

9. Directors' Duties: Duties of Good Faith, and Conflicts of Interest

Good Faith

- A fiduciary relationship: **Principal-agent relationship**, i.e. the agency theory
- Shareholders invest the money → director use that money = owe legal duties to act in shareholder's best interests
- **A fiduciary relationship arises when** "one person is obliged, or undertakes, to act in relation to a particular matter in the interests of another and is **entrusted with the power** to affect those interests in a legal and practical sense", and where there is a "...**special vulnerability** of those whose interests are entrusted to the power of another": *Hospital Products Ltd v United States Surgical Corporation* (1984)
- Fiduciary duties are **legal obligations imposed on one party** (the directors) to act in the best interests of another (the company)

The proscriptive/prescriptive distinction

- **Proscriptive:** Prohibitive meaning; preventing you from doing something
- **Prescriptive:** Allowing or mandating you to do something
- The proscriptive/prescriptive distinction in *Breen v Williams* (1996) was affirmed by the HC in subsequent cases: *Pillmer v Duke Group Limited (in liq)* (2001); *Friend v Brooker* (2009); and *Howard v Federal Commissioner of Taxation* (2013)
- However, there's *Westpac Banking Corporation v The Bell Group Ltd (In Liq)* (2012); *Motor Trades Association of Australia Superannuation Fund Pty Ltd v Rickus (No 3)* (2008)

The duties of good faith

Four overlapping sub-duties:

1. the **duty to act bona fide in the interests of the company** → An overarching obligation
2. the **duty to exercise powers for proper purposes** as opposed to improper purposes → Using the powers as they should be
3. the **duty not to fetter discretion**
4. the **duty to avoid actual or potential conflicts** between one's personal interests and those of the company

General Law

The duty to act bona fide in the interests of the company *and* for proper purposes

- The common law duty encompasses two limbs:
 1. "the duty to act **bona fide** in the **interests of the company**", and
 2. "the duty to act for **proper purposes**"

The meaning of 'bona fide'

- **Bona fide** means "in good faith" → "**Good faith**" means that directors must act honestly

- Director's decisions must be exercised in good faith, not arbitrarily or at the absolute will of the directors, but **honestly in the interests of the shareholders** as a whole: *Australian Metropolitan Life Assurance Company Ltd v Ure* (1923)
- Whether this duty has been complied with is a **subjective test of "honesty or good faith"**: *Whitehouse v Carlton Hotel Pty Ltd* (1987)
- Courts have considered both subjective and objective tests:
 - **Subjective Test** [What *ought* this individual have done in this situation?]

Problematic: See the UK case, *Hutton v West Cork Railway Co* (1883)

 - Held that the director had no right to pay employees in liquidation (as a kind of compensation to those made redundant) because it wasn't good for the company
 - While the intentions were charitable, it was not focused on the company, nor did it serve a business purpose → the money should've gone to shareholders
 - Controversial: An example of a court being intrusive with what the directors were doing (though, today, the BJR might apply)
 - **Objective Test** [What should a *reasonable person* have done in this situation?]
 - An objective test was applied in *ASIC v Sydney Investment House Equities Pty Ltd* (2008)
 - This test is also problematic because it gives little regard to directors in the application of the duty



Both tests were then combined in ***Bell Group Ltd (In Liq) V Westpac Banking Corporation and Others (No 9) (2009)***

The meaning of 'in the interests of the company' [See previous topics]

- The interests of the company have historically been **equated with the interests of the company's members as a whole** (the general body of shareholders): *Greenhalgh V Arderne Cinemas Ltd.* (1951), *Bell Group Ltd (in Liq) v Westpac Banking Corporation (No.9)* (2009), etc.
- Every decision they make, the directors need to **focus on the medium to long-term profitability** of the company, but then a specific decision will sometimes have to focus more on the short term
- The interests of the company **could be extended** to include:
 - **Future members:** *Darvall v North Sydney Brick & Tile Co Ltd* (1989)
 - **Different classes of shareholders:** *Mills v Mills* (1938)
 - **Individual members:** *Brunninghausen v Glavanics* (1999)
 - **Beneficiaries of trusts:** *Hurley v BGH Nominees Pty Ltd (No 2)* (1984); *Cope v Butcher* (1996)
 - **Other companies within a corporate group:** s 187, *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970], *Walker v Wimborne* (1976) and *Equiticorp Finance Ltd v BNZ* (1993)
 - **Employees:** *Parke v Daily News Ltd* (1962)
 - **Creditors:** *Walker v Wimborne* (1976), *Kinsella v Russell Kinsella Property Ltd* [1986], *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* [2008] and *Kalls Enterprises Pty Ltd (in liq) v Baloglow* (2007)
 - **NOTE:** When winding up, creditors *need* to be included (this is a hard legal standard)
- There have been situations where directors, for various reasons, have chosen to seemingly and overtly favour the interests of a group other than shareholders

- Often, directors will be able to argue this based on long-term interest
- While directors have an obligation to look after the best interests of the members, it doesn't mean that they're going to do what the members say (acting only in the short-term interests of members)
- Legally permitted to take a very long-term view, or focus on a project, industry, etc. → it's their business judgment (s 180)
- Breaches of duty to act in good faith are generally about **self-interest**, e.g.
 - Controlling members treating company assets as if they are assets held in their own names
 - Providing personal benefits to directors/particular members
 - Undertaking transactions with directors/particular members on terms very favourable to them
 - Forgiving debts owed to the company by directors/particular members
 - Transferring company assets to others in an attempt to avoid recovery by creditors/receivers

The duty to act for a proper purpose

- Description of the duty: *Mills v Mills* (1938)
 - The duty concerns **how directors**, in managing a company, **exercise the powers given to them** by their employment contract, the company's internal rules and the Act
 - The duty arises under fiduciary law (general law), and s 181 of the Act

• Determining whether there has been a breach of duty

The two-step test: To determine whether there has been a breach, courts apply a two-step test (see *Howard Smith Ltd v Ampol Petroleum Ltd* [1974]):

1. **The legal purpose:** Ascertain as a matter of law the purposes for which the power may, and may not be exercised → *how the power should be exercised*
 2. **The actual purpose:** Determine, as a matter of fact, the purpose for which the power was exercised in the particular case and whether that power is within the category of permissible purposes → *how was the power exercised?*
- When directors have **multiple or mixed** purposes for issuing shares, there will be a breach of duty if their motivating purpose is improper; two tests that *can* be used are
 - **Substantial or dominant purpose test:** *Mills v Mills* (1938)
 - This test ascertains the 'substantial object the accomplishment of which formed the real ground of the board's action' → **What was the main reason the Board was doing?**
 - **The "but for" test**
 - Whether the **impermissible purpose** (whether the dominant purpose or but one of many significantly contributing causes) **was causative** in the sense that, **but for its presence**, "the [relevant] power would not have been exercised": *Whitehouse v Carlton Hotel Pty Ltd* (1987)
 - **Would the power still have been exercised if the improper purpose did not exist?**
 - A main way is the improper use of power to issue shares, including

Proper uses of the power to issue shares	Improper share issue if shares are issued	Other improper purposes
To raise capital: <i>Ngurli v McCann</i> (1953)	To maintain control: <i>Ngurli v McCann</i> (1953)	Use of company funds to promote re-election of directors in certain