

Do directors' duties in Australia provide adequate scope for risk-taking? An examination of the current law and defence reform proposals

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Directors must be able to make decisions which inevitably involve some degree of commercial risk if the economy is to be advantaged. Likewise, careless and dishonest director behaviour must be discouraged if shareholder interests are to be adequately protected. Australian corporate law has attempted to strike this balance through the enactment of provisions such as the business judgment rule contained in s180(2) of the federal *Corporations Act 2001*. This rule was introduced for the purpose of protecting and providing deference to directors in making management decisions. Yet, since its enactment, the rule has seldom been argued and has never been successfully applied in a major case. This article compares and contrasts the Australian business judgment rule with the more successfully argued US business judgment rule, and then examines current law reform proposals to extend the protection offered to directors in carrying out their duties. The article concludes that a general defence should be enacted to provide better protection for directors and prevent the undue restriction of their entrepreneurial activities.

Keywords: Directors' duties, corporate law, business judgment rule, entrepreneurialism, corporate governance.

Introduction

Legal rules have played an important role in the corporate governance framework in Australia by ensuring that relevant information is provided to shareholders and that directors meet certain standards of conduct in carrying out their management function (Hanrahan et al. 2008, 111). However, the question of whether the content of these rules is helping to achieve an adequate balance between entrepreneurialism and the deterrence of questionable conduct remains contentious.

In light of the foregoing there has been ongoing debate as to what the optimal content of Australian law should be, in order that a proper balance is struck between the ability of directors to take reasonable risks in exercising their management function, while ensuring that such actions benefit the company and its associated stakeholders.

The most recent debate surrounding director legal responsibility in Australia concerns the available defences which can be argued by directors whose conduct is impugned, and whether these should be reformed, extended, or remain the same. This article deals with this question, particularly as it relates to the business judgment rule.

This article begins with a focus on the existing legal framework of directors' duties and the corresponding defences which are currently available. It then outlines the key aspects of the Australian business

judgment rule, followed by the US business judgment rule which is presented as a comparative example of a successful director defence. Lastly this article examines current law reform proposals to broaden the protection available to directors in order to address the issue of balance between active management on one hand, and deterrence of undesirable commercial conduct on the other.

Directors' duties

Company directors in Australia are subject to a range of legal duties and responsibilities which exist both in general law (case law) as well as under the federal *Corporations Act 2001* (the Corporations Act). Directors' duties have been enacted with the purpose of making sure that directors act with reasonable care and diligence, in the best interests of the company, with good faith, and for a proper purpose.

The general law directors' duties fall broadly under the classifications of care and diligence, and loyalty and good faith (Hanrahan et al. 2008). The first category is broadly concerned with the active monitoring of the affairs and financial position of the company, while the second category aims to ensure the loyalty of the director to the company by purporting to deter, for example, business deals which would benefit directors to the detriment of the company.

The general category of care and diligence also includes the statutory duty to prevent insolvent trading. Similarly, the duty of loyalty and good faith also includes a number of other more specific duties, these are: The duty to act in good faith in the best interests of the company, the duty to act for a proper purpose, the duty to retain discretions, and the duty to avoid conflicts of interest (Hanrahan et al. 2008). The statutory directors' duties are found in sections 180-184 and section 588G of the Corporations Act.

The general law and statutory duties have common characteristics and in practice entail similar standards of review of director conduct by the courts (Hanrahan et al. 2008). The result of this is that a director found to be in breach of, for example, the Corporations Act duty of care will also be in breach of the equivalent general law duty. However, one noteworthy difference between directors' duties under the Corporations Act and the common law relates to the enforcement of these duties. The Corporations Act duties are enforced by the Australian Securities and Investment Commission (ASIC), whereas the general law duties must be enforced by the company itself (Hanrahan et al. 2008).

Taken as a whole, the Australian legal regime requires compliance with numerous standards of conduct in order for directors to avoid legal responsibility for management decisions or monitoring requirements. Australian directors are subject to a stringent regime of legal duties which are viewed by some as overly strict (Baxt 2008a, 62; Young 2008, 218), but may conversely be considered necessary due to the importance of the role of a director in leading the strategic direction of a company (Young 2008, 218).

The goal of a successful corporate governance framework should be to motivate directors and reduce agency costs, so that directors monitor the affairs of the company with due care and refrain from self-dealing transactions. It has been argued that the biggest problem in corporate governance has been the passive board of directors (Elsion 1999). While legislatures have increased directors' legal liability to impel directors to actively monitor and manage, it is not clear that this is the best way to deal with this problem (Elsion 1999).

The many legal standards that must be met by directors, particularly in recent times, has arguably engendered an increase in the difficulties faced by those who are willing to take up director positions (Baxt 2008a, 62). If this is indeed the case, a review of the existing law and the broadening of the defences available to directors may well be necessary.

The difficulty in establishing the current defences

The defences which exist for directors who find themselves facing legal action are few, underutilised, and seldom successful. This paper focuses on the defences available to directors under the insolvent trading provisions and the business judgment rule.

Section 588H of the Corporations Act enumerates the four defences which a director can argue in order to be relieved from liability for insolvent trading. These operate if the director:

- Had reasonable grounds to expect the company was solvent (s588H(2));
- Reasonably relied on another person responsible to provide information to the director (s588H(3));
- Had an illness or some other good reason for not taking part in management (s588H(4)); or
- Took all reasonable steps to prevent the company from incurring the debt (s588H(5)).

In theory, while the availability of four defences covering varying situations which may be faced by a director at the time of insolvency appears positive; in practice, case law in Australia has shown that these defences are very difficult to establish (Baxt 2008a, 62). The defences are framed narrowly and courts have not interpreted them in an expansive manner.ⁱⁱ For example, the phrase 'reasonable' used throughout s588H is interpreted in an objective manner, which means that courts do not weigh up the subjective state of mind of the director. The courts will only have regard to what would be expected of a reasonable person of ordinary competence in a director's position in similar circumstances (Hanrahan et al. 2008). Thus, the wording of the defence sections, and the objective standard of review applied by the courts has led to the insolvent trading defences being described as 'inadequate' (Baxt 2007b, 373).

Empirical research in this area found that in 63% of the insolvent trading cases examined,ⁱⁱⁱ the defendant directors argued that they had fulfilled the requirements of one or more of the available defences (James et al. 2004; Hanrahan et al. 2008, 222). Yet, in only seven (10.8%) of the 65 cases in which a defence was argued was the director held to satisfy the defence (James et al. 2004; Hanrahan et al. 2008, 222). Noteworthy, this evidence does not necessarily identify a fault with the current defences, as the study by James et al (2004) did not evaluate the merits of the decisions; it simply collated the statistics from insolvent trading cases.

What is apparent is that the courts have interpreted the section 588H defences narrowly, ensuring they are not easily satisfied, regardless of the situation or level of culpability of the impugned director.

The Australian Statutory Business Judgment Rule

The business judgment rule (BJR) encapsulates the principle that courts will generally not review the merits of a management decision made by a director (Hanrahan et al. 2008). The rationale behind the existence of this rule is to protect directors, encourage risk taking and director action, while balancing this with the need for directors to act in good faith and adequately inform themselves before making management decisions.

The statutory BJR first came into being in the late 1990s in Australia, as an element of the Corporate Law Economic Reform Program (CLERP). Section 180(2) of the Corporations Act was introduced by the *CLERP Act 1999* in order to clarify and confirm the general law position that bona fide business decisions are seldom open to review.^{iv} Its rationale was to promote entrepreneurial business activities and prevent excessive inhibition of directors, while also increasing certainty regarding director liability.^v The introduction of the BJR was ultimately motivated by a perception in Australia that the legal rules which were imposed on directors were unnecessarily harsh (Baxt 2008a, 62).

The current Australian BJR can be viewed as a protection from liability, or a safe harbor, for directors who make a business decision to take or not to take action regarding the business operations of a corporation.^{vi} Under section 180(2) of the *Corporations Act 2001*, a director of a corporation will be taken to have met the requirements of the duty of care and diligence in section 180 of the Corporations Act in respect of making a business judgment if the relevant judgment is made:

- In good faith and for a proper purpose;
- While acting on an informed basis to the extent reasonably believed to be appropriate;
- Without material personal interest; and
- Holding a rational belief that the decision is in the best interests of the corporation.

The Australian application of the BJR is objective in nature. For example, the belief of a director that a decision is in the best interests of the company is rational unless it is a belief that no reasonable or similar person in the director's position and circumstances would hold (Hanrahan et al. 2008, 210). Similarly, the element of 'informed to the extent reasonably believed to be appropriate' indicates that the director must exercise an appropriate amount of care and diligence in the given circumstances as determined by the court (Hanrahan et al. 2008, 211).

The objective nature of the rule, while making the standard applied rational and exacting, necessarily results in the BJR being difficult to satisfy. This objectivity can be viewed as a positive characteristic of the BJR from the perspective that this sets a reasonable or minimum level of compliance which is not related to the subjective belief of the director. For example, a director may argue that the elements of the rule are met, but if no other person in a similar situation, in the opinion of the court, would ever come to such a conclusion, the defence would fail.

Moreover, the Australian statutory BJR has the effect of confining courts to an evaluation of the procedural aspects of a director's conduct, such that courts refrain from examining the merits of the director's actions (Noakes 2001, 138). Thus, the result is a rule which is difficult to satisfy in practice.

Without further empirical evidence it is difficult to determine whether the BJR has been a successful gatekeeper to escaping liability, or a bar to excusing the liability of an honest and well-informed director who made a poor management decision. What is apparent is that the statutory BJR has never been successfully argued in any major case (Baxt 2007a, 71).

The US Business Judgment Rule – a lesson for Australia in director deference?

The US structure of directors' duties arguably creates a significant obstacle to court intervention in corporate governance decisions which, in the absence of a director conflict of interest, raise issues only under the duty of care and hence directors are consequently protected from judicial intervention by the BJR (Griffith 2005). The US BJR thus establishes corporate law's balance between director authority and judicial accountability. It protects directors by allowing them to manage the corporation without having to account to courts for their decisions for the most part. As discussed, the Australian BJR does not have the same sweeping protective effect.

Under the US BJR, courts will generally allow a director's business decision to stand when directors make a decision in good faith, on an informed basis, with no self-interest, and reasonably believing that it is in the best interests of the corporation (Telman 2007; Davis 2000). Directors will have no liability for the consequences of that decision, regardless of how bad the outcome may be (Telman 2007).

The US BJR has very broad application; it can apply to decisions made by directors in the context of anything from mergers and acquisitions to executive compensation (Telman 2007). Conversely, the Australian statutory BJR, if satisfied, can only result in the director in question meeting the requirements of the statutory duty of care and diligence in section 180(1) of the Corporations Act. That is, they can still be pursued in litigation for breach of, for example, the duty to prevent insolvent trading, the duty to act in good faith, or any of the other directors' duties. Hence, the Australian BJR offers only limited protection even if satisfied.

The Delaware Supreme Court has characterised the rule as a presumption in favour of directors when a business decision is attacked.^{vii} That is, the burden of proof is on the party challenging the directors' decision to ascertain facts rebutting the presumption (Telman 2007). Contrastingly, the Australian BJR does not operate as a presumption in favour of directors. It is for the impugned director to prove that he/she satisfies the requirements of s180(2) of the Corporations Act.

In practice, the US BJR has been said to operate as a significant barrier to claims under the duty of care directors owe to a company (Griffith 2005). The usual effect of this is that a director will avoid any liability as the court simply does not interfere with the situation (Griffith 2005). Conversely, as stated, the Australian BJR has never been successfully applied in any major case (Baxt 2007a, 71) and courts have indicated how difficult the BJR is to apply (Baxt 2007c, 502).

Finally, in the US the directors' subjective belief is given credence (Keller 2000); whereas in Australia the courts do not look at the subjective nature of the directors' belief, the court analyses the elements of the BJR objectively (Hanrahan et al. 2008) which results in the Australian rule being more difficult to satisfy.

Ultimately, as asserted by Young (2008, 222), the Australian BJR in its current form is simply window dressing. It sets out a standard which is arguably no less strict than that required by the duty of care and diligence in section 180(1), making it hard to imagine a scenario in which the BJR would be satisfied when section 180(1) would be breached (Young 2008, 222). If that is indeed the case, it would appear that the BJR in its current form is redundant.

The proposals to extend the Australian BJR and to enact a General Defence

The first step towards change in Australia began in 2006 with the release by the Treasury of the consultation paper entitled 'Corporate and Financial Services Regulation Review'.^{viii} This paper proposed a number of reforms to the Australian Corporate Law framework. One of the most interesting suggestions made by the consultation paper was the proposed extension of the BJR, foreshadowing an extension of the BJR to apply to all liabilities of directors under the Corporations Act, including the duty of good faith, use of position and use of information, and insolvent trading.

This suggestion, particularly as it relates to extending the BJR to apply to insolvent trading, has since engendered vigorous debate in the business community and extensive disagreement amongst professional organisations as to whether this proposal should be supported or not (Baxt 2006, 205).

This was followed by the release of the latest consultation paper in 2007 by the Treasury, entitled 'Review of Sanctions in Corporate Law'^{ix}, which seeks further consultation on the issue of introducing a 'general defence' to protect directors from breaches of their duties (this would perhaps act as a replacement to the statutory BJR). This significant proposed change would be implemented to enable directors to pursue risk-taking business activities with the ability to rely on a general defence which would potentially excuse liability for breaches of ss180-183 and the insolvent trading prohibition in s588G of the Corporations Act.

The general defence proposed by the latest consultation paper is drafted to protect directors from liability for their decisions where they act:

- In a bone fide manner;
- Within the scope of the corporation's business;
- Reasonably and incidentally to the corporation's business; and
- For the corporation's benefit.

The former federal Government's Review of Sanctions in Corporate Law consultation paper highlights the importance of achieving a balance between preventing objectionable behaviour and ensuring that corporations are prepared to take reasonable risks in their commercial operations. In line with this aim, the consultation paper highlights the need to provide directors with the necessary scope to make decisions which unavoidably contain an element of risk.

Should Australia extend the BJR or enact a general defence?

One persuasive reason for Australia to implement a general defence, as raised in the latest consultation paper, is the desirability of providing directors with certainty about the legality of their actions when they have satisfied specified criteria. That is, if such a defence could assist in better focusing the attention of directors on advancing the interests of the company and at the same time allow directors to be more certain of their own potential liability, it would be a positive reform.

However, Langford (1998, 558), in her article on whether the BJR should be extended to the insolvent trading duty, outlines the development of the insolvent trading duty in Australia and argues that the

interpretation and application of the insolvent trading duty is not lacking in certainty. If Langford's (1998) analysis is accepted, bringing clarity to the law is arguably not a convincing justification for extending the BJR, at least in relation to the duty to prevent insolvent trading (Langford 1998).

Additionally, strong arguments against the extension of the BJR have been made on the basis that business decisions made while a corporation is trading successfully are strikingly different to those made during phases where a corporation is insolvent or close to insolvent, hence, the requirements of the BJR are arguably inconsistent with a situation of actual or impending insolvency (Topp 2007).

Topp (2007) submits that broader societal issues should also be considered, including the fact that as it stands entities often have no assets when it comes to liquidation. Thus, when corporations collapse without assets, liquidators often have nothing at all except a cause for action against directors under the insolvent trading provisions (Topp 2007). Therefore if the BJR is to be used as a defence by directors to such claims, liquidators and creditors may be left without any form of remedy (Topp 2007). A number of submissions in response to the 'Review of Sanctions in Corporate Law' consultation paper raise this issue. For example, CPA Australia argues that "[i]t is highly undesirable to introduce into the law any mechanism that would derogate against the protection afforded to unsecured creditors by way of the insolvent trading provisions – a general defence presents such risk."^x

It has additionally been argued in some of the consultation paper responses that the application of a general defence may add to the degree of complexity and the costs involved in prosecuting a breach of the relevant Corporations Act provisions. This is also a potential disadvantage which must be considered by the Government in the decision whether to extend the BJR or to implement a general defence.

Conversely, the Australian Institute of Company Directors (AICD) submitted a response to the consultation paper stating that both current and potential future directors were reluctant to take up board positions due to concerns about legal liability and the risk of litigation (Young 2008, 217). Similarly there have been increased concerns about director liability due in part to a growth in shareholder actions, and a widely held perception by directors that the duties imposed upon them are too stringent and expose them to legal action (Young 2008, 217).

Yet Young (2008) argues that there is no evidence to support a linkage between onerous directors' duties and increases in litigation. The problem is that there is a lack of empirical evidence which measures the extent to which the Australian legal regime influences directors in their management decisions and risk-aversion (Young 2008, 218).

The best justification for reform seems to be the need to accord directors more deference in management decisions. In Australia, as stated, if the BJR is satisfied the director in question is still open to attack under any of the other directors' duties in the Corporations Act, and the penalties are extensive and range from civil to criminal penalties which include fines of up to \$200,000, disqualification from taking up a director position, and jail time.^{xi} Additionally, under the Corporations Act there is no possibility for indemnification from liabilities owed to the company as exists in the US (Young 2008, 232); yet the current Australian BJR is very difficult to satisfy in comparison to the US BJR, which seems non sequitur if entrepreneurialism is desired.

As Baxt (2008b) asserts, the evidence indicates that Australian courts will only provide relief from liability in the most suitable cases. Therefore, adding scope and flexibility to the law so that a court has the necessary tools to absolve a director from liability in an appropriate case should be viewed as desirable. Undeniably, in order to salvage companies from difficult financial situations, directors need to be proactive; hence encouragement of this in the long term will arguably be in the best interests of all shareholders (Baxt 2008a).

The Treasury has now closed submissions on the latest consultation paper; however the recent change of Government may impact upon the proposed corporate law reforms (Baxt 2008a). Post-election comments made by ASIC Chairman Tony D'Aloisio foreshadow a change in attitude towards director regulation in view of the recognition of the difficulties being faced by directors in performing their roles (Baxt 2008a). It is hoped that this shift in attitude will carry through to the law reform process so that a more equitable balance between the deterrence of undesirable conduct and the promotion of proactive management will be achieved.

Conclusion

While upright conduct is certainly desired, the growth of the Australian economy requires directors to likewise be encouraged in their entrepreneurialism and motivated to accept director positions without undue hesitation due to the extensive legal regulation of management activity.

The most convincing justification for extending the BJR or enacting a general defence appears to be the need to balance risk taking and director deference with the need to protect shareholders and prevent bad faith behaviour or self-dealing. In practice, this has occurred in the US, and Australia can draw from the success of the wide scope and application of the US BJR.

Conversely, the narrow scope and application of the Australian BJR leads to the conclusion that a general defence should be preferred to an extension of the current BJR. It would appear that extending the existing BJR to apply as a defence to other directors' duties would have little practical effect. This is particularly the case given that the currently available defences are both underutilised and rarely successful, which is not necessarily evidence of their success or their usefulness.

A general defence should be drafted to specifically remedy the outlined difficulties with relying not only on the BJR, but on other defences in the Corporations Act such as those contained in s588H. It would be useful to consider the formulation of a general defence in Australia which would draw further parallels with the US BJR, such as operating as a presumption in favour of directors. Moreover, any such defence must be drafted broadly enough to provide sufficient scope for courts to relieve directors of liability in appropriate circumstances, in contrast to the narrowly framed existing defence provisions.

Further empirical research in this area is undoubtedly needed; however there is no doubt that the Australian courts would be better equipped to deal with directors' duty situations if a broader and more wide-ranging defence was available moving into the future.

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ⁱ This is contained in s588G of the *Corporations Act 2001* and requires that directors do not allow their company to trade while it is insolvent.

ⁱⁱ See, for example, *Metropolitan Fire Systems v Miller* (1997) 23 ACSR 699.

ⁱⁱⁱ 103 cases constituted the basis for the study.

^{iv} *CLERP Act 1999* Explanatory Memorandum, paragraph 6.4.

^v *CLERP Act 1999* Explanatory Memorandum, paragraph 2.11.

^{vi} Section 180(3), *Corporations Act 2001*.

^{vii} See, for example, *Aronson v Lewis* 473 A.2d 805, 812 (Del. 1984).

^{viii} The Treasury, Australian Government (2006) 'Corporate and Financial Services Regulation Review', consultation paper, released April 2006.

^{ix} The Treasury, Australian Government (2007) 'Review of Sanctions in Corporate Law', discussion paper, released 5 March 2007.

^x CPA comment (2007) in response to 'Review of Sanctions in Corporate Law' consultation paper. Available from the Treasury website <http://www.treasury.gov.au/contentitem.asp?NavId=066&ContentID=1285>, at 2.

^{xi} See Part 9.4B *Corporations Act 2001*.