

COMPANY DIRECTORS*

THEIR POWERS, DUTIES AND RESPONSIBILITIES

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I was recently reading the English journal *The Director* and in it I came upon the powerful observation by a writer that if you pay directors peanuts, you must expect monkeys. Be that as it may, the spectacular failures of a number of large Australian companies in recent times have suggested that the monkeys have not always been the directors. Indeed the reports of inspectors have suggested, to use a word of almost unbelievable moderation, that the directors of some of these companies have been either partly or fully responsible for their failures. In view of the often disastrous financial consequences to shareholders (and to others who have invested in such companies), it is appropriate to ask whether the law as it stands in Australia imposes sufficiently stringent controls on the activities of public company directors.

In this paper I propose to consider the common and statutory law in Australia relating to the public company director, to note comparisons with the American law on this subject and to conclude with a review of recent proposals for partial reform of the law in this area which were made by the Hon. J. W. Galbally in the form of a Bill which he introduced into the Victorian Legislative Council in April and with even more recent governmental proposals in that State.

The legal aspects of a public company director's relationship to the company and to the shareholder are governed by both the general, that is to say the common law and by statute—in the form of the Uniform Companies Act. The most important sections are those contained in Division 2 of Part V of the Act which impose duties which go to the standards of conduct imposed on directors. I refer particularly to the provisions of Section 124. It may be advisable in this connection to note immediately the terms of Section 124(4):

This section is in addition to and not in derogation of any other enactment or rule of law relating to the duty or liability of directors or officers of a company.

* This article formed the subject of a lecture given at Hobart in 1966 under the auspices of the Companies Auditors' Board. The editors are grateful for the permission to reproduce it in the *Law Review*.

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The section does not therefore modify the general law by relieving from existing duty or liability and it does appear that the effect of the section is to increase the duty and liability of directors.

Directors are strictly neither employees nor trustees but are regarded rather as agents of their companies so that the acts of the director are the acts of the company. As an agent the director stands in a fiduciary relationship to his principal, the company, and the duties of good faith which this fiduciary relationship imposes are in many respects identical with those imposed on a trustee.

Now, a fiduciary relationship exists between one person and another where the former is bound to exercise rights and powers in good faith for the benefit of the latter. Directors being agents of the company are required to exercise the rights and powers conferred upon them by the constitution of the company in this way, and although directors are generally required to act collectively as a board when they act on behalf of their company, the fiduciary duties they have are owed by them individually to their company.

There are two aspects of the directors' duties as fiduciaries:

1. A director must act *bona fide* for the benefit of the company *i.e.* in a manner which he honestly believes will benefit the company.
2. A director must not place himself in a position in which his duty to act *bona fide* for the benefit of the company is in conflict with his personal interest.

In regard to the first aspect of the fiduciary duties of a director, it has been held by the High Court of Australia in *Mills v. Mills*¹ that the directors' dominant purpose must be to serve the interests of the company, but it is for the directors to choose the means which will serve the interests of the company, unless the means they have chosen are such that no reasonable man could choose them having the interests of the company in mind. Relief from the duties of a director may, so far as the general law is concerned, be given by the consent of the company—*i.e.* consent of the majority in general meeting after full disclosure of all material circumstances, or by a provision in the articles. However, relief from the directors' general law duties by the articles is the subject of special provision in the Act.

Section 133 (1) provides:

Any provision, whether contained in the articles or in any contract with a company or otherwise, for exempting any officer or auditor of the company from, or indemnifying him against, any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company, shall be void.

Therefore any provision in the articles which seeks to set a lesser liability is now an 'exempting' provision.

¹ (1938) 60 C.L.R. 15.

The statutory duty to act 'honestly' imposed by sub-section (1) of S. 124 should also be noted here as perhaps importing the first aspect of the general law fiduciary duty.

Section 124 (1) reads:

A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.

The duty to act honestly imposed by the section can be regarded as a shorthand formulation of the duty to act in a manner which the director honestly believes will serve the benefit of the company.

The duty to 'use reasonable diligence' imposed by this sub-section will be discussed later in relation to the general standard of care which is required of directors.

In its second aspect, the fiduciary duties of a director involve the directors' duty not to allow conflict to arise between any duty and interest. Such conflict may arise in various situations. For example:—

1. *Where a director contracts with the company of which he is a director or is interested in a contract with the company.*

It is a general rule that if the contract is in respect of a matter connected with the fiduciary relation and if it is not authorized by

- (a) the articles of association, or
- (b) the company in general meeting after full disclosure to it of all material facts,

then such a contract is voidable at the option of the company. The general rule also applies in respect of a contract made with another company of which the director is a member, so that unless the articles, or the company in general meeting, authorize the company whose board enters into a binding contract with another company in which a member of the quorum holds shares, to do so, the company may treat such contract as voidable and it makes no difference whether the shares are held in trust or beneficially.

The articles of association can provide that such a contract will be wholly null and void and not merely voidable. However in the modern business and commercial world it will frequently be found that one person may act on the board and/or be a member of several companies and it may be found that the interest of each of these companies may be best served if they contract among themselves or it may be that a company will benefit considerably if it enters into particular contracts with one of its directors personally. Accordingly, the articles of association are generally drafted to provide:

- (a) That a director (or a company or firm in which a director is interested) may contract with the company but
- (b) that the interest of the director concerned must be disclosed, and

- (c) that he is to be precluded from voting at the meeting which considers the contract, and
- (d) that the director (or a company or firm in which the director is interested) may retain the benefit of such a contract if the above conditions are adhered to.

If the articles require the director to declare his interest in a proposed contract, it is not sufficient if he merely states that he has an interest; he must clearly state the nature of his interest and this would generally involve disclosing the amount of profit he stands to gain. In addition, the Uniform Companies Act by Section 123 provides that a director must disclose his interests in contracts with the company unless the interest of the director may properly be regarded as not being a material interest. The Act does not indicate what sort of interest 'may properly be regarded as not being a material interest.' But in making such a determination the extent of the director's holding of shares or debentures and the nature of the contract should surely be relevant. Generally the effect of the provisions of Section 123 is to impose a statutory penalty for failure by a director to disclose his interest in a contract with the company.

The rules of the general law and the provisions of the articles of association must still be taken into consideration in order to ascertain the extent to which a director may profit personally in a contract with the company in which he is interested. It should also be noted that where a director derives a profit from such a contract and the profit is not authorized by the articles or the company in general meeting, then the director may be in contravention of the provisions of Section 124 (2), as he may be said to have gained an 'improper' advantage' for himself or to have caused detriment to the company as a result of using information acquired by virtue of his position as a director.

2. *Competing Directorships.* It often happens that a director sits on the boards of two or more companies which are engaged in competition with each other. The articles of many companies specifically permit their directors to sit on other boards but in nearly all such cases the articles are silent on the point whether the other directorships authorized include those of rival companies.

A fiduciary is normally strictly precluded from entering into competition with the person to whom he stands in fiduciary relationship. But it is generally stated that this does not apply to directors of companies. It was held in the case of *London & Mashonaland Exploration Co. Ltd. v. New Mashonaland Co. Ltd.*² and approved by Lord Blanesburgh forty years later in the House of Lords in *Bell v. Lever Bros.*³ that a director of one company cannot be restrained from acting as a director of a rival company. But the director concerned is still

² [1891] W.N. 165.

³ [1931] All E.R.1.

subject to the equitable principles applicable to his duty as a fiduciary so that he cannot make use for the benefit of one company of confidential information which comes to him as a director of a rival company. The general rule on this point was stated by Lord Blanesburgh in *Bell v. Lever Bros*:

The principle will be found in the case usually cited in relation to it although reported only in the Weekly Notes. *London & Mashonaland Exploration Co. Ltd. v. New Mashonaland Exploration Co. Ltd.* where it was held that if not appearing from the regulations of the company that a director's services must be rendered to that company and to no other company he was at liberty to become a director even of a rival company and it not being established that he was making to the second company any disclosure of information obtained confidentially by him as a director of the first company he could not at the instance of that company be restrained in his rival directorate.⁴

This seems hardly satisfactory and in this context I would refer to a recent comment by Sir Douglas Menzies on this aspect of the law.

He says, after a review of these cases, that

when the problem whether a director is at liberty to compete with his company, either directly or indirectly, arises again, it can be anticipated that it will be approached on the footing that a director does occupy a fiduciary position and that the general principles applicable to a person in such a position will be applied, rather than attention being concentrated exclusively upon the absence of any contractual obligation to devote time to his company's affairs and to refrain from putting himself in a position where his duty to his company would conflict either with his own interest or with the duty he undertakes to someone else. It can also be anticipated that to succeed the company concerned will not have to prove against the director anything beyond what would be sufficient to warrant the dismissal of an employee for conduct incompatible with his office.⁵

In this context, it is useful to look at the authorities dealing with the master-servant relationship where it has been held that the servant's duty of fidelity prevents him from engaging in work for competitors even in his spare time. I refer to the case of *Hivac-Industries v. Park Royal Scientific Industries Ltd.*⁶ It has been established that the servant's duty of fidelity imposes lesser obligations than the full duty of good faith owed by a director. Accordingly it does not appear reasonable that a director should be permitted to compete whereas a servant is not. And it seems clear that at the very least a service director should not be allowed to compete. It is interesting to note that there are now statutory provisions requiring the disclosure of competing directorships. The provisions of Section 123 (5) require every director of a company who holds any office, or possesses any property whereby whether directly or indirectly duties or interests might be created in conflict with his duties or interests as director 'to declare at a meeting of the directors of the company the facts and nature, character and extent of the conflict.' Time limits for the disclosure are imposed by sub-section (6).

⁴ *Ibid.*, p. 17.

⁵ *Company Directors*, (1959) 33 *A.L.J.* 156, 160.

⁶ [1946] Ch. 69.

Section 134(2)(b) is also relevant here. It requires that the register of directors must include particulars of any other directorships of public companies held by a director.

3. I turn now to the important question of the *directors' use of inside information*. It is a general rule that any person who occupies a fiduciary position must observe the fundamental rule that he must not use his position so as to make it a means of gain for himself without the knowledge and assent of the person with whom he stands in the fiduciary relationship.

There are numerous ways in which directors may profit from their position, whether intentionally or unintentionally. If they use knowledge which they have acquired as directors and use their positions as directors to obtain the profit then the rule applies and they will be held liable to account to the company for such profit unless of course they acted with the knowledge and consent of the company. It makes no difference that they acted in good faith and were not in any way guilty of fraud. As stated by Lord Russell of Killowen in *Regal (Hastings) Ltd. v. Gulliver & Others*.

The rule of equity which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of *bona fides*; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took the risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having in the stated circumstances been made. The profiteer, however honest and well-intended cannot escape the risk of being called upon to account.⁷

The facts of the *Regal Case* were as follows:

The appellant company was the owner of a cinema in Hastings and with a view to the sale of the property of the company was anxious to acquire two other cinemas in Hastings. For this purpose they formed a subsidiary company with a capital of £5,000 in £1 shares. They were offered a lease of two cinemas but the landlord required a guarantee of the rent by the directors unless the paid up capital of the subsidiary was £5,000. The intention of the directors of the appellant company was that the appellant company should hold all the shares in the subsidiary but it could find only £2,000. The directors were unwilling to give the guarantee and instead subscribed for some of the shares with their own money. Ultimately, instead of a sale of assets, the transaction was carried through by a sale of shares in the appellant company and the subsidiary. The directors made a profit on the sale of their shares in the subsidiary and were held liable to account for that profit to the appellant company. The two propositions which the appellant had to establish in order to succeed were:

⁷ [1942] 1 All E.R. 378, 386.

1. that what the directors had done was so related to the affairs of the company that it could properly be said to have been done in the course of their management and in the utilization of their opportunities and special knowledge as directors; and
2. that what they did resulted in a profit to themselves.

Both these propositions were held by the House of Lords to have been established.

It follows from this decision that directors who join with their company in subscribing for shares in a subsidiary without the consent of the company in general meeting are in breach of their fiduciary duty in the sense that if they make a profit from the sale of such shares they will be accountable no matter how innocent the circumstances.

In the *Regal Case*, let me point out, the persons who benefited from the recovery were, through the company, its new owners.

It should be noted however that the real persons who had lost by what the directors had done in the *Regal Case* were the other former shareholders in the principal company, who may have got less for their shares because the directors got a generous price for their shares in the subsidiary. Section 129 (2), (3), (4) of the Act endeavours to avoid this twist of absurdity in some take-over situations. It is concerned with payments by way of compensation for or in connection with retirement from office to be made to a director in connection with a transfer as a result of an offer made to shareholders for all or any of the shares. The director has to tell the shareholders of the payments in the manner required by sub-section (2) unless disclosure has been made under Section 184, the take-over bid provision. The duty is to take all reasonable steps to secure that particulars with respect to the proposed payment, including the amount thereof, are included in or sent with any notice of the offer made for their shares which is given to shareholders (ss 2). Where a director is to get more for his shares than the other shareholders or any valuable consideration is given to him and he is a director whose office is to be abolished or who is to retire from office the excess price or the consideration is deemed to be compensation for loss of office. If he does not take the steps required by sub-section (2) he is guilty of an offence and any sum received by him as compensation or what is deemed compensation, he receives in trust for any person who has sold his shares as a result of the offer.

But the section operates only where the director is to retire. Where it is proposed that he should remain a director, only the general law with the absurdity revealed in the *Regal Case* will be applicable, and only the general law will apply where, as in the *Regal Case*, the shares sold by the director are not shares in the company of which he is a director. Sub-sections (2), (3) and (4) of S.129 cannot extend to such a situation.

Let me take another situation. In *Cook v. Deeks*⁸ the company concerned carried on the business of railway construction contractors. Three of the directors of the company obtained a contract in their own names to the exclusion of the company under such circumstances as to constitute them trustees of its benefits on behalf of the company. At a general meeting of shareholders of the company a resolution controlled by the votes of the directors as holders of three-quarters of the issued shares was passed declaring that the company had no interest in the contract. The House of Lords held that the benefit of the contract belonged in equity to the company and that the directors could not validly use their voting power to vest it in themselves. The principle was stated by Lord Buckmaster L.C. as follows:

. . . men who assume the complete control of a company's business must remember that they are not at liberty to sacrifice the interests which they are bound to protect and while ostensibly acting for the company divert in their own favour business which should properly belong to the company they represent.⁹

It is a question whether, on the facts, the directors have entered into a contract connected with the fiduciary relation in which they stand with their company in such a way that rights and benefits accrue to the directors when in fact they ought to accrue to the company. If they have committed a breach of duty in the course they took to secure the contract then they cannot retain the benefit of such contract for themselves, but must be regarded as holding it on behalf of the company. Nor in such case may the directors use their voting power at a general meeting to vest the benefit in themselves.

There is also a clear breach of duty where the directors exploit the company's property—in a broad sense of 'property'—as for example by making use of confidential information such as their knowledge of the company's lists of customers,¹⁰ or the company's trade secrets to further a competing business.¹¹ The breach of duty arises from the rule that a director is not permitted either during or after his service with the company to use for his own purposes anything entrusted to him for use by the company.

A further very important situation which must be considered in this area is the case where the directors of a company are also shareholders of the company so that what they do as directors may benefit them as shareholders. The question was referred to by Latham C.J. in *Mills v. Mills*:

I do not read the general phrases which are to be found in the authorities with reference to the obligations of directors to act solely in the interest of the company as meaning that they are prohibited from acting in any matter where their own interests are affected by what they do in their capacity as directors. Very many actions of directors who are shareholders, perhaps all of them, have a direct or indirect relation to their own interests. It would be

⁸ [1916] 1 A.C. 554.

⁹ *Ibid.*, p. 563.

¹⁰ See *Measures Bros. v. Measures* [1910] 1 Ch. 336.

¹¹ See *British Industrial Plastics Ltd. v. Ferguson* [1938] 4 All E.R. 504.

ignoring realities and creating impossibilities in the administration of companies to require that directors should not advert to or consider in any way the effect of a particular position upon their own interests as shareholders. A rule which laid down such a principle would paralyse the management of companies in many directions. Accordingly the judicial observations which suggest that directors should consider only the interests of the company and never their own interests should not be pressed to a limit which would create a quite impossible position.¹²

Directors dealing in the shares of their own company invite criticism, and not surprisingly, but how far a director can be made accountable for doing so does not appear to have been decided. In *Percival v. Wright*¹³ certain shareholders had asked the secretary of the company to find a purchaser for their shares in the company. The shareholders caused an independent valuation of their shares to be made by competent persons. The shares were bought by the chairman of directors of the company and transferred to him and to his two nominees. Unknown to the shareholders at the time of the sale, negotiations were proceeding between the chairman and a third party with a view to ascertaining the terms upon which the undertaking of the company would be sold, a transaction within the powers of the directors by the constitution of the company. In the circumstances neither fraud nor any other malpractice could be imputed to the chairman. It was held by Swinfen Eady J. that the directors were not precluded from purchasing the shares and that the sale and purchase could not be set aside, on the ground that the shareholders had notice of the director's powers and were not entitled to assume that they were not exercising their powers. This case is said to have established the proposition that no fiduciary duty is owed by a director to individual members of his company, but only to the company itself and *a fortiori* that none is owed to a person who is not a member, and accordingly has led to the assumption that directors buying shares in the company were under no duty to vendor shareholders to make any disclosure which would affect the price.

Since *Percival v. Wright* it seems to have been generally assumed that directors have a *carte blanche* to utilize their inside information in private speculations. This is clearly not in accord with sound principles of commercial morality and the decision hardly squares with the high standard of conduct expected of directors as formulated in the *Regal (Hastings) Case*.¹⁴ Probably the *Percival Case* could be distinguished on the ground that the shareholders approached the directors and offered their shares. Take-over transactions are now regarded very much more seriously and it is recognized in the Uniform Companies Acts that shareholders should be given early information of take-over offers. See S. 184, 10th Schedule. The Cohen Committee¹⁵ made strong comments about the decision in *Percival v.*

¹² (1938) 60 C.L.R. 150, 163.

¹³ [1902] 2 Ch. 421.

¹⁴ [1942] 1 All E.R. 378.

¹⁵ *Report of the Committee on Company Law Amendment*, 1945, paras. 86, 87.

Wright and the Jenkins Committee of 1962¹⁶ in its recommendations (which will be discussed below) has sought to abolish the proposition which the case is said to have established.

The provisions of Section 124 of the Uniform Companies Act were first introduced into the Australian Company field by the Victorian Companies Act of 1958 and the Tasmanian Act of 1959. Sections 124 (2) and (3) provide as follows:

- (2) An officer¹⁷ of a company shall not make use of any information acquired by virtue of his position as an officer to gain directly or indirectly an improper advantage for himself or to cause detriment to the company.
- (3) An officer who commits a breach of any of the provisions of this section shall be
 - (a) liable to the company for any damage suffered by the company as a result of the breach of any of the provisions, and
 - (b) guilty of an offence against this Act.

A director who commits a breach is liable to the company for any profit made by him or for any damage suffered by the company as a result of a breach, and the director who commits a breach is liable to the company for any profit made by him whether the company has suffered damage or not. This confirms the existence of the fiduciary duty of a director to the company. But as stated above a director is *not in a fiduciary relationship with a shareholder*, and it must be noted that liability is under the sub-section confined to the company and no right of action is given to shareholders who may have suffered loss as a result of a director using information he acquired as a director.

There is clearly an addition to the general law in the attaching of a criminal sanction by sub-section (3) to the breach of duty in sub-section (2). It is necessary now to consider the effect of the principle expressed in sub-section (2) in relation to the general law.

It seems clear from the wording of the sub-section that a director must have intended to gain an advantage for himself or to cause detriment to the company, and that the advantage or the detriment is gained or caused as a result of the director using any information acquired by virtue of his position as a director. The sub-section on the 'detriment to the company' aspect covers the *Cook v. Deeks*¹⁸ situation, and the other situation stated earlier involving what may be called appropriating the company's property, and in this aspect it does not appear to extend the general law. In its other aspect, that is, of gaining 'an improper advantage,' the sub-section is likely to be in issue where there is a share-dealing by the director in his company's

¹⁶ Report of the Company Law Committee, 1962.

¹⁷ 'Officer' is defined in S.5(1) to include directors.

¹⁸ [1916] 1 A.C. 554.

securities. It gives statutory recognition to the improper conduct of a director who deliberately buys or sells shares in his company acting on a particular piece of inside information, which if generally known would affect the market.

It is helpful at this stage to note United Kingdom and American experience in dealing with the type of situation comprehended under S. 124 (2). The following observations and recommendations were made by the Cohen Committee in connection with dealings in shares by directors:

Whenever directors buy or sell shares of the company of which they are directors, they must normally have more information than the other party to the transaction and it would be unreasonable to suggest that they were thereby debarred from such transaction; but the position is different when they act not on their general knowledge but on a particular piece of information known to them and not at the time known to the general body of shareholders, e.g., the impending conclusion of a favourable contract or the intention of the board to recommend an increased dividend. In such a case it is clearly improper for the director to act on his inside knowledge and the risk of his doing so is increased by the practice of registering shares in the names of nominees. None the less we do not recommend a prohibition on directors holding shares in the names of nominees. This is a useful convenience to the director and prohibition could be readily evaded e.g. through the medium of a company controlled by a director. We do, however, consider that the law should be altered so as to discourage improper transactions of the kind we have indicated. Even if legislation is not entirely successful in suppressing improper transactions, a high standard of conduct should be maintained and it should be generally realized that a speculative profit made as a result of special knowledge not available to the general body of shareholders in a company is improperly made. We would add that some directors who would not let themselves take advantage of inside information do not so clearly appreciate the impropriety of letting it be known to their friends that events as yet unknown to the shareholders have made the shares of the company an attractive purchase.¹⁹

It is interesting to note the use of the words 'improper' and 'advantage' both of which appear in S. 124 (2). The Cohen Committee did not however recommend legislation equivalent to S. 124 (2) but went on to recommend that disclosure by directors of all their transactions in the shares and debentures of their companies should be made obligatory. The Committee appeared to rely on the moral pressure of such a provision and said:

The fact that disclosure is obligatory will of itself be a deterrent to improper conduct and the shareholders can, if they think fit, ask for an explanation of transactions disclosed in the return which we recommend.²⁰

In response to the above recommendations of the Cohen Committee, provisions were inserted in the United Kingdom Companies Act 1948 Section 195. Similar provisions to those contained in Section 195 appear in the Uniform Companies Act, Sections 126, 127 and 178.

By S. 126 the company must keep a register showing the number, description and amount of shares or debentures of the company or of a related corporation held by or in trust for each director or of which he has any right to become the holder. And any transactions

¹⁹ *Report of the Committee on Company Law Amendment, 1945*, paras. 86, 87.

²⁰ *Ibid.*, para. 87.

after the Act in those securities including the date, price, or other consideration. A duty on the director to give the necessary information is imposed by Section 127: there is a penalty of \$1,000. The register is to be kept at the registered office and is to be open for inspection during ordinary business hours by any person acting on behalf of the Minister and, during the period of 21 days before the date of the annual general meeting and ending five days after its conclusion, to the inspection of any member or holder of debentures. The register must be produced at the commencement of the company's annual general meeting and remain open and accessible during the continuance of the meeting to any person attending. The period during which the register is to be open to inspection by shareholders and debenture holders is the same as under the United Kingdom Act. It may be that the Minister can appoint a member to inspect where the member has his suspicions. It is assumed that the Board of Trade under the corresponding United Kingdom Act provision can appoint a member in those circumstances.

It has been found in the United Kingdom that the provisions of S. 195 fail to achieve their object, which is to show what dealings had taken place by the directors and when. Because unfortunately the sanctions are inadequate to secure compliance and the register is not available for public examination and only at special times is it open even to members and debenture holders and it has been said that this period is too short.

The Jenkins Committee Report of 1962 endorsed the statements quoted above of the Cohen Committee and added:

We agree with those observations. We could certainly not suggest that a director should be debarred from buying or selling shares in his company because he as director must normally have more information than the other party to the transaction. We are, however, concerned to see what can be done (apart from the disclosure advocated by the Cohen Committee and now achieved by Section 195) to protect the other party to the purchase or sale by directors of a company's securities where the directors are acting (as the Cohen Committee put it) 'on a particular piece of information known to them and not at the time known to the general body of shareholders.'²¹

In its recommendations, the Jenkins Committee adopted in principle the provisions contained in Section 124 with, however, some important additions which do not yet appear in Australian company law. It should be particularly noted that it seeks to abolish the proposition in *Percival v. Wright*²² which provides authority for the proposition that no fiduciary duty is owed by a director to individual members of his company but only to the company itself, and a *fortiori* that none is owed to a person who is not a member. The Committee said:

²¹ *Report of the Company Law Committee*, 1962.

²² [1902] 2 Ch. 421.

²³ In this Report, unless the context otherwise requires, 'securities' includes both shares and debentures and 'group' means a holding company and all its subsidiaries.

The result of that case is that a director who has by reason of his office acquired in confidence a particular piece of information materially affecting the value of the securities²³ of his company (or any company in the same group) will incur no liability to the other party if he buys or sells such securities without disclosing that piece of information. This seems to us to be wrong. We have come to the conclusion that the law should protect a person—whether or not a member of the company or companies concerned—who suffers loss because a director has taken unfair advantage at his expense of a particular piece of confidential information about the company or any other company in the same group in any transactions relating to the securities of such companies. We realise that it might well be very difficult in the case of transactions through the London Stock Exchange because of the method of settlement. It may also often be difficult for the other party to establish a loss. Nevertheless we think a remedy should be provided and we recommend accordingly below:

90. It has been suggested to us, and we agree, that a director of a company should not deal in options in securities of his company or of the group to which the company belongs. A director who speculates in this way with special inside information is clearly acting improperly, and we do not believe that any reputable director would deal in such options in any circumstances.

This prohibition should not extend to options to subscribe for securities given to the directors by the company or another member of the group because we consider that the terms of such options are a matter for the company and that, while restrictions on sales may well be imposed by the company, it is not necessary for the law to restrict a director from reselling such options in any manner permitted by the terms on which they are given to him.

91. We agree with the suggestions of many witnesses that the provisions for disclosure in Section 195 should be strengthened and clarified, and we make recommendations to this effect below.

99. We recommend that:

(a) the Act should provide that:

- (i) a director of a company should observe the utmost good faith towards the company in any transaction with it or on its behalf and should act honestly in the exercise of his powers and the discharge of the duties of his office.
 - (ii) a director of a company should not make use of any money or other property of the company or of any information acquired by virtue of his position as a director or officer of the company to gain directly or indirectly an improper advantage for himself at the expense of the company.
 - (iii) a director who commits a breach of these provisions should be liable to the company for any profit made by him and for any damage suffered by the company as a result of the breach;
 - (iv) these provisions should be in addition to and not in derogation of any other enactment or rule of law relating to the duties or liabilities of directors of a company;
- (b) a director of a company who, in any transactions relating to the securities of his company or of any other company in the same group, makes improper use of a particular piece of confidential information which might be expected materially to affect the value of these securities, should be liable to compensate a person who suffers from his action in so doing unless that information was known to that person;
- (c) a director of a company should be prohibited from dealing in options in the securities of his company or of other companies in the same group. This prohibition should not extend to the acceptance and sale of options to subscribe for securities given to a director by his company or by other companies in the same group.
- (d) If recommendation (c) above is not adopted, section 195 (1) shall be amended to make clear that it extends to 'put' as well as to 'call' options.

- (e) Section 195 (1) should be amended to make it clear that securities in which a director has an interest, jointly or in common with others or in which he has had a limited interest—(such as a life interest) or an interest as the object of a discretionary trust must be disclosed.
- (f) A director should be required to notify the company of details of any transaction affecting his holdings within seven days of such a transaction coming to his knowledge, and the details should be entered in the register within three working days of their notification to the company. Transactions to be notified or entered in the register by purchase (or vice versa) within a Stock Exchange accounting period and consequently are not recorded in any formal instrument of transfer; the maximum penalty for failure to notify and to record such transactions in the register should be a substantial default fine.
- (g) The register of director's holdings should be kept open by the company for inspection by the same persons and during the same periods as the register of members of the company. Copies of the register of directors' holdings should be made available to the public on the same terms as copies of the register of members.

In par. 99, recommendations (b) and (c) should be especially noted as those which seek to abolish the proposition in *Percival v. Wright* and could well be adopted into Australian company law.

It should also be noted that Section 126 of the Uniform Companies Act, which corresponds to Section 195 in the English Companies Act, requires the register of directors' holdings to show only the shares or debentures held by a director and the shares or debentures over which he has an option to purchase but excluding put and call options. Since these have appeared on the Australian financial scene it could be advisable that the register should also disclose such holdings as suggested in sub-section (b) of par. 99 of the Jenkins Committee Report.

It would also be desirable to adopt in Australia the recommendation in sub-section (g) of par. 99 of the Report as the period for which the register is open for inspection and the persons by whom it can be inspected (see S. 126 (b)) are the same as in the United Kingdom and as mentioned earlier experience in that country has shown this to be unsatisfactory.

American law has gone much further than United Kingdom law and much further than Australian company law. Even apart from statute, courts in some jurisdictions (although at present they represent a minority view) have taken the view that directors dealing in their company's shares should disclose all facts in their knowledge which may seriously affect the value of the shares.

In *Strong v. Repide*²⁴ the United States Supreme Court laid down what has been called the 'special facts' doctrine. In that case a director with knowledge of an impending sale of property which would greatly enhance the value of the company's shares bought out a shareholder at a price less than one tenth of the final value of the shares. The purchasing director purchased through an intermediary. The court

²⁴ (1909) 213 U.S. 419.

granted rescission of the sale on the grounds that under the circumstances it was the duty of the director to disclose the special facts affecting the value of the shares. There is some uncertainty as to what developments call for disclosure of special facts and some courts have gone to the extreme of holding that a director of a corporation stands under a fiduciary duty of disclosure to individual shareholders as to all dealings in its shares and may not purchase from them without disclosing any official knowledge which affects the value of the shares and puts the shareholders at an unfair advantage.²⁵

This appears to put the duty very high and it has been suggested²⁶ that the special facts doctrine should be limited to important transactions such as a prospective merger or takeover or a sale of an undertaking or an impending declaration of an unusual dividend. In such circumstances it seems clearly reasonable to require directors to refrain from taking advantage of the ignorance of the shareholders whom they as a member of a group are supposed to protect and represent.

In addition Section 16 of the Securities and Exchange Act 1934 requires any director or officer or a person holding 10% or more of a class of equity security to file a report on his holding and of changes in his holdings of equity securities in the company with the Commission, reports are made available to the public through the Commission and through the Exchange on which the shares are registered. The Commission compiles and publishes the information. The section goes on to provide that any profit realised by sale and purchase or purchase and sale, irrespective of any intention on the part of the director, officer or owner within a period of 6 months is recoverable by the company. It is enough to show that the director has made a profit; it need not be shown that he has made use of confidential information. Thus short term dealings by insiders in their company's shares are discouraged. As well as giving a remedy to the company the Federal Securities Legislation has given a remedy to the individual with whom the director or officer has dealt. A remedy to the company alone would leave the person who has really suffered loss without remedy. There is thus a statutory rejection for American law of the principle stated in *Percival v. Wright*. The relevant provisions are in Section 17 (a) of the Securities Act 1933 and 10 (b) of the Securities Exchange Act 1934 and rule 10 (b) - 5 under the latter section. These provisions impose an affirmative obligation to disclose not only on a director or officer but on a controlling shareholder and upon members of their immediate families. Whether the obligation extends to one who has been informed by an insider is rather obscure. The obligation clearly arises in a purchase by the insider and also in a sale when the person buying is already a shareholder. The obligation arises whether or not the transaction is on an Exchange—which seems to involve the

²⁵ See *Brophy v. Cities Service Co.* (1949) 31 Del. Ch. 247.

²⁶ *Ballantine on Corporations*.

consequence that the insider cannot safely deal until the information he has has been made public. The duty to disclose relates to any 'fact coming to their knowledge by reason of their position which would materially affect the judgment of the other party to the transaction.'²⁷

Against this background it could be useful to return to a discussion of the effect of the terms of sub-section (2) and (3) of Section 124. The following points should now be noted:

- (a) Sub-section (2) provides that an officer of a company shall not make use of any information acquired by virtue of his position as an officer *to gain directly or indirectly an improper advantage for himself* or to cause *detriment* to the company.
- (b) The meaning of the word 'improper' may be ascertained from the words in the Cohen Committee Report. It would seem that the director must have acted on a particular piece of information known to him and not at the time known to the general body of shareholders.
- (c) The sub-section will most commonly be in issue in regard to a director's dealings in his own company's securities and will apply to a purchase of shares or sale of shares and to a subscription for shares.
- (d) The director must have gained the improper advantage for himself. Accordingly it will probably not be wide enough to cover dealings by relatives and friends.
- (e) The sub-section does not give a remedy to the individual shareholder. The statutory duty is enforceable by criminal proceedings or by recovery by the company. The individual is thus only protected by the deterrent effect of the criminal penalty and the civil proceedings available to the company.
- (f) There may be difficulty in proving that the director did in fact make use of the information. Note that this difficulty is obviated in America by the arbitrary rule adopted by Section 16 of the Securities Exchange Commission Act.
- (g) It may also be that consent of the majority by a resolution in general meeting to the particular dealing of the director will preclude breach of duty by the director as the advantage will not then be an 'improper' advantage.

I will now leave the fiduciary duties of directors and turn to a consideration of the general standard of care which is required of directors. In the *Luganas Nitrate Case* Lord Lindley said:

If directors act within their powers, if they act with such care as is reasonably to be expected of them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company.²⁸

²⁷ *Kardon v. National Gypsum Co.* (1948) 73 Fed. Supp. 798.

²⁸ [1899] 2 Ch. 393, 435.

A similar formulation of the duty of care is set out in greater detail in the judgment of Romer J. in *Re City Equitable Insurance Co.*²⁹ when he stated the law in three propositions as follows:

1. A director need not exhibit in the performance of his duties a greater degree of skill than may be reasonably expected from a person of his knowledge and experience.
2. A director is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature to be performed at periodical board meetings and at meetings of any committee of the board upon which he happens to be placed. He is not however bound to attend all such meetings though he ought to attend whenever in the circumstances he is reasonably able to do so.
3. In respect of all duties that having regard to the exigencies of business and the articles of association may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

The first proposition lays down the standard of skill to be expected of a director. The duty expected appears to be different from the duty which arises where a person holds himself out as competent in some particular field. Directing is apparently not yet a profession or even a trade. How does one discover what a man knows and what his experience has been? Romer J. gave the example, that the director of a life insurance company does not guarantee that he has the skill of an actuary or of a physician. Sir Douglas Menzies, in a paper which he read to the Australian Legal Convention in Perth in 1959,³⁰ expounding this postulate, added that neither should he be expected to have mastered in detail all the provisions of the Life Insurance Act, but it can be properly demanded of him that he should know and learn something about the investment of large sums of money in a changing economy, that he shall bring an informed and independent judgment to bear upon different matters that come before the board for decision.

Rising standards of commercial education must inevitably increase the standards of skill required of directors. The standard must be governed to a large extent by what is in general expected of a director by the business community of his day and age. It follows that the standard of skill required of a director may be expected to rise gradually, but will still be capable of measurement by the propositions stated by Romer J.

In the United States it is said that directors are expected to hold and attend meetings with reasonable regularity and to exercise some degree of care in the selection and supervision of the chief executive

²⁹ [1925] Ch. 407.

³⁰ (1959) 33 A.L.J. 156.

and other officers of the company. They should make themselves familiar with the requirements of by-laws (articles of association) and observe them. They are supposed to take the usual steps to inform themselves of the business, its policies and the manner in which it is being conducted, its products and advertising and difficulties which need to be met.

There must be some distinction drawn between the duties expected of full-time directors and those expected of outside or part-time directors. The full-time directors are executives of companies and as such will be expected to give full-time attention to the affairs of the company. However it is probable that a large amount of the full-time director's time will be devoted to their executive duties dealing perhaps with particular phases of the organization, and in reality their directoral work may take up very little more time than in the case of the part-time directors. The Courts have understandably refrained from laying down any objective standard of skill for company executives. Until they do the same rules laid down by *Romer J.* would seem to apply to all directors, subject of course to a necessary adjustment of time and attention to the propositions in the case of full-time directors.

The effect of Section 124 (1) of the Uniform Companies Act must now be considered against the background of the duty as formulated in the *Re City Equitable Fire Case*. The sub-section imposes the statutory duty that a director 'shall at all times act honestly and use reasonable diligence in the discharge of his duties of office.' A breach of the duty constitutes an offence under the Act and the penalties for a breach as provided by S. 124 (3) are identical with those provided for a breach of S. 124 (2) and have already been discussed. The sub-section does not mention skill, no doubt because of the difficulty of enforcing a duty of skill in an area where definition is so vague.

Some light has been thrown on the effect of this legislative intervention by the Supreme Court of Victoria in the recent case of *Byrne v. Baker*.³¹ The defendant was charged that between May 1960 and June 1962 as a director of Garrison Industries Ltd. 'he did not at all times use reasonable diligence in the discharge of the duties of his office.' The particulars of offence specified 49 various acts over the period. These included the permitting of unauthorized and unsecured borrowings, failure to check account books at regular intervals, and allowing misleading figures to be placed in annual reports. At the hearing before the magistrate the defendant objected that the information was bad for publicity and obtained an *order nisi* to review. The Full Supreme Court of Victoria³² rejected the argument of the informant that the duty to use diligence 'at all times' was of a continuous nature to be measured by conduct over a selected period of

³¹ [1964] V.R. 443.

³² Herring C. J., Smith and Adam JJ.

time rather than by reference to specified acts. The Court said that such a construction would involve a departure from the important principles that crime should be so defined as to enable the accused to know with precision what he is charged with.

The Court also expressed the view that the 'diligence' required by the section is merely part of the concept of negligence in company law, and this concept has reference to identifiable acts or omissions and not to any general characterisation of the conduct of the director over a settled period. Consequently the information was held bad on the grounds that it purported to charge the accused with one continuing offence, whereas it in fact charged him with 49 separate offences.

The Court did not consider that the statutory requirements of diligence had imposed any obligation on directors to give continuous or any greater degree of attention to company affairs than had been previously expected under the propositions of *Romer J.*

After noting the significance of the omission of any reference to skill the Court stated that what the legislation by the sub-section is demanding of honest directors is diligence only, and the degree of diligence demanded is what is reasonable in the circumstances and no more.

Although it appears from the foregoing discussion that the law imposes a fairly high standard on public company directors in regard both to their fiduciary duties and to their duties of skill and diligence, it is obvious in the light of the recent failures of companies due to misconduct of directors that there is a need for legislative reform in this area. The principles stated by the law are often not applied in every case where they should be applied due to practical difficulties. This is in part due to the fact that while the company is a going concern proceedings against directors who fail to observe their obligations must in general be taken in the name of the company and this often prevents contravention of duty being brought home to erring characters.

The first question to be considered is what may be done by a minority of shareholders who wish to use the law to vindicate the rights of the company against directors who have acted improperly but who have the support of the majority of the shareholders. The best statement of proceedings which are open to a minority in such a case is given by Lord Davey in *Burland v. Earle*:

It is an elementary principle of the law relating to joint stock companies that the court will not interfere with the internal management of companies acting within their powers and in fact has no jurisdiction to do so. Again it is clear law that in order to redress a wrong done to the company the action should prima facie be brought by the company itself. These cardinal principles are laid down in the well known cases of *Foss v. Harbottle* (1843) 2 Hare 461 and *Mozley v. Alston* (1847) 1 Ph. 790 and in numerous later cases which it is unnecessary to cite. But an exception is made to the second rule where the persons against whom the relief is sought themselves hold

and control the majority of the shares of the company and will not permit an action to be brought in the name of the company. In that case the courts allow the shareholders complaining to bring an action in their own names. This however is a mere matter of procedure in order to give a remedy for a wrong which would otherwise escape redress and it is obvious that in such an action the plaintiffs cannot have a larger right to relief than the company itself would have if it were plaintiff and cannot complain of acts which are valid if done with the approval of the majority of the shareholders or are capable of being confirmed by the majority.³³

We must note in connection with this last sentence in the quotation that the courts have now said that a majority is not at liberty to defraud a minority.³⁴ Also there is provision (see S. 240 and S. 305 (1) in the Uniform Companies Act whereby an investigation can be carried out into the conduct of erring directors and proceedings may be taken against such directors. But such an investigation can at present only take place if the company is in liquidation, and experience today has shown that at this stage it is often too late to be of any value to those who have suffered loss.

The Companies (Defaulting Officers) Bill introduced into the Legislative Council of Victoria by the Hon. J. W. Galbally in April was an attempt to remedy some of the defects contained in the present legislation. Clause 2 of the Bill inserted a new Section 374A into the Act which gave power to the Attorney-General or any member or creditor of the company or the Registrar or the liquidator with the consent of the Attorney-General to apply to the Court at any time for an order to summon a defaulting company officer to appear before the Court to be publicly examined.

Mr. Galbally stated that the new section was not new in principle but was based on the present Section 249. The major advantage which was introduced by Section 374A was that the power contained therein could be used *at any time*, that is, while the company is a going concern. He added that the safeguard in giving such a wide power to the Attorney-General was contained in the expression '*An inference might reasonably be drawn that the officer or former officer.*'

The Bill also introduced a new section 374B into the Act which is based on the principle at present contained in Section 305 (1). Section 305 (1) was severely limited in its effect as it could only be used in the course of winding up of a company and again this defect is overcome by the new section as it enables the Attorney-General to commence proceedings at any time when he is in possession of the appropriate evidence. Section 374B provides as follows:

(1) Where it appears to the Attorney-General that any person who has taken part in the formation promotion or administration of a company has misapplied or retained or become liable or accountable for any money or property of the company or has been guilty of any misfeasance or breach of trust in relation to the company the Attorney-General may apply to the court to examine into the conduct of that person and for an order that that person

³³ [1902] A.C. 83, 93.

³⁴ See e.g. *Cook v. Deeks* [1916] 1 A.C. 554, the facts of which have already been discussed.

do repay or restore the money or property or such part thereof as the court thinks fit together with interest at such rate as the court thinks just or pay to the company by way of damages in respect of the misapplication retainer misfeasance or breach of trust as the court thinks just.

(2) This section shall extend and apply to the receipt of any money or property by any officer or former officer of the company whether by way of salary or otherwise which appears to the court to have been unfair or unjust to the company or its members.

The aim of the new section is to obtain compensation for those persons who have invested money in companies and their money has been lost due to misconduct of the companies' officers in their management of the affairs of the companies. It is not the purpose of the sections to impose criminal sanctions on the offending officers and they cannot be treated as creating any new heads of liability on the part of the directors and officers. The terms of the new sections are purely procedural.

The summary procedure provided in these sections is in lieu of an action of misfeasance against a director or officer. It has been seen that since the rule in *Foss v. Harbottle*³⁵ the right of a shareholder to bring such an action has been seriously curtailed. Therefore the provisions of Section 374B which enable the Attorney-General to commence an investigation into a director's conduct at any stage where he appears to have been guilty of misfeasance should be extremely valuable. It should also be noted that both sections were made retrospective in effect, and therefore would prevent directors from escaping liability by claiming that the acts or matters the subject of the proceedings all occurred before the commencement of operation of the sections.

Mr. Galbally's bill did not become law in Victoria. But the Attorneys-General, through the Law Council of Australia, have also been discussing provisions similar to those contained in the draft bill and these proposals were considered further at their meeting in Perth in July. It was decided that provisions similar to those contained in Mr. Galbally's bill would be introduced into the Uniform Companies Act at least in Victoria, and it now can only be hoped that the other Australian States will soon follow Victoria's example.

³⁵ (1843) 2 Hare 461.