

## CHAPTER 2

### DIRECTORS' DUTIES AND CORPORATE GOVERNANCE

#### Proposed changes to directors' duties and corporate governance

##### *Business judgement rule*

2.1 The Bill introduces a business judgement rule, which provides directors with a *safe harbour* from personal liability in relation to honest, informed and rational business judgements.<sup>1</sup> Directors will not be found to have breached their duty of care and diligence if, when making business decisions, they:

- acted in good faith for a proper purpose;
- did not have a material personal interest;
- informed themselves about the subject matter of the decision; and
- rationally believed the decision was in the company's best interests.<sup>2</sup>

##### *Directors' duty of care*

2.2 The Bill redrafts the duty of care and diligence in section 232(4) of the Law to clarify the standard of care and diligence required of a company officer. The Bill makes clear that whether an officer has breached that standard will be determined both by regard to the company's circumstances and the officer's position and responsibilities.<sup>3</sup>

##### *Conflicts of interest*

2.3 Section 187 of the Bill deals with conflicts of interest faced by directors where they are directors of two or more companies. The Bill will permit directors who serve on wholly or partly owned subsidiaries to take into account the interests of the holding company in certain circumstances. The Explanatory Memorandum notes:

The proposed new provision is designed to give directors some certainty in the performance of their obligations as the problem of conflict of interest is potentially one that will increase given the growing complexity of corporate groups and the limited pool of people from which directors are drawn in

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1 Subsection 180(2) clarifies and confirms the common law position that the Courts will rarely review bona fide business decisions. The Explanatory Memorandum observes that "the statutory formulation will provide a clear presumption in favour of a director's judgement" (para 6.4).

2 The statutory business judgement rule does not extend protection to directors from liability for decisions made in connection with areas of the Law already governed by a separate liability regime, such as insolvent trading or a defective prospectus.

3 Subsection 180(1).

Australia, resulting in many directors of public companies taking on multiple directorships. The proposed provision is based on S.131 (2) of the New Zealand Companies Act 1993 and gives legislative expression to the current state of the common law in this area.<sup>4</sup>

2.4 The Committee is concerned with the views expressed in the Government's explanatory memorandum that there is a 'limited pool of people from which directors are drawn in Australia'.<sup>5</sup> The Committee is also concerned about a concentration of directorships of Australian Companies. At a time when the Government is promoting the apparent increasing level of share ownership in Australia, the pool from which company directors can be chosen should be increasing, not decreasing.

2.5 While the CLERP proposals claim to provide certainty for directors in the performance of their obligations and apparently give legislative expression to the common law in this area, this is an area which the Government should carefully monitor and review if necessary.

2.6 Subject to certain exceptions, the Bill requires directors of a proprietary company to disclose any material personal interest the director has in a matter before the board.<sup>6</sup> Currently the disclosure obligation applies to contracts, proposed contracts, offices and property. The Bill also extends the disclosure obligation to directors of public companies.

#### *Statutory derivative action*

2.7 The Bill introduces a statutory derivative action that will allow shareholders and directors to commence proceedings on behalf of a company where the company is unwilling or unable to do so. However, such proceedings cannot be commenced without leave of the court (subsection 237(1)). The court must grant leave if the following five criteria have been satisfied: (i) inaction by the company; (ii) the applicant is acting in good faith; (iii) the action appears to be in the best interests of the company; (iv) there is a serious question to be tried; and (v) the applicant give 14 days notice of the application and reasons to the company (subsection 237(2)).

#### **Issues raised in submissions**

2.8 A number of submissions to the Committee raised several issues in relation to the changes contained in the Bill.

2.9 The Australian Stock Exchange (ASX) is of the view that the introduction of a statutory derivative action, without adequate statutory safeguards, may lead to vexatious actions in the courts. To overcome this the ASX proposed that the onus of

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4 Explanatory Memorandum, paras 6.93-94.

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6 Section 191. The exceptions relate to certain insurance contracts. The changes proposed in the Bill bring into line the disclosure obligation of directors of public and proprietary companies.

proof for any action should rest with the applicant. The ASX also stated that there is no provision in the Bill that would enable a company to challenge the continuation of a statutory derivative action if the company subsequently had reason to believe that the applicant was no longer acting in good faith or in the best interests of the company.<sup>7</sup>

2.10 It was suggested to the Committee that the business judgement rule should extend to business judgements beyond merely “business operations”. Mr Greg Bateman, representing the Commercial Law Association of Australia Ltd, proposed that the business judgement rule should provide a *safe harbour* not only in relation to the duty of care and diligence but also in relation to: the duty to prevent insolvent trading, liability for mis-statements in a prospectus and liability for mis-statements in takeover documents.<sup>8</sup> The defining of “business judgement” by reference to “business operations” in section 180(3) of the Bill would suggest that there are some business judgements that will not have a safe harbour.

2.11 Generally, submissions to the Committee welcomed the reforms contained in the Bill concerning directors’ duties and corporate governance as a means of facilitating decision-making by directors and promoting investor protection. The Committee has considered the issues raised and supports the introduction of the CLERP reforms, in particular the business judgement rule and statutory derivative action, both of which will serve to clarify and add certainty to this area of the Law.

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7 Australian Stock Exchange, Submission 5, pp 12–13.

8 Dr Greg Bateman, Submission 29, pp 2-3.