

CLASS 14-17 - DIRECTORS + OFFICERS DUTIES

Duty to Act in Good Faith and for a Proper Purpose

Derives from:

1. Equity (eg duty of loyalty and good faith)
2. Common Law (duties under contract law)
3. Statute (eg duty to avoid insolvent trading)

S185 → Duties overlap

- One action may render them liable to civil and criminal action

'Fiduciary' Duties

- Duties owed to the company by directors and other senior officers
- Fiduciary refers to notion of trust and confidence
- 2 categories:
 - Loyalty and good faith; and
 - Skill, care and diligence

Hospital Products Ltd v US Surgical Corp (1984)

A fiduciary agrees to act for, or on behalf of, or in the interests of another person the exercise of a power or discretion that will affect the interests of that other person in a legal or practical sense

WHO OWES these duties:

- Statutory obligations apply to directors and officers and sometimes employees
 - (and former directors, officers and employees)
- S9 → director and officer
 - Includes de facto and shadow directors
 - 'Officer'
 - Makes, or participates in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
 - Who has the capacity to affect significantly the corporation's financial standing; or
 - In accordance with whose instructions or wishes the directors of the corporation are accustomed to act

TO WHOM these duties are owed

Percival v Rights 1902

'Directors owe their fiduciary duties to the company as a whole, not individual shareholders'

Facts:

- Directors agreed to buy shares from shareholders, including Mr Percival, at 12.5 pound each
- Directors had been negotiating the sale of the whole company at far more than 12.5 pounds per share
- Directors did not disclose these takeover negotiations with shareholders
- Mr Percival claimed breach of fiduciary duty

Issue: Did the directors owe a fiduciary duty to the shareholders?

Court:

- Directors owe duties to the company and not shareholders individually
- Although the 'company as a whole' is usually considered to comprise the body of shareholders, directors do not owe duties to any individual shareholder

The Bell Group (in liq) v Westpac Banking Group 2008

Reiterates Percival point

Foss v Harbottle 1843

Duties are owed to the company as the company is the proper plaintiff

- Any profits recovered via a shareholder derivative suit will be recovered for the company

DUTY 1 - Director's Duty to Act in Good Faith for the Benefit of the company and for a Proper Purpose

Where a party has a position of power over another party → law requires the former to act in the latter's best interest

- Directors have a fiduciary relationship with a company → therefore subject to duties
- Duties can expand to officers and employees
- Duties can be shaped by company internal rules (Ie Constitution)

Elements:

1) Bona Fide or in Good Faith

- i) honestly, with the best of intentions (subjective test); **or**

- ii) genuinely, in the sense that the action was not distorted by some irregularity or impropriety (objective test)

Re Smith v Fawcett 1942

‘Fiduciary duty to act bona fide is generally interpreted subjectively’

Facts:

- A private company’s constitution provided that:
 - The directors may, at any time in their absolute and uncontrolled discretion, refuse to register any transfer of shares
- Company’s 2 directors, S and F, held all the issued shares
- F died and his son (Executor of his will) sought to have his shares registered in his name
- S refused to register all the shares but offered to buy ½ of the shares from him and register the transfer of the remaining shares

Issue: Could S be compelled to register all the shares in the son’s name?

Court:

- Appeal dismissed
- S had the power to refuse to register the transfer of any shares
- Directors must exercise their discretion bona fide in what they consider is in the interests of the company (NOT what the court considers to be in the interests), and not for any collateral purpose
 - Subjective good faith
 - This is a necessary but not sufficient condition for validity

Confirmed in Bell Group Ltd (in liq) v Westpac Banking Corp 2008

Hutton v West Cork Railway Co 1883

- Bona fide cannot be the sole test, otherwise you might have a lunatic conducting the affairs of a company

Australian Metropolitan Life Assurance Co Ltd v Ure 1923

Facts:

- A minority shareholder (ure) purchased additional shares and sought to have the share transfer registered by the company → refused by directors
- Company’s internal rules:
 - Directors may refuse to register any transfer of any shares without assigning any reason thereof

Court:

- Upheld board’s refusal to register the share transfers
- The onus of proving that the directors had NOT acted in good faith is on URE!
→ who failed to discharge that onus
- The power in the constitution to refuse to register shares must be exercised
 - Bona fide → for the power for which was conferred, not arbitrarily or at the absolute will of the directors, but honestly in the interests of the shareholders as a whole

If a company’s constitution provides power to refuse to register share transfers, the only condition on the exercise of that power is that it must be exercised in good faith

2. For the benefit of the company
i) the corporators as a general body

Ngurli v McCann

Default rule: the phrase 'the company as a whole' does not mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body. No acting in self interest

Facts:

- C formed 4 companies for tax avoidance purposes and transferred 2k shares in Southcott Ltd to each company.
- The purchase price was an unsecured debt
- Each company had 61 issued shares, 1 controlling share held by C , 30 by his sister, and 30 by his niece (the McCanns)
- Each company received dividends from Southcott Ltd - used them to repay the unsecured debt
- C died and left 4 controlling shares in a trustee company, in trust, to his brother H
- Under the articles, the controlling share was lost (lost control) when it ceased to be held by C. It ranked equally with others.
- The trustee company took steps to transfer voting control to H
- H issued shares to trustee company in satisfaction of C's unsecured debt, on the understanding that the shares would be transferred to him

Issue: Whether H breached his duty to act bona fide in the best interest of the company as a whole

Court:

- Breached.
- Duty here = to act in the best interest of the shareholder as a whole (McCanns). H only acted in HIS best interest
- Also breaches proper purpose aspect of duty - he was not issuing the shares for any legitimate corporate purpose, such as to raise capital for the company - **merely to benefit himself and remove control of the companies from the McCanns**

- ii) present and future members

Gaiman v National Association for Mental Health

Facts:

- Scientologists (hostile to health treatment) had applied for membership of a mental health organisation
- The organisation's governing council invoked a power to expel members who were "known or reasonably suspected of being scientologists"

Court:

- In determining whether the directors had acted in the best interest of the company as a whole:
 - Phrase means interests of PRESENT AND FUTURE members of the association as a whole

- Council did not act in good faith in the interests of the association and members as a whole, since scientology posed a threat to the very basis of the organisation (eg loss of revenue, support later on etc)

iii) particular members

Coleman v Myers 1977

In some exceptional circumstances, fiduciary duties may be owed to individual shareholders

Facts:

- Chair and MD of a family company made a takeover offer of the company
- MD would buy out the company and after the takeover, he could use the company's assets to pay out the loans he would need to effect the takeover
- Chair and MD advised the shareholders to accept an offer to buy their shares at \$4.80 per share
- Minority shareholders who had opposed to takeover (but whose shares had been compulsorily acquired) argued that MD owed a fiduciary duty to disclose material facts to the individual shareholders

Court:

- Chair and MD had breached their fiduciary duties to individual shareholders
- Statements to shareholders (eg re retaining company assets when MD intended to sell them to pay off the cost of the takeover) amount to fraudulent misrepresentation
- Rejected per se: directors CAN sometimes owe a fiduciary duty to individual shareholders

Significant factors whether a fiduciary duty exists:

- Dependence on info and advice
- Existence of a relationship of confidence
- Significance of some particular transaction for the parties
- The extent of any positive action taken by or on behalf of the directors to promote a particular transaction
- The extent of inside knowledge of directors

Bunninghausen v Glavanics 1999

Facts:

- G and B (brothers in law) were both directors and shareholders in a family company
- After a disagreement, G took no part in the management of the company
- G agreed to sell shares of B at a price, which B knew was undervalued
- G was unaware that B had negotiated to sell the company to a third party for a higher price per share than B was offering to B
- G sold shares at agreed price; B then sold company at a great profit

Issue: Did B breach a fiduciary duty to G to disclose the proposed takeover?

Court:

- Sale did not involve 'the company', it involved only the other shareholder
- It was not possible to say that B only owed a duty to disclose information about other negotiations in which he was involved

- G was entirely dependent on B for information and advice about the transforming circumstance that negotiations were in hand
- B was in a position of great relative advantage to G
- G was almost totally powerless and B had the capacity to affect G's interests in a practical sense

iv) Creditors

When approaching insolvency or insolvent, must consider creditor as well as shareholder interests (ie a bar to shareholder ratification of breaches)

Kinsela v Russell Pty Ltd 1986

Facts:

- K family operated a funeral business through a company which included a type of insurance to cover the cost of funeral services
- The company signed a lease with the husband and wife (who were also shareholders and directors in the family company) to rent premises at a price substantially lower than market value
- This occurred when the company was clearly insolvent

Issue:

1. Did the directors breach their duties to the company by engaging in an uncommercial transaction that disadvantaged the company's creditors?
2. Could there be a breach of duty even though the company's shareholders approved the transaction?

Finding

- Directors acted in breach of their duties and could not as shareholders approve their own conduct due to the detriment it caused to creditors
- **Insolvency changed the interest of the company from shareholders to creditors**

Wimborne

Mason J: it should be emphasised that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors

Bell Group Ltd (in liq) v Westpac Banking Corporation [No. 9] 2008

In a solvent company, the proprietary interest of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise

Owen J: "it is, in my view, incorrect to read the phrases 'acting in the best interests of the company' and 'acting in the best interests of the shareholders' as if they meant exactly the same thing. To do so is to misconceive the true nature of the fiduciary relationship between the director and the company. And it ignores the other range of interests that might... legitimately be considered.

Spies v R (2000)

Facts:

- Spies was a director of Stirling nicholas, which owed various amounts to different creditors
- Spies caused Stirling Nicholas to purchase share in another company, which impaired its ability to repay its creditors
- Spies was prosecuted and convicted for the criminal offence of defrauding the company's creditors
- Spies appealed on the basis that he had no direct relationship to the creditors and could not therefore have defrauded them by the transaction

Issue: did Spies have an obligation as a director to refrain from acting to the detriment of the company's creditors?

Finding:

- Spies did not owe any duties to the company's creditors
- His duties were owed to the company, and the company had a contractual relationship with the creditors
- Any fraud committed by Spies was done to the company, not to its creditors

Teck Corp Ltd v Millar 1973

If [the directors] observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view leave directors open to the charge that they have failed in their fiduciary duty to the company

Parke v Daily News Ltd [1962]

Facts:

- Daily News published 2 newspapers which had been struggling for survival. The papers were the main asset of the company
- The board entered into a contract for the sale of the newspapers, which would result in the redundancy of most of the company's employees
- Management proposed to pay the net proceeds from the sale of the business to the displaced workers
- This decision was to be ratified by a resolution of the shareholders meeting
- A shareholder challenged the resolution as improper

Issue: Could the directors benefit the employees over the shareholders?

Court:

- This was a breach of duty
- The defendants were prompted by motives which however laudable, and however enlightened from the point of view of industrial relations, were such as the law does not recognise as a sufficient justification
- NO employees at the expense of shareholders

Equiticorp Finance Ltd (in liq) v Bank of NZA 1993

Facts:

- BNZ lent \$200mil to Uruz (a company in the Equiticorp Group) to finance a takeover
- BNZ subsequently reviews its risk exposure re: Equiticorp group
- Equiticorp Finance Ltd (EFL) and Equiticorp Financial Services Ltd (Aust) EFSA apply \$50mil in liquidity reserves to reduce Uruz debt to BNZ
- EFA and EFSA go into liquidation, and their liquidators seek orders that application of \$50mil was in breach of directors duties of the two companies

Approaches:

1. Strict
 - The emphasis given by the primary judge to the circumstance that the group derived a benefit from the transaction tended to obscure the fundamental principle that each of the companies was a separate and independent legal entity, and it was the duty of the directors to consult its interests and its interests alone in deciding whether the payments should be made to other companies
2. Intermediate
 - A preferable view may be that where the directors have failed to consider the interests of the relevant company they should be found to have committed a breach of duty. If, however, the transaction was, objectively viewed in the interests of the company, then no consequences would flow from the breach
3. Liberal
 - The proper test, in the absence of actual separate consideration [of the individual company's interests], must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company

Corporations Act - s187

Directors of wholly owned subsidiaries

A director of a wholly-owned subsidiary will be deemed to have acted in good faith and in the best interests of the subsidiary if:

- a) The subsidiary's constitution expressly authorises the director to act in the best interests of the holding company;
- b) The director acts in good faith in the best interests of the holding company;
- c) The subsidiary is not insolvent and does not become insolvent as a result of the director's act

Proper Purpose

- Cases of proper purpose **predominantly arise in the context of share issues by directors designed to ward off hostile takeovers**
- A key takeover defence is to issue shares to someone sympathetic with management, making it difficult for the Offeror to gain sufficient acceptances to gain control
- Note: onus of establishing that directors have acted improperly rests on person making the allegations
- Note: consequences of breach - voidable transaction
- Share issuances also raise capital for the company
 - It was the share issue made to raise capital (a proper purpose) or to defeat a takeover (an improper purpose)

Has a proper purpose been breached?

- Key point: 2 limb process (Howard Smith v Ampol)
 - 1. **Analyse the power, and as a matter of law, the purpose** for which it may be **exercised** (eg allotment of shares);
 - 2. **Analyse as a matter of fact, the purpose** for which the **power** has **actually** been **exercised** in this case

Howard Smith Ltd v Ampol Petroleum Ltd 1974

Facts:

- HS and Ampol = competing to takeover Miller
- Ampol owned approx 55% of Miller
- Miller issued shares to HS on the basis it would offer more for the company than Ampol
- The dilution of Miller's shares turned Ampol's majority shareholding into a minority interest, making HS's bid more likely to success
- Ampol sought a declaration that the share issue was undertaken for an improper purpose

Issue: Were Miller's directors acting for a purpose when they issued shares to assist with Howard Smith's takeover?

Court:

- Shares were issued for an improper purpose because it was primarily undertaken to dilute the majority shareholding
- Merely because the directors acted in what they thought was the best interest of the company is not sufficient to render the conduct for a proper purpose
- 2-step process:
 - Nature of the power → ascertain and define how it may be exercised
 - Substantial purpose for which the purpose was exercised and reach a conclusion whether that purpose was proper or not
- It was the motivation to frustrate the hostile takeover and dilute the bidder's holdings = not a reason for the existence of the power to issue shares
- Considered:
 - Transaction breaches ASX rules
 - No info given to board re financials of company
 - Capital needs not urgent
 - Company normally raised finance through debt

- If capital raising was true motive, should have been offered to all shareholders pro rata

Whitehouse v Carlton Hotel Pty Ltd 1987

Facts:

- The hotel company = owned by the Whitehouse family
- Mr whitehouse = governing director
- 3 classes of shares:
 - A) Mr Whitehouse - unrestricted voting powers;
 - B) Mrs whitehouse - voting rights only after Mr whitehouse's death;
 - C) children - profit sharing but no voting rights
- Mr and Mrs W divorced
- Mr W issued 'b' shares to 2 sons to ensure his sons controlled the company after he died
- Mr W had a falling out with one of his sons and directed the company to challenge the share issue as being for an improper purpose

Issue: Was the share issue invalid as being for an improper purpose?

Court:

- Share issue = invalid
- Mr whitehouse's purpose in issuing shares was to dilute the control of the company away from his wife and daughters after his death

Key point: Attempts to manipulate voting power by issuing shares = improper purpose and invalid

Exercise Powers for a Proper Purpose

- Where there are dual purposes, the mere presence of impermissible purpose does not taint directors' actions - only if impermissible purpose is dominant purpose
- Test:
 - 'Substantial object the accomplishment of which formed the real ground of the board's action' - **Mills v Mills**
 - 'But for' - **whitehouse v Carlton; Hogg v Cramphorn**

Corporations Act - s181

Directors of wholly owned subsidiaries

A director or other officer of a corporation must exercise their powers and discharge their duties:

- a) In good faith in the best interests of the corporation; and
- b) For a proper purpose

ASIC v Adler

S181 is breached if a director acts in a way that no reasonable director would have considered to be in the best interest of the company

Corporations Act - s184
Directors of wholly owned subsidiaries

A director or other officer of a corporation commits an offence if they:

- a) Are reckless; or
- b) Are intentionally dishonest;
And fail to exercise their power and discharge their duties
- c) In good faith in the best interest of the corporation; or
- d) For a proper purpose

Honest Intentions

- Cases suggest no requirement for subjective honesty

ASIC v Adler 2002

The standard of behaviour required by s181(1) is not complied with by subjective good faith or by a mere subjective belief by a director that his purpose was proper, certainly if no reasonable director could have reached that conclusion

ASIC v Maxwell 2006

S181 is contravened only where a director engages deliberately in conduct, knowing that it is not the interests of the company

Colorado Products Pty Ltd (in prov liq) 2014 | armagas Ltd v Mundogas SA 1985

The credibility of a witness and his or her veracity may be tested by reference to the objective facts proved independently of the testimony given, in particular by reference to the documents in the case, by paying particular regard to his or her motives, and to the overall probabilities

Structure: Duty to in Good Faith for a Proper Purpose

General Question:

- Have the directors breached their fiduciary duties? (if not a director, do these duties apply to the person in question?)
 - If so, which one
- Duty to act in good faith for a proper purpose → s181 mirrors the general law.
- Note: onus of establishing that directors have acted improperly rests on person making the allegations
- Note: consequences of breach - voidable transaction
- Elements:
 - 1. Good Faith
 - Smith v Fawcett - Subjective Test
 - Directors intentions at the time (honesty with best intentions) - do they honestly believe what they are doing is in the best interest of the company?
 - 2. For the benefit of the company
 - Golden Rule - Ngurli v McCann - “corporators of a general body”
 - Default rule in group companies /equiticorp case:
 - liberal approach provides that there is no breach when an honest and intelligible man reasonably and honestly believed he was
 - 3. For a proper purpose
 - Honest belief (subjective test) is irrelevant if purpose if not proper (objective test)
 - Legal test: Default position from Howard Smith: 2 limb test to determine proper purpose breach:
 - 1. Analyse the power as a matter of law (what the power is and why is may be exercised) EG to raise capital, allotment of shares; (or did it happen to block a takeover?);
 - 2. ‘But for’ the statutory equivalent: s181
 - Can attract criminal liability (reckless or dishonest → ie if they have knowingly done this... you would say “this could potentially be dishonest to attract criminal liability with respect to s184”
 - Note: Dual purpose (dominant must be proper)
 - Note: hostile takeover or allotment of shares = s181