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Abstract
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Keywords
business judgment rule, Corporate Law Economic Reform Program Bill 1998

Cover Page Footnote
My thanks to Professor John Farrar and Professor Jim Corkery for comments on an earlier draft of this paper.
THE STATUTORY BUSINESS JUDGMENT RULE: PUTTING THE WIND INTO DIRECTORS’ SAILS

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Introduction

Company directors should welcome and embrace the statutory business judgment rule, due to commence on 13 March 2000. It finally provides them with the certainty that they need to take their companies into the next millennium. The Corporate Law Economic Reform Program Bill 1998 (the ‘Bill’) was passed by Parliament on 20 October 1999. 1 The position is now clear – the merits of bona fide business judgments made by directors, meeting the four requirements, will not be subject to judicial review. Directors will be taken to have met their duty of care and diligence. Here they will find an ‘explicit safe harbour, being effectively shielded from liability for any breach of their duty of care’. 2 The business judgment rule will protect those directors who make business judgments in good faith and for a proper purpose, have acted on an informed basis without material personal interest and who have a rational belief that the decision is in the best interests of the corporation. If one of these requirements is not met, the rule will not provide any assistance.

Finally, after three major law reform reports recommending its enactment, and the decisions of Rogers CJ, at first instance, 3 and the NSW Court of Appeal in Daniels v Anderson, 4 the business judgment rule has found its anchor in the Corporations Law.

The Corporate Reforms were designed to ‘promote optimal corporate governance structures without compromising director’s flexibility and innovation’. 5 The focus of the reform was to facilitate economic activity based on the principles of market freedom and investment protection. 6 The Government has attempted to balance the rights of the shareholders, on the one hand, with the commercial reality of corporate governance and risk taking, on the other. The Commonwealth Treasurer, Mr Peter Costello, has stated that the reforms seek to strike the balance between companies maximising the return to shareholders by making innovative business decisions while maintaining

* My thanks to Professor John Farrar and Professor Jim Corkery for comments on an earlier draft of this paper.

1 Tabled into Parliament by the Minister for Financial Services and Regulation, Mr Hockey.
3 AWA Ltd v Daniels (1992) 10 ACLC 933.
6 Corporate Law Economic Reform Program Discussion Paper para 3. In addition to the other principles underlying the CLERP reforms – Information Transparency, Cost Effectiveness, Regulatory Neutrality and Flexibility and Business Ethics and Compliance.
investor confidence in management and governance structures encouraging further investment.\footnote{7}

This theme is not too dissimilar from that found in the American Law Institute Corporate Governance Project.\footnote{8} It was said that the business judgment rule developed because of a ‘desire to protect honest directors and officers from the risks inherent in hindsight review of their unsuccessful decisions, and…a desire to refrain from stifling innovation and venturous business activity’\footnote{9}.

Directors are expected to display entrepreneurial flair to maintain and improve shareholders’ return on their investment.\footnote{10} The essence of any system of efficient corporate governance is to allow the board and management the freedom to drive their company forward but exercise that freedom within a framework of effective accountability.\footnote{11} If their wings were ‘clipped’ to such an extent that they feared taking those commercial risks, shareholder returns would be reduced, the market would respond, and the directors would be ousted from their positions. On a larger scale, this would impact on Australia’s competitiveness in the global market. Hence, globalisation was a key factor driving the changes to corporate regulation. The need for Australian companies to remain competitive in the global market and share in the benefits of competition and innovation was high on the Treasurer’s agenda.\footnote{12}

So why has it taken almost ten years for the rule to find its way into the Corporations Law? The business judgment rule is not a new invention – it has been a creature of common law in the United States\footnote{13} and had its origins there over 160 years ago.\footnote{14} In Australia, a version of the business judgement rule had been on the official drawing board since 1989 and fragments of it had been referred to over the years by the Courts, particularly in cases concerning director’s fiduciary duties and the proper purpose doctrine.\footnote{15} A number of reasons were submitted as to why the rule did not find its way into the Corporate Reform Acts of the past. One reason for the delay was the thought that the most appropriate forum for the development and application of the rule was the Courts.\footnote{16} Another reason was the argument that there was already sufficient protection available under the discretionary relief provisions in the Corporations Law, namely ss 1318 and 1317JA. A further reason was the reluctance expressed by the Courts in scrutinising business judgments made by the board.\footnote{17} General principles and guidelines were thought to have developed

\footnote{9} See above n 4, 658.
\footnote{11} See above n 6 para 2.1.
\footnote{12} See above n 8.
\footnote{13} Percy v Millendon 8 Mart (NSW) 68 (1829) where concern was expressed that ‘persons of reason, intellect and integrity would not serve as directors if the law exacted from them a degree of precision not possessed by people of ordinary intellect and integrity’. Tan D, ‘Delivering the Judgment on a Statutory Business Judgment Rule in Australia’ (1995) 5 AJCL 462; Hodges v New England Screw Co 3 re 9, 28 (1853).
\footnote{14} Harlowe’s Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL (1967) 121 CLR 483 (breach of fiduciary duties), Ngurli v McCann (1953) 90 CLR 425 (proper purpose doctrine).
\footnote{15} Explanatory Memorandum (1992) 89.
\footnote{16} Howard Smith Ltd v Ampol Petroleum Ltd [1974] 1 NSWLR 68.
to ascertain sufficiently the standard of care and diligence required of company directors.

However, after a series of cases from 1992 to 1997 the uncertainty regarding those standards and the piecemeal application of the business judgment rule led to the establishment of the CLERP committee and the announcement made by the Treasurer in March 1997. The judgment of Rogers CJ at first instance in the AWA case was the impetus for reform and codification.

This article:
1. examines the statutory business judgment rule;
2. considers the nexus between control and accountability, the relationship of director to company and the resultant duties owed to the company;
3. examines the development of the business judgment rule and the application of the rule by the Australian courts;
4. considers the statutory derivative actions and the rebuttable presumption of the business judgment rule;
5. identifies the benefits of the rule and examines the criticisms of the rule.

**Draft Provisions**

Two key features of the Reforms are the statutory enactment of a business judgment rule and the extensive rights given to shareholder to take action on behalf of the company.

The relevant sections of the Bill are extracted below:

Chapter 2D – Officers and Employees

Part 2D.1 – Duties and powers

Division 1 General duties

180 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:

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18 Corporate Law Economic Reform Program.
20 See above n 3.
21 See above n 5.
22 See above n 1.
(a) were a director or officer of a corporation in the corporation’s circumstances; and
(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

**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 common law principles governing liability for negligence) – it does not operate in relation to duties under any other provision of this Law 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.

Part 2D.1 ‘Duties and powers’ is designed to replace completely the existing duties under section 232 of the *Corporations Law*. The duty of care has been amended to clarify that the particular circumstances of the corporation will be taken into account in assessing the standard of care required of a director or officer. The standard remains an objective one and will vary according to the size and nature of the business of the particular corporation.\(^{23}\)

\(^{23}\) See above n 4 at 688.
The rule is said to offer directors and officers a ‘safe harbour’ from personal liability for breaches of the duty of care and diligence in relation to honest, informed and rational business judgments. The Commentary identifies a ‘fundamental purpose of the business judgement rule’ as the protection of the authority of directors in exercise of their duties. It is not intended to insulate directors from liability and can be said to be a rebuttable presumption that the director has not breached his duty of care if the four requirements are met.

The rule is found in section 180(2), immediately following a relocated ‘care and diligence’ duty in section 180(1). It is important to treat the two as having separate and distinct identities. For example, a director who makes a decision in which he/she has a material personal interest will not be able to rely on the business judgment rule if the decision is bad. This does not mean that the director has automatically breached the duty of care. That is a separate matter for a Court to decide.

The business judgment rule only provides protection regarding the duty of care and diligence in s 180 (1) and the equivalent duties at common law or in equity. It does not have universal application to any other duty under the Corporations Law. This limitation is expressed in the endnote of s 180 (2).

CLERP’S contains a package of reforms. The package provides a clarification of a Director’s duty of care, protection under the business judgment rule, and the ability to delegate and rely on the advice of experts when making a decision. The shareholder gets greater access to bring an action in the name of the company against the director. The statutory derivative action provides a new avenue of enforcement and action by shareholders. The shareholder may be able to gain access to the company’s funds to pay for the action through increased powers enabling the Court to make costs orders. The package is intended to find the balance between the freedom and flexibility of directors on the one hand, and the interests of the shareholder on the other.

The following diagram sets out the various ‘bases’ that the judgment must reach before the court will grant relief to a complainant.

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24 See above n 5 Commentary, 38. See above n 2 Explanatory Memorandum.
25 See above n 5 at 43.
26 See above n 5 at 45.
Business Judgment Rule

1st BASE
Is there a duty of care owed?
If so
Has the director or officer made a business judgment?
If so
Have the four requirements of the rule been met?
If so
The directors and officers have met the standard required and satisfied the duty of care owed to the company.
The judgment must make it to 'home base' before the director is protected. The merits of the business judgment will not be subject to review by the Courts. The duty of care under s 180(1) has also been met.

2nd BASE
If not
No application

3rd BASE
If not
No protection

HOME BASE
If so
Complainant must still establish breach of duty of care. No protection for director or officer.

The directors and officers have met the standard required and satisfied the duty of care owed to the company.
They are protected from liability.

The rule will apply when following prerequisites are met:

(a) there must be a business judgment;
(b) made by a director or officer;
(c) who owes a duty of care and diligence.
A Business Judgment

Business ‘judgment’ has been given a wide meaning under s 180(3) and includes ‘…any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.’ 27

There must be a decision – whether to do something or not to do something. It does not extend to the failure to make a decision or where the directors ‘abdicate their responsibilities and fail to exercise any judgment’. 28 The Australian Securities and Investment Commission suggests that a director cannot be satisfied that a decision is truly in the best interests of the company where he/she has simply ‘rubber-stamped’ the decision. 29 There must be exercise of judgment in reaching the conclusion.

In Graham v Allis Chalmers Mane 30 the business judgment rule did not apply where the Board failed to identify and take steps to avoid anti-trust breaches by one of its divisions. In Vrisakis v Australian Securities Commission, the failure by Mr Vrisakis to take reasonable steps to implement a rescue plan was held to be a commercial decision. 31 However, this was in the context of an ASC prosecution and was not a case involving a breach of duty of care. If it had been an action for breach of duty, the business judgment rule would not have applied because the prerequisite (ie a business judgment) had not been satisfied.

The subject matter of the decision must be a matter relevant to the business operations of a company. Bosch identified 15 main functions of the Board, 32 most of which involved aspects of setting and achieving the company’s goals, planning and budgeting, promotion of the company’s business, acquiring and disposing of assets, raising or altering capital etc. 33 Obviously, the nature and extent of the performance of these functions depend on the size, complexity and nature of the company.

The Board is at the centre of the corporation, making many decisions affecting the corporation in some way. The variety of decisions varies from the most mundane to the most complex and monumental decisions having far reaching effects on the corporation. For example, the decision to recommend a merger with another company will have a profound impact on the shareholders in the corporation. 34

It is clearly recognised that the board is the most appropriate body to make the decisions for the company. In Solash v Telex Corp 35 it was stated that

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27 See above n 1 s 180(2).
30 1963 41 Del Ch 78, 188 A2d 125.
32 See above n 10 at 8.
businessmen and women possess the skills, information and judgment not possessed by others and are therefore the better ones to make the decisions. The Courts are reluctant to ‘second-guess’ the decision if it had been made in good faith by the directors. 36

Decisions made by directors in the context of insolvent trading or in relation to misstatements in a prospectus or takeover document are outside the ambit of the rule. 37 The reason for this is that the business judgment rule does not operate in relation to any other provision of the Corporations Law where a sanction or remedy is prescribed. 38

The original proposal referred to a business ‘decision’ rather than a business ‘judgment’. The use of the word ‘decision’ did not recognise the notion of collegiality of the Board and that a director, acting alone, does not have the capacity to bind the company. Therefore, the word ‘judgment’ is more representative of the notion of collegiality – that the director exercises judgment in deciding whether to vote for or against a proposal. The majority decision is the decision of the Board. Directors who disagree with the board’s decisions should minute their dissent. Every member of the Board can rely on the business judgment rule, even if that member voted against the majority. However, the duty of care is applied individually and each case will be considered on its own merits.

**Director or Officer**

The definition of ‘director’ in section 60 of the Corporations Law remains unaltered. However, under the changes, the definition of ‘officer’ has been extended to ‘other people who manage the corporation or its property’. 39 Receivers and liquidators are specifically mentioned. The definition allows managers and in some cases employees to seek protection under the rule. In the past, senior managers have been held liable for business decisions of the company. 40 It follows that they should be afforded the same protection as directors. Jesserson Holding Pty Ltd v Middle East Trading Consultants Pty Ltd 41 held that if a person is connected with the making or implementation of policy or management decisions in the company, they may come within the ambit of the term ‘officer’.

A trustee is protected under the American version of the rule. 42 An accountant successfully relied on the rule when he was acting as an interim manager of the corporation while the sole director or de facto director was absent. 43 If a person is held to be a shadow director or de facto director and subject to the same

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36 See above n 14 Harlowe’s case.
37 See above n 5 at 44.
38 See s 558G Corporations Law - directors duty to prevent insolvent trading.
39 See ss 9 and 179 (2) CLERP Bill.
41 (1994) 13 ACSR 455 at 460.
42 Johnson v Johnson referred to at 333 Branson (see above n 8).
43 Para-Medical Leasing v Hangmen 739 P2d 717 721 (Wash App 1987).
statutory duty of care and diligence, it follows that they should be entitled to protection under the rule.

**Categories of Directors**

Directors can be placed in two categories – executive and non-executive. The executive director is an employee of the company, engaged under a contract of employment to provide personal services to the company. The executive director is involved in the daily operation of the company and is contractually bound to perform the duties under that contract.

Under the contract of employment the executive director has an obligation to perform the work agreed with reasonable care and diligence. In addition to the contractual duties, the executive director owes a duty of care to the company.44 By accepting the position, there is an implied warranty that the executive has the ‘skill’ required45 and an implied promise to exercise that skill. Is there a conflict between the duties owed by the executive director under the contract of employment and the statutory duty of care and diligence under the Corporations Law? This issue will be considered later in the article.

Non-executive directors are not employees and a percentage of them should be truly independent of management.46 They possess special experience and qualifications and add an independent flavour to the composition of the Board. The non-executive director monitors the operations of the company and provides guidance and expertise in certain areas to ensure the enhanced performance of the company. Non-executive directors usually attend monthly board meetings and make decisions on matters of policy involving the company.

Company directors do not belong to an acknowledged profession. However, there are some non-executive directors who are so experienced and hold so many board positions, that they could be considered to be ‘professional directors’.47 In America, non-executive directors are referred to as ‘outside’ directors.48 The different roles played by executive and non executive directors was one of the reasons why Rogers CJ reached different findings as to the liability of Hooke, as Chief Executive Officer, and the non-executive officers.49 Whilst part of his finding was overruled on appeal, s 180 (1) (b) recognises that the nature of the office held and the responsibilities of the director are relevant factors in deciding the standard of care.

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44 *Lister v Romford Ice and Cold Storage Co* [1957] AC 555 and more recently in AWA Rogers CJ.

45 *Harmer v Cornelius* (1858) 141 ER 94.


47 Rogers CJ in AWA; and former politician Nick Greiner holding 17 directorships at once.

48 *Puma v Marriott* Del Court of Chancery (1971) 283 A2d 693.

49 See above n 3 at 106.
Duty of Care and Diligence

The statutory standard of care in s 232(4) of the *Corporations Law* reflected the standard already required at common law. Prior to its introduction in 1992, attempts were made to hold directors to higher standards than the common law required.50

Section 180 (1) amends s 232(4). This amendment requires the exercise of powers and discharge of duties with the degree of care and diligence that a reasonable person would exercise. Diligence has been limited to mean what may reasonably be expected of a director in the circumstances.51

The Explanatory Memorandum52 to the 1992 proposal refers to the expression ‘a reasonable person’. It was intended to confirm that the required standard of care and diligence was to be determined objectively. The reasonable person was then placed in the company’s circumstances to allow matters such as the state of the financial affairs, size and nature of the company and the urgency and magnitude of problems to be considered.

The word ‘skill’ is missing from the section, unlike from the New Zealand statutory duty of care provision.53 The section goes further to include parts (a) and (b) outlining the subjective factors that are relevant in determining the standard. In particular, (b) recognises that not every director can be expected to have equal knowledge and experience. The Courts are able to consider the different roles played by members of the Board. The standard required is that of an ordinarily prudent person.54 This could be seen as a legislative reversal of the finding in *Daniels v Anderson* which effectively found no difference between the standards of care required of a non-executive and an executive director.55

The essence of the directors’ relationship with the company and the duty of care owed necessitate the existence of the rule. As mentioned above, the two are to be treated separately but Branson states that the business judgment rule relates to the duty of care in a subtle and complex way.56 To appreciate the duty owed by director to company, it is necessary to examine the concept of control and the relationship of director and company. Who are the constituents, ie to whom are the duties owed?

50 Eg Commonwealth Bank of Australia v Frederich (1991) 9 ACLC 115; AWA see above n 2.
51 *Byrne v Baker* [1964] VR 443 at 450.
52 Paragraph 84.
53 Section 137 Companies Act 1993 New Zealand: ‘A director of a company when exercising powers or performing duties must exercise the care, diligence and skill that a reasonable director must exercise…’
54 ALI Model Business Corporation Rule.
55 See above n 4.
56 See above n 8 at 334.
Concept of Control

It is beyond the scope of this paper to attempt to unravel the ‘complex and elusive’ concept of control. However, it is necessary to briefly examine the role that directors play in wielding control and the nexus between control and accountability. The more control, the more demand for accountability.

‘In proportion, as an economic organism grows in strength and its power is concentrated in a few hands, the possessor of power is more easily located, and the demand for responsible power becomes increasingly direct’. In the 90’s however, the ‘demand for responsible power’ by shareholders and markets is subject to the shelter provided by the business judgment rule.

Law and Economics theorists identify a company as:

1. serving as a Master Standard Form as the nexus for a variety of contracts; and
2. representing a pooling of capital ‘to enable an elaborate organisation to be set up with professional management.’ The directors are hired as agents to manage other people’s property – the agency theory.

Berle & Means considered that the power to select the board of directors was central to their idea of control. To identify that group led to the identity of the ultimate controller of the company. Immediate management control existed where the shares are so widely distributed that no individual or small group has an interest large enough to dominate the affairs of the company. Ultimate management control involves control by another company holding a majority interest. Their examination of the 200 largest companies in America in 1930 found that 32.5% were under ‘immediate’ management control and 44% under ‘ultimate’ management control. In 1981, Edward Herman found that 81% of the 200 largest companies were under ‘immediate’ management control and 82.5% under ‘ultimate’ management control.

Voting shareholders elect the Board, exercising their contractual right to vote at a general meeting. In some cases, the exiting Board may have sufficient proxies to ensure that preferred directors are appointed. The prospect of management control becoming a ‘self-perpetuating body even though it shares in the ownership are negligible’ is a reality in some companies.

57 Farrar J, ‘Ownership and Control of Listed Public Companies: Revising or Rejecting the Concept of Control, from Companies in Change (ed B Pettet) 39.
59 See above n 57 at 45.
60 See above n 57 at 45.
61 See above n 58.
62 See above n 58 at 40.
64 Identified in the 5th category of control in the Berle & Means study, see above n 58.
65 See above n 58 at 82.
The ultimate control of the company rests with the Board, subject to the article that determine the extent of the powers conferred. Companies of the future will have their powers contained in the constitution or replaceable rules that set out the basic rules of internal management. Since most matters are reserved for the Board to decide, the scope of power is extensive. In Darwall v North Sydney Brick & Tile Co Ltd, the Court of Appeal recognised a greater role for management in matters that were traditionally reserved for shareholders.

The focus of the Board’s functions as outlined in the Bosch Report is on the maintenance and enhancement of the company’s profitability and increasing shareholders wealth:

- Taking steps designed to protect the company’s financial position
- Adopting a strategic plan for the company
- Determining that the company has instituted adequate reporting systems and the internal controls
- Monitoring management and its performance

It is trite to say that the board is powerful. However, a balance must be struck between the powers of the board and fairness to the shareholder, to ensure that shareholder confidence remains intact and the company continues to return dividends and attracts further capital investment.

The relevance of the concept of control to the business judgment rule is in the context of the independence of the director – the requirement that the director does not have a ‘material personal interest’. The domination or significant influence exerted by a director over the board was considered in Aronson v Lewis. The ownership of shares alone does not amount to domination. However, this coupled with a direct pecuniary interest, was held to amount to a conflict of interest.

The Constituents

The shareholders exercise their contractual right to vote and elect the directors who make up the Board. There is no direct contractual relationship between the directors and shareholders. The contract is between the company and the shareholder and is one of the many that falls under the umbrella of the company being the Master Standard Form. As a result, the directors owe contractual duties and obligations to the company. The directors, as fiduciaries,

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68 (1989) 7 ACLC 656.
70 See above n 10 at 9.
71 473 A2d 805, 815-816 Del 1985 referred to in Branson see above n 8 at 353.
72 See above n 8 at 354; Clark v Lomas & Nettleton Financial Corp 625 F2d 49, 52-53 (5th Cir 1980).
owe fiduciary duties to the company. In exceptional cases this duty may be owed to the shareholder.

In America, directors’ duties are owed to the company and the shareholders. In a takeover context, the directors’ duties are owed to the current shareholders due to the expected demise of the company. Creditors have also been considered as directors’ constituents as recognised in the General Motors Board Guidelines.

**Relationship and Duties**

Directors are unique fiduciaries and are different from other trustees. They are an integral part of the company and are interested in the protection and enhancement of the company, by ensuring the successful performance of the company.

A fiduciary duty was described by the High Court in *Aberdeen Railway Co v Blaikie Bros* as a duty to act with fidelity and trust to another, to act honestly, in good faith and to the best of one’s ability in the interest of the company.

Directors are in a position of trust and have control over property belonging to the company. Behind this is the property belonging to the shareholder, ie the investment made by the shareholder in the company.

The existence of a fiduciary relationship does not mean that every duty owed by a fiduciary to the beneficiary is a fiduciary duty. In *Permanent Building Society v Wheeler* Ipp J considered that if a duty is a fiduciary duty then the director is strictly liable for all loss flowing from the breach. In *Re City Equitable Fire Insurance Co*, Romer J examined the origins of the duty of care as an incident of the director’s general fiduciary office. The degree of care and diligence was that which a person would apply in his or her own affairs. He also considered the difference between the duties owed by directors as opposed to duties of a trustee. This was referred to in AWA and is central to the existence of the business judgment rule.

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74 For example, in a takeover defence, directors have been held to owe duties to shareholders.
75 Aronson v Lewis see above n 1 at 811; McCabe see above n 69 at 47.
77 See above n 10, 37-38.
78 [1843-1860] All ER 249.
80 [1925] Ch 407.
81 See above n 3.
The Four Elements of the Rule

Good faith for a proper purpose

The director must make the decision in good faith. It would be inconsistent to allow the director to rely on the business judgment rule when judgment was exercised in the absence of good faith. For example, a director may not have a material personal interest, may have been fully informed and rationally believed the judgment was in the best interests of the company but the decision was to engage in tax evasion. It would be contrary to public policy to allow the director protection under the business judgment rule.

The ‘proper purpose’ doctrine has been around for many years. Its strict application requires all company power to be exercised for the purpose for which it was originally conferred. However, since *Howard Smith v Ampol*, the doctrine has not been strictly enforced in Australia. It now appears that if the power is exercised for the benefit of the company as a whole, then the actions are for a proper purpose. Therefore, if the judgment is made in good faith and will benefit the company as a whole, the first requirement of the business judgment rule ‘…judgment made in good faith and for a proper purpose’ is satisfied.

The American version of the rule does not express this first requirement. It is thought that the requirement of good faith is an ‘umbrella’ requirement or implied when considering the other requirements.

Material personal interest

The director must not have a material conflict of interest. The word ‘material’ suggests that if a conflict of interest is present, then it must relate to more than an immaterial or insignificant interest.

The question of what is material is to be determined objectively. For example, if the Board was to decide on whether to engage the services of a consultant, the fact that the consultant was a friend or associate of a director, is not a material personal interest. At the other end of the spectrum, if the Board was to decide on whether or not to forgive a sizeable loan owing by a friend or associate director, then this may amount to a material personal interest and deny that director the protection of the business judgment rule.

The ‘significant influence’ issue referred to in respect of the concept of control is relevant to this requirement. If a director exerted significant influence over the other directors, to the extent that they were simply ‘rubber-stamping’ the decision, this requirement would not be satisfied and those directors could not rely on the business judgment rule.

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82 Harlowe’s case see above n 14; *Howard Smith* see above n 16.
83 *Whitehouse v Carlton Hotel Pty Ltd* 5 ACLC 421; *Pine Vale Investments Ltd v McDonnell and East Ltd* (1983) 8 ACLR.
84 See above n 8.
Reasonably informed

This is fundamental to the duty of care. The question of exactly how much information is required depends on the nature of the decision, including the subject matter and complexity. In *Smith v Van Gorkom* the issue of whether the directors were reasonably informed was considered. In that case, when deciding whether to approve a merger agreement, the directors:

(i) failed to obtain independent valuation; and
(ii) failed to consider any documents regarding the proposed merger or adequacy of the price.

The CEO had not even read the merger agreement. The directors had 2 hours notice of the meeting. Regardless of this lack of information, the directors approved the merger agreement. When things went horribly wrong, and a class action was instituted by the shareholders seeking a rescission of the merger agreement or damages against the Board, action was taken for a breach of duty. The directors attempted to rely on the business judgment rule for protection. The Court held the directors were grossly negligent and that their blind reliance amounted to bad faith. They could not rely on the business judgment rule because they failed to be fully informed before making the decision.

There is a subjective orientation to what constitutes being ‘reasonably informed’. The extent of information required to satisfy the requirement depends on the circumstances of the particular decision, made by the particular board, in the company’s circumstances. Even though the duty of care establishes an objective standard, a director could seek protection under the rule if the director had the reasonable belief that he or she was sufficiently informed to make the decision.

A director should be informed about:

- the business reasons for the transaction;
- the impact of the transaction on the shareholders, employees, customers and other constituencies (note: in Australia, this may only extend to shareholders);
- management’s view as to the price and factors affecting the price including forecasts; and
- the fairness of the transaction.

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85 See above n 34.
Rationally believed that the judgment is in the best interests of the corporation

If the directors are informed and their decisions make sense, then the decision is said to have a rational basis. However, if the decision makes no sense at all, then this requirement is not satisfied. For example, a decision by the board, after investigation, to accept a ridiculously low price for the sale of the company or its assets, may lead to an inference that there is a conflict of interest or lack of good faith. If so, the rule does not apply.

The last paragraph in the section gives some guidance as to what amounts to a rational belief. This is known as the corporate equivalent of the ‘perverse jury test’ – is the verdict such that no reasonable jury could have reached it. (If so, then the Court of Criminal Appeal may overturn the verdict.) In a corporate context, is the decision of the director such that no reasonable person could have made it? If so, then the last requirement of the rule is not satisfied.

If one of the requirements is not satisfied, the rule will not protect the director. This does not automatically mean the director has breached the duty of care. The Court will then go on to consider that issue applying the objective test.

The statutory rule seeks to modernise this area of corporate law and the flexibility in order to meet future challenges to directors. But there is nothing revolutionary about the section. Words like ‘reasonable person’, ‘care and diligence’ are not new. The addition of part (b) – ‘…had the same responsibilities…’ adds a subjective flair to the equation of satisfying the duty. This addition comes from Rogers CJ’s decision in AWA where he accepted Romer J’s subjective standards 87 and applied them to non-executive directors, taking into account their particular knowledge and experience.

As mentioned above, the executive director owes contractual duties to the company under the employment contract. The ‘skill’ requirement is omitted from the statutory duty but is included (either expressed or implied) under the employment contract. If the executive director is found liable for a breach of statutory duty of care, the company may be able to seek damages from the director on the basis that he/she has breached the contractual duty. This may be grounds for a cross claim by the company against the executive. However, this is a matter between the company and the director. As far as any third party (or the company in a derivative action) is concerned, the action would be against the company and/or the executive director.

Application of the Business Judgment Rule by the Courts

Justice Kirby 88 identified two trends that had developed in Australian courts over the past decade. Firstly, the judicial impatience with sleeping or passive

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87 See above n 80.
directors. Secondly, the appreciation that directors can not assume all functions of managers, auditors and controllers of companies. That those directors who carried out their duties honestly to the best of their ability would not normally be held to have breached their duty.

Baxt suggests that the re-evaluation of the role of sleeping director led the strong movement for the introduction of a business judgment rule.  

**The AWA Case**

Much has been written about the AWA case and its impact on the duties owed by executive and non-executive directors in Australia. For the present purpose, an examination of Rogers CJ’s decision in the Supreme Court of New South Wales will be restricted to his practical discussion of directors duties.

In what was a logically thought out judgment, Justice Rogers examined the corporate history of AWA, the background and experience of its non-executive directors, its executive officer and key personnel.

He drew a distinction between the duties of the executive and non-executive directors, resulting in the sheeting home of full responsibility for the losses to the CEO on the part of the company and the company auditors. He found that the duty of care owed by the non-executive directors was to be judged by subjective and not objective standards with the ability to delegate to the CEO. Non-executive directors were only to be held liable in the case of gross negligence.

He identified the difficulties faced by large companies in supervising their activities.

> It is something of an anachronism to expect non-executive directors, meeting once a month, to contribute anything much more than decisions on questions of policy. Senior management is not exercising the powers of decision and management which in less complex days was reserved for the board.

Perhaps the last page of his judgment left a powerful message to legislators:

> The division of responsibility between Directors, auditors and senior management is not sufficiently clear...Yet the commercial reality is that...directors’ ability to exercise meaningful control

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89 *Metal Manufacturers Ltd v Lewis* (1998) 13 NSWLR 315 at 318-19; Darvall’s case see above n 68 at 659 where Kirby J was in dissent.


92 See above n 3 at 942.

93 See above n 3 at 988.
over management is about as slight as the ability to control a vast bureaucracy.\textsuperscript{94}

The Court of Appeal reversed Rogers CJ’s decision.\textsuperscript{95} The Court found that the test to be applied was an objective test; that a minimum standard was required of all directors; and rejected the notion that liability of non-executive directors was limited to gross negligence. This left non-executive directors in the unenviable position of the threat of litigation which in turn contributed to a stifling of innovative decisions to enhance company profits. The business community was more confused than ever.

While the sleeping director hasn’t completely woken up\textsuperscript{96} - with only 35\% of companies surveyed by Professor Ramsay and Mr Hoad reviewing the performance of management and directors - things are moving in the right direction.

**Shareholders Derivative Actions and the Business Judgment Rule**

While some see the business judgment rule as a win for directors, shareholders have not been forgotten in the reforms. Part 2F.1A provides a shareholder with the right, after seeking leave from the Court, to bring an action on behalf of a company for a wrong done against the company where the company chooses not to sue. The Court will grant leave if:

1. there has been inaction by the company; and
2. the applicant is acting in good faith; and
3. the action appears to be in the best interests of the company; and
4. there is a serious question to be tried; and
5. the applicant has given 14 days written notice to the company of the intention to apply for leave.

In deciding if the action appears to be in the best interests of the company, a rebuttable presumption is found in 237 (3) where the Court will not grant leave if all directors who participated in the decision (not to bring, defend, to discontinue, settle or compromise, the action) had met the four requirements of the business judgment rule. This follows the American procedures in respect of derivative actions – the business judgment rule protection applies to directors in responding to the notice given by the applicant.

\textsuperscript{94} See above n 3 at 1023.
\textsuperscript{95} See above n 4.
\textsuperscript{96} Ramsay I and Hoad G, ‘Disclosures: Corporate Governance in Practice’ (1998) 14 (2) Company Director 11.
In the United States, shareholders are able to institute litigation to enforce duties against directors. A notice of intention to commence an action is served on the Board. The first step is for the Board to review the allegations and decide whether to pursue the action. A sub-committee is formed for this purpose. This decision is subject to protection under the business judgment rule. The Court has overriding discretion to permit the suit to continue.

Brandon suggests that a shareholder may encounter the business judgment rule on a number of occasions. In order to appreciate the effectiveness of the rule, let us consider it in the context of the fictitious Smith company, a publicly listed company involved in the manufacture of white goods. It is the year 2000 and the 1999 amendments to the Corporations Law have been made. A shareholder is disgruntled with the failure by the company to issue dividends and the planned expansion of the company’s operations to Majorca in Spain (where the managing director has a holiday home). The shareholder serves a notice of intention to apply for leave to the Court.

The Board considers the notice and decides not to take any action. The judgment was made by a majority of disinterested directors and officers (the managing director abstained from voting). The directors can apply the business judgment rule to this decision.

If the Court grants leave after considering the requirements of section 237(2), i.e., inaction by the company; the shareholder acting in good faith; the action appears to be in the best interests of the company; and there is a serious question to be tried, then the directors might argue that the judgment not to declare a dividend and to expand the operations to Majorca was a business decision and the four requirements of the business judgment rule had been satisfied. The Court might use the rule as the standard to determine whether or not to defer to the decision of the board.

Back to the present – obviously, the statutory form of the business judgment rule has not been tested in the Australian jurisdiction, so comparison must be made with the American version of the rule.

**The American Version of the Business Judgment Rule**

The American Law Institute formulated the following Model rule to codify what was already embedded in the law:

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;

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97 See above n 8 at 327.
98 See above n 8 at 327.
2. is informed with respect to the subject of business judgment to the extent 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.

It provided an 'easy standard for directors to satisfy'. The rule exists in case law and in some jurisdictions it has been enacted in statute. As mentioned above, fragments of the rule can be found in cases over the past 160 years. The traditional version of the rule was that courts would defer to the board’s decision if the directors acted in good faith and in furtherance of what they reasonably believed to be in the best interests of the company.

It was recognised that the courts were ill equipped to evaluate what essentially were business judgments made by directors in the corporate context. This, coupled with the fact that there was no objective standard by which the correctness of the corporate decision may be measured, was the foundation of the rule.

The limitations of the rule have been tested by the American Courts. If the director has a vested interest in the business judgment, he/she will not meet the requirement in paragraph (a). In Clark v Lomas & Nettleton Financial Corp the Court held that the directors could not seek the safety of the business judgment rule. In that case, the directors had received salaries and consultants fees and were elected to the board by the votes of the majority shareholder who happened to be the defendant in a shareholder derivative action. This created a conflict of interest sufficient to render the business judgment rule inapplicable. The case also highlighted the impact of control. The majority shareholder had elected the directors to the board and had the power to remove the directors from their positions.

The decision must be a business decision. This has been defined to be a decision to take or not to take action in respect of a matter relevant to the business operation of the corporation. In Graham v Allis Chalmers Marine inaction by the directors in failing to take steps to learn of and prevent anti-trust practices in the corporation was not a ‘business decision’ for the purposes of the business judgment rule. The directors in that case were unable to rely on the rule to excuse them from their negligent failure to act or monitor the company activities.

In Shlensky v Wrigley, the decision not to install lights to enable night games for the Chicago Cubs baseball club was a decision for the purpose of the

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100 See above n 13.
101 See above n 72.
102 See above n 30.
business judgment rule. The directors successfully fended off an action that their decision not to spend the money and install the lights, based on concerns for the neighbourhood, was a breach of duty.

The decision by the board in *Dodge v Ford Motor Co*\(^\text{104}\) not to declare a dividend and to save the money for future exemption was a decision for the purposes of the business judgment rule. The Court held that they were not prepared to interfere with the proposed expansion plans of the Ford Motor Company. The judges further acknowledged that they were not business experts and the decision of the board should stand.

In *Joy v North*\(^\text{105}\) the Court identified 3 grounds for the basis of the business judgment rule. Firstly, the fact that shareholders voluntarily invest in the company. Secondly, the Courts recognise that after the fact litigation, sometime years later, is not a perfect device to judge decisions not easily reconstructed in the courtroom. Business imperatives call for quick decisions based on less than perfect information. Thirdly, potential profit equals potential risk. The higher the profit, the greater the risk, providing incentives for boards to take risks to achieve high return for shareholders. The court considered that it would not be in the best interests of the company to create barriers for directors in taking risks.

The directors in *Puma v Marriott*\(^\text{106}\) were not liable for their decision to acquire shares in six companies owned by members of the Board, in exchange for 313,000 shares in the Marriott group. The court examined the composition of the board and in particular, the ‘outside’ directors and found that they were prominent in legal and financial centres and were competent directors. Three other factors influenced the court – the fact that the directors obtained two independent valuations for each company, the fact that the board obtained independent tax, accounting and legal advice regarding the proposed acquisitions and the fact that the shareholders had approved the transaction (including the plaintiff).

The Board’s decision in *John Hancock Capital Growth Management Inc v Aris Corporation*\(^\text{107}\) not to repurchase the company bonds at a substantial discount was protected by the business judgment rule. The decision had been approved by a majority of disinterested directors.

Owing to the diversity of companies in the United States and litigation frenzy, the rule has been misapplied by the Courts on some occasions. It has been suggested that the reason for this is that there has been no single common judicial definition or formulation of the rule.\(^\text{108}\) With the introduction of the


\(^{106}\) See above n 48.

\(^{107}\) No 9920 (Del Ch Aug 24, 1990).

rule in statutory form in Australia, it is hoped that any misapplication will be avoided.

**Benefits of Enactment of the Business Judgment Rule**

Directors and officers, shareholders and the Courts will benefit by having the rule enacted in the *Corporations Law.*

The benefits for directors and officers can be summarised as follows:

1. Providing an enhancement and clarification of the path to be followed in making decisions.
2. Providing an awareness of the duties owed.
3. Encouraging responsible risk taking with the comfort of knowing that decisions will not be second-guessed by the Court if the four requirements are met.
4. Attracting a high calibre of directors and officer to the positions knowing that the duty of care is no higher than that expected of a reasonable person.

The benefits to shareholders include the increase of return on their investments resulting from the ‘green-light’ given to directors to engage in responsible risk taking. Shareholders also have the right to apply to the Court for leave to take action against the company and/or directors under the statutory derivative action.

The rule will reduce the involvement of the court and free up the courts’ time. It has been said that this provides a standard of judicial review and is used as a tool for achieving judicial economy. 109 The disgruntled shareholder can allege that there has been a breach of the duty of care and diligence. The plaintiff bears the onus of proof. The defendant directors can rely on the protection afforded by the business judgment rule if the four requirements are satisfied. Even if they cannot rely on the rule, they can still defend the proceedings on the basis that the duty of care has been met or that their conduct did not cause damage to the company.

Potential applicants (defined in proposed s236(1)) when deciding whether to apply for leave may be deterred from going further if they are unable to rebut the presumption in section 237(3) due to the satisfaction of the four elements in section 237(3)(c). If they do proceed further, then the Court will not grant leave if the elements of section 237(2) are not present. Unmeritorious or vexatious applications will be cut off at an early juncture, freeing up the Court to handle other matters.

109 See above n 8 at 338-341.
Generally, the rule recognises the vast differences between companies and the roles played by executive and non-executive directors. It embraces the concerns that Rogers CJ expressed regarding the reality of corporate bureaucracy. Finally, and most importantly, the rule overcomes the uncertainty and ad hoc development in this area of corporate law.

**Criticism of the Rule**

Some writers referred to by Farrar suggest that there should be no rules. Those who adopt the strict economic theory would prefer that the law be left at the Boardroom door and allow management to go unregulated, with unfettered power. Such a view does not recognise the need for balance that is required to instil confidence in the marketplace. There is a happy medium somewhere. The business judgment rule may be the answer.

Australian commentators have raised specific points in criticising the rule. Allan Rose put forward five reasons why the business judgment rule was not to be introduced in 1992 amendments.

1. The rule was a creature of common law from the United States, and based on an entirely different company law regime. It was therefore impossible to implement the rule in parts, without an overview of the entire corporate system.

   Farrar suggests that this is not entirely correct. Aspects of the rule have been appearing in judicial decisions in Australia for many years. The rule, he suggests, is compatible with the Australian system.

2. The rule in America was uncodified. Since 1992, some American states have adopted a statutory version of the rule, either in whole or in part. In any event, the USA has had a model rule for over 10 years where Australia has not had any guide. The fact the American Law Institute considered the task of codification best left to the Courts, reflected the fact that the American corporate system was larger and more complex than the Australian system.

3. He suggested that the rule was already embodied in Australian company law in the form of the Courts’ reluctance to apply hindsight review to considered business judgments. This did not, however, clarify to what extent the directors have a safe harbour or protection under the rule. The fact that Courts have been reluctant to interfere with business decisions has not stopped them from making obiter comments that have lead to confusion about the standard of care and the application of the business judgment rule.

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110 See above n 3 at 988.
111 See above n 57 at 46.
112 Secretary of the Attorney-General’s Department in 1992.
114 Above n 114.
4. He suggested that s1318 was sufficient protection. However, this remedy is discretionary and the decision of the director must come under the microscope before relief is granted. There is a stigma attached to a finding of a breach of duty, even if the court exercises its discretion under s1318.

5. He argued that it was unclear what the proponents of the rule intended to achieve.

Redmond questioned whether the threat of litigation to Australian directors was as prevalent as the threat to American directors. It is submitted that the state of uncertainty created by the decisions over the past 20 years, and more recently from 1992 onwards, resulted in the need to discourage unmeritorious claims. Hopefully, this will result in fewer actions. The fact that litigation is more prevalent in the American jurisdiction is all the more reason for enacting the rule – to stop the trend of whimsical litigation and to redefine the roles that all parties play in the corporate adventure.

Social policy arguments have been advanced that the business judgment rule would provide directors with legal immunity and therefore create a privileged class in society. This argument is completely at odds with the policy basis of the rule designed to attract persons of reason, intellect and integrity. This does not create a privileged class. It reflects the fact that directors are human and, when making decisions, should not be culpable for the bad ones, subject to the four requirements.

**American Critics**

Franklin A Gevurtz argues that directors should not be treated any differently from doctors or lawyers and that business decisions are very similar to decisions of other professionals. There are three main points which distinguish directors from other professionals. Firstly, other professionals undergo extensive theoretical training (usually six years to complete a degree) followed by a period of practical training to achieve their position. Directors, on the other hand, whilst usually possessing university qualifications, must adapt to the philosophy and culture of the company, bearing in mind the nature of the company’s activities.

Secondly, other professionals act within a narrow range where the variables are constant and there are, to an extent, protocols to be followed. Directors, on the other hand, are acting in an unpredictable environment, where factors such as economic conditions are outside their control.

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116 See above n 86 at 20.
117 See above n 114.
118 See above n 116.
Thirdly, at the end of the treatment (in the case of doctors) or the transaction (in the case of lawyers) the relationship ends (subject to any residual claims in tort). Directors are in a continuing relationship with the company and are more akin to permanent consultants rather than sub-contracted experts.

The ‘after the fact’ review was considered by Gevurtz where he argued that after the fact review raised the same problems as with other professionals who are engaged in risk taking. In his opinion, judges are called upon regularly to make decisions in cases involving conflicts of interest and argues that negligence cases should not be distinguished.

Some have considered that the rule fails to recognise the practical workings of a Board. Branson notes that the rule envisions Boards acting like faculty meetings in which most matters are brought to the fore through committee processes. Instead, Boards operate by consensus and are more collegial than faculties. Its not so much a matter of what they do but what they don’t do that is important.

As a result of the fact that the business judgment rule requires a decision, Branson suggests that more boards may create a paper trail to achieve the business judgment rule protection. It has been suggested that this already occurs in the takeover context. When directors are faced with the possibility of litigation and therefore cautious about the nature of the documents that are created and retained, a paper trail may be revealed evidencing a proper purpose when there may be some ulterior improper purpose.

**Conclusion**

Many of the above criticisms have been addressed by leading commentators and it is clear that the time is right in Australia for a statutory business judgment rule.

A Joint Parliamentary Committee provided a Report on 12 May 1999. The Bill was debated in the Senate and passed by Parliament on 20 October 1999. Major provisions of the legislation, including the statutory business judgment rule, will commence on 13 March 2000.

The enactment is not a fortress for directors. Dishonest, delinquent and irrational directors will still face the sanction of the court for breach of duty. Further, the rebuttable presumption in shareholder derivative actions will not protect them from actions by shareholders.

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121 See above 120 at 305.
121 See above n 8 at 342.
123 See above n 8 at 343.
Justice Kirby\(^{126}\) suggests that we should be thinking creatively about the ways in which the law can facilitate economic development and not simply coerce, regulated and control its occasional errors and ugly manifestations. The time is right in Australia for a statutory business judgment rule which finds the balance (or at least comes as close as ever before) between directors decisions on the one hand and shareholders rights and interests on the other. The rule is a way for the law to facilitate economic development without being overly prescriptive and finds that framework of effective accountability.\(^{127}\)

\(^{126}\) See above n 89 at 3.
\(^{127}\) See above n 10.