A Statutory Business Judgment

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This article discusses the 'business judgment rule' proposed as a reform to Australian Corporations law, through a comparison of the business judgment rule in America to the position of business judgments and associated rules in Australia. It provides arguments for and against a statutory rule. The author argues that the current common law principles for business judgments are unsatisfactory and that what is needed is a clear statutory rule to provide certainty in decisions made by the courts.

Introduction

On 17 March 1998 the Business Law Division of the Treasury released a set of proposed policy reforms to Australia's corporate law regime. One of these was the enactment of a statutory "business judgment rule", designed to

> "provide directors with a safe harbour from personal liability in relation to honest, informed and rational business judgments. The rule will apply where an officer makes an informed decision in good faith, without a material personal interest in the subject matter of the decision and rationally believes that the decision is in the best interests of the company."[1]

A stated objective of the rule is to provide certainty in the law, and so to encourage an appropriate level of business risk-taking by corporate managers, without fear of being made liable for decisions which, though unsuccessful, were made in good faith and with due care.[2] The proposed rule provides that:

> "A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1) [the duty of care and diligence], and their equivalent duties at

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1 Corporate Law Economic Reform Program, *Policy Reforms*, AusInfo, Canberra (1998), p 2.

2 id, p 2-3.

> common law and equity, in respect of the judgment if they:
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> (a) make the judgment in good faith for a proper purpose; and
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> (b) do not have a material personal interest in the subject matter of the judgment; and
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> (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
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> (d) rationally believe that the judgment is in the best interests of the corporation.
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> The director's or officer's belief that a 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."[3]

For these purposes, "business judgment" is defined as "any decision to take action or not take action in respect of a matter relevant to the business operations of the corporation".[4] This is designed to include only the "ordinary business operations" of the company, and will not apply to areas which are regulated by separate liability regimes, such as decisions made in the context of insolvent trading or in relation to misstatements in registered prospectuses or takeover documents.[5]

A statutory business judgment rule was first proposed (and rejected) in 1992[6] when the Exposure Draft of the *Corporate Law Reform Bill 1992*, released in February of that year,

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3 *Corporate Law Economic Reform Program Bill*, proposed new Chapter 2D "Officers and Employees", s 180(2).

4 Proposed s 180(3).

5 Explanatory Memorandum to the Corporate Law Economic Reform Program Bill, para. 6.8.

6 Following recommendations by a number of reports prepared by various law reform committees that a United States-style business judgment rule be adopted: see Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors*, Proposals for Reform: Paper No. 3, Australian Government Publishing Service, Canberra 1997, p 77-81.

recommended the addition of a new sec 232(4AA) to the *Corporations Law*. The new subsection would have required the court to have regard to a number of matters in determining whether or not an officer had contravened the sec 232(4) duty of care. The final version of the Bill did not include such a provision, with the Government deciding against it on the grounds that:

> "...no State in the USA has adopted a legislative statement of the Rule. Instead the matter has been left to the courts to develop. Similarly the Government considers that the development of similar principles in Australia is better left to the courts."[7]

The judgment of Rogers CJ at first instance in the *AWA* case,[8] handed down shortly after the Exposure Draft was released, encouraged this view.[9] His Honour allowed non-executive directors a generous right of reliance upon the advice of senior management, which could only be displaced where the director concerned was aware of circumstances so manifest and simple of appreciation that no reasonably prudent person would have relied upon the advice given.[10]

Since then, however, partly due to the overruling on appeal of Rogers CJ's statements on the degree of reliance non-executive directors may place on management,[11] concerns have been expressed about the adequacy of the standard of

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7 Explanatory Memorandum to the Corporate Law Reform Bill 1992, cited by Redmond, P, "Safe Harbours or Sleepy Hollows: Does Australia Need a Statutory Business Judgment Rule?", in Ramsay, I (ed), *Corporate Governance and the Duties of Company Directors*, Centre for Corporate Law and Securities Regulation, University of Melbourne, Melbourne 1997, p188. See also Farrar, J, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 *Corporate and Business Law Journal* 1, p 23.

8 *AWA Ltd v Daniels* (1992) 7 ACSR 759.

9 See Farrar, J, "The Duty of Care of Company Directors in Australia and New Zealand", in Ramsay, I (ed), *Corporate Governance and the Duties of Company Directors*, Centre for Corporate Law and Securities Regulation, University of Melbourne, Melbourne, 1997, p 86; and Redmond, P, "Safe Harbours or Sleepy Hollows: Does Australia Need a Statutory Business Judgment Rule?", in Ramsay, id, p 187-188.

10 (1992) 7 ACSR 759, at 868.

11 *Daniels v Anderson* (1995) 16 ACSR 607, at 665. See text p n 41-47 below.

care expected of company directors in Australia,[12] and the balance of opinion now appears to be in favour of a statutory provision such as that proposed in *the Corporate Law Economic Reform Program Bill.*

This article examines the elements of the business judgment rule as it has been developed by the judiciary of the United States; the current state of the law in Australia with respect to directors' business judgments; and the arguments both for and against the introduction of a statutory "safe harbour" for Australian directors.

The American Business Judgment Rule

The proposed Australian business judgment rule is based on the rule developed by the courts of the United States,[13] principally those of the State of Delaware. The rule arose in recognition of the fact that it is not the role of the courts to act as "an insurer of shareholder investment",[14] and that company directors must be free to take risks in order to conduct business effectively:

> "The rule provides that a court will not second guess a director's decision if it is convinced that any loss to shareholders resulted from a genuine business risk, and not from the carelessness,

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12 See Redmond, already cited n 7, p 189; and Law, L, "The Business Judgment Rule in Australia: A Reappraisal Since the *AWA* case" (1997) 15 *Company & Securities Law Journal* 174, p 175.

13 *Percy v Millaudon* 8 Mart (NS) 68 (1829) and *Godbold v Branch Bank* 11 Ala 191 (1847) appear to be the earliest cases in which the rule was applied. These decisions expressed "concern 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 knowledge", and stated that the rationale for the rule was "a recognition of human fallibility - directors do make mistakes": Tan, D, "Delivering the Judgment on a Statutory Business Judgment Rule in Australia" (1995) 5(4) *Australian Journal of Corporate Law* 442; see Balotti, R, and Hanks, J, "Rejudging the Business Judgment Rule" (1993) 48 *The Business Lawyer* 1337, p 1341-1342, and Moran, J, "Business Judgment Rule or Relic? *Cede v Technicolor* and the Continuing Metamorphosis of the Directors' Duty of Care" (1996) 45 *Emory Law Journal* 339, p 353.

14 "Outside Directors and the Modified Business Judgment Rule in Hostile Takeovers: A New Test for Director Liability" (1989) 62 *Southern California Law Review* 645, p 651.

> selfishness or dishonesty of the director ... [It] acknowledges that decisions dealing with the day-to-day operations of the business are best left to the directors."[15]

Cases from the United States dealing with the duty of care of directors emphasize this reluctance of the judiciary to substitute its judgment for that of "those who know the corporation intimately, the directors".[16] For example, in *Auerbach v Bennett* the New York Court of Appeals described itself as "ill equipped ... to evaluate what are and must be essentially business judgments";[17] and in *Minstar Acquiring Corp. v AMF Inc.* it was held that the courts "have no place substituting their judgments for that of the directors".[18]

The rule therefore presumes that, when making a business decision, the directors of a company have acted in good faith and in what they honestly believe to be the company's best interests.[19] It is up to the plaintiff to show that a director has acted in his or her own interest rather than that of the company.[20] However, as noted by Cohn, the rule will generally protect a director only in cases where "due care" has been taken with the decision:

> "Lack of sufficient care in the decision-making process results in director liability for the mistake; the exercise of due care, even though a mistake

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15 ibid.

16 *Evans v Armour & Co.* 241 F Supp 705, 712 (1965).

17 419 NY 2d 920, (1979).

18 621 F Supp 1252, 1259 (1985). See also *Joy v North* 692 F 2d 880, 898 (1982): "Judges really are not equipped either by training or experience to make business judgments because such judgments are intuitive, geared to risk-taking and often reliant on shifting competitive and market criteria"; and Easterbrook, F, and Fischel, D, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 *Harvard Law Review* 1161, p 1196: "Courts lack the experience and information to make business decisions".

19 *Kaplan v Centex Corp.* 284 A 2d 119, 124 (1971); *Aronson v Lewis* 473 A 2d 805, 812 (1984).

20 *Johnson v Trueblood* 629 F 2d 287, 292 and 300 (1980). The proposed Australian provision is also designed to act as "a rebuttable presumption in favour of directors": Corporate Law Economic Reform Program, *Commentary on Draft Provisions*, AusInfo, Canberra, 1998, p 45. This aspect of the rule is not, however, immediately apparent from the proposed section as currently drafted: see n 3 above.

was made, invokes the business judgment rule."[21]

It is not the success or failure of the decision upon which a director is judged, but rather the process by which the decision is reached. A director is required to "proceed with a 'critical eye', by acting in an informed and deliberative manner respecting the corporate merits of an issue", and will only be liable for "unadvised judgments".[22] Thus, although the board must carefully consider the effects of their decisions on the company and are bound to obtain relevant information, the business judgment rule recognises that it is unreasonable to expect directors to predict accurately the results of every business decision; "a good decision is frequently not ... an ex post profitable one".[23] Directors are, after all, supposed to undertake a certain degree of business risk, and it is one of the fundamental roles of company law to encourage legitimate business risk-taking.[24]

On the other hand, the rule also acknowledges the "agency cost problem" which necessarily exists when ownership and control of a company are separated.[25] Although the directors are the managers and decision-makers of the company,[26] it is

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21 Cohn, S, "Demise of the Directors' Duty of Care: Judicial Avoidance of Standards and Sanctions through the Business Judgment Rule" (1983) 62 *Texas Law Review* 591, p 604.

22 *Smith v Van Gorkom* 488 A 2d 858, 872-873 (1985).

23 Moran, already cited n 13, p 351.

24 See, for example, the Long Title to the *Companies Act 1993* (NZ), paras (a) and (d), which state that the Act's purpose is to "reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks", and through encouraging the "efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment". Davies, P, *Gower's Principles of Modern Company Law (6th Ed)*, Sweet & Maxwell, London, 1997, p 644 notes that "companies are in business to take risks".

25 Moran, already cited n 13, p 342.

26 See the *Corporations Law*, s 226A; the *Companies Act 1993* (NZ), s 128; and Title 8 of the *Delaware Code 1991* (Del, USA), s 141(a). These all presumptively provide that the directors, not the shareholders, are the managers of a company. Such a separation of ownership and control gives directors "a natural incentive to appropriate perquisites out of the firm's resources for personal use", as well as other "less subtle temptations" like embezzling corporate funds: Jensen, M, and Meckling, W, "Theory of the Firm: Managerial Behaviour, Agency Costs and

the shareholders who bear the risk. The use of the corporate entity allows shareholders to place specialised managers in charge of their capital, and so produce profits at a relatively lower cost than if they all had to enter individual contracts with suppliers and customers. The differing interests of shareholders and directors, however, still require that there be mechanisms to limit the level of risk which directors may undertake with what is usually other people's money. The business judgment rule, with its requirement that decisions be informed and based on careful consideration of the merits of the proposed course of action, is one such mechanism.

Although the rule is a judicial, rather than statutory creation, attempts have been made to produce "black letter" statements of its elements, the latest appearing in the American Law Institute's (ALI) *Principles of Corporate Governance.*[27] The ALI model is substantially replicated in the proposed Australian provision.

Business Judgment in Australia

The Australian courts, like those of other common law jurisdictions,[28] have traditionally been reluctant to interfere with directors' discretion in matters of corporate management, under the "proper purposes" doctrine.[29] In *Harlowe's Nominees Pty. Ltd v Woodside (Lakes Entrance) Oil Co. NL*,[30] for example, the High Court considered whether or not a share issue by the defendant company to a third party (Burmah Oil Australia Ltd), when the company had no immediate need of capital, was a legitimate exercise of the directors' management powers.

Harlowe was at the time of the issue in the process of

Ownership Structure" (1976) 3 *Journal of Financial Economics* 305, p 313.

27 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, American Law Institute Publishing, St Paul 1994, ¶4.01(c).

28 See Beck, A, and Borrowdale, A, *Guidebook to New Zealand Companies and Securities Law (6th ed)*, CCH, Auckland, 1998, pp 67-68 and 342; *Re City Equitable Fire Insurance Co. Ltd* [1925] Ch 407, at 428, *Teck Corp. Ltd v Millar* (1972) 33 DLR (3d) 288, at 317 and *Baigent v DMcL Wallace Ltd* (1984) 2 NZCLC 99, at 122-99, 128-99, 130.

29 Law, already cited n 12, p 180-181.

30 (1968) 121 CLR 483.

increasing its stake in Woodside, with the object of obtaining control of that company. It contended that the issue by Woodside to Burmah had been made with the "irrelevant and inadmissible purpose" of preventing it from obtaining a controlling interest in Woodside.[31]

The court held that a director's judgment, "if exercised in good faith and not for irrelevant purposes, is not open for review in the courts".[32] By "irrelevant purposes", the court meant purposes which were for the directors' personal advantage, rather than for the benefit of the company as a whole. Thus, the court concluded that:

> "... it is not a matter for judicial concern ... that the allotment ... would frustrate the ambitions of [Harlowe] or even that the directors realised that the allotment would have that result and found it agreeable to their personal wishes ... But if, in making the allotment, the directors had an actual purpose of thereby creating an advantage for themselves otherwise than as members of the general body of shareholders, as for instance by buttressing their directorships against an apprehended attack from such as Harlowe, the allotment would plainly be voidable as an abuse of fiduciary power."[33]

In *Howard Smith Ltd v Ampol Petroleum Ltd*,[34] another case involving the validity of a share issue, the Privy Council followed the approach taken in *Harlowe*. Although the court found that the issue in this case had been made purely for the purpose of manipulating voting power within the company, and that it was therefore an improper use of directors' powers,[35] it observed that it was not in a position to substitute its judgment for that of the directors, or indeed to question the correctness of directors' decisions on matters of corporate

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31 id, p 492.

32 id, p 493.

33 id, p 493-494, citing *Mills v Mills* (1938) 60 CLR 150, at 163, where Latham CJ held that "before the exercise of a discretionary power by directors will be interfered with by the court it must be proved by the complaining party that they have acted from an improper motive, or arbitrarily and capriciously".

34 [1974] 1 NSWLR 68.

35 id, p 79-80.

management.[36]

Harlowe and *Howard Smith* are generally taken as stating the law in Australia with respect to the protection of business judgments,[37] although subsequent case law appears to have refined the approach taken in these cases somewhat. For example, in *Whitehouse v Carlton Hotel Pty. Ltd*,[38] the High Court held that, rather than being confined to decisions made *purely* for impermissible purposes, the proper purposes doctrine allows courts to invalidate directors' decisions where the impermissible purpose was "causative, in the sense that, but for its presence, the power would not have been exercised".[39] Mason, Deane and Dawson JJ stated that

> "... it is unavailing that Mr Whitehouse was not motivated by purely selfish considerations in that he believed that the manipulation of voting power ... was in the interests of the company ... [The] exercise of a power for an ulterior purpose or an impermissible purpose is bad notwithstanding that the motives of the donee of the power in so exercising it are substantially altruistic."[40]

The decision of the New South Wales Court of Appeal in *Daniels v Anderson*[41] provides some guidance on the extent of the directors' duty of care.[42] The case involved an allegation of

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36 id, p 77-78.

37 Farrar, J, "Business Judgment and Defensive Tactics in Hostile Takeover Bids", in Farrar, J (ed), *Takeovers, Institutional Investors and the Modernisation of Corporate Laws*, Oxford University Press, Auckland, 1993, p 375; Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors*, Proposals for Reform: Paper No. 3, Australian Government Publishing Service, Canberra 1997, p 25.

38 (1987) 162 CLR 285.

39 id, p 294.

40 id, p 292-293. See also *Darvall v North Sydney Brick & Tile Co. Ltd* (1989) 16 NSWLR 260, at 335-336.

41 (1995) 16 ACSR 607.

42 Although the *Daniels* case was concerned with the common law duty of care, its approach is still relevant to the interpretation of the statutory provision: see Tan, already cited n 13, p 9, who states that the 1992 amendments to s 232(4) did not change the law, but rather confirmed the position expounded in recent cases. In both *Australian Innovation Ltd v Petrovsky* (1996) 21 ACSR 218, 222 and *Gamble v Hoffman* (1997) 24 ACSR 369, at 382, the courts questioned whether there was any

negligence by a company, AWA Ltd, against its auditors. In their defence, the auditors alleged contributory negligence by the company and its directors. The court held that company directors could be liable for negligence under the normal *Hedley Byrne* proximity test,[43] and that the appropriate standard of care was that set out in the American case of *Francis v United Jersey Bank*,[44] where Pollock J held that directors must at least become familiar with the fundamentals of the company's business, and have a continuing obligation to keep informed about its activities.[45]

The court in *Daniels* also stated on a number of occasions that directors had a duty to "display entrepreneurial flair and accept commercial risks to produce a sufficient return on the capital invested", and to "make business judgments and business decisions in a spirit of enterprise".[46] Such comments suggest that the courts will give some protection to directors from liability for genuine commercial risk-taking behaviour.[47]

Arguments Against A Statutory Rule

There appears to be general agreement that the directors' duty of care, diligence and skill needs to be balanced by some recognition of the fact that directors must necessarily take business risks in order to make sufficient profits to satisfy shareholders.[48] This is true even of those commentators who

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difference between the duty imposed by s 232(4) and that owed under the general law.

43 *Daniels v Anderson* (1995) 16 ACSR 607, at 656, citing *Hedley Byrne & Co. Ltd v Heller & Partners Ltd* [1964] AC 465.

44 (1981) 432 A 2d 814, at 821-823.

45 (1995) 16 ACSR 607, at 666-667. Similar standards have been applied in cases dealing with the statutory duty of care, such as *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395 and *Hurley v National Companies & Securities Commission* (1995) 13 ACLC 1635.

46 (1995) 16 ACSR 607, at 658 and 664.

47 Law, already cited n 12, p 184.

48 See, for example, Bradley, M, and Schipani, C, "The Relevance of the Duty of Care Standard in Corporate Governance" (1989) 75 *Iowa Law Review* 1, p 24; and Sievers, A, "Farewell to the Sleeping Director - The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence" (1993) 21 *Australian Business Law Review* 111, p 149; cf. Langton, R, and Trotman, L, *Do We Really Want Even Our Biggest Companies to be Profit Crazy?*, Paper presented to the 1998 Corporate Law Teachers National Conference, Flinders University 1998, p265.

are critical of the way the traditional business judgment rule has been applied in certain situations, or of the way it has been formulated in particular cases or model pieces of legislation.[49] Disagreement arises, however, not over the necessity for such a doctrine, but over its precise content and whether it should be set out as a statutory rule or left to the courts.

The most common reason put forward against the enactment of a statutory rule in Australia is that the approach taken in recent Australian cases already amounts to the equivalent of the American business judgment rule. Indeed, this was the primary reason given for not enacting such a rule as part of the 1992 amendments to the *Corporations Law*. Opinions differ, however, on whether or not this is actually the case.

Whincop, who favours a statutory rule which would protect directors who act with the purpose of maximising value to shareholders, states that the concept is currently not "embedded in Australian law";[50] while Tan, although agreeing that a judicial business judgment rule of sorts does exist under Australian law, describes it as only having been enunciated in "a rather unsophisticated form", making it difficult to apply in practice.[51]

On the other hand, the authors of *Australian Corporation Law - Principles and Practice*, citing cases like *Harlowe's Nominees Pty. Ltd*,[52] *Howard Smith Ltd*,[53] and *Residues Treatment & Trading Co. Ltd v Southern Resources Ltd (No. 2)*,[54] are of the opinion that "the approach adopted in the Australian cases has an equivalent in the principle described in US law as the business judgment rule".[55] In a similar vein, Cameron notes

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49 See, for example, "False Halo: The Business Judgment Rule in Corporate Control Contests" (1988) 66 *Texas Law Review* 843, p 844-847; Above, n 14, p 651-653; and Gevurtz, F, "The Business Judgment Rule: Meaningless Verbiage of Misguided Notion?" (1994) 67 *Southern California Law Review* 287, p 287-288.

50 "Directors Statutory Duties of Honesty and Propriety", in Ramsay, already cited n 7, p 146-147.

51 Tan, already cited n 13, p 9.

52 (1968) 121 CLR 483, at 492.

53 [1974] 1 NSWLR 68, at 77-78.

54 (1989) 7 ACLC 1330.

55 Black, A, and Wines, P, "3.2 Company Officers", in *Australian Corporation Law - Principles and Practice*, Butterworths, North Ryde, March 1998, ¶3.2.0390.

that a statutory provision "would not change the substantive law at all".[56]

The Australian cases do seem to encapsulate all of the essential elements of the proposed rule - *Harlowe, Howard Smith* and *Whitehouse* have established that the courts will not challenge a director's decisions if they are made in good faith and for a proper purpose, and if the director has no material personal interest in the decision; while *Daniels* indicates that a director must at all times be informed about the company's activities, and will not be liable for genuine business risk-taking. In addition, in the words of Clarke and Cripps JJA in *Equiticorp Finance Ltd v Bank of New Zealand*, "it is trite law that directors must exercise their powers for the benefit of the company".[57]

What these cases do not provide, however, is certainty and simplicity for directors making business decisions.

Another argument against a statutory rule, suggested by Redmond, is that the threat of litigation against directors is not such that a statutory safe harbour is required, and that such a provision would only serve to weaken the already low standard of care expected of directors in Australia. He refers to the fact that

> "until very recently, there were no modern reported decisions in which a solvent company has brought proceedings against current or former directors for breach of general law or statutory duties of care and diligence," [58]

a situation which he believes is due to the financial obstacles to shareholder suit, and the fact that the right to enforce directors' duties generally lies with the company itself - in

56 "The Perspective of the Australian Securities Commission on the Enforcement of Directors' Duties and the Role of the Courts: A Comment", in Ramsay, already cited n 7, at 207. See also Redmond, already cited n 7, at 202 of the same publication: "There is a well established body of legal principles which in function, if not in fact, embodies a business judgment rule".

57 (1993) 32 NSWLR 50, at 146.

58 Redmond, already cited n 7, p 203.

practice the directors.[59]

On this point, the Australian Institute of Company Directors has noted that the business judgment rule is not designed to lower the **standard of care** required of directors, but rather to lower the risk of **liability**, in the sense that it would clarify the circumstances under which the duty of care has been satisfied, rather than altering that duty as such.[60]

Thus, while the proposal would make little substantive difference to the law, putting it in "black and white" would improve its accessibility for directors wishing to find an anchorage in the safe harbour provided by the provision.

Arguments for A Statutory Rule

Apart from the general rationale for any form of business judgment doctrine, namely the need to encourage risk-taking, innovation and entrepreneurship amongst directors, the arguments in favour of a statutory rule mainly centre around the need for a certain and consistent standard, so that directors can be sure of protection from liability if certain preconditions are met.

It has been noted that, in the absence of clear statutory guidelines, the American courts have tended to misapply the common law version of the business judgment rule. Tan states that

> "there is no single common judicial definition or formulation of the business judgment rule from the Unites States to facilitate Australian judges in the development of similar principles."[61]

The rule has, at times, been applied in a rather perfunctory fashion in the United States, with the courts emphasising

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[59] id, p 203-204. Note, however, that the Corporate Law Economic Reform Program Bill includes a proposed statutory derivative action as a quid pro quo for the business judgment rule: see text at n 70-73 below.

[60] *Submission to the Attorney General of the Commonwealth of Australia on the Exposure Draft (February 1992) of the Corporate Law Reform Bill 1992* (May 1992), p 32; cited by Redmond, id, p 203-204.

[61] Tan, already cited n 13, p 26.

unduly some elements of the rule over others,[62] and sometimes neglecting issues such as the good faith or otherwise of the decision in question[63] or the adequacy of the decision-making process.[64]

Some American courts, for example, have adopted a rather lax interpretation of the "due care" standard, and have deferred to obviously poor decisions solely on the grounds that the board was sufficiently informed. In *Northwest Industries Inc. v B.F. Goodrich Co.*,[65] the directors of a company approved a $35 million share exchange as a defence to a takeover bid. Their consideration of the exchange lasted a total of one hour, and consisted of perusing a "hastily prepared" three page memorandum and statistical analysis of the transaction. The court held in the directors' favour, with no analysis of the prudence of their actions, insisting that the plaintiff prove "fraud or manifestly oppressive" conduct before the decision would be overturned.

On the other hand, the American courts have also at times condemned transactions which ultimately proved to be successful, because of perceived faults in the decision-making process. In *Smith v Van Gorkom*[66] , a merger decision described by Herzl and Katz[67] as an "unqualified success" was nonetheless held to breach the directors' duty of care as they had not considered "all material information reasonably available to them". Herzl and Katz describe the defendant in *Smith* as

> "a seasoned chief executive officer and substantial shareholder. He was well placed and motivated to strike a good deal, even when acting by himself.

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62 Hanson, C, "The Duty of Care, the Business Judgment Rule and the American law Institute Corporate Governance Project" (1993) 48 Business Lawyer 1355, p 1360 notes cases like *Stern v General Electric Co.* 924 F 2d 472, 476 (1991), where it was held that "the actions of corporate directors are subject to judicial review only upon a showing of fraud or bad faith", and asks: "What happened in these cases to the informational requirement of the rule?"

63 *Shlensky v Wrigley* 237 NE 2d 776, 779 (1968).

64 *Panter v Marshall Field & Co.* 646 F 2d 271, 293 (1981).

65 301 F Supp 706 (1969).

66 488 A 2d 858, 872 (1985).

67 Herzel, L, and Katz, L, "*Smith v Van Gorkom*: the Business of Judging Business Judgment" (1986) 41 *Business Lawyer* 1187, p 1188.

> The other directors were also experienced and sophisticated. There is no reason why they shouldn't have been able to recognise and approve a good deal at the drop of a hat."[68]

Ajemian doubts whether such decisions represent the mainstream of American business judgment jurisprudence, however, suggesting rather that such exceptions prove the rule - by demonstrating its limits, they may simply serve to identify its scope.[69] Even if this is the case, however, common law formulations of the rule have not served to provide the certainty required for directors to know the precise circumstances in which they will be protected from liability for unsuccessful (or even successful) decisions.

Perhaps the most compelling reason in favour of a statutory rule is the commercial uncertainty which the piecemeal, and at times inconsistent, approach taken by the courts to the issue of directors' business judgments has the potential to produce.

One could perhaps draw a parallel with the proposed statutory derivative action.[70] Recent case law on the common law action, available under the exceptions to the rule in *Foss v Harbottle*[71] (including, in increasing numbers of cases, the rather all-encompassing "interests of justice" exception) indicate that the common law rule is probably no longer the substantial impediment to shareholder discipline of directors that it once was. [72] However, a statutory action such as that currently in force in Canada and New Zealand is preferable, in the sense that a shareholder is **assured** of standing to bring action if the requirements of the provision are satisfied and, if appropriate,

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68 id, p 1188-1189. These comments echo thoughts expressed by McNeilly J in his dissenting judgment: 488 A 2d 858, 894-895 (1985).

69 Above, n 14, p 657.

70 Corporate Law Economic Reform Program Bill, proposed Part 2F.1A - "Proceedings on Behalf of a Company by Members and Others", and the Explanatory Memorandum to the Bill para. 6.11-6.70.

71 (1843) 2 Hare 461.

72 See, for example, *Biala Pty Ltd v Mallina Holdings Ltd (No. 2)* (1993) 13 WAR 11; *Aloridge Pty. Ltd v West Australian Gem Explorers Pty. Ltd* (1995) 18 ACSR 272; *Mesenberg v Cord Industrial Recruiters Pty. Ltd* (1996) 39 NSWLR 128; and *Cope v Butcher* (1996) 20 ACSR 37; Berkahn, M, "The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders' Enforcement Rights?" (1998) 10 *Bond Law Review* 74, pp 84-88.

may be indemnified for the costs of the proceedings.[73]

Similarly, although the *Harlowe - Howard Smith* line of Australian cases appear to encapsulate something like the proposed statutory business judgment rule, its application to all directors' decisions is far from clear. It is argued by the Treasury's Business Regulation Advisory Group that

> "while the courts have been reluctant to review judgments of directors exercised in good faith, they have also, on occasion, refused to exercise their discretion to excuse directors from liability where they have acted fairly and honestly ... It is argued that this lack of certainty regarding the limits of directors' duties is causing directors to be conservative and risk averse in their approach to carrying out their functions. Shareholders will ultimately suffer the economic consequences of this change in director behaviour."[74]

The Australian Institute of Company Directors has also argued that a statutory rule is necessary "to give directors certainty, **at the time when they take their decisions** that, if specified prerequisites are met their decisions will be beyond challenge".[75]

Recent cases cited by the Advisory Group as inconsistent with the business judgment doctrine include *Commonwealth Bank of Australia v Friedrich*,[76] *Chew v R*[77] and *Standard Chartered Bank of Australia Ltd v Antico*.[78]

Both *Friedrich* and *Antico* concerned the applicability of sec 535 of the *Companies Code* as a defence to a claim under sec

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73 Corporate Law Economic Reform Program, ***Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors***, Proposals for Reform: Paper No. 3, Canberra, Australian Government Publishing Service, 1997, p 33-40.

74 id, p 22-23.

75 *Submission to the Attorney General of the Commonwealth of Australia on the Exposure Draft (February 1992) of the Corporate Law Reform Bill 1992* (May 1992), p 24; cited by Redmond, already cited n 7, p 199 (emphasis in original).

76 (1991) 5 ACSR 115, at 191-192.

77 (1991) 5 ACSR 473, at 509 and 562.

78 (1995) 38 NSWLR 290, at 369-371.

556 of the Code, under which directors were made personally liable if a company incurred a debt which it was unable to pay as it fell due. In each case the court held that an action under sec 556 did not constitute a claim "for negligence, default, breach of trust or breach of duty", as required by sec 535 (as it did not involve "the performance of, or omission to perform, some act required or forbidden by the statute"), and that therefore the directors could not be relieved of liability, despite having acted fairly and honestly.

Chew involved a claim against a director for making "improper use of his position [as a company officer] to gain ... an advantage for himself ... or to cause detriment to the corporation".[79] The majority held that, although the defendant had not acted deliberately to the company's detriment,

> "an officer may fail to 'act honestly' within the meaning of the section without fraud. The section embodies ... a species of dishonesty which does not involve moral turpitude ... [A] director who exercises his powers for a purpose which the law deems to be improper infringes this provision notwithstanding that, according to his own lights, he may have acted honestly ... The basic requirement is simply that the accused acted consciously and deliberately in a way which was not in fact, objectively, to be regarded as in the interests of the company."[80]

The proposed rule still leaves room for a degree of uncertainty, given that clause (a) refers to the need for a "proper purpose", in contrast to the ALI model on which it is based, which requires only good faith, disinterestedness and an informed basis for the decision. As discussed above, the "proper purposes" approach lacks the certainty required for directors to be sure that, if specified steps are followed, their judgments will be beyond challenge.

The overall object of the proposed rule is to protect directors who have acted in good faith, that is, in a subjectively honest

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79 *Companies Code* s 229(4).

80 *Chew v R* (1991) 5 ACSR 473, at 562.

manner;[81] and in what they rationally believe to be in the company's best interests. Decisions like *Chew*, and to a lesser extent *Whitehouse*,[82] demonstrate the uncertainty surrounding the meaning of a "proper" purpose.[83] The requirement that a court investigate the objective purpose of a directors' decision does not sit well with the rest of the section, which stresses honesty and the need for directors to act in an informed and disinterested manner, and should be removed.

Conclusion

In business, confidence and certainty as to the law are essential. It appears probable that, if a directors' decision were challenged under the existing law, a court would exonerate the director under the *Harlowe - Howard Smith* "proper purposes" principle. This article argues, however, that such an approach is unsatisfactory. Currently the courts (and directors themselves) must extract this important company law principle from the cases, some of which are inconsistent, rather than looking to clear statutory statements for guidance.

An appropriately worded statutory business judgment rule would enhance the stated aim of improving the certainty of the law, and should not compromise the standard of care required of directors under the Corporations Law. However, the retention of the proper purpose requirement (undefined in the statute) is a major shortcoming of the proposed rule, perpetuating the common law difficulties with the meaning of the term. It should therefore be removed, leaving the emphasis of the rule where it belongs - on the honesty of directors and the quality of the decision-making processes they employ.

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81 *Re Smith & Fawcett Ltd* [1942] Ch 304; Tan, already cited n 13, p 29; cf. *Chew v R* (1991) 5 ACSR 473.

82 (1987) 162 CLR 285.

83 See also Tompkins, A, "Directing the Directors: The Duties of Directors under the *Companies Act 1993*" (1994) 2 *Waikato Law Review* 13, p 20, who describes the proper purpose duty in New Zealand as the most troublesome of the enacted duties: "The problem with the provision is its great uncertainty. It appears to be directly contrary to the purpose of the enacted directors' duties, that is, to make it easier for directors to know just what their responsibilities are. A director looking at this provision will be left completely in the dark. Even if he or she consults a lawyer to find out what it means, I doubt that much light will be cast."