Should the Statutory Business Judgment Rule Apply to Directors’ Compliance Decisions?

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Should the statutory business judgment rule apply to directors’ oversight responsibilities and compliance decisions?

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Introduction

This note considers the scope of the term ‘business judgment’ in the statutory business judgment rule (‘the rule’) set out in s 180(2) of the Corporations Act 2001 (Cth).¹ While the interpretation and impact of this sub-section has been debated in scholarly journals,² that debate has focused on other elements of the provision rather than on the definition of the term ‘business judgment’. However, in the public sphere the scope of this term has been strongly criticised by the Australian Institute of Company Directors (AICD). The AICD’s concerns are twofold. First, it is disappointed that s 180(2) does not apply to directors’ responsibilities to monitor and oversee companies’ financial position and general business activities.³ Second, the AICD takes issue with the exclusion of a directors’ judgments as to whether or not a company should comply with the law.⁴

These criticisms form part of the argument underlying the AICD’s campaign for the introduction of an ‘honest and reasonable director defence’: a proposed statutory defence that the AICD argues would be more effective than s 180(2) in reassuring directors that they can take reasonable entrepreneurial risks without fear of attracting personal liability. After providing some brief background context, this note considers each of these criticisms from both a legal and a policy perspective.

¹ Unless otherwise stated all references to statutory provisions in this note are to provisions of this Act.
³ Australian Institute of Company Directors (AICD), ‘The Honest and Reasonable Director Defence: A Proposal for Reform’ (7 August 2014) <http://www.companydirectors.com.au>, 6-7; unless otherwise stated, all references to ‘directors’ should be read as ‘directors and other officers’.
⁴ AICD, n 3, 8-10.
Background
The rule has been part of Australian corporate law since March 2000. It was introduced by the Howard government as part of its Corporate Law Economic Reform Program (CLERP) in response to concerns that the NSW Court of Appeal decision in the case of Daniels v Anderson (‘Daniels’) had created uncertainty as to state of the law regarding directors’ duty of care.⁵ The relevant CLERP policy paper argued this uncertainty was ‘causing directors to be conservative and risk-averse in their approach to carrying out their functions’.⁶ The rule was therefore introduced to reassure directors that business decisions ‘taken in good faith and in the company’s interest … would not be subject to challenge’.⁷

The wording of s 180(2) was influenced by the business judgment rule developed by US courts and, in particular, by the American Law Institute’s model provision.⁸ In broad terms, s 180(2) provides that if directors act in good faith for a proper purpose, take reasonable steps to inform themselves before making a business judgment and do not have a material personal interest, then their judgments will be held to a lower standard of care than the usual ‘reasonable person’ test for negligence.⁹ Most relevantly for this note, s 180(3) defines a ‘business judgment’ as a ‘decision to take or not take action in respect of a matter relevant to the business operations of the corporation’.

Although the AICD was involved in lobbying for the introduction of s 180(2), it has expressed disappointment with its operation in practice. The AICD has conducted a number of surveys of its members since s 180(2) came into operation and the majority of directors who fill in those surveys consistently report that fear of personal liability is making them excessively cautious and that the same fear is dissuading talented people from taking up board positions.¹⁰ The AICD points to these surveys as evidence that s 180(2) is failing to achieve its purpose of encouraging entrepreneurialism. Inter alia, the AICD argues that the exclusion of directors’ oversight responsibilities and compliance decisions from s 180(2)’s protection has contributed to the provision’s failure to achieve its goals.

The criticism that s 180(2) does not apply to directors’ oversight responsibilities

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⁷ CLERP Paper No. 3, n 6, 25.
⁹ The author has recently completed a more detailed analysis of these elements of s 180(2) with co-author Wesley Bainbridge. This paper will hopefully be published soon.
It is worth noting that the first of these criticisms does not actually relate to entrepreneurialism, or at least not directly. The AICD is critical of the fact that the reference in s 180(3) to ‘a decision’ excludes circumstances in which a director has failed to consider a particular issue, with the consequence that the rule generally does not protect directors who have neglected their duty to monitor and oversee the company’s operations.\textsuperscript{11} Extending the rule’s protection to directors’ monitoring responsibilities would have no direct impact on entrepreneurial risk-taking, since entrepreneurialism necessarily involves making business decisions. However the AICD argues it is unfair to exclude oversight duties from the rule’s protection since directors, and non-executive directors in particular, cannot reasonably be expected to be across every aspect of a company’s operations and must make strategic decisions regarding where to direct their attention.\textsuperscript{12}

As a matter of law, the AICD is correct that s 180(2) does not apply to directors’ monitoring responsibilities. The case in which the rule has received the most detailed judicial consideration is the 2009 NSW Supreme Court decision in \textit{Australian Securities and Investments Commission v Rich} (‘Rich’).\textsuperscript{13} In addition to listing a number of specific activities he believed fall within the definition of ‘business judgment’,\textsuperscript{14} Austin J made two general observations. First, he noted the breadth of the statutory language, observing that the formulation ‘in respect of a matter relevant to the business operations of the corporation’ enables matters not explicitly part of business operations to form the basis of a ‘business judgment’.\textsuperscript{15} Second, his Honour noted that the text of the provision contains an ‘important limitation’.\textsuperscript{16} Specifically, it requires that a judgment must actually be made; that is, there must actually be a conscious ‘decision to take or not take action’.\textsuperscript{17} The effect of this limitation is that the defence will not be available to a director who simply neglects to deal with an issue without turning their mind to it.\textsuperscript{18} Further, the rule will not protect directors who fail to discharge their oversight duties, including monitoring the company’s affairs and maintaining familiarity with its financial position, because these duties do not involve a decision to take or not take action.\textsuperscript{19} As a matter of statutory interpretation the above observations cannot be faulted and they have been routinely followed in subsequent cases.\textsuperscript{20}

\begin{itemize}
\item \textsuperscript{11} AICD, n 3, 6-7.
\item \textsuperscript{12} AICD, n 3, 25.
\item \textsuperscript{13} (2009) 75 ACSR 1, [7248]-[7295].
\item \textsuperscript{14} \textit{Rich} (2009) 75 ACSR 1, [7273]-[7274], [7280], citing Paul Redmond, ‘Safe Harbours or Sleepy Hollows: Does Australia need a Statutory Business Judgment Rule?’, in Ian Ramsay (ed), \textit{Corporate Governance and the Duties of Company Directors} (Centre for Corporate Law and Securities Regulation, University of Melbourne, 1997), 195.
\item \textsuperscript{15} \textit{Rich} (2009) 75 ACSR 1, [7273]-[7274].
\item \textsuperscript{16} \textit{Rich} (2009) 75 ACSR 1, [7277].
\item \textsuperscript{17} \textit{Rich} (2009) 75 ACSR 1, [7277].
\item \textsuperscript{18} \textit{Rich} (2009) 75 ACSR 1, [7277].
\item \textsuperscript{19} \textit{Rich} (2009) 75 ACSR 1, [7278].
\item \textsuperscript{20} See, eg, \textit{Great Southern Finance Pty Ltd (in liq) v Rhodes} (2014) 103 ACSR 137, [46].
\end{itemize}
As a matter of policy, the danger with the AICD’s argument that the rule’s protection should extend to directors’ oversight duties is that it could undermine important advances in directorial accountability associated with Daniels and subsequent cases. While it is true that some companies’ financial affairs and business activities are complex, it is not desirable to return to the situation where non-executive directors could legally pay minimal attention to the affairs of companies that they were purportedly responsible for overseeing. Although a detailed consideration of the relevant case law is beyond the scope of this note, arguably the minimum oversight expectations set out in Daniels are not overly onerous and it would be better to leave it to the courts to develop and refine these expectations as they consider cases relating to s 180(1) and the general law duty of care, rather than amending or replacing s 180(2) such that the lower standard of care set out in s 180(2)(d) could be applied to failures in oversight.

The criticism that s 180(2) does not apply to decisions regarding whether or not to comply with the law

The AICD’s second concern is that the courts have excluded decisions regarding compliance from the rule’s protection. The AICD notes that in a number of cases courts have used what it calls a ‘stepping stone’ approach, whereby directors can be found to have breached their duty of care if they have failed to prevent the company from breaching the law.21 The AICD expresses disappointment that the business judgement rule does not protect a director in such a situation. They argue that judgements in relation to compliance are often difficult and complex and hence deserve protection, citing as an example a situation in which directors with incomplete information have to weigh the possibility of causing the company to engage in misleading and deceptive conduct (if they disclose that information and it turns out to be false) against the possibility of falling foul of the continuous disclosure regime (by failing to disclose relevant information in a timely manner).22

Although, on balance, the AICD is probably correct to say that s 180(2) does not apply to judgments as to whether or not a company should comply with the law, as a matter of statutory interpretation this is not absolutely certain. In Australian Securities and Investments Commission v Fortescue Metals Group Ltd (‘Fortescue’),23 the Full Court of the Federal Court did hold that a decision by a director that a company should not comply with a requirement of the Corporations Act could not constitute a ‘business judgement’ for the purposes of s 180 because such a decision related to compliance rather than to the ‘business operations’ of the company.24 However this case was

21 AICD, n 3, 8-10.
22 AICD, n 3, 9-10.
23 (2011) 81 ACSR 563, [197]-[199], [218], [217].
24 In Fortescue, Keane CJ also held that ‘s 180(2) cannot be construed as affording a ground of exculpation for a breach of s 180(1) where the director’s want of diligence results in a contravention of another provision of the Act and where that other provision contains specific exculpatory provisions enacted for the benefit of the director’, Fortescue (2011) 81 ACSR 563, [199]. His Honour did not provide any reasons for this assertion and, as a matter of statutory construction, it is not clear how it could be justified. As a matter of policy it could perhaps be justified if his Honour assumed that the exculpatory
subsequently overruled by the High Court on unrelated grounds, so this interpretation did not establish a binding precedent.\textsuperscript{25}

As for the reasoning that led the Full Court of the Federal Court in \textit{Fortescue} to take this position, although it is not beyond question, it is nonetheless defensible. In the lead judgment, Keane CJ questioned whether the legislature could have intended to provide the protection of s 180(2) to a director who had made a ‘business judgment’ that a corporation should not comply with the Act. In support of this view, Keane CJ quoted the following extract from paragraph [6.8] of the Explanatory Memorandum (‘EM’) to the Bill that introduced s 180(2):

\begin{quote}
For example, the decision to undertake a particular kind of business activity promoted in a prospectus would be the kind of business judgment to which the proposed rule may apply. However, compliance (or otherwise) with the prospectus requirements imposed by the Law would not be a decision to which the proposed rule could apply.\textsuperscript{26}
\end{quote}

It is not absolutely clear that this passage was intended to carry the meaning Keane CJ attributed to it. The preceding paragraph [6.7] and the first two sentences of [6.8] of the EM explain that s 180(2) only operates in relation to s 180(1) and the equivalent duty at common law or in equity, not in relation to other laws under which directors can be held liable for their acts or omissions. Hence it is possible that the passage quoted above merely indicates that a director accused of breaching the prospectus requirements could not rely on s 180(2) to escape personal liability under those sections of the Act that regulate the prospectus requirements.\textsuperscript{27}

However, the immediate context of the quoted passage supports Keane CJ’s interpretation. The preceding sentence states that the ‘operation of the business judgment rule will be \textit{confined} to cases involving decision making about the \textit{ordinary} business operations of the company’.\textsuperscript{28} Given that the passage Keane CJ quoted was intended to exemplify the point made in this sentence (as indicated by the phrase ‘For example …’), it is likely the use of the word ‘ordinary’ was intended to distinguish everyday business decisions from decisions regarding compliance. This construction is further reinforced by the sentence that follows the quoted passage, which notes that s 180(3) defines a business judgment as one in relation to the ‘business operations’ of the corporation. Again, in context, this suggests the authors of the EM were seeking provisions to which he referred exculpate the director in relation to s 180(1) as well as the other provision of the Act.

\textsuperscript{25} See \textit{Fortescue Metals Group Ltd v Australian Securities and Investments Commission} (2012) 247 CLR 486; Note that overruled cases are not binding, even if overruled on a separate point of law, see \textit{Commissioner of Taxation v St Helens Farm (ACT) Pty Ltd} (1981) 146 CLR 336, 410.

\textsuperscript{26} Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1998 (Cth) 18, [6.8].

\textsuperscript{27} For example s 729(1) makes the directors of a company personally liable for any loss or damage resulting from misleading or deceptive statements in a prospectus issued by the company.

\textsuperscript{28} Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1998 (Cth) 18, [6.8] (emphasis added).
to distinguish decisions regarding business operations (which qualified as ‘business judgments’ for the purposes of s 180(2)) from compliance decisions (which did not).

Given that the US jurisprudence influenced the drafting of s 180(2), it is also worth noting that there is strong US authority for the proposition that the US business judgment rule will not protect decisions by directors to knowingly cause or permit companies under their supervision to break the law. Of course, as Austin J pointed out in Rich, ‘the primary task of an Australian court is to construe and apply the statute, which is not necessarily a complete reflection of the US position’. Nonetheless Justice Austin recognised that US case law regarding the business judgment rule provides a useful resource for Australian courts and he was hesitant to adopt an interpretation of s 180(2) that differed from the US approach. Given that there are no strong reasons to discount Keane CJ’s interpretation of paragraph [6.8] of the EM, the US position adds further weight to the view that the scope of the term ‘business judgment’ in s 180 should not extend to decisions to knowingly cause a company to break the law.

In so far as policy considerations are concerned, the AICD is correct that some courts have employed a ‘stepping stone’ approach in relation to directors’ duty of care, finding directors’ liable for breaching this duty because they have caused or allowed the company under their supervision to break another law. However as several scholars have noted, and the AICD itself concedes, there is a line of authority that puts a significant limit on the ‘stepping stone approach’, holding that a directors’ decision to cause or allow a company to break the law can only amount to a breach of s 180(1) or its general law equivalent if the risk to the company associated with that breach outweighs the potential benefit. This line of authority originated with Brereton J’s judgment in the 2007 case of ASIC v Maxwell and it has been affirmed in a number of subsequent cases. While this approach raises policy concerns of its own, it is

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30 Rich (2009) 75 ACSR 1, [7257].
31 Rich (2009) 75 ACSR 1, [7269].
33 AICD, n 3, 8-9.
35 It is at least arguable that, in the interests of upholding respect for the law, as part of directors’ duty of care they should be expected to refrain from deliberately causing companies to break the law, even when breaking a particular law would benefit the company (see n 40 and corresponding text). In so far as s 180(1) and the general law duty of care are concerned, it is beyond the scope of this note to weigh this argument against the concerns that have been expressed regarding the ‘stepping stone’ approach. This note instead focuses on whether or not it is appropriate to extend the protection of s 180(2) to directors’ compliance decisions. For discussion of the relative merits or otherwise of the stepping stone approach in relation to s 180(1) see AICD, n3; Tim Bednall and Pamela Hanrahan, ‘Officers’ liability for mandatory corporate disclosure: Two paths, two destinations?’ (2013) 31 Company and Securities Law Journal 474; Abe Herzberg and Helen Anderson, ‘Stepping Stones – From Corporate Fault to Directors’ Personal Civil Liability’ (2012) 40 Federal Law Review 181;
consistent with the principle that the directors’ duty of care is to the company rather than to other stakeholders or the public good. It is true that some of the cases in which the ‘stepping stone’ approach has been employed have not acknowledged the existence of this limitation. But nor have those cases explicitly overruled this line of authority and it is arguable that, in this respect, the cases that have ignored this limitation have been wrongly decided.\footnote{See the careful analysis of these cases in Pearce, n 35.}

In any case, section 180(2) is not the most appropriate instrument to resolve this legal uncertainty. This is because including decisions as to whether or not to comply with the law in the definition of ‘business judgement’ in s 180(3) would have the unfortunate consequence that a director who had deliberately caused a company to break the law might escape liability unless no reasonable person could believe that decision was in the interests of the company. That is, the director’s decision would potentially be subject to the lower standard of care expected in s 180(2)(d), rather than the ‘reasonable director’ test set out in s 180(1). Whether, as a matter of policy, directors should be able to deliberately cause a company to break the law without breaching their duty of care (provided that doing so is in the company’s interest) is a question that goes beyond the scope of this note. However, if that is to be the law, then it would send a more appropriate signal regarding respect for the law if the relevant decision is assessed based on the ‘reasonable director’ test in s 180(1).

As for circumstances where directors are potentially caught between two conflicting legal responsibilities, it is arguably better for the legislature to specifically amend the relevant legal provisions to better take this into account, rather than to treat all compliance decisions as ‘business judgments’ for the purposes of s 180(2). Hence, for example, the AICD’s concern about the continuous disclosure obligations (cited above) is addressed to some degree by ASX Listing Rule 3.1A, which makes an exception to the usual obligation to disclose information if that information is ‘insufficiently definite’.

\textbf{Can s 180(2) apply if a director makes a business decision that unintentionally causes a company to break the law? Insights from \textit{Mariner}?}\n
The preceding section focused on the applicability of s 180(2) to situations in which directors deliberately cause companies to break the law. What of a situation in which a director makes a business judgment and that business judgment causes, or contributes to, law-breaking by the company even though that was not the directors’ intention? On one reading of the judgment in the recent case of \textit{Mariner},\footnote{\cite{Mariner} [2015] FCA 589.}\ Beach J held that the latter kind of judgment should qualify as a business judgment for the purposes of s 180(2).
Briefly, ASIC had accused Mariner Corporation Limited of announcing a takeover offer in a manner that breached ss 631(2)(b) and 1041H. ASIC further accused the company’s directors of breaching s 180(1) by causing the company to announce the takeover in a manner that breached, or put the company in danger of legal action for breaching, those sections. Beach J found that the company had not breached either ss 631(2)(b) or 1041H and that, even if it had done so, the directors had not breached s 180(1). The latter conclusion was reached by contrasting the relatively minor risks to the company of breaching ss 631(2)(b) or 1041H with the significant potential benefits to the company of making the takeover offer at the time at which it was made.\textsuperscript{38} That is, Beach J reached this conclusion by applying the test espoused by Brereton J in Maxwell.\textsuperscript{39}

Interestingly, in the process of applying this test from Maxwell, at one point Beach J seemed to give some weight to the difference between situations in which directors deliberately cause their company to break the law and situations in which they do so unintentionally. ASIC had drawn attention to the comment about the test from Maxwell made by Reeves J in Australian Securities and Investments Commission v Cassimatis. In that case Reeves J observed that:

financial benefits of this kind can be offset against a possible breach of the law seems to me to offend public policy. It would, for example, mean that a director that causes a company to infringe another’s copyright could point to the significant profit made from the infringement to avoid liability under s 180(1).\textsuperscript{40}

There was no sense in which Beach J was obliged to follow this particular statement in Cassimatis: Reeves J deliberately avoided giving his statement the weight of a legal determination,\textsuperscript{41} and Cassimatis was a decision regarding an application to have a case summarily dismissed rather than a decision at trial. However, rather than respectfully disagreeing with Reeves J’s statement, Beach J instead distinguished it from the facts in Mariner, noting that: ‘In the present case, the upside benefit was not of a kind where one was profiting from one’s wrongdoing’.\textsuperscript{42}

In relation to s 180(2), Beach J found that the directors’ decision to initiate the takeover bid did constitute a ‘business judgment’. ASIC had characterised the directors’ decision as a decision to break the law and had invoked Keane CJ’s judgment in Fortescue to argue that it therefore did not qualify for s 180(2)’s protection. Beach J rejected this argument, describing it as ‘misconceived’ and saying ‘No decision was made not to comply with the Act, indeed the converse’.\textsuperscript{43}

\textsuperscript{38} Mariner [2015] FCA 589, [459]-[482].
\textsuperscript{39} (2007) 59 ACSR 373 [110]; see n 34 and corresponding text.
\textsuperscript{40} (2013) 220 FCR 256, [172].
\textsuperscript{41} Cassimatis (2013) 220 FCR 256, [173].
\textsuperscript{42} Mariner [2015] FCA 589, [482].
\textsuperscript{43} Mariner [2015] FCA 589, [486].
Whereas Beach J emphasised that he would not have found a breach of s 180(1) even if the company had breached ss 631(2)(b) and 1041H, it is unclear whether he still had this hypothetical possibility in mind when he considered s 180(2). This is important: if his Honour's finding that the directors had made a business judgment depended on his earlier finding that that judgment had not in fact caused the company to break the law then the later finding is not relevant to our current enquiry. Alternatively, if his Honour would have characterised the decision as a ‘business judgment’ even if that decision had caused the company to break the law, then it is of direct relevance. Even on a close reading of the relevant part of his Honour's judgment, both possibilities are open. For example, his Honour may have used the above-quoted phrase ‘indeed the converse’ to indicate that the company had not actually broken the law. But equally he may have intended that phrase to refer to the directors’ efforts to avoid breaking the law, by seeking legal advice and acting on the basis of that advice. Certainly the phrasing ‘No decision was made not to comply with the Act’ appears to put the focus on whether the directors intended to cause the company to break the law, rather than on whether they did in fact do so.

It is interesting that—at least on one interpretation—Mariner suggests that business judgments that unintentionally cause a company to break the law can still qualify as ‘business judgments’ under s 180(2). However, given that the relevant judicial statements in Mariner were both obiter dicta and open to another interpretation, the case can hardly be said to have settled the question. In a policy sense, there are good arguments both for and against. One the one hand, if directors’ knew that inadvertently causing their company to break the law would not deny them the potential protection of s 180(2) then it would tend to increase s 180(2)’s effectiveness in promoting entrepreneurialism. On the other, this would potentially put directors’ state of mind at issue, which may give rise to situations in which directors who have deliberately caused their companies to break the law still get the benefit of s 180(2) because plaintiffs are unable to persuade the court of the directors’ state of mind.

**Conclusion**

As a matter of statutory interpretation, the AICD is therefore correct in its assessment that s 180(2) does not apply to directors’ oversight duties and does not extend its protection to decisions to cause a company to break the law. However the AICD’s policy criticisms of these aspects of s 180(2) are questionable. It would be a backward step to reduce the standard of care in relation to directors’ oversight duties below a ‘reasonable director’ test. If there are concerns that directors’ oversight expectations are unrealistic, then it would be far better for the courts or Parliament to further refine the expectations associated with the reasonable director test in s 180(1) than to lower the overall standard by bringing oversight expectations within the ambit of s 180(2). Similarly, any concerns regarding inappropriate use of the ‘stepping stone’ approach are best dealt with in the context of developing s 180(1), rather than applying a standard of care below ‘reasonableness’ to a director’s decision to cause their company to break the law.

44 See n 43 and corresponding text.
45 Mariner [2015] FCA 589, [80], [86]-[89], [140], [322], [477]-[479], [539], [556].
As for situations in which a director makes a business decision that inadvertently causes a company to break the law, despite potentially relevant observations in *Mariner*, it is less clear—in both a legal and a policy sense—whether such a decision should qualify as a 'business judgment' for the purposes of the rule. It will be interesting to watch how the courts deal with this latter question in future.