Chapter 5

Duty to Act Honestly and in the Best Interests of the Company

Introduction

The fiduciary duties of directors are owed to the company. Directors, in exercising their powers, must act in the company's interests.[1] As Bowen L J said, charity cannot sit at the boardroom table: 'there are to be no cakes and ale except such as are required for the benefit of the company'.[2] Directors comply if they do what they honestly believe to be right and behave as one would expect honest business people to behave in the same circumstances.[3] Directors, when making management decisions, should ask themselves (or at least be sensitive to) what, in their honest opinion, is the best decision for the company, and vote or act accordingly. They can be in breach of this duty even if what they are doing is 'technically' correct and on the face of it within the directors' powers. They will not be in breach if the act is beneficial to the company, even though they have not specifically turned their minds to what is in the company's best interests.[4]

The court will interfere when there is a breach of duty, such as fraud or an abuse of power, but it will not substitute its discretion or judgment for that of the directors acting in good faith.[5] The court is wary of usurping management's role, partly because it lacks intimate knowledge

1. Shareholders have the same duty when exercising their votes, even though, unlike directors, they are not in fiduciary positions: *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438; *Re Broadcasting Station 2GB Pty Ltd* [1964–5] NSWR 1648 at 1662; *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286. Note Walters J in *Hurley v BGH Nominees Pty Ltd (No 2)* (1984) 2 ACLC 497 at 506:

   > But I am far from persuaded that 'the directors of a company [are] entitled in all circumstances to act as though they owed no duty to the individual shareholders' (*Allen v Hyatt* (PC) (1914) 30 TLR 444).

2. *Hutton v West Cork Railway* (1883) 23 Ch D 654 at 673. In that case, a gratuitous disposition from a company being wound up was ruled ultra vires.
3. See *Gower's Principles of Modern Company Law* (4th ed) at 577.
4. Pennycuick J in *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] 1 Ch 62 at 74.
5. Brennan J in *Wayde v NSW Rugby League Ltd* (1985) 3 ACLC 799 at 805; Lord Wilberforce in *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832; Street C J, Kirby P and Hope J A in *NSW Rugby League Ltd v Wayde* (1985) 3 ACLC 177 at 190–191. Cf the American 'business judgment rule', under which directors enjoy a presumption of sound business judgment which will not be disturbed if a rational purpose can be attributed to their decisions: *Panter v Marshall Field & Co* (1981) 646 F 2d 271 at 293–294.

and experience of the day-to-day affairs and needs of the particular company.

An example of a breach of the duty to act bona fide in the best interests of the company arose in *Clarkson Co Ltd v White*.[6] The only two directors (and majority shareholders) of Rustop Ltd passed a board resolution forgiving another company (of which they were sole directors and shareholders) a debt of $26,650. The directors then sold their shares in Rustop. The company became bankrupt some months later. The trustee in bankruptcy, who took control of the company, successfully claimed that the directors had not observed their fiduciary duty to act in the best interests of Rustop Ltd in forgiving the debt.[7]

Two tests or one?

There is a subjective element to this duty, that is, the directors must act bona fide or honestly. There is also an objective element, that is, they must act in what are the best interests of the company. Pennycuick J, in *Charterbridge*, thought that the 'proper test' was

> . . . whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.[8]

There is doubt over whether the two semantic components of the test — bona fides and in the company's best interests — should or can be separated out into subjective and objective elements respectively and applied on each occasion. Scrutton L J in *Shuttleworth v Cox Bros & Co (Maidenhead)*,[9] Isaacs J in *The Australian Metropolitan Life Assurance Co Ltd v Ure*,[10] and Warrington L J in *Sidebottom v Kershaw Leese & Co*[11] thought not. Astbury J in *Brown v British Abrasive Wheel Co*[12] appeared to separate the two. An action by directors may be done in good faith but it may not, on an objective view, be in the best interests of the company. In such a case, the court should find a breach of duty.[13] As dishonest or fraudulent behaviour by directors is invariably not in the company's best interests, for practical purposes the distinction between the components is rarely material.

6. (1980) 102 DLR 403.
7. The Nova Scotia Supreme Court, Appeal Division, ibid at 413 and 416, suggested that if the directors (who beneficially owned 67% of the issued shares) and the other shareholder (the company which was forgiven the debt) had authorised the directors' action by resolution at a general meeting, the trustee in bankruptcy could not have taken action. From the point of view of creditors of the company, this seems hardly fair.
8. *Charterbridge Corporation Ltd v Lloyds Bank Ltd*, above n 4 at 74.
9. [1927] 2 KB 9 at 22–24 (in relation to shareholders' actions).
10. (1923) 33 CLR 199 at 217.
11. [1920] 1 Ch 154 at 172.
12. [1919] 1 Ch 290 at 295.
13. See Scrutton L J in *Shuttleworth v Cox Bros & Co (Maidenhead)*, above n 9 at 24.

The duty to act bona fide

The duty to act honestly or bona fide means, for example, that directors must make sufficient and accurate disclosures to shareholders when seeking the general meeting's support, opinion or decision.[14] If a director sees a course of action as being harmful to the corporation, he must in honesty advise the shareholders of this and, if he has the appropriate skills, advise them of a proper course of conduct.[15] Honesty was also at issue in the 'tricky circular' cases.[16]

Eve J concluded in *Sidebottom v Kershaw, Leese & Co* that lack of bona fides can be tested by asking

> Was the resolution adopted, or was the alteration made for the benefit of the company or for the benefit of some section of the company, without reference to the benefit of the company as a whole?[17]

This, in essence, runs the two components or parts of the test together. It says you are bona fide if you act in the company's best interests.

Peterson J in *Dafen Tinplate Co v Llanelly Steel Co* ruled: 'The question is whether in fact the alteration [of the articles] is genuinely for the benefit of the company.'[18] His Honour rejected the proposal that the only question was whether the shareholders 'bona fide or honestly believed that the alteration was for the benefit of the company'.[19]

More helpful is the formulation by Isaacs J, in *The Australian Metropolitan Life Assurance Co Ltd v Ure*,[20] that acting honestly or bona fide means exercising a power 'for the purpose for which it was conferred'. If directors act for themselves or for some private interest they have not satisfied this requirement.[21]

The duty to act in the company's best interests

A company is usually created to maximise profit through efficient production. Accordingly, anything within the law which fosters that aim is in the company's best interests. Whilst this philosophy still prevails, it is increasingly under challenge. Challengers, who view the big corporation as being akin to large private governments in their power and influence, argue that large companies especially should be run in the

14. *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 at 486ff; *Bulfin v Bebarfalds Ltd* (1938) 38 SR (NSW) 423 at 431ff.
15. *Peel v London and North Western Railway Co* [1907] 1 Ch 5 at 16 and 21, per Fletcher Moulton L J.
16. *Jackson v The Munster Bank Ltd* (1884) 13 LR Ir 118; *Kaye v Croydon Tramways Co* [1898] 1 Ch 358; *Baillie v Oriental Telephone and Electric Co Ltd* [1915] 1 Ch 503; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1980] 3 WLR 543 (first instance).
17. [1920] 1 Ch 154 at 173.
18. [1920] 2 Ch 124 at 140.
19. Ibid.
20. Above n 10 at 217.
21. See discussion of this problem by Powell J at first instance in *Kinsela Pty Ltd v Kinsela* (1983) 8 ACLR 384 at 402–405.

wider public interest and that they should take account of non-financial aims, such as nondiscrimination, consumer protection, compliance with the law, environmental cleanliness and industrial safety.[22] Commonsense and survival demand that close attention be paid by boards to profitability, but increasingly we see them advised or required to consider matters other than profit maximisation. Modern managers seek to balance competing interests, and they more readily acknowledge a company's broader social responsibilities.

Developments along these lines have further strengthened the hand of management and have made the duty to act in the company's best interests less inhibiting. The broader the range of acts open to directors, the less control there is over their activities.[23]

What is meant by the 'company' in this context? It is said that it does not mean the company as a separate, abstract entity but 'the corporators as a general body'.[24] Should the term 'company' also include employees or creditors of the company? When acting in the 'interests of the company', can and should one consider the interests of customers and, especially for large companies, even of the general public? Is it not unrealistic to see 'the company' as being only the shareholders, to the exclusion especially of creditors and employees? Some of these other 'interested' groups will now be considered.

The interests of present and future shareholders

Directors are usually hired and fired by the general meeting. It seems fitting, then, that when acting in the interests of the company the directors must have regard only to the interests of present and (providing that the company is a going concern and not insolvent) of future shareholders. Directors must balance the short-term considerations of present shareholders against long-term considerations which would embrace the interests of future shareholders as well.[25] This means all shareholders, not just a majority,[26] and all classes of shareholders, not just some.[27] Afterman concluded: 'As a matter of law, the commercial interest of the company may be considered only so far as it serves the shareholders (present and future) who are its real beneficiaries.'[28] The English Court of Appeal reaffirmed this in the *Multinational Gas and Petrochemical Co*

22. See Galbraith, *The Age of Uncertainty* (1977) at 278. Cf Fischel, 'The Corporate Governance Movement' (1982) 35 Vand LR 1259.
23. See comment to this effect by Dawson, 'Acting in the Best Interests of the Company — For Whom are Directors "Trustees"?' (1984) NZULR 68 at 80–81.
24. Evershed M R in *Greenhalgh v Arderne Cinemas Ltd* (1951) Ch 286 at 291.
25. See the *Savoy Hotel* case (HMSO 1954) — this case did not reach the courts but produced valuable legal opinion on the meaning of the 'interests of the company'. Gower discussed this case in 'Corporate Control: The Battle for the Berkeley' (1955) 68 Harv L R 1176.
26. *Henry v Great Northern Railway* (1857) 1 De G & J 606 at 638; 44 ER 858 at 871.
27. *Martin v Gibson* (1907) 15 OLR 623, per Boyd C.
28. *Company Directors and Controllers* (1970) at 46.

case: 'So long as the company is solvent the shareholders are in substance the company.'[29]

There may well be a divergence at this point between law and managerial practice. As already noted, management commonly regard it as unethical to ignore the interests of creditors, consumers and employees. And rarely will the present and long-term success of a company be incompatible with the reasonable expectations of such groups. A balancing of all these interests usually predicates long-term prosperity. At strict law, however, it is usually only when the interests of shareholders coincide with those of the employees, creditors and the public at large that the interests of the latter groups can be pursued.[30]

The courts have consistently refused to acknowledge openly the interests of outsiders. Reformers have suggested that directors should be permitted or even compelled to take account of creditors and employees, who have an obvious interest in the welfare of the company. Upholding the interests of creditors and employees is not a new concept. Bonus payments to employees to encourage productivity have long been permitted as being beneficial in the long term to the company.[31] In the last 20 years or so, the notion of the 'company' has broadened to embrace such groups.[32]

The interests of employees

The traditional rule of the paramountcy of the interests of shareholders was demonstrated in some of the 'corporate gifts' cases. ('Corporate gifts' are gratuitous payments by a company to its own directors, employees or even outsiders, such as educational institutions or political parties. These gifts are made either to reward employees, to create goodwill, or in the expectation that the company's reputation will rise or that the community or public at large may benefit.) The companies thought that such donations or payments were reasonably incidental to their businesses. Is such a wide vision of the company's role and interests acceptable at law? Some English courts in the 1960s thought not, even where the memoranda of association of companies expressly said that 'corporate gifts' could be made. They held that the companies should adopt a straightforward role of using profits for the benefit of shareholders only. Wider responsibilities were ruled out.

In *Parke v The Daily News Ltd*,[33] the directors, rather than run the risk of a further loss of assets, sold the copyright, plant and premises of the company's two newspapers. Most of the employees of the company lost their jobs as a result. The directors, keen to treat the former employees

29. [1983] 3 WLR 492 at 519, per Dillon L J. See also Lawton L J at 501–502.
30. See *Gore-Browne on Companies* (44th ed, 1986) at para 27.4. Cf Instone, 'The Duty of Directors' [1979] JBL 221 at 226–228.
31. *Hampson v Prices Patent Candle Co* (1876) 24 WR 754.
32. See a good discussion of this by Dawson, above n 23.
33. [1962] Ch 927.

generously, decided that the balance of the price obtained for the property sold would, after deduction of expenses, be allocated to the retrenched employees in compensation payments and benefits. A minority shareholder, Parke, objected to the proposal. He asserted that the ex gratia payments were not made with the continuing company's interests in mind because it would no longer be an employer in the newspaper industry. Plowman J took a narrow view. He agreed that the company's funds could not be applied in this way. Such payments could only be valid if they were reasonably incidental to the carrying on of the company's business (that is, intra vires) and bona fide and for the benefit of, and to promote the prosperity of, the company. The onus on the directors to justify the ex gratia payments on these grounds was not satisfied. This finding ran against any trend favouring a duty between directors and employees. The notion of the company, it seemed, did not embrace employees.

There was a similar finding in *Re W & M Roith Ltd*.[34] The memorandum had been altered expressly to allow the directors to award pensions to the wives of company employees. In the managing director's service agreement, the company covenanted to pay a pension to his widow. Despite the covenant, the court upheld the liquidator's rejection of the widow's claim.[35] The directors had acted only to benefit the widow; the company's interests had not been addressed by the directors. This, too, was a harsh decision.[36]

The traditional view was also spelled out in *Dodge v Ford Motor Co*.[37] The successful Ford Motor Company, dominated by its founder, Henry Ford, proposed to plough profits back into the company's development and to reduce the selling price of Ford cars. The founder hoped by so

34. [1967] 1 WLR 432.
35. Plowman J reasoned that, although providing a widow's pension *could* be incidental to the business, on the facts before him the entering into the agreement with the deceased managing director had *not* been reasonably incidental to the carrying on of the company's business *or* bona fide to benefit and promote the company's prosperity.
36. *Gower* (4th ed) at 577 notes that *Re Roith* illustrates how directors may be in breach of this fiduciary duty, 'notwithstanding that it is not shown that they have acted with any conscious dishonesty, if they have acted as they did because it was in their own interests or that of some third party, without considering whether it was also in the interests of the company'. Cf the approach in *Re Roith* with that in *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62. The 'objects clause' in the memorandum allowed the company to grant mortgages over its property to secure the bank overdrafts of other companies in the same group. Pennycuick J ruled that it was not necessary to establish whether or not the directors had actually considered the benefit of their company as a separate legal entity in its granting of such mortgages. Their state of mind was irrelevant. An objective test was appropriate:

   > . . . whether an intelligent and honest man in the position of a director. . . could. . . have reasonably believed that the transactions were for the benefit of the company (at 74).

   See also *Bell Houses Ltd v City Wall Properties Ltd* [1966] 2 All ER 674 (CA) and *Reid Murray Holdings Ltd v David Murray Holdings Pty Ltd* (1972) 5 SASR 386 esp at 398–401, per Mitchell J.
37. (1919) 170 NW 668. Discussed by Dawson, above n 23 at 73–74.

doing to increase employment and 'to spread the benefits of the industrial system to the greatest possible number, to help them build up their lives and their homes'. Two shareholders successfully acted to force the company to pay out increased dividends instead. The court ruled that the board lacked the power to run the company to benefit non-shareholders: 'A business corporation is organised and carried on primarily for the profit of stockholders.'[38]

Breach of duty and ultra vires

The usefulness of some of these decisions is doubtful, however, because of the confusion of the tests used to discover if there has been an excess of power (ultra vires) with those used to discover an abuse of power (breach of duty). In the past, the validity of these gifts has been seen as a question of ultra vires, as a question of legal capacity in the narrow sense. It is now established — contrary to *Re Roith*[39] — that the 'bona fide for the benefit of the company' test is not relevant to questions of the company's powers or capacity, that is, to questions of ultra vires. It applies only to the question of the propriety of the exercise of a power, that is, to questions of breach of duty.[40] As Pennycuick J pointed out in *Charterbridge*:

> Where directors misapply the assets of their company [as in some of these 'corporate gifts' cases], that may give rise to a claim based on breach of duty. . . . But all that. . . has not of itself anything to do with the corporate powers of the company.[41]

In other words, in past years such 'gifts' were usually within the *company's* powers. But they may well have not been within the powers of *directors*, because of the motives of the directors at the time. The motives or state of mind of the directors is relevant when considering breach of duty (for example, to discover whether directors have acted

38. Ibid at 684.
39. Contrary to the dictum of Eve J in *Re Lee, Behrens & Co Ltd* [1932] 2 Ch 46 at 52–53. Vinelott J further complicated the issues in *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1982] 3 All ER 1057. His Honour distinguished between 'narrow' ultra vires, which is the traditional concept of the company lacking legal capacity, and 'wider' ultra vires, which includes actions not in the best interests of the company. Professor Austin concluded in his paper, 'A Survey of the 1985 Exposure Draft — Part 1', Proceedings of a Joint Seminar held at the University of Sydney, 25 July 1985 at p 5: 'Vinelott J's idea rests on a confusion of principles and ought not to be accepted in Australia.' The 1985 amendments to the Code (which came into force on 31 March 1986) include a new s 67(3). It says:

    > The fact that the doing of an act by a company would not be, or is not, in the best interests of the company does not affect the legal capacity of the company to do the act.

    The Explanatory Memorandum says that sub-s (3) 'specifically excludes the application of the *Rolled Steel* case and is designed to prevent any suggestion that any doctrine of "wider ultra vires" as expounded by the courts remains in existence'.
40. See *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016 at 1029, 1034–1035, per Oliver J. See also Baxter, 'Ultra Vires and Agency Untwined' (1970) 28 CLJ 280 at 295.
41. Above n 36 at 69.

bona fide and in the company's interests), but not when considering ultra vires issues.[42]

Developments in the law have chipped away at the idea that a company must only be concerned with profit-maximisation. There have been recent UK decisions on ultra vires, upholding the validity of gratuities and the wide drafting of objects clauses. Further, the removal in Australia of the ultra vires doctrine, by ss 66A–68 of the Code (as amended in 1985), and legislative changes in New Zealand and the UK allowing employees' interests to be considered by boards, mean that such decisions as *Parke* and *Re Roith* are probably of historical interest only.[43] Directors are now able to have greater regard for the interests of employees and even the public at large. But while these developments further enhance the power of management, they increase the possibilities of the abuse of power. Now that the company may have the legal capacity of a natural person, and objects need not be stated in the memorandum of association, it will be even more difficult to determine if the board has breached its duty to act bona fide and in the company's best interests.[44] To this extent, there is still an incentive to take the trouble to draft objects for a new company's memorandum which restrict the company's powers and hence the activities of its directors. Of course, most companies registered before 1 January 1984 still have objects in their memoranda, and regardless of the abolition of the ultra vires doctrine, such restrictions, if contravened by actions of the board or an officer, may under s 68(6)(g) be relied on in proceedings (other than an application for an injunction) by the company or a member against officers.

The interests of employees on the one hand and of shareholders and creditors on the other may sometimes clash. The introduction of new technology, for example, may jeopardise jobs and yet promise much for

42. See above n 36 at 70–71, per Pennycuick J. See also Baxter, (1970) 28 CLJ 280 at 288–289; *Re Horsley & Weight Ltd* [1982] 3 WLR 431 at 440–441, per Buckley L J, at 442, per Cumming-Bruce L J. The complex question of ultra vires will not be addressed in this book. The legislature has made valiant efforts to rid Australia of its few remnants: see ss 66A–68 of the Code (as amended by Act No 192 of 1985). Section 66C optimistically declares an intention to abolish 'the doctrine of *ultra vires*' as it applies to companies. Thankfully, this is not a burning issue in Australia. There has not been an 'ultra vires case' in Australia since *Reid Murray*, above n 36, which concerned events taking place before s 20 of the *UCA* came into force in 1962.
43. But Slutsky has pointed out that

    > . . . it is quite possible, for example, that a gift totally unrelated to the carrying on of the company's business — perhaps one which could not even be said to create or preserve goodwill . . . — would be held invalid as not being for the benefit of the company, even in the absence of an ultra vires argument.

    See his unpublished PhD thesis, London School of Economics and Political Science (1971) at 176. Such statements must be considered now in the light of legislative changes to the law on ultra vires.
44. See discussions of this in the NZ context by Partridge, (1984) 5 Akld ULR 73 at 79 and Shapira, 'Ultra Vires: Not Quite the End' [1985] NZLJ 124. If the memorandum does not list the objects for which the company's powers as a natural person must be exercised, gifts to charity by companies may be beyond challenge.

the company's profitability. In Australia, at present, the interests of the shareholders and creditors would prevail.

Legislation on employees' interests overseas

The Australian position offers little joy to employees as yet. But, overseas legislatures, reflecting the public's changing expectations of corporate responsibility, allow or even require consideration of the position of employees. Subsections 15A(l)(g) and (2) of the New Zealand *Companies Act 1955* allow the board to act in favour of employees' welfare when a business ceases, regardless of whether or not it is in the best interests of the company.

Section 719 of the UK *Companies Act 1985* purports directly to overcome the effect of *Parke*. It provides that the company may, with the members' sanction, make provision for present or past employees in the event of cessation of business, even though the exercise of the power may not be in the company's best interests.[45] Section 309 of the 1985 UK Act adds that 'The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members'. Section 309(2) says that the duty is owed by the directors to the *company*.

Proving that the directors did not take adequate account of employees' interests will be difficult. Further, as the duty is owed to the company, only the company, or minority shareholders who establish an exception to the Rule in *Foss v Harbottle*, can sue the directors for breach. Fears of a flood of litigation probably deterred the legislature from allowing employees to enforce the section. The section may, however, encourage greater consultation with employees and the appointment of worker-directors.[46] Interesting clashes between members' and employees' interests will arise. For example, Instone asks what priorities the board will adopt when directors must decide whether or not to close a loss-making factory.[47]

The interests of creditors

Mason J, in the High Court of Australia, recognised the importance of creditors' interests in *Walker v Wimborne*.[48] The company was in liquidation. Three of its directors had paid money out in risky circumstances to other related companies of which they were also directors. The company in liquidation had not received any benefit from these payments, although, of course, the payee companies had. The High

45. Subsections (1) to (3) contain provisions formerly in the UK *Companies Act 1980*, s 74(1)–(3).
46. On the UK provision (formerly s 46 of the UK *Companies Act 1980*), see Birds, (1980) 1 Co Law 62 at 72–73; Boyle, (1980) 1 Co Law 280 at 284–285; Mackenzie, [1982] NLJ 688.
47. 'The Duty of Directors' [1979] JBL 221 at 230.
48. (1976) 137 CLR 1 at 7.

Court found the directors guilty of 'misfeasance' within s 367B of the *UCA*. Mason J noted:

> Indeed, the emphasis given by the primary judge to the circumstance that the group derived a benefit from the transaction tended to obscure the fundamental principles that each of the companies was a separate and independent legal entity, and that it was the duty of the directors of Asiatic to consult its interests and its interests alone in deciding whether payments should be made to other companies. In this respect it should be emphasized that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders *and its creditors*. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them. The creditor of a company, whether it be a member of a 'group' of companies in the accepted sense of that term or not, must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent [Emphasis added].[49]

He reasoned that failure to look after the interests of creditors amounts to failure to look after the company's interests and thus to a breach of directors' duties to the company.

The *Walker v Wimborne* dictum was cited and applied in *Ring v Sutton*[50] in the context of a loan on favourable terms by a company to one of its directors, and by White J at first instance in *Permakraft (NZ) Ltd (in liq) v Nicholson*.[51] His Honour specifically considered the interests of creditors when he concluded that the directors had not fulfilled their duty to consider the interests of their own company. Buckley L J in *Re Horsley & Weight Ltd* cautioned that it was a 'misapprehension' to suppose that directors owed a duty to creditors to keep the company's capital intact, although he did concede:

> It may be somewhat loosely said that directors owe an indirect duty to creditors not to permit any unlawful reduction of capital to occur, but. . . [it would be] more accurate to say that the directors owe a duty to the company in this respect and that, if the company is put into liquidation when paid-up capital has been improperly repaid, the liquidator owes a duty to the creditors to enforce any right to repayment which is available to the company.[52]

Cooke J of the New Zealand Court of Appeal was more forthright in *Nicholson v Permacraft (NZ) Ltd (in liq)*.[53] His Honour, in a dictum, spoke not only of directors having to consider the interests of unsecured creditors as part of their duties to the company, but also of *breach of duty to*

49. Ibid at 6–7.
50. (1980) 5 ACLR 546 at 547–548, per Hope J A. See also Fullagar J in *Re 67 Budd St Pty Ltd v The Commonwealth* (1984) 2 ACLC 190 at 197 and again in *Commonwealth of Australia v O'Reilly* (1984) 52 ALR 631 at 639–640.
51. (1982) 1 ACLC 488 at 509.
52. [1982] 3 WLR 431 at 442.
53. (1985) 3 ACLC 453.

the creditors.[54] Drawing on 'the now pervasive concepts of duty to a neighbour', Cooke J suggested that an objective test should be applied, namely, whether the directors 'ought to have realised that their action is likely to cause loss to existing and continuing creditors'.[55]

Street CJ, in the NSW Court of Appeal, relied on *Permakraft* when concluding in *Kinsela v Russell Kinsela Pty Ltd (in liq)*:

> In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.[56]

In this case, the company, near to financial collapse, leased property to its own directors. The intention was to put a valuable asset of the company out of the reach of creditors. The terms of the lease were apparently favourable to the directors. The court affirmed the lower court's finding that the lease was voidable. The duty to act in the best interests of the company had been breached by the directors.

These two cases signal major changes in the obligations of company directors. They firmly establish the principle that the directors of insolvent companies must act in the interests of creditors. Must directors of solvent companies bear creditors' interests in mind too? Cooke J in *Permakraft* suggests there may be a direct duty owed by directors to creditors, a duty of care based on the expanding 'neighbour principle' in the law of torts. This is a bold change to the law which formerly has said that creditors' interests were to be regarded really as part of the interests of the company and not as a separate category of direct duties. There are several possible repercussions of such an innovation. The *Foss v Harbottle* problems of standing (discussed in Chapter 9) would not hinder actions brought by creditors for a breach of duty owed directly to them. Second, the expansion of the categories of negligence actions associated with the 'neighbour principle' may be imported into the law of directors' duties, and affect even directors of solvent companies. Such a change would be very significant.

Further, would the standard of care expected of directors in relation to creditors be higher than that expected of directors in relation to the

54. Ibid at 459 and 460. In the US, a fiduciary relationship may exist between directors and creditors: see, for example, *Dannen v Scafidi* (1979) 393 NE 2d 1246 at 1250.
55. Ibid at 462.
56. (1986) 4 ACLC 215 at 221. See, recently, *Grove v Flavel* (1986) 4 ACLC 654 at 660–662 per Jacobs J.

company? As the 'neighbour principle' expands in the law of tort will it drag up the traditionally low standards required of directors in performance of their duty of care to the company?

In the end, a balance must still be struck that enables the company to function and business risks to be taken. Also, the interests of creditors must be weighed at times against those of shareholders. Shareholders may want the board to take business risks but a separate duty of care to creditors may inhibit the board. It is likely that only in exceptional cases, notably where the company is insolvent or the proposed board action will plunder the company's funds, that any such separate duty of directors to the creditors will be seriously considered.

When, in a solvent company, the shareholders' and creditors' interests clash beyond reconciliation, what should be done? One commentator suggests:

> In ordinary circumstances where insolvency and impending liquidation do not emphasise the statutory protection afforded to creditors, it must continue to be the duty of directors to have regard primarily to the interests of the company as a general body of shareholders.[57]

The interests of beneficiaries of corporate trustees

Recent discussion has centred on the position of directors of trustee companies vis-à-vis beneficiaries of the trust who are not shareholders of the trustee companies.[58] This is a matter of importance because of the geometric increase in the number of trustee companies in recent years.[59] Whilst directors of trustee companies owe fiduciary duties to their companies, on traditional principles they owe no such duties to beneficiaries of a trust for which the company is trustee. This leaves the beneficiary in a curious and unenviable 'relationship' with the trustee company's directors. Traditionally the beneficiary has no tie or fiduciary bond with the directors. The beneficiary cannot directly challenge the directors. However, the company, being the trustee, owes duties to the beneficiaries. And the directors act for the company: their acts are the acts of the trustee.

The question then is, if the company has no beneficial interest in assets of any importance (as is common with '$2 companies'), can the beneficiaries ask the court to lift the corporate veil so that they can take action directly against the directors? The authors of *Corporate Trustees* think so.[60] The South Australian Supreme Court, in *Hurley v BGH Nominees Pty Ltd*,[61] discussed the matter but reached no firm conclusions.[62] However, it was

57. Barrett, (1977) 40 MLR 226 at 231.
58. See *Bath v Standard Land Co Ltd* [1911] 1 Ch 618. See generally, Coleman, 'Duties of Directors of Corporate Trustees to Beneficiaries' (1984) 2 C & SLJ 147.
59. See Betts, Buchanan and Baxt, *Corporate Trustees* (1979) at paras 101, 328.
60. Ibid at para 330.
61. (1982) 1 ACLC 387.
62. See White J, ibid at 394. See also Robson, (1983) 53 Aust Accountant 773.

prepared to chance its arm in *Hurley v BGH Nominees Pty Ltd* (*No 2*). Walters J noted in a dictum:

> . . . it seems to me that a director must not disregard the interests of members of his company, or the interests of beneficiaries who are not shareholders but who are entitled to receive a benefit from the company's activities as a trustee of the relevant trust. I think it would be entirely unreal if a director were allowed to address his mind simply to the interests of the company and not to the additional consideration whether the transaction sought to be impugned was for the benefit of the shareholders or, indeed, the beneficiaries of a trust of which the company is trustee.[63]

His Honour went on to suggest that the position of beneficiaries of a trading trust should be 'no lower' than that of the company's creditors. The directors' fiduciary responsibilities embrace, Walters J implied, beneficiaries of a trust of which the company is trustee.[64] This goes far indeed. But it does not seem unreasonable to insist, perhaps by legislation, that the directors of trustee companies owe a duty to beneficiaries akin to the fiduciary duties owed by directors to companies.[65] If creditors and employees of companies can argue that their interests should be taken into account by directors, so too can beneficiaries.

Some directors may also be brought to account directly as constructive trustees of trust property and may be required to hand over or 'disgorge' property wrongly expropriated from the company.[66] Because such directors would be constructive trustees for their companies, the companies and not the beneficiaries would have to initiate this action.[67]

Directors of companies within a group of companies

It would be naive to think that, where companies operate closely together in groups, cartels or transnational businesses, directors of one company will not have regard to the interests of related companies.[68] There will often be great benefit for a group of companies, but not necessarily to individual members of the group, in the shuffling around of money and 'internal' arrangements so as to promote or retard certain parts of the

63. (1984) 2 ACLC 497 at 506.
64. Ibid.
65. But note Wishart, 'A Conservative Response to *Hurley's* Case' (1986) 4 C & SLJ 4, where the writer cautions against 'facile analyses' (at 13) and well-meaning but inappropriate legislative intervention in this area.
66. *Re James* [1949] SASR 143. This doctrine is also discussed in chapter 9. See also Coleman, above n 58 at 158–160.
67. See discussion by Coleman, above n 58 at 159–160.
68. Murphy J, in his dissenting judgment in *Commonwealth Aluminium Corporation Ltd v FCT* (1980) 80 ATC 4,371 at 4,384–4,385, spoke of the realities of power in transnational groupings of companies in large industries. Jenkinson J, in the Supreme Court of Victoria in the lower court hearing in the same case (and cited at 4,384–4,385 by Murphy J), found that through its power in the marketplace and its ownership of nearly all of the shares in Commonwealth Aluminium (the respondent), Comalco influenced board decisions in the respondent. See also Baxt, [1976] Bus LR 289 at 296–298.

overall enterprise. In the common good, one might argue, some companies in the group should suffer and others thrive. After all, the accounts provisions in the legislation treat groups of companies more or less as financial entities. But directors' duties are well established: they must look after the best interests of their own company, of their own shareholders and creditors.

Mason J in *Walker v Wimborne* was inclined within limits to accept the realities of control in groups of companies (that is, companies linked by common or interlocking shareholders or unified control of the capacity to control):

> In such a case [where a group exists] the payment of money by company A to company B to enable company B to carry on its business may have derivative benefits for company A as a shareholder in company B if that company is enabled to trade profitably or realize its assets to advantage. Even so, the transaction is one which must be viewed from the standpoint of company A and judged according to the criterion of the interests of that company.[69]

It matters not that company B (to take Mason J's example) is the wholly-owned subsidiary of company A. This very situation arose in *Reid Murray Holdings v David Murray Holdings*.[70] David M's shareholding was entirely owned by Reid M. The directors of the former had acted upon directions from the latter's board. Mitchell J found that David M's directors had not acted in its best interests in the transactions at issue. Her Honour chose to

> . . . adopt a statement of Pennycuick J in *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62, 74 that in a case where one company is the member of a group with common shareholding 'each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company'.[71]

Nominee directors acting in the company's best interests

The articles or a separate contract may permit the appointment of directors by a parent company, a related company, classes of shareholders, debenture-holders, creditors or employees. Such nominees give their appointors greater information about and influence over the company than they would otherwise have. But how far can such 'nominee' directors go in promoting the interests of their patrons? And what should nominee directors do when conflicts of loyalties to their patrons and their companies arise?

Lord Denning suggested that a subsidiary company's interests should never be subordinated to those of the nominating body or patron by the nominee directors on the subsidiary's board.

69. Above n 48 at 6.
70. Above n 36.
71. Ibid at 402–403.

> Or take a nominee director, that is, a director of a company who is nominated by a large shareholder to represent his interests. There is nothing wrong in it. It is done every day. Nothing wrong, that is, so long as the director is left free to exercise his best judgment in the interests of the company he serves. But if he is put upon terms that he is bound to act in the affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful. . . or if he agrees to subordinate the interests of the company to the interests of his patron, it is conduct oppressive to the other shareholders for which the patron can be brought to book. . . .[72]

Lord Denning cited Viscount Simonds and himself from *Scottish Co-operative Wholesale Society Ltd v Meyer*.[73] A co-operative society formed a subsidiary — a textile company — to manufacture and sell rayon cloth. Under the subsidiary's articles, the parent, co-operative society was able to nominate three out of the five directors of the subsidiary company. The parent nominated three of its own directors. As Lord Denning pointed out:

> So long as the interests of all concerned were in harmony, there was no difficulty. The nominee directors could do their duty by both companies without embarrassment. But, so soon as the interests of the two companies were in conflict, the nominee directors were placed in an impossible position.[74]

When the textile (subsidiary) company and the co-operative society came into business competition the three nominee directors 'did nothing to defend the interests of the textile company against the conduct of the co-operative society. In this they were wrong'.[75] Their first loyalty was owed to the textile company when its business interests were at stake, yet they had the same duty with regard to the society. What could they have done? Lord Denning suggested that on the textile company's behalf they should at least have 'protested' against the setting up of a competing business by the co-operative society.[76] Even though their protest may have been in vain (they were in a minority on the society's board) it still should have been made:[77]

> . . . when a frank and prompt statement to their co-directors might have enabled them to retrieve its [the company's] fortunes, they played their part by maintaining silence.[78]

72. *Boulting v Association of Cinematograph Television and Allied Technicians* [1963] 2 QB 606 at 626–627. See also Young J in *Morgan v 45 Flers Avenue Pty Ltd* (1986) 10 ACLR 692 at 705; Street J in *Bennetts v Board of Fire Commissioners of NSW* (1967) 87 WN (NSW) 307 at 310–311.
73. [1959] AC 324 (HL).
74. Ibid at 366.
75. Lord Denning, ibid at 367.
76. Ibid at 367.
77. By either subordinating the interests of the textile company to those of the society, or by doing nothing to protect the textile company, the directors acted oppressively towards the other shareholders of the company within the meaning of the equivalent of s 320 of the Code. Oppression is discussed below in Chapter 12.
78. Viscount Simonds, above n 73 at 341.

Jacobs J in the Supreme Court of New South Wales referred to the 'realities of company organisation' and acknowledged that appointees must often harbour partisan feelings for their patrons.[79] His Honour concluded that to insist that every director confront every company decision with a 'completely open mind' would in effect 'make the position of a nominee or representative director an impossibility'.[80] However, if the directors, acting as nominees of Fairfax, were to act in the interests of Fairfax, whether contrary to their own company's interests or without regard for its interests, or were to do nothing when action to defend their company was required, then they would be in breach of their duty to the company.[81]

In certain circumstances, it may actually be in the company's best interests if nominee directors represent and advocate only the interests of patrons.[82] Whilst the broad fiduciary principle does dominate, its ambit can be narrowed by agreement amongst the shareholders.[83] *Gower*[84] and Afterman[85] suggest that a provision in the articles permitting nominee directors to act solely in the interests of their patrons/nominators could be effective. However, officers should be aware of s 237 of the Australian Code which renders void provisions exempting officers from any liability for breach of duty. In principle, however, the duty to act bona fide in the company's interest should prevail, irrespective of the influence and needs of the nominator.

Gower in his 1961 Ghanaian Code draft suggested allowing nominees to give 'special but not exclusive consideration to the interests of that class [that is, nominators]'.[86] This was not adopted.

Directors on more than one board

In *Meyer's* case, the parent and subsidiary companies had common directors. In such situations, difficulties can arise. What is good for one company may not be good for the other. What should directors do in this situation? Hulme offered an answer.

> There is no inconsistency between the same person as a director of Company A voting to ask Company B for a loan, and then as a director of Company B voting against making it. On the board of Company A,

79. *Re Broadcasting Station 2GB Pty Ltd* [1964] NSWR 1648. See also *Morgan v 45 Flers Avenue Pty Ltd*, above n 72 at 705.
80. Ibid at 1663.
81. On the facts, there was no evidence of such a breach here.
82. *Levin v Clark* [1962] NSWR 686 at 700–701, per Jacobs J.
83. Ibid at 700.
84. (4th ed) at 523, n 46.
85. *Company Directors and Controllers* (1970) at 61.
86. Section 203(2) of the Ghanaian Code 1963 provides:

    A director shall act at all times in what he believes to be the best interests of the company as a whole so as to preserve its assets, further its business, and promote the purposes for which it was formed, and in such manner as a faithful, diligent, careful and ordinarily skilful director would act in the circumstances.

> his duty is to Company A. On the board of Company B, his duty is to Company B. These separate duties may well lead him to ask on one board, and reject on another. Very many of the problems of this sort disappear if one says: Which board am I sitting on now?[87]

While this is a solution in theory, interlocking directorships will always pose two problems for the director — a potential clash of loyalties to the different companies and the temptation to exploit inside information for personal gain.

Director's duty not to fetter discretion

Analogous to the possible influence by nominators of directors to boards is the principle that the director cannot bind, pledge or fetter his future discretion to be exercised in making management decisions.[88] There are relatively few authorities on this facet of the director's fiduciary duties.[89]

This duty arises from the fact that the director exercises powers in the fiduciary or trust position *for his company*. Thus he should not, for example, contract with outsiders or fellow directors as to how he shall vote at board meetings, no matter that he may be of the opinion that he is acting bona fide and for the company's interests. By so promising his vote, the director breaches his duty.[90] Directors must observe what they conscientiously think are the company's best interests whenever decisions are taken.[91] The court will not enforce a contractual fetter, and resolutions purporting to dictate future exercises of discretion are invalid.[92]

Remedies

The remedies available when there is a breach of the fiduciary duties are discussed in Chapter 9. In brief, because not acting in the company's best interest constitutes a breach of fiduciary duty, in equity the company (to whom the duty is owed) usually seeks either an accounting or disgorgement of any profits made through the breach, or, when' an accounting would not be appropriate, rescission or setting aside of the transactions directly tainted by the breach of duty. Any contract made with an informed third party is in a proper case voidable at the company's option.[93]

87. In a paper printed by the Australian Institute of Chartered Accountants and the Business Law Education Centre (November 1981) at 160, 167. See a good discussion of interlocking directorships by Farrar, *Company Law* (1985) at 395–397. See also discussion in Ch 6 below of directors competing with their companies.
88. See generally, Finn, *Fiduciary Obligations* (The Law Book Company, 1977) Ch 7 at 25ff.
89. See brief discussion in *Gower's Principles of Modern Company Law* (4th ed) at 582–583; also *Thorby v Goldberg* (1965) 112 CLR 597 at 605, per Kitto J and 617–618, per Owen J.
90. See also *Clark v Workman* [1920] 1 Ir R 107 at 117–118.
91. See, for example, *Harris v North Devon Railway Co* (1855) 20 Beav 384; 52 ER 651.
92. See discussion of consequences of improper fetter by Finn, above n 88 at 30–32.
93. *Charterbridge Corporation Ltd v Lloyd's Bank Ltd*, above n 36 at 69.

If a director, by the improper exercise of his powers, gains directly or indirectly an advantage for himself or another person, or causes detriment to the corporation, he could also be liable upon conviction under s 229(4) for a penalty of $20,000 or imprisonment for five years, and be liable under s 229(6) to compensate the company.

Conclusion

The many powers which directors have must be exercised bona fide and in the best interests of the company. Their powers usually include the powers of raising capital, applying the assets of the company, allotting shares, making calls on shares, approving transfers of shares and granting compensation payments or pensions to employees or directors. They must all be exercised with the broad principle in mind. The associated fiduciary duty of directors to exercise their powers for proper purposes is discussed in a later chapter. These two duties do overlap, but they can differ. A director can act honestly in what he believes is the company's best interest, yet he may still have exercised his powers as a director for improper purposes.

The important fiduciary duty to act in the best interests of the company is not codified in Australia. It exists only in general law. The provision drafted by Professor Gower for the 1963 Ghanaian Code has much to commend it. It is succinct and clear, although it perhaps allows for too little attention to the interests of groups other than shareholders and creditors.

> A director shall act at all times in what he believes to be the best interests of the company as a whole so as to preserve its assets, further its business, and promote the purposes for which it was formed. . . .[94]

94. Section 203(2).