

# Strict liability laws too stifling

It is time to consider extending the business judgement rule, writes Pamela Hanrahan.

In the end, a director's job is to make complex decisions in conditions of uncertainty. For directors of a number of high-profile property and financial services companies in Australia, recent events in global debt markets have brought this into sharp focus. What should the consequences be, for individual directors who get these decisions wrong?

Holding directors legally accountable for their decision-making is a vital part of any successful framework for good corporate governance. However, extending directors' personal liability too far can have a dampening effect on business, if it discourages good people from joining boards and promotes an excessively risk-averse or conformance-driven culture at board level. So getting the liability balance right is crucial.

Recent discussion about extending the operation of the so-called business judgement rule in the Corporations Act is part of this broader balancing exercise.

The business judgement rule provides a safe harbour for some — but not all — director decision-making from the churning seas of the law of negligence. All directors are required by law to meet a requisite standard of care and diligence in exercising their powers and discharging their duties. The business judgement rule says that in the context of business — but not other — judgements, a director is taken to meet that standard of care and diligence if certain conditions are met. Those conditions are that they make the judgement in good faith for a proper purpose; that they do not have a material personal interest in the subject matter of the judgement; and that they have taken appropriate steps to inform themselves in relation to the judgement before making it. In



Directors increasingly have to make complex decisions in conditions of uncertainty.

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these circumstances, a director cannot be sued for negligence unless their judgement was so poor that no reasonable person in their position could rationally believe it to be in the best interests of the company.

The difficulty for directors is that, increasingly, they are being required to make complex decisions in conditions of uncertainty about matters that go beyond the business operations of the company. Decisions about matters other than the company's business operations are not "business judgements" under the law, and therefore cannot be admitted to the safe harbour. Two clear examples emerge from the recent market turmoil. The first is the complex decision about when to pull the pin and conclude that a company is insolvent. The second is whether, and when, to disclose information to the market.

When there are reasonable grounds to suspect that a company is or will become insolvent, and a director is (or ought to be) aware of those grounds, he or she has a

positive duty to prevent the company from incurring further debts that cause its insolvency or while it is insolvent. If they fail to do so, then substantial civil penalties and lengthy disqualification from managing companies can follow, along with personal liability for an amount equal to the debt incurred. This would be so even if the directors made the judgement call about solvency in good faith, in the absence of self-interest, and with what they reasonably considered to be all relevant information before them.

Decisions about continuous disclosure put directors in a similarly difficult position. The decision about whether, and if so when, particular information should be disclosed to market is also one that ultimately requires directors to make a judgement call.

The law makes it clear that, despite being involved in a contravention by his or her company, a director has no personal liability for non-disclosure so long as they can prove that they took all

reasonable steps to ensure the company was complying with its disclosure obligations, and reasonably believed that it was.

However unless they can prove, in a sense, that they were not negligent in making their decision about the company's disclosure obligation, directors potentially face civil penalties, disqualification and maybe even personal liability to those affected by the non-disclosure.

Legal and regulatory requirements have greatly expanded the range of circumstances in which complex judgements, not concerned with the company's business operations as such, are required of directors. It may be time to give some real thought to whether directors acting in good faith in the absence of self-interest and after appropriate inquiry, should be protected from potential liability in respect of their (rational) judgement calls in these areas.

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