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Abstract
Self interested transactions by directors have always been a difficult area on which to advise. The main problems arise out of the complex interface of the original equitable rule, the constitution and the relevant provisions of the statute which have changed over time. Although the Corporate Law Economic Reform Program Act 1999 has made a number of improvements to the law there still remain problems, some of which have been caused by the style of drafting used in the new sections.

Keywords
directors, self interested transactions, personal interests, corporate law

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NOTE

A NOTE ON DEALING WITH SELF INTERESTED TRANSACTIONS BY DIRECTORS

By John H Farrar[*]

Self interested transactions by directors have always been a difficult area on which to advise.[1] The main problems arise out of the complex interface of the original equitable rule, the constitution and the relevant provisions of the statute which have changed over time. Although the Corporate Law Economic Reform Program Act 1999 has made a number of improvements to the law there still remain problems, some of which have been caused by the style of drafting used in the new sections.

The History of the Law on Self Dealing by Directors

To understand the present law one needs to know the history. The modern law starts with the strict equitable rule laid down by the House of Lords in the Scots case of *Aberdeen Railway Co v Blaikie Brothers*[2] in 1854. The company entered into a contract to purchase furniture from a partnership, which included one of its directors. The House of Lords held that the company could avoid the contract. The director was treated as an agent subject to fiduciary duties not to enter into engagements in conflict of interest. As Lord Cranworth LC said, 'So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.'[3]

The equitable rule was thought to be too strict by the business community and the practice developed of inserting articles which modified it. There were various ways of doing this: contracting out of the rule or liability for breach; allowing the director to attend and/or vote on the transaction; allowing a director who had disclosed an interest to attend and vote either generally or with the approval of a disinterested majority of the board. Most articles

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1 See Lipton P, 'Has the 'Interested Director Cloud' between Lifted? A Comparison between the US and Australian Approaches' (1994) 4 *Aust Jnl of Corp Law* 239.

2 (1854) 1 Macq 461, [1843-60] All ER Rep 249 (HL) 252-9.

3 [1843-60] All ER Rep at 252 I. The company loses this right by delay or if other equitable defences apply see *Roden v International Gas Applications* (1995) 13 ACLC 1817.

contained variations on these themes and many were held to be valid.[4] Another question, which arose, was whether a breach of this kind was capable of ratification by the general meeting. In the Canadian appeal to the Privy Council in *North-West Transportation Co Ltd v Beatty*[5] it was advised that a company could ratify the transaction even with the votes of the director in question in his capacity as shareholder. This view is rather lax since such conduct involves a breach of a main stream fiduciary duty and can easily be part and parcel of fraud on the minority.[6] If this is the case then such conduct is capable of review under section 232 of the Corporations Law or the new derivative action procedure. In the latter case ratification will be a matter taken into consideration by the court in exercising its discretion under section 239. With simple self dealing of this kind can be contrasted the case of a director usurping a corporate opportunity. In the Canadian appeal to the Privy Council in *Cook v Deeks*[7] it was held that the benefit of the contract in question belonged in equity to the company and the directors (as shareholders) could not validly use their voting power in general meeting to vest it in themselves. The directors could not be allowed to make a present to themselves in this way.

The next stage of development was the outlawing of articles which exempted directors from liability and the introduction of a mandatory disclosure rule with a criminal sanction. These were first introduced in Australia in sections 160 and 156-7 of the Queensland Companies Act 1931 which were based on the UK Companies Act 1929 and later adopted in other states and included in the Uniform Companies Act 1961, Companies Code 1981 and the Corporations Act 1989. The requirement for disclosure has as its purpose the prevention of undisclosed profit by a director. Its aim is to ensure honesty and integrity. It is not concerned predominantly with the prevention of loss to the company.[8] Between 1993 and 2000 the mandatory disclosure regime was limited to proprietary companies but since 2000 the old rule has been reinstated by sections 191 and 192 which apply to all companies, other than single person companies. In addition section 194 sets out a lenient regime for voting in the case of proprietary companies and section 195 sets out the more stringent regime for public companies first introduced in 1992. There are odd gaps in the drafting which necessitate recourse to the old Law.

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4 See the cases cited in *Hahlo's Cases and Materials on Company Law* 3rd ed, Sweet & Maxwell, London. 1987 by Hahlo HR and Farrar JH 392, 396

5 (1887) 12 App. Cas. 589 (PC); *Furs v Tomkies* (1936) 54 CLR 583,592. However, it may not be possible to ratify a breach of the statutory duties under sections 181, 182, 183 and 184: see *Miller v Miller* (1995) 15 ACSR 73, 89.

6 *Menier v Hoopers Telegraph Works* (1874) LR 9 Ch App. 350;*Winthrop Investments Ltd v Winns* [1975] 2 NSWLR 666.

7 [1916] AC 554, 564-5. This cited *Menier v Hoopers Telegraph Works* (supra).

8 *Castlereagh Motels Ltd v Davies-Roe* (1967) 67 SR (NSW) 279,287

Sections 191-2: Director's Duty to Disclose a Material Personal Interest

Section 191(1) provides that a director of a company who has a material personal interest in a matter that relates to the affairs of the company must give the other directors notice of the interest unless the interest is exempted under section 191(2).

Section 191(2) provides that a director need not give notice if:

(a) the interest:
- (i) arises because the director is a member of the company and is held in common with the other members of the company; or
- (ii) arises in relation to the director's remuneration as a director of the company; or
- (iii) relates to a contract the company is proposing to enter into that is subject to approval by the members and will not impose any obligation on the company if it is not approved by the members; or
- (iv) arises merely because the director is a guarantor or has given an indemnity or security for all or part of a loan (or proposed loan) to the company; or
- (v) arises merely because the director has a right of subrogation in relation to a guarantee or indemnity referred to in subparagraph (iv); or
- (vi) relates to a contract that insures, or would insure, the director against liabilities the director incurs as an officer of the company (but only if the contract does not make the company or a related body corporate the insurer); or
- (vii) relates to any payment by the company or a related body corporate in respect of an indemnity permitted under section 199A or any contract relating to such an indemnity; or
- (viii) is in a contract, or proposed contract, with, or for the benefit of, or on behalf of, a related body corporate and arises merely because the director is a director of the related body corporate; or

(b) the company is a proprietary company and the other directors are aware of the nature and extent of the interest and its relation to the affairs of the company; or

(c) all the following conditions are satisfied:

(i) the director has already given notice of the nature and extent of the interest and its relation to the affairs of the company under subsection (1)
(ii) if a person who was not a director of the company at the time when the notice under subsection (1) was given is appointed as a director of the company – the notice is given to that person
(iii) the nature or extent of the interest has not materially increased above that disclosed in the notice; or

(d) the director has given a standing notice of the nature and extent of the interest under section 192 and the notice is still effective in relation to the interest.

The key concept of 'material personal interest' is not defined in the section but on the basis of recent caselaw the following seem to be the relevant principles:

1. Materiality means the capacity to influence the vote of the particular director upon the decision being made.[9]

2. It is to be determined from the position of the relevant director, not the state of the company.[10]

3. A director would have a material personal interest in a resolution authorising payment of his legal costs in defending legal proceedings by a shareholder.[11]

4. An interest is not personal if it 'affects the director as a member of a group or class such as ordinary customers of a bank or shop on generally available terms'[12]

5. Whether a directorship of the other contracting party would be covered is not clear. A shareholding in the other contracting party would probably suffice.[13]

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9 Per Murray J in *McGellin v Mount King Mining NL* Supreme Court of Western Australia Unreported 7 April 1998. See discussion in Black A, Bostock T, Golding G and Healey D, *CLERP and the New Corporations Law* 2nd ed. Butterworths, Australia, 2000, [4.23]

10 *South Australia v Marcus Clark* (1996) 19 ACSR 606 commenting on 'direct or indirect pecuniary interest' in the State Bank of South Australia Act 1983 s11

11 Per Brownie J in *European Pacific Resources Pty Ltd v Aurifex Mining NL* Supreme Court of New South Wales unreported 27 June 1994. See Black, Bostock, Golding and Healey ibid.

12 ASIC Policy Statement 76, 23 December, 1993 (amended 3 March 1997) para 18. See the commentary by Black, Bostock, Golding and Healey op cit footnote 24.

Unlike its predecessors, section 191 simply refers to a matter and is not limited to contracts.

The notice must give details of:

(i) the nature and extent of the interest; and
(ii) the relation of the interest to the affairs of the company (s 191(3)).

It must be given at a directors' meeting as soon as practicable after the director becomes aware of his or her interest in the matter and details must be recorded in the minutes of the meeting. (s 191(3)).

No formal declaration is necessary provided that section 191(3) is complied with.[14] Section 192 provides for standing notices.

A director normally has no duty to act as a kind of devil's advocate and spell out the risks and benefits of the transaction[15] but circumstances may require him or her to be proactive where he or she is a director of two companies with conflicting interests.[16] In this kind of case a director should not merely declare an interest but should also point out potential harm to the company.[17] A case which illustrates the latter proposition is *Fitzsimmons v R*[18] in the Western Australian Court of Criminal Appeal where the applicant was convicted of offences, including breach of a duty to act honestly in connection with a takeover. He was a director of Duke Holding Ltd and an employee of the Duke Group. At the time of a reverse takeover by Kia Ora he became a director of Kia Ora. The essence of the charge was that he failed to disclose to the Board of Kia Ora the true financial position of the Duke Group. Owen J said:[19]

> Each case will depend on its own facts. A director who is confronted with a possible conflict must assess his or her position. The minimum requirement will be disclosure of the interest. This is simply part of, or an extension of, the statutory obligation that a director who is in any way 'interested' in a contract or proposed contract with the company must

13 See Black, Bostock, Golding and Healey op cit. Contrast section 191(2)(a)(i) which exempts an interest as member of the company itself.
14 *Woolworths Ltd v Kelly* (1991) 9 ACLC 539 but see Kirby P dissenting at 545 et seq.
15 *Centofanti v Eekimitor Pty* (1995) 13 ACLC 315. See *Robson's Annotated Corporations Law,* 2000 ed, LBC Information Services, Sydney, Vol 1, 239.
16 *Permanent Building Society v Wheeler* (1994) 12 ACLC 674.
17 *The Duke Group Ltd v Pilmer* (1999) 17 ACLC 1329 and the cases cited therein.
18 (1997) 15 ACLC 666. Noted by Baxt R (1997) 15 *C&SLJ* 326. See also *R v Byrnes* (1995) 183 CLR 501 at 517 per Brennan, Deane, Toohey and Gaudron JJ.
19 (1997) 15 ACLC at 668.

> declare the nature of the interest at a meeting of the directors: [S 232(1) Companies Code 1981 now S 191 of the Corporations Law] What action, above and beyond mere disclosure, the director must take will vary from case to case depending on the subject matter, the state of knowledge of the adverse information, the degree to which the director has been involved in the transaction, whether the director has been promoting the cause, the gravity of the possible outcome, the exigencies and commercial reality of the situation and so on. It may not be enough for the director simply to refrain from voting or even to absent himself or herself from the meeting during discussion of the impugned business. The circumstances may require the director to take some positive action to identify clearly the perceived conflict and to suggest a course of action to limit the possible damage.

The Court held that he should, at the very least, have disclosed to the board of Kia Ora his conflict of interest and that, as a consequence, he could neither participate in the deliberations or vote. Indeed given that he had accepted appointment when a conflict of interest was obvious he should either have refused or, having accepted the appointment, identified the risk to the Kia Ora board.

Breach of section 191 does not invalidate the transactions (s191(4)). However, it is a criminal offence although the section does not say so. The section is listed in Schedule 3 (penalties). This is an unfortunate way to legislate.

Section 193 makes it clear that sections 191-2 do not derogate from the general law, or any relevant provision of the constitution. These operate in addition. Thus the old equitable rule which makes the contract voidable still applies, notwithstanding section 191(4), unless the constitution modifies it.[20] Any modification must be consistent with Part 2D.2 which prohibits exemption from liability and restricts indemnities and insurance.

Section 194: Voting and Completion of Transactions by Directors of Proprietary Companies

Section 194 sets out a replaceable rule for proprietary companies. If a director of such a company has complied with section 191 then the director can vote, the transaction can proceed, the director can retain benefits and the company cannot avoid the transaction. This excludes the equitable right to rescind the contract.

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20 See too *Hely Hutchinson v Brayhead Ltd* [1986] 1 QB 549; *Guiness PLC v Saunders* [1990] BCLC 402(HL). However, see the replaceable rule in s194 for proprietary companies.

Section 195: Restrictions on Directors of Public Companies

This re enacts the old section 232A of the Corporations Law. This is a mandatory rule.

Notwithstanding disclosure under section 191, a director of a public company must not:

(a) be present while the matter is being considered at the meeting;

(b) vote on the matter unless allowed to by disinterested directors under section 195(2) or ASIC approval under section 195(3) or (where it is not possible to get a quorum of disinterested directors) by a general meeting.

Section 195(2) provides:

> The director may be present and vote if directors who do not have a material personal interest in the matter have passed a resolution that:
>
> (a) identifies the director, the nature and extent of the director's interest in the matter and its relation to the affairs of the company; and
> (b) states that those directors are satisfied that the interest should not disqualify the director from voting or being present.

If the disinterested directors are not acting in the best interests of the company then there is the paradox that the self interested director complies with the section but they will be in breach of their duty under the general law and section 181(1).

ASIC is given power to make a declaration or order under section 196. It can make specific declarations or class orders. Both may specify conditions. The power to make a declaration is limited to the situation where it is necessary to constitute a quorum and the matter is urgent or there is some other compelling reason to deal with the matter in the Board, rather than in a general meeting. (s196(1)(a) and (b).

Class orders have to be published in the Gazette (s196(5)). Contravention of section 195 does not invalidate the transaction (s195(5)) but constitutes a criminal offence under Schedule 3. Again the latter fact is not indicated in the section.

Related Party Transactions[21]

In addition to the above general provisions the Related Party Transactions provisions in Chapter 2E must always be considered and complied with. However, a number of the exceptions may well apply. Particularly relevant are section 210 (transactions on arms length terms), section 211 (reasonable remuneration), section 212 (indemnities, exemptions and insurance) and section 213 (small amounts given to director or spouse). If the transaction is a financial benefit which falls outside these exemptions it needs member approval and the rigorous disclosure regime in Division 3 must be followed.

Conclusion

The law has been considerably improved by the CLERP reforms but there are still a few problems. Express reference to the criminal offences for breach of sections 191 and 195 should be made in the sections. The relationship between these sections and the equitable rule and the constitution is still not clear. The law needs to make a decision about whether the equitable rule is important enough to survive in the case of public companies, given the present disclosure regime, and if so, whether and to what extent it can be modified by the company's constitution. In the case of proprietary companies the replaceable rule in section 194 effectively excludes it.

Canadian Law is satisfied by disclosure of the interest and fair value. New Zealand has now adopted this kind of approach in sections 139-147 of the Companies Act 1993. The American Law Institute's *Principles of Corporate Governance*[22] para 5.02 is more comprehensive. It provides that a director who enters into a transaction with the corporation fulfils the duty of fair dealing if:

1. Disclosure of the conflict of interest and the transaction is made and the corporation approves in advance or ratifies it *and*

2. (a) the transaction is fair to the corporation when entered into; *or*
   (b) it is authorised by disinterested directors in advance; *or*
   (c) it is ratified by the disinterested directors; *or*

21 For fuller discussion see Black, Bostock, Golding and Healey, op cit, paras 4.42-4.56]; Baxt R, Renard I, Simkiss R, Webster J in *CLERP Explained,* CCH Australia Ltd, Sydney, 2000, paras 2-500-550.

22 American Law Institute, St Paul, Minn, 1994, *Principles of Corporate Governance,* Vol 1,209-211. For a recent study see DeMott, DA, 'The Figure in the Landscape: A Comparative Sketch of Directors' Self-interested Transactions' (1999) 62 *Law and Contemporary Problems* 243.

(d) it is authorised or ratified by disinterested shareholders and does not constitute a waste of corporate assets.

These are more explicit rules than the Canadian and New Zealand sections and are worth considering as a basis for reform in Australia. The idea of waste of corporate assets is equivalent to transactions not for the corporate benefit.[23]

In the meantime, the safest course is to assume that the equitable rule still applies to public companies because of section 193(a) and a liability for breach cannot be exempted because of section 199A(1). Whether section 199A(1) outlaws the possibility of exclusion or modification of the rule is still not clear and needs clarification by statute.

23 Waste entails an exchange of corporate assets for consideration so disproportionately small as to be beyond the range at which a reasonable person might be willing to deal. See *Saxe v Brady* 184 A.2d.602,610 (1962); *Grobow v Perot,* 539 A2d. 180,189 (1988); *Lewis v Vogelstein* 699 A2d.327 (1996). See the ALI's, *Principles of Corporate Governance*, para 1.42. Compare *ANZ Executors and Trustee Co Ltd v Qintex Australia Ltd (receivers and managers appointed)* (1990) 8 ACLC 980; [1991] 2 Qd.360. It should be noted that the *Principles of Corporate Governance* are stricter than the law in a number of states.