

The Duties of Directors: the Fiduciary Relationship

Introduction

General law and statutory duties apply to all directors, whether they help to manage the largest public company in the land or the smallest 'family' proprietary company. The size of the company does not affect the nature and rigour of these duties.

Directors have two categories of general law duties: fiduciary duties and the duties of diligence and skill (often referred to simply as the duty of care). These duties are expressed as being owed by the directors to the company. They exist to protect the company's present and future shareholders and creditors. The fiduciary duties are owed only to the company, however, and not to holding or subsidiary companies or other bodies, or to individual shareholders, or to 'outsiders'.

Directors as agents

It is inappropriate to describe directors as agents of the company, even though there are similarities between the roles of director and agent. Directors, like agents, act on behalf of the company, they can contract on its behalf and, without taking liability upon themselves (except if they act outside their powers), they can bind the company to outsiders when acting within the scope of the company's business. Directors, however, generally have a much wider range for action than agents, and the company (the notional 'principal') usually exerts very little control over their actions. Shareholders, especially in large public companies, usually know relatively little about the directors' actions and motives. As we have seen in Chapter 3, management power is invariably reserved specifically for the board. Cozens-Hardy LJ, in *Cuninghame's* case, thought that it was appropriate to describe directors as 'managing partners . . . appointed to fill that post by a mutual arrangement between all the shareholders'.¹

1. *Automatic Self-Cleansing Filter Syndicate v Cuninghame*[1906] 2 Ch 34 at 45. For authorities which describe directors as agents, see: *Ferguson v Wilson* (1866) LR 2 Ch App 77 at 89; *Smith v Anderson* (1880) 15 Ch D 247 at 276; *CIR v John Blott* (1921) 8 TC 101 at 125.

Directors as trustees

Directors are also similar to trustees. The similarities are especially apposite when discussing the fiduciary duties of directors. However, there are obvious differences. Directors do not hold legal title to property for the company; they usually have a mandate to take greater risks in business decisions than trustees have acting under the trust instrument; and directors are often paid employees of the company (unlike trustees, who may be paid but who are not employees of the trust). Often, though, the principles which apply to trustees also apply to directors. For example, both groups manage or control funds which belong in equity to others. So trust law applies to make directors accountable for the company's funds or property and they are liable to make good personally any loss of that property. But as Slutsky comments:

It is generally accepted today that a director is a fiduciary of 'a kind all of his own'² and it might well be argued that it is no longer necessary or relevant for the courts to analogize in this way, but it still appears to be part of the judicial thinking.³

There is no true trust relationship between a director and the company, but their relationship resembles a trust and the fiduciary principles, which impose duties on directors, are trust principles.⁴

Directors as fiduciaries

The office of director is a fiduciary one. This means that directors and other officers in fiduciary positions must act with utmost good faith towards the company in all their dealings with or on behalf of the company. Any fiduciary, whether a trustee or someone (like a director) in an analogous position, is in a position of trust and confidence and must act with a high degree of candour and honesty. The vulnerable party must be protected. Fiduciaries cannot use their position for their own preferment. A 'fiduciary relationship' arises 'when there is a reposing of faith, confidence, and trust, and the placing of reliance by one upon the judgment and advice of another'.⁵ *Black's Law Dictionary* defines 'fiduciary' as

... an expression including both technical fiduciary relations and those informal relations which exist whenever one man trusts and relies upon another. It exists where there is special confidence reposed in one who in equity and good conscience is bound to act in good faith and with

2. Citing Parsons, 'The Director's Duty of Good Faith' (1967) 5 Melb ULR 395 at 397.
3. *The Duties and Powers of Management in the Company Law of Canada and England*, unpublished PhD thesis (London School of Economics and Political Science, 1971) at 341. See also *Mulkana Corp NL (in liq) v Bank of NSW* (1983) 1 ACLC 1143 per Powell J.
4. 'Directors, no doubt, are not trustees, but they occupy a trust position towards the company': *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134, 159. See discussion of these matters by Sealy, 'The Director as Trustee' [1967] CLJ 83.
5. Burns J in *Williams v Griffin* (1971) 35 Mich App 179; 192 NW 2d 283 at 285 (1971).

due regard to interests of one reposing the confidence. A relation subsisting between two persons in regard to a business, contract, or piece of property, or in regard to the general business or estate of one of them, of such a character that each must repose trust and confidence in the other and must exercise a corresponding degree of fairness and good faith. Out of such a relation, the law raises the rule that neither party may exert influence or pressure upon the other, take selfish advantage of his trust, or deal with the subject-matter of the trust in such a way as to benefit himself or prejudice the other except in the exercise of the utmost good faith and with the full knowledge and consent of that other, business shrewdness, hard bargaining, and astuteness to take advantage of the forgetfulness or negligence of another being totally prohibited as between persons standing in such a relation to each other. Examples of fiduciary relations are those existing between attorney and client, guardian and ward, principal and agent, executor and heir, trustee and *cestui que trust*, landlord and tenant, etc.⁶

Fundamentally, the director is a fiduciary to the company, the separate body or entity. In very rare cases, the director may be a fiduciary to others, such as shareholders or even creditors of the company. But as a general rule, the directors 'owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders'.⁷ This is not an easy position to defend in law, for the directors' acts can directly affect the rights of shareholders and creditors as well as those of the company.⁸ The law tries to deal with this by saying that 'the company' is really a manifestation of the shareholders, present and future, and sometimes the creditors, a theory which itself raises complex issues.

Is there a fiduciary relationship between directors and shareholders?

Directors traditionally owe their duties only to the company as a separate legal entity. They have, on that theory, no fiduciary bond with shareholders or creditors, nor with beneficiaries for whom the company may be trustee. This strict view is attributed to the much-criticised *Percival v Wright*.⁹ The directors bought unquoted shares in their own company

6. 5th ed, 1979 at 564. See also Mr Justice Douglas in *Pepper v Litton* (1939) 308 US 295 at 311; *Hospital Products Ltd v US Surgical Corp* (1984) 55 ALR 417 esp at 431–434 per Gibbs CJ and 458–460 per Mason J; Paterson, Ednie and Ford, *Australian Company Law* (Butterworths, 3rd ed) at para 228/14.

7. *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* [1983] 3 WLR 492 at 519, per Dillon LJ.

8. See comment on this by Finn, *Fiduciary Obligations* (The Law Book Company, 1977) at 64–69, esp paras 138, 139 and 141. Finn comments: 'Easily the most complex fiduciary office is the company board of directors' (at 64). He is generally unimpressed by the state of company law concerning the fiduciary office of director. See also discussion in Ch 5 below.

9. [1902] 2 Ch 421.

offered to them by shareholders, without disclosing to the shareholders that there were pending negotiations for the sale of the company's undertaking at a price which would have enhanced the value of the shares. Swinfen Eady J rejected submissions that there was a fiduciary relationship between the directors and the vendor shareholders requiring disclosure of the negotiations for the sale of the undertaking.¹⁰ *Percival v Wright* was affirmed in Western Australia in *Esplanade Developments Ltd v Dinive Holdings Pty Ltd*.¹¹

There are exceptions to this rule. In the New Zealand case of *Coleman v Myers*,¹² the Court of Appeal held that in the small family company at issue, where the shareholders relied heavily on the directors for specific information, a fiduciary duty may arise between directors and shareholders.¹³

White J, in *Hurley v BGH Nominees Pty Ltd*,¹⁴ adverted to the *Coleman v Myers* dictum of Mahon J but took the matter no further. Walters J in *Hurley No 2* hinted that there may sometimes be a direct duty to individual shareholders.¹⁵ This is as far as Australian courts have gone. There will be a direct relationship between directors and shareholders only in the exceptional case where there is a special dependence or the misuse of inside information or fraud. Apart from these exceptions, directors owe their fiduciary duties only to the company. This absence of a direct and acknowledged fiduciary relationship is, as one writer put it, 'a little mystifying',¹⁶ given that the board alone is entrusted with the major powers of management and that the shareholders are parties to the s 78 statutory contract.¹⁷

It has long been the view of United States' courts that not only directors but also majority shareholders owe fiduciary duties directly to minority shareholders.¹⁸ Directors owe fiduciary duties to all shareholders,

10. Note that s 229(3) and (4) of the Code outlaw the improper use of information and position by directors so to gain an advantage.

11. [1980] ACLC 34,232, esp at 34,237, per Brinsden J, citing *Gower's Modern Company Law* (3rd ed) at 517. See also *Winthrop Investments Ltd v Winnis* [1975] 2 NSWLR 666 at 680.

12. [1977] 2 NZLR 225. See also the special facts of *Allen v Hyatt* (1914) 30 TLR 444, where directors were held to be in the position of agents to the individual shareholders as well as to the company.

13. See comments on this aspect of *Coleman v Myers* by Dawson, (1979) 8 NZULR 265-267. See also *Gething v Kilner* [1972] 1 All ER 1166; [1972] 1 WLR 337.

14. (1982) 1 ACLC 387 at 393.

15. (1984) 37 SASR 499 at 510. Note also Young J in *Buttonwood Nominees Pty Ltd v Sundowner Minerals NL* (1986) 10 ACLR 360 at 362, where his Honour ruled 'that directors have a fiduciary duty to shareholders to give them full information on all material matters which are necessary for the shareholders to make an informed decision on the matter to be decided at the [general] meeting.'

16. Finn, above n 8 at 11 and 65.

17. The new s 78 (1985 version) adds a statutory contract between the company and each 'officer'. A far-reaching proposal to extend the statutory contract to bind officers not only to every other officer but also to members was abandoned.

18. *Jones v HF Ahmanson & Co* (1969) 460 P 2d 464 at 471-474; *Remillard Brick Co v Remillard-Dandini Co* (1952) 241 P 2d 66 at 74-75; *Panter v Marshall Field & Co* (1980) 486 F Supp 1168; affd 646 F 2d 271; *Treadway Companies Inc v Care Corp* (1979) 490 F Supp 653 at 657; 638 F 2d 357; *Dannen v Scafidi* (1979) 30 Ill Dec 899; 393 NE 2d 1246 at 1250. For a succinct account of the US position, see 18A Am Jur 2d at paras 762-777.

majority and minority, and must act fairly and in good faith towards them and for their common benefit. Australian courts are heading in this direction.

The full acceptance of a direct fiduciary bond in Australia would mean that shareholders could take action directly against directors where the fiduciary duties were not observed. For example, if the board acted capriciously, totally unreasonably, or failed to treat shareholders equally, actions could be brought by shareholders. The greatly expanded statutory grounds of action by shareholders — principally s 320 — cover this ground and have, in effect, created a type of fiduciary duty between directors and shareholders. The statute has taken the urgency out of achieving this development through the snail-paced general law.

Furthermore, as we shall see in Chapter 5, the traditional theory that fiduciary duties are owed only to the company indirectly serves the shareholders and creditors, and now possibly others as well. The concept of who constitutes 'the company' is broadening, and shareholders, creditors, employees and others should have their interests at least considered by the board. In serving the entity called the company, directors must turn their minds and bend their actions to the real financial interests of these other groups.

Categories of fiduciary duties

As we have seen, the relationship between director and company is fundamental to an understanding of directors' duties at general law. The director's fiduciary duties are:

- the duty to act honestly and in the company's best interests;
- the duty not to fetter his or her discretion;
- the duty to avoid conflicts between a director's personal interests and duties to the company, that is:
 - to avoid entering contracts in which the company has an interest;
 - to avoid making 'secret profits'; and
- the duty to exercise the director's powers for what have been called 'proper purposes'.

The director's duties of care, skill and diligence differ from the fiduciary duties in that they are not based solely on trust, loyalty, fairness and good faith. One can be faithful *and* negligent.