OF FAULT AND DEFAULT: CONTRACTARIANISM AS A THEORY OF ANGLO-AUSTRALIAN CORPORATE LAW*

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[This article examines the contractarian theory of corporate law as an explanation of the law and equity of company directors' duties, specifically the prohibition on conflicts of interest, the duty to exercise a power for proper purposes and the duty of care. A distinction is drawn between contracting around these rules ex ante *and* ex post*, the former being more restricted than the latter. The analysis demonstrates how these areas of legal doctrine rely on combinations of untailored (penalty) and tailored default rules. Statutory incursions into freedom of contract are studied for their impact on this contractarian characterisation.]*

CONTENTS

* I acknowledge with gratitude the valuable comments of an anonymous referee. I wish to thank my research assistants, Oliver Bennett, Lisa Moore and Elsa Van Wijk. The default rule about the responsibility of those persons for errors herein has not been excluded. This article celebrates the sixtieth anniversary of the publication of Nobel Laureate Ronald Coase's seminal article on the theory of the firm: Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

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I INTRODUCTION

In the past decade Australian corporate law scholars have increasingly used theory and interdisciplinary research techniques to analyse corporate law.[1] This tendency towards theorisation appeared to be a timely development when, in 1996, the newly elected federal government moved the responsibility for corporate regulation out of the Attorney-General's ward into the Treasury portfolio.[2] The move from law to law-with-economics has been taken a stage further by the announcement in March 1997 of a Corporate Law Economic Reform Program ('CLERP'). The program is officially described as a 'wide ranging initiative intended to improve the content and implementation of the law.'[3] The CLERP Strategy Document foreshadows an extensive review of various areas of corporate law, including directors' duties.[4]

As one would expect, the strategy document is strong on themes such as efficiency, cost-effectiveness and the balance between regulation and shareholder protection. At the same time, it is predictably vague about philosophical underpinnings. Nonetheless, law and economics methodology is necessarily implicated by any attempt to reform corporate law consistently with an economic efficiency objective. The conceptual centrepiece of modern corporate law and economics is contractarian theory.[5] Contractarian theory was developed by American scholars in the late 1970s and early 1980s. Its intellectual antecedents

1 Assuming the *Company & Securities Law Journal* to be a representative indicator of Australian corporate law scholarship, perusal of the volume from a decade ago reveals only a single article with significant theoretical or interdisciplinary content, that being the first important law and economics analysis in the Australian literature: Ian Ramsay, 'Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance' (1987) 5 *Company & Securities Law Journal* 129. For an analysis of theoretical perspectives in Australian corporate law, see the symposium, 'Corporate Law Research Methods and Theory' (1996) 3 *Canberra Law Review*. See generally Richard Posner, *Overcoming Law* (1995) 84–102 where the author discusses the relative merits of introducing interdisciplinary content into legal analysis.

2 'The Costello Vision: Changes Ahead for the ASC' (1996) 6 *Butterworths Corporations Law Bulletin* [90].

3 The Treasurer, Commonwealth of Australia, *New Focus for Corporate Law*, Press Release No 15 (4 March 1997) 1.

4 Corporate Law Economic Reform Program, *Strategy Document* (March 1997) 4.

5 The key exposition of contractarian theory is Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991). A somewhat different view is articulated in Henry Butler and Larry Ribstein, 'Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians' (1990) 65 *Washington Law Review* 1. The implications of the concept were explored in a series of papers published in the symposium, 'Contractual Freedom in Corporate Law' (1989) 89 *Columbia Law Review* 1395.

are Ronald Coase's work on transaction costs[6] and the firm,[7] the neoclassical theory of the firm,[8] and the efficient capital markets hypothesis.[9] The theory holds that corporate law supplies efficient terms to fill gaps in the contracts which constitute corporations.

Contractarianism has both normative and positive theses.[10] The normative implication of the theory is that corporate law should be structured as a corpus of default rules, which the parties may vary or exclude, and not as immutable, mandatory rules. The positive contractarian thesis asserts that corporate law *is* organised as a corpus of default rules and that mandatory rules *are not* adopted. Scholars have recently used contractarian theory to examine Australian corporate law.[11] This research uses the normative thesis primarily to criticise local institu-

6 Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law & Economics* 1.

7 Ronald Coase, 'The Nature of the Firm' (1937) 4 *Economica* 386.

8 See, eg, Armen Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62 *American Economic Review* 777; Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

9 For reviews, see Eugene Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383; Eugene Fama, 'Efficient Capital Markets' (Pt 2) (1991) 46 *Journal of Finance* 1575. For an application of the theory by lawyers, see Ronald Gilson and Reinier Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549; Jeffrey Gordon and Lewis Kornhauser, 'Efficient Markets, Costly Information and Securities Research' (1985) 60 *New York University Law Review* 761; Donald Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 *University of Pennsylvania Law Review* 851. For consideration by Australian scholars, see Mark Blair and Ian Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) 264, 275–7.

10 Easterbrook and Fischel, above n 5, 15.

11 Mark Byrne, 'An Economic Analysis of Directors' Duties in Favour of Creditors' (1994) 4 *Australian Journal of Corporate Law* 275; Robert Campbell, 'Opportunistic Amendment of the Corporate Governance Contract' (1996) 14 *Company & Securities Law Journal* 200; Rani John, 'Relieving Directors from the Liabilities of Office: The Case for Reform of Section 241, Corporations Law' (1992) 10 *Company & Securities Law Journal* 6; Jeffrey Lawrence, 'The Coleman v Myers Fiduciary Relationship: An Australian Resurgence?' (1996) 14 *Company & Securities Law Journal* 428; Justin Mannolini, 'Creditors' Interests in the Corporate Contract: A Case for the Reform of our Insolvent Trading Provisions' (1996) 6 *Australian Journal of Corporate Law* 14; Bernard McCabe, 'The Roles and Responsibilities of Company Directors in a Takeover' (1994) 4 *Australian Journal of Corporate Law* 36; Ian McEwin, 'Public Versus Shareholder Control of Directors' (1992) 10 *Company & Securities Law Journal* 182; Ramsay, 'Liability of Directors', above n 1; Ian Ramsay, 'Company Law and the Economics of Federalism' (1990) 19 *Federal Law Review* 169; Michael Whincop, 'Gambotto v WCP Ltd: An Economic Analysis of Alterations to Articles and Expropriation Articles' (1995) 23 *Australian Business Law Review* 276; Michael Whincop, 'A Transaction Cost Rationale for the Insolvent Trading Provisions' (1996) 4 *Griffith Law Review* 1; Michael Whincop, 'A Theoretical and Policy Critique of the Modern Reformulation of Directors' Duties of Care' (1996) 6 *Australian Journal of Corporate Law* 72; Michael Whincop, 'An Economic Analysis of the Criminalisation and Content of Directors' Duties' (1996) 24 *Australian Business Law Review* 273; Michael Whincop, 'Towards a Property Rights and Market Misconstructural Theory of Insider Trading Regulation: The Case of Primary Securities Markets Transactions' (1996) 7 *Journal of Banking & Finance Law & Practice* 212; Michael Whincop, 'Due Diligence in SME Fundraising: Reform Choices, Economics and Empiricism' (1996) 19 *University of New South Wales Law Journal* 433; Michael Whincop, 'Precontractual Disclosure by the Insiders of Closely Held Corporations: The Economics of Restrained Self Interest' (1997) 11 *Journal of Contract Law* 177; Michael Whincop and Mary Keyes, 'Corporation, Contract, Community: An Analysis of Governance in the Privatisation of Public Enterprise and the Publicisation of Private Corporate Law' (1997) 25 *Federal Law Review* 51. See generally references below in n 298.

tions and rules. However, the announcement of the CLERP changes the focus and elevates the importance of the contractarian debate. No longer a mere paradigm for analysis and critique, the theory emerges as a blueprint for a potentially far-reaching law reform programme. Corporate lawyers must now seriously address the adequacy of contractarianism when applied to Australian law. Australia is not the United States, obviously enough. Australia's balance between mandatory and default rules favours the mandatory end appreciably more than the American system does. Changing that balance raises two sets of research questions.

The first set of research questions, to which I refer in my conclusions, is empirical. We need to know, *inter alia*, how contract is used and how stock markets respond to contractual variation. This is fundamental to understanding the welfare consequences of changing the mandatory-default balance. The second set of research questions pursued here is theoretical and doctrinal. The doctrinal question involves examining the descriptive validity of the positive contractarian thesis; in other words, can Australian law be described as a corpus of default rules? The theoretical question considers what form default rules should take and how they would impact on contracting. This article explores these questions from contemporary and historical perspectives. The subject of inquiry is Anglo-Australian law on officers' duties. I conclude, first, that corporate law was historically contractarian. Secondly, these legal and equitable principles conformed to an economic theory of efficient defaults. In supplying a contemporary perspective, the article examines the statutory conversion of default rules into mandatory rules and the significance of these conversions.

The article thus offers a contractarian analysis of opting out that draws extensively from both historical doctrine and an economic theory of default rules.[12] That theory differs from the models of opting out offered by the earlier contractarian literature.[13] In particular, it shows how it can be efficient for corporate law to rely partially on *penalty defaults* which give parties the rules they do not want, not those they would be hypothetically supposed to prefer.[14] I conclude that historical Anglo-Australian law was efficient because it offered an appropriate mix of tailored default rules that the parties wanted and default rules they might not want but could contract around.

Part II of the article explains contractarian theory, its criticisms and defences. Part III explores a theory of default rules and its application to fiduciary duties. Parts IV, V and VI examine the structure of officers' duties and statutory changes to the mandatory-default balance. Part VII offers some conclusions and discusses some issues in the future pursuit of the contractarian research agenda in Australia.

12 See, eg, Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87.

13 Butler and Ribstein, 'Opting Out', above n 5, offer the best specified 'first generation' model of opting out of fiduciary duties. See below Parts II(B) and II(D).

14 See also Ian Ayres, 'Making a Difference: The Contractual Contributions of Easterbrook and Fischel' (1992) 59 *University of Chicago Law Review* 1391, 1400.

II THE CONTRACTARIAN THESIS IN REVIEW

A *Introduction*

This Part provides a primer on contractarian theory, followed by a summary of its opponents' criticisms and its advocates' rejoinders. Section B briefly describes the theory. Section C summarises the major critiques of the theory. Section D deals with the 'triviality' hypothesis, which modifies contractarianism by trivialising the existence of mandatory rules that invalidate the positive thesis. Unfortunately, that hypothesis poses a puzzle of its own: if mandatory rules are trivial, then that must be true of default rules also. What then is the significance of corporate law and, by extension, corporate scholarship? Two contractarian responses to that question are examined.

B *Contractarian Theory: An Outline*

Five years separate the publication of two works that have had unparalleled influence on corporate law scholarship. First, in 1932 Berle and Means analysed the separation of ownership and control in public corporations.[15] Second, in 1937 Coase showed that market transactions were costly and that firm organisation could reduce these costs.[16] Despite their proximity, it took nearly 40 years to synthesise the two ideas. When the synthesis came, it was not provided by lawyers, but by economists.[17] Jensen and Meckling regarded corporations as a subset of the larger economic concept of the 'firm'.[18] It followed from Coase that the corporation could be disaggregated into contracts between the various suppliers of factors of production, and those interested in the cash flow and product of the productive process. One form of contract involved in this 'web' of contracts is between those who manage the production process and those who contract for a right to share in its residual risk. This separation of ownership and control leads to the incentive problems that Berle and Means had recognised.[19] Jensen and Meckling subsumed this problem within the larger concept of an agency relationship, in which a *principal* delegates decision-making authority to an *agent* to perform a service.[20]

The divergent incentives of the two parties induce the principal to monitor the agent's activities. Agents may seek to bond themselves to principals' interests by making a credible commitment to suffer if they take actions detrimental to the principals. Because monitoring and bonding are costly, the parties' interests will always be imperfectly aligned. This is logical because the parties will seek to trade off the costs of monitoring and bonding and the expected reduction in

15 Adolph Berle and Gardiner Means, *The Modern Corporation and Private Property* (1932).
16 Coase, 'The Nature of the Firm', above n 7.
17 Alchian and Demsetz, above n 8; Jensen and Meckling, above n 8.
18 Jensen and Meckling, above n 8, 310–1.
19 Berle and Means, above n 15, 119–25.
20 Jensen and Meckling, above n 8, 308.

welfare from residual opportunism so that the sum of these *agency costs* is minimised. Such an approach was a powerful reconceptualisation of the problem, since it regarded the separation of ownership and control as essentially a problem of contracting. Jensen and Meckling observed that:

> Viewing the firm as a nexus of a set of contracting relationships ... serves to make clear that the ... firm is not an individual [but] ... a focus for a complete process in which the conflicting objectives of individuals ... are brought into equilibrium within a framework of contractual relations.[21]

Ideologically, this approach defused the normative import of the separation hypothesis. By invoking the contractual themes of consensus and exchange, the new theory conferred a presumptive legitimacy on existing institutional structures.[22] Scientifically, it redirected attention to the means of controlling agency problems. Three levels of control are identifiable.[23] The first operates at the firm level and includes mechanisms such as auditors, compensation committees and 'monitoring' boards of directors. Second, competition in factor markets also limits agent discretion. While product markets and markets for executive services are significant,[24] two markets are particularly important. One is the market for corporate control in which inefficient managers are displaced in takeovers by those who value the control of the corporation more highly than its present owners.[25] The other is the capital market. Jensen and Meckling argued that a corporation selling securities in an efficient market[26] would only receive the value of the securities net of agency costs.[27] This claim implied that the promoter selling the securities would have an incentive to subject the agent to controls that minimise total agency costs.

Corporate law is the third level of agency costs control. Agency theory conceptualises corporate law as a corpus of rules capable of decreasing contracting and agency costs. Corporate law provides standard terms to govern the contractual relationships constituting the corporation — those between managers, employees, shareholders, lenders and others.[28] Where the parties' contracts are incomplete, corporate law supplies terms which fill these gaps. Mandatory terms

21 Ibid 311–2.

22 See, eg, Henry Butler and Larry Ribstein, *The Corporation and the Constitution* (1995) 4: 'no one is forced to use the corporate form of organization'.

23 For an overview of market and contractual constraints on managerial discretion, see ibid 4–13.

24 Eugene Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288. Cf Bernard Black, 'Is Corporate Law Trivial? A Political and Economic Analysis' (1990) 84 *Northwestern University Law Review* 542, 579.

25 Henry Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110.

26 Market efficiency describes a condition in which the implications of information relevant to the risk or cash flows of a corporation are impounded into stock prices in a timely way and without *systematic* underestimation or overestimation. If the pricing process is efficient in this sense, the risk of error can be eliminated by holding a diversified portfolio of securities. See generally the references above in n 9.

27 Jensen and Meckling, above n 8, 312–30.

28 See, eg, Jonathan Macey, 'Corporate Law and Corporate Governance: A Contractual Perspective' (1993) 18 *Journal of Corporation Law* 185.

— those which cannot be excluded by the agreement of the parties — can only be justified if the body establishing those terms (the parliament or a court) is more competent in identifying the parties' interests than the parties are.[29]

Although conceptualising corporate law as a corpus of default rules was a straightforward outgrowth of the economic theory, contractarians originally had less to say about the form of these default rules. What makes one default rule better than another? The implication of 'reducing contracting costs' for the substantive law is not wholly clear. I return to this matter in Part II(D), after reviewing critiques of the theory.

C *Critiques*

Inevitably, the reorientation in contractual terms of separation of ownership and control proved controversial. Several writers reject the conclusion that the shareholder-manager relationship in a large corporation can be regarded as contractual.[30] The contract is not bargained or negotiated.[31] The contractarian response to that argument accords with Jensen and Meckling's original insight concerning pricing. It is irrelevant whether a contract is bargained or offered on take-it-or-leave-it terms.[32] All that matters is that the price the shareholders pay for their shares is unbiased in its estimation of the increase in agency costs associated with opting out of default rules.[33]

The idea that shareholders do not bear the agency costs of opting out needs to be scrutinised at two different points. The first, which Jensen and Meckling studied, is when a company goes public by making an initial public offering ('IPO'). The offeror of shares must take a lower price or convince the market (or the underwriter where one exists) of the value of the proposed opt-out. However, evidence on 'primary' market efficiency is unclear. There is Australian and

29 It should be acknowledged that some, but not all, contractarians have recognised a limited role for mandatory terms: see, eg, Easterbrook and Fischel, above n 5, 3.

30 Victor Brudney, 'Corporate Governance, Agency Costs, and the Rhetoric of Contract' (1985) 85 *Columbia Law Review* 1403; Robert Clark, 'Agency Costs and Fiduciary Duties' in John Pratt and Richard Zeckhauser (eds), *Principals and Agents: The Structure of Business* (1991) 55, 55–71; John Coffee, 'No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies' (1988) 53 *Brooklyn Law Review* 919; Deborah DeMott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' [1988] *Duke Law Journal* 879; Melvin Eisenberg, 'The Structure Of Corporation Law' (1989) 89 *Columbia Law Review* 1461; Jeffrey Gordon, 'The Mandatory Structure of Corporate Law' (1989) 89 *Columbia Law Review* 1549. In recent years, a second generation of critics (loosely described as 'communitarians') have questioned the normative foundations of shareholder primacy shared by their predecessors and the contractarians. Communitarians seek to reconceptualise corporations as having a wider range of legitimate constituencies than shareholders and managers: see, eg, Lawrence Mitchell (ed), *Progressive Corporate Law* (1995).

31 Brudney, above n 30, 1411–20; Clark, above n 30, 59–64; Coffee, 'No Exit', above n 30, 934–42; DeMott, above n 30, 890. Coffee argues that the lack of bargaining is not fatal to the contractual metaphor. However, it does lead to a lack of bonding, which requires limits on the opting out process to control agency costs.

32 This point is directed to the shareholder-manager contract. Most writers rejecting the contractarian hypothesis would agree that other contracts in the corporation are negotiated. The critiques in this section are concerned with the shareholder-manager contract, consistent with the focus of this article.

33 Easterbrook and Fischel, above n 5, 15–19.

American evidence that suggests IPOs are overpriced in the long term.[34] That evidence does not test the claim that corporate contract terms are priced. However, the apparent primary market inefficiency does no damage to the criticism that opting out will disadvantage shareholders, because they are under-informed about contract terms.[35] Despite the impressive evidence of secondary market pricing efficiency in reaction to corporate governance changes,[36] a finding of primary market efficiency means that promoters who opt out do not bear the costs of doing so.

The other point in time is a 'midstream' amendment, in which managers put a proposal to opt out to a shareholder vote at some time after the company goes public (for instance, by a change to the articles). Critics have argued that managers can manipulate the amendment process.[37] Also, shareholders fail to become sufficiently informed about the nature of the change because of their problems of acting collectively.[38] Mandatory rules therefore precommit promoters to tying the hands of managers in the future. Various arguments can be marshalled against this criticism.[39] First, it is easy to lock up rules in the articles against changes without risking the error costs of inefficiently specified mandatory rules.[40] Second, the argument assumes, without demonstrating why, that shareholders always vote in favour of amendments.

While critics of contractarianism agree on the necessity of mandatory rules, there is no unanimity concerning the correct proportion of mandatory rules to enabling ones. Coffee, for instance, envisaged a larger legitimate scope for opting out than Brudney and Eisenberg by noting the inherent problems in adapting fiduciary rules to entrepreneurial situations.[41] As a result, Coffee would

34 For US evidence, see Tim Loughran and Jay Ritter, 'The New Issues Puzzle' (1995) 50 *Journal of Finance* 23. For Australian evidence, see P Lee, S Taylor and T Walter, 'Australian IPO Pricing in the Short and Long Run' (1996) 20 *Journal of Banking & Finance* 1189. See also Ian Ramsay and Baljit Sidhu, 'Underpricing of Initial Public Offerings and Due Diligence Costs: An Empirical Investigation' (1995) 13 *Company & Securities Law Journal* 186; Whincop, 'Due Diligence', above n 11.

35 See, eg, Brudney, above n 30, 1416–20; Eisenberg, above n 30, 1463–70.

36 That is, the normal market, where shareholders sell to shareholders. See, eg, Frank Easterbrook, 'Managers' Discretion and Investors' Welfare: Theory and Evidence' (1984) 9 *Delaware Journal of Corporate Law* 540.

37 See, eg, Coffee, 'No Exit', above n 30, 949; Eisenberg, above n 30, 1474–80; Gordon, above n 30, 1575–6.

38 See generally Bernard Black, 'Shareholder Passivity Reexamined' (1990) 89 *Michigan Law Review* 520.

39 See, eg, Campbell, above n 11; Macey, above n 28, 190–3; Roberta Romano, 'Answering the Wrong Question: the Tenuous Case for Mandatory Corporate Laws' (1989) 89 *Columbia Law Review* 1599.

40 Corporations Law s 172(2). The Corporations Law follows s 82 of the Corporations Act 1989 (Cth). That Act applies the Corporations Law to the Australian Capital Territory. The following legislation gives effect to the Corporations Law in each Australian state and the Northern Territory as if it was Commonwealth Law: Corporations Act 1990 (NSW); Corporations Act 1990 (NT); Corporations Act 1990 (Qld); Corporations Act 1990 (SA); Corporations Act 1990 (Vic); Corporations Act 1990 (WA). Unless otherwise stated, all section references are to the Corporations Law.

41 Coffee, 'No Exit', above n 30, 950–3.

preserve a role for the courts in judging the validity of opting out.[42] Coffee's arguments about the judicial role are important to this article.[43] He noted the premise of the contractarian debate that 'contract' involves an unfettered right to opt out, and argued that this assumption is flawed because modern contract law has significant mandatory elements,[44] the most important of which is the active role of the courts in monitoring opportunistic reliance on contractual terms. Opportunism occurs because the corporate contract between shareholders and managers is inherently incomplete.[45] Coffee argued that courts should — and in fact do — permit contracting out if the provision for opting out is specific in its operation. More specific departures are more likely to be accurately priced. Opting out is more likely to be upheld if transactions that would otherwise be invalidated are disclosed at the time of the proposed exclusion.

Coffee therefore argued in favour of contracting around standards of selflessness, given the problems of applying fiduciary principles to managers who make undiversifiable and risky investments of human capital in their corporations.[46] However, opting out is not unlimited. Good faith in the proposal of, and reliance on, opt-out provisions is an irreducible minimum standard.[47] This is consistent with contract law itself: good faith is an ubiquitous, albeit imprecise, restraint on opportunism in the negotiation and performance of contracts.[48] Coffee argued that his normative thesis is consistent with the approach of American courts over the last 50 years where significant contractual innovation has been permitted. However, innovation was accompanied by related restraints and duties that were consistent with the good faith standard.[49]

D *Triviality and the Epistemic Significance of Contractarianism*

The validity of economic science depends on its ability to describe empirical phenomena.[50] Contractarianism was vulnerable to the existence of mandatory rules, even in the least regulatory of jurisdictions.[51] The most significant revision of the theory to address this empirical fact is Black's triviality hypothesis, which

[42] Ibid 970–4.

[43] John Coffee, 'The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role' (1989) 89 *Columbia Law Review* 1618.

[44] Ibid 1619.

[45] Ibid 1621–2.

[46] Ibid 1653–64.

[47] Ibid 1623–4.

[48] DeMott, above n 30, 892–902. See generally Paul Finn, 'The Fiduciary Principle' in T Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1; Whincop, 'Precontractual Disclosure', above n 11.

[49] Coffee, 'The Mandatory/Enabling Balance', above n 43, 1632–5. Cf William Bratton, 'Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law' (1993) 61 *George Washington Law Review* 1084, 1127–8. For advocacy of the good faith standard as a mandatory element in a normative theory of contract in Australian corporate law, see Whincop, 'Gambotto', above n 11 and Whincop, 'Precontractual Disclosure', above n 11.

[50] See, eg, Milton Friedman, *Essays in Positive Economics* (1953) 7–8; Michael Jensen, 'Organization Theory and Methodology' (1983) 58 *Accounting Review* 319, 319.

[51] See, eg, Eisenberg, above n 30, 1481–2.

trivialises mandatory rules.[52] First, mandatory rules might mimic the market — in other words, all firms would adopt them because they are efficient for all companies.[53] A duty of good faith may be an example.[54] Second, mandatory rules may be avoided. In the United States, the transfer of incorporation permits the avoidance of rules that are not mandatory in all states. The case for avoidability (and hence, triviality) depends on the ease of avoiding a rule. The larger the transaction costs of avoidance, the less trivial the rule.[55] Avoidability depends on 'how much' of the rule one wishes to avoid. Avoidability may also depend on *when* one seeks to avoid a rule: if, as contractarians suggest, voting 'yes' is not shareholders' usual strategy, it may be hard to seek an amendment that could have been priced if the firm had incorporated it from the outset.[56] Furthermore, rules may be trivialised by the comparative ease of legislative amendment. This applies with particular force in the United States because the responsiveness of states competing for corporate charters tends to eliminate undesirable rules.[57] Finally, rules are trivial if they can be complied with at nominal cost.

Some laws are not trivial. First, United States federal laws, particularly securities legislation, are not trivial. Avoidance by overseas reincorporation is difficult and costly.[58] According to Black, the other reason why laws are not trivial relates to the concept of the midstream amendment discussed above.[59] Although a contractarian would argue that mandatory terms are unnecessary to tie management's hands if a default rule can be locked up contractually, that argument cannot apply if a mandatory rule is converted into a default rule *after* the company makes an IPO.[60] Black also noted that a mandatory rule may be preferred to an optional rule if corporate governance terms are not fully priced in the primary market. This possibility has already been noted above.[61]

In Australia, triviality analysis is limited by the absence of jurisdictional competition for incorporations. This decreases the ability to avoid a jurisdiction's

52 Black, above n 24, 542. For a weak response to the existence of mandatory rules, see Butler and Ribstein, 'Opting Out', above n 5, 11–12. See generally Michael Whincop, 'Trivial Pursuit: A Theoretical Perspective on Simplification Initiatives' (1997) 7 *Australian Journal of Corporations Law* 250.

53 Black, above n 24, 552–3.

54 Cf Romano, above n 39, 1601.

55 Black, above n 24, 555–7.

56 Cf Whincop, 'Trivial Pursuit', above n 52, 263–6 (the rule in *Gambotto v WCP Ltd* (1995) 182 CLR 432 may be avoidable if an appropriation provision is included in the articles, but not thereafter).

57 Black, above n 24, 559. This process of competition is stigmatised as a 'race to the bottom' by some (see, eg, William Cary, 'Federalism and Corporate Law: Reflections Upon Delaware' (1974) 83 *Yale Law Journal* 663) and glorified as a 'race to the top' by others (see, eg, Daniel Fischel, 'The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law' (1982) 76 *Northwestern University Law Review* 913). Black's triviality thesis disputes the case put forward by both sides.Black argues that '[t]he triviality hypothesis is an argument that wherever we're racing to, the race is over.': Black, above n 24, 551.

58 Black, above n 24, 563.

59 See text accompanying nn 37–40.

60 Provisions can be locked up in Australia under Corporations Law s 172(2).

61 See text accompanying n 34.

mandatory rules and curbs the impetus for legislative change. Thus, Australian statutory rules are likely to be analogous to non-trivial federal rules in the United States. Some rules can be avoided by opting for a different formal structure (for example, a limited partnership), but the transaction costs of avoidance may be high. For instance, the greater the corporation's tax advantages, the less avoidable is the rule.

One of the oddities of the contractarian hypothesis, as modified by triviality analysis, is that the only phenomena that remain worthy of scholarly attention are the very phenomena that falsify it. That is, only inefficient mandatory rules (neither mimicking the market nor being easily avoided) escape conclusions of triviality. So understood, contractarian theory provides no insights concerning the form of default rules. This is true because the costs of specifying in the articles the contractual governance rules of a corporation, particularly for a public corporation at the time it goes public, are minor. If contracting costs are low, it scarcely matters what form a default rule takes because the parties will contract around it. The extra costs of doing so are unlikely to have significant efficiency consequences. Ayres, referring to Easterbrook and Fischel's argument that corporate law should be structured to reduce the costs of contracting, made this point when he noted that:

> The reduction in contracting costs afforded by off-the-rack rules provides, however, a much weaker ground for the efficiency of corporate law — especially the efficiency of corporate statutes. The costs of contracting around a cumulative voting default is insignificant for even the smallest publicly traded corporation. Moreover, virtually all corporations choose to state the preferred voting rule explicitly in their articles of incorporation. This leads to the conclusion that standard form off-the-rack rules have almost no effect on the transaction costs of publicly traded corporations.[62]

Contractarianism becomes the science of the unimportant and lacks power even to explain the form of the unimportant phenomena it studies. Two theories explain why corporate law and the form it takes are important even if its rules are defaults. Klausner argued that contractarian theory has neglected the possibility that terms used in corporate contracts have external effects.[63] In particular, the value of a contractual term depends on the degree of its use by others. This is described as a 'network externality'.[64] Products that feature network externalities are problematic because there is no guarantee that a free market will produce them in optimal quantities. An example of a corporate law term which has significant network externalities might be the rule concerning the

62 Ayres, above n 14, 1397.

63 Michael Klausner, 'Corporations, Corporate Law, and Networks of Contracts' (1995) 81 *Virginia Law Review* 757.

64 Such externalities are particularly characteristic of the computer industry. Software is a very good example, because an inferior product can edge out a better product as its users value its file compatibility, and the availability of support services. Observed equilibria are often path dependent, that is, they depend greatly on initial conditions. For a discussion of path dependency, see Mark Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 *Harvard Law Review* 641.

actions which fiduciary principles permit directors to take regarding the issue of shares during the pendency of a hostile takeover.[65] Assume that that rule *is* a default, but that for at least some corporations, it confers more discretion on managers than is optimal. Even if the law permits one to contract around it, such contracting may not occur. This is because the cost of contracting around the default includes, firstly, the greater uncertainty arising from less frequent judicial interpretation of a term less commonly used,[66] and secondly, the greater costs a firm must incur to explain its term when marketing its securities.[67]

The form that default rules take is therefore important. Klausner argued, by analogy with other products exhibiting network externalities, that corporate law default rules can serve a valuable function analogous to technical standards. That is, corporate law statutes can coordinate networks of contracts in order to achieve an efficient blend of uniformity and diversity in term usage.[68]

While Klausner demonstrated the importance of corporate statutes, Ayres demonstrated the importance of judicially administered default rules.[69] Ayres argued that some corporate law rules are 'muddy' defaults. These rules involve a delicate *ex post* balancing between various interests. Given its situational specificity, this type of rule cannot be accomplished either by *ex ante* contracting or by legislation. Legislation is even less likely to to establish such rules, because parliaments enacting legislation labour under even greater information disadvantages than contracting parties.[70] 'Muddy' rules make ideal defaults because contracting out of them in favour of a straightforward rule is easy. If the default is straightforward, opting for the 'muddy' rule would be difficult.

Ayres and Klausner both emphasised the importance of looking beyond *ex ante* contracting costs as the determinant of the form of corporate law rules. In the next part of this article, I continue the theme of looking for a more sophisticated theory of default rule choice. I examine how the effect of strategic incentives to withhold information provides a powerful insight into the application of fiduciary duties in corporate law.

III Default Rules and Fiduciary Duties

A *Outline of Part*

This part provides a method by which to describe default rules and illustrates how this method can apply to common law and equitable principles regarding directors' duties. Section B describes an economic theory of default rules. Section C deals with the complex marriage of the fiduciary concept with a

65 See below Part V(C).
66 Klausner, above n 63, 775–9.
67 Ibid 785. The less a term is used, the greater the costs to a firm of convincing markets that the term does not reflect adverse information concerning the issuer.
68 Ibid 838–9.
69 Ayres, above n 14.
70 Ibid 1403–5.

default rule analysis. The analysis introduces two dimensions of opting out: *ex post* contracting around a specific prohibition and *ex ante* modification of the fiduciary principle. Parts IV, V and VI apply this theory to examine *ex ante* contracting around the conflict rule, the rule prohibiting the exercise of a power for an improper purpose and the non-fiduciary duty of care.

B *Classifying Default Rules*

The theory of default rules developed below derives from the analysis by Ayres and Gertner of default rules in contract law.[71] They identified three types of defaults: penalty defaults, tailored defaults and strong defaults. I use company law rules as illustrations.

1 *Penalty Defaults*

Contractual incompleteness arises not only from contracting costs, but also because it may be in the interests of a party having private information that the counterparty lacks.[72] Appropriately formulated default rules can force that party to disclose that information, and thus lead to more efficient pricing. This information asymmetry explains why default rules may take a form that is not explicable by reference to what a majority of contracting parties would prefer. Such a rule is a *penalty default*, which penalises one or both of the parties if they do not contract around it. Contracting around the default reveals information.[73] For example, a promoter has a personal liability for pre-incorporation contracts.[74] Contracting around that default rule for a release discloses to the counterparty that no company presently exists, a matter which the counterparty can assess in determining the risk of the contract.[75] This rule is more easily explained by the information revelation effect than by reference to what a majority of contracting parties would want.

Although commonly regarded as a prophylactic prohibition which articulates the moral demands on the fiduciary's conscience,[76] the basic prohibition on a fiduciary buying the trust property is also a penalty default. Such a contract will

[71] Ayres and Gertner, 'Filling Gaps', above n 12. See also Ian Ayres and Robert Gertner, 'Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules' (1992) 101 *Yale Law Journal* 729; Richard Craswell, 'Contract Law, Default Rules, and the Philosophy of Promising' (1989) 88 *Michigan Law Review* 489; Clayton Gillette, 'Commercial Relationships and the Selection of Default Rules for Remote Risks' (1990) 19 *Journal of Legal Studies* 535; Charles Goetz and Robert Scott, 'The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms' (1985) 73 *California Law Review* 261; Robert Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *Journal of Legal Studies* 597.

[72] Ayres and Gertner, 'Filling Gaps', above n 12, 94.

[73] Ibid 97–8.

[74] Corporations Law s 183.

[75] Releases are permitted by ss 183(8) and (9).

[76] For exceptional examples of the piety and inflexibility of fiduciary rhetoric, see *Guth v Loft Inc*, 5 A 2d 503, 510 (1939); *Pepper v Litton*, 308 US 295, 311 (1939); *Meinhard v Salmon*, 164 NE 545, 547–8 (1928). *Contra Bray v Ford* [1896] AC 44, 52.

be voidable at the beneficiary's option[77] unless the fiduciary obtains the fully informed consent of the beneficiary.[78] If one adopted a majoritarian criterion, such a rule is not obviously what a majority of parties would want.[79] Fiduciaries and some classes of beneficiaries might prefer a rule which changes the price in the contract to a 'fair' price. Instead, the rule penalises the better informed party — the fiduciary — and forces him or her to disclose private information to the beneficiary, if the former wishes to contract with the latter.

Three points can be made. First, this analysis is historically defensible. Courts have long emphasised that the rule is justified by the difficulties (costs) of monitoring a fiduciary with superior information and in determining whether the fiduciary took unfair advantage of his or her position.[80] Second, the legal principle is a default rule, *not* an immutable rule. The law supplies a default prohibition on contracting and offers a procedural formula for its own exclusion. Third, the rule actually *prefers* contracting (by imposing a procedural means for information revelation) to litigation. Where the default has not been displaced, a court restores the antecedent *status quo* through an order for rescission. The court refuses to redraw the contract to suit the parties.[81] For example, in *Guinness plc v Saunders*,[82] the House of Lords held a director to be in breach of his fiduciary duty by agreeing to render certain services to the company. The director held his remuneration on constructive trust for the company. The director argued that he was entitled to *quantum meruit*, or an equitable allowance, for services rendered. The House of Lords rejected these claims.[83] This shows that where the parties fail to displace the default prohibition by contract, the court will refuse to redraw a hypothetical bargain *ex post*. This reinforces the character of the fiduciary duty as a penalty default.

2 *Tailored Versus Untailored Defaults*

As the number of possible default rules rises, a single formulation will appeal to a progressively smaller percentage of contracting parties. However, courts could fill contractual gaps by reference to the rules the *actual* parties would

77 See, eg, *Campbell v Walker* (1800) 5 Ves Jun 678, 680; 31 ER 801, 802; *Lister v Lister* (1802) 6 Ves Jun 631, 632; 31 ER 1231, 1232.

78 See, eg, *Whelpdale v Cookson* (1747) 1 Ves Sen 8; 27 ER 856; *Furs Ltd v Tomkies* (1936) 54 CLR 583; *Chan v Zacharia* (1984) 154 CLR 178, 204; *New Zealand Netherlands Society 'Oranje' Inc v Kuys* [1973] 1 WLR 1126, 1131–2. See also Tamar Frankel, 'Fiduciary Duties as Default Rules' (1995) 74 *Oregon Law Review* 1209 (fiduciary must provide sufficient information to enable beneficiary to determine the merits of waiver).

79 See, eg, *Bray v Ford* [1896] AC 44, 52 (Lord Herschell).

80 See, eg, *Ex parte Lacey* (1802) 6 Ves Jun 625, 627; 31 ER 1228, 1229; *Ex parte James* (1803) 8 Ves Jun 337, 345; 32 ER 385, 388; *Benson v Heathorn* (1842) 1 Y & CCC 326, 342–3; 57 RR 351, 361–2; *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461, 473; *Furs Ltd v Tomkies* (1936) 54 CLR 583, 592. For formal analysis, see Robert Cooter and Bradley Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 *New York University Law Review* 1045, 1051–6.

81 This is a common property of many penalty defaults — they deter inefficient gaps: Ayres and Gertner, 'Filling Gaps', above n 12, 98.

82 [1990] 1 All ER 652.

83 Ibid 661–2, 667. Cf *Boardman v Phipps* [1967] 2 AC 46, discussed by Lord Goff in *Guinness plc v Saunders* [1990] 1 All ER 652, 667–8.

want.[84] Ayres and Gertner describe these choices as being between tailored and untailored defaults:

> A 'tailored default' attempts to provide a contract's parties with precisely 'what they would have contracted for.' An 'untailored default,' true to its etymology, provides the parties to all contracts with a single, off-the-rack standard.[85]

Penalty defaults generally take an untailored form.[86] Unlike a penalty default, tailoring does not encourage information revelation.[87] Despite advantages in supplying rules that are difficult to contract for *ex ante*, a tailored default increases *ex post* litigation costs because of the costs of tailoring. One is inclined to think of fiduciary duties as being untailored. The rhetoric of 'inflexibility' reinforces this.[88] However, tailored fiduciary default rules do exist. A director may not exercise a power for an improper purpose. The court's task in cases alleging improper purpose involves, first, characterising the substantial purpose for which the power was exercised;[89] and second, articulating the range of legitimate or proper purposes. The courts or legislation could enumerate a default range of purposes and leave it to companies to contract around these. However, courts are willing to tailor purposes. The process was described by Isaacs J:

> [The power to refuse to register a transfer of shares] must be exercised, as all such powers must be, bona fide — that is, *for the purpose for which it was conferred.... [T]he ambit of the purpose of the power of course varies with the circumstances of each particular case.* The nature of the company, its constitution and the scheme of its regulations as a whole must all be taken into account in determining whether a given factor comes within its range.[90]

In other words, courts tailor their characterisation of a power's legitimate purposes to correspond with that for which the parties would have contracted. A further example relates to quorum rules. A modern authority considers whether officers with conflicts of interest can be counted as part of the quorum for a board meeting.[91] The board of the Sydney Futures Exchange was largely drawn from exchange members. A board resolution concerned dealings in a certain type of futures contract traded on the exchange. While a quorum was present for the

84 See generally David Charny, 'Hypothetical Bargains: The Normative Structure of Contract Interpretation' (1991) 89 *Michigan Law Review* 1815. Cf DeMott, above n 30, 890.

85 Ayres and Gertner, 'Filling Gaps', above n 12, 91.

86 Ibid 116–7.

87 Ibid 117.

88 See, eg, *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461, 473; *Parker v McKenna* (1874) LR 10 Ch App 96, 124; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n, 144–5n; *Warman International Ltd v Dwyer* (1995) 182 CLR 544, 557–8. Cf *Chan v Zacharia* (1984) 154 CLR 178, 205; *Woolworths Ltd v Kelly* (1991) 9 ACLC 539, 557.

89 For varying analyses of the significance of an impugned purpose, contrast *Mills v Mills* (1938) 60 CLR 150, 186 and *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, 294.

90 *Australia Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199, 217 ('*Ure*') (emphasis prior to ellipsis in original; emphasis after ellipsis added). Tailoring of proper purposes is explored below in Part V(C).

91 *Anaray Pty Ltd v Sydney Futures Exchange Ltd* (1988) 6 ACLC 271 ('*Anaray*').

resolution, most of the members, who traded in such contracts, were disqualified by the conflict. The plaintiff unsuccessfully alleged that a quorum was not present. Foster J's reasoning displays a tailoring approach:

> [I]t is of the utmost importance in the resolution of this problem to have regard to the nature of the company's functions and the constitution of the board of directors and the powers of the board to determine whether the principle is in fact brought into play ... [In the circumstances of this company] a quorum could be constituted at any time by persons who of their very nature would have an active association with the operations, dealings and general business activities of the Futures Exchange. ... [W]hen the members of the company enter into the contract which is constituted by the memorandum and articles of association of the defendant they recognise necessarily the extreme likelihood of any quorum of the board ... containing members who would hold contracts which could be affected by any resolution that is passed[92]

3 *'Strong' Defaults*

Defaults differ in the ease with which parties can contract around them. As the costs and difficulties of contracting around a default rule rise, they begin to look like immutable rules. Such rules are 'strong' defaults.[93] This parallels Black's argument that the extent to which a rule is avoidable (and therefore trivial) varies with the transaction costs of its avoidance.[94] This analysis suggests default rules might be conceived as a continuum, in which one observes pure defaults at one end, and immutable rules at the other, with a penumbral region involving defaults of various levels of strength. The thesis pursued below is that the fiduciary principle might be regarded as such a continuum.

C *The Fiduciary Concept: Some Basic Principles*

1 *Two Normative 'Centres of Gravity'*

The fiduciary concept restrains self-interest in consensual (including some contractual) relationships. It requires selfless service. It can be distinguished from a less intense restraint emanating from contract law — a good faith standard.[95] Such a distinction in corporate law is problematic. The most basic principle of directors' duties — a director, being a fiduciary, must act *bona fide* in the best interests of the company — conflates these concepts.[96] As noted above, Coffee argues that good faith forms an irreducible minimum standard in corporate law. Fiduciary rules are but one means by which shareholders might contract with corporate officers.[97] Bratton, however, argues that this assumes that corporate law has a single 'normative centre of gravity', namely good

92 Ibid 276.
93 Ayres and Gertner, 'Filling Gaps', above n 12, 119–22.
94 See text accompanying n 55.
95 See text accompanying nn 47–49.
96 See, eg, *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112, 135; Harold Ford, Robert Austin and Ian Ramsay, *Ford's Principles of Corporations Law* (8th ed, 1997) 292, 300–1.
97 Coffee, 'The Mandatory/Enabling Balance', above n 43, 1657–65.

faith.[98] Bratton would argue that the extent to which legal rules permit variation depends on the relevant normative centre of gravity. These two conceptualisations anchor the analysis in the remainder of this article. First, however, some basic issues in the contractarian analysis of fiduciary duties need consideration.

2 *Contracting* Ex Post

Contractarians assert that because they do not operate costlessly, parties should be able to opt out of fiduciary duties. There is no unfairness if the varied terms are priced.[99] Translating this into doctrinal terms is difficult. Contractarians have given limited attention to the means of excluding fiduciary duties.[100] This problem is exacerbated by the inherently protean nature of fiduciary duties. There are very few reported instances of attempts to exclude fiduciary duties completely; these have met with judicial disfavour.[101] This reinforces Coffee's argument that courts only permit, and should only permit, contracting out which is sufficiently specific to permit the alteration to be priced.[102] Yet how can one establish specificity in the context of a protean concept? The fiduciary concept attains specificity in the context of a transaction.[103] Santow J came to this conclusion recently when he stated that ratification of duty 'can never be a blanket indemnification or exemption on a prospective basis ... . Rather it is a specific absolution, afforded ... for specific and properly disclosed infractions.'[104] The fiduciary concept is not a default rule *per se* but is a principle which generates default rules *ex post* in response to a factual situation. The rules generated are usually penal and untailored. This property of fiduciary rules gives them unique suitability to relational, long-term contracting.[105]

Therefore, when 'contracting out' of fiduciary duties, one must focus on contracting *ex ante* at the inception of the relationship, as well as a more specific form of contracting *ex post*, when a conflicting transaction arises. Fiduciary duties supply default rules in situations where conflicts of interest arise.[106] They do not absolutely proscribe the conflict,[107] but permit it if the fiduciary places

98 Bratton, above n 49, 1127–8.

99 See, eg, Butler and Ribstein, 'Opting Out', above n 5, 6, 13–15.

100 Ayres and Gertner, 'Filling Gaps', above n 12, 120.

101 See, eg, *Irwin v West End Development Co*, 342 F Supp 687 (1972).

102 See text accompanying n 45.

103 See generally DeMott, above n 30.

104 *Miller v Miller* (1995) 16 ACSR 73, 87.

105 See generally Charles Goetz and Robert Scott, 'Principles of Relational Contracts' (1981) 67 *Virginia Law Review* 1089 (the hallmark of relational contract is the inability to reduce important terms to well defined obligations). For a review of the relational contract concept, see Ian Macneil, *The New Social Contract: An Inquiry into Modern Contractual Relations* (1980).

106 Doctrinal support for this approach can be found in the analysis of the self-dealing rule by Megarry VC in *Tito v Waddell [No 2]* [1977] Ch 106, 248–9. His Lordship said that the fair-dealing rule is 'essentially a rule of equity that certain persons (including trustees) are subject to certain consequences if they carry through certain transactions *without, where appropriate, complying with certain requirements*.' (emphasis added).

107 *North-West Transportation Co, Ltd v Beatty* (1887) 12 AC 589, 593–4 (any conflicting transaction may be affirmed by a majority of shareholders, if it is not brought about by unfair or improper means, and is not fraudulent or oppressive to those opposing it); *Furs Ltd v Tomkies* (1936) 54 CLR 583, 592 (director may only retain a profit from transacting with corporation if

the beneficiary[108] in a position where it is capable of exercising an informed judgment to contract around the default prohibition.[109] It does not deprive fiduciary duties of default rule status to acknowledge that equity scrutinises disclosure by the fiduciary before it admits the validity of the contract. It is important for lawyers to know the substantive and procedural means by which one contracts out of a default, especially a penalty default.[110] Other aspects of the conflict rule reinforce a preference for *ex post* contracting. If the fiduciary misappropriates property the subject of the relationship, he or she will hold it on constructive trust. This inclines a fiduciary who intends to utilise such property to contract with the beneficiary for it. As Lord Eldon held, '[t]he rule I take to be this; not, that a trustee cannot buy from his *Cestuy* [*sic*] *que trust*, but, that he shall not buy from himself.'[111]

In addition to the penalty default that a fiduciary inform the beneficiary of all relevant aspects of the transaction, a further penal aspect is observed in the requirement that any contract with the beneficiary be explicit and specific. In *The York and Midland Railway Co v Hudson*,[112] Sir John Romilly MR held that a resolution leaving shares 'at the disposal of the directors' did not imply that a director might issue shares to his or her nominees and receive the proceeds from their sale.[113] The discretion to dispose was conferred on the directors on trust; to hold otherwise required 'clear and unambiguous expressions'.[114] This requirement for explicitness in the terms of the bargain deters the fiduciary from leaving significant gaps when contracting *ex post* around a default rule. Such gaps are likely to favour the better informed fiduciary. Hence, a penalty default compels the fiduciary to disclose and to contract explicitly, so revealing information that improves the accurate pricing of the transaction.

authorised by all shareholders or a resolution of a general meeting); *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134n, 150n (directors may protect themselves from consequences of fiduciary duty by antecedent authority of or subsequent ratification by general meeting); *Miller v Miller* (1995) 16 ACSR 73, 86–7; *Gray Eisdell Timms Pty Ltd v Combined Auctions Pty Ltd* (1995) 17 ACSR 303, 312–3. Cf *Centofanti v Eekimitor Pty Ltd* (1995) 15 ACSR 629, 642 (when disclosing an interest to the board under an article, only the nature and extent of the conflict, and not the inherent commercial risks or alternatives, need to be disclosed).

108 In Anglo-Australian law, the director owes a duty to the corporation, in consequence of the separate legal entity principle, but the consent must come from a majority of shareholders. This oddity is reconciled by conceptualising the shareholders as exercising the power of the company through the general meeting.

109 Alternatively, a breach of fiduciary duty can be ratified. Ratification seems to be most commonly associated with 'proper purposes' cases. However, there is authority for the proposition that unless ratification is accompanied by a deed of release, the ratification is vulnerable to withdrawal should there be a change of control: *Miller v Miller* (1995) 16 ACSR 73, 87. The effect of these legal rules is to motivate the director to obtain shareholder approval before the transaction, not ratification after it.

110 Frankel, above n 78, 1213–4.

111 *Ex parte Lacey* (1802) 6 Ves Jun 625, 626; 31 ER 1228, 1228. Cf *Benson v Heathorn* (1842) 1 Y & CCC 326, 343; 57 RR 351, 362.

112 (1845) 16 Beav 485; 51 ER 866.

113 It seemed that the director paid for the shares in full: ibid 490–1; 868.

114 Ibid 491; 868–9.

Queensland Mines Ltd v Hudson[115] is often viewed as an exception to the rule that the consent to a conflict must come from the shareholders.[116] In that case, consent was given in a meeting of the directors of the plaintiff. The case may best be explained by the fact that the directors who gave consent represented the plaintiff's two (corporate) shareholders.[117] Thus, while there is some liberality in accepting that the fiduciary and the company had contracted around the default rule *ex post*, this liberality is formal (because it dispenses with the shareholder's approval in general meeting), not substantive.[118]

There are limits on *ex post* contracting between fiduciary and company. These derive from *Cook v Deeks*.[119] The case is relevant to *ex post* contracting in two ways. Both derive from the statement in the judgment that 'directors holding a majority of votes would not be permitted to make a present to themselves.'[120] First, this was not a case of contracting — it was one of expropriation.[121] Courts reserve a discretion to scrutinise the terms of any transaction between fiduciary and beneficiary for manifest inadequacy of consideration.[122] Cases where there is no consideration present a clear case where the default rule should be applied, since the parties have failed to contract around it. Second, problems arise where ratification depends on the interested director's vote. Shareholders do not owe fiduciary duties in Anglo-Australian law.[123] They may exercise voting power in self-interest. However, courts have required majorities to act in good faith.[124] Since the good faith concept is elastic,[125] it may apply with greater vigour where the majority is made up of fiduciaries acting to approve their own conflict.[126]

115 (1978) 18 ALR 1.

116 See, eg, Rosemary Teele, 'The Necessary Reformulation of the Classic Fiduciary Duty to Avoid a Conflict of Interest or Duties' (1994) 22 *Australian Business Law Review* 99, 101–2.

117 Cf Ross Cranston, 'Limiting Directors' Liability: Ratification, Exemption and Indemnification' [1992] *Journal of Business Law* 197, 202–3.

118 For other cases permitting or contemplating informality, see *Woolworths Ltd v Kelly* (1991) 9 ACLC 539 (a public company); *Hurley v BGH Nominees Pty Ltd [No 2]* (1984) 2 ACLC 497, 504 (a closely held company).

119 [1916] 1 AC 554.

120 Ibid 564.

121 Courts are hostile to such expropriation: see the discussion of Lord Eldon's *dictum* in *Ex parte Lacey* (1802) 6 Ves Jun 625, 626; 31 ER 1228, 1228 in the text accompanying n 111.

122 See, eg, *Thomson v Eastwood* (1877) 2 AC 215, 243–4 (Cairns LJ).

123 *Pender v Lushington* (1877) 6 Ch D 70, 75–6; *North-West Transportation Co Ltd v Beatty* (1887) 12 AC 589; *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 504; *Ngurli Ltd v McCann* (1953) 90 CLR 425, 447. Cf *Mason v Harris* (1879) 11 Ch D 97, 109.

124 The key authority is *Allen v Gold Reefs of West Africa, Ltd* [1900] 1 Ch 656, 671. See also *British Equitable Assurance Co v Baily* [1906] AC 35; *Sidebottom v Kershaw Leese & Company* [1920] 2 Ch 124; *Shuttleworth v Cox Brothers & Company (Maidenhead) Ltd* [1927] 2 KB 9; *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457.

125 Robert Summers, '"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code' (1968) 54 *Virginia Law Review* 195.

126 *Ngurli Ltd v McCann* (1953) 90 CLR 425, 447; *Hurley v BGH Nominees* (1982) 1 ACLC 387, 390. This principle would today commonly fall under the rubric of 'oppression': *Miller v Miller* (1995) 16 ACSR 73, 89. The oppression doctrine also finds statutory authority in Corporations Law s 260: see, eg, *Hannes v MJH Pty Ltd* (1992) 10 ACLC 400. It was also part of the language used in the High Court's decision in *Gambotto v WCP Ltd* (1995) 182 CLR 432, in which the doctrine in *Allen v Gold Reefs of West Africa, Ltd* [1900] 1 Ch 656 was revised and limited.

This demonstrates that *ex post* contracting is constrained by a good faith standard.[127]

3 *The Scope for* Ex Ante *Contracting*

I have observed that courts generally invalidate *carte blanche* exclusions of fiduciary duties.[128] While this is a mandatory rule, it is probably trivial. Invalidating sweeping exclusions of fiduciary duties, in the context of a relation characterised by moral hazard problems and imperfect agent observability, probably only mimics the market. Such exclusions would create high uncertainty and would function as a signal of fiduciary untrustworthiness.[129] No rational agent would proffer it and no rational principal would accept it.

Notwithstanding that conclusion, a more important question remains. Are fiduciary duties susceptible to *some* degree of *ex ante* modification? Part III(B) of this article conceptualised the fiduciary principle as a principle which generates situation-specific prohibitions. The principle operates by reference to precedent and equitable principle. Can the parties use contract to vary the mechanism by which the fiduciary principle generates its default rules? It is revealing to study the application of the fiduciary principle in two recent cases. Though neither involved the director-company relationship, they articulated a conception of fiduciary duties that strongly reinforces their character as gap-filling rules susceptible to contractual modification.

In *Hospital Products Ltd v United States Surgical Corp*[130] Mason J was concerned with the relationship between contractual relations and the fiduciary principle. The contract is 'all important' because it regulates the parties' basic rights and liabilities:

> The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction.[131]

Mason J thought that a precise contract might leave no room for a co-existing fiduciary duty.[132] Because the essential prohibition is of the pursuit of personal

[127] There are other limitations on ratification (eg, where the company is in financial distress, or a member's personal right is defeated): *Miller v Miller* (1995) 16 ACSR 73, 89. These are not of much present importance.

[128] I shall argue, however, that common law in England and Australia permitted overarching exclusions of duty of care liability: see below Part VI(B). I thus differentiate between fiduciary duties and duties of care, a distinction which has both theoretical imprimatur (DeMott, above n 30, 915) and judicial sanction (*Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109, 157–8). Although it is not a core feature of their argument, contractarians sometimes draw this distinction imprecisely. For instance, Butler and Ribstein seem to treat the two in a global manner: Butler and Ribstein, 'Opting Out', above n 5, 53–5. Coffee has articulated important economic analytical distinctions between the two duties: Coffee, 'No Exit', above n 30, 951–3; *contra* Easterbrook and Fischel, above n 5, 103.

[129] Cf *Re Trusts of Leeds City Brewery Ltd, Debenture Stock Trust Deed* [1925] Ch 532n, 538n.

[130] (1984) 156 CLR 41.

[131] Ibid 97.

[132] Ibid 98. To economists, this describes a fully specified contingent claims contract.

gain where there is a real or substantial possibility of conflict, the contract is relevant to ascertaining whether or not conflicts exist and how the parties desire them to be resolved. This analysis resembles that of Dixon J in *Birtchnell v Equity Trustees, Executors and Agency Co Ltd*,[133] where his Honour said that fiduciary obligations extend over a region ascertainable from express agreement and the actual course of dealing.[134]

In *Noranda Australia Ltd v Lachlan Resources NL*[135] joint venturers agreed to a provision obliging them to act *bona fide* 'to the intent that the relationship of the parties shall be fiduciary'. The case concerned the transfer of the interest of one of the venturers to a third party. The co-venturer wished to buy it. The joint venture agreement regulated the transfer of joint venture interests. Bryson J held that the selling venturer had not complied with that provision. However, the plaintiff also alleged that the defendant had breached its fiduciary duty by negotiating its sale price in secret and by failing to permit the plaintiff an opportunity to make a better offer. This contention was rejected, as there was no relevant fiduciary duty applying to the sale. The obligations created by the fiduciary clause were imprecise, whereas the obligation stated in the agreement was very specific. Bryson J held that the transfer provision excluded fiduciary obligations:

> [T]he positions in which [the parties] stand in relation to each other would create a fiduciary relationship between the parties in some respects even if [the fiduciary clause] were not in effect. However, in my opinion it would not be right to impose on the parties fiduciary obligations wider or different to those which in careful terms they imposed on themselves.[136]

His Honour's *dictum*, like that of Mason J, implies that fiduciary duties are fundamentally gap-filling default rules. Those duties can be excluded by *specific* provisions, not by overarching ones. These trends recur in the context of the rules analysed below.[137]

133 (1929) 42 CLR 384, 408.

134 Reference to a course of dealing confirms the relational quality of these contracts. The contract is not restricted to its formal terms, but depends on a wider contextual matrix: see above n 105. See also *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1, 10–11.

135 (1988) 14 NSWLR 1.

136 Ibid 17.

137 There are other aspects of the fiduciary principle, such as the prohibitions on secret profits or the appropriation of corporate opportunities. These are not considered below because there is no Anglo-Australian jurisprudence considering the *ex ante* contractual modification of these prohibitions. Prima facie, the analysis of the conflict rule would apply here. Two caveats apply. First, the good faith principle which is the normative, immutable centre of gravity of the conflict rule would apply with greater intensity given the potential moral hazard of *ex ante* releases. Second, although the statutory prohibition on releasing directors from liability for breach of trust (s 241) does not significantly affect the conflict rule (*Movitex Ltd v Bulfield* [1986] BCC 99,403), it may apply to these prohibitions.

IV THE CONFLICT RULE

A *The Fiduciary Prohibition and Changing Times*

As a fiduciary, a director may not permit his or her duty to the corporation to conflict substantially with a private interest or another duty.[138] To what extent can the requirements of this rule be varied *ex ante*? This section focuses on variation by the articles. In the last century, the articles of association was a more important document than it has since become. In unincorporated deed of settlement companies, members transferring their interests would require transferees to covenant that they would comply with the deed. The trustees would not otherwise recognise the transfer.[139] This practice of formally submitting to the articles may have influenced judicial willingness to enforce its terms.[140] Today, members are becoming increasingly remote from the articles.[141] The analysis considers the reception of attempts to contract out of, or to modify, the conflict rule. Legislative limitations on such contracting are also considered.

B *Contract and the Conflict Rule in the Courts*

Although it was not the first case to consider, or to endorse, the ability of companies to contract out of the conflict rule, *Imperial Mercantile Credit Association v Coleman*[142] is the most interesting. The case concerned an article vacating a director's office if he or she failed to declare to the board his or her interest in a contract. The defendant was entitled to a commission if the company bought certain bonds. This transaction was favoured by the directors. Lord Hatherley LC (sitting as the Court of Appeal in Chancery), who upheld the contract, articulated a strong role for contract in the definition of directors' duties. After comparing the fiduciary rule prohibiting interest with the possibility that companies may permit interests in order to encourage beneficial transactions,[143] his Lordship said:

> It is not for me to say which was the wiser or better course of the two, nor do I think that this Court professes to lay down rules for the guidance of men who are adult, and can manage or deal with their own interests. ... It must be left to such persons to form their own contracts and engagements, and this Court has only to sit here and construe them, and also to lay down certain general rules

138 See, eg, *Chan v Zacharia* (1984) 154 CLR 178, 198–9.

139 Len Sealy, 'The Enforcement of Partnership Agreements, Articles of Association and Shareholder Agreements' in Paul Finn (ed), *Equity and Commercial Relationships* (1987) 89, 95.

140 See, eg, *Hodgkinson v The National Live Stock Insurance Co* (1859) 4 De G & J 422, 428–9; 124 RR 319, 323, in which Turner LJ treated a deed of settlement as no less important than legislation as a source of authority for officer transactions.

141 This may be reflected in changing judicial attitudes: see *Bailey (as executrix of the estate of the late Dr Harry R Bailey) v New South Wales Medical Defence Union Ltd* (1995) 18 ACSR 521 ('*Bailey*').

142 (1871) LR 6 Ch App 558; on appeal (1873) LR 6 HL 189 ('*Coleman*').

143 See also *Bray v Ford* [1896] AC 44, 52.

> for the protection of persons who may not have been aware of what the consequences would be of intrusting their property to the management of others *where nothing is expressed as to the implied arrangement.*[144]

His Lordship went on to say that he:

> would not be supposed for one moment to throw out a word that could tend to lead any trustee into the notion that he may deal with the persons for whom he is a trustee, ... in any manner which will give him a benefit ... *But that, like any other rule of the Court, is open to contract between the parties, for it is not a principle the benefit of which parties cannot waive by express and direct contract for the sake of other advantages which they suppose they derive.*[145]

A contractual theory of the conflict rule had in fact already been established,[146] and has been frequently upheld even in modern times.[147] Although an appeal to the House of Lords succeeded, the contractarian principle Lord Hatherley expressed was not rejected. While the House of Lords reserved its opinion,[148] it held that the director had not complied with the contract. The articles required the director to declare his or her interest, but did not specify the nature of a 'declaration'. The House of Lords held that details of the interest had to be disclosed, not merely the fact that an interest existed. That decision can be interpreted in three different ways.[149] First, the House of Lords recognised that the conflict rule is a default rule, but that where the parties opt out they remain subject to a mandatory rule compelling disclosure. While this reading is possible and approximates the eventual path chosen by statute,[150] the House of Lords never implied that it was doing anything other than construing the contract of the parties.

The alternative interpretations recognise that requiring a director to 'declare' an interest leaves a gap in the contract concerning that term's meaning.[151] That

144 *Coleman* (1871) LR 6 Ch App 558, 569 (emphasis added).

145 Ibid 570 (emphasis added).

146 See, eg, *The York and Midland Railway Co v Hudson* (1845) 16 Beav 485, 491; 51 ER 866, 868 (conferral of benefit by corporation on shareholder requires clear and unambiguous words); *Bluck v Mallalue* (1859) 27 Beav 398, 404; 54 ER 156, 158 (conflict rule may be controlled by rules of company).

147 See, eg, *North-West Transportation Co Ltd v Beatty* (1887) 12 AC 589, 593; *Costa Rica Railway Co Ltd v Forwood* [1900] 1 Ch 756, 765–7 (Ch Div), [1901] 1 Ch 746, 758, 763, 766 (CA); *Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co* [1914] 2 Ch 488, 504 ('*Transvaal Lands*'); *AM Spicer & Son Pty Ltd (in liq) v Spicer and Howie* (1931) 47 CLR 151, 175; *Furs Ltd v Tomkies* (1936) 54 CLR 583, 592; *Boulting v Association of Cinematograph, Television and Allied Technicians* [1963] 2 QB 606, 636; *Re Automotive & General Industries Ltd* [1975] VR 454, 461; *Anaray* (1988) 6 ACLC 271, 276; *Movitex Ltd v Bulfield* [1986] BCC 99,403; *Australian Growth Resources Corporation Pty Ltd v van Reesema* (1988) 6 ACLC 529, 534; *Guinness plc v Saunders* [1990] 1 All ER 652, 661; *Woolworths Ltd v Kelly* (1991) 9 ACLC 539, 553, 569; *Claremont Petroleum NL v Cummings* (1992) 10 ACLC 1685, 1691; *Centofanti v Eekimitor Pty Ltd* (1995) 15 ACSR 629, 630. As to *Movitex Ltd v Bulfield*, see text accompanying nn 167–168.

148 *Coleman* (1873) LR 6 HL 189, 205.

149 I am grateful to the referee for pointing out these possibilities.

150 Corporations Law s 231.

151 Ascertaining whether or not a gap exists is perhaps the most difficult question for default rule analysis. Some contracts may have genuine gaps; elsewhere, future property rights may be 'coarsely' specified, so inviting a more refined division at a future point: Ayres and Gertner,

gap may be filled either by a tailored default or a penalty default. I believe it to be the latter. First, the House of Lords did not suggest that in different situations it would construe the undefined 'declaration' differently. Its interpretation is untailored and ignores the way in which the parties would have understood the term. Second, the default rule defining 'declaration' as requiring the disclosure of the nature of the interest serves the essential purpose of a penalty default. It forces the party to reveal information that the other party (in this case, the other directors) may have lacked. This is closest to the facts of the case, as not all of the directors knew of the size of the defendant's commission. They may have changed their decision had they known.[152]

In *Transvaal Lands*[153] a company's articles permitted contracts between the company and its directors or firms of which directors were members. The director was required to disclose his interest in such a contract and not to vote. The conflict in question concerned contracts under which the company bought shares from, and sold its own shares to, another company. One director did not disclose that he held shares in the latter company in trust and was offered a directorship of it prior to entering the latter of the two contracts. Astbury J ordered the rescission of the two contracts. Astbury J rejected an argument that since the article permitted a director to contract with the company, it must imply that a lesser conflict, deriving from a shareholding, should be treated analogously.[154] The Court of Appeal dismissed the appeal. As in *Coleman*, Astbury J perceived a gap in the contract dealing with the status of shareholdings held in trust. He filled the gap with a penalty default, not a tailored default. If he had tailored, he arguably would have acceded to the argument that the shareholding held in trust created no greater conflict than the interests for which specific provision had been made. Because the contract did not provide for that interest type, the 'strong' fiduciary default had not been excluded.

In contrast, there are cases where the courts will apply tailored defaults. In *Anaray*,[155] the articles provided that directors should neither deliberate nor vote where they had interests in certain enumerated contracts. The judge used these provisions as evidence that the parties intended that in other circumstances directors who declared their interests should be able to vote. This is significant for two reasons.

First, Foster J was prepared to imply a provision opting out of the conflict rule.[156] This differs from the approaches of Cairns LJ and Astbury J, since it refuses to construe a gap against the fiduciary. This may be explained by Foster J's insistence that the interest had to be declared and was in any event minor.

'Filling Gaps', above n 12, 92; Alan Schwartz, 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 *Journal of Legal Studies* 271, 279–83.

152 See also *Gray v New Augarita Porcupine Mines Ltd* [1952] 3 DLR 1, 14.

153 [1914] 2 Ch 488.

154 Ibid 498.

155 (1988) 6 ACLC 271. For discussion above, see text accompanying n 92.

156 Ibid 274.

However, as *Transvaal Lands* shows, a 'minor conflicts' theory is not necessarily convincing. Similarly, in *Costa Rica Railway Company Ltd v Forwood*[157] an article provided that a director's office should be vacated if the director was interested in contracts with the company and failed to disclose the nature of the interest. A further article stated that vacation should not occur in respect of specified interests. A director had two particular interests, the nature of which were known, but not disclosed, to the other directors. The director did not vote, as the articles directed. The Court of Appeal upheld the contract. The court did not construe the contract as requiring the director to disclose the interest, in the manner in which Lord Cairns did in *Coleman*.[158] The case may be explained by the other directors' knowledge of the interests. There is, therefore, some tension in the authorities as to the strictness of interpretation of provisions contracting around the conflict default rule.

Second, in *Anaray*, Foster J stated that the director could vote, notwithstanding his conflict, subject to his *bona fide* decision that he should not do so where his interest would, or might be apprehended to, affect his decision.[159] This suggests that even though the conflict rule can be suspended by contract, good faith constitutes a normative centre of gravity. The director must act in good faith in reliance on the contractual term modifying the conflict rule. This principle is supported by other Australian authority.[160]

An interesting application of the trends in this area can be found in *South Australia v Clark*.[161] The defendant permitted his duty as chief executive officer of the State Bank of South Australia to conflict with his private interests and duties, when the Bank bought shares from a company needing money to repay a financier. The defendant was the managing director of and a shareholder in the financier. He instigated the transaction without disclosing his interest. The Bank was incorporated under its own Act. The Act included two provisions under which the defendant sought to excuse his fiduciary breach. One provision required directors to disclose any pecuniary interest in proposals before the board and not to deliberate in respect thereof.[162] However, this did not extend to interests deriving from a shareholding in a public company. Perry J held that this

157 [1900] 1 Ch 756 (Ch Div); [1901] 1 Ch 746 (CA).

158 However, a stricter view was taken in *Re North Eastern Insurance Co, Ltd* [1919] 1 Ch 198 (two directors infringed article by voting and deliberating on a resolution to issue debentures to the other) and in *Victors Ltd (in liquidation) v Lingard* [1927] 1 Ch 323 (directors issuing debentures securing loans for which they had already given personal guarantees). It is impossible to say that principles were relaxed over time.

159 (1988) 6 ACLC 271, 277.

160 See *AM Spicer & Son Pty Ltd (in liq) v Spicer and Howie* (1931) 47 CLR 151, 176, following *Channel Collieries Trust, Ltd v Dover, St Margaret's and Martin Mill Light Railway Co* [1914] 2 Ch 506, 512. See also *Australian Growth Resources Corporation Pty Ltd v van Reesema* (1988) 6 ACLC 529, 536 (interested director must vote for benefit of corporation); *Centofanti v Eekimitor Pty Ltd* (1995) 15 ACSR 629, 630; *Permanent Building Society (in liq) v McGee* (1993) 11 ACSR 260, 290 (director in breach of duty to act *bona fide* notwithstanding non-participation in decision in which he was interested).

161 (1996) 19 ACSR 606 ('*Clark*').

162 State Bank of South Australia Act 1983 (SA) s 11.

section should be read as a code applicable to the procedure to be followed where a director had a pecuniary interest. It had precedence over any fiduciary rule.[163] Although this conclusion might follow from the statutory status of the rule, it could be said that the State, as the shareholder of the Bank, used this legislation to modify fiduciary duties. Perry J construed the provision strictly and held that the defendant was not protected by it. The defendant had a pecuniary interest as a paid director, which did not derive from his shareholding.

The other provision protected directors from liability for acts done in good faith.[164] Perry J held that the offence under the said pecuniary interest provision and the deliberate breach of fiduciary duty caused the defendant to forfeit the section's protection.[165] Although decided in the context of a statutory scheme, the case implies that provisions contracting out of fiduciary default rules will be strictly enforced in the context of conflicts that present possible detriment to the company. This approach implies that courts should fill gaps in express contracts with penalty defaults, in order, as here, to compel directors to disclose their interests fully.[166]

The above analysis of the conflict rule reveals a history in which it has been treated as a default rule. The cases demonstrate several principles about contracting around the default rule:

(i) Compliance with procedures stated in the provision contracting around the default will generally be enforced strictly. An exception may exist where the interest is known to those to whom declarations must be made.

(ii) Courts do not generally imply provisions contracting around the default rule.

(iii) Directors relying on a provision varying the default remain subject to an obligation of good faith in considering the appropriateness of the transaction and in making a decision in the company's best interests.

So far as (i) and (ii) are concerned, the exceptions are best understood as cases where the requirements of the conflict rule have been tailored rather than applied as a penalty default. Theory suggests that courts should take care in tailoring because it frees directors from revealing private information.

C *The Conflict Rule and Statutory Immutability*

Contractual freedom to modify the conflict rule has been limited in different ways. First, contracting around the conflict rule was scarcely affected by legislation preventing companies from releasing the director from liability imposed by law.[167] *Movitex Ltd v Bulfield*[168] held that provisions contracting

163 *Clark* (1996) 19 ACSR 606, 633.
164 State Bank of South Australia Act 1983 (SA) s 29.
165 *Clark* (1996) 19 ACSR 606, 641.
166 Cf *Daniels v Daniels* [1978] 2 WLR 73.
167 Companies Act 1929 (UK) 19 & 20 Geo 5, c 23, s 152. See now Corporations Law s 241.

around the conflict rule did not offend the legislative prohibition. English scholars had previously considered the reconciliation of this provision with permissive articles. Very different views were articulated.[169]

Second, the Corporations Law requires directors to declare their interests in contracts.[170] Prior to the Corporate Law Reform Act 1992 ('the 1992 Act'), s 231 served this purpose alone. The section trumps articles which permit undisclosed interests. Otherwise, it preserves the operation of the articles.[171] Breach of s 231 does not create a cause of action.[172] None of the above cases, which were decided prior to its introduction, involved an article dispensing with disclosure.[173] It follows that the section may be market-mimicking; if it is not, its costs of compliance are low.[174]

This regime was changed by the 1992 Act. First, the Act confines s 231 to proprietary companies.[175] Second, s 232A, which only applies to public companies, prohibits voting and deliberating on a wider range of matters than merely contracts. The director may vote and deliberate if the remaining directors pass a resolution specifying the nature of the director's interest and that those in favour are satisfied the director should not be disqualified from deliberating and voting.[176] It thus functions as a penalty default by compelling the director to disclose the interest and to satisfy the other members of the board of its legitimacy. Section 232A requires a quorum of two directors,[177] thus trumping the rule that if the articles permit an interested director to vote, the interested director should be counted as part of the quorum.[178]

Third, the 1992 Act introduced Part 3.2A to regulate the conferral of financial benefits on the related parties of public companies. The Part replaced a provision

[168] [1986] BCC 99,403.

[169] C Baker, 'Disclosure of Directors' Interests in Contracts' [1975] *Journal of Business Law* 181; John Birds, 'The Permissible Scope of Articles Excluding the Duties of Company Directors' (1976) 39 *Modern Law Review* 394; E Rule and H Brar, 'Exempting the Directors' (1979) 129 *New Law Journal* 6; J Parkinson, 'The Modification of Directors' Duties' [1981] *Journal of Business Law* 335.

[170] See generally Baker, above n 169 (discussing antecedents and equivalents of s 231).

[171] See, eg, Corporations Law s 231(4); *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549, 594.

[172] *Castlereagh Motels Ltd v Davies-Roe* (1966) 67 SR (NSW) 279, 284; *Roden v International Gas Applications* (1995) 18 ACSR 454, 457.

[173] There are cases where the relevant article adopts compliance with the section as a test of validity: eg, *Centofanti v Eekimitor Pty Ltd* (1995) 15 ACSR 629; *Camelot Resources Ltd v Macdonald* (1994) 14 ACSR 437. See generally Companies and Securities Law Review Committee, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No 10 (1990) [52]–[55] (proposing compliance with disclosure provision as minimum requirement of validating article).

[174] This is reinforced by the tolerance of relatively informal disclosure preferred by a majority in *Woolworths Ltd v Kelly* (1991) 9 ACLC 539.

[175] Section 231(6). Cf s 231(10).

[176] Section 232A(3).

[177] This is not necessarily trivial, since s 232A implies that when a quorum fails to be established, authority for the transaction is required from the general meeting (s 232A(5)), which is a costly procedure.

[178] *AM Spicer & Son Pty Ltd (in liq) v Spicer and Howie* (1931) 47 CLR 151, 18; *Anaray* (1988) 6 ACLC 271, 276.

dealing with directors' loans[179] and supplemented other specific provisions.[180] The Part prohibits certain transactions[181] subject to certain exceptions.[182] It is hostile to *ex ante* contracting. There is still scope for *ex post* contracting, as a general meeting may approve a transaction,[183] although the approval procedure is very technical and includes an intrusive jurisdiction for the Australian Securities Commission.[184] Despite preserving *ex post* contracting, the costly procedural technicalities and significant exposures for directors[185] are likely to reduce its incidence. Some companies may trivialise the provisions by reincorporation as proprietary companies, although companies needing public finance cannot do so. The Part is difficult to avoid through reorganising transactions.[186]

Is there a justification for the distinction (unknown to common law or equity) in the statutory treatment of contracts varying the conflict rule as between public and proprietary companies? Ostensibly, the economic justification may seem to be in the lower costs of collective action by a smaller number of shareholders in proprietary companies.[187] The transaction costs of monitoring and negotiating are correspondingly lower.[188] While such a point is important to recognise, it provides no support for the statutory scheme just described — indeed it draws attention to its perversity. To see this one must recognise that the legislation basically permits *ex ante* modification of the conflict rule in the proprietary company, but not in the public company. The public company must rely on *ex post* contracting, through the procedural formalities of the approval procedure in Part 3.2A. This is wrongheaded. *Ex post* contracting is in the nature of a negotiated contract between the fiduciary and the shareholders. However, in a public company the larger number of shareholders increases the costs of this negotiation. The smaller the proportional interests of shareholders, the less likely they are to acquire information about the proposal and to interrogate the information with which the Part requires them to be supplied. In contrast, *ex post* contracting around the conflict rule is most viable in a proprietary company where collective action problems are lower. The legislation therefore requires actual bargaining where it is least viable, and makes it unnecessary where it would work best and at least cost.[189]

179 Section 234 (now repealed).

180 Sections 237 and 239.

181 Of indefinite scope because benefit is ambiguously defined: s 243G. Prohibitions are enforced through civil penalty provisions: Part 9.4B.

182 Likewise of indefinite scope: s 243N.

183 Sections 243Q–243ZD.

184 Section 243W.

185 See, eg, the declarations required of directors in the explanatory statement sent to shareholders under s 243V(1). These declarations create possible exposures under ss 232(2), 232(4) and 1309, and also possibly under s 52 of the Trade Practices Act 1974 (Cth).

186 Sections 243C–243F (related entity provisions).

187 See generally Whincop, 'Due Diligence', above n 11.

188 See generally Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (2nd ed, 1971).

189 Cf Coffee, 'The Mandatory/Enabling Balance', above n 43, 1624; Eisenberg, above n 30, 1469–70. See text accompanying nn 218–219.

Ex ante contracting, on the other hand, involves examining transactions by reference to an initial bargain. Why would this be more reliable in a proprietary company than a public company? The answer must concern the relative effectiveness or independence of the board of directors, to which ss 231 and 232A declarations must be made, and which makes the eventual decision. It is not apparent why proprietary companies would be superior. If a public company board is dominated by the chief executive, a proprietary company board, on the occasions it actually sits as such,[190] is not obviously less dominated by its usual majority shareholder.

A relevant consideration to *ex ante* contracting is whether or not the contractarian 'pricing argument' holds.[191] Are the agency costs of opting out borne by the agents? While there may be reason to doubt the efficiency of the primary market for public company IPOs, shareholders buying in secondary markets stand a good chance of being price-protected. However, any argument concerning the pricing efficiency of the market for investments in proprietary companies must be a feeble one, given documented problems of illiquidity, opportunism and information asymmetry.[192]

Sections 232(5) and (6) also bear on the conflict rule. These provisions prohibit improper use of office and information acquired by virtue of office. Breach of these provisions carries penal consequences and, in aggravated cases, criminal consequences. The authorities hold that statutory prohibitions on improper use depend on the general law duties of officers.[193] Because fiduciary breach is usually a condition precedent to the operation of these provisions, it would seem to follow that transactions which are validated by *ex ante* modification of the conflict rule and which do not fall foul of any other statutory provisions would not invoke the section. The provisions merely reinforce either the default rule or the term contracting out of it by increasing the sanction for breach. So far as *ex post* contracting is concerned, the recent High Court decision, *R v Byrnes,*[194] is apposite. In that case, two officers committed their companies to conflicting transactions. They believed they would eventually obtain ratification, but the transaction proved a disaster. The court held that they had violated the section. This conclusion shows that courts avoid the use of tailored defaults in connection with conflicting transactions. A court will not reconstruct the parties' likely hypothetical bargain concerning that transaction at the time it is entered. That would be inconsistent with the information-revealing properties of a penalty default.

[190] Commonwealth Parliament, Joint Statutory Committee on Corporations and Securities, *Close Corporations Act 1989* (1992) [2.12].

[191] See text accompanying nn 32–33.

[192] National Investment Council and Marsden Jacobs Associates, *Financing Growth: Policy Options to Improve the Flow of Capital to Australia's Small and Medium Enterprises* (1995) 27–32; Whincop, 'Due Diligence', above n 11.

[193] See generally Michael Whincop, 'Developments in Directors' Statutory Duties of Honesty and Propriety' (1996) 14 *Company & Securities Law Journal* 157, 164–9; Whincop, 'Criminalisation', above n 11, 284.

[194] (1995) 183 CLR 501.

V THE RULE PROHIBITING IMPROPER PURPOSES

A *Character of the Rule*

A requirement that a fiduciary refrain from exercising a power for an improper purpose is a very old rule deriving from rules relating to the exercise of powers.[195] Like the conflict rule, the proper purposes rule springs from the impermissibility of a personal interest conflicting with the fiduciary's undertaken duty.[196] Nonetheless, the rules are capable of separate analysis since they tend to be raised in different types of cases. While the proper purposes rule has been directed to more conventional self-dealing cases,[197] it is mainly applied to cases involving share transfers and contests for corporate control. A proper purposes rule completes otherwise incomplete contracts. The powers exercised in cases like share transfers, for instance, involve transactions that are prima facie within the power of directors. While shareholders and directors are aware of the possibility of abuse, writing a contract which can strike down the abuses while upholding valid uses is difficult. First, abuses are only detectable by reference to the *effect* of exercising such a power, such as a dilution of a shareholder's voting interest. Drafting a contract sensitive to a range of such future contingencies is difficult.[198] Second, many transactions occur in circumstances of conflicts between self-interested shareholders. In the context of these conflicts, it can be difficult to ascertain whether the action that resolves the conflict is justifiable on utilitarian grounds.[199] While some contractarians may pretend otherwise, the difficulty is no easier to resolve *ex ante* if contracting is costly and foresight is limited. As noted above,[200] fiduciary duties respond to the first difficulty of *ex ante* contracting through their ability to generate a situation specific default rule. However, courts enforcing fiduciary duties in such cases are also faced with the

195 *Aleyn v Belchier* (1758) 1 Eden 132, 138; 28 ER 634, 637.

196 *Broughton v Broughton* (1855) 5 De G M & G 160, 164; 43 ER 831, 833. In more recent years, judges have emphasised that not every conflict is a breach of fiduciary duty, but only those which are 'real, sensible' possibilities of conflict: *Boardman v Phipps* [1967] 2 AC 46, 124; *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41, 102–3; *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1, 3.

197 See, eg, *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109; *Hannes v MJH Pty Ltd* (1992) 10 ACLC 400.

198 Ayres, above n 14, 1404–5.

199 A classic example is whether shareholders benefit if managers act passively in contests for corporate control. Contrast Frank Easterbrook and Daniel Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161 (advocating passivity as wealth-maximising for shareholders); David Haddock, Jonathan Macey and Fred McChesney, 'Property Rights in Assets and Resistance to Tender Offers' (1987) 73 *Virginia Law Review* 701 (permitting resistance as wealth-maximising for shareholders); and John Coffee, 'Shareholders Versus Managers: The Strain in the Corporate Web' (1986) 85 *Michigan Law Review* 1 (permitting resistance to protect legitimate interests of managers). On this theme, see also Lucian Bebchuk, 'Toward Undistorted Choice and Equal Treatment in Corporate Takeovers' (1985) 98 *Harvard Law Review* 1695; Ronald Gilson, 'Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense' (1982) 35 *Stanford Law Review* 51; Alan Schwartz, 'The Fairness of Tender Offer Prices in Utilitarian Theory' (1988) 17 *Journal of Legal Studies* 165.

200 See text accompanying n 105.

second difficulty of assessing utilitarian justifiability. The possibility of judicial error is naturally quite high.

Does the jurisprudence on the proper purposes rule support a characterisation of it as a gap-filling rule? Section B considers the extent to which courts permit contracting around 'default' proper purposes. Section C asks how, if at all, courts tailor proper purposes when the contract itself is silent. The analysis in these sections asserts that the proper purposes rule is contractarian. *Dicta* endorse the proposition that the law's default purposes can be expanded to include improper purposes. However, the remarkable feature of Anglo-Australian case law is the extreme infrequency with which this occurs. I believe that the reason for the infrequency of contracting out of the default has much to do with the application of the proper purposes rule as a tailored default. Courts balance a variety of interests in order to produce a ruling which, under the influence of a good faith standard, emulates the bargain that shareholders and managers would have reached had they been confronted with the facts *ex ante*. Finally, I analyse the impact of legislation.

B *Contracting for Proper Purposes*

In *Ure*[201] Isaacs J indicated that in determining the purpose for which a power was conferred, a court has regard to the company's constitution. This implies that articles might be used to extend, or possibly to narrow, the default purposes for which a power might be exercised. How has this notion been received by courts?

The case law is confined to closely held companies. The leading case is *Whitehouse v Carlton Hotel Pty Ltd.*[202] The articles of a company conferred all of the board's powers and discretions on the company founder. The founder issued shares having deferred voting rights to his sons. The effect was to give the sons a majority after their father's death, where before only their mother had held such shares. A majority of the High Court held the share issue to be invalid. Mason, Deane and Dawson JJ held that the issue of shares in order to destroy a majority was an improper purpose.[203] Their Honours held that articles 'may be so framed that they expressly or impliedly authorise the exercise of the power of allotment of unissued shares for what would otherwise be a vitiating purpose.'[204] In the circumstances, nothing in the articles had this effect. The vestiture of all powers and discretions in the founder did not free him from the constraints of fiduciary duty.[205] The fact that the class of shares in question only carried voting rights did not imply that the director could issue shares in order to destroy a majority.[206] Shares could permissibly be issued to change voting entitlements, if

201 (1923) 33 CLR 199. See text accompanying n 90.
202 (1987) 162 CLR 285 ('*Whitehouse*').
203 Ibid 289–90.
204 Ibid 291.
205 Ibid 292.
206 Ibid.

these changes were consensual or in association with capital raising.[207] Brennan J dissented on the basis that the articles gave the founder the power to decide who should hold voting interests in the company after he died. Since he exercised that power with a view to ensuring that the company would be well managed, the decision was valid.[208]

The principle that conferring very wide powers on a single director does not vitiate their fiduciary character was affirmed in *Hannes v MJH Pty Ltd*.[209] That case involved resolutions enriching a governing director with almost total control of his company. Although the court agreed that articles might be framed to expand the legitimate range of powers, it held the case was indistinguishable from *Whitehouse*.[210] This approach implies that courts regard principles relating to the exercise of corporate powers as 'strong' default rules, which can be contracted around by the articles, albeit with difficulty.[211] A provision that widens the legitimate range of purposes to include a motivation normally treated as improper therefore needs specificity. The improper purpose itself would need articulation. We see here a similarity with the conflict rule — courts are usually unwilling to imply a term contracting out. This conforms to Coffee's normative analysis that provisions varying fiduciary rules should be specific.[212]

Only one Australian case has held that fiduciary principles were modified. *Buche v Box Pty Ltd*[213] involved two family companies. The companies had been founded to minimise income and estate taxes. The plaintiff sought to invalidate transactions by the founder which diluted her interests and passed ownership and control to two siblings. Brownie J held that the fiduciary duty of directors, when deciding to issue shares, could be affected by express *or implied* provisions.[214] The plaintiff had been given shares by her father; it followed that the father had the right to make further gifts to her siblings:

> [I]t was only to be expected that for any of a wide variety of possible reasons, he might cause allotments to be made, whether or not accompanied by appropriate determinations, so as to redistribute the income or assets ... generally for the benefit of his family, consistently with the objects of avoiding or minimising death or estate duty, or income tax.[215]

Since the founder could make gifts to any of the children, the plaintiff's real complaint was that the provision he made for the others was excessive. Brownie J said:

207 Ibid.

208 Ibid 310–1.

209 (1992) 10 ACLC 400.

210 Ibid 408. An identical conclusion was reached in *Re Bagot Well Pastoral Co Pty Ltd* (1993) 61 SASR 165, 175–6.

211 Cf Companies and Securities Law Review Committee, above n 173, [47]–[51] (permitting definition of permissible purposes, but prohibiting exclusion of duty of good faith).

212 Coffee, 'The Mandatory/Enabling Balance', above n 43, 1623–4. See also text accompanying n 47.

213 (1993) 10 ACSR 359.

214 Ibid 368.

215 Ibid 369.

> [H]er father had the right to decide what provisions were appropriate, and so long as he made those decisions in good faith, and for the purpose of benefiting his family, while saving or minimising death or estate duty or income tax, the plaintiff cannot be heard to complain, in effect, that he made inappropriate decisions as to the quantum of these provisions. That is, the fiduciary duty which a company director ordinarily owes was modified in the circumstances ... so as to permit [the founder] to make allotments and determinations, for the purposes mentioned, and so long as he did so conscientiously.[216]

Three things are striking about this case. First, its consistency with the majority decision in *Whitehouse* is dubious. Both cases involved a director who believed that the allotments would be for the best management of the enterprise. Brownie J's decision resembles Brennan J's dissent. Second, Brownie J accepted that the fiduciary duty could be modified by implication. While the articles conferred on the founder the ability to decide share class rights, they did not expressly authorise a dilution purpose. Brownie J relied on the company's tax avoidance purposes. However, the plaintiff's dilution could not be explained by a tax avoidance purpose. In contrast, the majority in *Whitehouse* considered in that case that dilution needed the consent of the party diluted. This is interesting, as the majority's approach implies that *ex post* contracting is to be preferred to *ex ante* modification (perhaps because of the small numbers in these cases);[217] *Buche v Box Pty Ltd* takes the opposite view. Third, although Brownie J held the fiduciary duty to be varied, he nonetheless held that the exercise of the power was subject to a requirement of good faith. Once again, good faith occupies the normative centre of gravity of fiduciary defaults.

A refusal to imply an expansion of the range of proper purposes can function as a penalty default. It may compel a person who would rely on the power for that purpose to disclose such an intention. However, the gap in the contract may simply be attributable to a failure to foresee the contingency rather than to strategic behaviour. In these circumstances, courts must decide whether or not to imply a provision displacing the default rule. If they refuse, the parties fall back to *ex post* contracting. All parties must consent to any change to their property rights. By contrast, displacement through implication can, in cases like *Buche v Box Pty Ltd*, result in compulsory redistributions.[218]

C *Judicial Purposive Tailoring*

Buche v Box Pty Ltd is unique in holding that the fiduciary duty is to be modified by implication from the circumstances of the company and the purport and scheme of the articles. This analysis could be recast as the court tailoring the

216 Ibid.

217 Cf text accompanying nn 187–192.

218 Lawyer-economists will observe that the distinction drawn here parallels the manner in which the law protects legal interests — by a liability rule (which permits the invasion of a legal right, subject to payment of compensation), by a property rule (which prohibits such invasion, except with the proprietor's consent) or by an inalienability rule (which prohibits invasion and consensual transfer): Guido Calabresi and Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089.

default rule to the circumstances of the company and the larger contract between the family members. Given the usual requirement of express displacement of fiduciary defaults, this analysis is more satisfying. It is therefore important to examine whether or not courts tailor fiduciary principles in other circumstances. If one was to conclude that tailored rules were used, this might explain why there are so few cases which have expanded the range of proper purposes. If courts tailor *ex post* and the tailored rules are efficient,[219] one would expect few cases of *ex ante* contracting. The existence of tailoring therefore reinforces the confidence with which we can use a theory of default rules to describe the proper purposes rule. The following material examines the proper purposes rule's application to competitions for control.[220]

As we have seen, the fiduciary principle generates default rules applying to specific exercises of fiduciary power. However, the parties' contract expressly confers powers of management on the fiduciary, which the fiduciary may enforce even against the wishes of a transient majority.[221] The problem involves balancing the fiduciary default rule with the express management contract. Doctrinal analysis provides principles to resolve these cases. These were recently restated by Ipp J in *Permanent Building Society (in liq) v Wheeler*:

> (a) Fiduciary powers and duties of directors may be exercised only for the purpose for which they were conferred and not for any collateral, or improper purpose.
>
> (b) It must be shown that the substantial purpose of the directors was improper or collateral to their duties as directors of the company. The issue is not whether a management decision was good or bad; it is whether the directors acted in breach of their fiduciary duties.
>
> (c) Honest or altruistic behaviour by directors will not prevent a finding of improper conduct on their part if that conduct was carried out for an improper or collateral purpose.
>
> (d) ... The court must determine whether but for the improper or collateral purpose the directors would have performed the act impugned.[222]

This approach is conceptually problematic. First, it cannot be doubted that in any of the cases studied below directors had collateral purposes of retaining their own positions. The intensity of such a purpose may vary between cases, but

[219] Network externalities are an alternative explanation: see text accompanying nn 63–68. Even if the default rule's inherent value is lower than an alternative formulation, it is retained because its overwhelming use by others creates a positive externality.

[220] Prior to cases considering competition for control, the proper purposes rule developed in cases of share transfer registration: see, eg, *Re Gresham Life Assurance Society* (1872) LR 8 Ch App 43; *Re Stranton Iron and Steel Co* (1873) LR 16 Eq 559; *New Lambton Land & Coal Co Ltd v London Bank of Australia Ltd* (1904) 1 CLR 524; *Re Bede Steam Shipping Co, Ltd* [1917] 1 Ch 123; *Re Smith and Fawcett Ltd* [1942] Ch 304.

[221] *Automatic Self Cleansing Filter Syndicate v Cunninghame* [1906] 2 Ch 34; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113.

[222] (1994) 14 ACSR 109, 137.

denying its existence seems to try the credulity of the naive.[223] Second, an untailored application of the fiduciary principle does not guarantee a decision that is justifiable on utilitarian grounds. This is especially acute when a bidder's interests are imperfectly aligned with those of other shareholders. I have already noted that scholars cannot agree on how active a role target management should have.[224] The quality of the management decision is *surely* relevant, and only a seriously misspecified legal principle ignores it. Third, the 'but for' test sits uneasily with either the conventional test for the existence of a conflict (any conflict)[225] or the modern test (a real or substantial possibility).[226]

I believe that the courts' actual approach is best understood as involving a tailoring jurisdiction. The tailoring concept requires a court to determine what the parties in the particular circumstances would have contracted for, had they alluded to the problem *ex ante*. However, producing such a tailored 'hypothetical bargain' is limited by the jurisdictional constraints on a court's order. All a court can do is say whether the management action is valid or invalid. The court must therefore decide whether the specific management action would have been permitted by the parties *ex ante*. In order to make that decision, the courts' processes are undeniably 'muddy', in the sense in which Ayres used that term. That tailoring jurisdiction, which we observe in the cases discussed below, tends to confer significant discretion on directors. However, its exercise is scrutinised by courts in order to determine that the director's action advances a legitimate business purpose that benefits shareholders. This concept of tailoring resembles the restrained self-interest standard of good faith. It is true that balancing management self-interest and shareholder advantage may lead to mistaken estimation of that for which the parties would have contracted. However, as Ayres has argued, this process is a logical default.[227] Firms that disapproved of it could, on the basis of the doctrine studied in section B, contract out of the default rule. This would involve specifying, for instance, that capital raising during a takeover should be an improper purpose. If the default is untailored, it would be difficult to contract around it in favour of a provision opting for the balancing approach we observe in the cases.

Whether this analytical process is actually a default rule, rather than the imposition of a mandatory requirement to advance a legitimate business purpose, depends on the possibility that the articles might extend the range of legitimate purposes to include a right to issue shares to dilute the interests of a hostile bidder. Cases such as *Whitehouse* are consistent with the possibility of so contracting. Even if courts were to refuse to uphold such a provision, the rule

223 See, eg, *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, 495 ('*Harlowe's Nominees*'). Cf Jeffrey Gordon, 'Corporations, Markets, and Courts' (1991) 91 *Columbia Law Review* 1931, 1943–4.

224 See above n 199.

225 *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461, 473.

226 *Boardman v Phipps* [1967] 2 AC 46, 124; *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41, 103; *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1, 3.

227 Ayres, above n 14, 1403–7. See also Ayres and Gertner, 'Filling Gaps', above n 12, 108–18.

could still be a 'single sided' default,[228] provided the articles can prohibit capital raising or other defensive actions by managers during a takeover.

Ure[229] involved a refusal to register a transfer and an issue of shares diluting the majority of the insurgent faction. The court was pressed to apply an untailored rule — directors may not refuse a transfer to prevent a majority from having its way.[230] Isaacs J held that was not 'completely' true. Directors draw their power from the consensus of all shareholders. Therefore, directors may act honestly upon business considerations, including their perceptions regarding possible injury to the company.[231] This principle was described as a duty to act in good faith. The directors' refusal to register was upheld, given their honest perceptions of the likely harm from disruption by the insurgent faction including the undesirable appointment of the plaintiff's spouse to the board.[232] The court thus applied a tailored default that responded to particular business considerations. Nonetheless, the action taken is tested by a principle of good faith which requires the court to be convinced that the directors were honestly, and actually, motivated by the alleged business considerations.

This approach is also evident in *Mills v Mills*.[233] As part of a competition for control, the defendant director voted in favour of a resolution that restored him to an effective majority position. The High Court did not invalidate the resolution, based on the trial judge's finding that the scheme was motivated by a business consideration concerning the rights of ordinary shareholders (including the defendant) to retained earnings. The defendant therefore had two personal interests: an interest in his voting power allowing him to control the company and a pecuniary interest as a shareholder. Latham CJ considered that the law does not require 'detached altruism' from directors interested as shareholders, but does require fairness and good faith.[234] This implies that the selfless fiduciary standard is not helpful in judging actions taken in competitions for control. Self-interest, however, is restrained. Restrained self-interest is the hallmark of the good faith standard. Dixon J held similarly[235] and stated that courts must look for the substantial purpose of the exercise of power. Posterity has regarded this expression as involving a comparison of competing purposes.[236] However, his Honour seemed to be testing, on the basis of the trial judge's findings, whether or not the business purpose alleged by a defendant could support the actual exercise of power impugned. This represents an objective counterpart to the subjective good faith standard which was examined in *Ure*. The objective

228 Ayres, above n 14, 1402.
229 (1923) 33 CLR 199.
230 Ibid 204.
231 Ibid 218. See also ibid 224 and *Teck Corporation Ltd v Millar* (1973) 33 DLR (3d) 288, 317.
232 *Ure* (1923) 33 CLR 199, 221.
233 (1938) 60 CLR 150.
234 Ibid 164.
235 Ibid 185.
236 See, eg, *Ngurli Ltd v McCann* (1953) 90 CLR 425, 445; *Harlowe's Nominees* (1968) 121 CLR 483, 493–4; *Whitehouse* (1987) 162 CLR 285, 294.

test is a necessary supplement because of the difficulty of adjudicating on the motivations of individual directors.[237]

This approach is confirmed if one juxtaposes *Harlowe's Nominees*[238] with *Howard Smith Ltd v Ampol Petroleum Ltd.*[239] Both cases involved companies subject to an actual or potential takeover not favoured by the directors, who thwarted it by issuing shares to a 'white knight'. In both cases directors asserted that the company could advantageously use new capital; in neither case was there a finding that the motivating purpose of the issue was self-entrenchment. However, in *Howard Smith*, the Privy Council found that the substantial object was the dilution of the raider to facilitate the white knight's bid. The Privy Council reached this conclusion by means of a process like the 'objective' test of good faith which I described as being an interpretation of Dixon J's judicial method in *Mills v Mills*:

> [W]hen a dispute arises whether directors of a company made a particular decision for one purpose or for another, or whether, there being more than one purpose, one or another purpose was the substantial or primary purpose, the court ... is entitled to look at the situation objectively in order to estimate how critical or pressing, or substantial or, per contra, insubstantial an alleged requirement may have been. If it finds that a particular requirement, though real, was not urgent, or critical, at the relevant time, it may have reason to doubt, or discount, the assertions of individuals that they acted solely in order to deal with it, particularly when the action they took was unusual or even extreme.[240]

Thus, although the trial judge accepted that there was a need for capital, that need did not objectively support the share issue. The action was taken to dilute the hostile bidder's interests to facilitate the favoured takeover. While the Judicial Committee indicated that it would respect the directors' *bona fide* opinions on management matters, none was involved here.[241] This contrasted with *Harlowe's Nominees* where it was accepted that the share issue assured the company's financial stability.[242]

Although the case did not involve a share issue, the decisions in *Darvall*[243] show a similar willingness to give management latitude to take defensive actions. The scope of that latitude is tailored by reference to a variety of situation-specific criteria, including the extent to which the actions advance the commercial interests of the company, the likelihood of similar actions in the absence of the takeover, the ability to improve the options available to share-

237 *Mills v Mills* (1938) 60 CLR 150, 185–6.

238 (1968) 121 CLR 183.

239 [1974] 1 NSWLR 68 (PC) ('*Howard Smith*').

240 Ibid 74. See also *Darvall v North Sydney Brick & Tile Co Ltd [No 2]* (1989) 7 ACLC 659, 677 ('*Darvall*').

241 Cf *Teck Corporation Ltd v Millar* (1973) 33 DLR (3d) 288.

242 For an example of an even more intense scrutiny of the motivations of a business transaction (lending money to a corporation of doubtful solvency) alleged to have been entered into for an improper purpose, see *Permanent Building Society (in liq) v McGee* (1993) 11 ACSR 260, 291–2. The court used the rubric of good faith here too. The greater intensity corresponds with the fact that management brought the transaction on itself, unlike the case of a takeover.

243 (1988) 6 ACLC 154 (trial); (1989) 7 ACLC 659 (appeal).

holders, the diluting effect of the action and the incidence of benefits to management from the action.[244]

What does this review tell us? First, in these cases, courts overlook the supposed selflessness required of fiduciaries. Competitions for control present inevitable conflicts of interests for directors, especially for executive directors.[245] The relaxation of the fiduciary standard is depicted in the erosion of the test of a real or sensible possibility of conflict to a test of a real or substantial improper purpose. While the courts do not acknowledge an entitlement to advance interests as directors, the flexibility of the applicable law and the remarkable restraint courts have shown in holding directors to be acting in self-interest nonetheless marks out a limited domain in which directors may act in their own best interests.

Second, the compass of that domain can be understood by reference to the theory of tailored defaults. That is, courts undertake the difficult, and undeniably imprecise, task of determining whether shareholders as a whole would have regarded the action as being within management's authority had they directed their attention to it *ex ante*. The courts have refused to articulate an untailored default prohibiting directors from taking actions prejudicial to the bidder or advantageous to the director. As Clarke JA held in *Darvall*, 'the bald proposition that it is improper to take action to defeat a takeover offer is too widely stated to constitute a legal principle.'[246] The willingness to tailor here, but not in the closely held company cases looked at in section B, may reflect the impossibility or impoverishment of bargaining between managers, the bidder and other shareholders, given the numbers of these parties. Alternatively, it may reflect a judicial belief that shareholders gain from certain types of defensive actions in public company takeovers, whereas the cases in section B were purely redistributive. The tailoring process requires a court to examine, *inter alia*, the justifiability of action taken given the business circumstances of the company, the immediate benefit to shareholders of the action taken and the comparative intrusiveness of the directors' self-interest. The imprecision of this process is clear; its formalistic indeterminacy is arguable, given the court's difficulty in verifying information regarding some of these factors. Yet the outcome of these cases demonstrably turns on such matters. The factual orientation of these cases alone compels one to the view that the court is not applying untailored or penalty rules.

The contractarian assertion that this jurisdiction will lead to costly judicial errors is hard to doubt. However, it is unclear whether shareholders would be better off under a regime that prohibited defensive actions, as Easterbrook and Fischel once recommended, or under a regime that allowed managers and shareholders to contract *ex ante* and in inevitably general terms for any terms as

244 *Darvall* (1988) 6 ACLC 154, 176; (1989) 7 ACLC 659, 710.

245 See generally Coffee, 'Shareholders Versus Managers', above n 199.

246 *Darvall* (1989) 7 ACLC 659, 712. See also *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 1 ACLC 1294, 1304.

others recommend.[247] I have argued that it is possible to opt out of the default, either by prohibiting capital raising or other defensive tactics, or by expressly authorising share issues for the purpose of dilution. That such articles are not observed may suggest the default is efficient.

Third, the good faith standard is again the normative centre of gravity and the benchmark for the tailoring process itself. The *de facto* process of balancing manager and shareholder interests departs from fiduciary concepts of selflessness in all but doctrinal terms, in favour of a constrained standard of self-interest. Good faith both represents a subjective constraint on the motivations of directors and provides objective balance for the business considerations alleged to justify defensive action.[248]

Fourth, the nature of the tailoring jurisdiction conforms to a contractarian thesis that the law provides default rules referable to that which the parties would have wanted. Competitions for control inevitably present situations difficult to control by contract because the company's circumstances cannot be foreseen *ex ante*. Collective action problems in public companies prohibit *ex post* renegotiation. The response of the law has been to permit directors to make business judgments, but to compare those judgments with a hypothetical bargain for good faith. Courts act as proxy for shareholders in determining whether shareholders, confronted *ex ante* with the facts that arose *ex post*, would have permitted management to take the action that they did.

D *Proper Purposes and Statutory Immutability*

The extent to which the proper purposes rule supports a positive contractarian thesis is largely unchanged by statute. This may result from rare use of the articles to expand the range of proper purposes to include improper ones. However, the Corporations Law does operate to reinforce the proper purposes rule. Sections 232(5) and (6) were discussed above. They are relevant here too, because it has been held that the duty to exercise a power for proper purposes is relevant to whether directors make improper use of office.[249] Therefore, the consequences of violating the proper purposes rule are more onerous. Because the proper purposes rule is a tailored jurisdiction, the contours of prohibited action will be imprecise.[250]

247 Butler and Ribstein, 'Opting Out', above n 5, 16–17. Cf Easterbrook and Fischel, above n 5, 174, revising their previous 'hardline' on permissibility of defensive actions.

248 See also *Permanent Building Society (in liq) v McGee* (1993) 11 ACSR 260, 291–2; *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109, 144–54.

249 *Jeffree v National Companies and Securities Commission* (1989) 7 ACLC 556, 561, 565; *Chew v R* (1992) 10 ACLC 816, 824–5, 827; *R v Byrnes* (1995) 183 CLR 501, 515–6.

250 Whincop, 'Criminalisation', above n 11, 281–2.

VI THE DUTY OF CARE

A *Introduction*

In the past 15 years, the changes to the law concerning directors' duties have come from the legislature in matters of self-dealing[251] and the courts in matters of care and diligence. The metamorphosis of directors' duties of care from a gross negligence standard to a more demanding standard assimilated with general principles of negligence has been reviewed by other authors.[252] The chief statutory provision, s 232(4), probably reflects current judicial principle. I look first at the extent to which the common law permitted companies to exculpate directors from negligence liability. Such releases and indemnities contract out of the extant default rule concerning standards of care. These forms of contracting are now statutorily proscribed.[253] One would conclude that the common law could be characterised as contractarian, but that modern statutory law could not.

B *Contracting Around Duties of Care*

Re Brazilian Rubber Plantations and Estates Ltd[254] and *Re City Equitable Fire Insurance Co Ltd*[255] both involved allegations of negligence against directors who honestly relied on persons who acted fraudulently. In *Brazilian Rubber* an article provided that a director should not be liable for any loss, damage or misfortune which happened in the execution of the duties of office, excepting cases of personal dishonesty. Neville J held that there was no negligence, but that if there had been, the article was effective to absolve the directors from liability. It was not illegal to engage directors on such terms.[256] Neville J held that the article was effective to defeat a misfeasance summons[257] brought by the liquidator.[258]

Whereas the exclusion in *Brazilian Rubber* was for dishonesty, that in *City Equitable* was for wilful neglect or default. Romer J followed the decision in *Brazilian Rubber* concerning the effect of the article without expressing his own opinion.[259] 'Wilful' describes breaches of duty that the director knows to be such. It also extends to cases where the director does not care whether or not he

251 See above Parts IV(C) and V(D).

252 For recent reviews, with references to literature, see Whincop, 'Critique', above n 11; Robert Baxt, 'One "AWA Case" is Not Enough: The Turning of the Screws for Directors' (1995) 13 *Company & Securities Law Journal* 414.

253 Section 241. The Privy Council recently upheld such a provision under Jersey law, where no proscription exists: *Viscount of the Royal Court of Jersey v Shelton* [1986] 1 WLR 985.

254 [1911] 1 Ch 425 ('*Brazilian Rubber*').

255 [1925] Ch 407 ('*City Equitable*').

256 *Brazilian Rubber* [1911] 1 Ch 425, 440.

257 See Companies (Consolidation) Act 1908 (Eng) 8 Edw 7, c 69, s 215. See now Corporations Law ss 533, 534.

258 *Brazilian Rubber* [1911] 1 Ch 425, 440.

259 *City Equitable* [1925] Ch 407, 442.

or she is in breach of duty.[260] Such intentional 'negligence' approximates a failure to act in good faith. The defendant directors had acted in good faith and were excused. The decision was appealed, but only in respect of auditor liability. The auditor relied on the release in the articles, which extended to auditors. The House of Lords agreed with Romer J's interpretation of 'wilful'.[261] None of the judges thought an article releasing an auditor from statutory duties or liabilities was offensive.[262] Pollock MR and Sargant LJ considered that the duty remained, but the article might legitimately excuse the defendant from technical errors and defaults for which he might be held liable in law.[263] Warrington LJ considered that the article modified the auditor's duties and that the misfeasance summons merely introduced a procedure for prosecution of breaches of duty, but that contract might define the measure of the duty.[264]

In these cases, it was necessary to construe the contractual terms 'dishonest' and 'wilful'. Although it is difficult to say with certainty, it is probable that the judges would have held that the exclusion expressed in these contracts was in any event implied by law. Good faith would thus be a mandatory rule, although presumably a market-mimicking, and therefore, a trivial one.

C *Network Effects*

Duties of care are characteristically expressed in terms of general standards, such as 'gross negligence' or 'reasonable care'. *City Equitable* and *Brazilian Rubber* did not involve articles that attempted to substitute for the default rule a different set of standards, lying between the default rule standard and no standard. This suggests that the standard forming the default rule may have significant network externalities. This is predictable because the term's content depends on judicial interpretation.[265] 'Home-made' standards of care, apart from the total exclusions observed in these cases, are therefore unlikely. Coffee has argued that there are sound reasons for retaining a duty of care, while permitting a cap on the officer's maximum liability.[266] Even if the normative argument is correct, the presence of network externalities implies that one would not expect to see such terms. This might be overcome by redrafting the statutory duty of care as a menu of options from which firms could select capped liability.

260 Ibid 434.

261 *City Equitable* [1925] Ch 500, 517 (Pollock MR), 523 (Warrington LJ), 528–9 (Sargant LJ).

262 Ibid 515–6 (Pollock MR), 520–1 (Warrington LJ), 528 (Sargant LJ).

263 Ibid 515 (Pollock MR), 529 (Sargant LJ).

264 Ibid 525. See also *Re Canadian Land Reclaiming And Colonizing Co* (1880) 14 Ch D 660, 670; *Cavendish Bentinck v Fenn* (1887) 12 AC 652.

265 See text accompanying nn 63–68.

266 Coffee, 'No Exit', above n 30, 925–31. *Contra* Companies and Securities Law Review Committee, above n 173, [44]; Vanessa Finch, 'Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance' (1994) 57 *Modern Law Review* 880, 910.

D *Another View of the Cathedral: Subjectivity as Tailoring*

Not long after the *City Equitable* decision, companies were prohibited from relying on exculpatory provisions.[267] Such articles as those in *Brazilian Rubber* and *City Equitable* remain void to this day, although the overall statutory scheme regarding indemnity has recently changed.[268] Negligence arguably became an immutable rule. Such an analysis is complicated by the 'subjectivity' of the director's standard of care. Romer J in *City Equitable* said that 'a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.'[269] Critics of these traditional standards have viewed subjectivity as problematic and in need of reform.

It is possible to articulate another view of subjectivity. Subjective formulations of due care represent judicial tailoring of a legal rule. Prior to the prohibition of exculpations, firms could contract around the default standard of care. However, the incentive to contract around a default depends on two considerations. The first is the extent to which a default is penal. Although the notion that early principles of director negligence were penal is, in retrospect, laughable, it is instructive to remember that these principles were still largely nascent at the turn of the century. Corporate law was still under the influence of the more severe trusts doctrine which derived from deed of settlement companies. *City Equitable* authoritatively rejected the applicability of trustee standards to directors. Thus, a penalty default induces the parties to contract around it. The second consideration (which tends in the opposite direction) is the extent to which courts tailor the legal rule. A process which tailors the legal rule to the parties' circumstances by providing a term approximating one they would have reached (had they been permitted to do so) decreases the need for *ex ante* contracting. Tailoring thus partially overcomes the problem of selecting an inefficient legal rule.

A subjective standard of care therefore resembles a tailored rule, albeit no longer a tailored default. The rule requires directors to perform to a standard referable to their personal ability. This has two advantages. First, it permits more efficient risk allocation. Duties of care allocate between directors and shareholders the risk of various losses. A subjective standard of care allocates to directors those risks which they have the ability to bear. A director would not contract to bear risks that are beyond his or her ability. The second consideration involves network effects. I have noted above the disincentives and difficulties of drafting a due care term.[270] This discourages contractual innovation. Tailored defaults partially overcome this problem by *ex post* formulation of a subjective standard.

[267] Companies Act 1929 (Eng) 19 & 20 Geo 5, c 232, s 152. This provision was adopted by the Australian States in the following legislation: Companies Act 1931 (Qld) s 160; Companies Act 1934–5 (SA) s 170; Companies Act 1936 (NSW) s 132; Companies Act 1938 (Vic) s 152; Companies Act 1943 (WA) s 157; Companies Act 1959 (Tas) s 97.

[268] See below Part VI(E).

[269] *City Equitable* [1925] Ch 407, 428. See also *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392, 435.

[270] See also Ayres, above n 14, 1412–3.

The complaint that the subjective standard was insufficiently demanding is doubtful, since firms could choose to select highly skilled directors of whom comparatively more might be expected. If firms chose not to select such directors, it is not obvious that the legal rule is the problem.

There are two problems of tailoring. First, tailoring may favour a party possessing private information which a penalty default would force that party to disclose. This is arguably less of a problem in the context of director negligence. Unlike fiduciary breaches, negligence rarely involves information asymmetries. Second, the tailoring process may produce an unsuitable hypothetical bargain. It is important to note that the subjective duty of care process could only err if it produced too high a standard.[271] The statutory prohibition on exculpations never precluded a director from giving a contractual pledge to act according to a *higher* standard of care. A director might signal his or her quality by contracting to observe, say, a trustee standard of prudence, or by providing some other form of bonding.

It follows that even after contracting out of duties of care was proscribed, the law continued to supply legal rules that were sensitive to the contractual equilibria of shareholders and officers. This sensitivity was achieved by subjective standards which preserved tailoring. The law (or at least judicial rhetoric) has changed much in the last 15 years. Although there are few examples of directors being held to be negligent,[272] the subjective standard seems to have been rejected.[273] Ironically, however, the ghosts of subjectivity still haunt the statutory duty of care. The statutory exculpation provision, s 1318 (also structured around good faith standards), may open a back door for subjective tailoring. On balance, however, we again find that the modern law is less sympathetic to contract than was the old law.

E *Statutory Provisions on Indemnity and Insurance*

It was noted earlier in this Part that the duty of care default became an immutable rule when prohibitions on excusing directors from breach of duty were enacted. These enactments followed the *City Equitable* decision.[274] I noted above that these provisions do not affect the conflict rule,[275] and it has never

271 Of course, no one has ever suggested this to be a problem.

272 As opposed to indirect considerations in, for example, cases of insolvent trading. The reported cases are those of chief executive John Hooke in the AWA litigation (*Daniels v Anderson* (1995) 16 ACSR 607 *sub nom AWA v Daniels* (1992) 7 ACSR 759), and managing director and chief executive officer Marcus Clark in *South Australia v Clark* (1996) 19 ACSR 606. That case was complicated by a fiduciary breach, as was the case of chief executive Brian Hamilton (who was held to be negligent, but to have no liability to pay damages) in *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109. See also *Re Australasian Venezolana Pty Ltd* (1962) 4 FLR 60.

273 The most authoritative analysis of this issue is *Daniels v Anderson* (1995) 16 ACSR 607, 664–7.

274 Great Britain, *Report of the (UK) Company Law Amendment Committee* (Cmnd 2657, 1926) [46]–[47].

275 *Movitex Ltd v Bulfield* [1986] BCC 99,403.

been suggested they limit the ability to expand or narrow the ranges of proper purposes for the exercise of a power. However, these provisions, and those on directors' and officers' ('D & O') insurance were revised by the Corporate Law Reform Act 1994 (Cth). These changes are significant to contractarianism. I discuss them here since they have continued relevance for the duty of care.

Corporations Law ss 241 and 241A presently regulate officer indemnity and insurance. The former was amended and the latter added by the Corporate Law Reform Act 1994 (Cth). The old s 241 prohibited provisions (whether in articles or elsewhere) that exempted an officer from, or indemnified an officer against, liability for negligence, default, breach of duty, or breach of trust. The coverage was thus far greater than duty of care liability to company. Its width necessitated a provision, s 241(3), permitting directors to enter into insurance contracts, provided the company did not pay the premiums.[276]

After the amendments, the indemnity prohibition is restricted by s 241(1) and (2) to liabilities to the company *qua* officer. The other significant change in drafting was that the prohibited indemnification and exemption was of 'liability incurred by the person as such an officer'. The references to defaults, breaches of trust and breaches of duty were removed. The section continues to prohibit indemnifying directors for liability for damages in negligence. Although directors and shareholders are prohibited from agreeing to transfer directly the risk associated with the duty of care, that risk can nonetheless be shifted by insurance. The new s 241A removes the prohibition on companies paying the premiums.[277] The cost of such risk shifting is therefore indirectly borne by shareholders.

D & O insurance policies have recently been the subject of litigation in a way that has some interesting parallels to a contractarian theory of default rules.[278] In the *Compass Airlines Case*, directors were sued for negligence and looked to their insurer to meet the legal costs. The directors had not disclosed the company's insolvency to the insurer. The insurer alleged that it had no liability given the non-disclosure. The court held that the directors were obliged to disclose insolvency because they were parties to the policy and in consequence of their duty of utmost good faith.[279]

This result requires directors to disclose information of which they are aware in order to get the benefit of the corporate insurance policy. Interestingly, this

276 This is a self-trivialising rule. Insurance becomes part of the cost of functioning as director. Such an increase in marginal cost would result in a change in the equilibrium price paid for director remuneration.

277 However, this prohibition is retained to the extent that the insured liability is incurred as a result of an officer's wilful breach of duty in relation to the company: s 241A(1). This is a common exclusion in D & O insurance policies, anyway: see Desmond Derrington and Roger Ashton, *The Law of Liability Insurance* (1990) 555–6. This provision specifically includes liability under s 232(5) and (6), and in all likelihood, the duty of honesty in s 232(2).

278 *CE Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 ('*Compass Airlines* case') *sub nom Carden v CE Heath Casualty & General Insurance Ltd* (1992) 7 ANZ Insurance Cases [61-147]. The former s 241 was in force at all relevant times. See also *Antico v CE Heath Casualty & General Insurance Ltd* (1995) 8 ANZ Insurance Cases [61-268].

279 *Compass Airlines* case (1993) 32 NSWLR 25, 36–7.

serves much the same effect as a penalty default. It compels the contracting party to reveal information which the other party will systematically be disadvantaged in obtaining.[280] This has efficiency consequences because it reduces, or eliminates, the cross-subsidisation of high risk insured by low risk insured.[281] Cross-subsidisation results from the difficulty of distinguishing the two types. This disclosure compulsion reduces adverse selection *ex ante* and moral hazard *ex post*. In contrast, the release of directors from negligence liability by *ex ante* contracting is less effective in this respect. While a release from liability may be vitiated by relevant non-disclosures by corporate directors (so solving the adverse selection problem), a blanket release included from the time of incorporation could not be similarly treated. Moreover, no contractual means — apart from indirect ones such as bonding — can do much about the *ex post* moral hazard problem of directors 'slacking off' in consequence of a general release from duties.[282] On this criterion, permitting insurance and prohibiting release seems an efficient solution.[283]

However, is the insurance worth its price? While shareholders probably are no better risk-bearers than insurers (both can diversify), the scale of insurance premiums may lead to insurance being unaffordable for some companies, given the exposures in certain industries.[284] Therefore, while the insurer may be the best risk-bearer, the practical choice may end up being between director and shareholders. If legislation forecloses such a choice, as it presently does, social costs may follow.[285] CLERP should seriously consider the strategy followed by the American states concerning director indemnification. In the 1980s, successful negligence actions against directors drastically increased the cost of insurance, putting it out of many directors' reach.[286] The states responded by permitting companies to propose to shareholders an amendment of their articles, which would cap or eliminate liability for negligence.

A final point on duties of care and indemnity is raised by the insolvent trading provisions. These subject directors to liability where their corporations incur debts under circumstances of insolvency. The effect of the insolvent trading provisions on the development of the modern duty of care is inestimable. They

[280] Cf ibid 28. The decision in *Antico v CE Heath Casualty & General Insurance Ltd* (1995) 8 ANZ Insurance Cases [61-268] also implies that disclosure of possible claims needs to be very specific.

[281] Ayres and Gertner, 'Filling Gaps', above n 12, 100.

[282] This is because there are no opportunities for renegotiating, or 'settling up', the shareholder-manager contract: see generally Oliver Williamson, *The Economic Institutions of Capitalism* (1985) 304–6. The insurer, by contrast, can raise the premium.

[283] Easterbrook and Fischel, above n 5, 47–9; Charles Goetz, 'A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven' (1986) 71 *Cornell Law Review* 344. Cf Finch, above n 266, 890–1.

[284] See also Finch, above n 266, 893.

[285] On this issue, see generally Ramsay, 'Liability of Directors', above n 1; John, above n 11.

[286] For a review of crises in D & O insurance and the related passage of director indemnification legislation in the United States, see Cindy Schipani, 'Defining the Corporate Director's Duty of Care Standard in the United States and Australia' (1994) 4 *Australian Journal of Corporate Law* 152, 157–9.

provided a seed bed for reconceptualising directors' obligations to be informed.[287] In 1993, the provisions were revised to intensify this obligation. It is common to speak now of a director's duty to prevent insolvent trading. This duty has a strongly mandatory quality. However, in contrast to other contractarian critiques,[288] I have elsewhere suggested that the purposes of the rules would be better served if they were recast as default rules.[289] Specifically, a director knowing the company to be near insolvency could, by disclosing the company's condition, agree with each new creditor to exclude the director from insolvent trading liability. The debt could be more accurately priced, given the extra disclosure. They would thus function as a penalty default. Although not free from doubt, the desired result may be possible given the limitation of the new indemnity prohibition, since 1994, to the officers' liability *qua* officer to the company. Since creditors, not the company, are the intended beneficiaries, they should be able to waive their rights. The problem however is that the new insolvent trading provisions provide in effect that compensation recovered from the director is to be shared amongst all unsecured creditors. No longer is the right that of the counterparty to the insolvent trade, as under the old insolvent trading provisions. In effect, all creditors would have to agree to the directors' release. This is unlikely to occur.

VII Conclusions: The Contractarian Agenda in Prospect

This article has shown that the common law and equity traditionally permitted contractual variation of the duties imposed on officers on an *ex ante* basis and allowed contracting around its prohibitions *ex post*. Statute, however, has greatly restricted *ex ante* contracting, except for the conflict rule in proprietary companies and the possibility of cases where proper purposes are expanded. *Ex post* contracting still exists but in cases of conflicts has become heavily proceduralised. These conclusions have important implications for how we theorise Australian corporate law. Contractarians assert that their critics rely on a 'concession' theory of corporations, in which corporations are created by the state, having such rights as are conceded to them.[290] Contractarians accept that such an argument may have been correct in the eighteenth century, but has faded from view as incorporation became a general right. While such an assertion is doubtful on the basis that most modern advocates of mandatory law have not invoked concession theories,[291] it also distorts the history of Anglo-Australian

287 Whincop, 'Critique', above n 11, 74–6.
288 Byrne, above n 11; Mannolini, above n 11.
289 Whincop, 'Insolvent Trading', above n 11.
290 See, eg, Butler and Ribstein, 'Opting Out', above n 5, 8–10; Robert Hessen, 'A New Concept of Corporations: A Contractual and Private Property Model' (1979) 30 *Hastings Law Journal* 1327. For repetition in Australia, see Mannolini, above n 11, 17.
291 William Bratton, 'The "Nexus of Contracts" Corporation: A Critical Appraisal' (1989) 74 *Cornell Law Review* 407, 434–5.

law.[292] At times when incorporation was more of a concession that it is now, the positive contractarian thesis was a convincing explanation of officers' duties.[293] Mandatory provisions came later, primarily from parliament, and were justified not on concessionary grounds, but on implicit market failure grounds. Australian experience has thus been the reverse of that in the United States, where competitive chartermongering between state legislatures increased avoidability.

This article has shown that common law and equity treated directors' duties as default rules, which could be modified *ex ante* and which courts were sometimes prepared to tailor *ex post*. Generally, courts were willing to tailor the duty of care and the proper purposes rule, but applied penalty defaults in conflict rule cases, consistent with the moral hazard potential. Also, courts tailored rules which were harder to specify *ex ante*, whether because of the 'muddy' nature of the jurisdiction or the related network effects.

The case law implies that while fiduciary duties and duties of care permit modification and tailoring, a standard of good faith limits and informs this process. This analysis supports Coffee's theory that good faith is an essential mandatory principle in officers' liability and not Bratton's theory that company law contains various normative centres of gravity of which good faith is only one. However, the intensity of the good faith standard varies greatly. In the context of duties of care, it requires little more than honesty. In contrast, action taken in the context of a competition for control is reviewed closely.

I would conclude that the failure to understand the meaning of good faith in corporate law, and the neglect of its affinity to the contractual doctrine of good faith, has been unfortunate. When judges have referred to good faith or *bona fides*, they have usually indicated that this principle was simply part of the basic fiduciary principle — and, at times, a part that was of limited meaning.[294] Gower, for instance, thought that provisions equivalent to s 241 permitted the modification of some duties, but not the duty to act in good faith.[295] Despite its anticipation of the arguments herein, the argument was vulnerable to attacks on its derivation.[296] Those attacks could have been answered if the modification of directors' duties was understood as a matter of contract. So understood, modifying a duty was not a licence for fraud, because opportunistic reliance on the contractual terms could be invalidated by a flexible good faith principle.

I commenced this article by referring to CLERP and the implications of economics for corporate law. CLERP's brief to advise on the reform of the law must be seen in context: virtually every taskforce or program preceding it, for the past 70 years, has contributed to the restriction of contractual freedom in corporate

[292] Cf Stephen Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 *Federal Law Review* 203.

[293] In these times, the key mandatory terms in corporate law were justified as protecting creditors from the abuse of limited liability.

[294] *Mills v Mills* (1938) 60 CLR 150, 169, 187–8; *Peters' American Delicacy Company Ltd v Heath* (1939) 61 CLR 457, 512.

[295] See, eg, L Gower, *The Principles of Modern Company Law* (3rd ed, 1969) 531–2.

[296] See, eg, Baker, above n 169, 188; Birds, above n 169, 396; Rule and Brar, above n 169, 7.

law and the growing falsification of the positive contractarian thesis. The Simplification Task Force is hardly an exception to that conclusion.[297] If CLERP considers swinging the mandatory default pendulum back in the opposite direction, it will do so with the benefit of conforming to the basic ethos of corporate law at common law and in equity. Although this article has looked primarily at the positive contractarian thesis, it can offer one normative conclusion: the traditional law's default rule structure was efficient because it had powerful rules compelling the disclosure of private information as part of contracting processes. Other rules supplied the parties with what they would have provided for but found it difficult to obtain by *ex ante* contracting. The argument for default rules is not just historical, but is supported by economic analysis.

However, history and theory carry limited normative weight. Law reform cannot be determined only by doctrine or theory, to the exclusion of empirical evidence. Major strides have recently been taken in empirical corporate law research in Australia.[298] However, the research has told us little about how parties actually use contracts in the governance of corporate relations and the protection of the integrity of exchange.[299] The research has been primarily descriptive. It has not sought, at this stage, to test hypotheses derived from (for example, economic) theory.[300] In other words, it provides no unequivocal support for normative contractarian analysis. This is not to criticise the empirical research, but to demonstrate limitations on theoretical research used to generate policy implications. Contractarian research is built on assumptions and comparative assessments. Until there is evidence that those assumptions are realistic and tractable, contractarian scholars cannot convince regulators that they should abandon a Berle and Means world view.

297 Whincop, 'Trivial Pursuit', above n 52.

298 See, eg, Helen Bird, 'The Problematic Nature of Civil Penalties in the Corporations Law' (1996) 14 *Company & Securities Law Journal* 405; Andrew Defina, Thomas Harris and Ian Ramsay, 'What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation into the Relationship Between Pay and Performance in the Largest Australian Companies' (1994) 12 *Company & Securities Law Journal* 341; Thomas Harris and Ian Ramsay 'An Empirical Investigation of Australian Share Buy-backs' (1994) 4 *Australian Journal of Corporate Law* 393; Jennifer Hill '"What Reward Have Ye?" Disclosure of Director and Executive Remuneration in Australia' (1996) 14 *Company & Securities Law Journal* 232; Jennifer Hill and Ian Ramsay, 'Institutional Investment in Australia: Theory and Evidence' in Walker and Fisse (eds), above n 9, 289; Ian Ramsay, 'Corporate Disclosure of Loans to Directors: Report of an Empirical Study' (1991) 9 *Company & Securities Law Journal* 80; Ian Ramsay, 'Why is There so Little Empirical Corporate Law Research? A Comment' (1996) 3 *Canberra Law Review* 110; Ian Ramsay and Mark Blair, 'Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies' (1993) 19 *Melbourne University Law Review* 153; Geofrey Stapledon, *Institutional Shareholders and Corporate Governance* (1996); Roman Tomasic and Stephen Bottomley, *Directing the Top 500: Corporate Governance and Accountability in Australian Companies* (1993).

299 Most of the work in this area has been primarily done by accounting researchers: Greg Whittred and Ian Zimmer, 'Accounting Information in the Market for Debt' (1986) 26 (2) *Accounting & Finance* 19; Donald Stokes and Tay Kok Leong, 'Restrictive Covenants and Accounting Information in the Market for Convertible Notes: Further Evidence' (1988) 28 (1) *Accounting & Finance* 57; Donald Stokes and Michael Whincop, 'Covenants and Accounting Information in the Market for Classes of Preferred Stock' (1993) 9 *Contemporary Accounting Research* 463.

300 For an exception, see Ramsay and Sidhu, above n 34.

What, then, do we need to know? First, the normative contractarian thesis needs evidence on the 'pricing argument' that corporate governance terms are priced in primary securities markets. While tests with statistical validity are difficult, evidence may come from examining case studies in the pricing of IPOs. In particular, the negotiation process between underwriters and issuers would give us an indication of the extent to which insiders bear agency costs, and the connection between efficient governance and efficient markets.

Second, much evidence could be obtained by examining how contracts are used in small businesses. Small businesses represent a rare opportunity for us to examine contract in action, since the smaller number of parties provides them an opportunity to bargain out the terms of corporate governance in a way that is not readily paralleled in large corporations. The study of the contracts used is vital. Ronald Coase, in his Nobel Lecture, stated that:

> [i]t makes little sense for economists to discuss the process of exchange without specifying the institutional setting within which the trading takes place since this affects the incentives to produce and the costs of transacting. ... The process of contracting needs to be studied in a real world setting. We would then learn of the problems that are encountered and of how they are overcome and we would certainly become aware of the richness of the institutional alternatives between which we have to choose.[301]

Such a process sheds light on how corporate law impacts on private contracting. Do the parties assume that corporate law fills gaps in their bargains as contractarians suggest? Do they prefer to rely on reputation and ethics, rather than law and contract? If people answer these questions differently, why is that so? How we answer these questions may profoundly affect the cases for and against regulation. Such primary research can also explain the nature and incidence of transaction costs, which are at the heart of all economic theories of corporate law. A coherent theory of small corporations can then be incrementally modified for the changes one expects as firms evolve, such as the effect of listing and the increase in collective action problems.

Australian Stock Exchange managing director Richard Humphry recently called for the repeal of the Corporations Law and the building of a new Act from the ground up.[302] For all the statute's inefficiencies, I cannot join in this call with much enthusiasm. First, such abolition would destabilise existing networks of contracts, which depend on the fixity and status of legal default rules. Second, without the sorts of empirical research for which I have identified a need, we are no closer to selecting the most appropriate of the many available theoretical inputs to guide redrafting. Third, the call ignores the fact that a lot of the Corporations Law is trivial, and most of the replacement statute would also be

[301] Ronald Coase, '1991 Nobel Lecture: The Institutional Structure of Production' reprinted in Oliver Williamson and Sidney Winter (eds), *The Nature of the Firm: Origins, Evolution and Development* (1993) 227, 233.

[302] 'Humphry says "start again" with Corporations Law' (1996) 6 *Butterworths Corporations Law Bulletin* [443].

so. Fourth, as Ian Ayres has argued,[303] even the best legislation makes only a minor contribution to contractual equilibria. Legislatures labour under even greater difficulties of information than the parties to the corporate nexus of contracts. By contrast, the key players are the courts, which are in a position to effect *ex post* balancing of interests and to administer penalty defaults. It is important to understand the nature and economic underpinnings of the jurisdiction the courts exercise, and in particular, to recognise the role of good faith as a central normative principle. This article is a step towards that understanding.

303 Ayres, above n 14, 1413–4.