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The Business Judgment Rule: ASIC v Rich and the reasonable-rational divide

Abstract
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Keywords
Directors duties, Business judgment rule, 180(2)

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THE BUSINESS JUDGMENT RULE: *ASIC V RICH* AND THE REASONABLE-RATIONAL DIVIDE

Matthew Hooper[1]

INTRODUCTION

> In recognition of the risky nature of most business, courts are reluctant to intrude into the boardroom and second-guess directors' decisions. Providing the directors have performed their duties without personal interests being served, have informed themselves, and have acted in what they believe are the company's best interests, the courts will not interfere, unless the decisions are really very foolish. Only then will honest directors have to face actions for negligence. Certainly, they can make bad decisions and not be pursued. This notion or principle, which shields directors from all but the most egregious carelessness, is called the business judgment principle. In some jurisdictions, as in Australia, the principle has been set out in the statute as the business judgment rule. It blunts the blade of the director's duty of care and diligence.

The decision in *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1; 236 FLR 1 and the release of the Federal Government's discussion paper on the reform of directors' duties concerning insolvent trading are timely reminders of the difficult questions of interpretation surrounding the business judgment rule in Australia. On 18 November 2009, Austin J of the New South Wales Supreme Court handed down his lengthy decision[2] in ASIC's civil penalty proceeding against One.Tel Ltd's former directors Jodee Rich and Mark Silbermann ('the defendants').[3] While the decision turned on the facts, Austin J's judgment nevertheless considered important questions of law surrounding the meaning and operation of s 180(2) of the *Corporations Act 2001* (Cth) ('the Act').[4] This article will focus specifically on the question addressed by Austin J as to whether,

> the requirement that the defendant must rationally believe that the business judgment is in the best interests of the corporation (s 180(2)(d)) is less onerous than a requirement that the belief be reasonable.[5]

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1 BA, LLB (Hons) (Bond). Lawyer, Lander & Rogers. This article further develops a note by the author published in (2010) 28 CSLJ 423.

2 *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1. The judgment outrageously runs to more than 3,000 pages in its original form, mercifully reduced to 700 pages in the printed report.

3 Former joint chief executive Bradley Keeling and non-executive chairman John Greaves were initially defendants but settled with ASIC in 2003, avoiding the 232-day trial.

4 *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1, 608 [7178].

5 *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1, 608 [7179].

It is suggested that the answer provided by Austin J is close to correct, although not technically so. More importantly, a critical point of distinction between s 180(1) and s 180(2)(d) has been missed entirely in the debate over the meaning of 'rationally believe'. While s 180(1) looks to the particular standard of care and diligence required of directors in performing their duties and exercising their powers, s 180(2)(d) looks to the quality of the director's belief as to the best interests of the corporation. Thus the sections, even if they each impose a standard of reasonableness, do not 'cancel one another out'. The importance of parallels with administrative law, hitherto not adverted to in the definition debate, and the *ALI Principles* is highlighted in this article.

THE COURSE OF THE LITIGATION

ASIC claimed the defendants had contravened s 180(1) of the Act, which requires directors to use reasonable care and diligence in exercising their powers and discharging their duties. ASIC alleged that, in the months prior to administrators being appointed to One.Tel in May 2001, the defendants breached their duties by failing to: (i) properly assess One.Tel's financial position, (ii) inform the board as to One.Tel's true financial position, and (iii) ensure the existence of systems facilitating the flow of financial information to the board.

The case necessarily relied on proof that One.Tel's financial position between January and April 2001 was as dire as ASIC alleged, such that the defendants were bound to be aware of the situation and bring it to the board's attention. Justice Austin reviewed the vast amount of evidence and concluded that ASIC had failed to prove, on the balance of probabilities, its pleaded case. It was therefore unnecessary for Austin J to consider the business judgment rule in s 180(2); however, his Honour appears to have considered that the defendants could have successfully invoked the rule had they breached s 180(1), and his Honour's analysis of the rule was applied in supporting the conclusions he reached.[6]

Before commencing an analysis of *ASIC v Rich*, it is useful to set out the text of s 80 in full:

> **'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

[6] *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1, 637 [7295].

(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

Note: This subsection is a civil penalty provision (see section 1317E).

Business judgment rule

(2) 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:

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

(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.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

Note: This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (including the duty of care that arises under the common law principles governing liability for negligence)—it does not operate in relation to duties under any other provision of this Act or under any other laws.

(3) In this section:
business judgment means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.'

Section 180(1) creates the normative standard of conduct to which all directors must adhere, and in doing so essentially codifies the general law. The business judgment rule in s 180(2) is a defence to a contravention of s 180(1) or the equivalent duty of care at common law or in equity. According to the Explanatory Memorandum to the Bill that introduced s 180(2), it is a 'safe harbour' provision intended to protect directors who 'take advantage of opportunities that involve responsible risk-taking'.[7] Judicial consideration of the business judgment rule is notably sparse,[8] which may explain why Austin J took the opportunity to examine the rule.

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[7] Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998 (Cth) at 17 [6.3].

[8] See *Australian Securities and Investments Commission v Adler* (2002) 168 FLR 253, 364 [453]; 41 ACSR 72, 183 where Santow J concluded that s 180(2) could not apply as, inter alia, no

THE BUSINESS JUDGMENT RULE IN *ASIC V RICH*

That part of Austin J's reasoning which is relevant to this article lies in the meaning given to s 180(2)(d), which requires that the director 'rationally believe that the judgment is in the best interests of the corporation.' Section 180(2) further provides that a 'belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in [the director's] position would hold.' Because of the way in which the section goes on to define a 'rational' belief by reference to the 'reasonable person', it has been suggested by Neil Young QC that the business judgment rule 'arguably offers nothing but window dressing. As a defence to s 180(1), it propounds a standard no less stringent than that required by s 180(1)'.[9] He suggests that herein lies the reason for the lack of litigation on s 180(2), as its scope of operation is so limited that it can rarely be triggered.

In its submissions, ASIC contended that the effect of s 180(2)(d) and the definition of rational belief mean that the director's belief must be determined against the standard of reasonableness; the defence is not available for a decision based on an unreasonable belief. ASIC also submitted that there can be 'no multiple "reasonable directors".' Justice Austin agreed that there are,

> no degrees or levels of reasonableness. A belief is either reasonable or not reasonable. A 'reasonable person' is a person who holds beliefs that are reasonable, and if a person holds beliefs that are not reasonable, the person is not a reasonable person in the eyes of the law. If that meaning of the word 'reasonable' is employed in the definition [of rational belief] then ASIC's submission is correct.[10]

However, Austin J considered that accepting ASIC's submission would render s 180(2) otiose, failing to achieve 'the drafter's evident purpose of setting the standard at a lower level than objective reasonableness'.[11] His Honour therefore sought to find an alternative construction; one that was 'preferable' and avoided absurdity. His Honour reasoned that the drafter's objective was to define the phrase 'rationally believe' as taken from the American Law Institute's formulation of the business judgment rule,[12] which is reflective of precedent in most United States jurisdictions.[13] According to the dictionary

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business judgment had been made at all. See also *Gold Ribbon (Accountants) Pty Ltd (in liq) v Sheers* [2006] QCA 335 at [247]-[248].

9 Young N, 'Has directors' liability gone too far or not far enough? A review of the standard of conduct required of directors under sections 180-184 of the Corporations Act' (2008) 26 CSLJ 216 at 222.

10 *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1 at 635 [7288].

11 *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1 at 635 [7288].

12 American Law Institute, *Principles of Corporate Governance* (adopted and promulgated in 1992) at p 134, §4.01(c) ('ALI Principles').

13 *ALI Principles*, p 166.

definition of 'rational', one meaning is 'agreeable to reason, reasonable' while another meaning is 'based on, derived from, reason or reasoning'.[14] His Honour held that,

> [i]t is *plausible* to say that the drafters of the definition of 'rationally believe' intended to capture this latter idea, namely that the director's or officer's belief would be a rational one if it was based on reason or reasoning (whether or not the reasoning was convincing to the judge and therefore 'reasonable' in the objective sense), but it would not be a rational belief if there was no arguable reasoning process to support it. The drafters articulated the latter idea by using the words 'no reasonable person in their position would hold'.[15] (emphasis added)

ANALYSIS OF THE *ASIC V RICH* INTERPRETATION

It is clear that the text of s 180(2) closely resembles §4.01(c) of the ALI's *Principles of Corporate Governance* (*'ALI Principles'*). It is also clear, however, that §4.01 does not contain any definition of 'rationally believes', let alone one which links rationality with a standard of reasonableness. If one looks to the comment on §4.01(c) contained in the *ALI Principles*, one finds support for the proposition that the phrase 'rationally believes' is intended to 'permit a significantly wider range of discretion than the term "reasonable"'.[16] The authors recognised,

> that the word "rational" … has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here.[17]

It is therefore unclear why the drafters of s 180(2) thought it necessary to define an irrational belief as one which no *reasonable* person would hold. Nevertheless, the definition in s 180(2) exists and cannot now be ignored.

It may be that Austin J's interpretation is 'plausible' or 'preferable', but whether it is correct is another question. It clearly achieves a result which gives s 180(2) some work to do but it also seems to rewrite or overlook the express words that define when a belief is 'rational' by reference to a standard, at first glance, of reasonableness. His Honour rejected the idea that there are degrees or levels of reasonableness, even though this appears implicit in the

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[14] *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1 at 636 [7289] citing the *Shorter Oxford English Dictionary*.

[15] *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1 at 636 [7289].

[16] ALI Principles, p 136.

[17] ALI Principles, p 136. This point of confusion was also recognised in a different context by Crennan and Bell JJ in *Minister for Immigration and Citizenship v SZMDS* (2010) 240 CLR 611 at 645-646 [124]-[126].

continued acceptance of '*Wednesbury* unreasonableness'[18] as a ground of judicial review.[19] So much was noted by Crennan and Bell JJ in the recent case of *Minister for Immigration and Citizenship v SZMDS* (2010) 240 CLR 611 at 647 [129]. And if there are no such degrees, how then can the clear words defining a belief as rational unless 'no reasonable person … would hold' it be overcome? For if the words defining rational belief carry a literal meaning that is too strong (that is, the belief *must* be reasonable as all reasonable people only hold reasonable beliefs) then the absurd result cannot be overcome.[20] And so there is yet another secret compartment in the already open Pandora's box: whether s 180(2) looks at beliefs that are unreasonable in the *Wednesbury* sense or beliefs based on an illogical process of reasoning,[21] and what the difference is (if any) between the two. This raises questions of the relevance of administrative law to s 180(2), and notions of legal coherence. In the administrative law cases, it has been said that a decision is liable to be quashed for jurisdictional error if a finding of jurisdictional fact is not supported on logical grounds or 'not supported by reason'.[22] Austin J appears to have interpreted the definition in s 180(2) as being akin to the illogicality ground, despite the wording of the section being far closer to the *Wednesbury* test.

As for the genesis of the wording in s 180(2), it has been suggested to the writer that the Australian drafters borrowed from *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 where the validity of an alteration to the company's articles of association was challenged. Latham CJ, with whom McTiernan J agreed, said:

> It is not for the court to impose upon a company the ideas of the court as to what is for the benefit of the company. It is for the shareholders to determine whether an alteration of the articles is or is not for the benefit of the company, subject to the proviso that the decision is not such as no reasonable man could

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18 *Associated Provincial Picture Houses v Wednesbury Corporation* [1948] 1 KB 223, 233, where Lord Greene MR said 'if a decision on a competent matter is so unreasonable that no reasonable authority could ever have come to it, then the courts can interfere.'

19 Relevant also is the principle in defamation appeals that 'a finding of a jury may only be overturned if it is one that no reasonable jury could reach': *John Fairfax Publications Pty Ltd v Rivkin* (2003) 201 ALR 77, 78-79 [1], [6] (Gleeson CJ), 130 [185] (Callinan J), 136 [219] (Heydon J), 102 [112] (Kirby J).

20 See *Bennion on Statutory Interpretation* (5th ed, 2008) 969.

21 See *Minister for Immigration and Multicultural and Indigenous Affairs v SGLB* (2004) 207 ALR 12 at 20 [37]-[38] (Gummow and Hayne JJ); *Minister for Immigration and Citizenship v SZMDS* (2010) 240 CLR 611 at 625 [40]-[41] (Gummow ACJ and Kiefel J).

22 *WAIJ v Minister for Immigration and Multicultural and Indigenous Affairs* (2004) 80 ALD 568; [2004] FCAFC 74 at [22]; *SZLGP v Minister for Immigration and Citizenship* [2008] FCA 1198 at [15]-[16] (Gordon J).

> have reached (*Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9).[23]

That formulation of the test as to when an alteration would not be in the best interests of the company had its genesis in the judgment of Bankes LJ in *Shuttleworth* (at 18), a formulation which Dixon J does not seem to have preferred.[24] It is critical to recall that s 180(2)(d) likewise directs attention to a belief as to the best interests of the company. It should be noted that, according to *Peters' American Delicacy*, the decision as to best interests is examined not by reference to its quality or merit, but as upon a limited review by the court.

Two further oft-cited cases under the general law also inform the meaning of s 180(2). In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832 the Privy Council said that,

> such a matter as raising of finance is one of management, within the responsibility of the directors … it would be wrong for the court to substitute its opinion for that of the management's decision, on such a question, if bona fide arrived at. There is no appeal on the merits from management decisions to courts of law.

And in *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493, the High Court stated in a similar vein as follows:

> 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 and not for irrelevant purposes, is not open to review in the courts.

Justice Austin considered that while there is 'no "bright line" business judgment rule at general law' the matters noted in *Howard Smith* and *Harlowe's Nominees* form part of the assessment of whether a director has breached their general law duty.[25] His Honour held that the statutory standard of care and diligence in s 180(1) is informed by the general law standard applied in tort notwithstanding the differences between the statute and the general law.[26] It thus followed that the matters referred to in *Howard Smith* and *Harlowe's Nominees* were also to be taken into account when assessing a director's conduct against the standard in s 180(1).[27] Whether this proposition is correct depends upon a fuller analysis, not performed in this article, of the true interaction between the general law and the Act. For present purposes, it is sufficient to note that the general law background

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[23] *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 481.

[24] *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 511.

[25] *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1, 627 [7253].

[26] *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1, 611 [7191]-[7192].

[27] *Australian Securities and Investments Commission v Rich* (2009) 75 ACSR 1, 627 [7254].

against which s 180(2) was enacted spoke in terms of directors having latitude to make decisions as to the best interests of the corporation, which could not be interfered with on the basis that a court took a different view to that of the director. Approaching the question from this perspective accords with US authority, cited in the ALI Principles, which spoke of a belief only being irrational if it was 'so beyond reason' or 'so removed from the realm of reason' that it could not be sustained.[28]

The obvious task of statutory construction – to find the meaning from the text of the statute – has been reiterated in a number of recent High Court decisions.[29] Nonetheless, the ALI Principles, existing common law before the enactment of s 180(2), and the need to avoid an absurd result cannot be overlooked when discerning the meaning of the prolix and unclear drafting found in the sub-section. Justice Austin may not be correct to say that the intention manifested by the legislation is that a rational belief is one supported by reason, even though not necessarily reasonable in the circumstances. It may be a fine distinction, but the correct approach seems to be to give meaning to the words used in the statute, namely, that the belief will be rational unless it is so unreasonable that no reasonable person could hold it. The cases on *Wednesbury* unreasonableness would inform whether a belief was unreasonable to such a degree as to render it, in the words of the statute, not 'rational'. However, all of the above analysis as to the rational-reasonable struggle has distracted attention from a key difference between s 180(1) and s 180(2).

AN OVERLOOKED, AND EXTREMELY IMPORTANT, DISTINCTION

Regardless of whether the requirement in s 180(2)(d) is less onerous than a requirement that the belief be reasonable, a fundamental distinction between s 180(1) and s 180(2)(d) has thus far been overlooked. The standards proscribed by s 180(1) and s 180(2)(d) are directed to different matters; the former to the degree of care and diligence required of the director, and the latter to the quality of the director's belief as to the best interests of the company. As such, even if the latter standard is, as ASIC would have it, equated with reasonableness this does not render s 180(2)(d) otiose. A director's exercise of their powers and discharge of their duties may fall below the standard of reasonable care; however, the director may still have reasonably believed that their conduct was in the best interests of the corporation. Such a finding would not be internally inconsistent.

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[28] *ALI Principles*, pp 172-3.

[29] See eg *Lehman Brothers Holdings Inc v City of Swan* (2010) 265 ALR 1 at 12-14 [40]-[41], [49]; *Muslimin v The Queen* (2010) 264 ALR 9, 13 [14].

The *ALI Principles* note this distinction more clearly than any commentary to date on the Australian rule. The *ALI Principles* cite a line of cases decided under Delaware law that the business judgment rule protects decision where 'any rational business purpose' can be attributed to it.[30] The focus is properly on the *purpose* sought to be achieved by the judgment, that is, whether the director held a belief that the judgment (and its consequences) was in the best interests of the company, not whether that judgment involved a lack of care.[31] Whether the judgment was unreasonable, in the sense that making the judgment lacked the requisite level of care and diligence, is the focus of the inquiry under s 180(1), not s 180(2)(d). Indeed, this distinction properly recognises the very reason for the existence of the rule, namely, that,

> corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation, and other creative entrepreneurial activities.[32]

Thus, for example, a decision, despite involving a risk or risks unacceptable to a reasonable director exercising reasonable care and diligence, will not necessarily lead to liability on the part of the actual director. The decision will be protected by the rule if, the other conditions in the rule being satisfied, the director rationally believed[33] that risky course of action to be in the corporation's best interests. This will be so even though the decision 'may not be vindicated by subsequent success.'[34] Indeed, those are the very, if not the only, kinds of decision that will be litigated upon.

In sum, s 180(2) does provide protection where a director makes a business judgment that a director exercising reasonable care would not make in the circumstances, but where the particular director nevertheless rationally believed that course of action to be in the best interests of the corporation (and satisfies the three other elements of s 180(2)). Given this distinction, which reveals the true operation of the s 180(2) defence, there is strong support for accepting the literal meaning of the words used in the definition of rational belief, that is, the *Wednesbury*-type approach. No issue of absurdity or rendering the rule otiose arises once the proper distinction is taken into account.

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[30] ALI Principles, 172 citing *Panter v Marshall Field & Co* 646 F 2d 271 at 293 (7th Circ 1981); *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 at 954 (Del 1985); *Sinclair Oil Corp v Levien* 280 A 2d 717 at 720 (Del 1971). See more recently *Brehm v Eisner* 746 A 2d 244 at 264 (Del 2000).

[31] See Lumsden A, 'The business judgment defence: Insights from *ASIC v Rich*' (2010) 28 CSLJ 164 at 176-7.

[32] *ALI Principles*, p 130.

[33] According this phrase whatever may be its correct legal meaning.

[34] *ALI Principles*, p 130.

LOOKING TO THE FUTURE

ASIC did not appeal the decision of Austin J given that, in its view, the decision turned on questions of fact and so no important points of law could be raised on any appeal.[35]

For lawyers and company directors and officers, the focus may now shift to the discussion paper, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, issued in January 2010.[36] The discussion paper raises, inter alia, the option of a modified business judgment rule that would apply to a director's duty, under s 588G of the Act, to prevent insolvent trading. Submissions on behalf of several organisations supported that option,[37] while others most certainly did not.

Aside from the submissions, support has also been expressed elsewhere, perhaps somewhat tentatively, for the adoption of such a rule.[38] If that path were followed, it would be a ripe opportunity to consider and scrutinise closely the wording of not only the new modified rule, but also the existing provision in s 180(2). No doubt the potential for further corporate law reform will prompt much interest and debate as to the adequacy or otherwise of current protections from liability for company directors and officers.[39]

The inclusion of a definition of rational belief in the final paragraph of s 180(2) was unnecessary and caused the problems of interpretation now wrestled with by judges and corporate lawyers. This article has attempted to demonstrate that, applying rigour in the interpretation of the section, the definition does not stand in the way of affording protection to directors. Perhaps the drafters included the definition with the distinction highlighted in this article firmly in mind. Perhaps the link back to reasonableness was a

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35 ASIC Advisory 10-34AD, 'ASIC not to appeal One.Tel decision'.

36 Available at http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1713 (viewed 15 June 2010). Twenty-two submissions were received in response and are available at http://www.treasury.gov.au/contentitem.asp?ContentID=1748&NavID=037 (viewed 15 June 2010). The process of law reform does not appear to have advanced as at 9 March 2011.

37 For example, the Australian Bankers' Association, the Group of 100, the Institute of Chartered Accountants Australia, Minter Ellison and (jointly) the Law Council of Australia, Insolvency Practitioners Association of Australia and Turnaround Management Association Australia. It is perhaps unsurprising that the Australian Institute of Company Directors maintained that the application of the s 180(2) 'broad' defence should be expanded.

38 Justice Berna Collier, ALRC Part-Time Commissioner, *Corporate insolvency: restructuring the financial sector and understanding the long terms effects of the GFC* (7 August 2010) available at http://www.alrc.gov.au/news-media/debt-and-insolvency/corporate-insolvency-restructuring-financial-sector-and-understanding (viewed 9 March 2011).

39 See Baxt R, 'Insolvency Law Reform and the Business Judgment Rule: Some Mixed Messages from the Government' (2010) 28 CSLJ 147.

deliberate attempt at compromise or a watering-down of the rule's effectiveness. Regardless of the actual reason, if the purpose of the statutory business judgment rule is to provide a genuine 'safe harbour' for directors, the words should be removed. A repeal of the definition will achieve greater clarity and certainty for all concerned.