

Frequently Asked Questions

Honest & Reasonable Director Defence

This document sets out answers to frequently asked questions regarding the proposal of the Australian Institute of Company Directors to insert an Honest & Reasonable Director Defence into the Corporations Act 2001 (C'th).

These FAQs should be read in conjunction with the document titled *The Honest and Reasonable Director Defence: A Proposal for Reform*, which explains the Defence and its intended application.

1. *What is the Honest & Reasonable Director Defence?*

The Honest and Reasonable Director Defence is a proposed reform to the Corporations Act suggested by the Australian Institute of Company Directors.

It would provide a legal defence for directors who faced claims that they had breached their responsibilities.

It could be used by directors who are able to prove they had conducted themselves honestly, 'for a proper purpose' and with the degree of care and diligence they rationally believed to be reasonable in the circumstances presented to them.

The proposed Honest and Reasonable Director Defence is a broad legal defence which could be used by directors who faced allegations that they had breached their legal responsibilities. It would apply in situations where directors had acted honestly, 'for a proper purpose' and with the degree of care and diligence they rationally believed to be reasonable in all the circumstances.

It would be a safety net for directors who perform their roles with integrity but who now operate in a complex regulatory environment that often forces them to focus on legal compliance at the expense of big-picture decision-making.

The Honest and Reasonable Director Defence would be available to directors facing an alleged contravention under, or in connection with, any provision of the Corporations Act and the Australian Securities and Investments Commission Act. It would also apply to similar allegations made pursuant to legal principles developed by the judiciary (in common law or equity). The Defence could operate to defend both civil and criminal contraventions in the Corporations Act and the Australian Securities and Investments Commission Act.

For example, the provision could apply to alleged contraventions of:

- directors' statutory duties
- strict liability offences
- continuous disclosure provisions
- misleading or deceptive conduct provisions
- insolvent trading provisions.

The Defence would only apply in circumstances where directors - either non-executive or executive – were acting in their capacity as directors. It would not apply to officers. It has been confined to directors in order to address issues which are especially relevant to those acting in that capacity.

2. Why is the Honest & Reasonable Director Defence necessary?

There are a number of significant pressures which create a risk-averse corporate culture. This environment is a disincentive for directors to make decisions that would encourage the entrepreneurialism and innovation that stimulates economic growth. Existing mechanisms to help protect honest and diligent directors (such as the business judgment rule) have not proved effective. The aim of the proposed reform is to overcome these pressures to allow directors to focus on their real tasks of monitoring performance, strategic oversight and governance. This would in turn help them harness new opportunities for their organisations.

There are a number of significant pressures which create a risk-averse culture in companies:

- Directors can be found personally liable for a range of contraventions of the Corporations Act and Australian Securities and Investments Commission Act even when they have acted honestly, properly and rationally.
- Existing mechanisms to help protect honest and diligent directors (such as the business judgment rule) have not proved effective.
- Australia's strict insolvency laws discourage attempts to rescue businesses which might otherwise be saved.
- Current law makes directors reluctant to provide information which can be used as an indication of a company's future prospects, even though such forward-looking information is increasingly sought by regulators and investors.
- The interconnected nature of different provisions of the Corporations Act means that a contravention of one provision by a company itself may mean that its directors can be found to have breached their duty of care under the Act without access to a legal defence.
- Many public expectations of directors are misinformed and have led to unrealistic views about what directors should do in areas that are, in fact, the responsibility of management. This misconception has driven governments and regulators to impose detailed regulation on directors that distracts them from their real tasks of overseeing, monitoring performance, considering strategy and assessing risk. This, in turn, has an adverse impact on financial outcomes and business efficiency.

The Honest and Reasonable Director Defence is designed to give directors confidence that if they perform their roles and responsibilities honestly, 'for a proper purpose' and with the degree of care and diligence that they rationally believe to be reasonable, then they will not be at risk of personal liability.

The end goal is to improve the nature of corporate regulation so directors have a sound footing upon which to make business decisions which will have positive ripple effects across the economy by encouraging investment and creating more jobs for Australians.

3. Does anything like this exist in other countries?

The Defence is a solution specifically tailored to address problems that are unique to Australia's regulatory and corporate environment.

Other developed countries have an effective business judgment rule, legal defences and/or so-called safe harbours for directors which apply to the specific requirements in those jurisdictions.

4. Why isn't the business judgment rule an effective safety net for directors?

The business judgment rule only applies to one provision of the Corporations Act - the duty of care and diligence. Many other provisions in the Act create liability concerns for directors but the business judgment rule does not apply to them.

As yet, no director has been able to successfully on the business judgment rule as a defence.

A new broad defence would overcome its limitations, as well as those of other provisions, and would create a business environment where sensible risk taking is encouraged.

Australia has a statutory business judgment rule in section 180(2) of the Corporations Act that was introduced in 2000.

There are several limitations to it and, as yet, no director has been able to successfully on it as a defence.

We are of the view that the business judgment rule has not served its purpose. Our specific concerns are as follows:

- The business judgment rule only allows directors to defend themselves against allegations they have breached their duty to act with care and diligence. The rule is not available to defend an alleged breach of any other requirement or responsibility facing a director.
- The rule only applies to 'business judgments' as defined by the Corporations Act. This definition states that a business judgment is "any decision to take or not take action in respect of a matter relevant to the business operations of the corporation." While this definition appears broad, court decisions have confined the scope of activities that are 'business judgments.' For example, decisions taken in planning, budgeting and forecasting have been found to be business judgments. However, common director activities, like monitoring the company's affairs and maintaining familiarity with the company's financial position have been found not to fall into this category. As a result, directors cannot rely on the business judgment rule to defend themselves in many circumstances where judgments are involved.
- The business judgment rule only applies to actual "decisions". In other words, a director must positively turn their mind to an issue in order to use the rule in their defence.

5. If the proposal was adopted, how would the Corporations Act change?

There would be minimal change to the Corporations Act. Only one additional provision would be inserted and no existing provisions would be amended or repealed.

This would make the implementation of the Honest and Reasonable Director Defence a simple process that did not require significant legislative revision.

Only one provision, the Honest and Reasonable Director Defence itself, would be inserted into the Corporations Act.

The Defence could be inserted into Chapter 9 of the Act and the existing business judgment rule would remain in place without amendment. No other provision of the Corporations Act would be repealed or amended.

6. *Will this just allow well -paid directors to get “off the hook”? What safeguards will protect the community from corporate misconduct?*

No. The aim is to protect honest directors, not to allow others to escape their responsibilities. Directors that act dishonestly, irrationally or for an improper purpose will not be able to rely on the Defence.

The Honest and Reasonable Director Defence could be used by all directors of companies regulated under the Corporations Act, not just the directors of big companies. This includes small business directors and some not-for-profit directors.

Despite liability risks, 84% of NFP directors do not get paid at all. The Defence would offer a safety net that would hopefully encourage more people to serve on the voluntary basis often required for not-for-profit boards.

The Defence is intended to support honest and committed directors, not allow others to escape their responsibilities.

The Defence applies only to directors, not to companies, so there would be no change to the responsibilities of companies if the proposal was adopted.

The Honest and Reasonable Director Defence will not just be available to directors of large listed companies. It would apply to all directors of companies regulated under the Corporations Act. This includes directors of small businesses, private companies and some not-for-profit organisations.

There are almost 2.4 million directors in Australia and only a small proportion sit on the boards of companies listed on the ASX. The remaining directors serve on a wide range of company types and many are business owners. For not-for-profit directors, many volunteer their time. Company Directors' 2014 *Not-for-Profit Governance and Performance Study* identified that 84% of directors in the NFP sector do not get paid at all.

The proposed reform is about ensuring that honest, rational and careful directors are able to carry out their oversight responsibilities and make sound business decisions without undue concern for personal liability. Directors who act dishonestly, irrationally or for an improper purpose will *not* be able to successfully rely on the Defence.

7. *Can you give an example of a tangible benefit for direct shareholders or superannuation investors?*

Directors are continually required to make statements in relation to a listed company's activities, and increasingly so, in relation to its prospects going forward.

However, there is a significant risk that directors who provide such information could breach current provisions of either the Corporations Act or the Australian Securities and Investments Commission Act.

The Honest and Reasonable Director Defence would go some way towards resolving these concerns by offering directors a safety net against such allegations, which would in turn benefit direct shareholders and superannuation investors by giving them greater information about a company's activities.

There is an increasing demand from investors, regulators and others for more forward looking information about company affairs. This information has been sought out for the operating and financial review that forms part of listed companies' annual reports, and also

for inclusion in reports prepared according to a new global reporting framework known as Integrated Reporting.

The demand for more forward-looking information is also apparent in an ongoing debate about whether annual general meetings for listed companies should be discontinued or modified from their current format.

However, directors are often reluctant to disclose this information due to concerns that they could breach provisions of either the Corporations Act or the Australian and Securities and Investments Commission Act.

In this context, the Honest and Reasonable Director Defence could be used to defend allegations that a director has breached the misleading or deceptive conduct provisions or the continuous disclosure provisions of the Corporations Act.

For example, a director who is alleged to have breached a misleading or deceptive conduct provision by making a statement about a future matter without reasonable grounds would be able to defend themselves by either:

- showing that a statement about the future matter was made on reasonable grounds; or
- showing that at the time the corporation and/or the director made the statement, the director proceeded honestly, for a proper purpose and with the degree of care and diligence that the director rationally believed to be reasonable in all the circumstances.

Without such a safety net, directors will (on the basis of legal advice) continue to be reluctant to make statements as to future matters.

8. Would this defence have an impact on the broader economy? How does the lack of protection for directors hinder economic growth?

The Defence is just one measure which could help improve Australia's productivity as it transitions from an economy driven by a once-in-a-generation mining boom to one driven by other factors.

We believe it could contribute to economic growth by giving directors the leeway to take appropriate business risks that would stimulate investment and, ultimately, provide more jobs for Australians.

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Currently, the lack of adequate protections for honest, hard-working directors creates a risk-averse corporate environment in which directors are reticent to make significant decisions that may benefit the economy.

Our twice-yearly Director Sentiment Index (DSI) highlighted this mindset by identifying the following concerns in the first half of 2014:

- 70 per cent of directors stated that there was a risk averse decision-making culture on Australian boards;
- 62 per cent of directors stated that the risk of personal liability caused them to frequently or occasionally take an overly cautious approach to business decision-

making; and

- 49 per cent stated that director liability legislation reduced their willingness to accept new board appointments.

The lack of an effective broad legal defence for directors also puts Australia at a competitive disadvantage compared to other developed countries.

In other countries, honest directors are able to confidently perform their roles knowing they have the benefit of a broad business judgment rule and other effective legal defences. Courts in other developed nations are also very reluctant to second guess the decisions honestly and properly made by directors on business and governance matters.

9. The wording proposed for the Honest and Reasonable Director Defence is subjective. Doesn't that make it an unsatisfactory test?

Only one element of the proposed Honest and Reasonable Director Defence is subjective. All other elements of the Defence are objective.

A director must prove that he or she believed the degree of care and diligence they exercised in relation to a matter was "reasonable". The court will then *objectively* determine whether that assessment was rational.

10. Would previous cases such as the James Hardie and Centro cases be decided differently if this defence applied?

It is not possible to say whether the outcomes of previous cases would be different if the Honest and Reasonable Director Defence had been in place.

This is because previous cases were decided on the basis of the current law and the arguments put to the courts in those cases were designed to reflect that law.

It is also important to understand that our proposal is not a response to a particular case. It is about creating an environment where hardworking and honest directors can create and run productive businesses - it is not about absolving those who are dishonest or act improperly.

It is not possible to conclusively determine whether the outcomes of previous cases would be different if the Honest and Reasonable Director Defence had been in place.

This is because the matters considered by courts in recent cases have been framed by the causes of action pleaded, the arguments put forward to courts and because they have been decided on the basis of the law as it currently stands.

In any legal proceeding where the Honest and Reasonable Director Defence was to be used directors would need to prove each element of the Defence. Depending on the evidence presented, a court may or may not, decide that a director has made out the Defence based on the facts of the particular case.

It is also important to understand that our proposal is not a response to a particular case. It is a response to a number of corporate operating and regulatory pressures facing directors. The reform proposal is about creating an environment where hardworking and honest directors can create and run productive businesses, it is not about absolving those who are dishonest or act improperly.

11. Does the Honest and Reasonable Director Defence lower the bar or water down the laws for directors?

If adopted, the Defence would not alter the primary duties and obligations of directors.

The proposed provision is a safety net for honest and committed directors. It is not a re-definition of the standards of governance applicable to directors in Australia.

If adopted, the Defence would not alter the primary duties and obligations of directors. Only one legislative amendment, the insertion of the Defence would be required. No other changes would be made to the Corporations Act or the Australian Securities and Investments Commission Act.

The proposed provision is a safety net for honest and committed directors. It is not a re-definition of the standards of governance applicable to directors in Australia.

We are of the view that our system of regulation needs to actively create an environment where directors who act with integrity and commitment can pursue and harness new opportunities, drive performance and create jobs. The Defence is one step on the road toward achieving this. Directors who act dishonestly, irrationally or for an improper purpose would not be able to rely on the Defence.

We are committed to directors and boards achieving world-leading performance. We believe this can be achieved through a strengthening of the quality of governance; the proposed Honest & Reasonable Director Defence is designed to contribute to this goal.

12. Do you have real-life examples, or evidence beyond your survey results, to prove the need for reform?

The Honest and Reasonable Director Defence was not designed to address a particular example or case. It is an attempt to change a wider systemic issue, being the culture of risk aversion in our boardrooms, operating and regulatory environment. This culture has grown from a number of pressures on directors.

The analysis in our full law reform proposal on this issue explains why the current legal regime does not always appropriately support the directors, the innovators and the drivers of growth.

The data gained from surveys and the Director Sentiment Index also continues to be relevant because directors' perceptions are critical to driving behaviour and business decision-making.

13. Your proposal does nothing to address director liability issues in state legislation. Why not?

Company Directors has undertaken a significant amount of work on state director liability reform. Our work in this area targeted specific flaws evident in state legislation.

As a result of our efforts, there has been substantial reform - particularly in Queensland, NSW and Victoria. In Queensland, for example, approximately 86 per cent of the director liability provisions which failed to uphold the presumption of innocence for directors have now been amended or repealed. Further reform is anticipated.

While our work on state laws continues, the Honest and Reasonable Director Defence is designed to improve federal legislation.