DIRECTORS' DUTIES OF CARE

Issues of Classification, Solvency and Business Judgment and the Dangers of Legal Transplants

In the Anglo-American world and Singapore, the duties of care of directors developed in equity, statute and common law. This leads to complications. Some jurisdictions now have a business judgment rule which gives directors immunity from suit by the company if certain conditions are fulfilled. The question is whether the rule can be transplanted, what are the consequences and in particular what should be the relationship with insolvent trading.

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I. Introduction

1 The duties of care of directors in the common law world are complicated by reference to history and the untidy way in which the law has developed.[1] The original duty of care arose in equity and pre-dated

1 See Austin J's review of the history in *Australian Securities and Investments Commission v Vines* (2003) 48 ACSR 322 at 324 *et seq*; *Australian Securities and Investments Commission v Rich* (2003) 44 ACSR 341 at 348 *et seq*; *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1 at 608 *et seq*. See R P Austin & I M Ramsay, *Ford's Principles of Corporations Law* (Sydney: Butterworths, 15th Ed, 2010) at para 8.330; S Seivers, "Farewell to the Sleeping Director – The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence" (1993) 21 ABLR 111; J H Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 *Corporate and Business Law Journal* 1. As for New Zealand, D O Jones, *Company Law in New Zealand: A Guide to the Companies Act* (Wellington: Butterworths, 1993) at p 108 *et seq*; The Hon Justice Tompkins, "Directing the Directors: The Duties of Directors under the Companies Act 1993" (1995) 2 *Waikato Law Review* 13. See also *CCH New Zealand Company Law and Practice Commentary* vol 1 at para 10-835. *Company and Securities Law in New Zealand* (J H Farrar ed) (Thomson Brookers, 2008) ch 15; *Walter Woon on Company Law* (Tan Cheng Han ed) (Singapore: Sweet & Maxwell, 3rd Ed, 2009) at para 8.106 *et seq*. For a useful review of English law, see V Finch, "Company Directors: Who Cares about Skill and Care" (1992) 55 *Modern Law Review* 179 but see now Companies Act 2006 (c 46) (UK) s 174.

common law negligence. In Australia, Malaysia and Singapore, the next stage of development was the adoption of a statutory duty of care. Unlike other jurisdictions like Canada, New Zealand and the UK, this was not a restatement or codification of the law. Originally, breach was the subject of a criminal penalty and this is still the case in Singapore and Malaysia. In Australia, the criminal penalty has been dropped but a breach is still a subject of a civil penalty. More recently, Australian courts have recognised a common law duty of care and the assumption has been that this effectively supersedes the equitable duty of care. This, however, is not necessarily so and there are some differences. In Australia and now Malaysia, all three duties of care are subject to a statutory business judgment rule. This provides that in the case of a business judgment as defined, provided that four conditions are fulfilled, directors are immune from liability to the company for negligence. However, this does not apply to a failure to prevent insolvent trading. South Africa and Germany have also adopted their own versions of a business judgement rule.[2] The problem is that none of these jurisdictions seems to have adequately considered the complex and significantly different context of the business judgement rule in the US, a country which has Chapter XI in its Bankruptcy Act and a culture which is much more tolerant of lack of liquidity and strongly focuses on business rehabilitation. It also has an active Bankruptcy Bar from whom the federal bankruptcy judiciary is chosen. Chapter XI, which was originally designed for small firms, enables a company with liquidity problems to trade its way back to solvency under court supervision.[3] Insolvent trading as such does not lead to draconian penalties. The business judgement rule, which pre-dates the pro-debtor bankruptcy provisions, is basically a pro-business rule which is an abstention doctrine on the part of the courts.[4] The common theme between them is recognition of the legitimacy of entrepreneurial risk taking, absent fraud and self-dealing. Another matter which further complicates the situation in Australia is the adoption of prudential regulation for deposit taking institutions and insurance companies by the Australian Prudential Regulation Authority, which deals with appointment of directors, risk taking and liquidity and adds more rigorous standards for

2 See Tamo Zwinge, "The Business Judgment Rule in the United States, Australia, South Africa and Germany – A Comparative Study' in *Contemporary Issues in Corporate Governance* (J H Farrar & S Watson eds) (Centre for Commercial and Corporate Law, University of Canterbury, 2010).

3 See David A Skeel, Jr, *Debts, Dominion – A History of Bankruptcy Law in America* (Princeton University Press, 2001) chs 6 and 8. See too Gerard McCormack, *Corporate Rescue Law – An Anglo-American Perspective* (Cheltenham: Edward Elgar, 2008) at p 31 and ch 3.

4 See Dennis J Block, Nancy E Barton & Stephen A Radin, *The Business Judgement Rule – Fiduciary Duties of Corporate Directors* (New York: Aspen Law and Business, 5th Ed, 1998) vol 1 at p 12 *et seq*.

directors in those sectors.[5] These prudential regulatory standards have not been adequately promulgated and bear a complicated relationship with the law. This article will consider first the three duties of care and their consequences; secondly, the relationship between the duties of care and insolvent trading, and the relationship of these to the prudential regulatory standards; and thirdly, the impact of the business judgment doctrine and business judgment rule.

II. The duty of care in equity

2 The original development was in equity and the *locus classicus* on the duty and standard of care has long been the judgment of Justice Romer at first instance in the English case of *Re City Equitable Fire Insurance Co Ltd*[6] ("*Re City Equitable*") in 1925. This pre-dates *Donoghue v Stevenson*.[7] *Re City Equitable* was a long judgment involving a case of investigation of fraud in the winding up of an insurance company. The company had been defrauded by its managing director, Bevan, who was convicted and sentenced. A misfeasance summons was brought by the liquidator to make the other directors liable for negligence in respect of losses occasioned by investments, loans and the payment of dividends out of capital. Justice Romer found that the directors were guilty of negligence in certain respects but were exonerated by a provision in the articles in the absence of "wilful neglect or default". Such clauses have since been outlawed. Justice Romer laid down a number of propositions of law which were accepted by the Court of Appeal and later followed but which have increasingly been called into question.

A. Proposition 1

> In discharging the duties of his position … a director must, of course, act honestly; but he must also exercise some degree of both skill and diligence.[8]

5 See G Pearson, *Financial Services Law and Compliance in Australia* (Melbourne: Cambridge University Press, 2009) and John H Farrar, "The Global Financial Crisis and the Governance of Financial Institutions" (2010) 24 *Australian Journal of Corporate Law* 227.

6 [1925] Ch 407 (at first instance, affirmed on appeal). However, for an earlier more objective appraisal in the High Court of Australia see Isaacs and Rich JJ in *Gould v The Mount Oxide Mines Ltd* (1916) 22 CLR 490 at 529. See S Seivers, "Farewell to the Sleeping Director – The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence" (1993) 21 ABLR 111.

7 [1932] AC 562.

8 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 427.

3 In *Re Brazilian Rubber Plantations and Estates Ltd*,[9] Justice Neville said of a director of a rubber company:

> He is not, I think, bound to take any definite part in the conduct of the company's business, but so far as he does undertake it he must use reasonable care in its dispatch. Such reasonable care must, I think, be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf.

4 This seems to lay down an objective test for the standard of care but there is no reference to risk. It is clear from the other three propositions laid down by Justice Romer that some characteristics of the particular director could be taken into account. Note also the equivocation between care, skill and diligence in the judicial usage.

B. Proposition 2

> A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. A director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or a physician … [D]irectors are not liable for mere errors of judgment.[10]

5 It is difficult, if not impossible, to formulate a single objective duty of skill for company directors as there is no common body of knowledge shared by company directors. It is difficult to regard company directorship as a separate calling.

6 One final point is on the question of skill. A director acts as a member of a group, the board. What is required is not so much a skilful director as a skilful board. Different members may be chosen for different skills and, in some cases, their personal qualities of integrity, common sense and judgment, which are not skills as such.[11]

C. Proposition 3

> A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at

9 [1911] 1 Ch 425 at 437. See *Permanent Building Society v Wheeler* (1994) 14 ACSR 109.

10 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 428–429.

11 See Justice Kim Santow, "The Codification of Directors' Duties" (1999) 73 ALJ 336 at 342. See *Walter Woon on Company Law* (Tan Cheng Han ed) (Singapore: Sweet & Maxwell, 3rd Ed, 2009) at para 8.107 *et seq*.

> meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.[12]

7 Although this proposition indicated a lax standard, it did in fact tighten up existing law. Nevertheless, Justice Romer's *dicta* represent a more lenient approach than would be tolerated today. Directors are now regarded as being subject to a positive obligation to keep informed about the affairs of a company.[13]

D. Proposition 4

> In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.[14]

8 This is a maxim of common sense but the extent of delegation depended on the type of company and the nature of the business.[15] The extent of delegation had to be reasonable and there seem to be some duties which a director cannot delegate.[16] In Australia and New Zealand, delegation is expressly dealt with by statute.[17]

9 An interesting question is whether the equitable duty of care is fiduciary. Clearly it attaches to an office which is fiduciary but this does not necessarily make every duty of a director fiduciary. In *Permanent Building Society v Wheeler*,[18] Ipp J thought that it was equitable but not fiduciary. In an interesting extra-judicial paper, Justice J D Heydon[19] considers the contrary, that is that it is an equitable *and* fiduciary duty

12 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 429.

13 *Daniels v Anderson* (1995) 37 NSWLR 438.

14 *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 429. See also *ASC v Gallagher* (1993) 11 ACLC 286, 10 ACSR 43.

15 See *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 426–427. For a New Zealand discussion see *Jaguwar Holdings Ltd v Julian* (1992) 6 NZCLC 68,040 at 68,075 *et seq*.

16 *Drincqbier v Wood* [1899] 1 Ch 393 at 406; *Re Majestic Recording Studios Ltd* [1987] BCLC 601.

17 See Corporations Act 2001 (Cth) (Australia) ss 189 and 190 and Companies Act 1993 (New Zealand) s 130.

18 (1994) 11 WAR 187 at 237. Followed by Millet LJ in *Bristol and West Building Society v Mothew* [1998] Ch 1 at 17; *BNZ v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 680 (CA).

19 "Are the Duties of Company Directors to Exercise Care and Skill Fiduciary?" in *Equity in Commercial Law* (Simone Degeling & James Edelman eds) at p 185.

of care and that this has consequences for causation, remoteness, limitation and proprietary remedies.[20] However, the weight of authority seems to be against this view.[21]

III. The statutory duty of care

10 Until recently it was not the practice of UK legislation to include the general duties of directors. The first jurisdiction to include a provision was the Victorian Companies Act 1958 which provided the model for the Uniform Companies Acts 1961–1962. These in turn were followed in the Singapore and Malaysian legislation. This survives in s 157 of the Singapore Companies Act[22] which provides as follows:

> (1) A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.
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> …
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> (3) An officer or agent who commits a breach of any of the provisions of this section shall be –
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> (*a*) liable to the company for any profit made by him or for any damage suffered by the company as a result of the breach of any of those provisions; and
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> (*b*) guilty of an offence and shall be liable on conviction to a fine not exceeding $5,000 or to imprisonment for a term not exceeding 12 months.
>
> (4) This section is in addition to and not in derogation of any other written law or rule of law relating to the duty or liability of directors or officers of a company.

11 This was based on s 124 of the Australian Uniform Companies Act 1961. The Australian wording was changed in s 232(4) of the Corporations Act[23] to read as follows:

> In the exercise of his or her powers and the discharge of his or her duties, an officer of a corporation must exercise the degree of care and diligence that a reasonable person in a like position in a corporation would exercise in the corporation's circumstances.

12 This wording was regarded as not changing the law but merely confirming the position expounded in recent cases.[24] It is to be noted

20 "Are the Duties of Company Directors to Exercise Care and Skill Fiduciary?" in *Equity in Commercial Law* (Simone Degeling & James Edelman eds) at pp 189–191.

21 See *Australian Securities and Investments Commission v Rich v Rich* (2009) ACSR 1 at 611 where Austin J left it for determination at appellate level.

22 Cap 50, 2006 Rev Ed.

23 Corporations Act 2001 (Cth) (Australia).

24 Corporate Law Reform Bill 1992 (Cth) Explanatory Memorandum para 83.

that there was no reference to skill as such. The reference to "a reasonable person in a like position in a corporation … in the corporation's circumstances" was based on §8.30(a)(2) of the US Model Business Corporation Act. The section was amended in 1999 to read as follows:

> **180 Care and diligence – civil obligation only**
>
> Care and diligence – directors and other officers
>
> (1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
>
> (a) were a director or officer of a corporation in the corporation's circumstances; and
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> (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

13 In *Australian Securities and Investments Commission v Vines*,[25] Austin J analysed this wording. He said that although there is no express reference to skill in this section and no universal formulation for skill for directors, the position is different where the director is appointed because of special skill, such as the position of chief financial officer. The test then is what a reasonably competent chief financial officer would do in the circumstances. This can be justified on the basis of employment law. Consider, however, an accountant or solicitor appointed to a board. It is submitted that a distinction must be drawn between acting as a director and acting in a professional capacity. If the professional person is acting as a director their background means at most an obligation to flag an issue for further outside professional advice. To read s 180(1) of the Corporations Act or s 174 of the UK Companies Act 2006[26] as imposing a higher duty on the director *qua* director seems unsound in principle and draconian in effect.[27]

14 Section 180(1) is now subject to s 180(2) which provides for a statutory business judgment rule. This will be discussed below. Breach of s 180(1) gives rise to a civil penalty. Civil penalties are financial penalties, disqualification and statutory compensation.

15 The purpose of the statutory duty of care in Canada, New Zealand and the UK is for an entirely different purpose. It is intended as a restatement of the case law in statutory form.

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25 (2004) 48 ACSR 322. *Cf Walter Woon on Company Law* (Tan Cheng Han ed) (Singapore: Sweet & Maxwell, 3rd Ed, 2009) at para 8.107 *et seq*.

26 Companies Act 2006 (c 46) (UK).

27 For such a view see A Keay, *Director's Duties* (Bristol: Jordans, 2009) at para 8.115.

IV. The common law duty of care

16 A common law duty of care has now been recognised in Australia.

A. The AWA case

17 In the leading Australian case, *AWA Ltd v Daniels*,[28] AWA Ltd, a listed company, engaged in foreign exchange dealings to hedge against risks of foreign currency fluctuations. These were managed by a young employee, Koval, who was inadequately supervised, and proper records were not kept. The company made heavy losses in 1986 and 1987 which Koval concealed. The company was audited twice by Deloitte Haskins and Sells, and the auditing partner warned the company of inadequacies in internal controls but failed to warn the board. Instead, he wrote a letter suggesting improvements. The board did not become aware of the extent of the losses until the end of March 1987.

18 The company sued the auditors for negligence. The auditors counterclaimed for contributory negligence by the company.

19 Justice Rogers, Chief Judge of the Commercial Division of the Supreme Court of New South Wales, at first instance held that the auditors were negligent but that the company was also liable for contributory negligence.[29]

20 He made some sensible remarks about the relationship between non-executive directors and executive directors and management. He then applied the *Re City Equitable* principles to the non-executive directors and delegation by the board but applied a more rigorous standard to Hawke, the chief executive officer.

21 The decision of Justice Rogers was well received by the business community. It was followed in later cases although criticised by the Royal Commission into the Tricontinental Group of Companies. The decision was subsequently appealed.

22 The majority of the Court of Appeal allowed the appeal of the chief executive officer and allowed the auditors' appeal in part and AWA's appeal in part.[30]

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28 (1992) 10 ACLC 933; *Daniels v Anderson* (1995) 13 ACLC 614.

29 *AWA Ltd v Daniels* (1992) 10 ACLC 933.

30 *Daniels v Anderson* (1995) 13 ACLC 614. See R Baxt, "The Duty of Care of Directors – Does it Depend on the Swinging of the Pendulum" in *Corporate Governance and the Duties of Company Directors* (I Ramsay ed) (Centre for Corporate Law and Securities Regulation, University of Melbourne, 1997) ch 7.

23 The court held that the auditors were negligent and had failed to comply with the then Companies Code in respect of the foreign exchange operations.

24 The duties of the auditors and the AWA board and management had to be considered in the context of the duties owed by the others. Management was responsible for ensuring that adequate internal controls were put in place and operating. The duty of auditors was to report the absence of proper records and weaknesses in internal controls to management. In the absence of appropriate response by management, auditors should then report to the board.

25 While paying lip service to business judgment, Justices Clark and Sheller held that the directors were liable for common law negligence because:

(a) The law had developed since *Re City Equitable*.

(b) Directors are now required to take reasonable steps to place themselves in a position to guide and monitor the management of the company.

(c) The duty of care was not merely subjective, limited by the directors' knowledge and experience. Ignorance and inaction were no excuse.

(d) Following US authorities, they held that while delegation was possible, the test of grounds for suspicion formulated in *Re City Equitable* and repeated by Chief Judge Rogers was too low. A director may not rely on the judgment of others especially when there is notice of mismanagement. Certainly, when an investment poses an obvious risk, a director cannot rely blindly on the judgment of others. The test was whether the director had actual or constructive knowledge of any facts which would awaken suspicion and put a prudent man on his guard. Directors must devote a sufficient amount of time and energy to oversee the company's affairs.

(e) The directors were not only under an equitable and statutory duty of care. They were also under a common law duty of care, and were tortfeasors under s 5(1)(*c*) of the Law Reform (Miscellaneous Provisions) Act 1946 (NSW).

(f) Executives and non-executive directors were under the same duty and standard of care.

26 The law of negligence can accommodate different degrees of duty owed by people with different skills but that does not mean that a director can safely proceed on the basis that ignorance and failure to inquire are a protection against liability for negligence.

27 Justice Powell[31] dissenting said that the duty of care was equitable and statutory and an insufficient case had been made out to extend common law negligence on the facts.

28 The decision of the majority thus overturned Justice Rogers's views on a number of important points affecting directors. Whereas Justice Rogers's judgment was practical and clearly expressed, the majority judgment was not very clearly expressed in a number of crucial passages. The US authorities relied on were drawn from the financial services industry and were not necessarily typical of US case law. Hence, the confusion in the business community and an increased demand for the introduction of a business judgment rule.

29 In particular, the refusal of the majority in the Court of Appeal to see a distinction between executive and non-executive directors seems to ignore the significance of employment law[32] and the possible dangers of an overactive non-executive enclave on the board, substituting their judgment for that of management.

V. The duties of care and insolvent trading

30 The Australian, New Zealand and UK legislation now contains express provisions relating to insolvent trading. These do not appear in the Canadian legislation, and the Singapore legislation merely contains ss 339(3) and 340(1). Section 339(3) deals with contracting debts when there is no reasonable or probable expectation of the debts being paid and s 340(1) deals with fraudulent trading. Malaysia has similar provisions in ss 303 and 304 of the Companies Act 1965. Section 149(2)(*b*) of the Singapore Act deals with disqualification of unfit directors of insolvent companies. In the Australian, New Zealand and UK legislation, the provision constitutes an important subset of the duty of care. Section 588G of the Australian Corporations Act 2001 deals with a failure by directors to prevent insolvent trading.[33] It is subject to four specified defences. Breach of the section can give rise to civil and in some circumstances criminal penalty proceedings. Sections 588V–X extend the duty to a parent company for failure to prevent insolvent trading by a subsidiary. Section 135 of the New Zealand Companies Act 1993 provides for reckless trading and s 136 provides a duty not to agree to the company incurring an obligation unless the director believes on reasonable grounds that it will be able to perform the

31 *Daniels v Anderson* (1995) 13 ACLC 614 at 743 *et seq*.

32 Under employment law there is an implied warranty of competence and skill by executives. See also *Sheahan v Verco* (2001) 37 ACSR 117.

33 See R P Austin & I M Ramsay, *Ford's Principles of Corporations Law* (Sydney: Butterworths, 15th Ed, 2010) at para 20.100 *et seq*.

obligation.[34] There are no specified defences. Section 214 of the UK Insolvency Act 1986 provides a duty not to engage in wrongful trading.[35] There is only a limited defence in s 214(3) when the court is satisfied that the director took every step to minimise loss to creditors.

31 An important conceptual question is the relationship between solvency and liquidity. In the New South Wales Supreme Court case of *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation*,[36] Palmer J summarised the Australian Law in the following propositions:

> (i) whether or not a company is insolvent for the purposes of [the Corporations Act 2001] ss 95A, 459B, 588FC or 588G(1)(*b*) is a question of fact to be ascertained from a consideration of the company's financial position taken as a whole …
>
> (ii) in considering the company's financial position as a whole, the court must have regard to commercial realities. Commercial realities will be relevant in considering what resources are available to the company to meet its liabilities as they fall due, whether resources other than cash are realisable by sale or borrowing upon security, and when such realisations are achievable …
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> (iii) in assessing whether a company's position as a whole reveals surmountable temporary illiquidity or insurmountable endemic illiquidity resulting in insolvency, it is proper to have regard to the commercial reality that, in normal circumstances, creditors will not always insist on payment strictly in accordance with their terms of trade but that does not result in the company thereby having a cash or credit resource which can be taken into account in determining solvency …
>
> (iv) the commercial reality that creditors will normally allow some latitude in time for payment of their debts does not, in itself, warrant a conclusion that the debts are not payable at the times contractually stipulated and have become debts payable only upon demand …
>
> (v) in assessing solvency, the court acts upon the basis that a contract debt is payable at the time stipulated for payment in the contract unless there is evidence, proving to the court's satisfaction that:

34 See *Company and Securities Law in New Zealand* (J H Farrar ed) (Thomson Brookers, 2008) ch 16.

35 B Hannigan, *Company Law* (Oxford: Oxford University Press, 2nd Ed, 2009) at pp 25–26 *et seq*. See A Keay, *Company Directors' Responsibilities to Creditors* (London: Routledge-Cavendish, 2007) Pt C. See also the discussion of incompetence in the context of disqualification for unfitness. See A Walters & M Davis-White QC, *Directors' Disqualification and Insolvency Restrictions* (London: Sweet & Maxwell, 3rd Ed, 2010) at para 5.73 *et seq*.

36 (2001) 53 NSWLR 213 at 224–225.

> • there has been an expressed or implied agreement between the company and the creditor for an extension of the time stipulated for payment; or
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> • there is a course of conduct between the company and the creditor sufficient to give rise to an estoppel preventing the creditor from relying upon the stipulated time for payment; or
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> • there has been a well established and recognised course of conduct in the industry in which the company operates, or as between the company and its creditors as a body, whereby debts are payable at a time other than that stipulated in the creditors' terms of trade or are payable only on demand …
>
> (vi) it is for the party asserting that a company's contract debts are not payable at the times contractually stipulated to make good that assertion by satisfactory evidence … .

32 These principles have been accepted in later cases[37] although the case was reversed on appeal on other points.[38]

33 In the case of deposit taking institutions and insurance companies, these legal provisions are now supplemented by prudential regulatory standards formulated by the Australian Prudential Regulation Authority under the banking and insurance legislation.

34 In practice, insolvent trading is the most important aspect of the duties of care. Previously there have been only a few cases on the duty of care and insolvent trading but recently there have been more insolvent trading cases in Australia and New Zealand. The consequences for directors are serious.

VI. The business judgment doctrine and the business judgment rule

35 British Commonwealth courts have long recognised a business judgment doctrine that the court will not second guess honest business judgments by directors as the High Court of Australia said in *Harlowes*

37 The propositions have been approved in *Australian Securities and Investments Commission v Plymin (No 1)* (2003) 175 FLR 124; *Emanuel Management Pty Ltd v Foster's Brewing Group Ltd* (2003) 178 FLR 1; *Iso Lildow' Aliphumeleli Pty Ltd v Commissioner of Taxation* (2002) 42 ACSR 561; *Keith Smith East West Transport Pty Ltd v Australian Taxation Office* (2002) 42 ACSR 501; and in Paul Redmond, *Companies and Securities Law – Commentary and Materials* (Pyrmont, Australia: Thomson Reuters Professional, 5th Ed, 2009) ch 7.

38 *Deputy Commissioner of Taxation v Clark* (2003) 45 ACSR 332.

Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co[39] in 1968, "directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith or not for irrelevant purposes, is not open to review by the courts".

36 This states a general judicial policy and needs to be distinguished from the business judgment rule which creates a rule or presumption of no liability.[40]

37 In 1992, the Business Council of Australia and the Australian Institute of Company Directors pressed the Government to introduce a statutory business judgment rule. At the time, the Government refused to do so but made a reference to the business judgment doctrine in the explanatory memorandum to the Corporate Law Reform Act 1992. The matter was again considered on a change of government and a statutory business judgment rule was enacted in s 180(2) of the Corporations Act by the Corporate Law Economic Reform Program Act 1999. This provides as follows:

> A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:
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> (a) make the judgment in good faith for a proper purpose; and
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> (b) do not have a material personal interest in the subject matter of the judgment; and
>
> (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
>
> (d) rationally believe that the judgment is in the best interests of the corporation.

38 This provision is based substantially on the American Law Institute's ("ALI") formulation. That formulation provides:[41]

> A director or officer who makes a business judgment in good faith fulfils the duty under this section if the director or officer (1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent to

39 (1968) 121 CLR 483 at 493.

40 For a discussion of the distinction see J H Farrar, "Business Judgment and Defensive Tactics in Hostile Takeover Bids' in *Takeovers, Institutional Investors and the Modernisation of Corporate Laws* (J H Farrar ed) (Auckland, Oxford University Press, 1993) ch 11.

41 American Law Institute Principles of Corporate Governance and Structure Pt IV para 4.01(a).

which the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation.

39 There are a number of points to be made about s 180(2).[42] These are:

(a) Like s 180(1) it applies to officers, not just directors.

(b) It applies to the duty of care and diligence under the Corporations Act and the general law but not to any other breach of statutory duty.

(c) Conditions (a) to (d) in s 180(2) have to be fulfilled. These are based on the ALI draft but differ in the reference to "proper purpose" and the use of the term "material personal interest". The retention of proper purpose probably means that the rule cannot be used in takeover defence cases, unlike US law.

(d) There has to be a business judgment. Unlike the ALI draft which leaves it undefined, this is defined in s 180(3) to mean "any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation". This seems to predicate an actual decision, not mere inactivity.

(e) There has to be a reasonably informed decision. This springs from both a fiduciary and a tort basis.

(f) The need for rationality in (d) excludes decisions that cannot be coherently explained or are reckless or represent equitable waste of the corporate assets. It is likely that this will cause difficulty in the Australian courts since rationality is an alien concept.

(g) The note makes it clear that the rule is not intended to exonerate the officer from the liability under any other section of the Corporations Act or any other act or regulation.

(h) Paragraph 6.1 of the Explanatory Memorandum, using US language, refers to the rule as a safe harbour and its operation as a rebuttable presumption in favour of directors (sic). This ought to have been spelt out expressly in the legislation.

42 See J H Farrar, *Corporate Governance: Theories, Principles and Practice* (Oxford University Press, 3rd Ed, 2008) at pp 150–151. See also Tamo Zwinge, "The Business Judgment Rule in the US, Australia, South Africa and Germany – A Comparative Study" in *Contemporary Issues in Corporate Governance* (J H Farrar & S Watson eds) (Centre for Commercial and Corporate Law, University of Canterbury, 2010).

(i) The rule is not intended to apply to insolvent trading or misstatements in a prospectus or takeover document.

40 The adoption of the statutory business judgment rule has not necessarily found favour with the Australian judges. The late Justice Santow in a paper given in Cambridge seemed rather negative about the adoption of the provision.[43] Later, in *Australian Securities and Investments Commission v Adler*,[44] he adopted a conservative approach. In that case, the subsection was pleaded by Adler, Williams and Fodera. Adler was held to have a material personal interest. Williams was held to have either made no business judgment or, if he did, failed to satisfy ss 180(2)(a), 180(2)(b) and 180(2)(c). Fodera was held to have made no business judgment at all. The judgment of Santow J was upheld on appeal on these points and the High Court refused leave to appeal. The subsection was considered in the Queensland case of *Gold Ribbon (Accountants) Pty Ltd v Sheers*[45] but was held not to apply. The provision received substantial attention by Austin J in *Australian Securities and Investments Commission v Rich*.[46] This was a case brought about by the Australian Securities and Investments Commission ("ASIC") against Jodee Rich with extremely elaborate pleadings and evidence. His Honour dismissed the application with very critical comments in the way ASIC had presented it. In his long judgment, his Honour made a number of remarks about the subsection. He thought that s 180(2) was capable of providing a defence in some cases that would otherwise involve breach of s 180(1). These were cases where:[47]

(a) the impugned conduct is a business judgment as defined;

(b) the directors or officers are acting in good faith, for proper purpose and without any material personal interest in the subject matter;

(c) they make their decision after informing themselves about the subject matter to the extent they believe to be appropriate having regard to the practicalities listed above;

(d) their belief about the appropriate extent of information gathering is reasonable in terms of the practicalities of the information gathering exercise (including such matters as the accessibility of information and the time available to collect it);

43 K Santow, "Codification of Directors' Duties" (1999) 73 ALJ 336 at 347–351.

44 (2002) ACSR 72; 42 ACSR 74 (Santow J); (2003) 46 ACSR 504 (NSWCA), *Weekend Australian Financial Review* (29–30 May 2004) at p 7.

45 *Gold Ribbon (Accountants) Pty Ltd v Sheers* [2006] QCA 335.

46 (2010) 75 ACSR 1. See Andrew Lumsden, "The Business Judgment Defence: Insights from *ASIC v Rich*" (2010) 28C & SLJ 164.

47 *Australian Securities and Investments Commission v Rich* (2010) 75 ACSR 1 at 637.

(e) they believe that their decision is in the best interests of the corporation; and

(f) that belief is rational in the sense that it is supported by an arguable chain of reasoning and is not a belief that no reasonable person in their position would hold.

41 On the facts of the case, his Honour found that the onus of proof rested on the director[48] but that decisions taken in planning, budgeting and forecasting are capable of receiving the protection of the rule.[49] His Honour's judgment is the most detailed consideration of the section to date. It is understood that ASIC is not going to appeal the decision.

42 His Honour referred to the fact that some practitioners thought that it was of little effect. His Honour disagreed with this and said, "section 180(2) has the potential to be more than mere window dressing". It may be that its potential is particularly high in the case of decisions of the kinds referred to in the case. His Honour said that his analysis of the rule "applied throughout these reasons for judgment in supporting the conclusions [he] had reached".[50]

43 As mentioned above, the subsection does not apply to insolvent trading.

VII. Conclusion

44 What all this demonstrates is that a relatively simple matter is now gratuitously complex. Due to historical reasons we have three general duties of care and these have remedial consequences. In practice, in Australia, New Zealand and the UK, the most important obligation of care is the duty to prevent insolvent trading. This is subject to civil and criminal penalties in Australia and the possibility of personal liability of directors in all three jurisdictions. There is still some confusion as to the interpretation of the insolvent trading provisions and their application to situations of lack of liquidity. In Australia at least there are specified defences.

48 *Australian Securities and Investments Commission v Rich* (2010) 75 ACSR 1 at 628–632, [7258]–[7270]

49 *Australian Securities and Investments Commission v Rich* (2010) 75 ACSR 1 at 634, [7280]. Failure to turn one's mind to a matter, however, is insufficient and the rule does not apply to general oversight or monitoring duties.

50 *Australian Securities and Investments Commission v Rich* (2010) 75 ACSR 1 at 637, [7295].

45 All British Commonwealth jurisdictions recognise the business judgment doctrine and Australia and Malaysia[51] have adopted a statutory business judgment rule basically along the US lines. There are, however, dangers with such legal transplants.[52] In the US, the matter has been developed as state case law and is not the subject of statute. It is the subject of a provision in the ALI's Principles of Corporate Governance. This provided the basis for the Australian subsection. Unfortunately, not enough research was done on the operation of the rule in the US. The result is that it is inapplicable in takeover defences – the situation where it is most used in the US. Also, the US does not have any provision on insolvent trading. As we have seen, the Australian rule does not apply to insolvent trading. The Malaysian provision is substantially based on the Australian provision but the drafting is simpler and in one respect, mistaken.[53] South Africa and Germany have recently adopted their own versions of a business judgment rule which seem to be different in certain respects.[54]

46 Jurisdictions like Singapore and China need to bear all of this in mind when considering whether they should adopt such reforms. Section 180(2) of the Australian Corporations Act has not been the success which the business community hoped. This is because of defects in drafting based on a failure to research the US laws properly and reluctance on the part of some of the Judiciary to apply it. The question of the application of the rule to takeover defences and insolvency raises difficult policy issues which need to be addressed.

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51 Companies (Amendment) Act 2007 s 7 amending Companies Act 1965 (Act 125) s 132 by adding (1B). See the useful discussion by Sujata Balan, "Reform of the Law Relating to Directors' Duties in Malaysia" <http://www.segi.edu.my/onlinereview/chapters/vol4_sr1_art1.pdf> (accessed 15 September 2011).

52 See A Watson, *Legal Transplant: An Approach to Comparative Law* (Athens, Ga: University of Georgia Press, 2nd Ed, 1993). Compare P Legrand, "The Impossibility of Legal Transplants" (1997) 4 *Maastricht Journal of European and Comparative Law* 111. See also A Watson, "Legal Transplants and European Private Law" *Electronic Journal of Comparative Law* vol 4.4 (December 2000) <http://www.ejcl.org/44/art44-2.html> (accessed 15 September 2011).

53 Companies Act 1965 (Act 125) (Malaysia) s 132(1B)(b) which refers to "reasonably believes that the business judgement is in the best interest of the company". This is instead of the reference to "rationally" in the US and Australian versions and is based on a misunderstanding of the US doctrine of rationality.

54 Companies Act 2008 (South Africa) s 76(4) and Aktiengesetz (German Stock Corporation Act) s 93(1)2. See also *ARAG/Garmenbeck* [1997] *Neue Juristische Wochenschrift* 1926. See Tamo Zwinge, "The Business Judgment Rule in the US, Australia, South Africa and Germany – A Comparative Study" in *Contemporary Issues in Corporate Governance* (J H Farrar & S Watson eds) (Centre for Commercial and Corporate Law, University of Canterbury, 2010) for a full discussion.