

PRBL004
- Corporations Law
Lecture 4 – Directors Duties

Jeswynn Yogaratnam

Room: 39.3.72; Yellow 1 (3rd flr)

Telephone: (08) 8946 6085

Email: jeswynn.yogaratnam@cdu.edu.au



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Focus of this lecture:

Directors Duties:

■ Fiduciary duties

➤ Good faith and loyalty

■ Duty of care, skill and diligence

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Recap: The director as a fiduciary

■ Equity sets high standard of loyalty for directors because of their fiduciary relationship to company

■ Standard of loyalty is reflected in the **positive** and **negative obligations** of co. directors.

■ **Positive obligations** include the duties:

(1) to act in *good faith* in co's best interests

(2) to act for proper corporate purposes

(3) to give adequate consideration to matters being decided, and not to fetter their discretion

■ **Negative obligations** require directors to avoid various kinds of conflicts of interest (e.g. improper use of information, abuse of position, and insider trading)

Directors duties

– Why the need to recognise?

- It is a recognition that directors' duties may diverge from those of shareholders (e.g. excessive salary packages and perks)
- Shareholders are vulnerable to:
 - (a) **fraud** – e.g. directors using co's assets, opportunities or info to advance their personal interests
 - (b) **mismanagement** – e.g. director's risking loss or devaluation of co's assets through incompetence and poor judgement
- Mainly to ensure **loyalty of directors to co**
- Director is in a **fiduciary relationship with co (i.e. not at arm's length)**
- A fine balancing act – **directors must be made accountable** to co's interests while they must also have sufficient discretion to take decisions that carries some risks

Fiduciary duties of directors – What and Why?

- **Fiduciary relationship** exists where a person holds a **position of trust** in relation to another person, who due to the circumstances, is vulnerable to misuse of power by the fiduciary.
- **Owed to:**
 - (1) "**company as a whole**" – *Percival v Wright* (i.e. to co as a whole, not to shareholders)
 - (2) in some instances can be to **individual shareholders** – *Bunninghausen v Glavanics; Coleman v Myers (L & H p 304)*
 - (3) **Creditors** – e.g. *Kinsela v Russell Kinsela Pty Ltd*

Fiduciary duties (cont)

■ Who must perform the duties?

"Directors, secretaries, other officers and employees" of co.
– s 179(1)

s9 definition:

- "Officer" – any person who makes decision affecting corporation's business or on whose instructions the board is accustomed to act
- "Director" can be appointed director, alternate director, de facto or shadow director

What are the duties?

■ Broadly there are 2 categories of duties:

1. **Loyalty and Good Faith**
2. **Care, Skill and Diligence**

■ Where do the duties come from in law?

1. **General law**
2. **Part 2D.1 of CA**

1. Duties of loyalty and good faith (outline)

■ Directors, as fiduciaries, must show special qualities of good faith, fairness and loyalty when acting

FOUR SUB-DIVISIONS:

1. Duty to act in good faith in the interests of co as a whole
2. Duty to exercise one's powers for proper purposes (e.g. not collateral ones)
3. Duty not to fetter one's discretion: and
4. Duty to avoid conflicts between one's personal interests and those of co.

2. Duties of care, skill and diligence (outline)

■ This second group of duties owed by directors are those of care, skill and diligence

■ Concerned with whether sufficient care extended in management of the company

TWO SUB-DIVISIONS:

1. Duty to exercise reasonable care, skill and diligence when acting as director; and
2. Duty to prevent insolvent trading by co.

Duties of loyalty and good faith (a fiduciary and statutory duty)

Duties of loyalty and good faith

1. Duty to act in good faith in the best interests of the company as a whole

Sources:

- General law- fiduciary law
- S181 (1) (a) : *in good faith in the best interest of the corporation*
- S 184 makes it a *criminal offence* if reckless or intentionally dishonest

Duties of loyalty and good faith

1. Duty to act in good faith in the best interests of the company as a whole

■ Description:

- Has the director **acted dishonestly** or in a manner so **extraneous to the reasonable purposes of the company** that their conduct is incapable of being seen as promoting the interests of the company?
- Duty requires to act "**bona fide** – in what they consider – **not what the court may consider** – is in the interests of the company":
Re Smith & Fawcett Ltd [1942] – per Lord Greene MR
- Must be more than an mere honest belief: there is an **objective element** and it is breached if the director acts in a way that **no reasonable director would have considered** it to be in the best interests of the company
ASIC v Adler [2002] NSWSC 171

Duties of loyalty and good faith

1. Duty to act in good faith in the best interests of the company as a whole

What is the meaning of the '*interests of the company*'?

- Is the Co a separate entity or is it the collective of shareholders?
 - Collective shareholders - *Greenhalgh v Arderne Cinemas* 1951; *Darvall v North Sydney Brick & Tile Co Ltd* (1988)
- Is it individual shareholders?
 - NO- *Percival v Wright* [1902] 2 ch 421 but there may be exceptions: *Bunninghausen v Glavanics* (1999) 17 ACLC 1247 (where director was in direct and close contact member so that the director caused member to act in a way which turned out detrimental)
- Creditors?
 - When nearing insolvent or when insolvent
- Employees?
 - General rule - No, not at the expense of interests of co shareholders. But payment of employees is in best interest - improve industrial relations
 - *Parke v Daily News Ltd* 91962) Ch 927 (L&H 309)

Duties of loyalty and good faith

1. Duty to act in good faith in the best interests of the company as a whole

What is the meaning of the *interests of the company*?

- Who do Directors in corporate groups owe duties to?
 - see s 187
 - a director of a wholly owned subsidiary is taken to act in good faith in the best interest of the sub company if:
 - (b) the director acts in good faith in the **best interest of the holding company**; and

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

- directors who purport to act with reference to the powers granted to them, (RRs or the company's constitution) will be in breach of the duty where the **purpose or objective giving rise to the exercise of the power is not one reasonably contemplated by the RR or constitution**
- Ct looks at 2 things- 2 stage process:
 1. the **objective purpose** for which the power was granted and
 2. the **purpose which actually motivated** the exercise of the power

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

Legal purpose (Step 1)

- The court analyses the **provision conferring the power** being exercised (usually in co's **internal rules**) and interprets it in light of any restrictions and other internal rules of co.
- Court can also **infer (if necessary) purpose of power** from the type of co, its internal structure and activities

Actual purpose (Step 2)

- In ascertaining the actual reason or purpose behind directors' decision, court must determine **subjectively** whether such exercise was improper or collateral to their duties in that capacity.
- **Honesty does not necessarily absolve** those directors who have acted improperly from liability: ***Permanent Building Society (in liq) v Wheeler* (1994)**

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

■ Mixed purposes- the "but for" test

- ***Whitehouse v Carlton Hotel Pty Ltd* (9187) 5 ACLC 421 High Court:**
 - Where there is more than one purpose for a share issue the but for test should be applied to work out whether directors breached their duty and issued shares for an improper purpose
- "Regardless of whether the **impermissible purpose** was the dominant one or but one of a number of significantly contributing causes, the allotment will be invalidated if the impermissible purpose was causative in the sense that, but for its presence, the power would not have been exercised."

Per Mason CJ, Deane and Dawson JJ in *Whitehouse*

- ***Kokotovich Constructions Pty Ltd v Wallington* (1995) 13 ACLC 1113**
 - wanted to raise capital and allot more shares to children – manipulated voting power to do this – Court held: **'but for' manipulation... (extreme cases – court ordered winding up – oppression to minority)**

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

Applications of the duty to act for proper purposes

■ Power to issue shares

- The power to allot shares under s 124(1)(a) is a highly **contentious** one.
- Usually **arises when there's hostile takeover** or battle for co's control by existing shareholders.
- ***Howard Smith Ltd v Ampol Petroleum Ltd* (1974):** PC said that it was impossible to say in advance whether a power to issue shares would be a proper or improper one.

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

An allocation of shares may be invalid if:

- aimed at transferring control of a major co. asset:
Bailey v Mandala Private Hospital (1988);
- dominant purpose to preserve the position of exiting majority members:
Ngurli Ltd v McCann (1953);
- purpose to make rights of existing members valueless, and there's no apparent benefit to co: **Kotokovich Constructions Pty Ltd v Wallington (1995)** "diluting and devaluing" the other's share in the business.
- where co's assets are given away to a family co without any consideration: **Bishopsgate Investment Management Ltd (in liq) v Maxwell (1993)**

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

Other examples of breach of duty to act for proper purposes:

- Director's improper refusal to register a transfer of shares
- Exercise of management powers for improper purpose
- use of company funds to promote re-election of directors

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

Statutory force found in:

S 181 (1) (b)

(1) A director or other officer of a corporation must exercise their powers and discharge their duties ...

- (b) for a proper purpose

Duties of loyalty and good faith

2. Duty to exercise powers for proper purposes

Statutory force found in:

Consequences of breach -

■ Civil penalty

- S 1317E
- Enforceable by ASIC

■ person who is involved (aided, abetted...) in a contravention of "the Act" can also be liable – s 79

■ **Criminal liability: s 184 (1)** if a director of a corporation is reckless or intentionally dishonest and fails to exercise their powers and discharge their duties in good faith and in the best interest of the corporation for a proper purpose

Duties of loyalty and good faith

3. Duty to Retain Discretion

■ Co's internal rules may give discretionary powers allowing directors to determine if and when to exercise these.

Definition of duty

■ GL imposes **two duties** on board members in respect of their discretions:

(a) a duty to exercise an active discretion; and

(b) a duty to retain their discretions.

Duties of loyalty and good faith

3. Duty to Retain Discretion

• Due to first duty (a) directors **cannot blindly follow directions** of another person

• Due to second duty (b), they **cannot delegate their responsibility or fetter the exercise of discretions without authority**

• **no direct statutory equivalent of either duty**

• but **breach** may result in a simultaneous breach of the **GL and statutory duties of care and diligence**.

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

■ A fundamental rule of equity that a director must not allow a conflict to arise between a director's personal interest and duties owed to the director's company

Directors, being fiduciaries, are under a duty to avoid actual or potential conflicts of interest
Hospital Products Ltd v United States Surgical Corp.

- **Strict duty** – director liable even if he or she acts honestly and does not stand to profit.
- Cover situations where, although there's no clear conflict, yet there is a 'real possibility of conflict'
Phipps v Boardman.

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

Sources of the duty

- Duty to avoid conflicts of interest arises **under GL** (i.e. fiduciary law), and supplemented by **statutory duties under ss 182 – 184**.
- **Disclosure obligations include:**
 - (a) requirements in **ss 191-194, 195, 205G** (listed co's) and **200A - 200J** (retirement payments)
 - (b) **Chapter 2E** (related party transactions)
 - (c) **Part 7.11, Div 2A** (insider trading)

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

Dealings with the company

- Director may be in breach of duty by entering into a contract with co. of which he or she is a director.
- Such breach can also occur where **relationship is indirect** (i.e. where director is a director or member of another co. which enters into the contract) – *Transvaal Lands Co v New Belgium (Transvaal) Land & Development Co* [1914] and *State of South Australia v Marcus Clark* (1996)

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

Exception: if they provide full disclosure to the company and obtain shareholder approval (ratification)

Reduction of risk:

Risk of breaching duty to avoid conflicts of interest may be reduced by :

- (a) a **provision in constitution** authorising director to have an interest in a contract with the co. Directors can thereby be absolved from breach: **Re Automotive & General Industries Ltd [1975]**; or
- (b) interested director makes **full and frank disclosure** of their interests in any contract with co. – **Furs Ltd v Tomkies (1936)** and **Regal (Hastings) Ltd v Gulliver [1942]**; and
- (c) **director abstains** from taking part in deliberations or voting on the matter: **Jenkins v Enterprise Gold Mines NL**.

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : general law

- **Not to derive personal profit from being a director**

Since the opportunity exists for them to take advantage of their privileged position, **not only must they act** in good faith, they **must be seen to act in good faith**: **Regal (Hastings) Ltd v Gulliver [1942]**

NOTE: This case might be decided differently today because courts have discretion to excuse directors and officers from liability if they have acted honestly: **ss 1318 and 1317S**.

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : general law

- **Bribes or undisclosed benefits**
 - Breach of duty if they accept bribes or secret commissions in return for securing a certain course of action
Boston Deep Sea Fishing & Ice Co v Ansell (1888).
 - No need for co. to suffer any detriment for breach to occur
- **Misuse of company funds**
 - Must use company funds for company business.
 - Must not mix co's funds with their own.
 - **Paul A Davies (Aust) Pty Ltd (in liq) v P A Davies (1983)**: directors partly financed a holiday resort in their own names. When resort was sold, ct held that profit belonged to co.

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : general law

- **Taking up corporate opportunity**

- Breach of duty arises where directors take up opportunities that belong to co. – **Cook v Deeks [1916]**.

- Even if co cannot or will not take up an opportunity, director is still precluded from doing so

Regal (Hastings) Ltd v Gulliver [1942]; Green v Bestobell Industries Pty Ltd [1982];

- Some cases suggest that a **director may take up** a corporate opportunity where the **company has rejected** the proposal and the **director has been approached in a private capacity**:

Peso Silver Mines v Cropper (1966)

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : general law

- **Misuse of confidential information**

- Directors must not use confidential information for their own benefit

Thomas Marshall (Exporters) Ltd v Guinle [1978].

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : general law

- **Competing with the company**

- GL: Fiduciaries must not compete with the person for whom they act.

- **But a non-executive director** of two companies which are in competition **can compete**, provided there's no other conflict of duty: **Bell v Lever Bros [1932]**.

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : statutory position

- It is important to note that **some provisions codify the general law**, but mostly the sections supplement it

Misuse of confidential information

Sections 183 and 184(3) supplement the fiduciary duty not to misuse confidential information from the company

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : statutory position

S 183

Applies to directors or officers
a person who obtains information because they are or have been a director or an employee of a corporation **must not improperly** use the information to
(a) gain an advantage for themselves or someone else; or
(b) cause detriment to the corporation

S 184 (3)

applies to directors or officers
criminal offence if use the information dishonestly
(a) with the intention of **directly or indirectly gaining an advantage** for themselves or someone else or causing detriment to the company; or
(b) Recklessly as to whether the use may result in themselves or someone else gaining an advantage or causing detriment to the company

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : statutory position

• **Misuse of position**

S182 reinforces GL principle (Regal v Hastings) that a fiduciary should not profit by virtue of that position

A director, secretary, other officer or employee

- Must not improperly use their position to
 - (a) gain an advantage for themselves or for someone else; or
 - (b) cause detriment to the corporation

- Case examples
Jeffree v NCSC (1989)
ASIC v Adler

Duties of loyalty and good faith

4. Duty not to act in conflict of interest with the company

No Conflict Rule : statutory position

- Disclosure requirements:
 - **S 191** - "a director of a company who has a **material personal interest** in a matter that **relates to the affairs of the company** must give the **directors notice of the interest**."
 - If disclose then may vote on things related to the interest and transactions can proceed
 - *Financial benefits Ch 2E*
