COMPENSATION FOR DIRECTORS' LOSS OF OFFICE

TAUPO TOTARA TIMBER CO. v. *ROWE*

The service agreement between an executive or managing director and his company is a very important instrument which will delineate the employee's powers, rights and duties *vis-à-vis* the company. It will usually contain provisions concerning termination of office and compensation for that loss of office. Often, the service contract will contemplate the possibility of a takeover of the company and provide that, in such event, the employee may resign or be dismissed and in either case will be entitled to remuneration. This type of clause guards against an unsatisfactory relationship between the employee and his new masters. In this regard, the service contract is potentially very valuable in the hands of the employee and there is a serious possibility that this sort of agreement between a company and its executive directors could discourage takeovers and constitute a threat to shareholders.

On its face, s.129 of the Uniform Companies Act seems to limit the enforceability of such agreements; s.129(1) (a) provides:

> It shall not be lawful for a company to make to any director any payment by way of compensation for loss of office as a director of that company or of a subsidiary of that company or as consideration for or in connection with his retirement from any such office . . . unless particulars with respect to the proposed payment (including the amount thereof) have been disclosed to the members of the company and the proposal has been approved by the company in general meeting and when any such payment has been unlawfully made the amount received by the director shall be deemed to have been received by him in trust for the company.

Two cases, one decided by a Victorian judge at first instance and the other by the Privy Council on appeal from New Zealand, throw light on the meaning of this section of the Companies Act in relation to managing directors' service agreements and raise some disturbing questions.

The Privy Council decision in *Taupo Totara Timber Co.* v. *Rowe*[1] both affirms and amplifies the decision given in *Lincoln Mills (Aust.) Ltd.* v. *Gough*[2] by Hudson, J. in the Supreme Court of Victoria. The

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[1] [1977] 3 W.L.R. 466 (hereafter *Taupo*).
[2] [1964] V.R. 193 (hereafter *Lincoln Mills*).

facts of *Taupo* were as follows. The respondent, Rowe, became a director of the appellant company in 1964. He was later appointed managing director for a period of five years dating from 9th December, 1971, and a service agreement was duly executed. Clause 7 of this agreement provided that, in the event of a takeover or third party acquisition of 50% or more of the company's shares, the managing director should be free to resign his office within twelve months of the takeover upon giving at least three months' notice. It further declared that if the managing director resigned pursuant to this clause, he would become entitled to a "sum of money equivalent to five times the gross annual salary being paid by the company to the employee immediately prior to the date of the acquisition of such share capital" and that this sum should not be taxable in his hands.

A takeover proposal did eventuate and it became effective on 23rd August, 1972 when the transfer of the company's shares to New Zealand Forest Products Ltd. took place. On 28th May, 1973 the managing director tendered his resignation. His notice, therefore, fell within the twelve month period required by clause 7, but the date on which he would actually give up office, 31st August, 1973, fell outside it. It was in these circumstances that Taupo Totara Timber Co. refused to pay Rowe the sum referred to in clause 7 and Rowe sued for $67,500 plus interest. This claim was rejected at first instance, allowed by the Court of Appeal of New Zealand and then went to the Privy Council where Lord Wilberforce delivered the advice of the Board.

The Privy Council raises three questions for decision:

1. Did Rowe's notice actually have to take effect within the twelve month period before he could claim the sum in clause 7?
2. Was such a payment in contravention of the New Zealand equivalent of U.C.A. s.129?
3. Was the service contract *ultra vires* the company or the directors?

Questions 1 and 3 are dealt with only briefly, the Privy Council firmly answering both in the negative. Their Lordships' resolution of question 1 is interesting on the point of draftsmanship. They regard the phrase "to resign his office upon giving to the company, not less than three months notice" as meaning that resignation is effected "by" the giving of such notice. The notice and not the expiration of the three month period therefore constitutes the resignation. Their Lordships recognise but do not resolve the possible problems that this interpretation could produce. For instance, if eleven months after the takeover, Rowe had given a two year notice, would he have been entitled to his salary over that period as well as the compensation for loss of office? If the clause had stated that the compensation would be calculated as the equivalent of $1,000 for each month between the employee's resignation and the date on which his term of office should have ended under his

service contract, could Rowe, one month after the takeover, have given a year's notice and continued to receive his salary in addition to compensation dating back to the time when notice was given? These anomalies must remain unanswered for the present time.

It is in respect of the second question posed by the Privy Council that *Taupo* is particularly important and must be carefully examined. In discussing whether the proposed payment to Rowe under the service agreement was rendered unlawful by the section, their Lordships raise two separate issues. Firstly they ask whether the section extends to catch directors receiving payment in connection with another office held in conjunction with that of director. Secondly they ask whether the section operates to catch payments which the company is contractually obliged to make under a service agreement and not merely proposes as a golden handshake. These are clearly distinct issues and the Privy Council purports to be guided in the resolution of both by the decision in *Lincoln Mills*. Indeed their Lordships say that "there is only one reported case . . . in which these points have been considered: the Victorian case of *Lincoln Mills (Aust.) Ltd.* v. *Gough* . . . Hudson, J. gave a careful judgment . . . in which he decided on both the points above mentioned that the payment was not illegal."[3] It is necessary to see whether this is an accurate description of the decision in *Lincoln Mills*, a case factually almost identical with *Taupo* except that there payment had already been made to the managing director, who, it was argued, now held such sum as a trustee for the company under U.C.A. s.129.

Lincoln Mills is clearly important as regards the first issue raised by the Privy Council. Hudson, J. stressed that the offices of director and managing director are "separate and distinct"[4] and that, although loss of office as a director would, under the company's constitution, immediately terminate that of managing director, the reverse was not true. This being so, he concluded that when s.129(1) (a) speaks of "compensation for loss of office as a director", it is not sufficient that a payment for loss of another office such as managing director should be "coincident with the loss of or retirement from office as a director"[5] The compensation must in reality be for the loss of office of director. The logic of this argument is irresistible in view of the wording of s.129 as opposed, for example, to s.128 which begins "[a] company shall not pay a director remuneration (whether as director or otherwise) free of income tax . . . ." One of the results of Hudson, J.'s decision, however, is that the shareholders' protection is diminished in the area of managing directors' remuneration, since such payments will not need to be approved in general meeting.

The Privy Council applies this argument to the facts in *Taupo*,

[3] *Supra* n. 1 at 471.
[4] *Supra* n. 2 at 197.
[5] *Id.* at 199.

though it is more difficult for them, the New Zealand counterpart of s.129[6] being without the qualifying words "as a director" and "retirement from such office". Their Lordships are unperturbed by this, however, seeing these additional words in the Victorian Act as being "clarificatory" only and not "restrictive"[7]. This adaptation of the *Lincoln Mills* decision would clearly have been sufficient to dispose of the case in Rowe's favour.

Nevertheless, the Privy Council goes further, holding that a contract for payment, as distinct from a proposed payment, for loss of office is not within the ambit of the section. This would appear to considerably narrow the scope of the section and indeed constitute a departure from its generally understood meaning. It is this second basis for the decision in *Taupo* which must be regarded as somewhat controversial, since it is doubtful whether *Lincoln Mills* can stand as authority for such a point.

In his judgment, Hudson, J. stated:

> The nature and circumstances of the payment must be looked at with a view to determining its true character. If as a result of investigation it becomes apparent that it is a compensation for loss of the office of director or a consideration for retirement therefrom it will be unlawful unless the sanction of a general meeting has been obtained. If, on the other hand, the payment appears to have been made as a result of other considerations, then, even though it may be coincident with the loss of or retirement from office as a director, the payment will not fall within those prohibited by the section.[8]

This implies two things: firstly, as we have seen, that the payment must be examined to determine whether it is due to the defendant as director or as managing director. Secondly, it shows the need to ascertain whether the payment is actually "compensation for loss of office or consideration for retirement therefrom" or whether it is rather the result of "other considerations". These "other considerations", of which Hudson, J. spoke, are probably similar to those set out in U.C.A. s.129(5). If it appears that the payment arose from considerations such as providing a pension for past services or damages for breach of contract, the compensation, though it may become payable upon loss of office, is not in reality for such loss.

Hudson, J. seemed doubtful whether the compensation clause in issue there was of such a type as to be caught by the section. He said that "[i]f it is properly described as a compensation for loss of office or a

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[6] Section 191 Companies Act 1955 (N.Z.): "It shall not be lawful for a company to make to any director of the company any payment by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, without particulars with respect to the proposed payment (including the amount thereof) being disclosed to members of the company and the proposal being approved by the company in general meeting."

[7] *Supra* n. 1 at 471.

[8] *Supra* n. 2 at 199.

consideration for retirement from office, then it was for loss of or retirement from the office of managing director and not that of director".[9] He was not compelled to decide conclusively whether the payment was connected with loss of office or due to other considerations, because the case could be disposed of on the director/managing director distinction, but it is implicit in the above statement that he clearly conceived it possible that the contract was of the type prohibited by s.129 and thus caught by it, but for being made with a managing director. On the Privy Council's second basis of decision it could not have been within the section since it was a payment which the company was obliged under contract to pay rather than merely proposed to pay. Yet the Privy Council mysteriously states not only that Hudson, J. considered this contractual obligation issue but that he also decided the case on it. With respect, it is very difficult to find such a *ratio* in his judgment.

The Privy Council states that the New Zealand section is "identical"[10] with the Victorian section except for the latter's qualifying words "as a director" and "retirement from such office". There are, however, some other differences which are worth noting. The New Zealand section is without a complete counterpart to s.129(5). This subsection specifically excludes certain types of payment from the general prohibition in s.129(1). Subsection 5(e), for example, makes clear that "any payment to a director pursuant to an agreement made between the company and him before he became a director of the company as the consideration or part of the consideration for the director agreeing to serve the company as a director" is not unlawful. But if the Privy Council is correct, this subsection is otiose since no prior contractual agreement whatever could fall within the prohibition of s.129(1). Similarly when s.129(5) (b) declares that any reference to payments by way of compensation for loss of office does not include "any payment under an agreement particulars whereof have been disclosed to and approved by the company in general meeting", it would seem obvious that any such reference does include an agreement which has not been disclosed and approved. This does not follow, however, on the Privy Council view.

Another difference between the two sections is that the Victorian section prohibits payment "to a director of that company or of a subsidiary" whereas its New Zealand (and English) counterpart does not extend to directors of a subsidiary. This means that even a proposed payment, as opposed to a contractual payment, lies outside the New Zealand and English section, if it is to a director of a subsidiary. None of the sections refer to directors of a parent company.

The Jenkins Committee was critical of the omission in the English section as regards directors of subsidiaries. Indeed, the Committee went further in arguing that they could see no rationale in restricting the section's operation to compensation for loss of office as a director.

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[9] *Id.* at 200.
[10] *Supra* n. 1 at 470.

Rather they were of the opinion that it should be extended to cover payment to a director for loss of any office in connection with the management of the company's affairs, a suggestion quite contrary to the decision in *Lincoln Mills*. The Committee was, then, in favour of an approach which would give added protection to shareholders. This is further evidenced by the fact that they considered that the general meeting's approval should be by special resolution. It seems strange, then, that the Jenkins Committee should be cited by the Pricy Council in *Taupo* as support for its distinction between contractual and proposed payments, a distinction which considerably lessens shareholder protection. It is true that the Committee do at one stage refer to an "uncovenanted payment"[11] but they do not suggest that the covenanted/uncovenanted distinction is one that is critical to the operation of the section.

The result of the decision in *Taupo* is that instead of a gap in the operation of s. 129 there is a yawning gulf. *Lincoln Mills* precluded payments to managing directors from falling within its ambit but the fact that the Privy Council has superimposed a contractual/proposed payment distinction means that now even payments to directors for loss of office as directors will be outside the section, provided they are the subject of an *intra vires* contract between the director and the company. The section thus only has relevance in the area of proposed payments to retiring directors, an extremely narrow range indeed. Could a company proposing to give a golden handshake to a director avoid the prohibition in s.129, even then, by making a contract for nominal consideration to pay such money to him? If the section could be avoided in this way, it would be rendered virtually useless as a means of protecting the shareholder. The Privy Council does not deal with these possible problems, yet they briefly discuss two issues which may in fact constitute limitations on the power to enter into such service contracts without the approval of the general meeting.

One possible limitation is the doctrine of *ultra vires*, and it is this which forms the basis of the third question raised in *Taupo*. As regards the argument that the contract with Rowe was *ultra vires* the company, their Lordships state that "[t]here can be no doubt as to the general power of the company to engage servants and to enter into service agreements with them".[12] Similarly they say that there is no question of the agreement being *ultra vires* the directors of the company since they had an explicit power under the articles to appoint a managing director on such terms as they thought fit. If, however, a company's articles empowered directors to appoint a managing director only on certain specific terms, it could be argued that an agreement out-

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[11] Great Britain Board of Trade Company Law Committee Report, (Cmnd 1749, 1962) para 93.

[12] *Supra* n. 4 at 472.

side these terms was *ultra vires* the directors and hence invalid. Unfortunately this question was not raised in *Lincoln Mills*.

The other argument envisaged by the Privy Council is that the directors, in making the service contract with Rowe, acted in breach of their duty as directors, whereby they were bound to act for the benefit of the company. On the particular facts of *Taupo,* their Lordships held that the directors had acted *bona fide,* saying that "[t]he view that inclusion of a provision giving protection in the event of a takeover was in the interests of the company, was clearly one that reasonable and honest directors might take".[13] It was relevant that similar agreements had been entered into with other employees and that it was a method of retaining staff, who, according to the New Zealand Court of Appeal report,[14] were unwilling to remain with the company due to rumours of a takeover. There will be some cases, however, such as a golden handshake for nominal consideration or the situation arising in *Re W & M Roith Ltd.*,[15] where it would be very difficult to show any benefit derived by the company. Where there is an actual breach of director's duty, it results in a voidable contract and the employee receiving payment under the agreement would not be entitled to the sum if he had knowledge of the breach of duty.

On its face, nonetheless, the decision in *Taupo Totara Timber Co.* v. *Rowe* is disturbing, since it diminishes shareholder protection and may also decrease the attractiveness of takeovers if a company thereby becomes liable to pay large sums to the target company's officers. The importance of and concern with the area of takeovers is reflected in the recent proposals of the Commonwealth and State Ministers recommending that "where a takeover offer has been made or is about to be made, the target company is to be prohibited from entering into service contracts with its directors or officers without the consent of a general meeting of shareholders".[16] It is arguable that this is too extreme a reaction to the problem of takeovers and that service contracts made by the company for ordinary business reasons should not be subject to the prohibition. The proposals show, however, that there is an increasing amount of debate on takeovers and the decision in *Taupo* must be considered of great importance in any such debate.

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[13] *Ibid.*
[14] *Rowe* v. *Taupo Totara Timber Co.* [1976] 2 N.Z.L.R. 506.
[15] [1967] 1 W.L.R. 432.
[16] C.C.H. A.C.A.R. Vol. 2 at 25,412.