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Companies and Securities Advisory Committee

Report to the Minister for Financial  
Services and Regulation

on

Sections 181 and 189 of the  
Corporations Law

October 2000

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By letter of 20 June 2000, the Minister for Financial Services and Regulation, Joe Hockey, asked the Advisory Committee to review Senate amendments to the CLERP Bill that introduced sections 181 and 189 of the Corporations Law.

The Advisory Committee has closely considered both provisions, taking into account advice received from its expert Legal Committee.

## Duty of good faith

### The provision

Section 181 (duty of good faith) was amended by striking out the words “in what they believe to be” in para (1)(a), as indicated below.

181. (1) A director or other officer of a corporation must exercise their powers and discharge their duties:

- (a) in good faith ~~in what they believe to be~~ in the best interests of the corporation; and
- (b) for a proper purpose.

During debate in the Senate, it was said that the purpose of the amendment was to apply an objective, rather than a subjective, test of good faith. In consequence, conduct that is not objectively in the best interests of the corporation may contravene the duty of good faith, even if the director or officer held the contrary belief.<sup>1</sup>

Subsection 181(1) is a civil penalty provision, with consequential civil liability. A breach of the provision will be a criminal offence only if the contravention is either reckless or intentionally dishonest (s 184(1)).

### Commentaries

Ford, Austin and Ramsay in *An Introduction to the CLERP Act 1999*<sup>2</sup> consider that s 181 in its current form reflects the common law:

“The original wording [in the CLERP Bill] was probably taken from *Re Smith and Fawcett Ltd* [1942] Ch 304 at 306 where the court stated that directors must act ‘bona fide in what they consider - not what the court may consider - is in the interests of the company’. However, it is clear from many cases that the duty to act in the interests of the company has never been intended to be a duty only of subjective good faith. Many cases have held that directors may breach their duty to act in the interests of the company, even if they are acting in what they genuinely consider to be an honest manner. This is because they have failed to give proper consideration to what the courts determine are the interests of the company. .... Consequently, it is probably the case that the deletion of the words ‘in what

<sup>1</sup> *Commonwealth Parliamentary Debates*, Senate, 13 October 1999, p 9624 (Senator Conroy).

<sup>2</sup> Butterworths, 2000 at para 2.27.

they believe to be’ from s 181(1) during the Parliamentary debates makes little, if any, difference to the operation of the section.”

Black, Bostock, Golding and Healey in *CLERP and the new Corporations Law*<sup>3</sup> reach a similar conclusion:

“[The original CLERP Bill] was consistent with one formulation of the duty of good faith, which recognised that directors were obliged to act ‘bona fide in what they consider - not what the court may consider - is in the best interests of the company’: *Re Smith and Fawcett Ltd* [1942] Ch 304 at 306. The amended language makes it clear that the standard is an objective one so that the duty of good faith may be contravened by conduct which is objectively not in the best interests of the corporation, even if the director or officer held the contrary belief. There may be little practical difference between the duty of good faith formulated in s 181(1) and that duty as formulated in the case law, particularly the recent case law.”

### **Advisory Committee view**

The language of s 181(1)(a) is consistent with the common law test of acting in the best interests of the company, which contains an objective element. A subjective belief, while necessary, does not suffice.<sup>4</sup> By contrast, the original formulation, namely “in good faith in what they believe to be in the best interests of the corporation”, may have permitted directors to act on the basis of eccentric or irrational beliefs. This purely subjective test would therefore be inappropriate.

The Advisory Committee has compared the duty of care and diligence in s 180 with the duty of good faith in s 181. Directors who satisfy the business judgment rule thereby comply with the duty of care and diligence. However, these directors may not necessarily satisfy the separate duty of good faith.

There are some common elements in the duty of good faith and the business judgment rule, namely that directors must act “in good faith” and “for a proper purpose”. However, the duty of good faith requires directors to act in “the best interests of the corporation”, whereas the business judgment rule only requires directors to act in what they “rationally believe” to be in the best interests of the corporation.<sup>5</sup>

Thus two different tests now apply in determining whether directors have acted in the best interests of a company, for the purpose of satisfying their fiduciary duties. Directors may comply with the business judgment rule requirements by having the appropriate rational belief, yet could still breach the separate duty of good faith by making decisions which, on a purely objective test, are not in the best interests of the corporation. For instance, directors of a target company that is subject to a hostile

<sup>3</sup> 2<sup>nd</sup> edition, Butterworths, 2000 at para 4.14.

<sup>4</sup> The general case law on directors acting in good faith in the best interests of the corporation is discussed in H Ford, R Austin, I Ramsay *Ford’s Principles of Corporations Law* (Butterworths) looseleaf para [8.070] ff.

<sup>5</sup> The legislation contains a rebuttable presumption that the directors’ belief is rational. Subsection 180(2) provides that: “The director’s or officer’s belief that a judgement 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”.

takeover bid might take defensive steps that seek to comply with each of the requirements of the business judgment rule, yet remain open to litigation (initiated by the new board in the event of a successful bid) as not having acted in the best interests of the company in relation to those defensive steps and having thereby breached the separate duty of good faith.

The lack of symmetry between s 180 and s 181 on what constitutes acting in the best interests of a corporation could be overcome by redrafting s 181(1)(a) in a manner which retains an objective element, but uses language similar to that in s 180(2), namely:

“in good faith in what the director or officer rationally believes to be in the best interests of the corporation” [using the same test of rational belief as in s 180(2)].

This redraft would achieve the greatest consistency between the statutory duty of care and diligence and the statutory duty of good faith. An alternative approach would be to retain the difference in effect between these provisions, but recast the language of s 181(1)(a) to clarify how an objective test would operate, for instance:

“in good faith in what a reasonable person in the director’s or officer’s position would believe to be in the best interests of the corporation”.

## **Directors’ reliance on information**

### **The provision**

Section 189 was amended by striking out the original subpara (b)(ii) (as struck out below) and substituting a new subpara (b)(ii), as indicated below.

189. If:

- (a) a director relies on information, or professional or expert advice, given or prepared by:
  - (i) an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or
  - (ii) a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person’s professional or expert competence; or
  - (iii) another director or officer in relation to matters within the director’s or officer’s authority; or
  - (iv) a committee of directors on which the director did not serve in relation to matters within the committee’s authority; and
- (b) the reliance was made:

- (i) in good faith; and
- (ii) ~~after making proper inquiry if the circumstances indicated the need for inquiry~~ after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation; and
- (c) the reasonableness of the director's reliance on the information or advice arises in proceedings brought to determine whether a director has performed a duty under this Part or an equivalent general law duty;

the director's reliance on the information or advice is taken to be reasonable unless the contrary is proved.

Complying with this section may assist directors to satisfy the test in s 180(2)(c) of the business judgment rule, which requires directors to "inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate". Satisfaction of s 189 would also be relevant to complying with the general common law duty of care of directors.

### Commentaries

Black, Bostock, Golding and Healey in *CLERP and the new Corporations Law*<sup>6</sup> make the following comment on subpara (b)(ii):

"The amended provision imposes a more demanding obligation on directors, although the extent to which an independent assessment will be required will vary in the circumstances depending upon the matters specified in the provision. In order to satisfy the requirement of an independent assessment, the director must at least consider relevant views and material and bring his or her own judgment to bear in relation to the matter."

Ford, Austin and Ramsay in *An Introduction to the CLERP Act 1999*<sup>7</sup> make the following comments:

"What might be meant by the requirement that a director make an 'independent assessment' of the information or advice? Is there a difference between 'proper inquiry' (the original words) and 'independent assessment'? It would seem that under the original wording, it would only be if information or advice provided to a director put the director on notice of some possible irregularity that the director would then be under an obligation to make further inquiries. These inquiries would need to be 'proper'; that is, adequate in the circumstances.

The new wording requires an independent assessment of the information or advice. This does not of course require the director to obtain an assessment of the information or advice by some independent expert such as an accountant, although, should the circumstances be serious enough, this might be necessary.

<sup>6</sup> 2<sup>nd</sup> edition, Butterworths, 2000, at para 4.10.

<sup>7</sup> Butterworths, 2000, at para 2.18.

Rather, it is suggested that what the section contemplates is an analysis of the information or advice in a way that is unbiased. The words ‘having regard to the director’s knowledge of the corporation and the complexity of the structure and operations of the corporation’ would seem to contemplate that the type of assessment may vary according to these factors. Inevitably, some information or advice will be given greater scrutiny by a director than other information or advice. Some knowledge that the director possesses might require the director to scrutinise the information or advice more carefully than would otherwise be required. For example, if the position that the director holds is that of finance director, then it is reasonable to suppose that financial information or advice provided by others would be subject to more detailed scrutiny or assessment by that director than information or advice provided on a matter that lies outside of that particular director’s expertise but which the director knows that another director has the appropriate expertise to assess.”

Both commentaries refer to the decision in *Southern Resources Ltd v Residues Treatment and Trading Company Ltd* (1990) 3 ACSR 207 at 225, where the Court held that when directors are required to exercise independent judgment, this means “no more than that they, having listened to and assessed what their colleagues have to say, must bring their own mind to bear on the issue using such skill and judgment as they may possess.”

#### **Advisory Committee view**

There are various ways that the requirement that directors must make an “independent assessment” of the information or advice that they receive could be interpreted.

It is possible that the word “independent” could be interpreted as requiring each director to obtain advice from a third party on the information received. This interpretation might be compared with the original formulation “after making proper inquiry if the circumstances indicated the need for inquiry”, which could be interpreted as requiring a director, in some circumstances, to initiate a separate inquiry by a third party into information or advice received by that director.

The more likely interpretation of the requirement is that each director must personally assess the information or advice provided by others, but not have to seek external advice, unless the circumstances are serious enough to require this.

The Advisory Committee considers that, in principle, each director should be required to focus his or her mind on the information or advice provided by others, without necessarily having to obtain a third party analysis of that information or advice.

The Committee considers that, if an opportunity to amend the provision arises, it would be useful to clarify this matter by replacing the phrase “after making an independent assessment of” with the phrase “after personally assessing”.

The Committee also notes the difference in language between s 189, which deals with information or advice received by directors, and s 190, which deals with directors’ responsibility for the actions of their delegates.

Under s 189(2)(b)(ii), directors must make “an independent assessment” of information or advice received, whereas under s 190(2)(b)(iii), directors are not responsible for the actions of a delegate if, inter alia, they make “proper inquiry if the circumstances indicated the need for inquiry”. The language of s 190 is the same as that in the original formulation of s 189, prior to the Senate amendment.

The Advisory Committee considers that the tests in these two provisions need not be uniform. In many instances, it may be reasonable for directors not to make any further inquiry about the competence and reliability of their delegate, particularly if that person is well-known to them. In other circumstances, an inquiry by a third party might be appropriate if the directors do not know the potential delegate or are uncertain whether that person has the appropriate qualifications and experience.

## Conclusion

While supportive of the principles in ss 181 and 189, the Advisory Committee suggests that the wording of these provisions could usefully be clarified as follows:

- s 181(1)(a) be redrafted in either of the following ways:
  - “in good faith in what the director or officer rationally believes to be in the best interests of the corporation” [using the same test of rational belief as in s 180(2)]
  - or:
  - “in good faith in what a reasonable person in the director’s or officer’s position would believe to be in the best interests of the corporation”
- s 189(b)(ii) be amended by omitting the phrase “after making an independent assessment of” and substituting the phrase “after personally assessing”.