumstances where directors are allowed to delegate their decision making power, the directors remain personally responsible for the decision made by the delegate.<sup>70</sup> In the context of school boards, this means that a member of the school board cannot seek to avoid personal liability for the decisions of the board simply by delegating their decision making power.

Directors are under a duty to act in the best interests of the company<sup>71</sup> and to avoid all actual and potential conflicts of interest.<sup>72</sup> More specifically, the *Corporations Act* states that directors are under a statutory duty not to improperly use information obtained during the course of their employment with the company to gain an advantage for themselves or for someone else.<sup>73</sup> In the context of school boards, the duty to avoid conflict and not to improperly use information has increasing relevance, given the trend in recent years whereby educational institutions are encouraged by the State governments to build commercial relationships with a range of organisations, including local councils, businesses, commercial organisations, sport and recreation providers, and other training and NFP organisations.<sup>74</sup>

The liability of board members is not limited to civil penalties. Directors of a company may be held criminally responsible for breaching the duty to act in good faith in the best interests of the company, or the duty to avoid misuse of information and position, if they acted in a reckless or intentionally dishonest manner.<sup>75</sup>

## 5.0 THE 'COMPANY' AND OTHER MATTERS

As outlined above, board members of NFP companies are subject to the same general law and statutory duties as those imposed on directors of commercial for-profit firms.<sup>76</sup> The directors of a company must act in the best interests of the company.

A point of contention between for-profit companies and NFP companies is the meaning of 'best interests of the company', or more specifically what or who constitutes 'the company'.

With for-profit companies, the courts traditionally interpret the best interests of the company as being those of its shareholders as a whole.<sup>77</sup> But a corporation with perpetual succession has a variety of shareholders throughout its existence.<sup>78</sup> Since the duties of directors are owed to all shareholders, impliedly the duties are owed equally to present as well as future shareholders of the company.<sup>79</sup> Additionally, sometimes acting in the best

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<sup>69</sup> *Corporations Act 2001* (Cth) s 198D(1).

<sup>70</sup> *Corporations Act 2001* (Cth) s 190.

<sup>71</sup> *Corporations Act 2001* (Cth) s 181(1). These duties reflect the fiduciary duties recognised at equity.

<sup>72</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3<sup>rd</sup> ed, 2008) 108.

<sup>73</sup> *Corporations Act 2001* (Cth) s 183. These duties reflect the fiduciary duties recognised at equity.

<sup>74</sup> Department of Education and Early Childhood Development, *Shared Facility Partnerships – A Guide to Good Governance for Schools and the Community*, Report on a Victorian Government Initiative (2007) 5.

<sup>75</sup> *Corporations Act 2001* (Cth) s 184.

<sup>76</sup> AS Sievers, 'The Honorary Director: The Obligations of Directors and Committee Members of NFP Companies and Associations' (1990) 8 *Companies & Securities Law Journal* 87, 88.

<sup>77</sup> *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

<sup>78</sup> Simon Longstaff, 'Applied corporate governance: The purpose of a company – two competing conceptions' (1999) *Australian Company Secretary* 62, 63.

<sup>79</sup> *Darvall v North Sydney Brick & Tile Co Ltd* (1987) 16 NSWLR 212.

interests of the company will not sit well with acting in the best interests of existing or future shareholders.<sup>80</sup>

In other circumstances, the interests of other stakeholders may take precedence over the interests of the shareholders. One such circumstance may arise with insolvency, where the interests of the company's creditors must be taken into account.<sup>81</sup>

The traditional, legalistic view of corporate responsibility takes little account of community concerns. The emerging view, backed by the notion of corporate social responsibility, is that directors owe duties not only to shareholders, but to other stakeholders as well, such as the community at large and the environment.<sup>82</sup> The increased interest in corporate social responsibility is evidenced by legislative developments in various international jurisdictions including United States and United Kingdom. In the USA, some states have introduced legislation that allows directors of companies to have regard to the rights and interests of other stakeholders apart from the company's shareholders when making strategic level decisions. Connecticut and Arizona, for example, enacted statutes requiring directors to consider the interests of employees, customers, creditors, suppliers, the wider community and society as a whole when making decisions.<sup>83</sup> In the UK, the class of 'individuals' that directors must have regard to when discharging their duties was broadened from shareholders to members of the company.<sup>84</sup>

In Australia, unlike the US and UK jurisdictions, there is no express legislative requirement that corporate directors have regard to stakeholders other than shareholders, except in

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<sup>80</sup> Lynn A Stout, 'Bad and Not-so-Bad Arguments for Shareholder Primacy' (2002) 75 *Southern California Law Review* 1189, 1197. The author uses the example of a hypothetical situation where the board of directors of a company are faced with a choice between selling the company to the highest bidder, that will subsequently fire all the employees and shut down its manufacturing plant; alternatively the board could sell the company, at a lower price, to a more reputable firm that will keep the company operational and retain the majority of employees. There is little doubt that selling the company at the higher price would be most beneficial to the shareholders. At the same time, however, this choice would not be in the best interests of the employees or the community as a whole. Additionally, in circumstances where a company faces financial insolvency, although it may be more beneficial for the shareholders for the company to continue trading so as to avoid a share value decrease, it is not in the best interests of the company to do so, (as it simply incurs more debt that it is unable to repay), or the interests of the creditors.

<sup>81</sup> *Walker v Wimborne* (1976) 137 CLR 1. The duty also extends to prospective creditors: *Winkworth v Edward Barron Development Co Ltd* [1987] 1 All ER 114, 118. Similarly, the beneficiaries of a corporate trustee may have a similar position to that of the creditors, so that directors 'must not disregard ... the interests of beneficiaries who are not shareholders but who are entitled to receive a benefit from the company's activities as a trustee of the relevant trust': per Walters J in *Hurley v BGH Nominees Pty Ltd (No 2)* (1984) 2 ACLC 497, 506. This principle was affirmed in *Jeffrey v NCSC* (1989) 7 ACLC 556, 565.

<sup>82</sup> Simon Longstaff, 'Applied corporate governance: The purpose of a company – two competing conceptions' (1999) *Australian Company Secretary* 62, 65.

<sup>83</sup> Shelley Marshall and Ian Ramsay, 'Stakeholders and Directors' Duties: Law, Theory and Evidence' [2009] *UMelbLRS* 2, 17.

<sup>84</sup> *Companies Act 2006* (UK) s 172(1): Duty to promote the success of the company (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to— (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.

specific circumstances as mentioned above. Indirectly, however, the *Corporations Act* does support and promote corporate directors having regard to stakeholders other than shareholder - such as the environment. For example, the Annual Directors' Report must state whether the company's operations have been subject to environmental regulation under a Commonwealth or State law, and if so, the steps undertaken by the company to remedy any resulting damage and comply with the respective regulation.<sup>85</sup> Another example that clearly indicates a shift in focus towards corporate social responsibility in governance is illustrated by the 2009 decision of the NSW Supreme Court in the matter of James Hardie Industries Ltd. The Court found that the former board of directors of the company breached their statutory duties by failing to familiarise themselves with the contents of a 2001 press release prior to it being made available to the public.<sup>86</sup> The press release contained false and misleading information with respect to the company's ability to meet all liabilities arising from present and future asbestos claims. In doing so, the Court clearly indicated that the interests of potential investors, and the public at large, must be taken into account by directors in the course of discharging their statutory duties.<sup>87</sup>

NFP organisations (and impliedly, most schools) encourage a greater focus on stakeholders rather than members.<sup>88</sup> Those stakeholders include government, professional bodies, sponsors, volunteers, competitors and service users.<sup>89</sup> Can the directors' duties as prescribed by the *Corporations Act*, primarily concerned with for-profit companies, be equally applicable to NFP companies, given their divergent governance focus? This is a moot point. On the one hand, the shift from shareholder-focused governance to stakeholder-focused governance in the for-profit sector may continue and lessen the conceptual gap around governance as between for-profit and NFP activities. On the other hand, the differences might not be capable of reconciliation. If governance obligations are legislatively required to be equally applied to both sectors, it may harm both sectors rather than being optimal.

A second point remains, namely, that for-profit companies and NFPs ultimately have divergent purposes. The principal purpose or aim of for-profit entities is profit-seeking. On the other hand, NFPs' ultimate purpose is to 'achieve a community, altruistic or philanthropic purpose'.<sup>90</sup> The point of inquiry then is whether the current legislative regime, enacted primarily for the efficient and effective governance of the for-profit sector, would apply equally as effectively in the NFP sector.

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<sup>85</sup> *Corporations Act 2001* (Cth) s 299(1)(f). The aim of the legislation is to increase compliance through market forces, rather than simple monitoring and enforcement by the regulator. It is hoped that upon disclosure of breaches of current environmental legislation, market condemnation of the corporate entity's behaviour will follow.

<sup>86</sup> *ASIC v Macdonald (No 11)* (2009) 256 ALR 199.

<sup>87</sup> Drew Cratchley, 'Hardie case delivers strong message to all directors' *AAP* (Sydney), 24 April 2009 <[http://goliath.ecnext.com/coms2/gi\\_0199-10462401/AUSTRALIAN-HARDIE-CASE-DELIVERS-STRONG.html](http://goliath.ecnext.com/coms2/gi_0199-10462401/AUSTRALIAN-HARDIE-CASE-DELIVERS-STRONG.html)> at 6 May 2009.

<sup>88</sup> Suzanne Grant, 'Community (NFP) governance - What are some of the issues?' (2006) 12(1) *Third Sector Review* 39, 44; Productivity Commission Research Report, Commonwealth Government, *Contribution of the Not-for-Profit Sector* (2010) 17.

<sup>89</sup> David Fishel, *The Book of the Board: Effective governance for NFP organisations* (Federation Press, 2<sup>nd</sup> ed, 2008) 17.

<sup>90</sup> Bill Shorten, 'Scoping Study for a National Not-for-Profit Regulator' (Consultation Paper, Commonwealth Government, January 2011) 2.



For schools operating as incorporated companies, being part of the NFP sector does not preclude the making of a profit.<sup>91</sup> This entrenches the law around governance and director responsibilities, since the director owes stewardship to the nominated parties regardless of the purpose that a profit might be directed towards.<sup>92</sup> Schools have a *purpose* and in order to progress that purpose, it is necessary to cover costs. Because the covering of costs is an imprecise matter, it is not possible, even with the best management experience and governance practice, to precisely determine how much income needs to be earned. Therefore most schools make a profit but, unlike commercial for-profit enterprise, it is ancillary to their function.<sup>93</sup> Given that profit making is prudent, if not required, in both the for-profit and NFP sectors, the divergence between the two sectors may be more conceptual than practical. To the degree that this is so, the application of current governance obligations would not harm both sectors, but rather support them.

## 6.0 FUTURE DIRECTIONS

The governance of the NFP sector has been under considerable scrutiny internationally over recent decades.<sup>94</sup> Given the importance of the sector to the economy this trend is likely to continue.<sup>95</sup>

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<sup>91</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3<sup>rd</sup> ed, 2008) 441: 'All [not-for-profits] by definition exist for a purpose other than profit. That is not to say that they cannot or do not make a profit. It simply means that they cannot return it to investors. The purpose may include the promotion of some sport, the mission of a particular church or some educational objectives.'

<sup>92</sup> With commercial for-profit enterprise, the making of a profit is then subject to another governance decision: namely whether to declare a dividend and if not a full payment of profit, how the residual (that becomes retained earnings) is to be utilised in fulfilment of the company's objectives. Schools make similar decisions except that, as for all NFPs, there is no distribution of profit to stakeholders per se; rather profit is directed towards the furtherance of the school's objectives.

<sup>93</sup> It follows that growth considerations for a NFP are considered with the school's objectives in mind as distinct from those of a for-profit enterprise, where the key factor is maintaining earnings and profit growth to ensure a steady return to investors and to promote further investment to outsiders by portraying the enterprise as a sound investment opportunity: both in income and capital growth terms.

<sup>94</sup> For example: Institute of Law Research and Reform, *Proposals for a New Alberta Incorporated Association Act* (Report 49, 1987); Law Reform Commission of British Columbia, *Report on Conflicts of Interest: Directors and Societies* Vol 1 & 2 (LRC 144, 1995); Ontario Law Reform Commission, *Report on the Law of Charities 'The Non-profit Corporation: Current Law and Proposals for Reform'* (OLRC, 1996) ch 15, 451-506; *Building on Strength: Improving Governance and Accountability in Canada's Voluntary Sector* [The Broadbent Commission] (Canada, 1999); State Service Authority (Victoria) *Review of Not-for-Profits: Final Report* (2007); Ontario Ministry of Government Policy and Consumer Protection Services Division, *Modernisation of the Legal Framework Governing Ontario Not-for-Profit Corporations* (Consultation Paper No 3, 2008); British Columbia Law Institute, *Report on Proposals for a New Society Act: A report prepared for the British Columbia Law Institute by the Members of the Society Act Reform Project Committee* (BCLI 51, 2008); National Audit Office (UK), *Building the Capacity of the Third Sector* (2009); Australian Senate Inquiry into the Disclosure Regimes for Charities and Not-for-Profit Organisations (Canberra, 2009); Productivity Commission Research Report, *Contribution of the Not-for-Profit Sector* (Canberra, 2010); Commonwealth Attorney General, *Scoping Paper for National Not-for-profit Regulator* (Canberra, 2011).

<sup>95</sup> As mentioned by the Commonwealth Attorney-General in *Scoping Paper for National Not-for-profit Regulator* (Canberra, 2011), domestically the NFP sector consists of more than 600,000 entities and contributes approximately \$43 billion to GDP annually. In 2006/07 the NFP sector accounted for 4.1% of total GDP, a significant increase from 3.1% in 1999/00. The sector has experienced strong growth at a rate of 7.8% pa between those years. This growth rate is more than double the real growth rate of the economy (Productivity Commission Research Report, Commonwealth Government, *Contribution of the Not-for-Profit Sector* (2010) xxvi, 63).

In Australia, *Scoping Study for a National Not-for-Profit Regulator*, a consultation paper released in January 2011, is the most recent government initiative to critically assess the governance of the NFP sector.<sup>96</sup> Amendments to the legislative infrastructure of the sector will surely follow. The ongoing impetus for consideration of the NFP sector comes from its growth, government revenue concerns and the call for more public accountability.<sup>97</sup> The consultation paper sought to determine options and feasibility for a nation-wide regulator. This call for submissions augments a report of the Australian Productivity Commission ('APC'): *Contribution of the Not-for-Profit Sector* (2010).

The APC Report primarily outlined the significant contribution of the NFP sector to the economy and annual GDP growth. Additionally, the report critically evaluated the effects of the current regulatory regime upon NFP organisations and proposed legislative amendments with the aim of ensuring the future viability of the sector. A sound regulatory regime is one that encourages trust in the sector and facilitates the operation of NFPs.<sup>98</sup>

NFPs are structured as unincorporated entities, incorporated associations or companies limited by guarantee.<sup>99</sup> These types of organisational structures pose challenges to NFPs. For example, unincorporated entities require minimal costs to establish and they are subject to minimal governance requirements. However, their lack of a separate legal status makes it difficult to access capital.<sup>100</sup>

In relation to incorporated associations regulated by State and territory specific legislation, the costs of complying with legislative requirements are a concern, given that NFPs operate across State and territory boundaries.<sup>101</sup> One alternative is to migrate to the corporate legal form. This will result in transaction costs, which could be prohibitive to smaller associations.<sup>102</sup> A second alternative is to harmonise legislation. However, the administration costs of harmonisation would be a deterrent to government bodies.<sup>103</sup> These costs might be avoided with a nation-wide regulator of the sector.

Companies limited by guarantee do not have the same disadvantages. Their separate legal status makes it less problematic to raise operational capital, and the costs of operating across different States and territories are minimised by the existence of a single nation-wide regulator, the Federal government. The major disadvantage arises from the legislation's inability to differentiate between the various entities using this legal form. Pursuant to the *Corporations Act*, all corporate entities - public, proprietary or companies limited by

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<sup>96</sup> Previous Reports and Inquiries include: Charities Definition Inquiry's *Report of the Inquiry into the Definition of Charities and Related Organisations* (Canberra, 2001); Senate Economics Committee's *Inquiry into Disclosure Regimes for Charities and NFP Organisations* (Canberra, 2008); Australian Government's *Review into Australia's Future Tax System* (Canberra, 2008); Senate Economic Legislation Committee's *Inquiry into Tax Laws Amendment (Public Benefit Test) Bill 2010*.

<sup>97</sup> Commonwealth Government, Explanatory Materials, Exposure Draft: Australian Charities and Not-for-profits Commission Bill 2012 (Cth), released to explain the proposed structure of the NFP sector, including governance recommendations.

<sup>98</sup> Productivity Commission Research Report, Commonwealth Government, *Contribution of the Not-for-Profit Sector* (2010) 114.

<sup>99</sup> *Ibid* 7.

<sup>100</sup> *Ibid* 187.

<sup>101</sup> *Ibid* 124.

<sup>102</sup> *Ibid* 121.

<sup>103</sup> *Ibid* 125.

guarantee - are subject to largely identical duties and obligations, irrespective of their size or constituency. The costs of compliance, such as corporate reporting, can be prohibitive to smaller NFPs that lack significant resources.<sup>104</sup>

Nonetheless, the corporate structure appears to be the only one imposing substantial accountability and responsibility obligations on directors<sup>105</sup> and is the most reputable legal form. Recent legislative measures promote the adoption of this particular legal structure.

One such measure has been to minimise the burdens imposed by the corporate structure. The *Corporations Amendment (Corporate Reporting Reform) Act 2010* (Cth) has significantly altered reporting requirements of companies limited by guarantee, to take into account the size of the company. More specifically:<sup>106</sup>

- If the company's annual revenue is less than \$250,000, the company is not required to prepare a financial or directors' report, unless requested to do so by a member or ASIC. If a financial report is prepared, it does not need to be audited;
- If the company's annual revenue is less than \$1M, the company must prepare a financial and directors' report, although the financial report is less detailed than that required of other corporate forms. If a financial report is prepared, it can be either reviewed or audited;
- If the company's annual revenue is \$1M or more, the company must prepare a financial and directors' report, although the directors' report is less detailed than that required of other corporate forms. The financial report must be audited.

Another measure, at the State level, has been to encourage existing incorporated associations to transition to the corporate form. For example, the *Associations Incorporation Act 1991* (ACT)<sup>107</sup> allows incorporated associations to apply for incorporation as companies limited by guarantee under Commonwealth corporations legislation. Similarly, the Queensland Government Department of Employment, Economic Development and Innovation is currently considering amendments to the *Associations Incorporation Act 1981* (Qld). The proposed amendments would allow existing incorporated associations to transition to the company limited by guarantee structure without incurring transfer fees or capital gains tax liability.<sup>108</sup>

Subsequent to the recommendations made by the APC Report and the 2011 Scoping Study, the Australian Charities and Not-for-profits Commission ('ACNC') was to commence operations on 1 July 2012.<sup>109</sup> The 1 July 2012 timetable has since been revised and it is

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<sup>104</sup> Ibid 118.

<sup>105</sup> Ibid 127.

<sup>106</sup> *Corporations Amendment (Corporate Reporting Reform) Act 2010* (Cth) s 285A.

<sup>107</sup> *Associations Incorporation Act 1991* (ACT) s 82.

<sup>108</sup> Productivity Commission Research Report, Commonwealth Government, *Contribution of the Not-for-Profit Sector* (2010) 121.

<sup>109</sup> Commonwealth Government, Explanatory Materials, Exposure Draft: Australian Charities and Not-for-profits Commission Bill 2012 (Cth). The objects are set out in clause 1.50; to pursue the promotion of 'the good governance of NFP entities; accountability of NFP entities, including accountability to donors and to governments that provide funding and support to these entities, and to the public in general; transparency of NFP sector, including providing educational information to the sector and the provision of improved information about the sector to the public; and the simplification of NFP entities interactions with governments, including the minimisation of regulatory duplication.'

anticipated that ACNC will commence its operations on 1 October 2012, while the new governance standards will commence after 1 July 2013.<sup>110</sup> Initially, its primary purpose will be to determine the legal status of groups seeking NFP benefits.<sup>111</sup> The government has also undertaken further reviews of the NFP sector, particularly on appropriate governance obligations and the company limited by guarantee structure.<sup>112</sup>

No doubt the number of NFP entities choosing the company limited by guarantee structure will increase. The future direction of the sector may be to require *all* NFP entities to adopt the same legal structure. Will the company limited by guarantee structure be the most appropriate for all NFP entities? We think so.

There are inherent differences between the for-profit and NFP sector. These governance discrepancies could be addressed with a chapter in the *Corporations Act* for specific matters relevant to the sector. For NFPs structured as companies limited by guarantee this has the advantage that they will not have to comply with more than one regulatory regime. For example, if the ACNC proposed legal form differs, NFP companies limited by guarantee would have to comply with the *Corporations Act* *and* any regulation imposed by the new proposed regulator. This may prove difficult for a school so structured being required to manage regulatory risk in the same way as a for-profit concern with perhaps less ability to do so because of requirements imposed by an NFP regulator.

Further reviews of the NFP sector will surely ensue. The legislative amendments so far appear to indicate a preference for a corporate structure for NFP entities. We believe that this trend will continue because the corporate structure embodies the principles of a sound regulatory regime, not the least of which is public trust in the sector. However, there is a direct positive correlation between the degree of appropriateness of the corporate structure to the NFP sector, and flexibility by the regulatory regime to account of diverging purposes of NFP and for-profit companies.

## 7.0 RECOMMENDATIONS

- (1) **Non-governance obligations of schools:** Most common law decisions involving educational institutions have been confined to physical injuries suffered by students and, to a lesser degree, discrimination and defamation claims.<sup>113</sup> Litigation in the education field will increase in the future. In 1994, Dowsett J of the Queensland Supreme Court anticipated that the increase in future litigation would reflect

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<sup>110</sup> David Bradbury MP and Mark Butler MP, 'Staging the introduction of regulatory reform for the not-for-profit sector' (Media Release No 032, 17 May 2012)  
<<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2012/032.htm&pageID=003&min=djba&Year=&DocType=0>>.

<sup>111</sup> Australian Government, 'Making it Easier for Charities to Help Those Who Need It' (Media Release, 10 May 2011) 1  
<<http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/077.htm&pageID=003&min=brs&Year=&DocType=>>>.

<sup>112</sup> *Ibid* 3  
<<http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/077.htm&pageID=003&min=brs&Year=&DocType=>>>.

<sup>113</sup> Doug Stewart, 'Legal risk management in Australian schools' (1992) 18(4) *Unicorn* 39, 40.

growing community demands for accountability within the teaching profession.<sup>114</sup> There is no reason to consider that the obligations of schools more generally ought not be consistent with community standards generally. Nor is there evidence to suggest that those obligations be of a higher standard, although further consideration of these factors is warranted;

(2) **Governance obligations of schools:** There will also be increased litigation involving schools' governance issues. School board members will increasingly be held liable for their conduct in making financial decisions on behalf of the institutions. This is because of to two main developments:

- First, as evidenced by a Victorian government initiative, schools are increasingly encouraged by the State governments to forge commercial relationships with various bodies (such as local councils, local businesses, commercial organisations, sport and recreation providers, and other training and NFP organisations). The creation of these commercial relationships are for the purposes of building and maintaining facilities for the benefit of the schools and its student body.<sup>115</sup> Entering into such business arrangements has important implications for the schools' present and future financial planning and stability. These commercial relationships require that the school board members and the principal have a sound understanding of business practices and legislation;
- Second, financial scandals and bankruptcies affecting schools, as well as prosecutions of principals and school business managers, are increasingly common.<sup>116</sup> For example, in 2003 a large private school on the Queensland Sunshine Coast owed creditors \$8 million,<sup>117</sup> and in 2002 St Stephen's College in Coomera, Queensland, became the focus of media attention over levels of incurred debt.<sup>118</sup> The College was in receipt of substantial federal government funding but did not undertake the capital projects for which the grants were made.<sup>119</sup> In 2012, Mowbray College in Melbourne entered into voluntary administration, after the school board announced debts exceeding \$18 million.<sup>120</sup>

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<sup>114</sup> Douglas J Stewart, 'Principals' Knowledge of Law Affecting Schools' (1996) 1(1) *Australia New Zealand Journal of Law Education* 111, 114.

<sup>115</sup> Department of Education and Early Childhood Development, *Shared Facility Partnerships – A Guide to Good Governance for Schools and the Community*, Report on a Victorian Government Initiative (2007) 5.

<sup>116</sup> Jane Nicholls 'Commonwealth Funding Programs for Private Schools 1996-2004' (Paper prepared for the Australian Education Union, 2004) 5.

<sup>117</sup> The school was to receive a further \$4 million in Commonwealth funding in 2004. This is because non-governmental schools experiencing financial difficulties may apply for Schools Transitional Emergency Assistance (STEA) Grants if certain criteria for eligibility are satisfied. More specifically, the school must show that it has a recovery plan, the situation must be a genuine emergency, it must be unexpected and the school must show that it does not have access to alternative funding. One of the reasons for providing the grants cited by the Commonwealth was 'financial management problems.' For a more detailed discussion on this matter please see Jane Nicholls 'Commonwealth Funding Programs for Private Schools 1996-2004' (Paper prepared for the Australian Education Union, 2004) 19.

<sup>118</sup> Jane Nicholls 'Commonwealth Funding Programs for Private Schools 1996-2004' (Paper prepared for the Australian Education Union, 2004) 25.

<sup>119</sup> *Ibid* 26.

<sup>120</sup> Ami Humpage and Nathan Mawby, 'Mowbray College enters into voluntary administration after announcing \$18m debt' (30 May 2012) *Herald Sun* <<http://www.heraldsun.com.au/news/victoria/mowbray-college-enters-into-voluntary-administration-after-announcing-18m-debt/story-fn7x8me2-1226372949316>>.

There appears to be no good reason why a manager, including head masters, ought not to be fiscally responsible and aware about making third party dealings for the use of school property. Companies have property rights that are well established. Along with the benefits of a privately-held school utilising a corporate structure come attendant responsibilities, such as those outlined above. We see no need to make changes for these responsibilities. However, with respect to governance we reserve final judgement for the discussion around types of governance. As the discussion in the paper is around stakeholders,<sup>121</sup> the government might seek to define a different theory base in future legislating (see (5) below);

- (3) **Funding:** One issue between for-profit commercial firms and NFP schools is the consideration of how the latter are funded. The former typically draw the funds that they need from profit and investor shareholders and often government support, depending on industry type. Schools, on the other hand, are of interest to governments because of the traditional role that government has played in the provision of education services, and because schools are a politically-sensitive topic.<sup>122</sup> The difficulty with the strong historical interest is that government continues to hold a strong interest, even where it does not provide all of the funding. This is further complicated by the division of responsibility as between the Commonwealth and the States. The State and territory governments are responsible for the legislative administration of the school system, while the Federal government grants support through funding. Although the Commonwealth government does not directly legislate with respect to the administration of the school system in each jurisdiction, it does influence this through its funding policies.<sup>123</sup> The Commonwealth government financially supports both governmental and non-governmental schools through funding agreements with the States, agreements with non-governmental schools or individual authorities. The funding received by the State and territory governments is dependent upon various conditions imposed by the Commonwealth government, such as: (1) achievement and reporting against performance targets, and (2) school performance information being made publicly available.<sup>124</sup> It is anticipated that in response to recommendations<sup>125</sup> to amend its criteria for awarding funding to educational institutions<sup>126</sup> and to combat increased media attention to cases such as those mentioned above, the Commonwealth government will implement more stringent conditions on the State and territory governments to amend their respective legislation. Such legislative amendments might sit well with

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<sup>121</sup> Indeed, school stakeholders may have wildly differing opinion on property rights and residuals than their school board.

<sup>122</sup> In addition to government funding public serving NFPs (including schools) obtain part of their operating income from membership dues, donations, bequests, profits from unrelated business ventures, sponsorship and other forms of commercial arrangements and interest on capital reserves, as outlined by Mark Lyons, *Third Sector* (Allen & Unwin, 2001) 23.

<sup>123</sup> Behnaz Mohajeran, *An Investigation of the relationship between governance, decision-making and school effectiveness: a case study of four high schools* ( PhD Thesis, Faculty of Education, University of Wollongong, 2006) <<http://ro.uow.edu.au/theses/173>> 18.

<sup>124</sup> Jim Jackson and Sally Varnham, *Law for Educators: School and University Law in Australia* (LexisNexis Butterworths, 2007) 10.

<sup>125</sup> Jane Nicholls, 'Commonwealth Funding Programs for Private Schools 1996-2004' (Paper prepared for the Australian Education Union, 2004) 6-9.

<sup>126</sup> *Ibid* 29-30.

governmental schools since the government is their master and primary stakeholder. Funding for schools that receive minute amounts of government assistance, such as those that are the focus of this paper, becomes a governance risk for them because of the unpredictable nature of the requirements of government. Even if the governance requirements of the schools considered here are clear, they may be difficult to administer and impossible to predict (for planning purposes) if subject to the vagaries of government and political influence. Assuming for the moment that the recommendation is for NFP private schools to be fully compliant with all laws that apply to commercial enterprise, schools will have to deal with regulatory risk in the same way as for-profit concerns. More troublingly, NFP private schools will possibly receive more direction from government with the attendant risk that this direction is inconsistent with the best governance for the school's choice of operational structure. Our recommendation here, in the absence of new laws that make clear the particular governance requirements for schools, is for schools that have minimal government assistance to plan to remove any reliance or receipt of government funds or assistance and to be fully self-supporting. In this way schools will ensure that they have perfect capability in complying with the *Corporations Act* rules on directors' duties and governance. This will separate the requirements (albeit government imposed) of the provision of education services from those related to the provision of funds. We note the conflict that this course of action has in relation to the recent government stimulus package for schools;

- (4) **Compliance:** Directors' duties are grounded in equitable doctrine and augmented by *Corporations Act* provisions. The duties of office bearers are akin to the accounting notion of stewardship on which corporate governance rests. The development of the doctrine is a result of commercial activity and trust law where monies are held on trust for a variety of beneficiaries. The path dependence of the development of corporate governance therefore does not rest primarily with NFP schools in mind. It follows that the governance principles may not be the most appropriate for an overview of the conduct of a school.<sup>127</sup> The underlying principles of good faith and applying a degree of diligence and skill are, however, entirely applicable to schools and by implication to a wide range of activity. Imputing the duty, however, is another matter: this problem is solved when the school takes on the operating structure of a company. Once this is done, then it is the school's responsibility to comply with the general law and the *Corporations Act*. We think it very important that capable directors be appointed and that the law is followed and that this ought to be rigorously enforced by ASIC. Where there are conflicts between legal requirements and statutory education-specific requirements, then the board is under a duty to consider them, to seek advice and where necessary to liaise with government officers in the same way as a commercial enterprise will. A subsidiary question arising from these considerations is whether the school ought to have its own structure with a government determined legislative base that takes into account

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<sup>127</sup> Peter D Steane and Michael Christie, 'Nonprofit Boards in Australia: a distinctive governance approach' (2001) 9(1) *Corporate Governance: An International Review* 48, 51. The authors argue that governance principles adequately suited to the for-profit sector (concerned primarily with wealth creation) are not equally suited to organisations that are not concerned with wealth creation explicitly, such as NFPs.

the NFP basis of the school's operations. This is a possibility that relies in part on (5) below; and

- (5) **Theory:** There is some debate as to the true nature of the theory that underlies the operation of a school. John Farrar notes four possibilities:<sup>128</sup> trust culture, membership culture, shareholder culture, and strategic culture. If one subscribes to there being diverse stakeholders, the larger the number of interests that need to be taken into account by schools, the more difficult and unattainable the task. In the simplest for-profit company operation example, where the company is solvent, then its duty is to make a profit and increase the value of the firm. This is simple and the strategies to determine this are decided upon by the board of directors in accordance with sound governance of commercial principles. For a school, the stakeholders are ultimately those that attend: the aim might be similarly simple, namely to provide the best education possible for those attending school. However the implementation of this is not so simple and this is where the difficulties arise. We recommend that schools only take up the company structure where they are able to comply with the law as it exists. Lobbying for a different set of rules for the governance of NFP schools utilising the company as an operating structure would be difficult.
- (6) **Government: other jurisdictions:** It would be useful to compare the treatment of NFP entities in England and the USA. Such a comparison is not easily made, especially because the US has different defences for breaches of directors' duties from those in Australia. England has strayed somewhat by virtue of the *Charities Act* UK (2006) that establishes a Charity Commission and provides for charities that are incorporated entities. The *Companies Act* UK continues to apply with respect to certain aspects of NFP operation and the *Charities Act* makes provision to ensure that there is consistent treatment of the NFP sector. For example, Chapter Six of the *Charities Act* requires an accounts audit of a charity that is not incorporated; and Chapter Seven allows for alterations to the accounts requirements of a charitable company. Other countries that have placed specific focus upon charities include New Zealand, Ireland, Scotland and Canada.

## 8.0 CONCLUSION

An incorporated entity operating as a school, in the absence of its own act of Parliament, is subject to the same law and considerations as commercial entities, although those with an interest might not see the matter so clearly. There is no harm in holding schools to this standard, particularly in light of recent legislative initiatives recognising the distinctiveness of the NFP sector, of which schools are a part, and amending their application accordingly. Additionally, we suggest that the Courts are the most capable to make distinctions where required. There is a need for an enhanced push for education around governance for schools (as indeed there continues to be a need for private companies for similar reasons around director skill). Finally, if this is not suitable for a school, or if the conflict issues at (4) apply,

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<sup>128</sup> John Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3<sup>rd</sup> ed, 2008) 443 citing Ford Partnership Report, 'Under Pressure: Trends in the Governance of Large Charities for the 21<sup>st</sup> Century' (UK, 1997).



then a commercial decision around government versus non-government assistance is to be made and made promptly, as it is in a commercial for-profit enterprise.