

# Director's Duties – The Introduction of the Business Judgment Rule in Papua New Guinea

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## Key Points

- The *Companies (Amendment) Act 2014* (“CAA”) introduced the business judgment rule in PNG
- The business judgment rule provides indemnity from civil suit for directors and other officers for business decisions made in their official capacity.
- Directors need to be familiar with their duties and rights under the law, to ensure they continue to discharge their duties correctly and shield themselves from potential litigation.

## Introduction

Directors need to make business decisions all the time. But what happens if that business decision turns out to be wrong and results in a civil suit against the director? What protection does he or she have for making the business decision in the first place?

The *Companies (Amendment) Act 2014* was certified on 5 September 2015 and came into effect on 30 January 2015. Amongst other changes, the amendment introduced the, ‘business judgment rule’, which affects the way directors and other company office holders make decisions in the discharge of their respective duties to the Company. Section 115(2) introduced the business judgment rule which is in the same form as is found in Australia’s *Corporations Act 2001*. Although the business judgment rule is yet to be tested before the courts in PNG, directors and other officers need to understand what the business judgment rule is and what steps that they need to take protect themselves to avail themselves of the protection that the rule provides.

## What is the business judgment rule?

A director must exercise his or her powers and discharge their duties with a degree of care and diligence that a reasonable person would exercise.<sup>1</sup> The phrase, “*business judgment*” means, any decision to take or not to take action in respect of a matter relevant to the business operations of the company<sup>2</sup>.

The business judgment rule operates as a defence for all directors and other officers who comply with the principles of exercising business judgment in the making of a business decision. In order to be protected by the business judgment rule, a director or other officer must:

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<sup>1</sup> *Companies Act 1997* (PNG) s 115 (1)

<sup>2</sup> *Companies Act 1997* (PNG) s 115 (5)

- Make a business judgment in good faith for a proper purpose;
- Not have a material personal interest in the subject matter of the judgment;
- Reasonably believe they were appropriately informed about the subject matter of the judgment; and
- Rationally believe the decision was in the best interests of the company.<sup>3</sup>

Directors should be aware that establishing the defence is not a straightforward matter. As the section 115(2) defence remains untested before PNG courts, it is useful to look to Australian jurists for clarification on what constitutes business judgment.

In Australia, the defence has been applied with great difficulty. For example, in one case a CEO was unable to back a business decision with credible evidence to the effect that he rationally believed it was in the best interest of the company.<sup>4</sup> While, in another case, a director was unable to use the defence as he had a material personal interest in the business decisions because he owned shares in the company.<sup>5</sup>

However, if the requirements are met, a director or other officer is taken to have fulfilled their duties in compliance with section 115 (1), at common law and in equity and will be afforded a full defence against any civil claim brought as a result of the decision.<sup>6</sup> Compliance will indemnify against possible action from shareholders, other office holders, the regulator and the business itself when looking at care and due diligence requirements.

The defence has only been successful in Australia where the business judgment was made with an underlying financial basis, such as, the acquisition of another company.<sup>7</sup>

## How will the rule affect directors and other office holders?

With this added protection comes an increased obligation that directors and other office holders strictly adhere to the principles of making a reasonable business decision as outlined above. In order to establish the defence, the office holder must prove that they have made a business decision with care and due diligence.<sup>8</sup> This means the director must always be aware of the legal effects of their decisions and always have the requirements of section 115 (2) in mind when exercising business judgement.

Australian case law clearly defines a 'business judgment' as a decision to take or not take action in respect of matters relevant to the business operations of the corporation.<sup>9</sup> Since commencing operation in 2001, the business judgment rule has only been used successfully in relation to financial decisions.<sup>10</sup> Australian courts have narrowed the application of the business judgment defence to certain provisions of the legislation.<sup>11</sup> However, what is helpful for a PNG director is that Australian

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<sup>3</sup> *Companies Act 1997* (PNG) s 115(2).

<sup>4</sup> *ASIC v Macdonald (No 11)* (2009) 71 ACSR 368 per Gzell J at 457.

<sup>5</sup> *ASIC v Adler* (2002) 41 ACSR 72 per Santow J at 172.

<sup>6</sup> *Companies Act 1997* (PNG) s 115(2).

<sup>7</sup> *ASIC v Rich* (2003) 44 ACSR 341 per Austin J at 349.

<sup>8</sup> *ASIC v Rich* (2003) 44 ACSR 341 per Austin J at 351.

<sup>9</sup> *ASIC v Mariner Corporation Limited* (2015) 106 ACSR 343 per Beach J at 428.

<sup>10</sup> *ASIC v Mariner Corporation Limited* (2015) 106 ACSR; Australian Institute of Company Directors (2014), "The Honest and Reasonable Directors Defence", *Australian Institute of Company Directors*.

<sup>11</sup> Australian Institute of Company Directors (2014), "The Honest and Reasonable Directors Defence", *Australian Institute of Company Directors*, pp 6-7,

[http://www.governanceinstitute.com.au/media/681519/the-honest-reasonable-director-defence-a-proposal-for-reform\\_august-2014\\_f.pdf](http://www.governanceinstitute.com.au/media/681519/the-honest-reasonable-director-defence-a-proposal-for-reform_august-2014_f.pdf), accessed 17 October 2016.

case law has also clarified some other possible examples of where the exercise of a 'business judgment' may be effectual, for example in the following instances:

- Decisions that are preparatory to the making of a business decision;
- Decisions relating to corporate personnel;
- Decisions relating to the termination of litigation;
- The setting of policy goals;
- The apportionment of responsibilities between the board and senior management; and
- Decisions about planning, budgeting and forecasting.<sup>12</sup>

Directors should note that not all decisions will be business judgments, even when made by a person in their official role. Generally, excluded decisions are those that contravene requirements under other enactments.<sup>13</sup> For example, non-compliance with disclosure requirements may be taken to be a decision with regards to disclosure compliance, and not be a business judgment even where there is a financial basis for the decision.<sup>14</sup>

## What's does this all mean for directors and other officers?

There is always going to be an element of risk when directors make decisions for the Company. The change to the *Companies Act 1997* is not designed to curtail risk taking but it does provide a framework so that directors understand the elements of what they need to think about when making a 'business judgment'. By adhering to the framework, directors can avail themselves of the protection afforded by section 115 (2).

There are lessons to be learnt from the Australian case law examples and these can serve as useful guides in determining a course of action when a director is contemplating the exercises of business judgment.

This article is intended to be an outline of the basics under the business judgment rule, and is not legal advice. Directors and other office holders should obtain further legal advice regarding their duties and obligations.

For more information on how the defence or any other director's duties apply to you, please contact Paul Toua.

## Contact

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<sup>12</sup> *ASIC v Rich* (2003) 44 ACSR 341 per Austin J at 340-341.

<sup>13</sup> *ASIC v Healey* (2011) 83 ACSR 484 per Middleton J at 526; *ASIC v Mariner Corporation Limited* (2015) 106 ACSR 343 per Beach J.

<sup>14</sup> *ASIC v Healey* (2011) 83 ACSR 484 per Middleton J.