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A proposal for reform

The Honest and Reasonable Director Defence

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Introduction

The Australian Institute of Company Directors (Company Directors) is keen to play a role in reinvigorating, supporting and encouraging the entrepreneurial spirit of Australian directors and businesses which for many years now has been stifled by increased regulation, red tape and concerns over personal liability. We are eager to prompt a discussion among Australia's parliamentarians, policy makers, regulators, academics and businesses about the possibilities that might arise for Australia if our corporate regulatory policy settings encouraged strong and responsible corporate performance rather than excessive conformance.

As Australia re-focuses its efforts on international competitiveness and productivity, we are of the view that a cultural shift in how we approach the regulation of corporations and directors is well overdue. One component of this shift is to place greater emphasis on the need for efficient and effective regulation. We have addressed our thoughts on this issue in Company Directors' paper *Towards Better Regulation*.[1] The next component in this cultural shift is to focus on supporting directors who perform their roles honestly and diligently by re-considering the appropriateness of the many and varied ways in which directors' roles place them at risk of personal liability and the suitability of the defences available to them.

We are firmly of the view that Australia needs to actively create an environment where directors that act with integrity and commitment are free to pursue and harness new opportunities, drive performance and create jobs without being overly focussed on personal liability concerns. This will occur when the law reflects sound policy settings, is clear, capable of being complied with and appropriately targeted. In these circumstances, the Australian Institute of Company Directors has no objection to directors who breach the law being subject to appropriate penalties.

The Honest & Reasonable Director Defence (the Defence) is another step along the road toward this cultural shift. Company Directors has long advocated for the insertion of an effective broad-based defence for directors into the Corporations Act 2001 (C'th)(the Act). The proposed Honest and Reasonable Director Defence is designed to provide appropriate protection for directors who perform their roles with integrity and commitment, but who now operate in an increasingly complex and compliance focussed regulatory environment.

The Defence originated from concerns about the limited operation of the business judgment rule in Australia and the debate surrounding the appropriate form of any extension to that rule. As we will explore in more detail, the statutory business judgment rule[2] only applies to one section of the Corporations Act, being the statutory duty of care and diligence[3] and its equivalent duties at common law or in equity. The business judgment rule is not available as a defence to any other alleged contravention of the Corporations Act and is therefore not the broad "catch-all" defence it is sometimes suggested to be in public discourse.

The Honest & Reasonable Director Defence introduced in this paper presents an alternative. The Defence is designed to be an overarching defence and while it does not extend or replace the existing statutory business judgment rule, we are of the view that the Defence provides the type of safe harbour that directors and the business community have needed, and have been calling for, for some time.

We are of the view that the insertion of such a defence into the Corporations Act will contribute to more effective corporate governance and will allow boards and directors to focus on the strategic best interests of the company and appropriate risk taking without

[1] www.companydirectors.com.au

[2] Section 180(2) of the Corporations Act 2001 (C'th)

[3] Section 180(1) of the Corporations Act 2001 (C'th)

potential personal liability being at the forefront of their minds. In this way we anticipate that the Defence will contribute to supporting strong yet responsible corporate performance. If this occurs the Defence should also make a contribution, in conjunction with other measures, to boosting Australia's productivity and competitiveness and will address many of the personal liability concerns facing Australia's directors.

This proposal for reform is structured in two parts. Part 1 addresses the need for change and Part 2 addresses Company Directors' proposed solution, the Honest & Reasonable Director Defence and its elements.

1. The Need for Change

Australia is no longer in a position to rest on its previous successes. As Australia tries to increase productivity and international competitiveness, it must be acknowledged that corporations and directors are the drivers of Australia's growth and prosperity.[4] Australia's regulatory settings must therefore support the innovators, the entrepreneurs, the directors and the boards who run Australia's corporations.

Recent reports have suggested that Australia's competitiveness, innovation and regulatory settings have room for improvement.[5] One report made the following observation as to Australia's regulation: "the focus on domestic outcomes without an appreciation of the impact on international competitiveness may mean regulatory settings do not consider the full national interest."[6]

It is important to briefly address some of the domestic pressures that are evident in Australia's corporate operating and regulatory environment which suggest that a cultural shift in how Australia regulates directors, assisted by a new broad-based defence, is necessary. In this Part we address the following issues as examples:

- directors concerns about personal liability in Australia;
- the limited nature of the statutory business judgment rule;
- the interaction of legislative provisions in the Corporations Act which heighten personal liability concerns;
- the risks for directors when companies approach insolvency;
- recent concerns about forward looking statements;
- why the relief provisions in the Corporations Act of themselves are not sufficient; and
- the ongoing expectation gap facing directors.

The discussion of these issues provides an insight into why the Honest & Reasonable Director Defence set out in Part 2 should be adopted.

1.1 The impact of personal liability

In 2008, Federal Treasury conducted a survey of ASX 200 listed company directors[7] and found that of the directors surveyed:

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[4] In 2010-11 the private sector generated 85% of aggregate gross value added in the Australian economy - equivalent to $982 billion. Further, 91% of all Commonwealth activity is funded from revenue raised by taxing the private sector and approximately 87% of revenue raised from direct taxation is paid by individuals and companies in the private sector. Most wage and salary earners in Australia are also employed in the private sector. In 2011 this was over 83% of all employed persons in Australia, approximately 9.5 million people. See further, Deloitte Access Economics *The Economic Contribution of the Private Sector*, 16 March 2012 available at www.companydirectors.com.au

[5] For example, Australia was ranked 128th in the world as to its regulatory burden (IMD *World Competitiveness Yearbook* 2013) 11th as to the ease of doing business (World Bank *Doing Business 2014 Understanding Regulations for Small and Medium Enterprises*) and 21st as to its global competitiveness (*The Global Competitiveness Report* 2013-14, World Economic Forum). See also McKinsey Australia, *Compete to Prosper Improving Australia's Global Competitiveness* 2014.

[6] McKinsey Australia, *Compete to Prosper Improving Australia's Global Competitiveness* 2014 at p 54.

[7] The survey involved 101 directors of ASX 200 listed companies.

- 78 per cent of directors considered that there was a medium to high risk of being held personally liable for decisions they or their board had made in good faith;
- 78 per cent of directors believed that the risk of personal liability had caused them, or the board on which they sat, to occasionally or frequently take an overly cautious approach to business decision-making; and
- 64 per cent of directors felt that the overly cautious approach to decision making had inhibited an optimal business decision to a medium or high degree.

In 2010, the Australian Institute of Company Directors conducted another survey the results of which are included in *The Impact of Legislation on Directors*.[8] The survey obtained responses from directors and officers of public companies, private companies, not-for-profit companies and government enterprises. The survey found that of the directors surveyed across all company types:

- 73 per cent of directors considered that there was a medium to high risk of being held personally liable for decisions they or their board made in good faith;
- more than 90 per cent of directors said that the personal liability of directors had an impact on optimal business decision-making or outcomes;
- 65 per cent of directors felt that the risk of personal liability had caused them, or the board on which they sat to occasionally or frequently take an overly cautious approach to business decision-making;
- 79 per cent of directors were moderately or seriously concerned about the time their board spent investing in compliance duties which could be better spent focusing on enhancing organisational performance or productivity;
- more than 32 per cent of directors had declined a board position because of the risk of personal liability; and
- more than 22 per cent of directors had resigned from a board because of the risk of personal liability.

An extensive number of provisions throughout the Corporations Act and in other federal and state legislation render directors personally liable if the corporation fails to comply with any one of a multitude of requirements. These types of laws push directors' focus away from oversight, strategy and business opportunities and onto compliance issues. These concerns continue to emerge in the outcomes of the *Australian Institute of Company Directors' Director Sentiment Index* (DSI).[9]

In the first half of 2013, the DSI[10] highlighted that:

- 70 per cent of directors identified administrative costs and the time associated with compliance as having the greatest impact on their business;

[8] The survey involved 623 directors from a range of sectors, including ASX 200 companies, small and medium enterprises and not-for profit organisations, drawn from across the Australian Institute of Company Directors' membership. The full survey is available at www.companydirectors.com.au

[9] The Director Sentiment Index is Australia's only index of director views and sentiments on business, regulation, governance and public policy. A bi-annual survey is conducted by Ipsos on behalf of the Australian Institute of Company Directors to ascertain directors' views, current priorities and future intentions.

[10] The DSI in the first half of 2013 obtained responses from 504 directors from publicly listed Australian companies, private companies, non-listed entities and not-for-profit entities. An executive summary of the DSI for the first half of 2013 is available at www.companydirectors.com.au

- concerns about red tape ranked as the third highest concern for directors behind the high Australian dollar and global economic uncertainty;
- 59 per cent of directors found the current governance regulations in the Corporations Act onerous;
- 46 per cent of directors stated that director liability legislation had a negative impact on business decision making;
- 49 per cent of directors stated that director liability legislation negatively impacted their willingness to continue on a board; and
- 62 per cent of directors stated that director liability legislation negatively impacted their willingness to accept new board appointments.

In the second half of 2013, the DSI highlighted[11] that:

- general economic conditions followed by 'red-tape'/regulation were seen as the biggest impediments to productivity growth;
- 59 per cent of directors found the current governance regulations in the Corporations Act onerous;
- 41 per cent of directors believed that director liability legislation had a negative impact on their business decision making;
- 45 per cent of directors believed that director liability legislation had a negative impact on their willingness to continue on a board; and
- 57 per cent believed that legislation on director liability had a negative impact on their willingness to accept new board appointments.

In the first half of 2014, the DSI[12] identified that:

- 56 per cent of directors found the current governance regulations in the Corporations Act onerous;
- 36 per cent of directors stated that director liability legislation had a negative impact on their business decision making;
- 41 percent of directors believed that legislation on director liability legislation had a negative impact on their willingness to continue on a board; and
- 53 percent of directors believed that director liability legislation had a negative impact on their willingness to accept new board appointments.

These results suggest that the concerns over personal liability have reduced slightly since 2008. We anticipate that this is largely as a result of work undertaken by the Federal and State Governments pursuant to the director liability reform stream under the *COAG National Partnership Agreement to Deliver a Seamless National Economy*. These reforms focussed on improving existing provisions that imposed personal criminal liability on directors. The reform process was not designed to remove liability from directors who

[11] The DSI obtained responses from 527 directors from publicly listed Australian companies, private companies, non-listed entities and not-for-profit entities. An executive summary of the DSI for the second half of 2013 is available at www.companydirectors.com.au.

[12] The DSI obtained responses from 525 directors from publicly listed Australian companies, private companies, non-listed entities and not-for-profit entities. An executive summary of the DSI for the first half of 2014 is available at www.companydirectors.com.au.

themselves personally commit or are involved in criminal conduct. The purpose of the reforms was to reduce the number of legislative provisions making directors 'automatically' liable for the criminal conduct of the company.

The reforms saw the amendment or removal of a large number of 'Type 3' liability provisions. Type 3 provisions reverse the onus of proof and fail to uphold the fundamental legal principle that a person is innocent until proven guilty.

Despite some improvement in the area of personal liability for corporate fault in a criminal context, concerns over the wider liability issue remain. In light of the responses received to surveys and the DSI, we are of the view that regulatory settings that continue to hold directors personally liable for an extensive number of requirements must be re-considered. Unless directors that act honestly, with integrity and an appropriate level of commitment, feel comfortable that the law will appropriately protect them, the Australian regulatory environment will continue to have a negative impact upon business decision-making, business outcomes and a serious negative impact on the willingness of directors to accept new board appointments.

1.2 The limited nature of the business judgment rule

Australia has a statutory business judgment rule in section 180(2) of the Corporations Act. Section 180(2) was introduced into the Corporations Law in 2000 as a defence to the director's and officer's duty of care and diligence. The effectiveness of the rule continues to be a matter of debate and scepticism. As yet, no director has been able to successfully rely on the defence to avoid liability for a breach of their duty of care and diligence.

The business judgment rule in section 180(2) of the Act provides:

> "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."

The business judgment rule has very narrow operation. It only applies to one contravention of the Act, being the statutory duty of care and diligence in section 180(1) of the Act and its equivalent duties at common law and in equity. The business judgment rule is not available as a defence to any other alleged contravention of the Corporations Act (including for example, alleged breaches of disclosure, corporate reporting or insolvent trading provisions).

The business judgment rule is also specifically limited to "business judgments." A business judgment is defined in the Act as "any decision to take or not take action in respect of a matter relevant to the business operations of the corporation."[13] While this definition may appear to be broad and all encompassing, judicial decisions have considered and confined the meaning of "business judgment". For example, decisions taken in planning, budgeting and forecasting have been found to be business judgments but not a director's oversight duties like monitoring the company's affairs and maintaining familiarity with the company's financial position. Business judgments made in a planning, budgeting and forecasting

[13] Section 180(3) of Corporations Act 2001 (C'th)

context, however, only have relevance where the breach complained of is a section 180 duty of care and diligence breach. As we have seen above, if business judgments are made in a context where the resulting allegation is a breach of a disclosure or corporate reporting provision, whether there is a "business judgment" or not will have little relevance given that the defence is not available to these other statutory provisions.

In addition, the business judgment rule in section 180(2) applies to decisions. In other words, a director must positively turn their mind to an issue in order to rely on the rule. The defence will not be available in circumstances where the director has omitted to address a particular issue, even if this occurs honestly and for good reason.

Recently, judicial decisions have stated that if a company has breached a disclosure obligation this may suggest that the directors have also breached their statutory duty of care and diligence in section 180 of the Corporations Act. Ensuring that the company complies with a statutory provision is not considered by Courts to be a "business judgment" and therefore the business judgment rule defence is not available to defend allegations of a breach of section 180 in these circumstances. In other words, contraventions of other provisions of the Corporations Act by the company may be relied on to suggest that a director has breached his or her duty of care and diligence without the director having access to the business judgment rule. This approach, referred to as the 'stepping stone' approach, is explained in more detail in section 1.3 of this paper.

The purpose of implementing the business judgment rule in Australia was to "protect the authority of directors in the exercise of their duties, not to insulate directors from liability. While it is accepted that directors should be subject to a high level of accountability, a failure to expressly acknowledge that directors should not be liable for decisions made in good faith and with due care, may lead to failure by the company and its directors to take advantage of opportunities that involve responsible risk taking."[14]

We are of the view that the business judgment rule has not achieved its purpose in Australia and that the corporate regulatory regime must now place a greater focus on encouraging responsible risk taking. The purpose of the business judgment rule in overcoming a risk - averse corporate culture is in part summarised by several former Vice-Chancellors of the Delaware Court of Chancery (United States' leading corporate law jurisdiction) who write:

> "If law-trained judges are permitted to make after-the-fact judgments that business persons have made "unreasonable" or "negligent" business decisions for which they must respond in monetary damages, directors may, in the future avoid committing their companies to potentially valuable corporate opportunities that have some risk of failure. Highly qualified directors may also avoid service if they face liability risks that are disproportionate to the benefits of service."[15]

The added difficulty in Australia is that our corporate law does not confine potential director liability to breaches of director's duties as it does in Delaware. Rather Australia's corporate law (and then other federal and state laws) provide that directors may become personally liable for a plethora of other specific obligations on a vast range of issues. In the United States liability arising out of many similar obligations would rest with the company or in some circumstances with management.

[14] See Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1998 at page 17.

[15] W Allen, J Jacobs & L Strine, *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny As a Standard of Review Problem* (2002) 96 Nw. U.L. Rev. 449.

For these reasons the existing business judgment rule is not contributing to a responsible corporate risk taking culture in Australia. The Honest & Reasonable Director Defence set out in Part 2, because it extends to all contraventions in the Corporations Act and the Australian Securities and Investments Commission Act (duties or otherwise) and by not being confined to "business judgments", would assist by protecting responsible risk-taking.

1.3 Breach of care and diligence by corporate contraventions

Recently, judicial decisions have held that a director may breach his or her statutory duty of care and diligence if the company has breached a provision of the Corporations Act which the directors failed to prevent. In these circumstances, a company's contravention of the Act may lead to a breach of directors' duties without the need to prove that a director was "involved in" the company's offence or contravention.[16]

Herzberg and Anderson refer to the use of directors' duties in this "novel context" as the stepping stone approach.[17] They state:

> "The first stepping stone involves an action against a company for a contravention of the Corporations Act 2001 (C'th). The establishment of corporate fault then leads to the second stepping stone: a finding that by exposing their company to the risk of criminal prosecution, civil liability or significant reputational damage, directors contravened their statutory duty of care with the attendant civil penalty consequences."[18]

In these types of cases, the allegation is often that the directors have failed to prevent their company from contravening various disclosure provisions, such as the misleading or deceptive conduct provisions in either the Corporations Act or the Australian Securities and Investments Commission Act.[19] In *ASIC v Citrofresh International Ltd* (No 2) (2010) 77 ACSR 69, the Federal Court held that in circumstances where a director allows a company to make a statement which results in a breach of section 1041H of the Act (misleading or deceptive conduct), a director could be found to have breached their duty of care and diligence in respect of the same conduct.[20]

As Herzberg and Anderson note:

> "The stepping stone approach does not mean that directors who authorised or permitted their company's contravention automatically breach ss 180-2. … Whether or not directors contravened their duties as a result of their company's breach of the law requires an

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[16] Bednall T & Hanrahan P *Officers' liability for mandatory corporate disclosure: Two paths, two destinations?* (2013) 31 C&SLJ 474.

[17] Herzberg A and Anderson H *Stepping Stones – From Corporate Fault to Directors' Personal Civil Liability* (2012) 40 FLR 181 at 182.

[18] Herzberg A and Anderson H *Stepping Stones – From Corporate Fault to Directors' Personal Civil Liability* (2012) 40 FLR 181 at 182.

[19] For example, s 1041H of the Corporations Act and s 12DA of the ASIC Act.

[20] The following cases provide examples of where the stepping stone approach has been used: *ASIC v Sydney Investment House Equities Pty Ltd* (2008) 69 ACSR 1; *ASIC v Maxwell* (2006) 59 ACSR 373; *ASIC v Warrenmang Ltd* (2007) 63 ACSR 623; *ASIC v Macdonald* [No 11] (2009) 256 ALR 199; *ASIC v Elm Financial Services Pty Ltd* (2005) 55 ACSR 533; *Morley v ASIC* (2010) 274 ALR 205; *ASIC v Citrofresh International Ltd* [No 2] (2010) 77 ACSR 69; *ASIC v Fortescue Metals Group* (2011) 190 FCR 364; *ASIC v Healey* (No 2)(2011)196 FCR 364. See further Herzberg A & Anderson H *Stepping Stones – From Corporate Fault to Directors' Personal Civil Liability* (2012) 40 FLR 181 at 182 and Bednall T and Hanrahan P *Officers Liability for Mandatory corporate disclosure: Two paths, two destinations* (2013) 31 C&SLJ 474 at 475.

analysis of the particular duty and an assessment of whether the jeopardy to the company's interests arising from its breach of the law outweighs the potential benefits."[21]

As further noted by Justice Black of the NSW Supreme Court writing extra-curially:

> "The courts have rightly rejected a broader proposition that any contravention of the Corporations Act necessarily involves a breach of directors' duties. Nonetheless, a failure to prevent a contravention of the Corporations Act, or taking steps that would give rise to such a contravention may amount to a breach of directors' duties on the facts of the particular case."[22]

Interestingly, to find that a director has breached his or her duties under this approach it is enough that the company be *exposed* to the risk of criminal prosecution or civil liability, whether or not the risk eventuates. Further, ASIC has used the stepping stone approach in recent cases "to obtain orders using the negligence path in circumstances where the same orders would not have been available (in respect of the same conduct) via the involvement path."[23] Bednall and Hanrahan provide the following view of the stepping stone cases:

> "ASIC's decision in these cases to pursue individual officers for negligence in connection with disclosure failures is, we think, highly significant. It represents a new path to establishing officers' personal liability that sits alongside the path laid down by the mandatory disclosure laws themselves which (with the exception of the periodic disclosure laws in Chapter 2M of the Corporations Act) generally provide for officers to be liable only if they are "involved" in the entity's contravention."[24]

Another issue of significance is that the business judgment rule will not necessarily be available to defend an allegation of a breach of the duty of care and diligence in these circumstances. This is because ensuring the company's compliance with a statutory provision is not considered by the Courts to be a "business judgment". In *ASIC v Fortescue Metals Group* (2011) 190 FCR 364 at 427; 81 ACSR at [197] Keane CJ stated that:

> "the decision not to disclose the true effect of the agreements cannot be described as a "business judgment" at all. A decision not to make accurate disclosure of the terms of a major contract is not a decision related to the "business operations" of the corporation. Rather it is a decision related to compliance with the requirements of the Act."

In reality, disclosure issues and working to ensure that the company complies with the law often involve difficult and complex questions of judgment for directors. Consider for example, the judgments made by directors of a publicly listed company when determining whether information must be disclosed pursuant to Australia's continuous disclosure regime.[25] In circumstances where a company has uncertain information which potentially requires disclosure, the directors may put the company at risk of a misleading or deceptive conduct claim if they disclose the information to the market too early and the information is later found to inaccurate. Yet, if the company waits to disclose the information (in order to

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[21] Herzberg A and Anderson H *Stepping Stones – From Corporate Fault to Directors' Personal Civil Liability* (2012) 40 FLR 181 at 185.

[22] Black A: *Directors' statutory and general law accessory liability for corporate wrongdoing* (2013) 32 C&SLJ 511.

[23] Bednall T & Hanrahan P *Officers' liability for mandatory corporate disclosure: Two paths, two destinations?* (2013) 31 C&SLJ 474 at 502, refer to this as the "end run" issue.

[24] Bednall T & Hanrahan P *Officers' liability for mandatory corporate disclosure: Two paths, two destinations?* (2013) 31 C&SLJ 474 at 475

[25] Section 674 of the Corporations Act 2001 (C'th), ASX Listing Rule 3.1 and ASX Listing Rules Guidance Note 8: Continuous Disclosure.

make further inquiries as to its veracity) the directors may place the company at risk of breaching its continuous disclosure obligations by not having disclosed the information "immediately." While Courts review these 'compliance' issues with the benefit of hindsight, directors are required to make these judgment calls in real time, often with incomplete information. The complexity of these judgments is also highlighted by the fact that the guidance on how to approach continuous disclosure issues set out in ASX Listing Rules Guidance Note 8, is in itself 78 pages long.[26]

In addition to directors not having access to the business judgment rule pursuant to the stepping stone approach (or directly to defend breaches of disclosure obligations[27]) the penalties which may be imposed on a director as result of the stepping stone approach may be higher than the penalty for the company's original contravention. This will occur when the company's disclosure contravention is not a civil penalty provision[28] but the breach of the director's duty is. In other words, regardless of whether the statutory provision breached by the company is a civil penalty provision, because section 180 *is* a civil penalty provision, a director could be disqualified for a care and diligence breach without having access to the business judgment rule as a defence.

We agree with Bednall & Hanrahan that: "the consequences of a form of derivative liability should not be more harsh than the consequences of the primary contravention. To hold otherwise is disproportionate, and therefore unjust."[29] Further, it suggests that the regimes set up in the Corporations Act to regulate different types of contraventions are not being used in a way intended by the legislature.

The recent use of the stepping stone approach and the inability of directors to access the business judgment rule defence in these cases provides another reason why an additional broad based defence should be included in the Corporations Act.

1.4 Approaching corporate insolvency

A person, including a company, is solvent for the purposes of the Corporations Act if that person can pay their debts as when they fall due.[30] A person is insolvent if they are not solvent.[31] Section 588G of the Corporations Act provides that a director of a company will be personally liable if the company incurs a debt when the company is insolvent, or becomes insolvent by incurring debt. A breach of section 588G exposes a director to civil penalties of up to $340,000,[32] liability to compensate the company or the relevant creditor for the amount of any debt incurred as a result of the breach[33] and, in egregious cases meriting criminal prosecution, the possibility of a fine of up to $340,000, imprisonment for five years or both.[34]

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[26] See ASX Guidance Note 8: Continuous Disclosure, available at www.asx.com.au

[27] As set out above, the business judgment rule is only available to defend a claim brought under section 180(1) of the Corporations Act (the duty of care and diligence) it is not available as a defence to any other provision of the Act.

[28] Section 1317E of the Corporations Act specifies provisions which are civil penalty provisions.

[29] Bednall T & Hanrahan P *Officers' liability for mandatory corporate disclosure: Two paths, two destinations?* (2013) 31 C&SLJ 474 at 498.

[30] Corporations Act 2001 (Cth), s 95A(1).

[31] Corporations Act 2001 (Cth), s 95A(2).

[32] Corporations Act 2001 (Cth), s 1317E and s 1317G.

[33] Corporations Act 2001 (Cth), s 588M.

[34] Corporations Act 2001 (Cth), s 1311 and Schedule 3, Item 138.

Section 588H of the Corporations Act contains a number of defences that can be relied on by directors alleged to have contravened section 588G. These defences are based on a director being able to prove that the director reasonably believed that the company was solvent when a debt was incurred or was unable, having taken all reasonable steps, to prevent the debt being incurred.

The Chief Justice of the Western Australian Supreme Court has noted that Australia's insolvent trading laws are "arguably the strictest in the world".[35] In Company Directors' view, this regime:

- not only encourages, but effectively mandates directors to move to external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage;
- discourages directors from taking sensible risks when considering other kinds of informal corporate reconstructions or "work-outs" to deal with a company's financial problems;
- provides an incentive for creditors, especially secured creditors, to act in their own self-interest and arrange for the disposal of key assets and the termination of continuing contractual arrangements as soon as possible;
- can lead to financially viable companies suffering the consequences of external administration, including ceasing to be a "going concern", suffering the loss of value and goodwill and incurring the expense of engaging administrators or receivers when it may have been possible under a less prescriptive legislative regime for the company to restructure itself and secure its financial standing; and
- can lead to losses by shareholders, creditors, employees and, in many cases, may have downstream impacts on the broader community through the loss of the value of their investments, retirement savings and jobs.

A review of the insolvent trading legislation in a number of other common law jurisdictions in 2009, including the United Kingdom, New Zealand, Canada and the United States published in the *Australian Journal of Corporate Law* concluded that:

> "Many major economies have some form of reckless trading provision which requires an absence of reasonable prospects for continued trading. Some countries have no insolvent or reckless trading provision whatsoever. The Australian insolvent trading provision encourages directors to put businesses to the sword even where there may be prospects for future prosperity. An effective culture of corporate rescue requires a number of key elements, including cooperation of major stakeholders… It is important that struggling businesses are not put to a premature death because of an unwillingness of company directors to expose themselves to personal liability."[36]

We also note the comments made by the former Chief Justice of the Supreme Court of NSW, the Hon Justice Spigelman AC, who stated:

> "There are thought to be cases where directors have prematurely put their company into external administration, diminishing enterprise wealth and possibly destroying businesses in order to avoid exposing their company and themselves to breaches of insolvent trading

[35] The Hon. Wayne Martin, Chief Justice of Western Australia, 'Official Opening Address' (Speech delivered at Insolvency Practitioners' Association of Australia 16th National Conference, Perth, 28 May 2009).

[36] Jason Harris, "Director liability for insolvent trading: Is the cure worse than the disease?" (2009) 23 *Australian Journal of Corporate Law* 266, 286.

> or continuous disclosure law. If the Australian law has that effect, then the law is at odds with economic policy goals and needs to be reformed."[37]

It is critical to remember that a company may be placed into external administration for a range of reasons, including external economic or market related pressures. It does not follow that because a company has been placed into external administration that a director has acted improperly, incompetently or has failed to discharge his or her duties.

The insertion of a broad based defence that extends to the insolvent trading provisions is particularly important because the question of whether a company is solvent is extremely complex and time-dependant. The complexity of the question was acknowledged in *Metropolitan Fire Systems Pty Ltd v Miller & Ewins*[38] where Einfeld J said:

> "I do not doubt that many companies are or would be found to be insolvent on particular days or even for longer periods if a balance sheet were taken at a particularly difficult trading time. It is also easy in hindsight and in the remoteness of a courtroom many years later to be too artificial about the day to day running of the business in what I imagine was a highly competitive and 'rough and tumble' entrepreneurial field."

Irrespective of any further insolvency reform approaches that may have merit, we consider that a critical element to addressing the problems created by the insolvent trading regime is for directors to have access to a broad based defence such as the Honest and Reasonable Director Defence set out in Part 2 of this paper.

1.5 Forward looking statements

Recently there have been increased calls from regulators and others for corporations to include more forward looking information in corporate disclosures. The call for the inclusion of additional and meaningful forward looking information has arisen in the context of the operating and financial review[39], integrated reporting and commentary around the future of the annual general meeting.

The Corporations Act and the ASIC Act contain various provisions which are relevant to statements or representations about future matters. Aside from provisions which require the corporation to disclose information about a future matter,[40] corporations and directors must ensure that statements or representations do not contravene the prohibitions against misleading or deceptive conduct in both Acts. These provisions generally require that statements as to future matters be made on reasonable grounds.

The context within which a forward looking statement is made will also determine which provisions in the Corporations Act and the ASIC Act are applicable. For example, particular provisions apply to forward looking statements made in takeovers documents[41] and in

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[37] Supreme Court Annual Corporate Law Conference '*Restructuring Companies in Trouble: Director and Creditor perspectives*' Conference Papers: Welcome by the Chief Justice dated 15 August 2010.

[38] (1997) 23 ACSR 699, 710–711.

[39] See ASIC Regulatory Guide 247 which interprets section 299A of the Corporations Act.

[40] For example, section 299A of the Corporations Act which provides that: "The directors' report for a financial year for the company, registered scheme or disclosing entity that is listed must also contain information that members of the listed entity would reasonably require to make an informed assessment of:
(a) the operations of the entity reported on; and
(b) the financial position of the entity reported on; and
(c) the business strategies, and *prospects for future financial years*, of the entity reported on."

[41] Section 670A(2) relates to forward looking statements in takeover and compulsory acquisition and buy-out documents.

disclosure documents such as prospectuses,[42] and other provisions apply where the statement relates more generally to a financial product or financial service. We focus our comments in this section on the general misleading and deceptive conduct provisions relating to financial products and services.[43]

Section 1041H in Chapter 7 of the Corporations Act, within limitation, is considered to be one of the general misleading or deceptive conduct provisions in the Corporations Act. The section has found prominence in recent years by being used by plaintiffs in shareholder class actions who allege that a company has engaged in misleading or deceptive conduct by making, or failing to make, statements in market announcements.[44] The misleading or deceptive conduct allegation in these cases is generally coupled with an allegation that the company has breached its continuous disclosure obligations.

Section 1041H covers conduct that is "in relation to a financial product or service" and expressly excludes conduct that contravenes other provisions of the Act, for example, misleading statements made in takeover documents[45] or fundraising documents.[46]

Subsection 1041H(2) provides examples of what it means to engage "in conduct in relation to a financial product." These examples include dealing in a financial product[47], issuing a financial product[48], publishing a notice in relation to a financial product[49] and making (or making an evaluation of) an offer under a takeover bid or a recommendation relating to such an offer.[50]

Courts have also given a wide interpretation to the circumstances within which conduct will be deemed to have been made in relation to a financial product or service.[51] In *ASIC v Narain* (2008) 247 ALR 659, Finkelstein J stated:

> "I do not think the connection between misleading statements on the one hand and shares in a company on the other must necessarily be immediate or direct. I particularly do not accept as a necessary condition for the conduct to be "in relation to a financial product" that the conduct must on its face refer to or ...deal with a financial product."

Courts have found that a range of conduct falls within the definition of "in relation to a financial product or financial service." This conduct has included: statements made in an ASX announcement;[52] a film placed on a company website;[53] oral statements made by

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[42] Section 728(2) of the Corporations Act 2001 (C'th).

[43] There are other provisions in the Corporations Act pursuant to which directors can be liable for false or misleading statements. For example, section 1308 of the Act provides that it is an offence for a person in particular documents to make or authorise the making of a statement that to the person's knowledge is false or misleading in a material particular. Also, section 1309 makes it an offence for an officer or an employee of a corporation to give a financial market operator, information which the person knows to be false or misleading.

[44] See Grave, Watterson and Mould *Causation Loss and Damage: Challenges for the new shareholder class action* (2009) 27 C&SLJ 481 at 483-484.

[45] Pursuant to section 670A of the Corporations Act 2001 (C'th)

[46] Pursuant to section 728 of the Corporations Act 2001 (C'th)

[47] Section 1041H(2)(a) of the Corporations Act 2001 (C'th)

[48] Section 1041H(2)(b)(i) of the Corporations Act 2001 (C'th)

[49] Section 1041H(2)(b)(ii) of the Corporations Act 2001 (C'th)

[50] Section 1041H(2)(b)(iii) of the Corporations Act 2001 (C'th)

[51] See *ASIC v Narain* (2008) 247 ALR 650; *Clifford v Vegas Enterprises* (2010) 272 ALR 198 at 209

[52] *ASIC v Narain* (2008) 169 FCR 211

directors and officers as to the projected future performance of a fund;[54] and conduct and representations in connection with the acquisition of a security or securities.[55]

The range of conduct covered by section 1041H of the Corporations Act has seen the provision used widely in private actions, class actions[56] and ASIC proceedings. This is of concern to directors who are continually required to make statements in relation to the company, and increasingly so, in relation to the company's prospects going forward.

It is important to note that pursuant to section 1041H both the corporation and the director may be primarily liable for a statement that is found to be misleading or deceptive. This is because section 1041H uses the word "person" which includes companies, directors and officers.[57] The provision does also not require that there be any intention on the part of the company or its directors to mislead, deceive or defraud investors when making a statement.

It is therefore necessary to consider when a forward looking statement will be taken to be misleading for the purpose of section 1041H of the Act. The operation of section 769C of the Act is then relevant. In summary, section 769C provides that a representation as to a future matter must be made on reasonable grounds.[58] Section 769C applies for the *purpose of Chapter 7* and to *proceedings under Chapter 7*.[59] The provision is therefore relevant to whether conduct is misleading or deceptive under section 1041H of the Act.[60]

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[53] *ASIC v Cyclone Magnetic Engines Inc & Ors* (2009) 71 ACSR 1 at 38. The film placed on the company website showed the workability of a new product and was set in the context of a home page that referred to "obtaining direct investment" or shares in the company.

[54] In the matter of *Idylic Solutions Pty Ltd – ASIC v Hobbs* [20012] NSWSC 1276

[55] *See Clifford v Vegas Enterprises* 272 ALR 198 at 209

[56] Statements of claim in shareholder class actions which plead a breach of section 1041H of the Corporations Act have also alleged contraventions in relation to statements made in the company's annual report and financial statements.

[57] See *ASIC v Narain* (2008) 169 FCR 211. See also *ASIC v Cyclone Magnetic Engines Inc & Ors* (2009) 71 ACSR 1 where Martin J at 53 stated: "Nevertheless, s 1041H of the Act and ss 12DA and 12DB of the ASIC Act each commence with the words: 'A person must not'....Those words, of course, are in contrast to those used in s 52 of the TPA which refer to a corporation and which (subject to the extended application available under s 6) do not capture employees of corporations. Under the sections relied upon by ASIC, employees are caught and can be made liable for misleading or deceptive conduct." Further, Martin J at 54 stated "Neither Mr McClelland nor Mr Foster adduced evidence of 'reasonable grounds' as referred to in s 12BB of the ASIC Act. They are in the same position as CME with respect to the allegations about future matters. It follows then that *both* have contravened the sections asserted by ASIC....." [emphasis added].

[58] Section 769C of the Corporations Act provides: "(1) For the purposes of this Chapter, or of a proceeding under this Chapter, if:

(a) a person makes a representation with respect to any future matter (including the doing of, or refusing to do, any act); and
(b) the person does not have reasonable grounds for making the representation;
the representation is taken to be misleading.

(2) Subsection (1) does not limit the circumstances in which a representation may be misleading.
(3) In this section: *"proceeding under this Chapter"* has the same meaning as it has in section 769B.

[59] A reference to a *proceeding* under Chapter 7 is given the same meaning as section 769B of the Act. Section 769 (10) provides that:

(a) a reference to a proceeding *under* this Chapter includes a reference to:
(i) a prosecution for an offence based on a provision of this Chapter; and
(ii)a proceeding under a provision of Part 9.4B that relates to a provision of this Chapter; and
(iii)any other proceeding under any other provision of Chapter 9 that relates to a provision of this Chapter; and
(b) a reference to *conduct* is a reference to an act, an omission to perform an act, or a state of affairs; and
(c) a reference to the *state of mind* of a person includes a reference to the knowledge, intention, opinion, belief or purpose of the person and the person's reasons for the person's intention, opinion, belief or purpose.

Note: For the meaning of *offence based on* a provision, see the definition in section 9.

[60] Section 1041H is contained in Chapter 7 of the Corporations Act 2001 (C'th)

Section 769C has been invoked by both ASIC and private plaintiffs[61] in regard to representations about future matters made by both companies and individuals. The person alleging that the statement is misleading or deceptive must prove that the person does not have reasonable grounds for making the representation.

For the purpose of section 769C of the Act "future matters" have included statements as to; the types of investments in which funds would be placed;[62] rates of return on investments;[63] the effectiveness of a product,[64] as well as profit forecasts; forecast sales;[65] forecast royalties;[66] and forecast operating income.[67]

The liability regimes under the misleading or deceptive conduct and continuous disclosure provisions apply whether the statement as to a future matter is a forecast (quantitative information) or *any other* type of forward looking information (qualitative information). The regime applies to all statements as to future matters whether the statements include numerical forecasts or not. *Any* statement which includes a forward looking element if not made on reasonable grounds is at risk of causing a contravention of the relevant provisions.

Section 12DA of ASIC Act is a similar general misleading or deceptive conduct provision to that set out in section 1041H of the Corporations Act. Section 12DA(1) provides that "a person must not in *trade or commerce* engage in conduct in relation to *financial services* that is misleading or deceptive or is likely to mislead or deceive."[68]

In regard to statements as to future matters section 12BB of the ASIC Act is also relevant. In summary the provision provides that a representation as to a future matter must be made on reasonable grounds. However, unlike section 769C of the Corporations Act section 12BB of the ASIC Act reverses the evidentiary burden of proof and assumes that the director and/or the corporation did not have reasonable grounds for making the representation with respect to the future matter unless the company or director can adduce evidence to the contrary.

The existing provisions in the Corporations Act and the ASIC Act are arguably, premised on the basis that only limited statements as to future matters are required.[69] If a statement as to a future matter is unreliable, based on uncertain information or at risk of not being made on

[61] See for example *Brisconnections v Australian Style* (2009) 73 ACSR 133

[62] *In the matter of Idylic Solutions Pty Ltd – ASIC v Hobbs* [2012] NSWSC 1276 at 1473

[63] See *In the matter of Idyllic Solutions Pty Ltd – ASIC v Hobbs* [2012] NSWSC 1276 at 1473

[64] *ASIC v Citrofresh International Limited* (ACN 064 551 426) and anor (No 2) (2010) 77 ACSR 68

[65] See *Clifford v Vegas Enterprises Pty Ltd* (2010) 272 ALR 198 at 205

[66] See *Clifford v Vegas Enterprises Pty Ltd*(2010) 272 ALR 198 at 205

[67] See *Clifford v Vegas Enterprises Pty Ltd* (2010) 272 ALR 198 at 205

[68] Conduct that contravenes specified provisions of the Corporations Act is excluded from the operation of this provision. Section 12DA(1A) provides "Conduct: (a) that contravenes: (i) section 670A of the Corporations Act (misleading or deceptive takeover document); or (ii) section 728 of the Corporations Act (misleading or deceptive fundraising document); or (b) in relation to a disclosure document or statement within the meaning of section 953A of the Corporations Act; or (c) in relation to a disclosure document or statement within the meaning of section 1022A of the Corporations Act; does not contravene subsection (1). For this purpose, conduct contravenes the provision even if the conduct does not constitute an offence, or does not lead to any liability, because of the availability of a defence."

[69] ASIC Regulatory Guide 170 *Prospective Financial Information* which relates to disclosure documents, product disclosure statements and to conduct under section 1041H of the Corporations Act, supports this view. RG 170 provides that: "We consider that prospective financial information based on hypothetical assumptions (rather than reasonable grounds) is likely to be misleading and provide little value to investors… When there are no reasonable grounds for the prospective financial information it should not be disclosed." See further RG 170.18 - 19.

reasonable grounds, then the company making the statement must carefully consider whether it is appropriate to include it in a corporate disclosure. This position is under increased pressure in light of ASIC's guidance on the operating and financial review[70] and efforts to create new corporate reporting frameworks such as integrated reporting.[71] These initiatives have suggested that a broad range of forward looking information is expected to be disclosed. The difficulty with disclosing forward looking information is that this type of information is, by its very nature, uncertain. The further out the time period projected, the more difficult it is for directors to be comfortable that there are reasonable grounds for making the statement.[72] This is despite the fact that other provisions in the Act, regulatory guidance or proposed corporate reporting frameworks are requiring or recommending, that the information be disclosed.

The Integrated Reporting Framework,[73] provides that disclosures should be made over short, medium and long term time horizons. The framework recognises "that future-oriented information is by nature more uncertain than historical information" but provides that "uncertainty is not however, a reason in itself to exclude such information."[74] The key issue corporations and directors need to consider if choosing to report under such a framework, is that the Corporations Act and ASIC Act require statements as to future matters to be made on reasonable grounds.[75] Information that is so uncertain that it is unreliable would be unlikely to meet the requisite standard of disclosure.

The Integrated Reporting framework states: "the length of each reporting time frame might affect the nature of information disclosed in an integrated report. For example, because longer term matters are more likely to be more affected by uncertainty, information about them may be more likely to be qualitative in nature whereas information about shorter term matters may be better suited to quantification or even monetization."[76] Unfortunately, these statements fail to recognise that in an Australian context the misleading or deceptive conduct provisions described above make no distinction between qualitative and quantitative information. If a qualitative statement is made about a long term future matter it must still be made on reasonable grounds. If not, both the corporation and the directors risk contravening the Corporations Act and the ASIC Act.

[70] ASIC Regulatory Guide 247 *Effective Disclosure in the Operating and Financial Review,* March 2013. In RG 247 ASIC provides examples of the type of forward looking disclosures that ASIC expects to be included in the Operating and Financial Review. These examples suggest that increasingly detailed statements as to future matters and expectations are to be included in the operating and financial review.

[71] The Integrated Reporting Framework is available at www.theiirc.org

[72] An example of this is given in ASIC Regulatory Guide 170 *Prospective Financial Information.* ASIC states at RG 170.4 "research has shown …longer time horizons reduce the accuracy of prospective financial information." RG 170.39-41 provides "short term estimates (not exceeding two years) relating to an existing business and based on events that management reasonably expects to take place or actions management reasonably expects to occur may establish reasonable grounds for disclosing prospective financial information in a disclosure document or PDS…our regulatory experience has shown that the longer the period the prospective financial information relates to the less likely there are to be reasonable grounds for disclosing it because the grounds for longer term prospective information become less verifiable. We generally consider that prospective financial information for a period of more than two years may require independent or objectively verifiable sources of information to establish that there are reasonable grounds to provide it."

[73] The Integrated Reporting Framework available at www.theiirc.org is not a mandatory reporting framework in Australia.

[74] Integrated Reporting Framework, at paragraph 3.53.

[75] This is the case, even if the uncertainty is explained, based on assumptions and accompanied by a confidence interval as suggested at paragraph 4.5 of the Integrated Reporting Framework.

[76] Integrated Reporting Framework, at paragraph 4.59.

At face value, the provisions in Australia which require statements as to future matters to be made on reasonable grounds may appear appropriate.[77] What is overlooked is that a Court may open up the judgment of the directors and conclude that in the Court's view (and based on the information considered by the directors at the time) the statement as to a future matter was not made on reasonable grounds. This position may be tenable where the forward looking statements are made dishonestly, irrationally or with the intent to deceive or defraud investors. The difficulty lies when judgments as to the future direction of the company, its strategy or prospects are honestly and rationally made by directors and yet become the subject of a misleading or deceptive conduct claim and reviewable by Courts.

We question whether it is good policy for Courts to be able to open up the commercial judgment of directors, particularly in circumstances where the directors acted honestly and with the degree of care and diligence that the directors rationally believed to be reasonable at the time. As discussed above, the business judgment rule does not protect directors from judgments made in a disclosure setting, including judgments relating to forward looking statements, that are later alleged to contravene the misleading or deceptive conduct or the continuous disclosure provisions in the Corporations Act. Aside from the primary liability which may accrue to directors if a court believes that the directors' assessment as to the future prospects of the business are not based on reasonable grounds, a corporation's contravention of section 1041H may lead to an allegation via the 'stepping stone' approach that the directors' have breached their duty of care and diligence.[78]

Section 12BB of the ASIC Act also reverses the evidentiary onus of proof and assumes that the person making the statement (unless they can adduce evidence to the contrary) has *not* made the statement on reasonable grounds. We are of the view that this provision provides a further disincentive for corporations to make fulsome and considered forward looking statements on grounds which directors (applying their knowledge of the business and commercial skills) consider to be reasonable.

At a minimum, unless a broad based defence such as the Honest and Reasonable Director Defence is inserted into the Corporations Act, many directors will continue to be reluctant to make statements as to future matters. We are of the view that the Honest and Reasonable Director Defence set out at Part 2 of this paper will go some way towards relieving the personal liability concerns of directors relating to the provision of forward looking information. Consideration may also need to be given as to whether an effective safe harbour for forward looking statements should supplement the Honest and Reasonable Director Defence. A safe harbour for forward looking statements could address the company's liability in respect of forward looking information. As we will describe in more detail in Part 2, the Honest & Reasonable Director Defence, if adopted, would only apply to directors (not the corporate entity).

1.6 Relief provisions

A regulatory environment which requires directors who perform their roles honestly and diligently without an effective business judgment rule defence and with a high risk of personal liability is detrimental to strong yet responsible corporate performance in Australia. We have seen that red tape and concerns about personal liability deter good directors from

[77] See sections 1041H and 769C of the Corporations Act 2001 (C'th) and sections 12DA and 12BB of the ASIC Act. Section 769C(1) of the Corporations Act provides "For the purposes of this Chapter, or of a proceeding under this Chapter, if (a) a person makes a representation with respect to any future matter (including the doing of, or refusing to do, any act); and (b) the person does not have reasonable grounds for making the representation; the representation is taken to be misleading."

[78] See section 1.3 of this paper.

accepting board positions, stifle innovation and entrepreneurialism and slow or prevent optimal decision-making.

Some may ask why a new defence is necessary because Chapter 9 of the Corporations Act includes provisions which are capable of relieving directors from breaches of the Corporations Act. These provisions include sections 1318[79] and 1317S(2)[80] of the Corporations Act.[81]

Sections 1317 and 1318 of the Corporations Act confer a wide discretion upon the courts.[82] In *Daniels v Anderson* (1995) 37 NSWLR 438 at 525, the NSW Court of Appeal in considering an equivalent provision to section 1318 of the Act stated that the purpose of the section is to "excuse company officers from liability in situations where it would be unjust and oppressive not to do so, recognising that such officers are businessmen and women who act in an environment involving risk in commercial decision-making."[83]

Even though the relief provisions in section 1317S and 1318 of the Act confer a wide discretion upon courts, the provisions have been used sparingly by courts to relieve directors.[84] This may in part reflect the high threshold suggested by courts, including statements that the situation must be "unjust" and "oppressive" to employ the relief provisions. This is despite the fact that as drafted, the relief provisions require that the person act honestly and the situation be one where the "the person *ought fairly* be excused."

It is also important to note the difference between relief provisions and appropriate defences. Relief provisions generally operate to relieve a director once the director is found to be in breach of a legislative provision. On the other hand, a defence if made out will prevent a finding that there has been a breach of a legislative provision.

We are of the view that appropriate defences are required in legislation governing the duties and responsibilities of directors and that relief provisions alone are not sufficient. From a reputational standpoint, being relieved from liability as a director will rarely be satisfactory, if there is still a finding that the director was in breach of the relevant legislation. We are of the view that appropriate defences including the Honest & Reasonable Director Defence

[79] Section 1318 of the Corporations Act provides: "If, in any civil proceeding against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity as such a person, it appears to the court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default or breach but that the person has acted honestly and that, having regard to all the circumstances of the case, including those connected with the person's appointment, the person ought fairly to be excused for the negligence, default or breach, the court may relieve the person either wholly or partly from liability on such terms as the court thinks fit."

[80] Section 1317S (2) of the Corporations Act provides "If: (a) eligible proceedings are brought against a person; and (b) in the proceedings it appears to the court that the person has, or may have, contravened a civil penalty provision but that:

(i) the person has acted honestly; and

(ii) having regard to all the circumstances of the case (including, where applicable, those connected with the person's appointment as an officer, or employment as an employee, of a corporation or of a Part 5.7 body), the person ought fairly to be excused for the contravention;

the court may relieve the person either wholly or partly from a liability to which the person would otherwise be subject, or that might otherwise be imposed on the person, because of the contravention."

[81] The legislative history of section 1318 of the Corporations Act is set out in the decision of *ASIC v Vines* [2005] NSWSC 1349

[82] See *Hall v Poolman* (2007) 215 FLR 243 at 315.

[83] *Daniels v Anderson* (1995) 37 NSWLR 438 at 525 per Clarke and Sheller JJA

[84] Although see for example, *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* [2009] FCA 1415 where a director was excused from a contravention of 588G of the Act and *Hall v Poolman* where directors were partially excused from contraventions of section 588G of the Act.

should be available to directors so that in certain circumstances directors are found not to be liable (regardless of any relief which may follow).

1.7 The expectation gap

The board of directors has a monitoring, oversight and strategic role in relation to the company. The executive and managers on the other hand are responsible for the day to day operations of the company and for the implementation of the strategy set by the board. Directors have been described as the "hearts and minds" of corporations and the executive as the "arms and legs" because the executive provide the "doing" of the corporation and implement the decisions of the board and its delegates.[85]

Unfortunately this delineation is not well understood by the public and the media and is not often reflected in the way the law is applied in Australia. Instead, "there is a degree of blurring and misunderstanding of the appropriate division of roles and duties between directors and management which is out of kilter with the realities of running a modern corporation."[86] This expectation gap has been explained as follows:

> "Many people believe that corporate boards and their directors (both executive and non-executive) should be so closely involved in the affairs of the corporation that they can ensure nothing can go wrong. This view is fundamentally flawed, both in law and in practice, and has led to unrealistic expectations about what directors should be doing in areas that are the responsibility of corporate managers. If these expectations were to be met, all directors would have to become, in effect, full time employees of the organisation. This would undermine the non-executive directors' independence of outlook and objectivity which are vital for effective corporate governance."[87]

In one aspect of the Centro decision[88], the Court found that the directors breached the Corporations Act by not identifying that the management representation letter presented to the board did not comply with the precise requirements of section 295A of the Act. This was despite the fact that the letter had been prepared by the company's professional advisers in order to comply with the requirements. The non-executive directors argued that such a finding would mean that they "had to look up s 295A themselves, scrutinise its terms, and construe and compare the contents of the draft management representation letters provided to them. It was submitted that the notion of a non-executive director of a large and complex publicly listed corporation undertaking such a process has a complete air of unreality; that this sort of work is the exclusive domain of the financial accountants and general counsel who are employed to ensure that the material which they present to the Board is correct."[89] The Court took the view that the requirements of section 295A were succinct and clear and a simple reading of the provision would have indicated what was required.[90] The Court pointed out that none of the directors had looked up section 295A of the Act.

At a board meeting of a listed company, depending on the subject matter being considered, a large number of legislative provisions will relate to or impact upon, the matters being considered. The Corporations Act and Corporations Regulations currently span over 2000

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[85] Cole, S, *Mind the Expectation Gap*, Australian Institute of Company Directors 2012 at page 5.

[86] John Colvin, CEO and Managing Directors Australian Institute of Company Directors, *Company Director* magazine July 2010, volume 26, Issue 6 page 4.

[87] Tony Howarth, foreword in Cole S, *Mind the Expectation Gap The Role of A Company Director*, Australian Institute of Company Directors 2012.

[88] *Australians Securities and Investments Commission v Healey* [2011] FCA 717

[89] *Australian Securities and Investments Commission v Healey* [2011] FCA 717 at 418

[90] *Australian Securities and Investments Commission v Healey* [2011] FCA 717 at 418

pages and this is without considering other relevant federal and state legislation or the accounting standards. Company Directors is of the view that it is in the best interests of corporate governance for directors, to be able to effectively rely on management and professional advisers to navigate issues, such as, ensuring documentation meets legislative requirements.

There is a real concern that in Australia the role of the board is shifting, (to the detriment of the Australian economy) from governance, strategy and performance to technical compliance and conformance. This issue was recently recognised in the interim report released by the Financial System Inquiry. The interim report stated:

> "Good corporate governance across all industries involves clear and distinct duties performed by the board and senior management. A board's obligations are: overseeing, directing and monitoring the performance of the company; approving and overseeing strategic policies and frameworks, including for risk management; and satisfying itself that such policies and frameworks are effective. Management is responsible for operational day-to-day activities and implementing strategic policies and frameworks. Generally, boards oversee what management implements. In the Inquiry's view, although there is a public policy case for specific corporate governance requirements on financial institutions, there is no case for regulation to alter the delineation of responsibilities between boards and management... Many industry participants believe the requirements [APRA's requirements] imply an excessive level of managerial ownership by the board and, in some cases, overstate the board's influence. Submissions argue that this diminishes boards' ability to focus on governance and strategic direction, hampering their capacity to perform their core functions."[91]

Even from a small business perspective, the expectation that directors will at all times, be able to supervise every action taken by an employee is unrealistic. While small business owners are likely to be more involved in the day to day operations of the business than directors of larger companies, small business directors may also become liable for a contravention or an offence carried out on behalf of the company by an employee without the director's knowledge.

In the case of non-executive directors of larger companies, non-executive directors must:

> "make decisions and judgments on behalf of corporations:
>
> - within prescribed time deadlines
> - without the availability of all relevant information
> - knowing that future events and circumstances cannot be accurately predicted and thus present risks to the delivery of the anticipated or intended outcome, relevant to the decision or judgment taken by them.
>
> By contrast, the performance of corporations and their boards, and the decisions and judgments taken by NEDs [non-executive directors] in the course of their role and responsibilities, are usually assessed and judged by regulators, the courts, the media and the public with the benefit of hindsight, without time constraints and with access to all information possible that may be relevant to the decision or judgment made and its probable consequences. Hindsight truly is 20:20 vision but 20:20 vision is not available to the board when the decision needs to be made."[92]

In *Lewis v Doran* (2004) 50 ACSR 175 Palmer J at 198-199 recognised this commercial reality in an insolvency context and referred to the Court's "inestimable benefit of the wisdom of hindsight." Justice Palmer stated:

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[91] Financial System Inquiry, Interim Report, 15 July 2014, at pages 3-45 to 3- 46 available at http://fsi.gov.au/files/2014/07/FSI_Report_Final_Reduced20140715.pdf

[92] Cole S *Mind the Expectation Gap The Role of A Company Director*, Australian Institute of Company Directors 2012 at page 24

> "Where the question is retrospective insolvency, the court has the inestimable benefit of the wisdom of hindsight. One can see the whole picture, both before, as at and after the alleged date of insolvency. The court will be able to see whether as at the alleged date of insolvency the company was, or was not, actually paying all of its debts as they fell due and whether it did, or did not, actually pay all those debts which, although not due as at the alleged date of insolvency, nevertheless became due at a time which, as a matter of commercial reality and common sense, had to be considered as at the date of insolvency."

The benefit of the Court's hindsight in considering directors decisions is of course, not limited to insolvency matters. Remembering that directors are making decisions in real time, there may be circumstances where with the benefit of hindsight the Court, re-visiting a set of circumstances, may take the view that the director's conduct fell short of the requisite standard of care and diligence or because the director did not take *all* reasonable steps open to him or her to secure compliance with a particular provision.

There is empirical evidence which shows that persons who know the outcome of a decision or a series of events "tend to exaggerate the extent to which that outcome could have been correctly predicted beforehand. That tendency is known as 'hindsight bias.'"[93] It may also be "hard for judges to differentiate between bad business decisions and good business decisions that turn out badly. Business decisions are usually made with less than perfect information and thus decision makers are required to assess and assume some degree of risk."[94]

In *Martech International Pty Ltd v Energy World Corporation Ltd* [2006] FCA 1004 French J at [351] stated:

> "Commercial decisions, in the dynamic context of an ongoing commercial relationship and a complex development project, even important decisions are not unusually taken on imperfect or partial information and reasonably in reliance upon the advice of colleagues and other officers in common enterprise, whether it be a corporation or some other business structure."

The expectation gap and the scrutiny of directors' decisions with the benefit of hindsight present real and practical challenges for directors as they carry out their roles.[95] While the Honest and Reasonable Director Defence is unlikely to close the expectation gap described above, we anticipate that directors' confidence in being able to make decisions in the best interests of the company would increase if the Honest and Reasonable Director Defence was inserted into the Corporations Act. For example we anticipate that:

- directors may be able to move more confidently and in some cases more quickly to pursue opportunities that are honestly and carefully considered to be in the interests of the company;

[93] See Jacobs, Allen & Strine *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem, 96 Nw. U.L.Rev. 449, 451–52 (2002)* referring to Hal R. Arkes & Cindy A. Schipani *Medical Malpractice v The Business Judgment Rule: Differences in Hindsight Bias* 73 Or. L. Rev. 587, 588 (1994).

[94] See Jacobs, Allen & Strine *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem, 96 Nw. U.L.Rev. 449 (2002)* at 454

[95] For a more detailed discussion of the expectation gap we refer to Cole S *Mind the Expectation Gap The Role of A Company Director*, Australian Institute of Company Directors 2012.

- directors are likely to feel more comfortable relying on experts and others who are better placed than they are to form a view or judgment on a particular issue when making decisions;[96]
- directors are likely to feel more comfortable in designing and then appropriately relying upon the company's compliance systems and governance structures;
- directors would be placed in a better position to help rescue companies from the risk of insolvency by pursuing restructuring arrangements rather than prematurely placing their companies into administration due to concerns about personal liability;[97] and
- directors would be able to devote more time and focus to opportunities, or to addressing issues that are presenting red flags, without undue concern that issues given a lower priority at a particular time (which with the benefit of hindsight emerge later as more significant) would present personal liability risks.

With these concerns and benefits in mind, we now turn to the content and expected operation of the Honest & Reasonable Director Defence.

[96] For example, directors may consider that the degree of care and diligence reasonable in a particular circumstance is to seek out and then (if appropriate) to rely upon, the professional advice of subject matter experts such as accountants, auditors, lawyers, the company secretary, general counsel or management. Depending upon the circumstances and whether directors believe that this level of care and diligence is reasonable in all the circumstances we would consider that in many circumstances such an assessment would be a rational one.

[97] As one director noted in the *Impact of Legislation on Directors* survey (2010) at page 22: "I am particularly concerned about insolvency liability. I believe the pendulum has swung too far to the protection of creditors, such that, even if I strongly and defensibly believed a company could trade out of insolvency I would nonetheless be obliged to recommend that a company be wound up as soon as I believed that it was technically (but temporarily) insolvent. The fact is that I simply could not carry the company's liability. I am well aware that this breaches a fiduciary duty to shareholders since, in my hypothetical, this company could trade out of insolvency."

2. The Honest & Reasonable Director Defence

The purpose of the Honest and Reasonable Director Defence is to create an environment that is conducive to strong yet responsible corporate performance and which supports directors who act honestly. The defence would not alter the primary duties and obligations imposed on directors by the law.

Company Directors proposes that the Honest and Reasonable Director Defence be inserted into Chapter 9 of the Corporations Act and that it apply in addition to the other specific defences which already exist in the Act.

Company Directors' proposed Honest and Reasonable Director Defence is as follows:

> [section number] - Honest and reasonable director defence
>
> Notwithstanding any other provision of this Act or the ASIC Act, if a director acts (or does not act) and does so honestly, for a proper purpose and with the degree of care and diligence that the director rationally believes to be reasonable in all the circumstances, then the director will not be liable under or in connection with any provision (including any strict liability offence) of the Corporations Act or the ASIC Act (or any equivalent grounds of liability in common law or in equity) applying to the director in his or her capacity as a director.

2.1 A broad based defence

The Honest and Reasonable Director Defence is intended to have broad application and if adopted would apply, notwithstanding any other provision of the named Acts. The Defence would apply to *all* contraventions set out in the Corporations Act and the ASIC Act (and any equivalent grounds at common law or in equity) pursuant to which a director may be liable. This means that the defence will apply to alleged breaches of the directors' duties *and* to any other contravention.

In the same way that the current business judgment rule has application to equivalent causes of action in common law or in equity, where a contravention within the Corporations Act or the ASIC Act has an equivalent cause of action in common law or in equity, the Honest and Reasonable Director Defence is intended to apply.

The Honest and Reasonable Director Defence is an overarching defence that may be used as an alternative or in addition to, any other specific defences which may be available in the named Acts. The defence will not be excluded from operating because other specific defences are available and apply to particular contraventions within the Acts.

While it is anticipated that the Honest & Reasonable Director Defence would predominantly operate to defend allegations of civil contraventions within the Acts, the Defence would also operate in circumstances where the alleged breach is a criminal offence. There are numerous provisions in the Corporations Act which have the potential to impose personal criminal liability on directors, a number of these are strict liability offences.

To alleviate concerns about the application of a general and broad-based defence applying to criminal contraventions in the Acts it may be helpful to note that the most serious offences in the Corporations Act commonly include dishonesty as an element. Given that directors must

prove that they acted "honestly" in order to rely on the Honest & Reasonable Director Defence, the Defence will not be operative to absolve those who are involved in serious wrongdoing.

The onus would also be on the director to demonstrate that he or she is entitled to the protection afforded by the defence. It is intended that the standard of proof to be attained by a director to establish the Defence will be the balance of probabilities.

There has been much discussion in Australia about the appropriateness of the current business judgment rule and the fact that the onus has been stated to rest on the directors and officers seeking to prove its elements.[98] In many respects, the limitations of the business judgment rule (discussed in paragraph 1.2 above) and the onus, impose a high hurdle for those seeking to rely upon the defence. It is well known that this position is in contrast to other jurisdictions, such as Delaware in the United States, where the judicially developed business judgment rule is a rebuttable presumption in favour of directors. The workability of the business judgment rule in Delaware, which presumes that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company[99] has been very effective in protecting business judgments and calculated risk taking. This in turn has encouraged entrepreneurialism by U.S. corporations.[100]

The Honest and Reasonable Director Defence has been drafted as a defence, to be proved by directors, rather than as a rebuttable presumption for good reason. It is designed to address problems that are unique to the Australian environment, a number of which have been set out in Part 1 of this paper. Importantly, the proposal has been drafted as a defence to enable its broad application to *any* contravention of the Corporations Act and the ASIC Act. The Defence will not be limited, for example, to circumstances where a director has made a 'business judgment'. Had the subject matter sought to be captured by the Defence, been limited to business judgments, or even to discrete duties owed by the directors to the company, a rebuttable presumption may have been appropriate. However, as a defence, the Honest & Reasonable Director Defence is capable of wide application without the need to alter existing provisions within the named Acts.

By being a defence, the Honest & Reasonable Director Defence also makes clear that the provision is intended to be a safety net for honest and committed directors rather than a re-definition of the standards of governance applicable to directors in Australia. In this way, the Defence does not undermine or interfere with the specific regimes set up under the Acts to regulate particular subject matter.

The Honest & Reasonable Director Defence is designed to provide an effective and straight forward way to support directors that act with an appropriate level of care and integrity, while at the same time preserving the implicit messages as to the standard of conduct expected of directors as enunciated by the specific provisions and defences in both Acts.

2.2 Acts and omissions

As we have seen, the current business judgment rule defence is specifically limited to "business judgments." A business judgment is defined as "any *decision* to take or not take

[98] *ASIC v Rich* (2009) 75 ACSR 1 at [7264], *ASIC v Fortescue Metals Group Ltd* (2011) 81 ACSR 563

[99] *Smith v Van Gorkom* 488 A.2d 858 (Del. 1985)

[100] More than half of the publicly traded corporations on U.S. stock exchanges (including 64% of Fortune 500 companies) are incorporated in the State of Delaware. See J.W. Bullock, Delaware Division of Corporations, 2012 Annual Report available at: http://corp.delaware.gov/pdfs/2012CorpAR.pdf

action in respect of a matter relevant to the business operations of the corporation."[101] This means that a director must positively turn their mind to an issue in order to rely on the rule.

The Honest and Reasonable Director Defence will apply in circumstances where a director acts or does not act, as such, it will be available in proceedings that relate to allegations arising from positive acts as well as omissions.

As we have described above, an issue which is often overlooked is that the role of the non-executive director is a monitoring and oversight one. Non-executive directors are not intended to have an active "hands on" role in the day-to-day management of the company and, in practice, are often not in a position to do so in any meaningful way. It is therefore prudent and necessary for directors to make ongoing assessments as to the most effective way to use the time available to them, to effectively oversee and monitor the company's operations.

Assessments as to the appropriate level of detail within which to consider issues or to delve into the company's operations are continually made by directors. In practice this means that instances where a director did not act (for example due to a lack of red flags) should still fall within the scope of the Defence.

The Honest & Reasonable Director Defence would therefore be available to directors in proceedings where there is an allegation that the director has omitted to do something, has not turned their mind to an issue or has failed to act in a particular way. A broad-based defence which extends to acts and omissions reflects the modern commercial reality of today's corporations. It reflects an understanding that directors need to monitor the operations of the corporation by prioritising issues and that directors may have omitted to consider an issue because they were appropriately not involved in the minutiae of the company's operations at the relevant time.

2.3 Honestly

The Honest and Reasonable Director Defence will only apply when a director conducts him or herself honestly. Directors who act dishonestly or with an intention to defraud or deceive others will not receive the benefit of the Defence.

In the *Commonwealth Bank of Australia v Friedrich*[102] the Supreme Court of Victoria defined "honestly" as meaning acting "without moral turpitude."[103] Austin J, following *Friedrich* in *ASIC v Vines* (2005) 65 NSWLR 281 also defined "honesty" as meaning "without moral turpitude", this conclusion being upheld by the Court of Appeal.[104] In *Re Voets Investments Pty Ltd* (1962) 79 WN (NSW) 670 at 677 Jacobs J stated that "any intent to deceive or defraud would show a lack of honesty."

In *McCann v Switzerland Insurance Australia* Ltd (2000) 203 CLR 579 Gaudron J stated:

> "Dishonesty is an ordinary concept not a term of art. It is, on that account, difficult to define in any comprehensive manner. However, dishonesty is a matter to be determined by reference to the mental state of the person whose conduct is in issue...the question whether a failure to act is dishonest is usually answered by considering whether that failure was

[101] Section 180(3) of *Corporations Act 2001*

[102] (1991) 5 ACSR 115

[103] The term "honestly" considered by the Court in this case was as an element of the defence contained in section 535 of the Companies (Vic) Code.

[104] See *Vines v ASIC* (2007) 62 ACSR 1

> motivated by a desire to conceal the truth or to obtain an advantage to which the person knew he or she was not entitled."[105]

In *Lynch & Co v US Fidelity & Guarantee Co* [1971] 1 OR 28 at 37-38[106] Fraser J stated:

> "Dishonest is normally used to describe an act where there has been some intent to deceive or cheat. To use it to describe acts which are merely reckless, disobedient or foolish is not in accordance with popular usage or the dictionary meaning. It is such a familiar word that there should be no difficulty in understanding it."

Australian Courts have also interpreted the term "honestly" in the context of current provisions in the Corporations Act.[107] A number of these decisions have interpreted the meaning of "honestly" in the context of sections 1317S and 1318 of the Act. In *Hall v Poolman* (2007) 215 FLR 243, for example, Palmer J stated:

> "The descriptions 'dishonesty' and 'failing to act honestly' have a plain and perjorative meaning in ordinary usage....in my opinion Courts should not describe as 'dishonest' or 'fraudulent' conduct which would not attract those descriptions in ordinary usage."[108]

Some Courts have concluded that a director acts "honestly" for the purpose of section 1318 of the Act if the directors acts "bona fide in the interests of the company, including the unsecured creditors of that entity."[109] Bona fide has been defined in common usage to mean "without an intention to deceive", "genuinely" or having an "honest intention."[110]

We are of the view that there is a marked distinction between having an intention to deceive and making an error of judgment. In this regard the difference is adeptly articulated by Palmer J in *Hall v Poolman* where His Honour emphasised that:

> "there is a great deal of difference between acting in discharge of an office without prudence, skill or judgement and acting dishonestly. Imprudence is not dishonesty unless it is so reckless as to lead to the conclusion that the person could not have been making any genuine attempt at all to act in accordance with his or her duty."[111]

Palmer J stated that in his view, and for the purposes of section 1317S(2)(b)(i) or s 1318 of the Act, that when considering whether a person acted honestly:

> "the Court should be concerned only with the question whether the person has acted honestly in the ordinary meaning of that term, ie whether the person has acted without deceit or conscious impropriety, without intent to gain improper benefit or advantage for himself, herself or for another, and without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been made to carry out the duties and obligations of his or her office imposed by the Corporations Act or the general law."[112]

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[105] (2000) 203 CLR 579 at 596

[106] As cited in *McCann v Switzerland Insurance Australia Limited & Ors* [2000] 203 CLR 579 at 636-637 per Callinan J (dissenting).

[107] The term "honestly" is used in the following sections 601JD, 912A, 601FC, 601FD, 601UAA, 1322, 1318, 1317S, 1307, 219, 1101F, 111J. The main authorities interpret "honestly" as it applies in sections 1317S and 1318 of the Act.

[108] (2007) 215 FLR 243 at 316

[109] See for example, *Powell v Fryer* (2001) 159 FLR 433 and *Perkins v Viney* [2001] SASC 362.

[110] Oxford English Dictionary

[111] (2007) 215 FLR 243 at 317

[112] See also *McLellan v Carrol* [2009] FCA 1415 where the same criteria for determining honesty was used.

It is intended that "honestly" in the Honest and Reasonable Director Defence should be interpreted in accordance with the common meaning of the term. As such, we would expect that "honestly" requires consideration of the defendant's intention and state of mind at the time of the relevant conduct. While it may appear that Palmer J in *Hall v Poolman* extended the definition of dishonesty to include recklessness, we note that His Honour stated that such a high degree of recklessness would "demonstrate that no *genuine* attempt had been made to carry out" the person's duties. We are of the view that this is not inconsistent with a definition of honesty that focuses on the intention and state of mind of the defendant.

Honesty was also considered by Gzell J in *ASIC v MacDonald (No 12)* (2009) 73 ACSR 638. For conduct to be honest Gzell J stated it needed to be:

> "without moral turpitude in the sense that it is without deceit or conscious impropriety, without intent to gain improper benefit or advantage and without carelessness or imprudence at a level that negates the performance of the duty in question."

We note that in *ASIC v Edwards* (No 3)(2006) 57 ACSR 209, Barrett J found that dishonesty may exist in the absence of any subjective intention to deceive. Despite citing several authorities to reach this conclusion, we are concerned about the adoption of interpretations that extend terms such as "honest" and "dishonest" beyond their commonly understood meanings. On this basis we prefer the line of authorities which suggests that a consideration of the intention of the person whose conduct is in question is necessary to determining honesty.

In summary, we are of the view that "honestly" in the context of the Honest and Reasonable Director Defence, should be understood and interpreted in a way which accords with the general and commonly understood meaning of the term. We are of the view that "without moral turpitude", "without an intention to deceive or defraud others", "without deceit or conscious impropriety" and "without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been made to carry out the duties and obligations of a person's office" are all definitions that are consistent with the commonly understood meaning of "honestly".

2.4 For a proper purpose

The Honest and Reasonable Director defence will only apply when a director acts or does not act, for a proper purpose. Assessing whether a director's conduct or exercise of powers is for a proper purpose will be an objective test to be determined according to the circumstances of each case. Australian case law has considered the meaning of the term "proper purpose" in a number of different contexts including in relation to the business judgment rule at section 180(2) of the Act[113] and the duty of good faith at section 181 of the Act.[114]

In the context of section 181 of the Act, the Supreme Court of Western Australia has stated that:

> "Fiduciary powers and duties of directors' may be exercised only for the purpose for which they were conferred and not for any collateral or improper purpose. It must be shown that the substantial purpose was improper or collateral to their duties as directors of the company…The Court must determine whether but for the improper or collateral purpose the directors would have performed the act impugned."[115]

[113] Section 180(2) provides that "the director or other officer must make the judgment in good faith and for a *proper purpose*."

[114] Section 181 provides that a "a director or other officer must exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a *proper purpose*".

[115] *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 137.

In *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821 Wilberforce J stated:

> "It is necessary to start with a consideration of the power whose exercise is in question…having ascertained on a fair view the nature of this power, and having defined as can best be done in the light of modern conditions the, or some, limits within which it may be exercised, it is then necessary for the court, if a particular exercise of it is challenged, to examine the substantial purpose for which it was exercised, and to reach a conclusion whether that purpose was proper or not."

Generally, a power will be exercised for a proper purpose if the director's conduct is for the benefit of the company. When discussing the fiduciary character of a director's relationship with the company it has been stated: "The primary consequence of this principle is that a director is bound to exercise the powers and discretions conferred upon him bona fide in the interests of and for the benefit of the company as a whole."[116] The assessment of whether conduct is for a proper purpose will be objectively determined.[117]

There may be circumstances, however, where conduct which the directors believe to be in the best interests of the company is still improper. For example, an allotment of shares to defeat a minority shareholding or the issue of shares to prevent a takeover may be deemed to be an improper exercise of power even if the directors were of the view that the exercise of the power was in the best interests of the company. Further, honest or altruistic behaviour by directors will not prevent a finding of improper conduct if that conduct was carried out for an improper or collateral purpose.[118]

In circumstances where the conduct or exercise of powers, is for more than one purpose, we anticipate that Australian courts will inquire as to whether "but for" the improper purpose the directors' conduct would have occurred.[119] This is a similar inquiry to that made by Courts in identifying the "the substantial object"[120] or the "moving cause"[121] of the conduct in cases concerning the allotment of shares. In these types of cases, and where multiple purposes exist "the allotment will be invalidated if the impermissible purpose is causative in the sense that, but for its presence, the power would not have been exercised."[122]

Indicators that a director has not acted for a proper purpose may include where a director promotes his or her personal interests ahead of the company in circumstances where the director has a material conflict of interest[123] or where directors are exercising their powers to maintain control over the affairs of the company or merely for the purpose of defeating the wishes of a majority of shareholders.[124]

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[116] *Australian Growth Resources Corporation Pty Ltd* (1988) 13 ACLR 261 per King CJ, Cox and Johnston JJ citing *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 at 135 per Lathan CJ.

[117] In *Parker v Tucker* (2010) 77 ACSR 525 Justice Gordon of the Federal Court citing *Permanent Building Society v Wheeler* (1994) 14 ACSR 109 stated: "whether a director has acted for a proper purpose, namely for the benefit of the company, is to be objectively determined."

[118] *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 137.

[119] *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 137.

[120] *Mills v Mills* (1938) 60 CLR 150 per Dixon J.

[121] *Mills v Mills* (1938) 60 CLR 150 per Latham CJ

[122] See *Whitehouse v Carlton Hotel Pty Ltd* (1986) 70 ALR 251 at 257 per Mason, Deane and Dawson JJ and *Mills v Mills* (1938) 60 CLR 150 per Dixon J.

[123] *HIH Insurance Ltd and HIH Casualty and General Insurance Ltd; ASIC v Adler* (2002) 41 ACSR 72

[124] *Piercy v S. Mills & Co Ltd* (1920) 1 Ch 77 as cited by Starke J in *Mills v Mills* (1938) 60 CLR 150.

There may be circumstances where directors conduct will not be for a proper purpose even though the directors were acting honestly, were not motivated by any purpose of personal gain or advantage, or by any desire to maintain their position on the board. The absence of dishonesty or self-interest does not necessarily indicate that a person is acting for a proper purpose. As explained by Lord Wilberforce "self-interest is only one, though no doubt the commonest, instance of improper motive."[125] Conversely, the existence of a conflict of interest does not necessarily suggest that a person has acted improperly.

In summary, it is intended that if the directors' conduct is "extraneous to the interests of the company and not a legitimate purpose for the exercise of the powers of a director"[126] then the director will not be able to rely on the Honest and Reasonable Director Defence. Similarly, if the director is acting for a collateral purpose or with some bye motive[127] other than the interests of the company or outside his or her powers, then a director will not be able to rely on the Defence.

2.5 The degree of care and diligence the director rationally believes to be reasonable

In addition to the other elements set out above, to rely on the Honest & Reasonable Director Defence, a director will be required to show that they conducted themselves with the degree of care and diligence that the director rationally believed to be reasonable in all the circumstances.

Before considering this element of the Defence in more detail it is important to note that if the Honest and Reasonable Director Defence is adopted, the standard of care and diligence required by section 180 of the Act will remain unchanged.

Directors must therefore continue to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they were:

- a director or officer of the corporation in the corporation's circumstances and
- occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.[128]

While the standard of care and diligence would remain the same under section 180 of the Corporations Act should the Honest and Reasonable Defence be adopted, the Defence would recognise that in certain circumstances a director should not be held liable for failing to meet this objective standard. The Honest and Reasonable Director Defence recognises that a director (meeting all the criteria of the Honest and Reasonable Director Defence) should not be liable for conduct later found to be unreasonable, in circumstances where the director was acting honestly, genuinely believed that the care and diligence they exercised was reasonable and this assessment was rationally made, in light of the surrounding circumstances.

In performing their role as directors, it is important that directors are given the capacity to devote the degree of care and diligence which they rationally believe to be reasonable in all the circumstances. The Honest and Reasonable Director Defence gives a director a sound footing upon which to prioritise issues, to address (or not address) matters as appropriate, to monitor the operations of the company and to make effective business judgments with the level of care and diligence required having regard to the issue being considered and the

[125] *Howard Smith Ltd v Ampol Petroleum & Ors* (1974) 3 ALR 448 at 452 at 454.

[126] *Australian Growth Resources Corporation Pty Ltd v Van Reesma & Ors* (1988) 13 ACLR 261 at 270

[127] *Maronis Holdings Ltd and Another v Nippon Credit Australia Pty Ltd* (2001) 38 ACSR 404 per Bryson J

[128] Section 180 of the Corporations Act (C'th)

surrounding circumstances. In this way directors will have regard to, but not undue concern for, the potential for personal liability.

2.5.1 *The degree of care and diligence that was reasonable in all the circumstances*

The Defence requires a director to prove that they believed the degree of care and diligence they exercised was reasonable. This element of the defence is intended to be a subjective test. The director must genuinely believe that their conduct met a standard of care and diligence that was reasonable having regard to the surrounding circumstances.

The Honest and Reasonable Director Defence recognises that directors work in a complex environment with an array of information, risks and opportunities continually at play. Directors therefore need the ability to focus on the information, risks and opportunities that they consider to be relevant in light of all the circumstances. For a corporation to operate effectively, directors must also be free to prioritise issues. In doing so, they must make assessments as to the amount of time, information and resources that will be expended on any given issue.

At present there is pressure from the regulatory environment for directors to 'go deep' into management, operational and compliance issues or risk potential personal liability. Any suggestion that this is good for governance is confused. As set out in section 1.7 above, the primary role of the board is to monitor and oversee the work of the executive and management. If the regulatory environment continually sets the expectation that directors will consider issues at the same level of detail as management, the value of the board's monitoring function is diminished. If the board is too involved in the "doing" of the corporation's activities the board cannot provide the same objectivity and oversight of corporate management.

It is particularly important that given the finite time and resources available to directors, directors are not at risk of personal liability for matters they have not considered (or matters they have considered but have devoted less time to than others) in circumstances where they have proceeded honestly, for a proper purpose and where they rationally believed the care and diligence exercised was reasonable at the relevant time.

In some cases, there may be good reason why a director omitted to address a particular issue. For example, after making inquiries, a director may have no reason to doubt that a compliance system is not working effectively and may turn their attention to other pressing matters. While particular issues or information may, with the benefit of hindsight, later be found to be important, the Honest and Reasonable Director Defence recognises that directors are performing their roles in real time and often with incomplete information.

The Honest and Reasonable Director Defence is a broad-based defence, if adopted, it would be available as a defence in respect of a wide range of contraventions across the Corporations Act and the ASIC Act. The Defence would therefore apply not only to director's duties but to other contraventions. In the context of the duty of care and diligence the Defence recognises that "reasonableness is not a black and white concept"[129] and that there may be circumstances where directors, who fail to meet the objective standard of care and diligence set out in section 180 of the Act, should still not be subject to liability having regard to the surrounding circumstances.

[129] *ASIC v Vines* (2005) 56 ACSR 528 at 538, per Austin J.

2.5.2 *The belief must be rational*

It is important to emphasise that for the Defence to apply the director's belief as to the degree of care and diligence reasonable in all the circumstances must be a *rational* one. While the director's assessment as to the reasonableness of the care and diligence applied in a particular circumstance will be a subjective test, whether that assessment by the director is rational will be an *objective* test.

If all of the other elements of the Defence are met and a director has a rational belief that the degree of care and diligence exercised is reasonable in all the circumstances, then a Court will not be able to hold the director personally liable for that contravention. Irrational assessments made by a director as to the degree of care and diligence exercised in a particular circumstance will *not* be protected.

The meaning of the term "rational" has received little judicial consideration in Australia. For this reason if the Defence is adopted, it would be open for the courts to determine whether the director's belief was rational on the facts of the particular case.

We note that section 180(2) requires directors and officers relying on the business judgment rule to prove that they "rationally believe that the judgment is in the best interests of the corporation." Section 180(2) further provides that "a 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." It is clear that the legislature intended that there would be a difference between the concept of reasonableness in section 180(1) of the Act and the concept of rational belief in section 180(2). If not, the business judgment rule would not be available in the event there was a breach of the duty of care and diligence in section 180(1), and section 180(2) would be redundant. The concept of rational belief in section 180(2) has been interpreted to mean "based on reason or reasoning" whether or not the reasoning process is an objectively convincing one.[130]

Definitions of "rational" used in other contexts have included: "not foolish, absurd or extreme"[131], "not egregious, patently frivolous, or capricious"[132], a decision "that is so blatantly imprudent that it is inexplicable, in the sense that no well-motivated and minimally informed person could have made it."[133] These definitions may assist the interpretation of 'rational' for the purpose of the Honest and Reasonable Director Defence.

The Defence intends to make a distinction between the terms "reasonable" and "rational". In this regard it may be helpful to consider the views of Allen, Jacobs & Strine: "The distinction between these concepts has a utilitarian and important functional purpose, which is that a rationality standard gives directors greater freedom to make risky decisions than a reasonableness standard. That result flows from the definition of an irrational decision – one that is so blatantly imprudent that it is inexplicable, in the sense that no well –motivated and minimally informed person could have made it. By contrast, even the best of us will

[130] *ASIC v Rich* (2009) 75 ACSR 1 at [7289] -[7290]

[131] The Concise Oxford Dictionary

[132] *Stanziale v. Nachtomi* 330 B.R. 56 D.Del.,2004.

[133] W Allen, J Jacobs & L Strine, *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem,* 96 Nw. U.L.Rev. 449, 451–52 (2002)

occasionally make a lapse in judgment or factual error that a judge could later second-guess as "unreasonable" or "negligent.""[134]

The Honest and Reasonable Director defence recognises that there may be circumstances when a director acting honestly and exercising the care and diligence they rationally thought was reasonable, will fail to meet the statutory duty of care and diligence in section 180 of the Corporations Act *or* will fail to ensure compliance by them or their company with a provision of the Corporations Act. There may also be circumstances where with the benefit of hindsight[135] a court may find that a director failed to exercise "*all* reasonable steps" to secure compliance as required by some provisions of the Corporations Act.[136] The Honest & Reasonable Director Defence is intended to be available in these circumstances - so long as all of the elements of the Defence are met and the director's belief as to the reasonableness of the care and diligence exercised was *rational*.

2.6 In his or her capacity as a director

The Honest & Reasonable Director Defence is limited in its operation so that it applies only when a director is acting in his or her capacity as a director. This component of the defence is designed to recognise that provisions of the Corporations Act and ASIC Act will apply to individuals in circumstances when they are not acting as a director of a company.

If a contravention is committed by a director outside the performance of his or her role as a director, such as where a director is acting in their personal capacity, conducting their own affairs or acting as a shareholder, the defence will not apply. By way of example, an individual that engages in market manipulation by trading shares in their personal portfolio would not be entitled to rely on the defence simply because their main employment was that of a company director.

We anticipate that whether a director acts or does not act "in his or her capacity as a director" will be a matter to be determined by a court on the facts of the particular case. This will not be an unfamiliar inquiry for Australian courts. Judges have been required to consider whether a person was acting in their capacity as a director or in some other capacity in numerous circumstances. Examples have included:

- Breach of duty cases where consideration as to the capacity in which a person received a business or corporate opportunity was relevant[137];
- Proceedings where the capacity in which a person was joined to a proceeding and/or sought documents was relevant to whether company documents needed to be produced pursuant to a discovery order or request;[138]

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[134] W Allen, J Jacobs & L Strine, *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem,* 96 Nw. U.L.Rev. 449, 451–52 (2002)

[135]We refer back to our discussion of hindsight in section 1.7 above.

[136]See for example section 344 of the Corporations Act 2001 (C'th).

[137] See for example, *Links Golf Tasmania Pty Ltd v Sattler & Anor* [2012] FCA 634; *Streeter & Ors v Western Areas Exploration Pty Ltd* [2011] WASCA 17; *Omnilab Media Pty Ltd v Digital Cinema Network Pty Ltd* [2011] FCAFC 166

[138] *Archer Capital 4A Pty Ltd as Trustee for the Archer Capital 4A v Sage Group PLC* (No 3) [2013] FCA 1160 at [119] to [120] where Wigney J stated: "Mr Reed is a party to these proceedings in his personal capacity, not in his capacity as a director of two MYOB companies of which he is a director. The proceedings are not relevantly connected to the two MYOB companies or Mr Reed's role or conduct as a director of them. In these circumstances, in my opinion, Mr Reed does not relevantly have a right to obtain for inspection relevant

- Contractual disputes where the capacity in which a person signed an agreement was relevant;[139]
- Proceedings where the capacity in which a person supported a resolution at a board meeting was relevant;[140]
- Proceedings where it was necessary to determine whether a person was acting in the capacity as a solicitor or a director in regard to allegations of negligence arising from a property transaction.[141]

The Honest & Reasonable Director Defence applies to directors, whether non-executive or executive directors, acting in the capacity of directors. As such, the Defence as currently drafted, does not apply to officers. The Defence has been confined to directors in order to address issues which are keenly relevant to those acting in that capacity. These issues include the expectation gap between the role of directors and management, the limited application of the business judgment rule to monitoring and oversight responsibilities and the duty of directors to prevent insolvent trading. The Defence would also continue to ensure that relevant information flows up to directors for the purpose of decision-making. While currently confined to those acting in the capacity of a director, if the Federal Government took the view that there were sound policy grounds for extending the Defence to officers, the Defence could be easily amended to reflect this.

While courts may readily be able to determine whether a person is acting as a director or in some other capacity external to a company, we recognize that it may not be as straight forward to determine whether a person is acting as a director or an officer. Similarly, the Corporations Act does not, in its text, delineate between the roles of non-executive and executive directors. Despite this, we would expect that in determining whether a person is acting in the capacity of a director that courts may have occasion to take into account the scope and functions of the two directorial roles.[142] Arguably the executive director role may "in the capacity of a director" be broader in scope. However, as stated in *Streeter v WAE* (2011) 82 ACSR 1 at 79 per Murphy JA:

> "In considering the nature and scope of duties owed by a director it is necessary to consider substance over form. Regard should be had to the functions undertaken by the director and entrusted to him or her, rather than to whether the director as a matter of nomenclature is designated "executive" or "non-executive."

As the expectations of directors continue to increase and the detail in which directors are expected to consider issues are also heightened it is unclear whether the observations of Rogers J in *AWA v Daniels* would now receive wide public acceptance:

> "In contrast to the managing director, non-executive directors are not bound to give continuous attention to the affairs of the corporation. Their duties are of an intermittent nature to be performed at periodic board meetings, and at meetings of any committee of

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documents held by MYOB companies, either at common law or under the Corporations Act." See also *Dick v Alan Powell Holdings* [2009] QSC 184.

[139] See for example, *Padstow Corporation Pty Ltd v Fleming* (No 2) [2011] NSWSC 1572

[140] In *ASIC v Australian Property Custodian Holdings Ltd* (No 3)[2013] FCA 1342 at [506] the Supreme Court of Victoria per Murphy J rejected the argument that a particular director acted in his personal capacity as a shareholder representative as being completely without foundation. Murphy J found that the director supported a resolution passed at a board meeting in his capacity as a director.

[141] *Burke v LFOT Pty Ltd* [2000] FCA 1155

[142] See for example, the discussion about non-executive directors and executive directors in *Jacques v AIG* [2014] VSC 269.

> the board upon which the director happens to be placed. Notwithstanding a small number of professional company directors there is no objective standard of the reasonably competent company director to which they may aspire. The very diversity of companies and the variety of business endeavours do not allow a uniform standard…[t]hese matters may be influenced by considerations such as whether a director is an executive or a non-executive director, but are always dependent on the particular circumstances."

Regardless of one's view as to the observations of Rogers J, in the same way, for the purpose of the Honest and Reasonable Director Defence much will depend on the circumstances of the case. We anticipate that depending on the conduct in question courts may need to have regard to the scope and functions of the individual's role when determining whether the individual acted in the capacity of a director to rely on the Defence.

3. Conclusion

We have attempted to provide a glimpse of some of the unique challenges facing directors as a result of the Australian regulatory environment. From these examples an emerging picture of a potentially wider problem should be clear - if Australia is to reinvigorate, support and encourage the entrepreneurial spirit of Australian business careful attention needs to be given to the regulatory environment within which directors are required to operate.

In spite of the expectation gap, concerns over personal liability, limited defences, disincentives to rescue struggling businesses and more time being spent on compliance, the stark reality is that Australia's corporations, and the directors that guide them, are Australia's engine room for growth. Without corporations and their directors being free to perform to their potential Australia's ability to compete, innovate, maintain its standard of living, create jobs and provide for Australians in retirement will be in jeopardy.

The Honest and Reasonable Director Defence presents one avenue in the process of unlocking the potential of Australia's corporations. We are hopeful that if it is adopted the Defence will contribute to restoring the risk-reward equation for directors and will re-instate the ability of honest directors to make judgments on *all aspects* of their businesses without undue concern over personal liability.

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