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Directors' Duties in the Light of CLERP and Recent Legal Developments. The Four Commandments, the Four Pillars of Wisdom and the not so Golden Silence

Australian Institute of Company Directors

and

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Seminar

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DIRECTORS' DUTIES IN THE LIGHT OF CLERP AND RECENT LEGAL DEVELOPMENTS

THE FOUR COMMANDMENTS, THE FOUR PILLARS OF WISDOM AND THE NOT SO GOLDEN SILENCE

The Four Commandments

The CLERP reforms distil the major duties of directors to four crisp commandments in the exercise of powers and discharge of duties.

Directors must:

1. Use the care and diligence of a reasonable director in the corporation's circumstances occupying the same office and with the same responsibilities (section 180);

2. Act in good faith in the best interests of the corporation and for a proper purpose (section 181);

3. Not use their position improperly to gain an advantage for themselves or any person or cause detriment to the corporation (section 182);

4. Not use improperly information obtained because of being a director to gain advantage for themselves or someone else or cause detriment to the corporation (section 183);

The second Commandment with its three tiered standard poses a heavy onus for directors

The Four Pillars of Wisdom - Business Judgment

The statutory business judgment rule introduced by CLERP rests on four pillars:

1. good faith and proper purpose;

2. no personal interest;

3. appropriate information;

4. rational belief about best interests (section 180(2)).

The rule only operates to justify judgments made in the course of complying with the first commandment, and so is of no relevance to observing the other 3 commandments. There are however 4 quirks.

First, when deciding whether a director has fulfilled the business judgment rule criteria of care and diligence, it is the director's own rational belief about the best interests of the corporation that is normative.

But when a question of fulfilment of the second commandment as to the best interests of the corporation arises, that matter would now, it seems, be in the hands of the Court to determine, and rational belief is not an element of the standard. This appears to be an intended outcome, since the section was amended to this effect when the Bill was in the Senate. Even though Courts will probably remain reluctant to second guess board decisions, we may expect directors' justification of their action to be exposed to more rigorous analysis than previously; and the new business judgment rule may evaporate just when it is needed most. It would be a grievous disappointment for directors who rationally believe that a sound judgment was made in the circumstances to find that in the judicial view the decision is not in the best interests of the corporation.

Secondly, there is double jeopardy in that a decision must be made for a proper purpose as a condition for showing that standards of care and diligence are met through business judgment, but the absence of that quality is also a breach of the second commandment.

We thus reach the practical conclusion that a disinterested director rationally believing in good faith and on appropriate information his decision is in the best interests of the corporation, may nevertheless fail both first and second commandments by an objective determination of the Court as to proper purpose.

Thirdly, a difference between the first and second commandment is that the director carries the onus of showing the exercise of the four pillars of business judgment to establish fulfilment of care and diligence, but if lack of good faith, proper purpose, or the best interests of the corporation are alleged, the onus of proof will be carried by the complainant.

Fourthly, directors must take seriously the statement that they must inform themselves: it is not enough merely to accept information and advice provided by management, professionals and experts, or other board committees - directors must still make their own independent assessment of the information or advice (section 189(b)(ii)).

"In good faith in the best interests"

"Good faith" for a director involves loyalty and honesty in preferring the interests of the corporation to extraneous interests. A longer definition that makes "good faith" cover the field was given in *Chew v R.*

"Best interests" is a more elusive concept as a statutory term than its frequent judicial usage may suggest. It is certainly more difficult to grasp as a generic descriptor than it is, say, in the context of a scheme of arrangement. Ford's Principles of Corporations Law notes that most cases refer to situations where directors unreflectively assume that what is good for their interests is good for the company. The Explanatory Memorandum suggests that the rewrite will make it easier for company officers to know what is expected of them, but so far none of the leading text writers have analysed this new hot potato created by the Senate's finishing touch to section 181. In the context of section 181, unlike section 180, the Courts may not assume that the directors' judgment of what is best is best unless no reasonable director would so conclude. Is there only one "best", and must the Court come to its own conclusion about "best" because of the clear distinction in standard made between section 180 and section 181? One judge (Young J in the NSW Supreme Court in *Pioneer Concrete Services v Yalnah*) has previously raised the question of the meaning of acting in the "best interests" as distinct from "interests", saying that the sense is not only to act in the interests, but also to do so in the best of capacity. This approach would drive a wedge between best interests of the corporation and that other well worn phrase "the interests of the company as a whole".

Perhaps ominously, the Explanatory Memorandum refers to "best interests of the company" in the context of section 237 which requires the Court to be satisfied about those "best interests" in granting leave to bring proceedings in the name of the company. The EM suggests that the criterion "will allow the Court to focus on the true nature and purpose of the proceedings" and invites the Court to weigh the costs and benefits involved in a decision to proceed or not.

The bottom line is that it is open to the Courts to undertake an objective review of a decision by directors and to determine that the decision was not the best in the capacity of the directors to make in the interests of the corporation.

Invitation to a significant shareholder to propose a director

Developments in fiduciary duties culminating in CLERP may have set a trap for directors who have been invited to join the Board because they are also directors of a significant shareholder.

It is typical (and normally appropriate) that persons with a sufficient shareholding to exercise appreciable voting influence may arrange to have directors of their selection frequently a director of the shareholder, appointed to the board in approximate proportion to their shareholding.

What is the expectation of a director from the shareholder about information obtained by the director? First, the director may be expected to understand and advance the view of the shareholder on policy and strategy issues or the issues before the board.

Secondly, the director may be expected to be a sentinel to warn the shareholder of issues in which the shareholder has a particular interest, a matter I will discuss shortly.

Both of these functions are under pressure as fiduciary principles are being developed by CLERP and the Courts. In some instances the pressure threatens the continuing position of a director who has dual loyalties with an intolerable burden.

On the first point, the position of a director and a shareholder differs in this fundamental: a shareholder may normally advance its own distinctive interests in the company, while a director has a primary loyalty to the best interests of the corporation.

Business judgment about what is best for the whole company can be a matter in which two shareholders may rationally differ on grounds which have nothing to do with their distinctive interests. But specific goals or interests of the shareholder, for example, because the shareholder is also a competitor or customer, may place the common director in a dilemma, especially as objective review by a Court is a future possibility.

Even in the absence of distinctive interests not connected to the share investment, a large shareholding may present "best interests" issues. The idea that "control" gives, in the words of section 50AA (a CLERP amendment), "capacity to determine the outcome of decisions" may mask what are "best interests of the corporation" for directors who effectively represent controllers. Control ought never to have meant that any minority must wear whatever controllers see as best for the company, but new section 187 inserted by CLERP, which deals with directors of wholly-owned subsidiaries, now makes abundantly clear by necessary implication that the circumstances where control may be exercised merely for the benefit of the controller are very limited. The *Charterbridge* rule (for honest group company decisions) has now been replaced by the new statutory test. In the context of joint venture companies the Australian and New Zealand Courts have worked out a theory that representative directors can act in the interests of their appointor so long as they believe this is also in the interests of the company, or on one formulation at least not inconsistent with those interests. The concept of this acceptable coincidence of interests has been worked out by constitutional analysis, and no such aid is available to permit the mere controller to disregard minority interests.

The hammer that may break open the kernel of content of "best interests" is section 232, the revamped oppression provision, because it provides for more effective tailored relief than the new statutory derivate remedy. Dissatisfied minorities may ask the Courts to deal with an allegation that some act or course of conduct is "contrary to the interests of members as a whole". The latter phrase has been in the legislation for quite some time, but under CLERP it has become a separate and the primary paragraph justifying judicial intervention. The change in statutory emphasis of the remedy is stark.

Moreover, even though the specific statutory language has not changed, a difference between operation of the old oppression remedy and the new oppression remedy is the surrounding context of the CLERP refined directors' duties. I am willing to assume that what is contrary to interests as a whole cannot be in the best interests, even if sometimes it may be at least theoretically possible for something to be in the interests, but not the best interests. The revised oppression remedy combined with section 181 gives litigiously minded shareholders increased encouragement to challenge board decisions.

Proper

The reference to "proper purpose" in the use of position or information "improperly" put an emphasis on determining what is proper and how it should be measured. It is reasonable to assume that in future both the positive and negative expressions will be construed and measured by the same standards.

What is proper is measured by an objective standard and can therefore be determined by the Courts. It is not enough that the directors themselves honestly and rationally believe a decision to be right or in the best interests of their corporation if, when measured by external objective standards measured by the Courts, the purpose is not proper. This is true both in the context of the business judgment rule and when defending allegations of acting improperly.

Early cases of what is proper were often concerned with the doctrine of ultra vires - the constitutional capacity of the corporation - and involved reviewing the objects and powers set out in the constitutional documents of the company. In the context of directors' exercise of a power judicial analysis referred to its nature, and the purpose for which it was conferred. So in the consideration by the Privy Council in 1974 in *Howard Smith v Ampol Petroleum* of a share allotment, the court concluded in that case that the purpose of the director's power to issue shares should be viewed in the context of the constitutional right of shareholders to control the composition of the board, so that power to issue shares used effectively to displace an existing majority did not constitute use of the power for a proper purpose.

As Ford's Principles of Corporations Law points out, this kind of analysis could, if the constitution is appropriately drafted, show positively that the same use of power could be used for a proper purpose. Thus, in *Whitehouse v Carlton Hotel* the High Court conceded that articles could be framed so as to confer on a governing director authority to allot shares for the proper purpose of diluting voting power or other rights of existing shareholders.

In a standard constitution of a listed company there is unlikely to much specific guidance on limits of the proper purpose of directors' powers. However there may be some overlap between "proper purpose" and "best interests" because the constitution will probably vest full management powers in the board and the board will then decide what is in the interests of the company.

Therefore, in most cases (other than organic questions such as share capital issues or expenditure of corporate funds or preserve control) what the board thinks best will be what is constitutionally proper.

The CLERP reconstruction of the former statutory duty to act "honestly" has resolved a division of judicial authority about the former subjective element. One line of authority was to the effect that in order to fail to act honestly there would need to be a consciousness that what was being done was not in the interests of the company (*Marchesi v Barnes*). A contrary authority suggested that there would be a breach of duty even where the director exercised the power honestly yet was for a purpose that the court thought to be improper (*Australian Growth Resources v van Reesema*). The statute is now framed so that honest breach of the second commandment is still a breach.

The nature of proper purpose in the context of what is now section 181 must affect the references to acting "improperly" in sections 182 and 183. It follows that if a director acts for a purpose which is not a proper purpose and gives some advantage to a third party or thus causes some detriment to the company, there is a breach of duty. In short, the question of proper or improper is primarily dealt with as an issue of constitutional authority. Information used arguably in a good way for the company in a commercial sense may nevertheless fail a "proper purpose" test, determined on constitutional rather than commercial principles. Nevertheless the converse is not true: something done within the scope of due authority would still be done for an improper purpose if it were done in bad faith or not in pursuing the best interests of the company.

Is it proper to help selling shareholders?

By way of example of where the "proper purpose" debate may go next, a hot topic in the context of mergers and acquisitions has recently been the propriety of directors offering a "break fee" to induce a bid or an increase in a bid. The debate so far has been about whether any such fee contract may be in the "best interests of the company".

On strict analysis, directors do not normally have duties to assist shareholders who are sellers to get the best price for a sale of their shares. Instead their duty is to the company comprising its continuing and future shareholders as a whole. That was enunciated, at least for England, in

Dawson International v. Coates Paton although a slightly different Australian view emerged in *Darvall v North Sydney Brick and Tile Co.* Nevertheless, there may be a range of potential corporate benefits which can be identified as likely to flow from a company inducing a person to offer to enter a transaction with its shareholders, and those benefits may justify contracting for a break fee as being in the best interests of the company. There is however a sound of the ex post facto about some of these justifications, and the more relevant question may be whether, when directors commit the company to such fees, they exercise their powers for a proper purpose.

It is certainly not yet Australian law that when directors see that their company is "in play" they have a *duty* to conduct an auction, or to offer inducements to potential bidders solely for the purpose of encouraging them to bid for the shares.

Nevertheless, it has been a legal principle of Australian takeover law for 20 years that the acquisition of substantial interests should take place in an efficient, competitive and informed market, and encouragement can be found in that phrase to view facilitation of a competitive takeover bid as a proper corporate purpose in relevant circumstances, or the Panel or a court may even move closer to Delaware Law on the duty of target company directors to facilitate the highest sale price when it becomes likely that control will be sold. The "best interests" question can then be resolved into a question of whether best terms are being extracted by the target's board.

This issue is taken one step further if a form of inducement provided by the board is a share placement, as share allotments are the classic situation in which a Court will examine the propriety of purpose of the resulting alteration of capital interests. The action of IAMA in making a share placement in the context of negotiations for a business merger is currently being challenged in oppression proceedings in the Supreme Court of South Australia. The IAMA Board has explicitly said that one purpose of making the placement was to induce the new shareholder to negotiate to dispose of a business to IAMA, thus creating competitive tension between that potential transaction and other avenues of industry rationalisation potentially open.

Common Directorships and Not so Golden Silence

Questions of transfer or no transfer of information in possession of a common director may become increasingly contentious.

Three examples may illustrate the general point:

Example 1

Common directorship of the two companies which have a transaction with each other

A conventional approach is that the director should declare an interest and take no part in the transaction.

However, I have the impression that it is not universally accepted that a non-executive directorship, without more, constitutes a material personal interest.

My view is that the personal loyalty owed by a director to the company always gives that director a personal interest in transactions by the company and materiality will be determined by the circumstances of the case.

If abstention from the decision process of both companies would resolve the issue, well and good, but this may not always be practicable.

The two cases arising from the ill fated Duke Group liquidation illustrate how serious an issue for the common director information may become.

In *Fitzsimmons v R* a director was held to have breached his duty to act honestly (i.e. in good faith) when he failed to disclose to his board what he knew of the true financial position of another company by reason of his directorship of that other company. The Court of Criminal Appeal said that since the director knew both the true financial position of the other company and that his knowledge should have been brought to the attention of the board, the fact that he did not do so was sufficient to establish a criminal offence. The Court rejected the defence that he did not disclose the information gleaned from his other directorship because to do so would be a breach of his duty to that company not to reveal confidential information. The Court said that in the particular circumstances it would not be sufficient for the common director to absent himself

from a board meeting because of the conflict without disclosing any reason for absenting himself. The circumstances may require some positive action to identify clearly the perceived conflict and to suggest a course of action to limit the possible damage. In addition to disclosing the conflict of interest the director "may well have been required to identify what he knew to be the risk".

In a subsequent case relating to the same company, *Duke Group (in Liq) v Pilmer*, the Court held that in the particular circumstances, declaring an interest and taking no further part in the specific matter would not be sufficient if the director was aware that the board was likely to act to the detriment of the company if not warned.

A similar definition of need for positive action had previously been identified in *Permanent Building Society (in liq) v McGee*.

While the specific criminal offence has departed with CLERP, the principles of the two Court decisions could still leave such a common director with nowhere to go. If the director communicates his information to the second company, there is a breach of the second commandment duty to the first company because the director has no authority to disclose corporate information of the first company. If the director declares an interest and then remains silent, the Court may find that there has not been an adequate discharge of the duty under the first commandment. The business judgment rule will not assist because it does not apply to silence and withdrawal.

It is thus apparent that in some situations the knowledge that a common director acquires may put him in an impossible position of conflict of duty.

Example 2

Common directorship between shareholder and company

The shareholder decides to vary its holding at a critical moment.

The laws of insider trading (section 1002E) say that a body corporate is taken to possess any information which an officer possesses and which came into his or her possession in the course of performance of duties as such an officer.

Depending on the circumstances, there may be a question whether company information should be attributed to the shareholder through the common directorship. The inference would be strong if the common director is an executive director or non-executive chairman of the shareholder. The inference is more tenuous in the case of a common non-executive director unless special arrangements apply, or the non-executive director has been specifically requested by the shareholder's board to accept the common appointment as a representative of the shareholder (*TNT v Normandy Resources NL*).

The answer to the question when there may be a duty to communicate has become less clear, so prudence suggests that the "chinese wall" arrangement contemplated by section 1002M should always be put in place between any common director and investment decisions by the shareholder. This requires not only that common directors be excluded from the decision making processes, but that no information or advice actually pass to the shareholder from its director about the other company.

This will solve the insider trading issue and also avoid the breach of section 182 in relation to the company.

It does not necessarily solve all issues for the director as a director of the shareholder, especially if the whole point of the shareholder being represented to foster some interchange of strategic views.

Example 3

Common Directorship between Competing Companies

The current case law has it in several decisions that it is not a breach of duty to be a director of rival companies so long as confidential information is not divulged. Despite the fact that the line of authority is continuous and extends into the last decade there must be doubt whether it will always be able to survive rigorous analysis from the point of view of both companies and the standard now expected under the CLERP second commandment.

The reality of the issue was graphically illustrated in a report in mid September of the course of litigation between ASX and Computershare. The report said that "A deal to appoint the head of

ASX, Mr Christopher Hamilton, to the board of Perpetual Trustees was a deliberate attempt by ASX to obtain inside information about Computershare". The appointment was a "bid to circumvent a confidentiality agreement between Perpetual and Computershare".

If a company is about to take a step that should confer on it on overwhelming competitive advantage, how can a common director who acquires this information comply with his duty of loyalty to the competitor without taking a positive step to warn it of its impending doom? How can the company which has the information trust the director not to conclude that he has a duty to warn the competitor?

The problem with the case law is that the Courts have only been able to examine one aspect of a duality at a time, but a common director of competing companies must juggle the dual loyalties. Depending on which company affairs are being judicially scrutinised, a Court can either decide that the director should maintain the duty of confidentiality to one competitor or alternatively, if the other competitor is in focus, it may demand "positive action to suggest a course of action to limit possible damage". Directors of competing companies would be wise to contemplate the possibility that sometimes in a competition there is no second prize. In such circumstances they will need to consider carefully the retrospective judicial advice given by Owen J to Mr Fitzsimmons:

> "Once he had realised the gravity of the situation he might have come to the conclusion that the conflict was irreconcilable and that resignation was the only option. It was a matter for him."

If silence is not golden, then in all the corporate olympics in which directors enter two events we can only wish that there will be the prospect of a silver medal.