BUSINESS JUDGMENT RULE: DIRECTORS' SAVIOUR FROM THE LEGAL QUAGMIRE

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ABSTRACT

This paper aims to examine the business judgment rule relating to decisions made by company directors. When business decisions result in monetary and reputational losses, more often than not, the directors would be held liable for these unfortunate consequences. As such, the fear of the unknown consequences in decision-making may be inhibiting many directors. The effect of their fear could inevitably affect corporate investment and development, and in the long-run would stifle the economy. This paper examines the traditional duty of care and skill of directors, and charts its transformation into a statutory form. It will then examine further statutory improvements, which is the business judgment rule. It is contended that this rule which affords protection to directors who have made honest decisions, will provide the necessary balance between greater accountability and economic efficiency. For the purpose of this paper, the authors adopted a doctrinal legal approach in which the secondary data, comprising of primary sources involving the Companies (Amendment) Act 2007 and the Companies Act 1965 are analysed. Also, secondary sources including decided cases, official reports, articles in academic journals, on-line databases and Internet sources are examined. The expected outcome of this research would be to provide some insights into the legal protection for company directors in the Malaysian corporate sector via the business judgment rule.

***Keywords**: Corporate Governance, Directors, Duty of Care, Business Judgment Rule, Negligence, Good Faith*

Introduction

One of the major factors that contribute towards the stability of any nation's economy is the drive and efficiency of companies that are steered by capable board of directors. A company, being an artificial entity, is managed by directors who are appointed by the members of the company in the general meeting. The members, however, may not interfere with the powers endowed upon the directors by the company's articles, except for the general meeting's residual powers of management. No problems normally arise in small companies, where the members are the directors, and are thus, usually protective of their own investments. However, in larger companies, where the members are faceless and mostly unknown, the directors have, in theory, a free rein in managing the company's affairs. They are there to strategise and ensure that the company earns profits that the investors look for, or they could neglect the company, or even worse, falling to temptations and abusing their position to the company's detriment, and to a larger extent, cause chaos to a country's economy. The failure of corporate leadership is one of the causes of the economic crisis not only in the United States but also globally in 2009. To ensure that directors fulfil the objective of their appointment, the courts have enforced corporate governance mechanisms to monitor and control company directors. Directors are accountable for their exercise of their powers in managing corporate assets. Traditionally, common law and equity has imposed fiduciary duties and duties of care and skill on the directors to keep them in check. Over time, the Companies Act has codified these duties in order to improve the corporate governance mechanism. This paper intends to examine the traditional duties of care and skill imposed on directors, its development into statutory duties, and to what extent the newly introduced business judgement rule may insulate company directors from liability.

Traditional Duty of Care and Skill

Generally, directors have fiduciary duties to act in good faith or *bona fide* in the interest of their companies. Besides, directors also owe duties of care, skill and diligence to the company. Romer J. in the leading case of *Re City Equitable Fire Insurance Co Ltd* [1925] laid down the standard of care and skill expected of directors. In this case, the liquidators of the failed insurance company sued the directors for negligence, in particular, for allowing the company to lend substantial funds on an unsecured basis to its chairman and managing director. The directors had been making imprudent investments and also paying dividends out of capital. Romer J. found that there was negligence, but the directors were saved by an exclusion clause for negligence in the company's articles, a clause that is no longer lawful today. The judge in this case came to the conclusion that a director must act honestly in discharging the duties of his position, and must also exercise some degree of both skill and diligence, and so long as a director acts honestly, he cannot be made responsible unless he is guilty of gross or inculpable negligence in a business sense.

Romer J. made three propositions which were upheld by the Court of Appeal, but which since have been subjected to numerous criticisms. Despite these criticisms, the legal principle is still applicable to a certain extent today and formed the core of the law on duties of care and skill. The standards of skill were subjective as a director need not exhibit a greater degree of skill than may reasonably be expected from a person of his or her knowledge and experience. This means that there is no minimum standard of skill set for a director. A director has to act with care as can be expected from them basing on their knowledge and experience. Less skill is expected from a director who is inexperienced and naive. On the other hand, if a person is chosen because of the knowledge, skill and experience that he possesses, then the standard expected of him would be higher.

If a director based on his knowledge and experience makes a mistake, he is not in breach of his duty, and, therefore, not liable. Neville J. held in *Re Brazilian Rubber Plantations and Estates Ltd* [1911], that, directors who set about to manage a rubber company without knowing anything about the rubber industry were not liable for losses arising from rubber speculation. The reasonable standard required of a director was simply as to how he would take care of his own affairs. This means that if a director takes care of the company's affairs in the same way he takes care of his own affairs, he will not be liable. The company can only take action against him where he runs the company in a way that a reasonable man would not do in his own affairs. Amongst others, a reasonable person would make reasonable inquiries when asked to enter into certain transactions on behalf of the company, such as the signing of cheques. In *Re Railway & General Light Improvement Co.* [1880] or known as the *Marzetti's Case*, the court found a director negligent for signing cheques without knowing what the money was for and without making inquiries which a person in his position would have made.

In the light of current circumstances, Romer J.'s proposition as stated above, however, have been qualified. As business people today are normally sufficiently educated and qualified, several cases have suggested that the proposition would be applicable to non-executive directors. As for the executive director, minimum objective standards must apply. The standard of care expected of them will depend on the nature of their duties. In *Norman v Theodore Goddard* (1992), a solicitor fraudulently advised a director to invest the company's surplus funds offshore in companies under the solicitor's control. When the solicitor misappropriated the funds, the director was sued for negligence. He was not made liable as the judge said: "A director who undertakes the management of a company's properties is expected to have reasonable skill in property management, but not in offshore tax avoidance. In considering what a director ought reasonably to have known or inferred, one should also take into account the knowledge, skill and experience, which he actually had, in addition to that which, a person carrying out his functions should be expected to have.

The second proposition by Romer was that, a director is not bound to give continuous attention to the affairs of the company as his or her duties are of an intermittent nature, to be performed at periodic board meetings. This general proposition has been qualified in some situations. In *Re*

Denham & Co. [1883], although a director who had not attended a board meeting for 5 years escaped liability for the fraud of his co-directors, the judge found him guilty of negligence in not attending the meetings, and so refused to pay him his costs. In *Dorchester Finance Co. Ltd. v Stebbings* [1989], three directors of the company, including two inactive members who had acted bona fide throughout, were made liable for losses incurred when unsecured loans were made which turned out to be irrecoverable. The court held that it was unacceptable for directors not to attend board meetings or to take any active interest in the company's affairs.

Such proposition that a director is not bound to give continuous attention to the affairs of the company is not applicable to executive directors, who are usually appointed under service agreements, which would require them to give their exclusive attention to the affairs of the company. In *AWA Ltd. v Daniels* [1992], the court found the chief executive officer liable for negligence for not having made the proper inquiries based on the auditor's report. The non-executive directors, however, had been found not negligent. In the absence of information to the contrary, they were entitled to assume that the auditors had detected any irregularities.

Romer's third proposition was that, in the absence of grounds for suspicion and given the exigencies of business, a director is justified in trusting a person to whom a duty has been delegated, to perform such duties honestly. This proposition allows a director to delegate his powers for practical commercial reasons. Non-executive directors may safely delegate their power to the executive directors. In the absence of any reasonable grounds for suspicion, directors may trust the officials of the company to carry out their duties as entrusted by the directors. In *Huckerby v Elliott* [1970], a director of a gaming club was held not negligent in failing to check whether the club had the appropriate license when the task of obtaining it had been delegated to someone else. Similarly, in *Dovey v Cory* [1901] the director of a banking company was held to be not negligent in relying on the assertions of the chairman and general manager of the company, whose integrity, skill and competence he had no reason to doubt. They had, in fact, improperly paid dividends out of the capital and had given advances on improper security.

Directors, however, cannot blindly accept all that is placed before them. In *Dorchester Finance Co. Ltd. v Stebbings*, (supra) the court would not allow the non-executive directors with accounting experience to rely on the auditors' report without doing anything themselves. The task of managing a company may sometimes require the directors to delegate their power to experts, in particular areas, such as obtaining the legal opinion of a lawyer pertaining to some documents. Where the directors need to delegate, but they do not do so, they may be held negligent. In *AWA Ltd. v Daniels* (supra), the judge held that in complex situations, which need specialist knowledge, a director may be required to seek and rely on expert or professional advice. If the directors do not get the necessary assistance when such a need arises, they may be guilty of negligence and in breach of their duty.

The Statutory Duty of Care

Position Prior to the Companies (Amendment) Act 2007

The duty to act with care and skill is derived from common law. Prior to the 2007 amendment, Section 132(1) of the Companies Act 1965 is silent as to the standard of care, and skill required of a director. It merely prescribes that a director has a duty 'to act honestly and use reasonable diligence'. However, in New Zealand, s.137 of the New Zealand Companies Act 1993 requires a company director to carry out his directorial functions with such care, skill and diligence that would be exercised by a reasonable director. In the UK, the law moved towards an objective assessment of the standard of care required of directors as reflected in s.174 of the UK Companies Act 2006 which codified *Norman v Theodore Goddard*. However, despite these developments, the position in Malaysia remained as in *Re City Equitable Fire Insurance* as the court in *Abdul Mohd Khalid v Datuk Haji Mustapha Kamal* (2003), had cited *obiter Re City Equitable Fire Insurance* as the applicable authority for directors' duty of care and skill.

In 1999, the High Level Finance Committee Report on Corporate Governance realising the importance of the issue, recommended the amendment of s.132 (1) to incorporate the duties of skill and care of directors to the existing duty of using reasonable diligence. The committee recommended that the section "should not be amended to clarify that the standard of care imposed, is with reference to the particular circumstances of the director". This is because the law on non-executive directors is already well settled, and clarifying the standard may "impede the development of a higher standard of care being practised by directors."

Post 2007 Amendment situation

Section 132 (1A) of the 1965 Act now provides that a director of a company shall exercise reasonable care, skill and diligence with: (a) the knowledge, skill and experience, which may reasonably be expected of a director having the same responsibilities; and (b) any additional knowledge, skill and experience which the director, in fact, has. This is more reflective of the current position where a director who has additional knowledge, skill and experience, will be assessed against a reasonable person who has that additional knowledge, skill and experience. The actual knowledge and experience of a director is to be considered, in addition to the minimum standard. This provision now imposes different degrees of care and diligence on directors, depending on the company, the position they hold and the responsibilities they bear.

The Business Judgment Rule

The Companies (Amendment) Act 2007 that had extensively codified the directors' fiduciary duties and duties of care, skill and diligence also introduced a statutory business judgment rule, similar to the Australian legal position in section 180(2) of the Corporations Act 2001. The rule affords protection for directors from liability where they have acted in good faith, with due care, and not exceeding their authority. This rule evolved to find a balance between greater accountability and search for economic efficiency. This rule prevents the courts from questioning the merits of honestly made business judgments by directors, who had after reasonable investigation, in good faith without personal interest, reasonably believe that they are acting for the company's benefit. Laguado Giraldo(2006) explained that there are two reasons for the necessity of a business judgment plan; first, being the inadequacy or incapability of the courts to review business decisions, and second, the absence of an objective standard by which the correctness of the corporate decision may be measured. Section132 (1B) of the 1965 Act provides that a director who makes a business judgment is deemed to meet the requirements of the duty under subsection (1A), and the equivalent duties under the common law and in equity if the director : (a) makes the business judgment in good faith for a proper purpose; (b) does not have a material personal interest in the subject matter of the business judgment; (c) is informed about the subject matter of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and (d) reasonably believes that the business judgment is in the best interest of the company.

Section 132 of the 1965 Act defines business judgment to mean: 'any decision on whether or not to take action in respect of a matter relevant to the business of the company'. This would mean that the director would be protected only where the decision made is related to that company's business. From this definition, it appears that there must be a decision to do or not to do something, and not about merely doing nothing (Ruzita Azmi, Adilah Abd Razak, 2012). Sujata Balan (2008) agreed that the wording of the definition is intended to include acts, as well as omissions in relation to business decisions. The courts have always acknowledged the wisdom of the corporate leaders in managing their companies and have been reluctant to interfere, unless the decision has been tainted with improper motives, or was not made bona fide in the interest of the company (Samsar Kamar, 2007).

It is interesting to note that the United States developed the business judgment rule based on the American Law Institute's formula, whereby if a director has made a genuine business judgment in good faith, he will be protected from liability for negligence even if these judgments turned out badly. The rationale behind the reluctance of the court to interfere with the judgment of the directors in the area of commerce is not only to protect the directors in their business decision-making, which are honestly made, but also to avoid the risk of repressing creativity and enterprising business activity. As such, directors would be allowed the freedom to move the company to greater heights, but within 'a framework of effective accountability', whilst at the same time fulfilling the investors' desire for the directors, instead of the courts, to administer the company in which they have made investments.

In the wake of the financial crisis in the United States, the New York Supreme Court in the case of *In re Bear Stearns Litigation No. 600780/08 (2012)* extended this rule to protect the board of directors of Bear Stearns where Justice Cahn applied the business judgment rule to the extraordinary circumstances of the financial crisis. The rule was also applied in *Ehrenhaus v. Baker et al., No. 08 CVS 22632 (2008)* where the court refused to guess the directors' informed decisions, made in good faith under the financial and governmental pressures. The decisions of these two cases confirm that the board of directors who had sought the right assistance to inform themselves, and act in good faith will not suffer for their decisions, even where those decisions have been made under circumstances considered extraordinary.

In Malaysia, the High Court in *Mohd Shuaib Ishak v Celcom (Malaysia) Berhad [2011]*, had said that the rule was inapplicable and that it has the discretion to interfere with the decision of the management in this case. However, on appeal in *Celcom (M) Bhd v Mohd Shuaib Ishak [2011]*, the court decided that the decision of a Committee of Independent Directors was an exercise of the prudent business judgment rule by a completely honest and disinterested section based on independent legal advice. In the recent Malaysian case of *Mega Education Systems Sdn Bhd & Anor v Ozone Glass Design Sdn Bhd & Ors(2011)*, the High Court also showed its refusal in interfering with the company directors' wisdom on business and management decisions. The court had said, "When hard-nosed businessmen enter into an investment opportunity, they have to expect a risk of loss, as well as an expectancy of profits. The court cannot be expected to provide an exit mechanism for them when an investment turns sour. As is sometimes said, the court cannot be expected to conduct a judicial review of business judgments." The courts do not want to superimpose their views on the directors' business judgment (Sujata Bala, 2008).

Conclusion

The High Level Finance Committee on Corporate Governance in 1999 has recommended the adoption of the business judgement rule, after having observed such a rule that protected directors in the United States and Australia. Malaysian company directors, who previously would be liable for corporate losses, now would have a statutory defence when business decisions they made have caused corporate losses, provided they have made such decisions related to their business with reasonable care, skill and diligence. The Malaysian courts have acknowledged the business judgment rule within the meaning of s.132 (1B) as can be gleaned from the recent courts' decisions, and have emphasised that the directors will only be protected over a business judgment that has gone wrong if they had exercised their judgment with responsibility, honesty and in the best interest of the company. The primary motive behind the business judgment rule is to give company directors enough room to make necessary corporate decisions, without being subjected to judicial scrutiny so as to encourage a healthy investment climate, thus a strong economy. The investment climate may suffer if the directors are held back by the fear of making wrong decisions, which may open them to threats of legal action. If "they feared taking those commercial risks shareholder returns would be lessened, the market would respond, and the directors would be forced to leave their jobs." Apparently, in the modern corporate environment, the business judgment rule has now become a protective arm shielding corporate decisions-makers when reasonable diligence and care have been exercised.

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