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When it matters

Financial Good Governance, Related Parties and Protecting Funding Arrangements

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Carroll & O'Dea Lawyers

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- A member of the Australia and New Zealand Education Law Association and a past President of its NSW Chapter.
- A member of the English, American and South African Education Law Associations.
- A member of the Australasian Association of Workplace Investigators.
- A member of the Editorial Board of the CCH *School Principals Legal Guide*.
- The editor of *Education Law Notes*, which keep schools throughout Australia up-to-date with education law developments.
- A reviewer for the *International Journal of Law and Education*.
- A former Chair of the Council of MLC School, Sydney.
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David has presented at conferences in the United Kingdom, South Africa, Belgium, the Czech Republic, New Zealand and throughout Australia, and published numerous papers on topics as varied as enrolment procedures and conditions; student rights; teachers' liability; investigations; risk management; teachers, school counsellors and confidentiality; bullying (including cyber bullying); outdoor education; sport; multiculturalism in education; discrimination; discipline; and child protection.

David regularly presents in-school seminars for both teachers and administrators on education law matters. He also consults to schools and their boards on governance issues. David is often engaged by schools to conduct workplace and child protection investigations.

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What is this paper about?

With 2,831 non-government schools in Australia in 2018[1] employing almost 190,000 people, educating 1,335,665 students[2] and receiving government financial assistance of more than $14 billion[3], there is a real need for proper accountability and good governance.

I therefore focus in this paper on the standard of governance required of Australian schools and their board members. I also consider the statutory frameworks at both federal and state levels that require a significant level of accountability by schools in return for the financial assistance they receive from governments.

Good Governance

Schools are established for the general purpose of advancing education – a charitable purpose. In non-government schools, this purpose is set out in the school's constitution. The board members must ensure that the assets and income of the school are only used for that purpose.

Schools and their board members must comply with the law. The board members must always act in the best interests of their school. They must ensure that its funds, assets and reputation are not placed at undue risk.

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

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[1] Australian Bureau of Statistics - 4221.0 - Schools, Australia, 2018
[2] Ibid
[3] According to the Productivity Commission's Report on Government Services 2019 Part B, Chapter 4, recurrent expenditure by Australian, State and Territory governments on school education in 2016□17 was $57.8 billion, of which $43.7 billion was spent on government schools. (https://www.pc.gov.au/research/ongoing/report-on-government-services/2019/child-care-education-and-training/school-education)

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

Common law duties

Duty of loyalty

It is well established that there is a relationship of trust and confidence between director and company.[4] This is referred to as a fiduciary relationship. In *Hospital Products Ltd v United States Surgical Corp*, Mason J defined a fiduciary relationship:

> *The critical feature of these relationships is that the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense.*[5]

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

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

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

(b) to act for proper purposes; and

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

The negative aspects of the duty of loyalty are those which require directors to avoid conflicts of interest of various kinds. This includes the prohibition against directors improperly using information and/or their position.[6]

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

[5] (1984) 156 CLR 41 at 96-97

[6] Austin and Ramsay in *Ford's Principles of Corporations Law* (LexisNexis, 14th ed, 2010) at 364 [8.010] draw the helpful distinction between positive and negative duties.

Duty of care

The duty of loyalty is only one aspect of the duties of directors. In addition, directors owe a duty of care to their company. This is a common law duty arising out of the close relationship between a company and its directors.[7] It requires directors to act with sufficient care, skill and diligence in relation to the affairs of the company.

Statutory duty

Australian Charities and Not-for-profits Commission

Governance Standards

Since 1 July 2013, charities, which include most non-government schools, have been required to meet a set of five Governance Standards to be registered and remain registered with the Australian Charities and Not-for-profits Commission (ACNC).

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

Governance Standard 5 sets out the duties that apply to a charity's board members. Under Governance Standard 5, the board members must:

(a) act with reasonable care and diligence;

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

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

(d) disclose conflicts of interest;

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

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

Key to meeting this Standard is understanding that board members have a duty to act in their school's best interest. I now deal with each of these duties.

[7] *Daniels (formerly practising as Deloitte Haskins & Sells) v Anderson* (1995) 37 NSWLR 438

Reasonable care and diligence

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

(a) prepare for and attend meetings

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

James Hardie board members failed to do this as *Gillfillan v Australian Securities & Investments Commission*[8] revealed. In this case, the board considered a draft announcement to the ASX. Two directors were at the meeting by telephone. They had not seen copies of the draft and did not ask to see a copy. Yet they voted in favour of making the announcement.

The Supreme Court of New South Wales found that the board members appreciated that a significant announcement was to be made on the controversial subject of whether funding, which had been set aside for victims of asbestosis, could be guaranteed. The onus was on them to be cautious when voting on the making of the announcement – either by seeking further information or by explicitly abstaining. They gave evidence that they would not have voted for the announcement had they known its terms. Consequently, the Court made a declaration that each of the directors had contravened their duty of reasonable care and diligence and made orders disqualifying each director from managing corporations for five years and imposing on each a financial penalty of $30,000.[9]

The directors appealed to the New South Wales Court of Appeal, which set aside the declarations and orders made against them by the Supreme Court.[10] ASIC then appealed to the High Court, which reinstated the

[8] [2012] NSWCA 370; see also *Australian Securities and Investments Commission (ASIC) v Hellicar* (2012) 247 CLR 345 (French CJ, Gummow, Hayne, Heydon, Crennan, Kiefel and Bell JJ)
[9] *Australian Securities Investments Commission (ASIC) v McDonald (No 11)* [2009] NSWSC 287 (Gzell J) (Liability Judgment); *Australian Securities Investments Commission (ASIC) v McDonald (No 12)* [2009] NSWSC 714 (Gzell J) (Penalty Judgment)
[10] *Morley v Australian Securities and Investments Commission (ASIC)* [2010] NSWCA 331 (Spigelman CJ, Beazley and Giles JJA)

Supreme Court's declarations and orders and sent the case back to the Court of Appeal for it to remake its decision about how severe its disqualification and penalty orders should be.[11]

Barrett JA for the Court of Appeal offered some advice to board members participating in board meetings by telephone, audio-visual link or other like means of communication. His Honour said that, as a bare minimum, each participating director must be able to hear and be heard by every other participating director for the duration of the meeting.[12] However, he went on to say "more may be required in a given case".[13] He gave the following examples:

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

(ii) where a document is to be "tabled" at a meeting of directors, the technology being used must be such as to allow the full content of the document to be placed before every participating director.[14]

It follows that board members participating in board meetings remotely must:

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

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

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

(b) become familiar with the school's business

All board members, irrespective of their professional qualifications, are expected to keep themselves properly informed of the school's business and

[11] *Australian Securities and Investments Commission (ASIC) v Hellicar* (2012) 247 CLR 345 (French CJ, Gummow, Hayne, Heydon, Crennan, Kiefel and Bell JJ)
[12] *Gillfillan v Australian Securities & Investments Commission (ASIC)* [2012] NSWCA 370, [15]; see also *Re GIGA Investments Pty Ltd* (1995) 17 ACSR 472 (Branson J)
[13] *Gillfillan v Australian Securities & Investments Commission (ASIC)* [2012] NSWCA 370, [15]
[14] Ibid

to apply sound judgment based on proper information. Therefore, a minimum degree of skill and competence is required of board members. This excludes the possibility that board members could escape liability by pleading that they have insufficient education or experience to understand the complexity of the school's affairs.

This is precisely what the board members failed to do in *Commonwealth Bank of Australia v Friedrich*.[15] This case stemmed from the ruin by fraud of a company called The National Safety Council of Australia Victorian Division. The fraud was vast and its perpetrator was Mr Friedrich, the Chief Executive Officer of the company. He duped his fellow directors and the Commonwealth Bank of Australia, the company's principal source of finance, into believing that the company was solvent and profitable. In fact, the company was insolvent and carrying on its business at a huge and increasing loss. There was said to be a deficiency of assets of some $258 million. When the company was placed in provisional liquidation and ordered to be wound up in 1989, the CBA was owed nearly $97 million.[16]

This case is unusual and of particular interest for schools because the company was one limited by guarantee – the structure favoured by many non-government schools. In 1928, the founding members guaranteed £1.1.0 – clearly, an inadequate amount to cover its debts! Consequently, the CBA brought a claim against the directors personally, each of whom served in an honorary and part-time capacity. All but one of the directors, Mr Eise, reached a compromise with the CBA.[17]

Mr Eise argued that he was an unwitting victim of Mr Friedrich's deceit and that he should, therefore, be exonerated from any suggestion of unreasonable conduct or unreasonable appreciation of the facts.[18] Conversely, the CBA argued that Mr Eise was incompetent and this, combined with a lack of due care, diligence and astuteness, meant he had failed in his duties as a director.[19]

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[15] [1991] 5 ACSR 115 (Tadgell J)
[16] Ibid, 117-118
[17] Ibid
[18] Ibid, 121
[19] Ibid

When examining the company's structure and management, Tadgell J discussed the directors' professional qualifications. His Honour observed "that with one possible exception their talents did not extend to the field of corporate financial management".[20] His Honour then turned his attention to Mr Eise specifically, commenting:

> *He claims in particular to have only a passing acquaintanceship with commercial principles. He denied on oath that he had ever learned how to read a balance sheet or a profit and loss statement… He gave me the very clear impression that, throughout his involvement with the company, he was never much disposed to concern himself with financial detail. Plainly enough, for whatever reason, he was not in the habit of studying such financial statements as he received. By and large, he confined himself to the bottom line and was content with a balance sheet that showed an excess of assets over liabilities and a profit and loss statement that showed an excess of revenue over expenditure.*[21]

Although Tadgell J expressed sympathy for Mr Eise, a 75-year-old former plumber who had devoted himself enthusiastically to community service over a period of 20 or more years, his lack of education and experience and subsequent failure to understand the complexity of the company's financial affairs did not absolve him from liability.[22]

However, Tadgell J went on to observe that Mr Eise did not have to be professionally qualified in financial affairs to suspect that something was amiss. Originally, the company's objects were the provision of services and education to promote workplace, child and home, road, water and air safety.[23] However, after Mr Friedrich was appointed as CEO, there was an enormous expansion in the activities of the company in terms of staff employed, work done, property acquired (or that Mr Friedrich said had been acquired) (for example, a mass of expensive and high-quality engineering,

[20] Ibid, 135
[21] Ibid
[22] Ibid
[23] Ibid, 130

maintenance, medical, communications and training equipment) and fees earned (for example, from firefighting and search and rescue operations).[24]

Notwithstanding Mr Friedrich's dramatic expansion, the rate of it as reflected in the balance sheets and profit and loss statements was "largely illusory" and "fanciful".[25] Tadgell J said a mere comparison with other years would have been "enough to occasion surprise" and "naturally lead one to seek reasons".[26]

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

> *The whole case is to be viewed in the light of the clear fact that, over the last 5 years or more of its life, the [company] was inherently unsuitable as an organisation for the conduct of the business it had developed. The company purported to conduct itself as a commercial entrepreneur. The use for that purpose of a company limited by guarantee and having no share capital is altogether inappropriate.*[27]

Consequently, Tadgell J found in favour of the CBA, holding that the directors, including Mr Eise, did not take reasonable steps that could and should have been taken by them to obtain proper financial information.[28]

There are several lessons from this case for school boards, including:

(i) Board members must be chosen carefully to ensure that they have:

   a. the intellect to understand the complexity of the school's affairs; and

   b. the expertise and experience required to govern a school.

(ii) Board members must hone in on financial information but, at the same time, interpret that information and monitor the general direction and objects of their school by adopting a broad perspective.

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[24] Ibid, 131, 137
[25] Ibid, 131, 140-141
[26] Ibid, 140
[27] Ibid, 200, see also 131, 139
[28] Ibid, 189

(iii) It is good to have a diversity of skills and experience such as governance, finance, legal, cultural, education, strategy, technology, and building. No longer is there room for those who are simply well-meaning. There is also now only a limited role for those whose sole qualification is being a parent, a former student or a member of an associated faith-based organisation.

(c) ask questions

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

(i) seek additional information;

(ii) obtain external advice if necessary; and

(iii) question the principal when he or she puts a proposal.

In *Friedrich*, the fraud was discovered when the auditor took the "simple, obvious and expedient" step of telephoning a number of the company's supposed trade debtors, only to find out that they were "bogus".[29] The non-existence of the supposedly newly acquired safety equipment stored in shipping containers was exposed when the auditor made a simple inquiry with the company's stores officer.[30] Tadgell J concluded that "a simple and prompt check could and should have been made which would have revealed that those assets were largely illusory".[31]

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

(i) that once a project had been approved by the board, the affixing of the seal might be attested by three senior members of the company's staff, including the CEO, general manager and the like;[32] and

[29] Ibid, 190
[30] Ibid, 190-191
[31] Ibid, 191
[32] Ibid, 142

(ii) that the CEO be authorised to make payments by or on behalf of the company by bank draft, telegraphic transfer, periodical payments or direct debits.[33]

The practical effect of the first resolution was that the directors put out of their hands their sighting of any document before it was executed under the company's seal. The result of the second resolution was that the directors gave Mr Friedrich sole discretion to authorise payments for the company and, conversely, they not only lost the right to sign the company's cheques and negotiable instruments, but also the ability to supervise and control the signing of these documents.[34]

This was characteristic of Mr Friedrich's tenure as CEO: he requested a free hand in the conduct and financing of the company's operations. The board readily agreed and left many of the arrangements to him.[35]

At least two lessons can be drawn from these events. Board members should question the principal about a proposal if:

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

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

(d) make considered and independent decisions

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

One of the problems in *Friedrich* was that the board members wholly relied on Mr Friedrich's judgment. For example, the company, like all schools, was partly reliant on government grants. When Mr Friedrich recommended that the company forgo government grants to improve its "image as a

[33] Ibid, 143
[34] Ibid
[35] Ibid, 136, 139

successful and truly independent organisation", the board unquestioningly agreed.[36]

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

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

Tadgell J acknowledged that the board members' task of making considered decisions was made more difficult by the fact that Mr Friedrich manipulated, deceived and lied to them. However, Tadgell J found that the board was so impressed by Mr Friedrich and so caught up in all the excitement surrounding the company's "remarkable expansion" that they did not make independent decisions.[37] As His Honour put it, the board "greatly appreciated and enjoyed" the "almost euphoric sense of high achievement" that Mr Friedrich perpetuated,[38] they took "pride and great satisfaction" from the company's operational activities and they were "content" to watch the company "carry on financially by the force of its own momentum."[39]

Many school principals are charismatic leaders with an entrepreneurial spirit. It is easy for board members to be swept away with the principal's grandiose plans. They must continually remind themselves of why the school exists and ensure that its income and resources are devoted to achieving that purpose.

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

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[36] Ibid, 139
[37] Ibid, 136
[38] Ibid
[39] Ibid, 139

> *Value is often attached to collegiate conduct leading to consensual decision-making, with a chair saying, after discussion of a particular proposal, "I think we are all agreed on that", intending thereby to indicate that the proposal has been approved by the votes of all present.*
>
> *Such practices are dangerous unless supplemented by appropriate formality.*
>
> *The aim is not to consult together with a view to reaching some consensus, although it may well be, as a practical matter, that such consultation facilitates the making of the decision that is ultimately required. The aim is rather that the members of the board should consult together so that individual views may be formed and the individual will of each member may be made known in a clearly communicated way.*
>
> *The culmination of the process must be such that it is possible to see (and to record) that each member, by a process of voting, actively supports the proposition before the meeting or actively opposes that proposition; or that the member refrains from both support and opposition. And it is the responsibility of an individual member to take steps to ensure that his or her will is expressed in one of those ways.*[40]

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

This rule has since been enshrined in section 180(2) of the *Corporations Act*. Although this section does not apply to schools, since it is virtually identical to the common law rule, it is prudent for board members to be

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

mindful of its contents. It states that board members who make a business judgment are taken to meet the requirements of reasonable care and diligence and, therefore, courts will not review their decisions if they:

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

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

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

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

In practice, this means that if a board member prepares for and attends meetings, becomes familiar with the school's business, asks questions and makes independent and considered decisions, the courts will respect his or her judgment. However, a failure to turn one's mind to a matter will not constitute a business judgment.[41]

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

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

(a) Good Faith

There is much debate about the meaning of good faith. One view is that it means that board members must act honestly or have a bona fide belief that their decision or action is in the interests of the school.[42] That is, board members can be said to act in good faith unless they consciously and

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

deliberately engage in conduct knowing that it is not in the interests of the school.[43]

The second view, which has received more judicial and academic support,[44] holds board members to a higher standard of behaviour. This says that it is irrelevant if board members exercise their powers according to their personal moral compass or their "own lights" for acting honestly.[45] Otherwise, as Bowen LJ put it, you might have a "lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly *bona fide* yet perfectly irrational".[46] Rather, board members cannot be said to act in good faith if their decision is shown to be one which no reasonable board could consider to be within the interests of the school.[47]

A board member who is a representative or nominee of another organisation (for example, the former students' association or the parents' and friends' association) may tell the board about the concerns of the nominee organisation. However, the board member's ultimate duty is to make decisions that are in the best interests of the school, not to make decisions that are in the best interests of the nominee organisation.

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

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

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

[45] *Australian Growth Resources Corporation Pty Ltd v Van Reesema* (1988) 13 ACLR 261, 272 (King CJ)

[46] *Hutton v West Cork Railway Co* [1883] 23 Ch D 654, 671; cited with approval in *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* [2002] 41 ACSR 72, 234 [738] (Santow J)

[47] *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); Australian Securities and Investments Commission v Adler* [2002] 41 ACSR 72, 234 [739] (Santow J)

(b) Proper Purpose

Acting for a proper purpose means that a board member must make decisions that help the school to achieve its purpose. Board members must ask themselves, "What has the school been set up to do?"

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

Misuse of position or information

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

"Position" examples

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

(i) Board members actively encouraging or "causing"[48] their school to enter into a contract where the contract confers benefits on or gains advantages for themselves, their relatives or their friends. This includes any companies they, their relatives or their friends own or have an interest in. It is irrelevant whether the benefit or advantage is actually achieved.[49]

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

(ii) Board members using their position to get their friend's child enrolled ahead of others on the waiting list at the school.

In these examples, board members would be in breach of their duty.

"Information" examples

Similarly, if board members use information they have obtained through their position for personal gain or to benefit a family member or friend, they will also be in breach of their duty. For example, board members may hear about the details of a tendering process and know what quotes have been given. If they or their relative or friend operates a business that offers the services for which the school is seeking tenders and if they use or pass on that information to undercut other quotes, this would be improper conduct.

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

Conflict of interest

In my experience, school board members often do not recognise a conflict of interest.[50]

When do conflicts of interest occur?

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

Actual and perceived conflicts of interest

An actual conflict of interest exists where board members decide to contract personally with the school to provide goods or services. In that situation, the board members want to do the best by themselves but at the same time have a duty to act in the best interests of their school. Similarly, an actual conflict of interest exists where board members also hold governance roles with

[50] The ACNC has useful material on conflicts of interest; for example, *Managing conflicts of interest guide – About conflicts of interest* (2015) acnc.gov.au/tools/guides/managing-conflicts-interest-guide

entities with which the school contracts; for example, a board member who is the pastor of a church which owns the land leased to the school has a conflict of interest when the terms of the lease are being negotiated.

A perceived conflict of interest occurs where it could reasonably be perceived, or give the appearance, that a board member's interest in something other than the school's best interest could improperly influence the performance of a board member.

To avoid problems with conflicts of interests, payments to board members and their companies, relatives and friends for goods and services should not be made unless the terms are more favourable than could be obtained at arm's length from a third party. Even then, it is important to be able to demonstrate that this is the case by having obtained quotes from third parties. School boards should have in place a procurement policy dealing with such matters and requiring a competitive tendering process.

The Returned & Services League of Australia (South Australia Branch) Incorporated (RSL SA) learnt this the hard way when, in early 2017, the ACNC commenced an investigation into its governance. In its August 2017 report of the investigation, the ACNC criticised the failure of the RSL SA to manage actual and potential conflicts of interest, in particular its use of firms of lawyers and accountants, two of whose partners were former board members. The specific failures of the RSL SA included:

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

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

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

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

Although the then president, Mr Hanna, said that the relationship between the RSL and the firms was based on a "very clear understanding… [and] on a very long course of conduct", the ACNC said that it did not consider this

explanation to be a "sufficient and transparent agreement".[51] It follows that it is not enough to engage a board member's company on the basis that there is a long running association or because it has charged reasonably in the past.

What should board members do?

If board members have a conflict of interest, or if they perceive that they might have a conflict, they should:

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

(ii) not take part in any discussion or decision-making where they have a conflict – this is not only a good idea but it is also often required by the school's constitution.

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

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

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

Financial management and insolvency

Donations and financial management

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

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

Examples of financial controls

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

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

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

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

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

(v) keeping information about bank accounts safe by making sure any passwords to online banking are kept secure and that there is limited access to them.[52]

Solvency and insolvency

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

[52] *Managing Charity Money: Guide for board members on managing finances and meeting ACNC duties* (ACNC, January 2016) acnc.gov.au/tools/guides/managing-charity-money-guide-board-members-managing-finances-and-meeting-acnc-duties

In its recent investigation into the RSL SA, the ACNC found that the president, Mr Hanna, sought and received payments of $8,769 for his president's allowance and phone expenses on the day the charity was placed in administration. Although Mr Hanna was entitled to the payments, the ACNC said that he "would have known" of the RSL SA's financial situation and, therefore, attempted to benefit himself ahead of the creditors (the RSL SA owed its lawyers $92,410 and its accountants $322,332, although the latter waived its debt).[53]

On a much larger scale, in *Friedrich*, the National Safety Council of Australia Victorian Division represented to major Australian banks that "it was solvent and profitable".[54] In fact, it was insolvent and "carrying on its business at a huge and increasing loss",[55] owing $258 million to the banks. As previously stated, one of the directors, Mr Eise, was found to be personally liable for almost $100 million.

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

Government Financial Assistance to Schools

As already noted, Commonwealth, State and Territory governments provide significant financial assistance to both government and non-government schools throughout Australia. Not surprisingly, governments at all levels have, through legislation and regulation, imposed various conditions designed to ensure that the financial assistance they provide is actually used for the operation of schools and for the benefit of their students.

In this section of the paper, I outline in some detail the financial assistance framework at the Commonwealth level and make brief reference to some of the State legislation, regulation and guidelines.

[53] Castello, above note 51
[54] [1991] 5 ACSR 115, 118 (Tadgell J)
[55] Ibid

Commonwealth

Australian Education Act 2013

This Act provides Commonwealth financial assistance for schools. However, financial assistance is not payable to a school unless there is an approved authority for the school.[56] The approved authority is approved by the Federal Education Minister.[57] The approved authority for a government school in a State or Territory is the State or Territory. The approved authority for a non-government school is a body corporate that is approved by the Minister for the school. The Minister may only approve a person if:

(a) the person satisfies, and will continue to satisfy, the requirements in section 75; and

(b) the ongoing policy requirements in section 77 will be satisfied in relation to the schools;[58] and

(c) the ongoing funding requirements in section 78 will be satisfied in relation to the schools.

The Minister may:

(a) refuse to approve, as an approved authority, a person that the Minister would otherwise approve, if the Minister is satisfied that it would be contrary to the public interest to approve the person;

(b) approve, as an approved authority, a person that the Minister would not otherwise approve, if the Minister is satisfied that it is in the public interest to approve the person.[59]

Section 75

The section 75 requirements are:

(a) The approved authority must be a body corporate.

(b) That body corporate must not conduct a school for profit.

In determining whether or not the school is conducted for profit, the Federal Minister may have regard to whether the State or Territory Minister considers that the person conducts the school for profit. In

[56] Section 31A
[57] Section 73
[58] These requirements are primarily about reporting information to the Minister and therefore fall outside the scope of this paper.
[59] Section 74

other words, if the school offends the "for profit" provisions of the State legislation, it is likely that the person conducting the school will not be approved for Federal financial assistance by the Federal Minister.

(c) The approved authority must be financially viable.

In determining whether or not the approved authority is financially viable, the Federal Minister may have regard to:

i. whether the approved authority is being wound up; and

ii. whether the affairs of the approved authority are under any form of external control (for example, the control of a manager) under a law of the Commonwealth, a State or a Territory; and

iii. whether the Minister considers that the liabilities of the approved authority are greater than its assets; and

iv. whether the Minister considers that the approved authority is (and is likely to continue for a substantial period to be) unable to pay its debts as and when they fall due for payment; and

v. whether an audit conducted in accordance with a law of the Commonwealth, a State or a Territory:

a. is expressed to be qualified; or

b. expresses concern about the financial viability of the approved authority.

(d) It must be "fit and proper" to be an approved authority for one or more schools.

In determining whether or not the person is "fit and proper" to be an approved authority, the Federal Minister may have regard to:[60]

i. the experience and expertise of the approved authority and its key individuals in administering a school and providing education at a school; and

ii. the approved authority's governance arrangements, including:

a. arrangements for managing and supervising the provision of education at the school; and

[60] Regulation 28

b. arrangements to ensure compliance with the laws of the Commonwealth, a State or a Territory relating to the provision of school education;

iii. whether the approved authority has debts due to the Commonwealth in relation to the provision of school education;

iv. the approved authority's governance arrangements, including arrangements to receive independent and professional advice about the way in which the approved authority complies with its obligations under the *Australian Education Act*; and

v. the record of financial management of the approved authority and its key individuals, taking into account whether the approved authority or individual has been:

a. bankrupt or insolvent; or

b. placed under external administration; and

vi. whether the approved authority or one of its key individuals has been convicted of, or charged with, an offence, including an offence in relation to children, dishonesty or violence;[61] and

vii. whether the approved authority or one of its key individuals has engaged in a deliberate pattern of immoral or unethical behaviour.

Judges of the High Court have made it clear that the expression "fit and proper" carries no precise meaning apart from its context[62] and that the Minister may take into account qualities and characteristics apart from the matters mentioned in the list above.[63]

(e) The approved authority must be permitted under the relevant State or Territory legislation to provide education at the level and location specified in its application to be an approved authority.

In considering whether the person conducts a school for profit, is financially viable or is "fit and proper", the Federal Minister may also have regard to any other matter that the Minister considers relevant or that is prescribed by the regulations. Regulation 26 sets out the following matters:

[61] Subject to Part VIIC of the *Crimes Act 1914* (Cth) which deals with pardons, quashed convictions and spent convictions.
[62] *Australian Broadcasting Tribunal v Bond* (1990) 170 CLR 321 per Toohey and Gaudron JJ at paragraph 36
[63] Ibid per Mason CJ at paragraph 64

i. whether the person has not-for-profit status under Commonwealth[64], State or Territory law;

ii. whether the person has financial policies and practices and, if so, the quality of those policies and practices;[65]

iii. whether money derived from or relating to the school:

   a. has been applied for the purposes of the school or for the purposes of the functions of the approved authority; or

   b. has been distributed (whether directly or indirectly) to an owner of the approved authority or any other person; and

iv. if the person is a body corporate, the requirements in any legislation under which the person is established, or in the person's constitution.

There are also ongoing policy requirements for an approved authority:

i. The approved authority must implement a curriculum in accordance with the regulations.

ii. The approved authority must ensure that the school participates in the National assessment program in accordance with the regulations.

iii. The approved authority must provide information in accordance with the regulations.

Financial assistance is provided directly to a State or Territory for its government schools. Financial assistance for a non-government school in a State or Territory is provided to the State or Territory which must give it to the approved authority for the school.

Section 78

The section 78 requirement is set out in Regulation 29(1) which states that an approved authority for a school must spend, or commit to spend, financial assistance that is payable to the authority **for the purpose of providing school education** at a school for which the approved authority is approved.

[64] For example, the *Australian Charities and Not-for-profits Commission Act 2012*
[65] A school board should, at least, have the following policies: conflict of interest, procurement, fraud prevention, resolution of disputes, board professional development, board performance review, and external audit.

Without limiting what is meant by "the purpose of providing school education", this purpose includes:[66]

(a) salaries and other expenses relating to staff at the school, including expenses related to the professional development of the staff;

(b) developing materials related to the school's curriculum;

(c) general operating expenses of the school;

(d) maintaining the school's land and buildings;

(e) purchasing capital equipment for the school;

(f) in any case, administrative costs associated with the approved authority's compliance with the Act and Regulation.

However, financial assistance must not be spent:

(a) as security for any form of loan, credit, payment or other interest; or

(b) for the preparation of or in the course of any litigation;[67] or

(c) on any of the following:

(i) the purchase of land or a building for the school;

(ii) the construction of a building or a part of the building for the school;

(iii) capital improvements for the school;

(iv) any form of loan, credit or other interest in relation to expenditure mentioned in subparagraphs (i) to (iii).[68]

The prohibition on the use of financial assistance for the preparation of, or in the course of, any litigation is interesting in the current situation where many survivors of abuse from teachers are bringing claims against schools. It is not clear whether this prohibition extends to settlement payments or to making payments ordered by a court. It is also not clear whether financial assistance may be used to meet the costs associated with belonging to the Redress Scheme or to making payments under it.

[66] Regulation 29(2)
[67] Except litigation by a State or Territory to recover a debt from an approved authority.
[68] However, this does not extend to interest payments on the forms of loan, credit or other interest mentioned in this subparagraph – Regulation 29(3A).

Records – Regulations 37, 38 and 39

Regulation 37 requires an approved authority to keep records relating to:

(a) the authority's compliance with the Act and Regulation;

(b) the financial administration of the authority;

(c) the financial administration of the school; and

(d) capital expenditure in relation to land or buildings at or for the school, including expenditure by contractors and sub-contractors carrying out works in relation to that capital expenditure.

These records must:

(a) be identifiably separate from other records that the authority may hold for the purposes of other undertakings the authority conducts or to which the authority is related; and

(b) identify all income and expenditure that relates to any financial assistance paid to the authority in accordance with the Act.

A record must be kept for 7 years.

Regulation 38 requires an approved authority to prepare and audit financial statements.

Regulation 39 requires an approved authority to allow a person appointed by the Minister (an authorised person) full and free access to any record relating to:

(a) the authority's compliance with the Act and Regulation; and

(b) the financial administration of the authority and of the school.

States

As noted above, Commonwealth financial assistance must be used for the purpose of providing school education at a school operated by the approved authority. While this is expressed in various ways in the relevant State legislation, the general thrust is the same. I set out here a brief summary of the relevant State legislation, regulations and related guidelines and standards.

New South Wales

Education Act 1990 Part 7 Division 3

Not-For-Profit Guidelines for Non-Government Schools December 2018

The Registered and Accredited Individual Non-government Schools (NSW) Manual – a New South Wales Education Standards Authority publication

Section 47 of the *Education Act 1990* sets out the requirements for the registration of non-government schools. These include that:

(a) the school is financially viable;

(b) each responsible person for the school is a fit and proper person; and

(c) policies and procedures for the proper governance of the school are in place.

The New South Wales Education Standards Authority (NESA) has additional, but consistent, requirements in relation to the governance of non-government schools.

In New South Wales, a school operates for profit if the Minister is satisfied that:[69]

(a) any part of its proprietor's assets (in so far as they relate to the school) or its proprietor's income (in so far as it arises from the operation of the school) is used for any purpose other than for the operation of the school, or

(b) any payment is made by the school to a related entity or other person or body:

(i) for property, goods or services at more than reasonable market value, or

(ii) for property, goods or services that are not required for the operation of the school, or

(iii) for property, goods or services that is in any other way unreasonable in the circumstances having regard to the fact that financial assistance is provided to or for the benefit of the school by the Minister, or

(c) any payment is made by the school to a person in connection with the person's activities as a member of the governing body of the

[69] *Education Act 1990* Section 83C

school unless it is in reimbursement for a payment made by the person in connection with the operation of the school.

Queensland

Education (Accreditation of Non-State Schools) Act 2017

Education (Accreditation of Non-State Schools) Regulation 2017

In Queensland, a school is *operated for profit* if any profits made from the school's operation are used for any purpose other than a purpose for advancing the school's philosophy and aims, as stated in the school's statement of philosophy and aims.[70]

Also, a school governing body meets the government funding eligibility criteria if:

(a) the school is not operated for profit;

(b) the board is not a party to, and does not intend to enter into, a prohibited arrangement in relation to the operation of the school, and

(c) there is no direct or indirect connection between the board and another entity that could reasonably be expected to compromise the independence of the board when making financial decisions.[71]

South Australia

Education and Early Childhood Services (Registration and Standards) Act 2011

Education and Early Childhood Services Registration and Standards Board of South Australia

Standards for Registration and Review of Registration of Schools in South Australia - Version 1 finalised 5 April 2017; approved by Education Standards Board 29 March 2017

Tasmania

Education Act 2016

Education Regulations 2017 Schedule 3 (Standards for Registration of New Individual Non-government Schools) and Schedule 4 (Standards for Renewal of Registration of Registered Individual Schools)

[70] *Education (Accreditation of Non-State Schools) Act 2017* Section 7
[71] *Education (Accreditation of Non-State Schools) Act 2017* Section 10

Western Australia

School Education Act 1999 Part 4 Division 5

School Education Regulations 2000

Victoria

Education and Training Reform Act 2006

Education and Training Reform Regulations 2017

Victorian Registration and Qualifications Authority *Guidelines to the Minimum Standards and Requirements for School Registration* - new Guidelines commence on 1 July 2019

In Victoria, the government funding must be used "for the operation of the school" and this involves having "sufficient controls to prevent" gain or profit from occurring.

The proprietor must structure the governance of a registered school to enable:

(a) the effective development of the strategic direction of the school; and

(b) the effective management of the finances of the school; and

(c) the school to fulfil its legal obligations.[72]

So how do school boards respond to all of this?

Unfortunately, many school boards focus almost entirely on the Commonwealth and State legislation and regulation dealing with the provision of financial assistance. This is understandable given that they do not want to lose government funding. They therefore want to know what they need to do to comply with the various conditions imposed by Commonwealth and State governments. However, this approach tends to lead to "do the minimum required to keep our funding" attitude.

Instead, I suggest that school boards should be focusing on what it means to govern their schools properly. Understanding and implementing good governance practices will be to the overall benefit of a school and will not jeopardise government funding.

[72] *Education and Training Reform Regulations 2017* Schedule 4 clause 15 (1)