Sections 181 and 189 of the
Corporations Law
and
Directors of Corporate Group Companies

by

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Sections 181 and 189 of the Corporations Law

In June this year, 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 reported to the Minister in October.

Duty of good faith

The provision

Clause 181 (duty of good faith) of the original CLERP Bill was amended in the Senate 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. 1

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 19992 considered that s 181, as enacted, 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 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* reached 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 Advisory Committee considered that the language of s 181(1)(a), as enacted, was 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. 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 then 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, set out in s 180(2), thereby comply with the duty of care and diligence. However, these directors may not necessarily satisfy the separate duty of good faith in s 181.

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.

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

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5 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”. 

corporation. For instance, directors of a target company that is subject to a hostile 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 Advisory Committee considered that 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

Clause 189 of the original CLERP Bill was amended in the Senate 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 s189 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 made 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 made the following observations:

“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. Rather, it is suggested that what the section contemplates is an analysis of the

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7 Butterworths, 2000, at para 2.18.
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 referred 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

The Advisory Committee noted that 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 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 considered 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 therefore recommended 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 noted 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 considered 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.

Summary

While supportive of the principles in ss 181 and 189, the Advisory Committee suggested 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”.

Corporate Group Management

The Corporate Groups Final Report discussed whether and under what conditions the directors of a group company may subordinate the interests of that company to the overall interests of the parent company or the corporate group collectively.

The problem in practice

In Australia, the directors of a group company owe fiduciary duties to that company, including to act in good faith for the benefit of that company as a whole. Those directors may also wish to make decisions and act for the corporate group’s overall benefit. This may place them in the dilemma of seeking to balance their fiduciary duty to their group company and the interests of creditors of that company against the possibly competing economic goals or needs of the corporate group collectively.

In practice, this problem may particularly arise with intra-group transactions, such as where one group company lends funds to another group company on uncommercial terms, provides a guarantee, or mortgages its own assets, to support a loan taken out
by another group company, or transfers assets on uncommercial terms to another group company.

From a purely economic perspective, it may be logical for directors of a group company to adopt a group enterprise approach in making decisions. However, this may detrimentally affect minority shareholders of partly-owned group companies, particularly where intra-group transactions involve a considerable degree of financial sacrifice by their own group company. These transactions may also affect the unsecured creditors of particular group companies.

**Current law**

Under current Australian law, directors of a wholly-owned group company may act in the interests of the holding company under certain conditions. However, directors of a partly-owned group company may only enter into intra-group dealings if their company derives some direct or derivative commercial benefit. To that limited extent only, directors of these companies may consider the wider corporate group interests without breaching their fiduciary duties.

**Advisory Committee response**

The Advisory Committee considered that directors of partly-owned group companies should have greater flexibility to act in the overall interests of the corporate group. The Report recommended that directors of a partly-owned group company be permitted to act in the interests of the holding company, if:

- the constitution of the partly-owned group company so permits, and
- the minority shareholders of that group company pass an ordinary resolution authorising the directors to exercise their powers in the interests of the holding company.

However, the directors may exercise the power only if it does not materially prejudice the company’s ability to pay its creditors.

The possible benefits of this authorisation approach are:

- to protect directors of a partly-owned group company who wish to act in the overall corporate group interest, but where there is no clearly discernible direct or derivative commercial benefit to their own company. The authorisation approach lays down specific procedures to achieve this “safe harbour”,

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8 Section 187 of the Corporations Law provides:
   “A director of a corporation that is a wholly-owned subsidiary of a body corporate is to be taken to act in good faith in the best interests of the subsidiary if:
   (a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and
   (b) the director acts in good faith in the best interests of the holding company; and
   (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director’s act.”.

9 The Australian case law is discussed in detail in Chapter 2 of the Corporate Groups Final Report.

10 Corporate Groups Final Report Recommendation 3.
• to improve financial efficiency in some corporate groups by permitting the group to fully utilise all its resources and borrowing capacity in financing the group’s operations, and

• to better protect lenders to a corporate group, particularly where they seek a guarantee or security from a partly-owned group company to support a loan by another group company. Currently, under Australian law, these guarantees or mortgages may be unenforceable if the lender had actual knowledge that the directors of a partly-owned group company were breaching their fiduciary duties in entering into them.

The Advisory Committee recommendation requires authorisation by a simple majority of those minority shareholders who actually vote on the resolution. This raises the further issue of whether, in the event of authorisation, any minority shareholders who voted against the resolution, or failed to vote, should have the right to require the company to buy their shares at a fair price (“sell-out” rights).

The Advisory Committee recommended that any minority shareholder who did not vote in favour of the authorisation be given sell-out rights. The initiative to seek an authorisation would invariably come from the corporate group controllers or the directors of the partly-owned group company. These persons could assess in advance the financial consequences of seeking that authorisation, including the likely costs involved in minority shareholders exercising the sell-out right.

The procedure recommended by the Advisory Committee for exercising this sell-out right has the following key elements.

• Notification of sell-out rights. A company would be obliged to notify all minority shareholders who did not vote in favour of an authorising resolution of their sell-out rights within a prescribed period following that resolution.

• Time for exercise of sell-out rights. Eligible minority shareholders could exercise their sell-out rights within a prescribed period of receiving the notice. To permit eligible shareholders to exercise that right at any subsequent time could create a long-term contingent liability for the company or the controlling shareholder.

• Valuation of shares. The same fair value test would apply as with compulsory acquisitions, that is, to value the shares against the company as a whole, excluding any premium or discount for the shares being minority shares. The company would be required to include a sell-out price, together with an independent expert’s report, in the original notice to eligible shareholders. Minority shareholders could seek a court appraisal in the event of any dispute over fair value.11

Conflicts of duty

The Corporate Groups Final Report also examined the possible conflicting fiduciary duties of a person who is a director of two or more partly owned group companies. That person may receive confidential price-sensitive information as a director of one group company, which is also relevant to the affairs of a second group company of which that person is also a director.

A director in these circumstances is faced with a potential conflict between the fiduciary duty of confidentiality to the first group company, and the fiduciary duty of disclosure to the second group company. To disclose the information to the second group company may prejudice the interests of the minority shareholders of the first group company. However, to withhold the information may be detrimental to the minority shareholders of the second group company. The Advisory Committee considered that one fiduciary duty should not take precedence over the other. Instead directors should take steps to avoid placing themselves in this position of conflict.¹²

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