*In light of recent developments in case law, company directors are entitled to complain that the duty of care, skill and diligence effectively limits their ability to be entrepreneurial. Discuss.*

## I. Introduction

The balance between entrepreneurial risk-taking and a director's corporate responsibility are inversely correlated under current securities law. The success of any corporate enterprise is entrenched in the ability of its executive management to facilitate and incorporate risk as a function of its operating capability. It is antithetical to contend that shareholder value can be created without undertaking some risk as it is a fundamental component of the corporate profit-return ratio. Of course, these principles must be balanced in light of those directors who embrace risk as an extremity and who carelessly and dishonestly destroy value through overzealous adoption. While Australian corporate law has attempted to balance these conflicting notions with the enactment of risk assessment provisions such as the business judgement rule in s180(2) of the *Corporations Act 2001 (Cth)*[1] – the degree to which the law fosters and encourages directors to undertake structured entrepreneurial risk still remains questionable.

The function of a director is enshrined[2] in Chapter 2D – Part 1 – Division 1 of the *Corporations Act 2001 (Cth)* and their primary duties are to act in the best interests of the company and for a proper purpose.[3] The extent to which this essential requirement is rationalised with unsystematic risk adoption rests on the judicature's ability to interpret risk and determine the degree to which a managerial judgement was reasonable in the circumstances. Of course, the inherent nature of a judicial inquiry in relation to corporate risk infers that the risk undertaken was excessive and the complainant is disputing the efficacy of it. The Courts consideration in this regard must then fall to an examination of whether a director failed to exercise a reasonable degree of care and diligence in the discharge of his duties. As stated by Ipp J in *Vrisakis v Australian Securities Commission*[4]

> 'The management and direction of companies involves taking decisions and embarking upon actions which may promise much, on the one hand, but which are, at the same time, fraught with risk on the other. That is inherent in the life of industry and commerce.'[5]

In this regard, the law must attribute some liability to directors for corporate losses and the magnitude of this attribution must flow from the degree to which they have been responsible for managing and controlling the company. In *Downery v Crawford*[6] Weinberg J stated that 'power to control the management of a company is generally vested by the company's constitution in its board of directors'.[7] Such a conferral infers that directors can easily misuse their power and erode shareholder value for which they must be held accountable. Arguably, the enormity of this responsibility should be relatively proportioned to an arbitrary degree of loss in respect to the entrepreneurial spirit and its consequential endeavours. However, the

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[1] *Corporations Act 2001 (Cth).*
[2] In the absence of any corporate constitutional provisions to the contrary.
[3] Ibid 2 at 181(1).
[4] *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395.
[5] Ibid at 449.
[6] *Downey v Crawford* (2004) 51 ASCR 182.
[7] Ibid at [172].

law in its current form takes an adverse approach and enforces strict liability on directors who cause corporate loss with the business judgement rule contained in s180(2) doing nothing to advance the entrepreneurial cause.

Consequently, this paper will seek to argue that the law in its current form does not promote substantive and justified entrepreneurial risk but rather seeks to suppress it. It will consider the business judgement rule and examine relevant common law cases and the conclusions of such cases. It will also review director's liabilities under the *Corporations Act 2001 (Cth)* and determine whether they facilitate risk-taking or are too encroaching on a director's ability to be entrepreneurial. A conclusion will then be drawn in relation to the merit of these considerations and a determination will be formed in relation to whether the law facilitates entrepreneurial risk-taking and innovation.

## II. Risk & Business Judgement

The realistic assessment of risk is a core component of the decision making process and is vital to the achievement of corporate profitability. To assert that shareholder value can be adequately returned without a degree of risk incorporation is to ill understand the nature of the corporate entity. S180 of the *Corporations Act 2001 (Cth)* seemingly merges the law of negligence at common law to the fiduciary nexus which must exist between a director and a company.[8] It seeks to require a director to discharge their duties in manner, and with a degree of care, that a hypothetical reasonable person would exercise given the company's circumstances, the director's position and level of responsibility within the corporation.[9] The question as to whether a director has exercised reasonable care and diligence within the confinements of their statutory duties can only, as Ipp J explained in *Vrisakis v Australian Securities Commission*,[10]

> 'be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.'[11]

In this light, it seemingly apparent that a subjective element to s180 should be required as opposed the objective comparison to the hypothetical reasonable person. Such an element should be incorporated into s180(2) which purports to ascertain whether a director has made a rationally executed decision – termed the 'business judgement rule'. The rule attempts to act as a defensive shield for directors in determining whether their decision was made in good faith and with a proper purpose relevant to s180(1). The purpose of the business judgement rule was outlined in *Corporate Law Economic Reform Program Bill*[12] providing that directors should not have to continuously consider the legal uncertainties of their actions but instead focus on undertaking rational decisions which encourage innovation and responsible risk taking. Despite this purported intention, the rule has little judicial exposure at common law because of its strict objective nature and its overbearing requirements. The reliance on the hypothetical reasonable person holds a director in the same judicial stead as that required

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[8] *Daniels v Anderson* (1995) 37 NSWLR 438.
[9] Ford, Austin and Ramsay, Fords Principles of Corporations Law, 12th Edition, LexisNexis Butterworths, 2005, Pg. 387.
[10] *Vrisakis v Australian Securities Commission* (1993) 9 WAR 395.
[11] Ibid at 449.
[12] *Corporate Law Economic Reform Program Bill 1998*, http://www.aph.gov.au/library/pubs/BD/1998-99/99bd071.htm, Viewed 14th October 2009.

under s180(1) and this affords no realistic utility to the defence. For example, the requirement evinced in s180(2)(c) that a director is informed about the subject matter of a decision to an extent 'reasonably believed to be appropriate', infers that the Court will determine the reasonableness of 'care and diligence' that a director exercised in making the decision and objectively determine whether this was appropriate. In a narrowly constructed light, it is difficult to imagine that the Court will look favourably on executed decisions which adopt a significant component of risk.

It is contended that this is an organic deficiency of s180(2) since the inherent nature of entrepreneurial risk-taking requires a merit based assessment of the available information before the risk is undertaken. The construction of an objective review of a director's decision making process only articulates the procedural steps which were undertaken in reaching the decision. It is arguable that this poses a significant element of retrospectivity or 'hindsight review' which questions the reasonableness of the decision in light of an adverse outcome. This would, for example, provide no practicability to a director who is attempting to starve off liquidation by adopting an entrepreneurial risk that may rescue the company. Often companies in great financial difficult or on the verge of collapse require a higher degree of entrepreneurial risk in an attempt to preserve shareholder value and rescue the company from collapse.[13] In light of s180(2), it would seem that such a course of action would be nonsensical as it could be easily argued by a complainant that no 'rationality' existed in a director attempting to undertake such a risk.

In this sense, it seems evident that the business judgement rule disregards entirely the notion of short and long term decision making. The juxtaposition between short and long term risk adoption will always cause conflicting views as to whether a decision was rational or irrational in the given circumstances. Under the current s180(2), the balance between a short-term risk which returns significant shareholder value against that of a longer term, and more capital intensive risk, seemingly deters the former and rewards the later. This is entirely due to the objective nature of the current test requiring directors to substantially rationalize their decisions according to a prefixed substratum of information. Evidently, in the absence of such information, it is exceedingly difficult for a director substantiate that they 'informed themselves of the subject matter of the judgement'[14] or that the decision was 'rational'.[15] In this regard, under the current test, a director who undertakes short term entrepreneurial risks which require opportunistic responses to dynamic market changes would be unable to substantiate their position regardless of the positivity of the outcome. It is ostensibly clear that such risks fall outside of the scope of the s180(2) and deter directors from capitalising on significant environmental changes that while opportunistic and value adding – possess too great a legal risk to justify. This is perhaps why the business judgement rule has been scarcely the subject of Australian case law.[16]

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[13] Robert Baxt, *Encouraging entrepreneurialism: What parts do/should courts play?*, Australia Business Law Review, 2008, Vol 36, Pg 62 at 64.
[14] *Corporations Act 2001* s180(2)(c).
[15] Ibid at s180(2)(d).
[16] Neil Young, *Has Directors Liability gone too far or not far enough?*, Company and Securities Law Journal, 2008, Vol 26, Pg 216 at 222.

In the United States, the business judgement rule affords significantly more flexibility to directors, in the absence of conflict of interest, and focuses on the importance of protecting risk-taking by corporations in a broad manner.[17] It can apply to almost any decision made by a director in comparison to the Australian business judgement rule which is only extended to the requirements of the statutory duty of care and diligence in s180(1).[18] The United States rule focuses on a subjective element and considers the directors belief that the decision was made reasonably in the best interests of the company.[19] It is argued that this flexibility has attributed greatly to the advancement and economic growth of the United States through the bold taking of risk and corporate innovation.[20] Accordingly, the United States implementation of such a rule exists as a strong proponent that such subjectivity should be introduced into the *Corporations Act 2001 (Cth)* and the scope of protection extended to encompass other Part 2D – Division 1 provisions – most notably s180 through s184.

Such a broad encompassing defence has been proposed[21] and it would enable directors to rely on an overarching defence as opposed to that currently limited in s180(2). It is contended that such a defence would facilitate justified entrepreneurial risk taking and encourage directors to be entirely more innovative. The proposed change seemingly adjusts the current business judgement rule to be more in line with the United States rule in affording more flexibility to directors for decisions which are made

(a) In a bona fide manner; and
(b) Within the scope of the corporations business; and
(c) Reasonably and incidentally to the corporations business; and
(d) For the corporations benefit.[22]

The removal of the directive statutory language from s180 and the introduction of a reasonableness test – as highlighted above – would provide more utility to the defence. Perhaps even more importantly, the introduction of broader defensive would assist directors by providing an increased level of legal certainty in relation to their permissible actions and relevant decision making processes.[23] Practically, the vast majority of directors abdicate[24] from entrepreneurial risk laden decisions because of the litigation risk associated to the decision and the danger of 'hindsight' considerations by the Court. Evidently, such abdication does not advance shareholder value but is rather a root cause in reducing it.

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[17] David Rosenberg, *The Future of Corporation Risk-Taking and the Business Judgement Rule*, Baruch College, 2008, Pg 3.
[18] Jenifer Varzaly, *Do directors duties in Australia provide adequate scope for risk-taking?*, Monash Business Review, Vol 4 – Issue 3, 2008, Pg 4.
[19] Ibid 17 at Pg 8.
[20] Ibid.
[21] The Treasury, *Review of Sanctions in Corporate Law*, http://www.treasury.gov.au/documents/1182/PDF/Review_of_Sanctions.pdf, Viewed 16th October 2009.
[22] Ibid at Pg 29.
[23] Ibid at Pg 32-33.
[24] Ibid at Pg vii.

## III. A Time for Change

In Part II of this paper, it was advocated that a broader general defence is introduced into the *Corporations Act 2001 (Cth)* in order to advance justified and reasonable entrepreneurial risk taking by directors. Evidently, the introduction of such a defence must be balanced with the rationalization of director's liabilities under the current law. In *Ignot Capital Investments Pty Ltd v Macquarie Equity Capaital Markets*,[25] McDougall J commented that directors should only be liable once a consideration of the

> '[b]alance of risk and reward, or, more accurately, to be satisfied that the directors, acting reasonably and in the best interests of the company and employing their individual knowledge and skills and taking account of relevant circumstances, did so.'[26]

His Honour seemingly advocates for allowing directors to adopt entrepreneurial flair without persistently concerning themselves with the legal outcome. Most notably are His Honours comments which recognise that in some circumstances it is critical that directors

> '[d]isplay entrepreneurial flair and accept commercial risks to produce a sufficient return on the capital invested such that the mere foreseeability of harm does not of itself dictate that the question must be answered always adversely to directors.'[27]

Evidently, it is contended that His Honours comments plainly recognise that simply because a director participates in conduct which contains a reasonable degree of risk to a company, it does not mean that the director – in light of their skill level – exercised their degree of care and diligence in a manner converse to their statutory obligations. This infers that any associated statutory defence mechanism introduced into the *Corporation Acts 2001 (Cth)* should not measure the 'rationality' of a director's decision-making process as opposed to the 'reasonableness' of it. The rationality of a decision questions the decision maker's logic as a purely objective standard from a finite end-point while the reasonableness of a decision affords a greater consideration to decision maker's sensibilities. This evidently poses the question of whether a rationale director is a reasonable one? For entrepreneurial risk, such a question must be answered in the negative as the inherent nature of entrepreneurial risk relies on an individual directors 'knowledge and skills and taking account of the relevant circumstances'[28] which may not always encompass a degree of rationality if opportunistic risk is to be capitalised upon.

In this regard, it has been commented that the imposition of personal liability on directors above that already contained within the *Corporations Act 2001 (Cth)* would serve to more adequately balance the rationality of the risks taken by directors.[29] This contention is refuted on the basis that any imposition of personal liability on directors will only seek to compound the problem. It is critical to appreciate that the practical utility of a director joining a board is to provide significant experience and knowledge to a company's operations and offer

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[25] *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets* (No 6), [2007] NSWSC 124.
[26] Ibid at [1437].
[27] Ibid.
[28] Ibid.
[29] Mark Byrne, *Directors to hide from a sea of liabilities in a new safe harbour*, Australian Journal of Corporation Law, Vol 22, 2008, Pg 255 at 261.

strategic advice on decision making. Many directors have commented[30] that the risk associated with personal liability has directly affected their decision making processes and resulted in a selection of the more conservative decision option available to them. In this respect, the introduction of any additional statutory laws – above those already contained within the *Corporations Act 2001 (Cth)* – which seek to enforce even greater personal liability on directors in the absence of personal fault significantly disincentives these experienced individuals from taking directorships and senior managerial positions at all.[31] A practical manifestation which could result in even greater risks being undertaken by ill advised and inexperienced board members resulting in a paradoxical outcome to the purpose of any such enactment.

An additional consideration of a broader encompassing business judgement rule defence is the contention that it is extended to insolvent trading.[32] This reasoning is advocated by many directors who are of the view that a company should be able to trade out of its financial difficulties and any such attempt to preserve shareholder value ought to be afforded statutory protection.[33] Evidently, such a broad ranging notion must be careful balanced with reckless or unreasonable risk adoption on behalf of directors tied to financially troubled corporations. It is a pragmatic reality that the adoption of entrepreneurial risk strategies in financial troubled corporations is at the expense of creditors.[34] However, the law should not seek to deter directors from engaging in reasonable and bona fide decision making which is in the best interests of the corporation and could starve off liquidation through such endeavours. The law should place the onus on a director to adequately balance the obligations owed to shareholders and creditors, and to utilise their relative skills and reasonable decision making processes to determine whether the pursuit of such an entrepreneurial risk adoption has a realistic possibility of reversing the company's financial course. Constructed in this light, it is argued that encompassing insolvent trading within the wider business judgment rule proposed in Part II of this paper, does not protect those directors who act outside of their statutory duties of owing a duty of care and diligence and to act in the best interests of the corporation and requests that they instead justify the reasonableness of their decision.

In *Daniels & Ors v AWA Limited*[35] Clarke and Sheller JJA stated that

> 'Great risks may be taken in the hope of commensurate rewards. If such ventures fail, how is the undertaking of it to be judged against an allegation of negligence by the entrepreneur? In our opinion the concept of negligence can adapt to measure appropriately in the given case whether the acts or omissions of an entrepreneur are negligent.'[36]

Evidently, in adapting their Honours view to a statutory context, the introduction of a broader encompassing business judgement rule would facilitate a wider legal base for the judicature to interpret the degree to which a director has breached their obligations. The standards imposed on a director in s180 through s184 of the *Corporations Act 2001 (Cth)* do not, in any

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[30] Treasury, *How did the risk of personal liability affect the decision-making process and the decision?*, http://www.treasury.gov.au/content/Company_Directors_Survey/10_0.html, Viewed 27th October 2009.
[31] CAMAC, *Personal Liability for Corporate Fault*, 2006, CAMAC Report, Pg 32.
[32] Ibid 30 at Pg 32.
[33] Ibid 30 at Pg 32 .
[34] M J Whincop, *Taking the Corporate Contract More Seriously: The Economic Cases against, and a Transaction Cost Rationale for, the Insolvent Trading Provisions, Griffith L Rev*, Vol 5, 1996, Pg 1 at 28.
[35] *Daniels & Ors (Formerly Practising as Deloitte Haskins & Sells) v AWA Limited* [1995] 37 NSWLR 438.
[36] Ibid at [494].

manner, codify the common law comments evinced by Clarke and Sheller JJA above. Instead they restrict a directors freedom to dynamically respond to market opportunities by requiring persistent legal counsel as to whether the decision is made in good faith, for a proper purpose, is not reckless or intentionally dishonest or is ‘without moral turpitude’.[37] The current statutory requirements are unrealistic when superimposed onto the practical realities of decision making and business judgements. In *Vines v Australia Securities and Investment Commission*[38] Ipp JA stated that if a director fails

> ‘[i]n their duties by contravening the Act such that their conduct attracts a penalty under s1317EA(3)(b), that penalty should not be mitigated by the fear that others might, in the future, be overly cautious’.

Yet, evidently this is exactly what such a penalty achieves – an overcautiousness and concern from directors whom do not fully understand the extent of their statutory liability without detailed legal advice. The real effect of such cautiousness on shareholder value is predominately unknown as missed opportunity can only be observed as a matter of hindsight. Evidently, to argue against the broadening of the business judgement rule is to support conservative risk adoption and reject the principle notion that embracing justified and reasonable risk can be positively correlated to shareholder value. In this light, it is perhaps an equally poignant argument to contend that resistance towards entrepreneurial risk in the corporate environment similarly exposes directors to increased liability as they are not acting in the best interests of shareholders by adopting strategies which could significantly increase economic value. As a result, it is contended that the invisible statutory hand which is currently binding directors from adopting such risk strategies is directly affecting the fair equity value of the corporation.

Practically, most directors are placed onto boards in order to extend and facilitate growth of a company and use their position of substantial influence to advice on positivistic directions a business should explore. The plethora of duties which exist in this regard do overtly complicate the responsibility that this underlying function attempts to achieve. Clarke and Sheller JJA commented on such realities in *Daniels & Ors v AWA Limited*[39] where their Honours stated that

> ‘Any entrepreneur will rely upon a variety of talents in deciding whether to invest in a business venture. These may include legitimate, but ephemeral, political insights, a feel for future economic trends, trust in the capacity of other human beings.’[40]

The law should seek to foster, not punish, these legitimate insights and should afford directors the ability to engage in entrepreneurial risk with as much vigour as can reasonably be afforded. Shareholders and creditors ultimately gain from the successful execution of such risks through increases in profitability, corporate value and the expansion of stakeholder adoption. As a result, anyone with an economic interest in a corporation would expect that directors engage in such endeavours relative to an appropriate level of regulatory oversight. In the event that such risks fail, corporate law should only seek to punish directors who purposefully and calculating take such decisions without any reasonable basis given the company’s circumstances at the time the decision was made. The adoption of such a merit

[37] *Australian Securities and Investment Commission v Vines* (2005) 54 NSWLR 281 at [43].
[38] *Vines v Australian Securities and Investments Commission* (2006) 63 ACSR 505 at [256].
[39] *Daniels & Ors (Formerly Practising as Deloitte Haskins & Sells) v AWA Limited* [1995] 37 NSWLR 438
[40] Ibid at [501].

based approach provides directors with the opportunity to quantify their decision making rationale under a judicial setting and subsequent their claims.

## IV. Conclusion

The law should not deter reasonable and calculated behaviour but rather embrace it. The function of any legal rule is to 'deter certain undesirable behaviour without simultaneously deterring (too much) desirable behaviour'.[41] The binding of directors to the overtly rigorous confinements evinced in s180 through s184 of the current statutory regime only deters undesirable behaviour and is not adequately balanced to encourage desirable. While in no manner does this paper attempt to contend that the current statutory requirements of reasonable care and diligence, good faith and proprietary and prudent management are overarching and ineffective – it does attempt to highlight the current inadequacies of corporate law against the adoption of risk. It is contended that by affording no merit based defence to directors to subjectively quantify and substantiate their decision making processes, the statute has forced directors to adopt a conservative stance on risk and reject entrepreneurial opportunities and dynamic market opportunities.

While it has been commented[42] that the introduction of such a broad reaching defence would in no way alter the current statutory terrain as it requires a director to disprove the elements contained in s180 through s184 – it is contended doing nothing does not advance the current seemingly reactive – as opposed to proactive – nature of director decision making in corporate Australia. It has long been the accepted view of financial theorists[43] that the creation of shareholder value is entrenched in the risk-return principle evinced through modern portfolio theory which illustrates the notion that both risk and return are positively correlated variables – only through a greater adoption of risk is one able to achieve a greater level of return. Evidently, such a notion must be encouraged and advanced to corporate Australia to ensure that shareholders are being adequately provided the greatest opportunity to capitalise on the growth of their investment. It is only through the adoption of a more flexible statutory framework that directors will feel confident in their decision making processes with respect to risk, entrepreneurial activities and innovation. In this regard, it is contended that the introduction of a broader and more subjective statutory defence will provide directors with the continued ability to discharge their duties faithfully, honestly and in confidence while also adopting and embracing strategies which advance entrepreneurial endeavours and facilitate innovation in the Australian corporate environment. In the absence of such a defence, it is argued that directors, corporate, shareholders and interested parties will continue to suffer from risk adverse decision making and a focus on litigation alleviation.

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[41] Easterbrook FH and Fischel DR, *The Economic Structure of Corporate Law*, Harvard University Press, USA, 1996, Pg 316.

[42] Neil Young, *Has Directors Liability gone too far or not far enough?*, Company and Securities Law Journal, 2008, Vol 26, Pg 216 at 223.

[43] Reilly, Frank K, Brown, Keith C, *Investment Analysis & Portfolio Management*, Thomson South Western, 7th Edition, USA, 2003, Pg 210.

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