

Directors' Powers: their Purposes and Abuse

Corporate law texts and judgments talk of a separate fiduciary duty of directors to exercise their powers for proper purposes. There is a convincing argument that there is no such separate duty. Or, if there is such a 'proper purpose' doctrine, it does not deserve to stand alone.¹ The argument says that this duty is only a sub-class of, or another way of describing, the duty to act bona fide in the company's best interests; that powers are not given to directors with certain set purposes in mind so that one can say that this purpose is proper, that is improper, and so on. Every power is given to be exercised to further the best interests of the company. The author agrees with that view. For convenience, however, the proper purpose doctrine is discussed separately here. Whether the duty or doctrine stands alone or is part of the wider duty, it is important, especially in controlling the behaviour of directors of target companies in corporate takeover struggles.

The traditional 'proper purpose' doctrine

The articles of the company give directors a variety of powers. Regulation 66(1) of Table A, for example, says that

. . . the business of the company shall be managed by the directors, who . . . may exercise all such powers of the company as are not, by the Act or by these regulations, required to be exercised by the company in general meeting.

1. See Instone in a letter to [1981] 131 NLJ 1154; Santow, 'Defensive Measures Against Company Takeovers' (1979) 53 ALJ 374; Slutsky, 'Canadian Rejection of the *Hogg v Cramphorn* "Improper Purposes" Principle — A Step Forward?' (1974) 37 MLR 457. Williams A C J, Fullager and Kitto J J in *Ngurli Ltd v McCann* (1953) 90 CLR 425 at 438 noted:

Voting powers conferred on shareholders and powers conferred on directors by the articles of association of companies must be used bona fide for the benefit of the company as a whole.

Cf Privy Council in *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126. Street C J, in *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215, treated a question of the valid exercise of a power to grant a lease as an issue concerning the duty to act in the company's best interests.

In addition to this general power of management, there are more specific powers given in such articles as regs 2 and 38 of Table A relating to the significant power to issue shares, reg 21 giving a discretion as to the registration of transfers of shares, reg 40 on the power to convene general meetings, reg 68 regarding the power to draw negotiable instruments and receipts, reg 66(2) on borrowing money and issuing debentures, and regs 86 and 87 on deciding on dividends and their size.

The proper purpose principle — as it is called — is said to control the exercise of these and any powers the directors have under the memorandum and the articles. As part of their fiduciary duty, directors must exercise their powers for the purposes for which they were conferred and to benefit the company. Otherwise, they exceed their powers and may be liable accordingly. As *Gore-Browne on Companies* put it:

if the directors exercise a power conferred by the articles for a purpose other than that for which, upon its proper interpretation, it was so conferred, their conduct is open to challenge, and in such a case it is no answer for them to maintain that they bona fide believed their conduct to be in the interests of the company. . . . To this limited extent, their assessment of the company's interests in the exercise of their powers is open to review, on an objective basis, by the court.²

In *Mills v Mills*, Rich J summarised the doctrine:

The validity of the directors' resolution, therefore, must depend on the question whether they exercised the power in good faith for the purpose for which the power was given.³

And, more recently, Megarry VC in *Cayne v Global Natural Resources PLC* said:

The basic rule seems clear enough. The power of directors to issue shares is a fiduciary power. It must be exercised *bona fide* in what they consider to be in the interests of the company and not for some collateral purpose.⁴

Accordingly, many cases have referred to and imposed the duty to exercise powers for proper purposes on the exercise of the directors'

2. (44th ed, 1986) at para 27.5. For discussions of the nature of the doctrine see Birds, (1974) 37 MLR 580; Slutsky, (1974) 37 MLR 457. Chow notes, (1979) 129 NLJ 123 at 124, that directors are 'fiduciaries in exercise of a fiduciary power. This is the reason why the proper purpose duty is prescribed on them, not because of the drafting of the articles'.
3. (1938) 60 CLR 150 at 169. Isaacs J said in *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199 at 217:

[This power] must be exercised, as all such powers must be, bona fide — that is, for the purpose for which it was conferred, not arbitrarily or at the absolute will of the directors, but honestly in the interest of the shareholders as a whole.

See also *Howard Smith Ltd v Ampol Petroleum Ltd*, above n 1 at 1133, per Lord Wilberforce.

4. Unreported, Chancery Division of the High Court of Justice, 12 August 1982.

powers to make calls on shares,⁵ to forfeit shares,⁶ to set aside funds in reserve to meet contingencies,⁷ to make rights issues,⁸ and to refuse to register transfers of shares.⁹

Abuse by directors of the power to issue shares

Most of the cases on the proper purpose doctrine involve the alleged misuse by directors of their power to issue shares. Issuing shares is one way of raising money for the company's operation. Raising capital is usually the major purpose of an issue.¹⁰ Other purposes which have been regarded as 'proper' in the exercise of this power include the fostering of desirable business connections, the maintenance of the minimum necessary membership in the company and improvement of the company's financial position.¹¹ Improper (sometimes called collateral) purposes for an issue have included the defeat of a takeover, the entrenchment of a board in control of a company, 'benefiting some shareholders or their friends at the expense of other shareholders or so that some shareholders or their friends will wrest control from the other shareholders'¹² and the prevention of interests unfriendly to the directors from gaining power.¹³

Appropriately drafted articles can determine which purposes are proper and which are improper. Prentice maintains that an article can validly permit directors 'to allot shares to maintain themselves in control, provided they thought that this was in the best interests of the company'.¹⁴

In *Hogg v Cramphorn Ltd*,¹⁵ Buckley J held that an allotment of shares (each with weighted voting power) made bona fide by the board, but with the intention of defeating a possible takeover bid and of retaining the present board in control, was an improper exercise of that power. The fact that the directors undoubtedly 'acted throughout in the belief that what they were doing was for the good of the company'¹⁶ was of no avail. The complaint of the minority shareholder, Mr Baxter, was accepted. The

5. In *Galloway v Halle Concerts Society* [1915] 2 Ch 233; *Alexander v Automatic Telephone Co* [1900] 2 Ch 56; *Re National Provincial Marine Insurance Co, Gilbert's case* (1870) 5 Ch App 559.

6. In *Harris v North Devon Railway Co* (1855) 20 Beav 384; 52 ER 651.

7. In *Henry v Great Northern Railway* (1857) 1 De G & J 606; 44 ER 858.

8. See *Pine Vale Investments Ltd v McDonnell and East Ltd* (1983) 1 ACLC 1294; *Pennell v Venida Investments Ltd*, unreported (1974), per Templeman J, noted by Burridge, (1981) 44 MLR 40 and Farrar, *Company Law* (Butterworths, 1985) at 315-316.

9. *Re Smith & Fawcett Ltd* [1942] Ch 304.

10. See dictum in *Punt v Symons & Co Ltd* [1903] 2 Ch 506 at 515-516; *Ngurli Ltd v McCann*, above n 1 at 440; *Tavola Pty Ltd v South Eastern Petroleum NL* [1985] *Australian Securities Law Cases* 85,065 at 85,069-85,070.

11. See *Winthrop Investments Ltd v Winns Ltd* [1979] ACLC 32,257.

12. See *Ngurli Ltd v McCann*, above n 1 at 440.

13. See Franzi, (1976) 10 Melbourne ULR 392 at 395.

14. (1970) 33 MLR 700 at 703.

15. [1967] 1 Ch 254.

16. *Ibid* at 262, counsel's submission.

issue was shown to be 'intended not only to ensure that, if Mr Baxter succeeded in obtaining a shareholding which, as matters stood, would have been a controlling shareholding, he should not secure control of the company, but also, and perhaps primarily, to discourage Mr Baxter from proceeding with his bid at all'.¹⁷ Buckley J relied on *Piercy v Mills*.¹⁸ There, the directors were held to be acting in breach of duty in issuing shares to procure a majority for their side in an internal power struggle.¹⁹

In *Ngurli Ltd v McCann*,²⁰ the High Court ruled that the controlling director could not use his power — termed 'fiduciary power' in the judgment — to issue shares at par to a friendly interest to the exclusion of the two McCanns (minority shareholders). This issue was solely for the controlling director's benefit.

The power must be used bona fide for the purpose for which it was conferred, that is to say, to raise sufficient capital for the benefit of the company as a whole. It must not be used under the cloak of such a purpose for the real purpose of benefiting some shareholders or their friends at the expense of other shareholders or so that some shareholders or their friends will wrest control of the company from the other shareholders.²¹

The major authority: Howard Smith Ltd v Ampol Petroleum Ltd

An important example of an 'improper' issue is *Howard Smith Ltd v Ampol Petroleum Ltd*.²² Millers, the target company, was subject to a takeover offer of \$2.27 per share from Ampol. Ampol already held nearly 30% of the issued shares in Millers and an associated company (Bulkships) owned another 25%. Millers' directors thought that the offer was too low. Howard Smith Ltd then made a rival offer (\$2.50 per share). This rival offer was not acceptable to Ampol or Bulkships, who issued a statement that in future they intended to 'act jointly in relation to the future operation' of Millers. Under the articles of Millers, the directors had power to allot unissued shares to such persons and on such terms as they thought fit. A majority of the board favoured the Howard Smith offer. They agreed to issue enough shares to Howard Smith to reduce Ampol and Bulkships to the status of minority shareholders. Millers did, at the time, need some capital to secure its financial position. 4,500,000 shares were then issued at \$2.30 each to Howard Smith. Ampol sought to have the issue set aside.

Street C J found that the allotment had been made by the Millers' directors for self-interest: that the primary or substantial purpose of the directors was not to raise capital for the company (as the directors had argued) but rather to encourage Howard Smith's offer and discourage Ampol's takeover bid.

17. Ibid at 265–266, per Buckley J.

18. [1920] 1 Ch 77.

19. See also *Punt v Symons & Co Ltd*, above n 10.

20. (1953) 90 CLR 425.

21. Williams A C J, Fullager and Kitto JJ, ibid at 438.

22. [1974] 1 All ER 1126 (PC); [1972] 2 NSWLR 850; [1974] 1 NSWLR 68.

The Privy Council, dismissing the appeal, agreed that the power to issue shares had been improperly exercised. Lord Wilberforce observed:

- (a) it was too narrow an approach to rule that the *only* proper purpose for which shares could be issued was to raise capital: 'the law should not impose such limitation on directors' powers'.²³ Although raising finance is the most usual purpose for issuing shares, the courts have long said it is not the only legitimate purpose. There may be other valid purposes.²⁴ Granting of shares to employees as incentives may be one such proper purpose.²⁵ Lord Wilberforce specifically declined to set out the limits of the power to issue shares, for example by enumerating a list of acceptable purposes: 'the variety of situations facing directors of different types of company in different situations cannot be anticipated'.²⁶
- (b) the absence of self-interest in the directors was insufficient in itself to make an issue valid. Honest behaviour also is not enough. '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.'²⁷

Honesty of belief was an issue in *Ansett v Butler Air Transport (No 1)*.²⁸ The directors issued shares to employees in an attempt to prevent Ansett gaining majority control. There was no suggestion here that the placement was to increase capital. The directors honestly believed that the Ansett takeover would be detrimental to the interests of the company. This would not have availed them. The power to issue shares granted to directors in the articles must, the court ruled, be exercised for proper purposes. Depriving a majority of its control or staving off a takeover was not such a purpose.²⁹

Lord Wilberforce in *Howard Smith* set out the approach which he considered a court should take:

In their Lordships' opinion it is necessary to start with a consideration of the power whose exercise is in question, in this case a power to issue shares. Having ascertained, on a fair view, the nature of this power, and having defined as best can be done in the light of modern conditions the, or some, limits within which it may be exercised, it is then necessary for the court, if a particular exercise of it is challenged, to examine the substantial purpose for which it is exercised, and to reach a conclusion whether that purpose was proper or not. In doing so it will necessarily give credit to the bona fide opinion of the direc-

23. Ibid at 1133.

24. See *Punt v Symons & Co Ltd* [1903] 2 Ch 506 at 515–516.

25. See, for example, *Condraulics Pty Ltd v Barry & Roberts Ltd* (1984) 8 ACLR 915.

26. Above n 22 at 1134.

27. Ibid at 1133.

28. (1958) 75 WN (NSW) 299.

29. See also Buckley J in *Hogg v Cramphorn*, above n 15 at 268, reiterating the point: a conscientious exercise of the powers under the articles was not enough of itself. The Butler Air Transport directors would get a more sympathetic hearing today in the light of developments in the law.

tors, if such is found to exist, and will respect their judgment as to matters of management; having done this, the ultimate conclusion has to be as to the side of a fairly broad line on which the case falls.³⁰

His Lordship applied this approach:

. . . 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. The right to dispose of shares at a given price is essentially an individual right to be exercised on individual decision and on which a majority, in the absence of oppression or similar impropriety, is entitled to prevail. Directors are of course entitled to offer advice, and bound to supply information, relevant to the making of such a decision, but to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold can not be related to any purpose for which the power over the share capital was conferred upon them.³¹

Support for the *Howard Smith* approach came in *Kinsela v Russell Kinsela Pty Ltd (in liq)*. Powell J, at first instance, concluded:

. . . the true duty of directors is a duty to refrain from exercising any of the powers vested in them in order to obtain for themselves or any of them some private advantage or in order to achieve some other object other than that for which the power was vested in them . . .³²

Improper purpose must be primary purpose

Howard Smith confirmed that, to constitute a breach, the improper purpose must be the directors' primary, dominant or substantial purpose.³³ There is authority for a lesser standard (that is, that a substantial or a major purpose will suffice).³⁴ The former, prevailing view is set out by Dixon J in *Mills v Mills*:

30. Above n 22 at 1134.

31. *Ibid* at 1136.

32. (1983) 8 ACLR 384 at 404; (on appeal) (1986) 4 ACLC 215. Although it said that the 'essential question is whether that power had been validly exercised' (at 220), the NSW Court of Appeal did not directly treat the validity of the lease agreement as a proper purposes matter, but rather as a breach of the general duty to act for the benefit of the company. As the interests of creditors were prejudiced by the exercise of the power to issue the lease, the fiduciary duties were breached and even unanimous absolution by the shareholders could not cure it.

33. Above n 22 at 1134; [1974] AC 821 at 831, 835.

34. *Ashburton Oil NL v Alpha Minerals NL* (1971) 123 CLR 614 at 627, 631, 641-642.

[The law] must, it seems to me, take the substantial object the accomplishment of which formed the real ground of the board's action. If this is within the scope of the power, then the power has been validly exercised. But if, except for some ulterior and illegitimate object, the power would not have been exercised, that which has been attempted as an ostensible exercise of the power will be void, notwithstanding that the directors may incidentally bring about a result which is within the purpose of the power and which they consider desirable.³⁵

Occasionally, as in the *Ansett* case,³⁶ there is no problem. No seriously competing purpose to the improper purpose existed there. Mixed purpose cases conceivably may cause problems where the actuating motives are equally powerful.³⁷ But, despite the obvious problems of proof, the courts seem to have had relatively little trouble in isolating one dominant purpose.

Relaxation of the 'strict' approach

The cases discussed above can be contrasted with different findings in more recent authorities. Some relaxation of the strict rule is emerging. In certain circumstances, share issues *may* be used for manipulation or maintenance of control. Such issues may not always be deemed improper.

In *Harlow's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL*,³⁸ an issue of shares to an oil company to secure the financial future of the issuing company was upheld, even though the issue had the effect of defeating the plaintiff's attempt to gain control of the company. The High Court was not concerned that the allotment frustrated someone's ambition to gain control of the company 'or even that the directors realized that the allotment would have that result and found it agreeable to their personal wishes', as long as 'in truth the issue was made honestly in the interests of the company'.³⁹

*Teck Corporation Ltd v Millar*⁴⁰ excited more interest. Teck had gained a majority shareholding in Afton Mines Ltd. Teck wanted to replace the existing Afton directors with its own nominees so that it could then cause Afton to enter into an agreement with Teck for the exploitation by Teck of valuable mineral rights owned by Afton. Afton Mines, however, then entered into a minerals exploitation agreement with another company — Canex — which had been negotiating with Afton before Teck came on the scene. One of the provisions of that agreement was that Canex would be issued with a large number of shares in Afton, thereby diluting Teck's holding from 52% of Afton's shares to approximately 35%. The Supreme Court of British Columbia upheld the agreement with Canex:

35. (1938) 60 CLR 150 at 185–186.

36. Above n 28.

37. See, generally, Lindgren, (1972) 10 U of WALR 364 at 377ff.

38. (1968) 121 CLR 483.

39. *Ibid* at 493.

40. (1973) 33 DLR (3d) 288.

[The directors'] object was to obtain the best agreement they could while . . . still in control. Their purpose in that sense was to defeat Teck. But, not to defeat Teck's attempt to obtain control, rather it was to foreclose Teck's opportunity of obtaining for itself the ultimate deal [that is, an exploitation agreement].⁴¹

Berger J found for the defendants. The deliberate intention of diluting Teck's shareholding was found to be 'truly incidental and subordinate' to the main or primary purpose of the agreement. The directors' primary goal was to develop the copper rights to Afton's best advantage. The Canex connection apparently offered greater experience and expertise, even though Teck offered more money. Berger J stressed that from the beginning, and before Teck began to acquire Afton shares, Afton had reasonably believed the Canex connection would, for sound business reasons, be better than the Teck connection. A dictum of Berger J proved controversial:

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, a takeover will cause substantial damage to the company's interests, they are entitled to use their powers and protect the company.⁴²

Strictly speaking, this was not acceptable under the traditional rules of the fiduciary doctrine. Even though the directors had the best interests of the company in mind, an issue of shares could not be made for control purposes.⁴³

The complexities of corporate takeovers and their effects, however, demand greater flexibility. Iacobucci argues for a less rigid rule. He suggests that whilst the issue of shares for control should generally not be allowable, it should be open to directors to plead exceptional circumstances to validate the issue:

Thus in an impending takeover by a looter, the incumbent directors would be entitled to consider the best interests of the company, including its employees and creditors, and issue shares to prevent what they felt would be tantamount to a disaster. Such a share issuance would have to be a last resort; the directors would have to have taken all other reasonable steps to prevent a takeover, such as advising the shareholders not to sell their shares. The directors would also have to demonstrate reasonable grounds for thinking that the persons attempting the takeover would be harmful to the company. The directors should not be able merely to point to different business practices or vague charges of different policies on the part of the would-be acquirors; on the contrary, differences over policies are a legitimate reason for taking over a company so that rules would not be developed to prevent such a transaction. Finally, of course, the directors' actions

41. *Ibid* at 328.

42. *Ibid* at 317.

43. See *Hogg v Cramphorn*, above n 15.

in this kind of situation would be subject to court review to determine whether the normal strict fiduciary duty of directors should be relaxed.⁴⁴

The winds of change are blowing on the strict *Hogg v Cramphorn* ruling in the English courts as well. In his unreported judgment in *Cayne v Global Natural Resources PLC*,⁴⁵ Megarry VC took a less strict line on issuing shares for control purposes. He was encouraged in his views by *Harlowe's Nominees* and *Teck Corporation*, which he cited when limiting *Hogg v Cramphorn*:

At the same time, this principle must not be carried too far. If Company A and Company B are in business competition, and Company A acquires a large holding of shares in Company B with the object of running Company B down so as to lessen its competition, I would have thought that the directors of Company B might well come to the honest conclusion that it was contrary to the best interests of Company B to allow Company A to effect its purpose, and that in fact this would be so. If, then, the directors issue further shares in Company B for the purpose of defeating Company A's plans and continuing Company B in competition with Company A, I cannot see why that should not be a perfectly proper exercise of the fiduciary powers of the directors of Company B. The object is not to retain control as such, but to prevent Company B from being reduced to impotence and beggary, and the only means available to the directors for achieving this purpose is to retain control. This is quite different from directors seeking to retain control because they think that they are better directors than their rivals would be.

The issuing of shares for control purposes is not necessarily improper. It may be 'proper' to issue shares to deny a change of control and thereby prevent real damage to or running down of the company by would-be controllers. An issue for control purposes is not per se an abuse of power and a breach of the director's fiduciary duty.⁴⁶

A similar situation arises if the directors issue shares to raise money 'to take advantage of a genuine commercially favourable opportunity', as in *Pine Vale Investments Ltd v McDonnell and East Ltd*.⁴⁷ Within two months of a takeover announcement for their company, the board resolved to make an offer to buy a business. To fund this purchase, they proposed to make a rights issue of one for every two shares owned by existing shareholders. This issue would so raise the number and market value of the company's shares and the funds needed to complete the takeover, that it would put off the takeover offeror. McPherson J found that even

44. (1973) 11 Osgoode Hall L J 353 at 368–369.

45. Chancery Divn, 12 August 1982. Appeal over the refusal to issue injunctions dismissed: [1984] 1 All ER 225.

46. See comment on this decision by Barrett, (1982) 56 ALJ 600–601. It can be argued that *Cayne* and *Teck Corporation* come close to abolishing the doctrine.

47. (1983) 1 ACLC 1294 at 1304; (1983) 8 ACLR 199 at 209. See a similar observation by Waddell J in *Winthrop Investments Ltd v Winns* (1979) 4 ACLR 1 at 12.

if the purchase of the business was manufactured, in the sense that it would not have arisen if the takeover offer had not been made, this did not mean that the decision to buy the business was a breach of duty.

Once it is established that action is commercially justified in the corporate interest, it is difficult to understand why the directors should be reduced to inertia because of the pendency or possibility of a takeover offer.⁴⁸

Although it may satisfy arguments for 'commercial realism', this relaxation allowing share issues even for control purposes in appropriate cases does create problems. The difficulties of proof of breach of duty are well understood. Directors will not be willing instruments in their own execution. Board minutes and the like will rarely be helpful, so 'objective' evidence must be relied on in seeking the true reasons for the share issue. There must be a considerable temptation to concoct suitable evidence of boardroom motives.⁴⁹ Sheeting home an improper purpose action is difficult indeed, given the advantages the board enjoys of control over inside information and the company's purse.

Takeovers and directors

As we have seen, the proper purpose 'doctrine' is dominated by takeover cases. A takeover occurs when the ownership or control of a company passes to new hands, usually by the purchase of enough shares to enable a new party/parties to control the company's activities. An offeror or 'raider' may want to buy control over the 'target' company for a variety of reasons. One reason could be that the value of the target company's assets are much greater than the cost of buying enough shares to get control on the open market (that is, its capitalisation value) and thus the company may be bought at a bargain price. The discussion which follows concerns principally the fiduciary duties and the directors' responses to open market 'raids' on listed public companies.

*Defensive tactics*⁵⁰

As is evident in Australia recently, target companies' boards often put up vigorous, even desperate, opposition to takeover bids. The motives for the opposition may be that the bid is inadequate or otherwise financially undesirable for the target's shareholders. Or the target's directors may be keen to protect their own positions or those of existing controlling shareholders. The former is proper; the latter is usually not.

48. *Ibid* at 1304.

49. As Steel points out in 'Defensive Tactics in Company Takeovers' (1986) 4 C & SLJ 30 at 36-37.

50. See list of possible defensive actions by Danziger, 'Remedial Defensive Tactics Against Take-overs' (1983) 4 Co Law 3; *Weinberg and Blank on Takeovers and Mergers* (4th ed) at 575ff. For an American analysis, see Schmults and Kelly, 'Cash Take-over Bids — Defense Tactics' (1967) 23 Bus Law 115; Bradshaw, 'Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers' (1969) 21 Stan L Rev 1104.

There are many defensive strategies used by target company boards. New ones are invented constantly. Many of these strategies involve changing the company's articles (for example, to prevent the removal of directors), thus putting obstacles in the way of would-be raiders. Another method of dampening a raider's enthusiasm for a takeover is to make it financially more difficult or impossible. This can be done by issuing more shares, whether by a fresh issue or by a bonus issue, so that more have to be bought to get effective control.⁵¹ If those extra shares are issued to institutions or individuals (sometimes called 'White Knights'), who are 'friendly' to the present board or sympathetic to the company's present operations, then the raider's bid can be blocked altogether. The 'friends' will not sell and there may be too few shares for sale to enable control to pass. Alternatively, the 'White Knights' may simply enter the open market and buy the target's shares. They thereby reduce the number of shares available for sale to the raider and possibly also bid up the market price of the shares, making the takeover more expensive.⁵² A variation on this defence is the issuing of other securities, such as options or convertible notes, carrying rights of conversion into voting shares or rights to subscribe for shares in the target company.

With the increase in takeover battles, it seems that some companies' boards are forming mutual assistance pacts. If 'unfriendly' raiders buy the shares of one of the crony boards' companies with a view to a takeover, the others leap to its defence by buying their ally's shares also. The use of a company's funds for such ally defence would be difficult to justify on the best interests of the company criterion.

Another tactic is the so-called 'pac-man' defence. The target company itself turns on the raider, buys shares in it and seeks to take it over. There is also the 'well-known device'⁵³ of setting up an employees' benefit scheme or pension fund which purchases shares in the company and loyally votes them to please the incumbent board.⁵⁴ The announcement of generous dividends as a takeover looms is a common defensive device. But it is often criticised as 'death-bed' repentance: if the dividends are paid now why were they not forthcoming before? The dividends may cause the market price of the shares to rise, in reflection of the higher return per share, and make the takeover more expensive; it may also inspire affection for the newly-generous board. Cash dividends may reduce the company's liquidity, making the target less attractive. The

51. Target listed company directors must obey Rule 3 R(3) of the AASE Listing Requirements, which controls the allotment of securities after receipt of notice of an actual or potential takeover.

52. Australian companies are prohibited by s 129 of the *Companies Code* from buying their own shares or providing financial assistance for the acquisition of shares in their companies or their holding companies. The officers are liable to penal sanctions if these provisions are breached. See Ford, *Principles of Company Law* (4th ed, 1986) at paras 838-842.

53. *Condraulics Pty Ltd v Barry & Roberts Ltd* (1984) 8 ACLR 915 at 923, per Derrington J.

54. See NCSC commentary: 'Responsibilities of directors of target companies', Release No 403, and discussion of 'White Knight', 'pac-man' and other defensive activity by Steel, 'Defensive Tactics in Company Takeovers', above n 49 at 44-46.

bidder may have been attracted by the company's cash or be relying on the target's strong credit line or cash reserves for the eventual financing of the takeover.

The expensive and time-consuming device of instituting litigation against the raiding company is part of American corporate life. It is becoming increasingly popular in Australia as a way of fending off an offer and denying the shareholders a chance to consider the merits of the bid. For example, the target board may seek an injunction over misstatements in the bidder's takeover documents or some other breach of the takeover rules. Expensive publicity campaigns against the raider, appeals to emotional loyalty, favourable profit forecasts for the target under present management,⁵⁵ and what are known as 'defensive mergers' with other 'friendly' companies, are also common tactics. In a defensive merger, the threatened company itself makes a takeover bid for a compatible company, often buying the shares of the other company in return for shares in the target. The shareholders in both of the merged companies then have an interest in the common enterprise, often with the board of the target in overall control of management. As a result, the larger, merged entity is less attractive to or attainable by the raider. A defensive acquisition is also sometimes effective. The target company acquires another company and pays for it by issuing shares in exchange for the shares of the acquired company. Thus, the number of shares in the target company increases, making a takeover more difficult.

A once-popular defensive technique — the arrangement by the target company's board for the payment of large benefits or compensation payouts to retrenched management, which could deplete the company's assets on replacement of management after a takeover — is controlled in Australia by s 50 of the *Takeovers Code*. The recently imposed capital gains tax legislation in Australia will, by contrast, help to 'defend' the company against raiders. It may be a disincentive to the selling of shares if the sale realises a capital gain.⁵⁶ Alerting shareholders to the possible tax effects of a sale may be effective in future in discouraging takeovers.

The target company's board has the advantage of using the company's finances in any such defence. Seeking expert advice, preparing and sending out proxy forms and circulars, calling meetings and conducting advertising campaigns can be very expensive. A right of reimbursement for directors of target companies was advocated by the Jenkins

55. See ss 37 and 38 of the *Takeovers Code*, which control profit forecasts relating to target companies. Section 37 is discussed in *Bond Corporation Holdings Ltd v Grace Bros Holdings Ltd* [1983] *Australian Securities Law Cases* 86,358; *Re Evan Deakin Industries Ltd* [1980] ACLC 34,425; NCSC Policy Statement No 103. See also s 44 of the *Takeovers Code* regarding falsehoods and material omissions in Part A, B, C and D Statements and in the statutory reports of experts.

56. Under the *Income Tax Assessment Amendment (Capital Gains) Act 1986*, the Principal Act of 1936 is amended so that real gains on shares acquired after 19 September 1985 will be taxed on disposal of the shares. The gain to be taxed will be arrived at by deducting from the sale proceeds the cost price of the shares inflated by an index (based on the Consumer Price Index).

Committee,⁵⁷ and enacted for Australia in s 41 of the *Companies (Acquisition of Shares) Code* (known as the *Takeovers Code*).⁵⁸ Section 41 limits reimbursement to 'expenses reasonably incurred' by the directors in pursuit of 'the interest of the members of the company'. Unrestricted access is not available. Using company funds for the personal purpose of maintaining themselves in power would rarely qualify.⁵⁹

A library has been written on takeover battles, defensive tactics adopted by boards of management and the growing conflict between traditional company law principles and modern managerial practice. This reflects the popularity and complexity of takeovers and the bulk and impenetrability of securities legislation. Curiously, defensive tactics of target company directors have almost escaped the legislator's prolific pen.⁶⁰ Their behaviour is still regulated primarily by the general law which, while it retains its importance, is rarely used. Target company boardroom behaviour in the 1980s in Australia indicates either a limited knowledge of, or a disrespect for, the director's fiduciary duties.

Australia's *Takeovers Code* is complex and concerned with ensuring that the bidder gives adequate information so that the shareholders and management of the target companies can properly assess the merits of the proposed takeover. As Olney J noted:

... the evident policy and objectives of the [Takeovers] Code is to ensure that the shareholders of a target company receive the utmost protection and that they should not in any way be the subject of exploitation by the directors or other persons having control.⁶¹

The *Takeovers Code* is not discussed in detail here. Suffice to say that, although it restricts significantly the actions of raiders, it virtually ignores the conduct of directors subject to the takeover bid.⁶²

57. Cmnd 1749 (1962) para 279.

58. The *Companies (Acquisition of Shares) Act 1980* (Cth) applies in the ACT and has been adopted by the States as the *Takeovers Code*. The South Australian State Code, to take an example, came into force on 1 July 1981.

59. See a discussion of the principle of reimbursement of target company directors by Danziger and Skoyles, (1984) 5 Co Law 217-220. See also s 36 of the *Takeovers Code*, which requires the offeror to pay the offeree a sum towards expenses.

60. Steel, above n 49 at 30.

61. *Parry Corp Ltd v Boans Ltd* (1984) 2 ACLC 249 at 250 (ex tempore judgment).

62. In brief, the *Takeovers Code* prohibits the acquisition of shares, if it would increase a person's entitlement to more than 20% of the company's voting shares, unless a formal takeover offer for all shares has been made under a takeover scheme, or a takeover announcement has been made on the floor of the target's home stock exchange, or no more than 3% of the target's voting shares are acquired every six months: see ss 15, 16 and 17. Other types of acquisitions are also allowed, but they do not apply to the takeovers of listed public companies. Directors of the target companies will receive statements from the offeror. They have 14 days to decide on their attitude to the proposed takeover, take advice and reply. The Code prohibits false and misleading statements by directors. In addition, general law duties apply. Directors of the target company must provide proper information to their shareholders, and 'be honest' and not mislead: *Gething v Kilner* [1972] 1 All ER 1166 at 1170, per Brightman J. There may even be a fiduciary duty between directors and shareholders in certain circumstances: *Coleman v Myers* [1977] 2 NZLR 225. See discussion in Ch 4 above.

*Target company directors must act bona fide in company's best interests*⁶³

As we have seen, the broad fiduciary duty to act bona fide and in the company's best interests applies to the activities of target company directors when facing a takeover bid. Often this duty is expressed as a duty to act for proper purposes. Regrettably, sometimes little heed is paid to this duty in the melees that accompany major corporate acquisitions in Australia. Resisting takeovers has become a well-established and much-publicised pattern.

It may well be, as was argued by Dowset Q C in *Pine Vale*,⁶⁴ that there is no general principle which stops directors from using their power to thwart a takeover offer. Rather, the purpose of the thwarting action may make the defence invalid.⁶⁵ Reasons accepted by courts as valid have included that the raiders intended to harm the company by, say, running it down,⁶⁶ running it badly,⁶⁷ selling off valuable assets, or fundamentally altering the nature of the company's business.⁶⁸ The courts have also not impugned boardroom motives of driving up the value of the shareholders' investment. This object alone is not enough to 'validate' an issue,⁶⁹ although the NCSC has commented that 'defensive tactics which produce higher prices from bidders can only be to members' advantage'.⁷⁰ Other acceptable motives may be that the company may be choosing the best of several business agreements available to the company and a share issue may be part of consummating a deal,⁷¹ or that the board may wish to take up a good commercial opportunity or raise more capital for expansion or pay for new assets with a share issue.⁷² Irrespective of management's immediate aim, however, the underlying or background purpose of benefiting the company as a separate entity must prevail.⁷³

A likely explanation of a share issue at the time of a takeover offer is the maintenance of control. Although it is not formulated in these terms by the courts, there may be a strong suspicion, almost an assumption, that a share issue which occurs contemporaneously with the advent of a takeover offer for the company is primarily to create a new majority, or to destroy the takeover offer's chances, or to maintain the incumbent

63. Chapter 5 discussed the duty of directors to act bona fide and in the company's best interests.

64. McPherson J was sympathetic; above n 47 at 210.

65. Statistical evidence suggests that resisting a takeover enhances the shareholders' return on their investment in the company: see Steel, above n 49 at 30.

66. See *Rosfield Group Operations Pty Ltd v Austral Group Ltd* [1981] Qd R 279; 5 ACLR 290.

67. See *Teck Corporation Ltd v Millar*, above n 40 at 317, dictum of Berger J.

68. See, eg, *Re Tivoli Freeholds Ltd* [1972] VR 445; see an analogy in *Cheff v Mathes* (1964) 199 A 2d 548.

69. See *Howard Smith Ltd v Ampol Petroleum Ltd*, above n 22.

70. NCSC Release No 403, above n 54.

71. See *Teck Corporation Ltd v Millar*, above n 40.

72. *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL*, above n 38 at 493; *Pine Vale Investments Ltd v McDonnell and East*; *Winthrop Investments Ltd v Winns Ltd*, above n 47 at 13.

73. *Ibid.*

directors in control.⁷⁴ The timing of the issue, at least, should have to be explained. But the onus is not on the directors to explain their defensive manoeuvres; the burden of proof is on those who allege an improper purpose. It is a difficult onus to discharge, as the results in *Pine Vale*, *Winthrop* and *Rossfield* show.

Crucial to an assessment of whether the duty to act bona fide and in the company's best interests has been honoured is a clear idea of what the 'company' is and what its 'best interests' means. These concepts were discussed above in Chapter 5. Although the notion that whatever lawfully maximises the company's profit is in its best interests is under challenge, in Australia that traditional view prevails. So long as concern for the interests of groups such as employees, consumers and the public at large can be reconciled directly or indirectly with lawful profit maximisation, then attention to their interests will be tolerated. But the concept of the company as a separate entity means, in this context, the present and future shareholders⁷⁵ and, when the company's financial position is shaky, the creditors.⁷⁶ One court has gone so far as to suggest there is a duty between directors and creditors,⁷⁷ which is saying much more than that, as part of honouring one's duty to the company, one must have regard to the interests of creditors.

If the directors are faced with a takeover which favours shareholders, but not a non-investor group such as employees, the law will probably require them to serve the interests of shareholders. Easterbrook and Fischel point out:

A manager responsible to two conflicting interests is in fact answerable to neither. A principle of divided loyalty ultimately would harm everyone by reducing the willingness of people to entrust their money to managers.⁷⁸

Rarely will the interests of the company as an ongoing concern (taking account of the interests of future shareholders) and the interests of creditors not agree with those of the current shareholders. However, the interests of 'non-investor' groups, such as employees, will not always be in step. A raider who intends to 'rationalise' the company's operations, close down plant and reduce employment, may suit shareholders keen

74. See Steel, above n 49 at 51. See also, in the American context, Gutman, 'Tender Offer Defensive Tactics and the Business Judgment Rule' (1983) 58 NYUL Rev 621.

75. See discussion, above, Ch 5.

76. See *Walker v Wimborne* (1976) 137 CLR 1 at 7; *Ring v Sutton* (1980) 5 ACLR 546 at 547-548; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215 at 221-223.

77. Cooke J in *Nicholson v Permakraft (NZ) Ltd (in liq)* (1985) 3 ACLC 453 at 459-460. Note also Templeman LJ in *Re Horsley & Weight Ltd* [1982] 3 All ER 1045 at 1056 who spoke of 'fraud on the creditors'.

78. 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 Harv L Rev 1161 at 1192. *Weinberg and Blank on Take-overs and Mergers*, above n 50 at 622, concludes:

It is suggested that the only appropriate test which directors ought to apply in assessing the interests of the company is as to what decision the company in general meeting would make, if fully appraised of the facts known to the directors.

for the best return on their investment and creditors anxious for security of repayment. But it will not suit the dismissed employees. In the United Kingdom and New Zealand, vigorous resistance to a takeover based on the belief that the takeover would hurt employees may attract judicial sympathy.⁷⁹ It has less force in Australia where the legislature has not yet imposed a duty on directors to consider the interests of employees.

Permissible defensive action

As we have seen, in the face of takeover activity, the law does not say that directors should be passive, 'reduced to inertia'⁸⁰ or merely restrict themselves to offering information to their shareholders. *Pine Vale*⁸¹ and *Winthrop*⁸² sanction reasonable defensive action:

Even assuming . . . that 'but for' the takeover offer, the purchase would not have occurred when it did, it does not follow that in a case such as this the propriety of the decision to purchase is vitiated by the ulterior and illegitimate purpose [of defeating the takeover].⁸³

Contrary to the tenor of *Hogg v Cramphorn Ltd*,⁸⁴ and *Howard Smith*,⁸⁵ it is no longer improper *of itself* for shares to be allotted for control purposes. A more complex standard applies. An issue is improper if it is for control purposes that, in addition, cannot be justified as being for the best interests of the company. In other words, directors may have secondary, improper or collateral motives so long as their underlying purpose is to benefit the company. The deeper or underlying valid purpose will validate the superficial improper motives.

In *Condraulics Pty Ltd v Barry & Roberts Ltd*,⁸⁶ a proposed general meeting resolution empowering the board to advance interest-free money to a trustee and to allow the purchase of shares in the company by the trustee, who would hold the shares for the benefit of employees, was held to be valid, even though it was contemporaneous with and would discourage a takeover proposal. The 'overriding motivation' of the directors was apparently to 'encourage employee loyalty and so benefit the company'.⁸⁷ The benefit scheme had been under consideration for some time before the takeover announcement. The court noted that the proximity of the employee benefit scheme resolution to the takeover bid did

79. Because of the provisions in their Companies Acts allowing or requiring directors to take account of employees' interests: see ss 309(1), 659 and 719 of the *Companies Act 1985* (UK); s 15A(l)(g) and (2) of the *Companies Act 1955* (NZ). Discussed above in Ch 5. See also Mackenzie, 'The Employee and the Company Director' (1982) 132 NLJ 688 at 689.

80. See *Pine Vale*, above n 47 at 1304 and 209 respectively.

81. Above n 47.

82. Above n 47.

83. McPherson J in *Pine Vale*, above n 47 at 1304 and 209 respectively. Cf Santow, (1979) 53 ALJ 374 at 375.

84. Above n 15.

85. Above n 22.

86. (1984) 8 ACLR 915.

87. *Ibid* at 920.

'give rise to an eyebrow of suspicion. But they do not suffice to support an injunction. Something more substantial must be shown'.⁸⁸

Where there is a genuine commercial opportunity in the offing, or a real threat to the company's future, or an employee benefit proposal of genuine benefit to the company, it seems that directors can use their power to issue shares to defeat a takeover, so long as the shares are issued to secure the opportunity or protect the company. Providing that the directors are 'motivated primarily by considerations of corporate advantage', they will have discharged their fiduciary duty to the company.⁸⁹

Will the motive to defeat a takeover bid amount to a breach of duty if the actions taken result in higher returns to shareholders? In *Rossfield Group Operations Pty Ltd v Austral Group Ltd*,⁹⁰ when the raider announced its offer, the target's directors created a new company which made a successful takeover offer for the target company, thereby frustrating the raiding company. The shareholders received a tax-free return of capital on redemption of notes issued to them as part of the arrangement. Connolly J approved the scheme, saying that it was legitimate for the directors to use their powers 'to obtain for all shareholders what they considered to be the true value of their stock'.⁹¹ However, the underlying purpose must still be to benefit the company's shareholders. An explanation that resistance was intended to increase the value of the shares could mask other, less worthy or selfish motives of the board.

Some incumbent directors sternly resist takeovers because they believe that they alone know what is in the company's best interests. They feel that the company's success depends on their survival. Sometimes that may be so. But often shareholders benefit greatly from a takeover and a shake-up in the board of directors. Several American commentators argue that takeovers confer managerial, economic and social benefits, that resistance ultimately hurts shareholders and that target company directors should be passive in response to a tender offer.⁹²

In any event, the shareholders as a whole will usually want to assess for themselves the value of the proposed takeovers. And they will want to make that assessment with the help of full and unbiased advice from their directors.⁹³ The 'owners' — the shareholders — should be able to decide for themselves. The NCSC states, as one of its objectives, that it wants to ensure 'that the directors of a company whose members are in receipt of a takeover offer do not, by exercising managerial powers, do

88. *Ibid* at 923, per Derrington J.

89. *Pine Vale Investments Ltd v McDonnell & East Ltd*, above n 47 at 211.

90. (1980) 5 ACLR 290.

91. *Ibid* at 296.

92. See Easterbrook and Fischel, above n 78; Gilson, 'A Structural Approach to Corporations: the Case Against Defensive Tactics in Tender Offers' (1981) 33 *Stan L Rev* 819; and articles listed in n 97 below.

93. See the *London City Take-Over Code*, General Principle 3, which says shareholders should be fully informed and have enough time in which to make 'an adequate judgment and decision'.

anything to frustrate the offer before members have had an adequate opportunity to consider it'.⁹⁴ By implication, then, the NCSC rejects the idea that the directors of the target company should be able to make the decision to oppose a takeover offer outright, to use the company's money to this end and to impede the shareholders' consideration of the offer. The NCSC's policy is that the investor should be free to decide, after being fully informed by the board. The directors should also be scrupulously fair in assessing the merits of any takeover proposal, especially as the shareholders are likely to rely heavily on what the incumbent management says. A board concerned about a takeover bid would be well advised, wherever possible, to get the general meeting's approval for their proposed defensive tactics.⁹⁵

Many think that the best defence by management to takeovers is to run the company so well that a takeover on the open market will not offer great profits. Such behaviour as making profits, paying good dividends, making bonus issues and fully informing the members and the market of the company's true value will keep up the market price of the shares and endear incumbent directors to their shareholders. Such behaviour is the best long-term antidote to takeovers. As the NCSC has stated,⁹⁶ 'the best defence against a takeover bid is said to be a fully priced share'.

The threat of takeover is also good discipline for directors. With their jobs on the line, they have an incentive to perform well.⁹⁷ Greater managerial efficiency means lower 'agency costs' because the performance of the directors and the management team (as the shareholders' agents) sharpens up.⁹⁸ Indirectly, takeover activity vets management's ability and performance.

Corporate ratification of share issues

An improper share issue is normally voidable at the election of the company,⁹⁹ but the company may waive its right of action and ratify a

94. NCSC Policy Statement: 'Role of the Commission under the Takeovers Code' (Release No 101), originally issued 1 July 1981, para 2(v). See also NCSC Commentary: 'Responsibilities of Directors of Target Companies' (Release No 403), above n 54.

95. Danziger concludes with this advice, above n 50 at 13.

96. Release No 403, above n 54.

97. See Easterbrook and Fischel, 'Takeover Bids Defensive Tactics and Shareholders' Welfare' (1981) 36 Bus Law 1733 at 1735-1739. The authors argue that 'shareholder's welfare is maximised by a binding legal rule requiring managers to acquiesce when confronted with a tender offer' (1746). Cf Lipton, 'Takeover Bids in the Target's Boardroom: An Update After One Year' (1981) 36 Bus Law 1017. Lipton suggests the incumbent board should consult experts to see if the offer should be resisted. If it decides for resistance then, he argues, the board should be allowed to resist with a range of defensive techniques. See also Lynch and Steinberg, 'The Legitimacy of Defensive Tactics in Tender Offers' (1979) 64 Cornell L R 901; Gutman, 'Tender Offer Defensive Tactics' (1983) 58 NYULR 621.

98. This argument is made by Easterbrook and Fishel, *ibid* at 1168-1174.

99. See also *John Cahill v Australian Conversion Services* [1978] ACLC 30,043, where a minority shareholder (with 40% shareholding) successfully sought an injunction restraining the allotment of shares.

breach. In *Winthrop Investments Ltd v Winns Ltd*,¹ following *Bamford v Bamford*,² it was noted that, as long as proper and full disclosure of all relevant facts is made to the general meeting, it may ratify a past, contemporary or future exercise of power by the directors, even a breach of fiduciary duty.³

In *Winthrop*, the directors became aware that the company was the target of a takeover bid. They entered into a contract to buy certain department stores and to issue shares in the company in part payment. The object of the arrangement was to distribute 'friendly' voting shares and to defeat the takeover bid. The 'raider' gained over 14% of the target company's issued capital on the open market. It then obtained interlocutory injunctions restraining the target company from going on with this proposed arrangement. But an extraordinary general meeting of the shareholders of the target company then passed resolutions approving the arrangement (including the issue of shares in part payment). Before the meeting, both the offeror and the target company had issued circulars to shareholders outlining their respective proposals.

Whilst acknowledging that prospective ratification is possible, the majority of the NSW Court of Appeal held that the resolutions were ineffective. The directors had not disclosed to the shareholders all the material facts required for them to arrive at an informed judgment. In particular, the Court thought that it was imperative that the members should have been told that the directors were planning to act in breach of their duty. The circulars did not make this clear.⁴ There must be full disclosure of both the nature of the breach and of the fact that there will be a breach. Translating this into practice may be difficult for management,⁵ but they would be ill-advised to ignore the matter. Powell J, at first instance, in *Kinsela v Russell Kinsela Pty Ltd (in liq)* called for appropriate approval after 'a full and frank disclosure of the actions of, or the actions proposed by, the directors, and of the consequences, or potential consequences, of those actions or proposed actions'.⁶

Consequently, Wedderburn's advice appears to be as good today as it was in 1967:

Where any new issue could possibly affect voting control, only an unwise management will now fail to have it approved by the share-

1. [1975] 2 NSWLR 666.

2. [1970] Ch 212.

3. This does not, it should be noted, amount to the general meeting usurping the board's exercise of its powers: see *Hogg v Cramphorn* [1967] 1 Ch 254 at 269–270. The Court of Appeal in *Winthrop* did not rule on what limits, if any, there are to general meeting ratification. There is consensus to the effect that fraudulent acts cannot be ratified: see Hansen, (1978) 10 Ottawa L Rev 617 at 678 and later discussion of fraud at Ch 9. McPherson J adverted to *Winthrop* and *Bamford* in *Condraulics Pty Ltd v Barry & Roberts Ltd* (1984) 8 ACLR 915 at 920, and noted cryptically that 'The last word on that subject may not yet have been said'. See also *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1983) 8 ACLR at 406–407; (on appeal) (1986) 4 ACLC 215.

4. See Samuels J A, above n 1 at 685; Mahoney J A at 705–706.

5. See Hansen, above n 3 at 677.

6. Above n 32 at 406. Note the attempt at 406 to place the finding in *Queensland Mines Ltd v Hudson* (1977–1978) 52 ALJR 399 into context. Cf discussion of that case in Ch 6.

holders. This in turn is likely to make directors act at an even earlier stage, at the stage of rumours rather than knowledge of a bidder's interest in the shares, in order to ensure that there is no possible risk of not getting their majority at the meeting.⁷

With their often large shareholding interests in the company (providing that these votes can be used) and their control of the company's purse and proxy apparatus, the directors could secure early ratification in most cases with comparative ease.

Rectification of register

Under s 259 of the Code, 'any member . . . may apply to the Court for rectification of the [share] register' where, inter alia, an entry wrongly exists in the register, or where an entry is made on the register without sufficient cause. The Rule in *Foss v Harbottle* would not limit the member's right to issue proceedings under this provision.⁸ One could argue that a transferee to whom shares are allotted in breach of the proper purpose doctrine is wrongly placed on the share register, that his name was entered without cause on the register, and that under s 259 the register should be rectified accordingly.⁹ But it seems that, because the court's power under s 259 is discretionary, it will be reluctant to remove a name from the register where the propriety of an issue of shares is contested on substantial grounds and the court cannot decide on the basis of evidence on affidavit.¹⁰

The proper purpose doctrine and companies legislation

The Jenkins Committee, in addition to recommending that directors should have to observe the utmost good faith towards the company,¹¹ thought that issues of shares should be submitted to the general meeting for approval.¹² There is much to be said for the view that there should be no change in the control of the company without the fully-informed approval of the shareholders. One way of ensuring this is to take away the power to issue shares from the board. Another is to require pro rata offers to existing shareholders of shares, at least of those being issued for cash.

7. (1967) 30 MLR 77 at 83.

8. See *Grant v John Grant & Sons Pty Ltd* (1950) 82 CLR 1 at 31–32, per Williams J, with whom Kitto and McTiernan JJ agreed. Cf *Kirton Investments Pty Ltd v C C Bottlers Ltd* (1984) 2 ACLC 699 at 705–706, per Olsson J; *Whitehouse v Carlton Hotel Pty Ltd* (1982) 7 ACLR 329 at 331, per Thomas J; Ford, above n 52 at para 1108.

9. See *Grant v John Grant & Sons Pty Ltd*, *ibid*.

10. See *Re Russian (Vyksounsky) Iron Works Co (Stewart's case)* (1866) 1 Ch App 574 at 586. See discussion of s 155 of the UCA (predecessor of s 259 of the Code) by Thomson, (1975) 49 ALJ 134–136.

11. Cmnd 1749 (1962) para 99.

12. *Ibid* at paras 119–121, 122(h).

Clause 52 of the ill-fated UK Companies Bill 1973 did not deal specifically with the proper purpose doctrine.¹³ The 1978 UK Bill offered cl 44(2): 'The directors of a company shall not perform any of their functions for a purpose not contemplated by the instrument or resolution conferring or imposing that function.' This did not make its way into the UK *Companies Act 1980*.

The 1963 Ghanaian *Companies Code* has such a provision in s 204:

The directors shall not, without the approval of an ordinary resolution of the company . . . exercise such powers for a purpose different from that for which such powers were conferred notwithstanding that they may believe such exercise to be in the best interests of the company.

Section 202(1) adds:

. . . the directors of a company with shares shall not, without the approval of an ordinary resolution of the company . . . issue any new or unissued shares . . . unless the same shall first have been offered on the same terms and conditions to all the existing shareholders or to all the holders of the shares of the class or classes being issued in proportion as nearly as may be to their existing holdings.

Such a provision as s 202(1) — like s 89 of the 1985 UK Act, which also gives existing equity shareholders pre-emption rights — aims at equal treatment for all shareholders and helps to control share issue abuses. It gives the force of law to the policy that also underlies reg 38 of Table A of the Code and Rule 3 R(3) of the AASE Requirements. Rule 3 R(3), which applies to listed public companies, reads:

Where a company or the directors . . . have received notice of an actual or proposed takeover offer . . . the company will not for a period of 3 months from the date of receipt of such notice by the directors, allot equity securities or other securities with rights of conversion to equity unless — (a) the proposed issue has first been approved by the company in general meeting; or (b) the issue is offered to all shareholders (other than the holders of preference shares) pro-rata to their holdings; or (c) details of the proposed issue have been notified to the Home Exchange pursuant to Listing Requirement 3 E(5) prior to the receipt of the notice of an actual or potential takeover offer or takeover announcement by the directors; or (d) the allotment of equity securities is made pursuant to exercise of rights of conversion to equity.

The 'notice' required in Rule 3 R(3) means notice in writing.¹⁴ It seems, too, that the notice must be intended for the company or the directors in their corporate capacity and not just directed 'to individuals who were, incidentally, directors' of the company.¹⁵ The 1981 Australian legislation did not follow the Ghanaian examples. Section 229(1) of the Code speaks

13. See Birds, (1974) 124 NLJ 1163.

14. *Tavola Pty Ltd v South Eastern Petroleum NL* [1985] *Australian Securities Law Cases* 85,065 at 85,070.

15. *Ibid* at 85,071.

of the officer's duty to at all times 'act honestly in the exercise of his powers and the discharge of the duties of his office'. There is no specific statutory formulation of the proper purpose doctrine. Nor is there any statutory guarantee of pre-emptive rights in share issues,¹⁶ or any statutory requirement that share issues be first submitted to the general meeting for approval.

16. Although see reference to reg 38 of Table A above.