Fulfilling parliament's intention: A business judgment rule to stimulate responsible risk-taking and economic growth

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- The business judgment rule (BJR) has failed to fulfil its purpose largely due to drafting deficiencies.
- Under the current BJR, the goals of certainty and protection for calculated risk-taking by directors have not been achieved.
- The New BJR Proposal from Dr Robert Austin would provide directors with substantial reassurance regarding their exposure to liability when making business judgments.

The long running debate about appropriate director protections has once again intensified. It has been fuelled by the emergence of derivative liability for corporate fault[1], a proliferation of regulation, an increasingly complex business environment, continuing economic uncertainty, growing activist investor scrutiny of business decisions and the rise of litigation funding.

The ongoing debate is symptomatic of the fact that the statutory business judgment rule (BJR), introduced by the Australian parliament 15 years ago, has failed to fulfil its purpose, essentially because of drafting deficiencies.

In recognition of the importance of directors' business decisions to the nation's economic health and growth, parliament introduced the BJR with effect from 13 March 2000.[2] The policy rationale was clear: to address the problem of director uncertainty as to liability for good faith decisions inhibiting business activity and promoting risk averse behaviour by directors.[3] Statutory protection of bona fide commercial decisions was intended to provide directors with a 'safe harbour' from which to take calculated risks in pursuit of shareholder wealth.

The need for reform

Contrary to parliament's intention, directors continue to indicate[4] that they are overly concerned with liability for decisions made in good faith. This persistent state of uncertainty has led to a focus on compliance matters and an unduly cautious approach to business decision-making.[5] The goals of certainty and, in turn, protection for calculated risk-taking have not been achieved. The ineffectiveness of the BJR is further evidenced by the fact that it has never been successfully invoked in Australia.

There appear to be three reasons for the BJR's failure, all of which relate to unsatisfactory drafting rather than deficient policy.

1. The decision under challenge must be a 'business judgment', which has been narrowly defined.
2. Directors seeking to invoke the rule have the burden of proving its elements.
3. It is confined to the duty of care and does not extend to the multitude of other statutory provisions that impose liability on company directors.

To address these deficiencies, Dr Robert Austin proposed a new business judgment rule last year (New BJR Proposal). An alternative model, 'The Honest and Reasonable Director Defence', has been put forward by the Australian Institute of Company Directors (AICD).

New BJR Proposal

The essence of the New BJR Proposal[6] is as follows:

A director is protected from any liability and penalty, unless the party alleging breach of duty or exposure to liability proves:

- there was no business judgment; or
- there was a business judgment, but:
  - the director was dishonest;
  - the director had an undisclosed material personal interest; or
  - the business judgment was one that no reasonable person in the director's position could have made.

Additionally, the New BJR Proposal has several important features. They are outlined below.

Applies to director capacity only

The New BJR Proposal only protects directors when they are acting in their capacity as a director. It would not apply to executive directors when they are acting in their executive capacity. Nor would it apply to a director acting in his or her personal capacity.

Also, the New BJR Proposal would not apply to non-director officers. The arguments for protecting such officers from liability are different and depend to a degree upon the kind of liability proposed. There is too ready a tendency for legislators to expose corporate officers to liability for matters outside their sphere of responsibility, but that problem is not addressed by the New BJR Proposal.

A broad conception of 'business judgment'

Under the New BJR Proposal, 'business judgment' means 'an exercise of judgment relating to taking or not taking action in connection with any business of the corporation'. This definition is intentionally broader than in the present law which restricts the concept of 'business judgment' to 'any decision to take or not take action in respect of a matter relevant to the business operations of the corporation'.

A limitation of the narrow BJR definition is illustrated by the judgment of Keane CJ in *ASIC v Fortescue Metals Group Ltd*.[7] In that case, his Honour held that a decision not to make accurate disclosure of the terms of a major contract was a decision related to compliance with the requirements of the *Corporations Act 2001* and not to the 'business operations' of the corporation'. Hence it was not a 'business judgment'. Such an outcome ignores the reality that many compliance decisions are grounded in questions of judgment relating to the company's business.

To overcome the problems arising from the BJR's definition of 'business judgment', the AICD's proposed defence is not limited to business judgments of any nature. Such an approach is erroneous because it abandons the policy basis of protecting business judgments, which was accepted by the Australian Parliament in 1998, and leads to the question: why should company directors, alone in the community, have an 'honest and reasonable' defence?

The provision of a 'safe harbour' for directors is justifiable on the basis that their entrepreneurial business decisions are essential contributors to wealth creation, and therefore should not be inhibited by the threat of legal liability. It follows that any reform proposal should be connected to directors' business decisions for their companies, as that is the policy rationale for protecting directors from liability. It is for this reason that the New BJR Proposal retains a business judgment nexus, defined more broadly and realistically than under the current law.

Reversal of the onus of proof

At present, a director who has been accused of breaching a duty must prove the elements of the BJR in order to invoke its protection.[8] Likewise, if the AICD defence were to be made law, a director seeking to invoke the defence would have to prove all its ingredients. Commercial men and women who have been involved in litigation will know how important questions of burden of proof can become.

In contrast, the New BJR Proposal reverses the onus of proof and replaces the BJR defence with a presumption of no liability for business judgments. Thus, it will be necessary for the person alleging contravention by a director to prove either that the director's conduct was not referable to a business judgment, or if it was, that the director was acting dishonestly, failed to disclose a conflict or formed a judgment that no reasonable person in that director's position would have.

By operating as a rebuttable presumption of no liability, the New BJR Proposal reduces the emphasis on directors accumulating evidence regarding their business judgments just in case, months or years after a board decision is taken, the decision is challenged in court. Additionally, the costs and loss of reputation associated with defending a finding of breach can be substantial and are not necessarily restored by successfully raising the BJR defence. As a director's good reputation is a valuable asset upon which board appointments will be based, a BJR which fails to preserve a director's reputation when invoked is not a safe harbour.

At a more fundamental level, a presumptive approach is more consistent with Parliament's objective than the current model. The statutory BJR was meant to 'clarify and confirm the common law position that the courts will rarely review *bona fide* business decisions'.[9] Hindsight judicial review of good faith commercial decisions, which are made under conditions very different from those of a courtroom, has long been considered inappropriate. It should be for directors, not courts, to determine what is in a company's interests. If the BJR is available only as a defence with no presumption in favour of the director, or a director is given an 'honest and reasonable' defence, the process of proving the elements of the defence will lead to the kind of hindsight judicial scrutiny that should be avoided. The New BJR Proposal overcomes this problem, while still ensuring that directors are accountable if they are dishonest, inappropriately conflicted or make business decisions that are beyond the realm of reason.

Objective elements

The AICD's defence has been criticised as an 'honest idiot's defence'[10] because it uses a largely subjective

test based on the relevant director's belief as to whether or not the degree of care and diligence that he or she exercised was reasonable. This analysis does not, however, paint the full picture. For the AICD defence to apply, a director's subjective assessment of reasonableness would have to be 'rational' (ie '... with the degree of care and diligence that the director *rationally* believes to be reasonable in all the circumstances' [emphasis added]).[11] The objective requirement for rationality tempers the director's subjective belief. In any event, concern has been raised that the introduction of a subjective element runs counter to the general standards currently imposed on Australian directors.[12] Relevantly, in enacting the BJR, parliament strove to balance the competing policy concerns of directorial authority and accountability.[13] The New BJR Proposal, which depends on purely objective assessments of its elements, arguably strikes an appropriate balance between these policy tensions.

Covers the field

The current BJR applies only to the duty of care and diligence (statutory, common law and equitable). The narrow application of this rule is instrumental in the elevated levels of uncertainty regarding directors' liability for business judgments. This is particularly so given the plethora of laws potentially imposing liability (personal, accessorial and derivative) on directors. To remedy this, the New BJR Proposal would apply to any Australian statute that seeks to impose a duty on a director, or expose a director to liability, in connection with a business judgment. The rule would operate irrespective of whether the director's corporation was formed in Australia or abroad, and regardless of where the director's alleged wrongdoing occurs. This outcome would be achieved by inserting the New BJR Proposal in the interpretation legislation of the Commonwealth and every state and territory. It would then apply to every existing and new Australian law unless expressly excluded.

The AICD proposal would not provide such comprehensive coverage. Instead, it would be confined to limiting liability under the Corporations Act and *Australian Securities and Investments Commission Act 2001*. There is no particular reason why protection for directors needs to be confined in this way. A safe harbour should be available to protect entrepreneurial directors from any kind of legal liability with respect to their honest, unconflicted business judgments.

Responding to concerns

The feasibility of realising the New BJR Proposal has been doubted on the basis that it would be difficult to secure Commonwealth, state and territory agreement to the necessary statutory amendments.[14] This criticism is based on the false assumption that implementation of the New BJR Proposal is an all or nothing affair. Even if only the Commonwealth Parliament were to legislate, that would be a significant improvement on the status quo. In any event, through the medium of COAG, there would be a prospect that at least some states and territories would also legislate.

It has been argued that directors' concerns around liability could be addressed through specific legislative proposals (particularly in relation to forward-looking statements, near-insolvency workout situations and OH&S), which would allow for more nuanced protection than a 'cure-all'.[15] A piecemeal approach would, however, further complicate the already complex liability regime and fail to achieve the policy objective of certainty that a blanket rebuttable presumption could provide. It would, of course, still be open to parliament to disapply the New BJR Proposal in those (rare) circumstances where there are very compelling public policy reasons for doing so.

Conclusion

As an overarching presumption against director liability, the New BJR Proposal would provide directors with substantial reassurance regarding their exposure to liability when making business judgments. As a result, parliament's goal of ensuring that liability concerns do not unnecessarily divert the attention of directors from the pursuit of maximising shareholder wealth would be fulfilled. At the same time, investor confidence could be maintained because the New BJR Proposal does not provide directors with safe refuge from liability for dishonest, secretly conflicted or unreasonable business decisions. With these dual policy objectives of director authority and accountability met, all Australians stand to benefit from the potential for further economic growth. The Governance Institute is right to call[16] for stakeholder consultation on this issue of national significance.

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Notes

1 See Herzber A, and Anderson H, 2012, *Stepping Stones — From Corporate Fault to Directors' Personal Civil Liability*, 40 FLR 181.

2 *Corporate Law Economic Reform Act 1999*.

3 *Corporate Law Economic Reform Program Bill 1998*, Explanatory Memorandum at [2.9].

4 Australian Institute of Company Directors, *The Impact of Legislation on Directors*, November 2010; and Australian Institute of Company Directors, *Director Sentiment Index*, first half 2013, second half 2013 and first half 2014, cited in Australian Institute of Company Directors, *The Honest and Reasonable Director Defence*, August 2014.

5 Ibid.

6 To view the full text of the New BJR Proposal, visit http://chqa.minterellison.com.

7 (2001) 190 FCR 364 at 427. On appeal, the High Court of Australia did not address this question: *Forrest v ASIC* (2012) 247 CLR 486; [2012] HCA 39.

8 *ASIC v Rich* (2009) 75 ACSR 1; [2009] NSWSC 1229 at [7258]–[7270].

9 Above n 3 at [6.4].

10 Paatsch D, 2015, 'The business judgment rule: A case for the 'known quantity', *Governance Directions*, Vol 67 No 3, p 140.

11 Australian Institute of Company Directors, *The Honest and Reasonable Director Defence*, August 2014.

12 Fox J, 'Honest and reasonable director defence', 2015, *Governance Directions*, Vol 67 No 4, p 218 at p 219.

13 Above n 3 at [6.3].

14 Broomhead M, 2015, 'The business judgment rule: A case for change to the AICD model' *Governance Directions*, Vol 67 No 3, p 138 at 139, and Paatsch, above n 10 at p 142.

15 Paatsch, above n 10 at p 141.

16 Fox, above n 12 at p 221.