

## AN ANALYSIS OF THE PROPER PURPOSE RULE

By SAUL FRIDMAN, Senior Lecturer, Faculty of Law, The University of Sydney.\*

In recent years there has been a growing appreciation of the parallels between corporate law and public law<sup>1</sup>. For sure, as we know, law often follows practice, and the growing use of the corporate form by the public sector may be one reason that there is an increasing similarity between corporate and public law.<sup>2</sup>

It has always been difficult to develop a theory which is capable of explaining the corporation in its entirety. Economists have applied their analysis, which focuses on the corporation as transactions costs minimiser. To be sure, the economist's perspective helps to explain much of corporate law<sup>3</sup>. Indeed, in Australia we are in the midst of a substantial round of corporate law reform that is expressly economically motivated.<sup>4</sup>

By the same token, there are aspects of corporate law that may equally be rationalised on the basis of moral or ethical norms, which may or may not be consistent with economists' notions of efficient outcomes. There is no doubt that there is considerable overlap between these theoretical approaches. For example, the imposition of fiduciary duties on directors is equally consistent with modern economic analysis as it is with notions of accountability and justice. The economists posit that the imposition of fiduciary duties minimises agency costs.<sup>5</sup> The ethicist would argue that those entrusted with discretionary

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1 See for example Bottomley S 'Shareholder Derivative Suits and Public Interest Suits: Two Versions of the Same Story?' (1992) 15 *University of NSW LJ* 127.

2 There is a growing body of work on government owned corporations. Recent publications include: Seddon N and Bottomley S, 'Commonwealth Companies and the Constitution' (1998) 26 *Federal LR* 271; Mantziaris C 'Interpreting Ministerial Directions to Statutory Corporations: What does a Theory of Responsible Government Deliver?' (1998) 26 *Federal LR* 309. Financial reporting and accountability of Commonwealth authorities and companies is now dealt with by the Commonwealth Authorities and Companies Act 1997 (Cth) – see Bottomley S 'Corporatisation and Accountability: the case of Commonwealth Government Companies' (1997) 7 *Aus J of Corp Law* 156. As to the general theme of subjecting the exercise of corporate power to standards that reflect a public interest, see generally Parkinson J, *Corporate Power and Responsibility: Issues in the Theory of Company Law*, Clarendon Press, Oxford (1993).

3 See generally, Cheffins B, *Company Law: Theory, Structure and Operation*, Clarendon Press, Oxford (1993) and Easterbrook F and Fischel D, *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge (1991).

4 At time of writing, Parliament is considering the Corporate Law Economic Reform Bill 1998. The Corporate Law Economic Reform Program was established in March 1997. The goals of this reform program were set out in a Policy Framework published in 1997. The program is motivated by a desire to implement 'reforms to Australia's companies and securities regulation...which aim to facilitate a more efficient and competitive business environment' at 1. This document clearly sets out what is described as an 'economic approach to corporate regulation' at 3. In the area of corporate governance, this is described in the following terms:

'To address concerns that current regulation inhibits sound business judgments, changes are being considered to the Law to give greater certainty in this area.' at 5.

5 See Hart O, 'An Economist's View of Fiduciary Duty' (1993) 43 *University of Toronto LJ* 299.

power to act on behalf of others must always act in the best interests of those others<sup>6</sup> (refer *Hospital Products*, Finn, definitions of fiduciary). Either way, the imposition of duties on such persons is justified and explained.

This paper is concerned with one particular aspect of the fiduciary duty of directors, that being the duty to act 'for a proper purpose'. It would be fair to say that this aspect of the fiduciary standard has often caused considerable difficulty in analysis. While it is axiomatic to hold that a power that is given must be used for the purpose for which it was originally granted, it is often hard to perceive the basis on which the analysis proceeds.<sup>7</sup> It is submitted that this confusion as to the proper basis for the imposition of the 'proper purpose' standard explains the confusion that arises from consideration of the cases.<sup>8</sup>

In the near future, the proper purpose standard will become part of the Corporations Law. Section 181 of the Corporate Law Economic Reform Bill 1998 will provide a new version of the general fiduciary standard applicable to directors and officers of corporations:

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.

The statute will not contain any definition of 'proper purpose'. Presumably, the intention of the drafters is to incorporate by reference the substantial case law

6 This is generally considered to be the hallmark of the fiduciary. Thus, as Finn observes, 'For a person to be a fiduciary he must first and foremost have bound himself in some way to protect and/or to advance the interests of another.' Finn P, *Fiduciary Obligations*, Sydney, The Law Book Company (1977). Another way of stating the position is that of Parkinson: 'Within certain relationships, and in certain situations, equity enforces stringent duties of loyalty and propriety which go far beyond the obligations which people owe to each other at common law. [These fiduciary obligations] are imposed upon those who are placed in positions of trust and confidence': Parkinson P (ed), *The Principles of Equity*, Sydney, LBC Information Services, (1996) at 325. In *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, Mason J wrote 'The critical feature of these [fiduciary] relationships is that the fiduciary undertakes or agrees to act for or on behalf of or in the interests of another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense...It is partly because the fiduciary's exercise of the power or discretion can adversely affect the interests of the person to whom the duty is owed and because the latter is at the mercy of the former that the fiduciary comes under a duty to exercise his power or discretion in the interests of the person to whom it is owed.' Mason cites Weinrib E 'The Fiduciary Obligation' (1975) 25 *University of Toronto LJ* 1 at 4-8.

7 Thus there is some question as to the proper basis for imposing this standard of review upon the exercise of power by directors. See Grantham R, 'The Powers of Company Directors and the Proper Purpose Doctrine' (1994-95) 5 *Kings College LJ* 16 where it is argued that 'the doctrine...is based on the concept of fraud on a power, one that is concerned with the scope of the power granted not the duties controlling its exercise'. Compare Nolan's argument that the 'proper purpose doctrine is an independent basis on which the courts may review the purported exercise of power by a board, or by a director...a significant amount can be learnt from a comparison of the proper purpose doctrine with the ways in which contemporary administrative law controls the exercise of discretionary power vested in 'public' bodies.' See Nolan R, 'The Proper Purpose Doctrine and Company Directors' in Rider B (ed) *The Realm of Company Law*, London, Kluwer Law International (1997) at 1.

8 Nolan, for example, describes the proper purpose doctrine as 'the least discussed and least well understood of the fiduciary obligations affecting a director', Nolan, above note 7 at 1. Compare for example the analysis of majority and dissenting judgments of the High Court of Australia in *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285. Similar observations can be made of *Darvall v North Sydney Brick and Tile Co Ltd* (1989) 16 NSWLR 260.

which makes use of this standard.<sup>9</sup> However, the cases are by no means clear as to the precise meaning of the duty to act for a proper purpose. It is therefore somewhat surprising to find this standard expressly contained in a Bill produced as part of a reform package motivated by a desire to achieve greater certainty in this area of the law.

In any event, it is clear that Australian corporate law will now undoubtedly impose a statutory obligation on directors to act for a 'proper purpose'.

In this paper, I will argue that the 'proper purpose' standard is one that is best understood in historical terms. The application of this standard to company directors is a direct consequence of the application of equitable principle. Thus, once the Chancery Courts were given jurisdiction over corporate law, the recognition of the company director as a fiduciary was inevitable.<sup>10</sup> The treatment of the director as a fiduciary provided an early means by which Courts could control the exercise of power by directors. Furthermore, in the absence of discretionary statutory remedies providing a means for courts to intervene in intractable internal corporate disputes, the application of a vague 'proper purpose' standard was useful<sup>11</sup>. In effect, widely construed, the 'proper purpose' doctrine might have allowed courts to do precisely that which they expressly eschewed: intervene in matters of internal corporate management.<sup>12</sup>

9 This appears to be implicit. The Explanatory Memorandum merely states:

6.27 Current section 232(2) requires officers to act honestly. The draft provisions will rewrite section 232(2) to require officers to exercise their powers and discharge their duties in good faith in what they believe to be in the best interests of the corporation and for a proper purpose.

Subsequent paragraphs then discuss the difficulties arising from the drafting of the present provision which describes the duties of directors and officers as being a duty 'to act honestly'. The discussion here centres on the difficulty arising from different usage of the word 'honestly' in the legislation. This problem has received considerable academic attention: see Whincup M 'Directors' Statutory Duties of Honesty and Propriety' in Ramsay I (ed), *Corporate Governance and the Duties of Company Directors*, Melbourne, Centre for Corporate Law and Securities Regulation (1997) 125-147 and Carroll R, 'The Test of Honesty in Civil Proceedings under s 232(2) Corporations Law' (1995) 5 *Aust Jnl of Corp L* 214.

The Explanatory Memorandum then continues:

6.32 The draft provisions overcome these difficulties by rewriting section 232(2) to mirror the fiduciary duty of a director to act in what they believe to be in the best interests of the corporation and for a proper purpose.

Prior to releasing draft provisions, CLERP produced a discussion paper entitled 'Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors', Proposals for Reform: Paper No 3 (1997). In this paper, at page 16, the proper purpose aspect of directors' duties was described thus:

Directors must exercise their powers for the purpose for which they were conferred and not for any collateral purpose even if directors may have honestly believed that they were acting in the company's best interests (citing *Permanent Building Society (in liq) v Wheeler* (1994) 11 WAR 187 at 218.

10 As we shall see, this formulation of the 'proper purpose doctrine' is not the only possible such formulation. There are numerous cases describing the company director as a fiduciary: see for example *Re Lands Allotment Co*, [1894] 1 Ch 616. The history of ascribing fiduciary responsibilities to company directors is described in L Sealy [1967] *CLJ* 83

11 The theory was that if the articles granted to the directors the power to manage the corporation, then it was not open to the shareholders to interfere with the exercise of that power: *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34. As directors were elected by a majority of shareholders, this acted as a form of indirect control. This would explain why courts were particularly interested in attempts by the directors to manipulate the control of the general meeting through use of their power to issue shares: see *Punt v Symons and Co* [1903] 2 Ch 506 and *Piercy v S Mills and Co* [1920] 1 Ch 77. These cases in fact form the basis for much of the subsequent analysis of the 'proper purpose' doctrine. Both cases involved consideration of the action of a board in issuing shares so as to ensure that shareholders friendly to the board were in control of the general meeting. These cases are further discussed below.

12 This of course is the 'internal management' aspect of the rule in *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189. The Judicial Committee of the Privy Council described it as 'an elementary principle of the law relating to joint stock companies that the court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so.' See *Burland v Earle* [1902]

However, in an era where corporate law statutes contain provisions which allow judicial intervention on broad grounds<sup>13</sup>, it is hard to justify the proper purpose doctrine this way. The proper purpose doctrine is in effect simply a means to control the exercise of a discretionary power. Furthermore, this means of control appears to go beyond limiting the power's exercise according to the express terms on which it is granted, simply because, in most of the cases the power in question was not expressly limited.<sup>14</sup> It has been suggested that the control of the discretionary power of directors might be effected by utilising means employed by administrative law.<sup>15</sup> Thus, it has been said that 'company law, when it too has to face the question raised by judicial control of discretionary power, could learn much from administrative law'.<sup>16</sup> Of course, it is not so simple to translate public law norms to the private sphere:

'...it must always be borne in mind that there are differences between the objectives and techniques of private and public law, which mean that any commentator must tread with caution when trying to use the one to illuminate the other.'<sup>17</sup>

It has already been observed that corporate law rules of standing are analogous to those which apply in administrative law.<sup>18</sup> Could one make similar observations of the proper purpose doctrine? The suggestion has been made:

'After a somewhat hesitant start, administrative law has managed ...to set useful standards of review...it would be a shame if company law proved unequal to the task.'<sup>19</sup>

Of course, this observation must be understood within the caveat the author himself provided: that it is not always advisable to translate public law norms to the realm of private law. It is argued herein that the 'proper purposes' standard is so indeterminate that it has the potential to undermine the goal of providing certainty in corporate law. Furthermore, it is submitted that, in the final analysis, the appropriate standard to apply is the fiduciary standard: requiring the fiduciary to act in the best interests of the fiduciary principle, in this case the corporation.

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AC 83 at 93 per Lord Davey. More recently, the principle was expressed in terms that left open a 'proper purposes' qualification: 'Directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts' see *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493.

13 Such as s 246AA of the Corporations Law.

14 See for example *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 dealing with the directors' power to issue shares.

15 See Nolan, above n 7 at 17.

16 *Id.*

17 *Id.*

18 Bottomley S, 'Shareholder Derivative Actions and Public Interest Suits: Two Versions of the Same Story?' (1992) 15 *University of NSW LJ* 127.

19 Nolan, above n 7 at 35.

## The Source Of The Duty To Act For A Proper Purpose

As the Chancery Courts assumed jurisdiction for corporate matters in nineteenth century England, it was only natural that Chancery Judges would apply equitable norms to restrain the powers of company directors. In this instance, the equitable concept of ‘fraud on a power’ was of assistance. Simply put, equity prevents the donee of a power from exercising that power beyond the scope of, or not justified by, the instrument creating the power.<sup>20</sup> This limitation makes intuitive sense, and it would seem, in the case of the trustee, to be relatively straightforward in its application. The powers of trustees are normally set out in the instrument by which the trust is created. It would be open to the drafter of the deed of trust to provide for any limitation on the powers of the trustees. If no express limitation could be found one might be found by inferring such a limitation from the deed of trust.

Given the fact that the modern business corporation can trace its roots to joint stock companies established by deed of settlement<sup>21</sup> it again is hardly surprising that concepts applied to trustees came to be applied to company directors. However, in order to apply the ‘fraud’ on a power rules sensibly, one needed to determine the limitation on such power. In the case of the trust, one looked to the deed of settlement. Even in this case, the determination of the propriety of the exercise of a power could be difficult. As Finn has observed:

‘This process of adjudicating upon the propriety of an exercise of power as a power requires the court to make some definition of the nature and scope of the power itself and then to judge against this the object which the donee intended to achieve when exercising it. The initial process of definition can itself give rise to intractable problems as it is impossible in many cases to make anything like an exhaustive statement of the purposes to which particular powers can be put.’<sup>22</sup>

Nonetheless, it is submitted that in the normal case, the identification of proper purpose in the case of a trust is quite possible. This is illustrated by the case of *Cowan v Scargill* [1985] Ch 270 where it was argued that certain coal mining union-appointed trustees of a mine workers’ pension scheme were in breach of their fiduciary duties in resisting attempts by the other trustees to invest in oil and overseas. In the course of the analysis, the Court made the following observations (at p 279):

The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust, holding the scales impartially between different classes of beneficiaries. This duty of the trustees towards their beneficiaries is paramount. They must, of course, obey the law; but subject to that, they must put the interests of their beneficiaries first. When the purpose of the trust is to provide

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20 *Vatcher v Paull* [1915] AC 372 at 378 per Lord Parker of Waddington. See generally Finn P, *Fiduciary Obligations*, Sydney, Law Book Company (1977) at 39 *et seq.*

21 See generally Cooke C A, *Corporation, Trust and Company: An Essay in Legal History*, Manchester, Manchester University Press (1950) and Hunt B, *The Development of the Business Corporation in England 1800-1867*, Cambridge, Harvard University Press (1936).

22 P Finn, above n 20 at 40.

financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests.

The Court quoted from *Balls v Strutt* (1841) 1 Hare 146, where Sir James Wigram V-C said: 'It is a principle in this court, that a trustee shall not be permitted to use the powers which the trust may confer upon him at law, except for the legitimate purposes of the trust...'.<sup>23</sup> In the *Scargill* case, the court concluded that while it might, in exceptional cases, be right to conclude that beneficiaries of such a trust were willing to subsume their financial interests in favour of some moral or ethical concern, this was not the case here. Important in the analysis, however, was the relative ease with which the court could conclude about the purpose of the trust. One should also note the extent to which the question of the purpose of the trustee was coextant with the question of the best interests of the beneficiaries.

While initially attractive, one must take care in transferring elements of trusts law to corporate law. Indeed, I have already observed that great problems have been caused by doing precisely that in the case of ratification of breaches of duty by directors.<sup>24</sup> The problem with ratification in the corporate context is the identification of the principal's means of assent to breach of duty by the fiduciary. Likewise, when it comes to application of a proper purpose limitation, the problem in the corporate context is the identification of the purpose for which a power is granted to directors. In the case of the exercise of powers by directors, the source of the power is the corporate constitution. However, typically the corporate constitution contained a grant of either general managerial power or a grant of power without express limitation. As most cases in this area concern the issue of shares by directors, note the relevant provision of the former Table A articles:<sup>25</sup>

Without prejudice to any special rights previously conferred on the holders of any existing shares or class of shares but subject to the Law, shares in the company may be issued by the directors and any such share may be issued with such preferred, deferred or other special rights or such restrictions, whether with regard to dividend, voting, return of capital or otherwise, as the directors, subject to any resolution, determine.

Clearly, this provision contains no express restriction on the directors' power to issue shares. One might, appropriately enough, elect to search the corporate constitution for some guidance as to the purpose for which the directors' power might be exercised. Once again, recent changes to corporate law make this exercise less likely to yield satisfactory results. As most are aware, originally, corporations were required to state their objects in their constitutions. The current position (effectively in place since 1983) is that corporations are not obliged to state their objects and have 'the legal capacity and powers of an

<sup>23</sup> (1841) 1 Hare 146 at 149.

<sup>24</sup> See Fridman S, 'Ratification of Directors' Breaches' (1992) 10 *C&SLJ* 252 at 253-254.

<sup>25</sup> Table A, regulation 2. Since July 1, 1998, by virtue of the Company Law Review Act, 1998 (Cth), Table A has ceased to exist. Corporations are now offered the choice of electing whether or not to be governed by 'replaceable rules' contained in the legislation. Accordingly, many of the matters that were dealt with in Table A articles can now be found in the Corporations Law itself. Section 141 contains a table of replaceable rules. There is no 'replaceable rule' equivalent to Table A, regulation 2.

individual'.<sup>26</sup> Thus, a search of the constitution for some statement of objects by which the grant of power to directors might be limited by inference is not likely to be helpful.<sup>27</sup>

In such cases, courts tended to overcome the difficulty of determining a 'proper purpose' by applying the general limitation applicable to fiduciaries: that they exercise their powers in the best interests of the beneficiaries.<sup>28</sup> This was always the primary equitable obligation of a fiduciary.<sup>29</sup> Thus, in the case of the company director, the obligation is to act in the best interests of the company.<sup>30</sup>

Of course, the same problem of indeterminacy exists, for it is difficult for an outsider (such as a court) to define what is in the corporate best interest. One way of overcoming this is to leave the determination of the corporate best interest to those entrusted with the power to do so, the directors. As Finn observes:

As a general rule, it is the province of the fiduciary to determine what actions *are in the interests of his beneficiaries*. The courts are not entrusted with this decision. On the other hand, it is the province of the courts to determine what actions *are not in the beneficiaries' interest*, and an action will not be in the beneficiaries' interest if it constitutes a breach of any of the specific duties. By approaching review of a fiduciary's actions through these duties, the courts have been relieved of the impossible task of defining exhaustively what is meant by the 'interests of his beneficiaries' in any particular case...<sup>31</sup>

We can see this analysis applied in the context of judicial review of the directors' power to issue shares. In *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, the High Court of Australia dealt with a challenge to the allotment of shares by management which had the effect of blocking an attempt to secure control of the company. It was argued that this power (to allot shares) had been used for an improper purpose and was

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26 Corporations Law s 124(1).

27 Interestingly enough, there was one case where the powers of company directors to bind their corporation to a contract were said to be subject to a general limitation. In *ANZ Executors and Trustees Co Ltd v Qintex Ltd* (1990) 2 ACSR 676 an attempt to compel a subsidiary company to execute a guarantee was resisted on the ground that the order sought would require the directors to commit corporate assets to non-corporate purposes. This has been referred to as 'ultra vires in the wider sense': see *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246, [1985] 3 All ER 52. Note, though, how closely this concept of ultra vires in the 'wider sense' is linked to the consideration of the best interests of the company. In the current context, therefore, even if such a limitation were to apply to the exercise by directors of their power to bind the corporation to contracts, it would do little more than restate the general fiduciary obligation of a director. This concept of ultra vires has been roundly criticised: see Baxt R, 'Ultra Vires: Has it Been Revived?' (1991) 9 *C&SLJ* 101.

28 See Finn, above n 20 at 39. See also Ford H, Austin R and Ramsay I, *Ford's Principles of Corporations Law* (9th ed) Sydney, Butterworths (1999) 305 et seq, Welling B, *Corporate Law in Canada: The Governing Principles* (2nd ed) Toronto, Butterworths (1992) 337-338.

29 See Finn, above n 20 at 15-18.

30 Curiously, the drafting of the Corporations Law is such that this is reflected in s 232(2) which obliges a director to act 'honestly'. This has been interpreted as requiring the director to act bona fide in the interests of the company: see *Marchesi v Barnes* [1970] VR 434. In other jurisdictions, the statutory language is much clearer. For example, s 122(1) of the Canada Business Corporations Act, RSC 1985, c C-44, reads: Every director and officer of a corporation in exercising his powers and discharging his duties shall (a) act honestly and in good faith with a view to the best interests of the corporation...

31 Section 181 of the Corporate Law Economic Reform Bill, 1998 contains similar language. Finn, above n 20 at 16.

therefore invalid. It was suggested that the power in question was restricted to the raising of necessary capital. The Court reasoned thus:

In many a case this [argued limitation on the power to allot shares] may be true as a proposition of fact; but in our opinion it is not true as a general proposition of law. To lay down narrow lines within which the concept of a company's interests must necessarily fall would be a serious mistake...The principle is that although primarily the power is given to enable capital to be raised when required for the purposes of the company, there may be occasions when the directors may fairly and properly issue shares for other reasons, so long as those reasons relate to a purpose of benefiting the company as a whole, as distinguished from a purpose, for example, of maintaining control of the company in the hands of the directors themselves or their friends. An inquiry as to whether additional capital was presently required is often most relevant to the ultimate question upon which the validity or invalidity of the issue depends; but that ultimate question must always be whether in truth the issue was made honestly in the interests of the company...Directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.<sup>32</sup>

One can see in this passage a concern that judicial determination of some 'proper' purpose is simply not appropriate. Rather, the court presupposes a negative test, whereby the exercise of a power outside the corporate best interest can be invalidated.

We shall look more closely at the share issue cases below. For the present, however, it is useful to add one further observation as to the possible genesis of the 'proper purpose' limitation. This observation derives from the fact that the two cases generally regarded as the starting point for such judicial review<sup>33</sup> as most of the other such cases concern the directors' use of their power to issue shares.

The traditional view of the division of power within the corporation is that the incorporators determine how power is to be divided between the board of directors and the general meeting. In most cases, as we know, managerial power is given to the board.<sup>34</sup> The board is ultimately accountable to the general meeting by means of the election of directors.<sup>35</sup> If one adheres to this theory, one would, of necessity, take a dim view of directors' attempts to gerrymander the general meeting through use of the power to issue shares selectively. This view is clearly reflected by the following:

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32 (1968) 121 CLR 483 at 492-493.

33 *Punt v Symons and Co* [1903] 2 Ch 506 and *Piercy v S Mills and Co* [1920] 1 Ch 77. See above n 11.

34 This is reflected by s 226A of the Corporations Law, a replaceable rule designating the board as having the power to manage the corporation.

35 This is reflected in s 224C of the Corporations Law which provides (as a replaceable rule) for the election of directors by resolution passed in general meeting. It is further reflected by s 227 which preserves the power of the general meeting to remove, by ordinary resolution, a director of a public company.



...directors are not entitled to use their powers of issuing shares merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders. That is, however, exactly what has happened in the present case. With the merits of the dispute as between the directors and the plaintiff I have no concern whatever. The plaintiff and his friends held a majority of the shares of the company, and they were entitled, so long as that majority remained, to have their views prevail in accordance with the regulations of the company; and it was not, in my opinion, open to the directors, for the purpose of converting a minority into a majority, and solely for the purpose of defeating the wishes of the existing majority, to issue the shares which are in dispute in the present action.<sup>36</sup>

One must bear in mind that this case was decided at a time prior to the introduction of a more direct means of protecting the minority interests in a corporation: the statutory oppression remedy.<sup>37</sup> Therefore, a judicial standard, inspired by the equitable principles applicable to fiduciaries, is no longer required when the statute provides a more direct means of protecting the interests threatened by inappropriate exercise of a power. Indeed, given the inherent difficulty in applying the 'proper purpose' limitation, and assuming that such a limitation was inspired by the desire to protect the minority from oppressive conduct, one ought prefer the more direct remedy. The proper purpose test was only ever, perhaps, an approximate means of achieving what the statutory oppression remedy now allows a court to achieve by clear and direct means.

### **The Parallels With Administrative Law**

The preceding historical analysis ignores the parallels one now finds with administrative law. True, administrative law limits the exercise of discretionary power in similar fashion. The Administrative Decisions (Judicial Review) Act 1977 (Cth) provides that an order of review may be sought in respect of 'an exercise of a power for a purpose other than a purpose for which the power is conferred'.<sup>38</sup> Nonetheless, however similar the standard of judicial review may be, the context in which it is applied is entirely different. Furthermore, as the preceding section has demonstrated, the development of this aspect of corporate law was informed by fiduciary principle, rather than administrative law.

The application of the administrative law standard of review is also inherently more straightforward. In the context of the review of a statutory power, the authorised purpose will often be found by construction of the statute conferring the power. The simplest such means is where the statute itself specifies some purpose.<sup>39</sup> In addition, it may be the case that constitutional limitations will determine the purposes for which the enactment in question may be

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36 *Piercy v S Mills & Co Ltd* [1920] 1 Ch 77

37 Now contained in s 246AA of the Corporations Law.

38 Administrative Decisions (Judicial Review) Act 1977 (Cth), s 5(2)(c).

39 See *Sydney Municipal Council v Campbell* [1925] AC 338.

administered.<sup>40</sup> Where the statute does not contain any express limitation on the purpose for which a power may be exercised may more easily be inferred.<sup>41</sup>

The process of divining the permitted purposes for the exercise of a statutory power is reasonably well worked out. Furthermore, it is supported by applicable rules of statutory interpretation.<sup>42</sup>

Therefore, while it may be initially attractive to consider borrowing from administrative law, tools developed to control the exercise of statutory power, there are a number of reasons for which this would be inappropriate. First, the process of statutory interpretation renders the application of the doctrine more certain than is the case in corporate law. Corporate constitutions rarely, if ever, contain express restrictions on the exercise by directors of their powers to manage the corporation. Second, it is reasonable, given the context within which statutory power is exercised, to impose some purpose-related restraint. This is not the case when it comes to the powers of corporate directors. Directors are, by virtue of their fiduciary status, subject to a general equitable limitation in the exercise of their powers. This limitation exists to protect those for whose benefit the directors are obliged to act. It is particularly important in respect of matters internal to the corporation, such as the issue of shares by directors. In corporate law, unlike administrative law, courts are given the power to intervene in the management of a company directly where there is a case of oppression or unfair prejudice. Members of a corporation can, if they wish, define the purposes for which the directors may exercise their powers more precisely. Where the concern is that directors may cause the corporation to engage in conduct that is improper, it should be pointed out that, as a person, the corporation is subject to the general law. It is submitted that it is more appropriate therefore to look to the general law to control such excesses.<sup>43</sup>

If there is one case where it may be appropriate to apply administrative law norms to corporations, it may be where the corporation in question is incorporated by statute. In such a case it is more likely that the statute in question contains some statement of purpose. Even if the statute is silent, it would be possible to employ rules of statutory interpretation in order to ascertain a purpose. A possible second case may be where the shares of a corporation are owned by either the Commonwealth or a State Government. In such cases, there may be constitutional limitations on the power of the corporation which translate to

40 See *Shrimpton v Commonwealth* (1945) 69 CLR 613.

41 As in *R v Toohey; Ex p Northern Land Council* (1981) 151 CLR 170, 56 ALJR 164; 38 ALR 439 where a statutory power to make regulations defining the boundaries of a town was held to be limited to use for planning purposes; see also *Brownells Ltd v Ironmongers' Wages Board* (1950) 81 CLR 108, 24 ALJ 36 where a power to fix wage rates could not be used to regulate shop closing hours indirectly.

42 Particularly s 15AA of the Acts Interpretation Act 1901 (Cth) which directs a purposive interpretation of a Commonwealth statute. Section 15AB of the same Act permits the use of extrinsic material to determine the purpose of an enactment.

43 The ability of the general law to perform this function has been greatly assisted by decisions limiting the applicability of the privileges against self-incrimination or exposure to penalty to corporations: see *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993) 178 CLR 477, 118 ALR 392, 12 ACSR 452 and *TPC v Abbco Ice Works Pty Ltd* (1994) 14 ACSR 359. See also Evidence Act 1995 (Cth), s 187 and *Calderwood v SCI Operations Pty Ltd* (1995) 130 ALR 456.

restrictions on the powers of directors. A complete analysis of this question is beyond the scope of this article.<sup>44</sup>

### **The Proper Purpose Doctrine In Action**

Perhaps the most stinging indictment of the proper purpose doctrine is that, in practice, it adds little but confusion to the review of directors' exercise of power. One commentator has observed of the proper purpose doctrine that it involves 'a crypto value judgment of the kind which the courts find useful but which produces flexibility at the price of certainty'.<sup>45</sup> A brief review of some of the salient cases clearly demonstrates this.

It has already been observed that much of this analysis traces its roots to two early twentieth century cases.<sup>46</sup> Both cases involved the issue of shares by directors for allegedly improper purposes and resulted in judicial statements to the effect that the purpose of the power to issue shares was somehow restricted to the raising of capital. In neither case did the corporate constitution contain any express limitation on the power to issue shares.

In *Hogg v Cramphorn Ltd* [1967] Ch 254 directors of a corporation responded to a takeover proposal by issuing a sufficient number of shares to ensure continuing majority support for the incumbent board. In this case, the directors were informed of the takeover bid by one of their number, Cramphorn, who had previously carried on the business of the company with his family. Cramphorn was of the view that if the takeover were successful there would be a detrimental change in the nature of the company's trading activities. The shares in question were issued to trustees of a trust formed on behalf of corporate employees. This issue of shares was challenged on the ground that it was for an improper purpose. Buckley J agreed with the plaintiff in this case and set aside the allotment of shares.

Interestingly enough, Buckley J held that the directors had acted in what they believed to be the best interests of the corporation:

'I am satisfied that Mr Baxter's offer, when it became known to the company's staff, had an unsettling effect upon them. I am also satisfied that the directors and the trustees of the trust deed genuinely considered that to give the staff through the trustees a sizeable, though indirect, voice in the affairs of the company would benefit both the staff and the company. I am sure that Colonell Cramphorn and also probably his fellow directors firmly believed that to keep the management of the company's affairs in the hands of the existing board would be more advantageous to the shareholders, the company's staff and its customers than if it were committed to a board selected by Mr Baxter.'<sup>47</sup>

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44 But see Bottomley S and Seddon N, 'Commonwealth Companies and the Constitution' (1998) 26 *Federal LR* 27

45 Farrar J, 'Abuse of Power by Directors' [1974] *CLJ* 221 at 223.

46 *Punt v Symons and Co* [1903] 2 Ch 506 and *Piercy v S Mills and Co* [1920] 1 Ch 77.

47 [1967] Ch 254 at 265.

Despite this finding, the judge set aside the exercise of power on the basis that the directors had acted for an improper purpose. Notwithstanding the fact that the power in question contained no express limitation, Buckley J, on the basis of earlier authority<sup>48</sup> held that the power to issue shares was limited. After stating his agreement with the relevant passages contained in the earlier cases, the judge added:

Unless a majority in a company is acting oppressively towards the minority, this court should not, and will not itself interfere with the exercise by the majority of its constitutional rights or embark upon an inquiry into the respective merits of the views held or policies favoured by the majority and the minority. Nor will this court permit directors to exercise powers, which have been delegated to them by the company in circumstances which put the directors in a fiduciary position when exercising those powers, in such a way as to interfere with the exercise by the majority of its constitutional rights...<sup>49</sup>

It is thus clear what really motivated the decision: a desire to prevent corporate gerrymandering. This even though it was accepted that the directors acted in what they honestly believed to be in the best interests of the corporation. This is confusing as it had long been held that '[the directors] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company, and not for any collateral purpose'.<sup>50</sup> Even more confusing is the explicit recognition by the judge that there exists a legitimate statutory basis for protecting the position of the minority in the form of the oppression remedy. A finding that the issue of shares in this case constituted oppressive conduct would have been understandable. A finding that the directors breached their duties, even though acting bona fide in what they considered to have been the best interests of the company, is simply incomprehensible.

One can contrast this case with the Canadian case of *Teck Corporation Ltd v Millar*<sup>51</sup>, another case where directors issued shares with the consequence of defeating a takeover bid. The facts are well-known. Directors of Afton Mines Ltd, seeking a partner with which to exploit a valuable mining property, offered shares as an incentive. After having decided on a suitable partner, the directors feared that this decision would be upset by Teck, which was acquiring shares in Afton on the share market. Shortly after Teck had acquired 50 percent of its shares, Afton signed an agreement with its chosen partner pursuant to it a number of shares would be issued. This issue would have the effect of reducing Teck to a minority position. Teck challenged the issue of shares on the usual grounds.

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48 *Punt v Symons and Co* [1903] 2 Ch 506 and *Piercy v S Mills and Co* [1920] 1 Ch 77.

49 [1967] Ch 254 at 268.

50 See *Re Smith and Fawcett Ltd* [1942] Ch 304 at 306. See also *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 at 493: 'Directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.'

51 [1973] 2 WWR 385, 33 DLR (3d) 288.

In this case, however, Berger J chose not to restrict the power to issue shares by implying a proper purpose limitation. Rather, he chose to apply the general fiduciary standard, which required that the directors act in the best interests of the corporation. As he put it:

‘How can it be said that directors have the right to consider the interests of the company, and to exercise their powers accordingly, but that there is an exception when it comes to the power to issue shares, and that in the exercise of such power the directors cannot in any circumstances issue shares to defeat an attempt to gain control of the company? It seems to me that this is what *Hogg v Cramphorn* says. If the general rule is to be infringed here, will it not be infringed elsewhere? If the directors, even when they believe they are serving the best interests of the company, cannot issue shares to defeat an attempt to obtain control, then presumably they cannot exercise any other of their powers to defeat the claims of the majority or, for that matter, to deprive the majority of the advantages of control. I do not think that the power to issue shares can be segregated, on the basis that the rule in *Hogg v Cramphorn* applies only in a case of an allotment of shares.

Neither can it be distinguished on the footing that the power to issue shares affects the rights of the shareholders in some way that the exercise of other powers does not. The court’s jurisdiction to intervene is founded on the theory that if the directors’ purpose is not to serve the interest of the company, but to serve their own interest or that of their friends or of a particular group of shareholders, they can be said to have abused their power. The impropriety lies in the directors’ purpose. If their purpose is not to serve the company’s interest, then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a collateral purpose; it does not depend upon the nature of any shareholders’ rights that may be affected by the exercise of the directors’ powers.<sup>52</sup>

The analysis employed in this case simply involved making an assessment of whether the directors had properly assessed the corporation’s best interests as well as whether the directors had been improperly motivated. The assessment of the corporation’s best interests had generally been left to the directors, so long as they did so honestly. In this case, Berger J held:

‘I think that directors are entitled to consider the reputation, experience and policies of anyone seeking to take over the company. If they decide, on reasonable grounds, that a takeover will cause substantial damage to the company’s interests, they are entitled to use their powers to protect the company. That is the test that ought to be applied in this case.’<sup>53</sup>

As to the motivation of the directors, Berger J held that the directors were substantially motivated by their desire to pursue what they believed was an agreement that was in the best interests of the company.<sup>54</sup>

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52 [1973] 2 WWR 385 at 410-11, 33 DLR (3d) 288 at 312.

53 *Ibid* at 415-416 (WWR, 317 (DLR)).

54 This case has subsequently been followed in *Olson v Phoenix Industrial Supply Ltd* (1984) 26 BLR 183, *Re Royal Trustco (No 3)* (1981) 33 OR (2d) 631, *Exco Corp v Nova Scotia Savings & Loan co* (1987) 78 NSR

The case of *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 is similar. Once again, directors caused shares to be issued at a time when the issue had the effect of thwarting an incipient takeover bid. While it was argued that the share issue power ought be restricted to the raising of capital, the Judicial Committee held that it was ‘too narrow an approach to say that the only valid purpose for which shares may be issued is to raise capital for the company’.<sup>55</sup> On the other hand, it was argued that the only restriction on the exercise of the power was that it not be exercised in self-interest. Of this, the Judicial Committee said: ‘it does not follow...that the absence of any element of self-interest is enough to make an issue valid. Self-interest is only one, though no doubt the commonest, instance of improper motive: and before one can say that a fiduciary power has been exercised for the purpose for which it was conferred a wider investigation may have to be made.’<sup>56</sup>

The Judicial Committee then examined the actions of the directors in order to determine what was their ‘substantial purpose’. Relying on the findings of fact made by the trial judge, the Judicial Committee held that the purpose of the directors had been ‘simply and solely to dilute the majority voting power...so as to enable a then minority of shareholders to sell their shares more advantageously.’<sup>57</sup> In the view of the Judicial Committee, this involved the issue of shares to dilute voting power, which, on the authorities, was impermissible. In the opinion of one commentator:

‘The test used by the Judicial Committee was not the same as that of Berger J. ...their approach to the problem was backwards. They said that the directors’ motives could not be related to any purpose for which the power over the share capital was conferred upon them. This indicates that they were falling into the old trap of assuming that there was a specified list of purposes, unmentioned in the corporate constitution, for which the share-issue power was given. The Teck case was decided on a simpler proposition: where the statute and the corporate constitution are silent as to purpose, no purpose (other than the general overriding equitable requirement of pursuing the corporation’s best interests) is imposed on the directors.

In effect, the Judicial committee found that none of the directors’ purposes could be found on their imaginary list of proper purposes. This is understandable, as there was no such list in existence. Had they approached the question from a more basic point of view – had they simply asked whether it was proved that the directors had done anything improper – the decision may or may not have been the same, but the reasoning would have been impeccable.’<sup>58</sup>

Interestingly enough, the trial judge had come to his view of the directors’ motives after a lengthy examination of both the directors’ actions and its timing

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(2d) 91, 35 BLR 149 and *Re Olympia & York Enterprises Ltd and Hiram Walker Resources Ltd* (1986) 59 OR (2d) 254.

55 [1974] AC 821 at 835.

56 *Ibid.* at 834.

57 *Ibid.* at 837.

58 Welling B, *Corporate Law in Canada: The Governing Principles* (2d) edition, Toronto, Butterworths (1992) at 352-353.

and the history of the company in question and its prior financing practices.<sup>59</sup> This inquiry was necessary, as the directors had defended their actions by arguing that they were motivated by a desire to secure finance, and there was some evidence that the corporation was in need of funds. Street CJ came to his conclusions on the basis that the prior history of this corporation revealed that the issue of shares was not a preferred means of securing funds.

The Judicial Committee referred to *Teck Corporation Ltd v Millar* in its reasons, but distinguished the case on the basis that in *Teck* the defeating of Teck's majority control had been incidental to the board's desire to pursue a mineral exploitation agreement with its preferred partner. The problem with this reasoning is that it necessarily involves second-guessing the board's determination of the corporate best interest, which is precisely what courts have long stated they are unprepared to do.

Perhaps the real justification for the Judicial Committee's approach can be found in this passage:

'Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders, and indeed that the majority of shareholders cannot control them in the exercise of these powers while they remain in office (*Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34), so it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. To do so is to interfere with that element of the company's constitution which is separate from and set against their powers. If there is added, moreover, to this immediate purpose, an ulterior purpose to enable an offer for shares to proceed which the existing majority was in a position to block, the departure from the legitimate use of the fiduciary power becomes not less, but all the greater.'<sup>60</sup>

The High Court of Australia appear to have endorsed the proper purpose test in *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285. This case involved a director admittedly issuing shares in an attempt to influence control. The Court accepted that the director in question had been motivated by a desire to do what he believed to be in the best interests of the corporation. The majority in the High Court held that 'what was conferred upon Mr Whitehouse was the power to allot shares...and the cases clearly establish that a purpose of manipulating the voting power of shareholders is at least ordinarily foreign to such a power.'<sup>61</sup> As to Mr Whitehouse's assertion that he acted in what he honestly believed was in the best interests of the company, the Court held:

'...it is simply not to the point that Mr Whitehouse believed that it was in the overall interests of the company that the voting power attaching to the shares held by his former wife be diluted so as to ensure that the control of the company in the period after his death would be in the hands of

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59 [1972] 2 NSWLR 856 per Street CJ.

60 [1974] AC 821 at 837.

61 (1987) 162 CLR 285 at 292.

those whom he favoured. That belief was an explanation of, or reason for the allotment for the impermissible purpose. It did not constitute a competing permissible purpose.<sup>62</sup>

The existence of this so-called impermissible purpose is so potent, qua the High Court, that it need not be the dominant purpose. It need only be 'causative in the sense that, but for its presence, 'the power would not have been exercised''.<sup>63</sup>

As is evident, the Court appeared to accept that there might be some cases where the desire to influence the control of the corporation might be excusable. The majority said:

'It is arguable that special circumstances may arise in which the dilution of the voting power of an existing shareholder or group of shareholders or the creation of new voting power may constitute a legitimate purpose to be pursued by directors in the exercise of a fiduciary power to allot shares. Circumstances in which statutory provisions make a particular spread of voting power compulsory or commercially essential are a possible example of the kind of case where that may be so.'<sup>64</sup>

The minority views in this case are worth referring to, as they provide evidence of the significant uncertainty inherent in this area of law. Brennan J held that the power to allot the shares in question was conferred for the precise purpose of determining the control of the company after the death of Mr Whitehouse. Accordingly, in his opinion, as Mr Whitehouse admitted that he allotted the shares in question for the purpose of affecting the control of the corporation in those circumstances, the power was validly exercised. Wilson J quoted at length from the reasons for judgment of Berger J in *Teck Corporation Ltd v Millar*<sup>65</sup> and concluded that the question was one of whether the directors acted in what they believed to be the best interests of the corporation. Wilson saw the *Teck* case as 'a striking illustration of the propriety of directors taking action which they bona fide believed to be in the best interests of the company notwithstanding that it had the effect of destroying the voting power and intentions of the majority shareholder.'<sup>66</sup>

It is worth noting that Wilson J, aside from indicating a preference for the reasoning in the *Teck* case, considered that reasoning consistent with the earlier High Court case of *Harlowe's Nominees v Woodside (Lakes Entrance) Oil Co NL*<sup>67</sup>.

A more recent case clearly demonstrates how uncertain the law in this area is, despite the seeming clarity of the majority reasoning in the *Whitehouse* case. In *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260, 15 ACLR 230, 7 ACLC 659, the company in question was subject to a hostile take over

62 *Ibid.* at 293.

63 *Id.* Quoting Dixon J from *Mills v Mills* (1938) 60 CLR 150 at 186.

64 *Ibid.* at 292.

65 Above note 51.

66 (1987) 162 CLR 285 at 297.

67 (1968) 121 CLR 483.



bid. The directors were of the view that the offer in the bid was inadequate. The company owned land which was worth substantially more than was disclosed on the company's balance sheet. The board approved a scheme whereby the land would be sold to a subsidiary which would enter into a joint venture agreement for the development of the land. The joint venturer then financed a rival bid for the company's shares. The directors' decision to proceed with the joint venture was challenged by the initial bidder on the basis that the purpose underlying the joint venture agreement was indirectly to defeat the attempt to gain control of the company. The case was eventually decided in the New South Wales Court of Appeal.

Mahoney JA held that it was going too far to hold that directors have no legitimate interest in the identity of the company's shareholders or the price to be paid for company shares. Nonetheless, Mahoney JA did observe that directors are not to 'take action to ensure that its shareholders comprise those who will retain the directors in control of it'<sup>68</sup> However, this was not, in his opinion, such a case. Mahoney JA distinguished the *Howard Smith* case on the ground that the Judicial Committee had not laid down any rule against promoting offers for the acquisition of shares (as opposed to issuing shares to defeat a majority). As to the argument that the joint venture agreement was motivated by a desire to defeat a takeover bid, Mahoney JA said:

'There is a distinction in principle between a transaction for the purpose of defeating a takeover bid and one prompted by the takeover offer but, in the end, entered into because the directors believe it to be in the interests of the company as a whole.'<sup>69</sup>

Clarke JA concurred with Mahoney JA. His reasoning is substantially similar to that of Berger J in the *Teck* case. The *Whitehouse* case was distinguished on the basis that it involved the issue of shares, which was not the case here. This passage is indicative of the reasoning of the judge:

'In this case there is no question of the wrongful exercise of the power to issue shares. Upon the footing that there was power in appropriate circumstances to resolve that the company enter into a joint venture agreement the sole question is whether that power was exercised for an improper purpose. That depends upon whether the directors genuinely believed that it was in the best interests of the company to enter the joint venture agreement. In this respect the existence of the takeover offer and the directors' desire to defeat it does not automatically lead to the conclusion that the power was exercised for an improper purpose. It is a factual consideration which must be weighed in the balance in determining whether the directors did honestly believe that entry into the agreement was in the best interests of the company. This position is to be distinguished from that, such as in *Hogg v Cramphorn Ltd* [1967] Ch 254 and *Whitehouse*, which arises when the directors exercise their power to resolve that new shares be issued for an improper purpose albeit that they believe the new issue is in the best interests of the company.'<sup>70</sup>

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68 (1989) 16 NSWLR 260 at 325.

69 *Ibid.* at 328.

70 *Ibid.* at 338.

Although Kirby P dissented, he did so on the basis of a conclusion that, despite what he accepted as the subjective honesty of all but one of the directors (that director being involved in the rival bid financed by the joint venturer), the decision to approve the joint venture agreement could not be said to be in the best interests of the company. Kirby P's conclusions seem to have been based, at least in part, on a finding that, in the circumstances, the directors had been neglectful. As he put it:

'To sustain the directors' decision in the light of all that had gone before, as being in the best interests of the company as a whole, would be to countenance an unacceptable standard of neglect of directors' obligations, especially where matters had been specifically called to their notice. It would be to ignore the many blunt reminders of their obligation to conduct a thoroughgoing investigation. It would be to sustain a passive conception of the duty of a fiduciary which has no place in company board rooms. Higher standards of vigilance and honesty are required there in dealing with other people's moneys.'<sup>71</sup>

The reasoning in this case is, it is submitted, quite correct. Yet, it is hard to see how this reasoning can stand in the face of the High Court's decision in *Whitehouse*. Surely the distinction that the *Whitehouse* case involves an issue of shares is a distinction without a difference. Furthermore, if the reasoning in *Darvall* is correct, then it is hard to see why a proper purpose requirement is added to the requirement that directors exercise their powers bona fide in the best interests of the company in s. 181(1) of the Corporate Law Economic Reform Bill.

### **The Proper Purpose Rule And Business Judgments**

In a recent case, it was made clear that the proper purpose requirement could no longer be seen to be restricted to exercises of power affecting control of the corporation. In *Permanent Building Society v Wheeler*<sup>72</sup> the Supreme Court of Western Australia dealt with various allegations of breach of duty against a board which caused their company to purchase land at an overvalue. It was found that the transaction had been motivated by a desire to assist the vendor in meeting obligations it had to another company in which a number of the society's directors had personal interests. While the findings in this case are complicated, involving parallel allegations of breach of the duty of care as well as conflict of interest, Ipp J clearly based his conclusions, at least in part, on a finding that the purchase was improperly motivated. This conclusion involved a detailed analysis of the financial positions of the parties and the structure of the transaction.

As we now know, the Corporate Law Economic Reform Bill 1998 contains a proposed statutory business judgment rule.<sup>73</sup> It is also the case that the decision to enact such a rule was motivated in part by concern expressed following

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<sup>71</sup> *Ibid* at 288.

<sup>72</sup> (1994) 12 ACLC 674, 14 ACSR 109.

<sup>73</sup> In section 180(2).

decisions such as *Wheeler* and *Daniels v Anderson*<sup>74</sup>. Given the degree of concern that has been expressed regarding the appropriateness of courts reviewing business decisions made by boards of directors, it is surprising to see the same Bill opting to make specific reference to a duty to act 'for a proper purpose'. Indeed, the statutory business judgment rule itself will contain a requirement that a director 'make [a] judgment in good faith for a proper purpose'.<sup>75</sup>

## Conclusion

In this article, I have attempted to demonstrate that the requirement that directors act for a proper purpose adds little to the more general rule that directors must act in the best interests of the company. As many before me have argued, this proper purpose rule adds a level of analysis that causes great confusion in its application.

It is submitted that the development of the proper purpose rule, though understandably inspired by equitable notions of fraud on a power, has been poorly translated to the corporation. Generally speaking, corporate management is granted discretionary power to manage the corporation. The most appropriate way to restrain that power is to subject it to a requirement that it be exercised in what the directors themselves believe to be in the corporate best interest. Indeed, this is what some courts appear to hold, even when the proper purpose doctrine is applied.

In order for it to be applied sensibly, and as an independent doctrine, the proper purpose rule requires some evidence that the power in question has been restricted in a manner that goes beyond the general requirement that it be exercised in the best interests of the corporation. The only corporations where this is likely to be the case are those whose constitutions contain either express restrictions on the exercise of a particular power or objects clauses or those whose incorporation is achieved by statute rather than under the Corporations Law.

As to the argument that, in this respect, corporate law might effectively borrow from administrative law, it is submitted that courts are ill-equipped to determine the purposes for which specific powers are given to directors in the absence of express limitations. While there is admittedly some need to control the exercise of discretionary power, corporate law now contains adequate means to do so in the form of the oppression remedy (which protects the members of the corporation) and the requirement that directors exercise their powers in the best interests of the corporation (which, as recent cases have demonstrated, includes the interests of creditors as the corporation approaches insolvency).

There may be some who continue to see the need for a separate category of fiduciary duty in addition to the more general requirement. To those adhering to

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74 (1995) 16 ACSR 607, 13 ACLC 614.

75 Corporate Law Economic Reform Bill Program 1998, s 180(2)(a).

this view, perhaps there is some merit in following a trend of simplification. Recently, the High Court of Australia decided that there was no longer any justification for a separate rule in tort law relating to dangerous substances. Accordingly, the rule in *Rylands v Fletcher* was subsumed within the general law of negligence.<sup>76</sup> I see no reason why the proper purpose rule ought not similarly be subsumed within the general obligation to act in the best interests of the company.

Ultimately, it is surprising to find that a corporate law reform program that is expressly motivated by an economics-inspired desire to render the law more certain chooses to include expressly a reference to the proper purpose rule. Even more surprising is that a business judgment rule, motivated by a desire to offer directors "a safe harbour from personal liability in relation to honest, informed and rational business judgments"<sup>77</sup> incorporates the proper purpose rule by reference.

Were it not for the inclusion of the proper purpose requirement in s. 181(1)(b) it would be tempting to conclude that the effect of recent cases such as *Darvall* has been to confine the proper purpose rule to the share issue cases. However, the drafting of the Corporate Law Economic Reform Bill 1998 makes this argument impossible. In any event, there is no justification for treating the share issue power any differently from other discretionary powers held by directors.

The recent federal election in Australia has delayed the passage of the Corporate Law Economic Reform Bill Program 1998. While many awaiting passage of a statutory business judgment rule may be disappointed that the legislation has been delayed, perhaps the delay will be worthwhile should the proper purpose requirement be deleted.

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76 See *Burnie Port Authority v General Jones Pty Ltd* (1994) 179 CLR 520.

77 Corporate Law Economic Reform Bill 1998, Explanatory Memorandum, 17.