DIRECTORS' "WIDER" RESPONSIBILITIES – PROBLEMS CONCEPTUAL, PRACTICAL AND PROCEDURAL†

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INTRODUCTION

This is a period of major change for company law. The massive output of the legislators is ample testimony to this. Less obviously, but potentially every bit as far-reaching and fundamental, there are stirrings in the case-law too, as it slowly becomes apparent that the ancient rules and concepts which may have served their purpose well enough when the companies of the 1880s brought their disputes before the courts of the 1880s can no longer cope satisfactorily, even with the same problems, a century further on. And of course, many of the problems are new too.

We have been slow to recognise how different everything has become since that formative period a hundred years ago when Lord Lindley and his brethren laid down the ground rules of the company law that we have inherited. The typical company has changed, but our perceived image of the notional company that the law exists to serve has not. The framework of fundamentals on which the more detailed rules of company law are based has lost some key components; but we have been slow to adjust. Have we given proper thought to filling the vacuum left by the abolition of ultra vires, or to the adequacy of the "maintenance of capital" principle to deal with the ubiquitous two-dollar company? Judges (particularly in the wider world remote from London) today come from different backgrounds and bring different experiences to bear in their adjudication of corporate disputes. The language of nineteenth-centry chancery is imperfectly understood by most lawyers and is inconsistently applied. Concepts, procedures, remedies, and above all, fact-situations have not remained static, and we must expect the law to respond.

I make this state of affairs my excuse to examine the law of directors' duties not simply as an analysis of the precedents appears to show it but, rather more radically, as I believe we ought to be beginning to see it. In so far as writing *de lege ferenda* allows one to ignore the more exciting demands of traditional scholarship, I make apology in advance.

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BACKGROUND

The pattern of the nineteenth-century company was so well settled that its essential features could be assumed not only by the judges, but by the Joint Stock Companies Acts themselves. This "model" company would have corresponded roughly with the middle-sized public company of today, though it would have had a markedly different capital structure, fewer institutional shareholders and more of the human variety — interested, active and vocal — and a less professional directorate. In the heyday of laisez-faire, it would unquestionably have been dedicated to the maximisation of profit, in banking, manufacturing, the railways, and all the manifestations of the Industrial Revolution.

Although the separate personality of the company was acknowledged long before it gave immortality to Mr. Salomon in 1897, there is abundant evidence that in the Victorian lawyer's eyes "the company" was regarded as the associated members rather than the legal entity: the company was "they" and not "it". We have, of course, left this way of thinking behind us long ago. It would be hard, anyway, to conceive of the one-person company, the wholly-owned subsidiary or many other typical modern incorporations as "they", or indeed as an association of any kind.

Much of the law handed down to us reflects this Victorian perception of the company, in particular (for present purposes), the idea of the director as trustee or agent for his (or her) constituents, the company in the sense of the collective corporate membership. It is they who have chosen him, warts and all; they who can remove him; they who can ratify his acts in excess of authority and forgive his sins; even, for many decades, they who could dictate to him and his co-directors how to run the business.[1] His duties of care and skill can properly be assessed by subjective criteria, since he has been elected for whatever qualities he has. And in fixing his duties to the company it is right to take account of the particular terms of the members' social contract (i.e. the memorandum, including the objects clause, and the articles of associaton), since all concerned are party to it.

The language of trust, as Lord Lindley and his predecessors would have understood and used it, was apt to meet the claims of the day against delinquent directors. One could abuse (or breach) a "trust" without being formally constituted a trustee of particular property; there could be a "fraud" on a discretionary power without any imputation of dishonesty; the use of powers for an improper purpose was not a "bona fide" exercise of those powers, irrespective of any question of motive; and one could be held accountable in equity for one's wrongdoing without bringing into play all the ramifications of the constructive trust as it is generally understood nowa-

[1] See, e.g. *Companies Clauses Consolidation* Act 1845, s.90, and the judgment of Cotton L.J. in *Isle of Wight Rly Co.* v. *Tahourdin* (1883) 25 Ch.D. 320, 329. The modern approach, which regards the board of directors and the general meeting as separate autonomous organs, was first judicially recognised in *Automatic Self-Cleansing Filter Syndicate Co. Ltd.* v. *Cuninghame* [1906] 2 Ch. 34.

days. If the law on directors' duties is to be re-stated so as to make the best sense to us latterday twentieth-century lawyers, it might well be best to avoid old terms like these which contain the seeds of much misconception.

All directors owe duties of a fiduciary nature to their company, breach of which may give rise to the avoidance of contracts, accountability for secret profits, and so on. It is not with this aspect of directors' duties that we are concerned in this paper, but with duties in the exercise of their powers,[2] and incidentally with their obligations of care and skill. These duties are conventionally formulated as follows.

"Directors", said Lord Greene M.R.,[3] "must exercise their discretion bona fide . . . in the interests of the company, and not for any collateral purpose." This formula has been glossed in a succession of cases, particular in regard to the meaning of the term "the company", in whose interests the directors must act. I am grateful to adopt the exposition of Professor Ford.[4] "The company" is not "the abstract entity", but "the members as a whole in their capacity as associated persons." However, "the members" is the membership as a continuum: directors are to "balance a long term view against the short term interest of the present members." But that is not all, for there are shareholders and shareholders; membership of B.H.P. Ltd. is not the same thing as membership of a home-units company, and so the members' "capacity as associated persons" requires their particular social contract to be taken into account: "the position in Australia . . . is that the company is the totality of members viewed in the light of their association and corporate objects." The directors' duty to the company, so conceived, has at various times been contrasted with their position vis-à-vis its individual members, or a section of the membership, or its employees, or its creditors. Towards each of these, it is traditionally asserted, directors owe no legal duties whatever, least of all towards the company's creditors.

Before we move on from this classic statement of directors' duties one or two comments should be made.

(a) The duty to act bona fide in the interests of the company and the duty to use powers for proper purposes are treated in some books as distinct[5] and in others as being different ways of saying the same thing.[6] I do not think that this question is important, at least for the present discussion:

[2] The common-law duty is codified by the *Companies Code* (Aus.), s.229(1) as follows:
"An officer of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties in his office".
Apart from the fact that the company's creditors are referred to for the purposes of s.229(1)(*b*), which fixes a higher criminal penalty in cases of fraud, the section does not throw any light one way or the other on the issues considered in this paper.

[3] *Re Smith and Fawcett Ltd.* [1942] Ch. 304, 306.

[4] H.A.J. Ford, *Principles of Company Law* (Sydney, Butterworths, 4th ed. 1986), para. 1507, (hereafter "Ford"); cf. P.D. Finn, *Fiduciary Obligations* (Sydney, Law Book Co., 1977) paras. 136ff., esp. 139.

[5] E.g., L.C.B. Gower et al., *Principles of Modern Company Law* (London, Stevens & Sons, 4th ed. 1979), Chap. 24; Afterman, *Company Directors and Controllers* (Sydney, Law Book Co., 1970) at pp. 44, 63; J.H. Farrar, *Company Law* (London, Butterworths, 1985) at pp. 309, 312.

[6] E.g., Ford, op. cit. para. 1503; Finn, op. cit. paras 136ff.

even though there may be some advantage at times in looking at the two questions separately, there is certainly a large area of common ground where the issues can be put interchangeably. What is important is that a court should not be distracted from doing justice by giving too limited a meaning to a term such as "bona fide"; and if this can be avoided by recourse to the second formulation, whether as an additional test or as an alternative wording, that is all to the good.

(b) It has long been accepted that the test of "the interests of the company" is not an appropriate one where the only question is one of the relative rights of different categories of shareholders inter se and the directors' decision must operate favourably to one class and adversely to the other. Here the law can only impose a duty to act "fairly".[7]

(c) Elsewhere in the text-books,[8] we learn that there is also an obligation to act "bona fide for the benefit of the company as a whole" when majority shareholders exercise their voting powers so as to bind minorities in such matters as altering articles of association.[9] Whether this rule is in every respect co-extensive with that applied to directors (and, in particular, whether "the company" is to be understood in the same sense) is a question which we cannot fully examine here, although we shall not be able to avoid it entirely.[10]

(d) In some cases the judges speak of acts in abuse of the powers of the company rather than the powers of the directors.[11] Where the acts in question are those of the directors, the former is surely an unhelpful expression — at least now that no question of corporate capacity can arise, following the quietus administered to ultra vires. But where the acts being challenged are those of the shareholders, there may be room for talk of "abuse of the powers of the company": something of a novelty to which we shall return later.[12]

The juridical basis on which directors' duties have traditionally been enforced is that of the trust:[13] the fact that all the cases were heard in the Courts of Chancery and the ready parallel which could be drawn between

[7] *Mills* v. *Mills* (1938) 60 C.L.R. 150, 164; cf. Finn, op. cit. paras. 144ff.

[8] E.g. Ford, op. cit. paras. 1703ff.

[9] *Allen* v. *Gold Reefs of West Africa, Ltd.* [1900] 1 Ch. 656.

[10] If the issue is put in the alternative form, posing a "proper purposes" test, it is sometimes possible to throw a sharper light on the distinction. For example, while it may not be proper to use the directors' power to allot shares for the primary purpose of keeping the directors themselves in office and their corporate policies alive, there is no reason why a shareholders' vote authorising or ratifying the same decision should be struck down as improper, since the choice of directors (and the endorsement thereby of their policies) cannot be the concern of anyone but the company's shareholders — a point not taken in the leading case of *Winthrop Investments Ltd.* v. *Winns Ltd.* (1975) 2 N.S.W.L.R. 666.

[11] See, e.g., *Rolled Steel Products (Holdings) Ltd.* v. *British Steel Corporation* [1986] Ch. 246, 295ff., 303ff.

[12] Infra, p. 182.

[13] Ford, op. cit. para. 1502; F. Dawson, "Acting in the Best Interests of the Company — For Whom are Directors 'Trustees'"? (1984) 11 N.Z.U.L.R. 68, 78. [As will be apparent, my debt to Dawson is immense, not only for the observations in this most perceptive note, but also for stimulating discussions I have had with him both before and since its publication].

director and trustee were sufficient to see to that. Today, we would more naturally speak of the principles of fiduciary obligation. There is no reason why the law of directors' duties should stay within this conceptual straitjacket, if it is too restrictive or too uncongenial to deal with modern problems: in appropriate situations agency, contract, restitution, tort and (increasingly) statute may be called in aid as well. But trust law does have some advantages. By setting high standards of loyalty and integrity it acts as a salutary prophylactic, important wherever people have power over other people's property. The primary remedy sought is often not compensation or damages but the avoidance of a transaction and/or the return of property: equitable remedies allow for full and detailed orders, providing for restitution, accounting, and so on, and they can very readily reach implicated third parties as well as the immediate wrongdoers.[14]

The language of trust and trusteeship, and its principles, fit the directors' situation well enough in relation both to property and powers: directors as trustees of the corporate assets under their control, directors as trustees of their constitutional powers. The earliest cases were mostly about property: it was a "breach of trust" or "misfeasance" for directors to dispose of corporate property in an ultra vires or illegal transaction or to return capital to shareholders – and, of course, to give it without authority to themselves. In the present century, there have been more cases concerned with powers: the directors' power to make calls, to refuse registration of a transfer, to create reserves, capitalise profits, allot shares – even to deal with corporate assets. It is this latter topic of "powers in trust" on which most of the present discussion is centred.

The test of "bona fide in the interests of the company" served well enough in the earlier cases: if there was proof that an allotment of shares (say) had been wrongfully motivated – e.g. to favour one faction of shareholders, or to spite another, or *a fortiori* to benefit the directors themselves – it would be struck down, but in the absence of such proof the directors' decision would be upheld. An act which was in fact discriminatory in its effect would not necessarily be upset under this formula, however, if it could be seen as consistent with bona fides, or "fairness", or with the long-term interests of members generally; and the onus of proof to the contrary was on the objecting shareholders. It was recognised that the "bona fides" test was not wholly subjective: a board of "amiable lunatics" could not be allowed to give away the company's property in a manner perfectly bona fide yet perfectly irrational.[15] In the last two or three decades, the language of bona fides has been displaced by language of "proper purpose", largely to meet cases where

[14] The leading case of *Regal (Hastings) Ltd.* v. *Gulliver* [1967] 2 A.C. 134n. was inexplicably presented as a claim for money had and received, with the result that this advantage was lost, only four of the six defendants being held severally liable, instead of all six jointly and severally.

[15] *Hutton* v. *West Cork Rly. Co.* (1883) 23 Ch.D. 654, 671; *Pavlides* v. *Jensen* [1956] Ch. 565, 570. An objective threshold is also applied to the similar bona fides test applicable to shareholders' decisions in general meeting: see, e.g., *Re Westbourne Galleries Ltd.* [1971] Ch. 799,811 (reversed on other grounds, *Ebrahimi* v. *Westbourne Galleries Ltd.* [1973] A.C. 360).

the subjective good faith of the directors has been acknowledged but their decision has had implications for their own personal position — e.g. in throwing weight behind their own supporters in a take-over battle.[16] Here, it is said, a power must be exercised substantially within the limits of the purposes for which it can properly be regarded as having been conferred on them by the corporate constitution.

The techniques just described form quite a powerful array of weapons to keep directors' conduct under control, though there are gaps and weaknesses. Experience has proved that they are not adequate to deal with inactive or incompetent directors or with those who take irresponsible business risks — assuming that this should be a concern of the law. They are also subject to the potentially serious flaw that all these breaches of duty (ultra vires, illegality and "fraud"[17] apart) have always been considered capable of being ratified or condoned by the shareholders (consistently with the trust principle on which they are based), so that the ultimate control does not rest with the courts. This has led to a breakdown in the effectiveness of the law in the many modern instances where there is substantial identity between directors and controlling shareholders.

It is to this and similar "modern instances" that we must now turn. In today's world, Lord Lindley's prototype company hardly has a place: fewer than 0.5% of the companies registered in Britain are public companies, in contrast, about 70% are "close" or "shareholder-managed". No doubt the picture in Australia is much the same. The "group" company, the wholly-owned subsidiary, the joint venture company, the trading trust company and the small proprietary company dominate the scene, and if we are to reshape company law for the 1990s, these must be seen as its main subjects. Drafting refinements, worked out over decades, have produced corporate constitutions that contain enabling powers and self-serving licences of a breadth and indulgence which our grandparents would have found unbelievable. Most of the companies which have featured in recent key cases have been under-capitalised — another modern phenomenon, whose use our legislatures have (I believe rightly) not sought to check. The take-over bid, the shelf company, the multinational conglomerate, the comfort letter, the offshore nominee, and so on did not complicate the picture in Victorian days, nor did the all-pervasive intricacies of modern tax law.

THE TRADITIONAL VIEW UNDER CHALLENGE

It is against this background that the traditional rules and concepts of company law regarding directors' duties have come under challenge. This law, concentrated as it is on the interests of shareholders and no other group, is thought to be too narrowly focused. It is contended on many sides that

[16] The leading case is *Howard Smith Ltd.* v. *Ampol Petroleum Ltd.* [1974] A.C. 821. For a recent illustration, see *Pine Vale Investments Ltd.* v. *McDonnell and East Ltd.* (1983) 1 A.C.L.C. 1294.

[17] I.e. "fraud" in the equitable sense recognised in *Daniels* v. *Daniels* [1978] Ch. 406.

the law ought to allow, or even require, directors to have regard to other, wider, considerations and interests. There are demands for overt recognition of the claims of the company's workforce, its customers and clientele, its suppliers and creditors, more broadly, the local community, the national interest, exports, welfare, the environment.

These issues have come to the surface at different times and in different contexts. In the earliest group of cases, minority shareholders and liquidators challenged "enlightened" acts of ultruism, such as paying gratuities and pensions to employees[18] and donations to educational and other charities,[19] using primarily as a weapon of attack the still potent doctrine of ultra vires. With time, however, it has come to be seen as normal for directors to behave thus, consistently with the emerging notion of corporate "good citizenship", and their acts have been upheld on the argument that such apparent largesse could be seen as having derivative benefits, albeit perhaps long-term, for the shareholders. (The argument falls through, however, when the company is planning to go out of business.[20]) With changes in public opinion, more widely drafted objects clauses, and ultimately the demise of the ultra vires doctrine, we can now regard this as one of yesterday's problems.

The next challenge to orthodoxy was mounted mainly in fields outside the law, and has filled volumes of writing in political, economic and social theory.[21] It was inevitable that the shift away from nineteenth-century self-interest to modern theories of the business enterprise and the "responsible" corporation should lead to pressure for some recognition within company law of the view that the providers of share capital are not the only contributors to the wealth-making process; and in particular, for explicit acknowledgment of the role of the workforce. But despite the enthusiasm with which this cause has been taken up by many influential authors, the response has been lukewarm and it has found very little expression in company law. The first opportunity came when directors, in a series of take-over battles commencing with the bid for the Savoy Hotel in 1954, sought to justify defensive measures (which would, incidentally, secure the continuation of their own policies and, of course their own jobs) by arguments based on a concern to see that employees, customers and others were not sold down the river by asset-strippers interested only in short-term profits. This argument, as such, has found no support in the judicial rulings: such issues are for the shareholders, and the shareholders alone, to evaluate.

More ambitiously, in Europe, attempts have been made to have the traditional management structures of larger companies overthrown by legislative change, introducing compulsory employee representation on boards of

[18] *Hampson* v. *Price's Patent Candle Co.* (1876) 45 L.J. Ch. 437; *Hutton* v. *West Cork Rly. Co.* (1883) 23 Ch.D. 654; *Re Lee, Behrens and Co.* [1932] 2 Ch. 46.

[19] *Evans* v. *Brunner Mond Co. Ltd.* [1921] 1 Ch. 359.

[20] *Hutton* v. *West Cork Rly. Co.,* (1883) 23 Ch.D. 654; *Parke* v. *Daily News Ltd.* [1962] Ch. 927. (These rulings have now been nullified by statute: see e.g. *Insolvency Act* 1986 (U.K.), s. 187).

[21] For a selection of this writing, see the many references in Lord Wedderburn, "The Social Responsibility of Companies" (1985) 15 M.U.L.R. 4.

directors, perhaps using the two-tier German model with a supervisory as well as an executive board.[22] This will inevitably find expression in a Fifth E.E.C. Company Law Directive, but for the moment the negotiators are dragging their feet and what does emerge eventually will be a much watered-down series of options.

Meantime, perhaps in an attempt to appease the pressure for more comprehensive reform, a Conservative government in 1980 enacted the provision which is now the *Companies Act* 1985 (U.K.), section 309:

> "(1) The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members.
> (2) Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors."

What this apparently bold new statement of principle really amounts to in practical terms is something we must debate later.[23]

The latest development is to be seen in a series of judicial pronouncements, mainly in Australian and New Zealand cases,[24] concerned with the position of a company's creditors, particularly in the situation where it is insolvent or nearly so. Most have carefully stopped short of suggesting that directors owe duties of any kind to creditors directly; rather, couched in language very similar to section 309 of the U.K. Act above, they declare only that the directors' duties to the company in those circumstances include an obligation to have regard to the interests of creditors; for breach of this duty they may be made answerable in misfeasance proceedings.[25] Less cautiously, Cooke J.[26] has openly expressed a willingness to contemplate a duty directly owed to creditors, invoking the law of tort to rescue company law from its perceived inadequacies.

The cases in question have a number of features in common. All the companies were closely controlled, being either one-person companies, family companies, incorporated partnerships or group companies, and the acts in question took place with the full knowledge of all the members. All the companies were insolvent at the time proceedings were brought, the plaintiff suing as liquidator in the name of the company. In each case the claim was to recoup

[22] Ford, para. 1761; *Report of the Committee of Inquiry into Industrial Democracy* (the "Bullock report"), Cmnd. 6706, 1977; T. Hadden, *Company Law and Capitalism* (London: Weidenfeld & Nicholson, 2nd ed. 1977), Chap. 13.

[23] Infra, pp. 175-6.

[24] Infra, p. 172. For similar *dicta* in English cases, see *Charterbridge Corporation Ltd.* v. *Lloyds Bank Ltd.* [1970] Ch. 62, 74, *per* Pennycuick J.; *Lonrho Ltd.* v. *Shell Petroleum Co. Ltd.* [1980] 1 W.L.R. 627, 634, per Lord Diplock; *Winkworth* v. *Edward Baron Development Co. Ltd.* [1987] 1 All E.R. 144, 118, per Lord Templeman.

[25] The leading statement is that of Mason J. in *Walker* v. *Wimborne* (1976) 137 C.L.R. 1, 7: ". . . it should be emphasized that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them".

[26] *Nicholson* v. *Permakraft (N.Z.) Ltd.* [1985] 1 N.Z.L.R. 242, 249; hereafter *"Permakraft"*.

funds or property which allegedly had been diverted from the corporate estate in favour of one or more of the controllers or someone closely associated, e.g. another group company. To summarise the facts briefly:

Re Day-Nite Carriers Ltd.[27] The defendant director during the last days of the company "drew from the company all the cash that was available to him [by way of salary] according to the accounts prepared by his accountant", thus depriving it of funds to meet a debt for which liability had been strenuously (but unsuccessfully) contested. The director was held liable to refund the money.

Walker v. *Wimborne.*[28] The company's funds had been moved about between other companies in the group "as exigencies arose", and also used to pay the salaries of employees of those other companies. Directors were held liable in misfeasance.

Re Avon Chambers Ltd.[29] Facts were very similar to *Re Day-Nite Carriers Ltd.* (above), except that the sum in question was paid out as dividend. Replayment was ordered.

Ring v. *Sutton.*[30] Over a long period the company's principal shareholder and director had borrowed sums of money from the company at less than current commercial interest rates. The liquidator successfully claimed the difference in misfeasance proceedings.

Nicholson v. *Permakraft (N.Z.) Ltd.*[31] A substantial capital dividend was paid to members as part of a restructuring scheme. The money was immediately reinvested in a newly-formed holding company and for a period the business returned to profitability. When insolvency later supervened, the liquidator was successful at first instance in a misfeasance action brought against the directors, but the decision was reversed on appeal.

Russell Kinsela Pty. Ltd. v. *Kinsela.*[32] The company on the eve of insolvency granted a lease of its freehold property to its principal director and his wife. The court set aside the lease.

It is not so much the decisions reached in these cases which is of interest: all of them (with the exception of *Ring* v. *Sutton*, which is probably wrong on its reported facts) would almost certainly have been decided the same way at any period on the basis of a robust finding of mala fides or misfeasance. What makes the cases novel is the express reference by the judges to the concept of a duty towards creditors owed by the directors of a company when it is insolvent or nearly so.

A number of recent English cases are also of interest.

Re Halt Garage (1964) Ltd.[33] The company continued to pay remuneration to its two directors, C. and Mrs. C., even after the company had ceased to be profitable. The payments to C. were held to have been justified but not the whole of the sums paid to his wife, since she had been ill and had

[27] [1975] 1 N.Z.L.R. 172 (White J.).
[28] (1976) 137 C.L.R. 1 (H.Ct.).
[29] [1978] 2 N.Z.L.R. 638 (Casey J.).
[30] (1980) 5 A.C.L.R. 546. (C.A., N.S.W.); See also *Grove* v. *Flavel* (1986) 4 A.C.L.C. 654, esp. 660.
[31] [1985] 1 N.Z.L.R. 242 (C.A., N.Z.); See also *David Neil & Co. Ltd.* v. *Neil* (1986) 3 N.Z.C.L.C. 658.
[32] (1986) 4 A.C.L.C. 215 (C.A., N.S.W.).
[33] (1982) 3 All E.R. 1016 (Oliver J.).

ceased to play an active part in the business. The judge described the payment to her as not "genuine" remuneration but a "disguised gift out of capital".

Re Horsley & Weight Ltd.[34] A substantial sum was paid to provide a pension for a retiring director. The company was solvent at the time but went into insolvent liquidation a year later. The payment was held valid.

Multinational Gas case.[35] The directors of a joint-venture company set up by three oil companies incurred losses of £114 million through allegedly irresponsible trading which was entered into at the instigation of the three shareholding companies. It was held that the company had no action against the directors.

A duty to have regard to the interests of employees and a similar duty towards creditors raise quite different issues, though there is some overlap. I propose to keep them distinct, as far as I can, in the ensuing discussion. But what goes for employees would probably apply also to the case of any other interest group, such as local residents, customers, and so on. It should be stressed that the issue is not whether any of these "wider" interests merits recognition and protection, but whether this can be satisfactorily achieved within the framework of company law as we know it, through the conceptual and remedial vehicle of directors' duties.

SOME CONCEPTUAL PROBLEMS

The Company

In the traditional model of the company as an object of directors' duties, it is perceived entirely in terms of the members, present and future.[36] I propose to refer to this concept of the company as "the corporate membership". This simple model is inadequate when "wider" interests have to be reckoned in. If directors are to be required to have a concern for (say) employees and creditors, it is no longer appropriate to regard the membership alone as the constituent body so as (for example) to entrust it with an unfettered power to ratify and condone directors' irregular acts; and surely an objective yardstick ought to be used to measure directors' standards of care and skill, since these new beneficiaries of that care and skill have had no say in choosing them. Moreover, while it may be both reasonable and proper to bring the members' associative contract into the picture when the law is treating the membership as the body corporate, it is not obvious that we should do so when wider interests are affected — indeed, with the abolition of the doctrine of constructive notice of the memorandum and articles, there is no reason to suppose that non-members can have any knowledge of these documents. This would have repercussions in a case like *Re Horsley & Weight Ltd.*[37]

[34] [1982] Ch. 442 (C.A., Eng.).
[35] *Multinational Gas and Petrochemical Co.* v. *Multinational Gas and Petrochemical Services Ltd.* [1983] Ch. 258 (C.A. Eng.).
[36] Supra, p. 166.
[37] [1982] Ch. 442.

It was crucial to the decision of the Court of Appeal in that case that the granting of pensions was a substantive object of the company, i.e. that it was as much an object of the company to give money away as it was to make shop fittings. This reasoning is all very well so long as the directors are answerable only to the members, who are by statute deemed privy to the memorandum. But how are creditors to know nowadays that they are dealing with a company having non-commercial objects?

All these considerations suggest that for the future it may be necessary for the law to conceptualise "the company" not as the corporate *membership* but as the corporate *enterprise*, as an aid to the formulation of new rules of directors' duties in cases where interests other than purely membership-interests are affected. A workable "proper purposes" rule could not any longer resolve disputes by reference simply to the interests of the shareholders. Such an approach would, indeed, more accurately reflect the modern directors' own attitudes: of course they are conscious that their company has shareholders, but they are just as keenly aware that it has customers, a workforce, goodwill, a product, a brand-name and logo, possibly even a company flag and anthem. If disaster is threatening, their conscience stirs for the suppliers and other creditors who may be drawn in by the company's collapse. In fact, despite the time-honoured formulations to the contrary, there are clear instances of this thinking already in a good number of the decided cases — cases where the interests of a section of even the whole of the membership have been sacrificed for what was considered the good of the enterprise as a going concern.[38] To rationalise this as a decision in the "long-term" interests of the membership[39] or by invoking the spectre of the "individual hypothetical member"[40] is surely a far more artificial exercise.

Unfortunately, to abandon the old, simple "trust for the membership" model is not to solve our problems at a stroke, but rather to open the door to any member of additional new ones.[41] But for the time being, at least for the sake of the discussion which follows, let us accept that it is possible to envisage the company as the corporate *enterprise*, as an alternative to the corporate *membership*.

It will be helpful also to have an expression for the company as a financial corpus: let us call it "the corporate estate". The old "trust" of shareholders' money, like the rules for the maintenance of capital, cannot cope when the only significant capital is loan capital, still less cope with a balance sheet in deficit or with phantom concepts of property such as unexploited corporate opportunities and potential claims to claw back voidable preferences in a

[38] See, e.g. *Mutual Life Insurance Co. of New York* v. *The Rank Organisation Ltd.* [1985] B.C.L.C. 11; *Pine Vale Investments Ltd.* v. *McDonnell & East Ltd.* (1983) 1 A.C.L.C. 1294; and cf. J.K. Walsh, "The Exercise of Powers in the Interests of a Company" (1967—68) 8 U.W.A.L.R. 176, 188ff.

[39] Supra p. 166; cf. Afterman, op. cit. p. 45.

[40] A suggestion of Lord Evershed M.R. in *Greenhalgh* v. *Arderne Cinemas Ltd.* [1951] Ch. 286, 291, which has proved troublesome in later cases: see e.g., *Clemens* v. *Clemens Bros. Ltd.* [1976] 2 All E.R. 268.

[41] Infra, p. 175ff.

liquidation.[42] If we are to allow the notion of misfeasance to break away from the technicalities of trust without departing from its values, (as we must if we are to acknowledge the interests of creditors as an object of legal protection) we must get away altogether from the idea that "the company" is the associated membership, and think instead of a fund — all the sums under the directors' control for which in law they are or may be accountable.

Duty

There are many problems with "duty": a slippery word, especially when it is transplanted from language of unfocused judicial stricture or exhortation in one case into a supposed legal rule in another.

To have any significance for our purposes, the duty which is formulated must raise a justiciable issue. This is clearly possible where the law places a person under a duty to a single person or to a class of beneficiaries having similar or successive interests that are consistent *inter se*. It is therefore in order to think broadly in terms of a duty to all those (including creditors) having a financial interest in a winding up — to the company as "the corporate estate". But where duties are owed to persons with potentially opposed interests, the duty bifurcates and fragments so that it amounts ultimately to no more than a vague obligation to be fair; and (however much we may delude ourselves) this kind of "fairness", especially in a commercial context, is not a justiciable issue.[43] So it is pointless to seek to impose co-existing "duties" towards shareholders and employees, or towards preference and ordinary shareholders, or towards the contributors of risk capital and future creditors, in any situation of actual or potential conflict. If the law does this, it abandons all effective control over the decision-maker.

When Professor E. Merrick Dodd proposed in the *Harvard Law Review* over fifty years ago[44] that company law should regard the "trusteeship" of corporate managers as extending to embrace the interests of employees, customers and others, his colleague A. A. Berle was quick to point out[45] that the legal difficulties involved would make the whole proposal unworkable: "When the fiduciary obligation of the corporate management and 'control'[46] to stockholders is weakened or eliminated, the management and 'control' become for all purposes absolute. . . . The only thing that can come

[42] Even more mind-boggling is the notion that Mr. Sutton (in *Ring* v. *Sutton* (1980) 5 A.C.L.R. 546) should have been held liable to the company as a trustee of the notional extra interest that he had not charged himself. But he was, and was further held liable to pay interest on that interest: (1980) 5 A.C.L.R. 546, 550–551.

[43] Cf. A.F. Conard, *Corporations in Perspective* (New York, Foundation Press, 1976), at para. 27.

[44] "For Whom are Corporate Managers Trustees?" (1932) 45 *Harv.L.R.* 1145, written in response to A.A. Berle, Jnr., "Corporate Powers as Powers in Trust" (1931) 44 *Harv.L.R.* 1049.

[45] "For whom Corporate Managers *are* Trustees: a Note" (1932) 45 *Harv.L.R.* 1365. As Francis Dawson (supra. fn. 13) points out, Dodd ultimately came to share Berle's view: see (1942) 9 *U.Chic.L.Rev.* 538, 546–7. See further J.L. Weiner, "The Berle-Dodd Dialogue on the Concept of the Corporation" (1964) 64 *Columbia L. Rev.* 1458.

[46] In Berle's own words, "Control is here used to mean that individual or small group of individuals who are able to mobilize or cast sufficient votes to elect the corporate management": id. 1366.

out of it, in any long view, is the massing of group after group to assert their private claims by force or threat. . . . This is an invitation not to law or orderly government, but to a process of economic civil war."[47]

Whether we are are prepared to go as far as this or not, it is plain that, without some system of legally ordered priorities between the different groups having claims to recognition as part of the corporate enterprise, there is no way in which any one such claim could be positively enforced. So long as the acts under challenge could be defended as being consistent with the interests of any other group, there would be no basis to interfere. The concept of "the enterprise" can, in consequence, come into the reckoning only in a negative sense, as part of the directors' or controllers' defence: that they were justified in disregarding the traditionally exclusive claim of the membership out of regard for other interests in the composite enterprise.

In recognition of this, company law (at least as it stands, but probably in any form it could potentially take) must acknowledge that it has no mechanism to ensure the fulfilment of obligations of social responsibility.[48] At most, it may impose disclosure obligations,[49] or perhaps require the appointment of "social audit" watchdogs; but even these shadowy measures it cannot effectively police. The interests of consumers, the environment, welfare and the causes of equal opportunity, good race relations and so on can only be furthered by positive legislation extraneous to company law.

Duty and Source

The duty between director and company, statute apart, is based in the law of trust or, as we would more readily say nowadays, the law of fiduciaries. There is also a possible source of obligation in contract, particularly in the case of salaried directors. But there is no privity of contract between a company's creditors or its employees and its directors, and no fiduciary relationship. In particular, creditors deal with a company as a matter of bargain, not of trust, and bargain involves risk. The law has rightly looked askance at attempts in other contexts to infer a trust in a situation which is purely one of debt. So it would be unwise to look to either contract or trust if it were proposed to think of duties directly owed by directors to these interests.

It is tempting, and at first glance easy enough, to find the source of a director's duty towards creditors in tort: in the expanding tort of negligence and "now pervasive concept of duty to a neighbour", as Cooke J. hinted in *Permakraft*.[50] But there are many snags. It is not the director's primary role to take care but to take risks. A duty of care and the liberty to embrace risk are incompatible bedfellows.[51] Moreover, it has recently been affirmed

[47] Id. 1367–1369.

[48] As Berle himself observed in his own day: id. 1367.

[49] In the United Kingdom, the directors' report has become a favourite vehicle for this kind of empty gesture: at different times, companies have been required to record matters as diverse as their contribution to the export drive and their policy in regard to the employment of the disabled.

[50] [1985] 1 N.Z.L.R. 242, 249.

[51] The analogy with the sporting competitor in *Wooldridge* v. *Sumner* [1963] 2 Q.B. 43 is not altogether fanciful.

that directors have no liability to shareholders for the negligent, or even the dishonest, dissipation of corporation assets which indirectly causes them loss.[52] The relationship between directors and creditors is comparable, but surely less "proximate" by any standards. There are also policy arguments against developing duties which could favour some categories of creditor at the expense of others.[53]

Duty and Remedy

A supposed legal duty which is not matched by a remedy is a nonsense. If, as most would accept, there is no room within the established framework of company law for a direct remedy against directors to be sought by (say) a group of employees or creditors, we have to think of a remedy enforced through the company, as in the formulations of the British legislators[54] and the invariably cautious statements by judges in this (southern) hemisphere.[55] But even then, the arguments are flawed. In the case of employees, what could a court be asked to *do* for them, supposing that it is established that insufficient regard has been had to their interests? At best, it might be possible to think of some woolly form of declaratory or injunctive relief which obliged the directors to reconsider their decision. (We are almost into the realms of administrative law! Even so, there could be no question of requiring the directors to give the employees' case a hearing, since shareholders have no similar right.) The emptiness of the U.K.'s section 309 is thus exposed. It is either one of the most incompetent or one of the most cynical pieces of drafting on record.

To test the point further, let us suppose facts the reverse of those in the celebrated United States case, *Dodge* v. *Ford Motor Co.*[56] Ford declares that it will not give its employees any pay rise or bonus, or its customers any price cut, because it prefers to pay extravagant dividends to its shareholders. Even assuming that a court were bold enough to claw back some of the dividend, what mechanism is there in company law, or any branch of the law, to enforce the desired enrichment of these other interest-groups? In reality, these groups do not want the sort of remedy company law can give.

Even the most modest of the proposed extensions of directors' traditional duties – i.e. an extension to include "existing creditors" – is not free from difficulties. Assume that the directors, in disregard of the interests of existing creditors, improperly pay a sum of money to a third party. When the liquidator, in the name of the company, in the fullness of time recovers the sum in misfeasance proceedings, it is unlikely that these creditors will reap the benefit: many "existing" creditors will have been paid off and replaced by "future" creditors, and in any case the Taxation Department, the bank, etc. will come first, whether or not they themselves were "existing" creditors at the crucial time.

[52] *Prudential Assurance Co. Ltd.* v. *Newman Industries Ltd. (No. 2)* [1982] Ch. 204.
[53] Infra, p. 185.
[54] *Companies Act* 1985 (U.K.), s. 309.
[55] See, e.g., the leading statement by Mason J. in *Walker* v. *Wimborne* (1976) 137 C.L.R. 1, 7.
[56] 204 Mich. 459; 170 N.W. 668 (1919).

Creditors as a Class

Two points may be made. First, in contrast with shareholders, there is no homogeneity as between different creditors: they differ in bargaining power, and this may be reflected both in the terms secured when their debt was created and in the pressure they can bring to have their claim paid. Directors, as a matter of business judgment, may have to choose between competing creditors, preferring some to others. There may even be arguments for favouring or relegating the claims of some categories of creditor on what may broadly be regarded as moral grounds: consumer prepayments, arrears of wages and salaries, involuntary creditors (e.g. tort victims, the Taxation Department), depositors, intra-group loans. No simply formulated "duty" can hope to deal easily with all the cross-currents of argument latent here.

Second, at what point does the class of creditors crystallise? The dicta in the cases draw a sharp line between existing and future creditors, with continuing creditors perhaps forming a third class.[57] But, as noted above, the proceeds of any misfeasance action go into the corporate estate, in total disregard of this kind of categorisation. The flaw in the reasoning is not, I would say, related to the remedy (which is the only practicable one available): it is surely in the perception of the duty.

The Relevance of Insolvency

It is tempting to think of a duty that shifts its focus, or varies in content, as the financial health of the company waxes and wanes: a temptation not resisted in most of the judgments where the matter has been given thought. So long as the directors are playing with "shareholders' money" (so the reasoning goes), they may do more or less as they please; and even if they cannot do so unaided, the legal problem goes away if their acts have the shareholders' express or tacit approval. They may therefore pay themselves emoluments which bear no resemblance to the value of the services rendered, as long as the corporate kitty is in surplus;[58] but once the financial outlook becomes shaky, remuneration must be "genuinely" assessed or it will be disallowed.[59]

In general, I do not think that there is anything seriously wrong with this sort of reasoning, provided that the courts do not allow themselves to be distracted by the technicalities of company law, and the false assumption that they are directly relevant in this context. I do not see it as strictly material to bring into the discussion the question whether the company has "divisible profits", or whether it is making a return of "capital" to its shareholders, or whether proper provision is being made for a contingent liability, when that is not the issue before the court. (The risk is that the court will be deluded into thinking that it is.) It would be absurd, in any case, to allow a body of rules to develop which allowed directors to do X when their company had divisible profits, Y when there were profits which were not divisible, Z when

[57] As suggested by Cooke J. in *Permakraft* [1985] 1 N.Z.L.R. 242, 250.
[58] *Re Halt Garage (1964) Ltd.* [1982] 3 All E.R. 1016, 1039, 1044.
[59] Ibid.

there were no profits but the funds at risk were notionally the shareholders' capital contributions, and something else again when what they were hazarding was "creditors' money". The question both for the directors at the time, and for the court sitting in review, is whether the directors are behaving responsibly or irresponsibly within the proper limits of business judgment; the directors can only look at the matter broadly, even intuitively, and so should the court.

In this regard, neither the actual fact of solvency nor the definition by which it is determined[60] should be a decisive factor. Precision on this, as on the points mentioned in the previous paragraph, is neither desirable nor material. "Commercial" insolvency, in the sense that the company is unable to pay its debts as they fall due, may make it improper for directors to exercise a power for a particular purpose even though the company is solvent on balance-sheet terms, and vice versa, and quite often it may be proper for them to exercise the power regardless of any questions of insolvency. For example, to vote a substantial payment by way of salary to an executive director could well be improper when the company's fortunes were in jeopardy and the services in question were routine, but similar expenditure would be justified if the director in question was a corporate rescue expert brought in from outside in an attempt to avert catastrophe.

There is another reason for not seeking to determine the content of directors' duties by reference to any precise definition of insolvency, and this is that in the course of events a company's financial position may fluctuate so that technically it moves in and out of that state. There could be arguments not only that the nature of the duty changed with the circumstances but also that whenever a company's books were back in the black any past improprieties should be deemed cured by the turn of events and expunged from the record. Or it could be contended that a duty focused on "existing" creditors was discharged as soon as all the debts in question had been paid off. Directors' decisions are taken with reference to the company as an ongoing business concern and should be judged by that broad standard, not be technicalities and (perhaps fortuitous) coincidences of this kind.

There is, however, a price to be paid, if the tests of "bona fide" and "the interests of the membership as a whole" are to be replaced by a more elaborate formulation. If directors' conduct is to be judged in the light of factors and circumstances such as those we have been discussing, the courts have no option but to acknowledge that they must sit in review of business decisions. There can no longer be recourse to easy solutions like referring the matter to the shareholders to decide by a "ratifying" vote, for the members are now

[60] In a number of judgments "insolvency" is understood to mean an excess of liabilities over assets — e.g. by Richardson J. in *Permakraft* [1985] 1 N.Z.L.R. 242, 254. In the same case Cooke J. (at 249) thought it appropriate for directors to consider also "their company's practical ability to discharge promptly debts owed to current and likely continuing trade creditors". The court in *Kinsela* (1986) 4 A.C.L.C. 215, 223 "hestitate[d]" to formulate "a general test of the degree of financial instability which would impose on directors an obligation to consider the interests of creditors", thinking that this might differ with the nature of the company and its business.

only one of the constituent interests that the directors serve, and the shareholders' vote, too, must be amenable to review on similar considerations.[61]

Although it would be a break with long-standing tradition for the courts to admit to this new role, there would be the distinct benefit that they would be obliged to articulate more clearly the true reasons for their rulings rather than merely invoke as shibboleths the dicta collected uncritically from earlier cases. Take *Ring* v. *Sutton*,[62] for instance, and compare it with *Re Halt Garage (1964) Ltd.*[63] The tax advantages which Mr. Sutton procured for himself by paying soft rates of interest on the loans from his company (rather than full commercial rates offset by a higher salary), during all the years when his company traded successfully, were not of a different order from the inflated remuneration which Mrs. Charlesworth drew in *Halt* — and the arrangement surely made just as much business sense. None of the reasoning in the judgment of the court in *Ring* v. *Sutton* was addressed to the realities of running a small business or showed any awareness of the fiscal folly implicit in the "duty" which (with the benefit of hindsight and a solitary dictum as precedent) was retrospectively imposed on the unfortunate director.

Limited Liability

"The recognition of [directors'] duties to creditors," says Cooke J., "is justified by the concept that limited liability is a privilege".[64] Self-evidently, there are major conceptual leaps in this proposition, but we need not be hypercritical: what the learned judge is elliptically asserting is a down-to-earth truism. This is that, for all the prominence given in the books to the phenomenon of "lifting the veil", the one unassailable concept in our company law appears to be that of limited liability, in the sense of making a shareholder, as such, liable for his company's debts. Statutory exceptions apart, *Salomon* rules. Limited liability is sacrosanct. The only alternative target for a judge is the director, *qua* director; and, with a little fudged reasoning if needed, he is a soft target. "Fudged", because so many of the recent key cases in which directors have been held liable have featured small, shareholder-managed companies, where the distinction between shareholder and director is easily blurred: in effect, the question has not been whether the *director* has broken a duty to anyone but where, *qua* proprietor, he should be permitted to look after himself and his own interests behind the shield of limited liability in disregard of the expectations of creditors.

[61] In *Winthrop Investments Ltd.* v. *Winns Ltd.* [1975] 2 N.S.W.L.R. 666, 698ff., Mahoney J.A. raised, but did not determine, the question whether it is open to the shareholders in general meeting to elect to affirm a transaction which is voidable because of the directors' collateral purposes notwithstanding that the shareholders have the same collateral purpose. The Court of Appeal in *Kinsela* (1986) 4 A.C.L.C. 215, 223 took the view that once the interests of creditors are at risk the shareholders lose the competence to ratify. This approach may have been sufficient to dispose of the clear case of expropriation which was before the court on that occasion, but it is submitted that it is too simplistic to deal with all situations: see the discussion at pp. 181-3 infra.

[62] (1980) 5 A.C.L.R. 546.

[63] [1982] 3 All. E.R. 1016.

[64] *Permakraft* [1985] 1 N.Z.L.R. 242, 250.

Limited Liability and Risk

Any reformulation of directors' duties to take account of the interests of creditors and others has to accommodate the concept of risk, and allow for the fact that directors must be free to take risks and to judge what risks their business should take. We must not lose sight of the fact that it is the principal function of the limited liability company, and of company law, to facilitate this risk-taking; without it, the world's railways would not have been built and we would have had no Industrial Revolution, no modern technology. It is impossible to reconcile a duty of care towards creditors with this notion of risk. This is tacitly conceded by the repeated statement in the cases that such duty as exists is owed by the directors only to existing creditors and not to future creditors; but the analysis is imperfect. All creditors give credit, or continue to allow credit, to a limited company in the certain knowledge that they are running a business risk, perhaps none more so than banks, depositors and other providers of loan capital. What the law has to ensure is that the risks which that company elects to embrace fall within the range of legitimate business risks, consistently with the expectations of all those whose interests are at stake, creditors and members alike. Mr. Salomon's company became insolvent running what were (as the court found, to the knowledge of all concerned[65]) acceptable business risks by the commercial standards of his day; the joint ventures in *Multinational Gas*,[66] as a modern court ruled, had done likewise. There is no room in this context for any concept of *care*: it is a duty, which we may conceive of as owed to all those who have any stake (actual or potential) in the corporate estate, to use the powers to deal with that estate for proper business purposes, and risk is an inseparable part of that business.

Ratification

With the simple traditional corporate model in which the members are the directors' sole constituents it is relatively easy to accommodate the questions of authorising, ratifying and condoning acts which would otherwise be breaches of duty. The shareholders are plainly the appropriate organ to take corporate decisions for this purpose. Acceptance of a more complex model in which other interests are represented requires some adjustment in our thinking. Despite the remarks to this effect in the *Kinsela* case,[67] we cannot conclude that the shareholders are no longer competent to act, for they are the only residual organ that the company has. There is no room in company law to allow for any possibility of ratification by the creditors,[68] still less by any other interest group. The conclusion must be that such say as there is

[65] Including creditors: *Salomon* v. *Salomon and Co. Ltd.* [1897] A.C. 22, 53: "The unsecured creditors of A. Salomon and Company Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes . . . They had full notice that they were no longer dealing with an individual, and they must be taken to have been cognisant of the memorandum and the articles of association" (per Lord Macnaghten).

[66] [1983] Ch. 258.

[67] (1986) 4 A.C.L.C. 215.

[68] Apart, of course, from whatever may be achieved by a formal scheme of arrangement.

still remains with the shareholders, but inescapably their decisions must be more readily open to review by the courts, and probably on more enlarged grounds than has previously been accepted. It will not be enough that the members either formally or informally knew and consented: there must be room for an inquiry whether it was proper for them to do so in the interests of our new conception of the company.

Company law has a long record of precedents for striking down phoney or self-serving votes by shareholders which have purportedly authorised or ratified directors' breaches of duty:[69] the books usually collect them under the head of "fraud on the minority" (or, in this context, more accurately "fraud on the company"[70]). All that the new approach outlined in the preceding paragraph would call for would be a shift in the interpretation of "fraud on the company" to embrace the enlarged constituency. The court in the *Kinsela* case[71] ruled, in effect, that this is already the law; the dicta in earlier cases are rather more equivocal.[72] It plainly ought to become the law: a perverse or self-serving misappropriation of corporate funds by directors in disregard of the claims of creditors should not be capable of condonation or release by the votes of shareholders who may themselves be no better motivated, or who may even be the same persons as the directors. Unhappily for the courts, this may at times call for an inquiry into the state of mind of the individuals concerned.[73]

Shareholder Misfeasance?

If this development is seen as an inevitable concomitant of our new perception of "the company", the debate cannot stop at "secondary" action by the shareholders (i.e. authorising, ratifying or condoning acts primarily performed by the directors); we have to ask also whether the courts should assert a power to intervene and declare void, in a similar way, primary decisions of the members themselves which are comparably perverse or self-serving. Hitherto, it has probably been assumed that shareholders may act as wrongheadedly or selfishly as they like, so long at least as a majority do not oppress a minority, and in the last resort that unanimity will excuse anything. It now seems likely that if the shareholders themselves misapply

[69] See, e.g., *Cook* v. *Deeks* [1916] 1 A.C. 554; *Daniels* v. *Daniels* [1978] Ch. 406.

[70] K.W. Wedderburn, "Shareholders' Rights and the Rule in *Foss* v. *Harbottle*", [1957] C.L.J. 194; [1958] C.L.J. 93.

[71] (1986) 4 A.C.L.C. 215.

[72] E.g., *Re Horsley & Weight Ltd.* [1982] Ch. 442, 454, 455, 456; *Multinational Gas* case [1983] Ch. 258, 268–9, 280–2, 288ff.; *Permakraft* [1985] 1 N.Z.L.R. 242, 250, 255.

[73] Ford, para. 1732, says of shareholder resolutions (in the context of decisions by a majority to thwart a derivative action): "The test of validity would have to be an objective one since it would be impracticable to review the purpose of each member voting at a meeting of a large public company". I believe, however, that the courts would and should be willing to hear and evaluate the evidence of the members in all cases where the company is so closely held as to make this feasible. This they already do in reviewing directors' decisions and have, in effect, done in some cases involving shareholder-managed companies. The objective test should be seen as a fall-back or second-best option, consistently with the "no reasonable majority" or "amiable lunatics" criterion applied elsewhere in company law: supra, fn. 15.

"creditors' money" in the face of insolvency, the courts must find jurisdiction to strike it down. In fact, this was the decision in *Re Avon Chambers Ltd.*,[74] and should have been its ratio; but the reasoning missed its mark by ascribing the wrongful act (declaring a dividend) to the director rather than the body competent to act, viz., the shareholders. Again, Oliver J. in *Re Halt Garage (1964) Ltd.*[75] plainly saw the need for a new remedy, when he disallowed (as not "genuine") a decision by the shareholders to pay remuneration to a director which had not been properly earned. Unfortunately, he supported his decision by repeated reference to a wrongful "return of capital" to the shareholders which was neither borne out by the facts[76] nor central to his legal ruling.[77]

However, it is not easy to find a juridical basis for this new remedy without running into head-on conflict with most of company folklore. We are, in effect, drawing on the law of trust, in the teeth of a tradition which emphatically declares that a shareholder may vote his shares as he likes and owes no fiduciary or other duty to anyone, least of all creditors.[78] The explanation is, of course, that we are not constituting the shareholders "trustees" of the company's property or burdening them with the full panoply of fiduciary duties: we are simply acknowledging that the equitable jurisdiction to strike down a fraud on a power extends to the exercise by shareholders of those few powers that the corporate constitution gives them.[79] Hitherto, intervention on this ground has been restricted to decisions where majorities have improperly oppressed minorities,[80] in accordance with the traditional limited conceptual model of the company. Hereafter, it must extend to those business and quasi-business decisions like fixing directors' remuneration and declaring dividends which may affect the rights of creditors (and perhaps, in due course, others). The courts must be prepared to descend into the arena and ask whether these properly come within the range of the business decisions that they purport to be.[81]

[74] [1978] 2 N.Z.L.R. 638.

[75] [1982] 3 All E.R. 1016.

[76] The capital subscribed by the director was £1; the overpayment to her was some £2000.

[77] The reasoning on which Oliver J. relied should have been equally applicable whether the director in question happened to hold shares or not.

[78] *North-West Transportation Co. Ltd.* v. *Beatty* (1887) 12 App. Cas. 589, 600; *Peters' American Delicacy Co. Ltd.* v. *Heath* (1939) 61 C.L.R. 457, 504; *Multinational Gas* case [1983] Ch. 258, 269, 288.

[79] Under the usual form of articles, this will not include managing the company's business: see e.g., *Companies Code* (Aus.), Table A, art. 66. But it would normally include declaring a dividend (art. 86) and determining the directors' remuneration (art. 63), so that the decisions in *Re Avon Chambers Ltd.* [1978] 2 N.Z.L.R. 638 and *Re Day-Nite Carriers Ltd.* [1975] 1 N.Z.L.R. 172 should properly have been seen as examples of the judicial review of the shareholders', and not the directors', acts. See above p. 172.

[80] I.e., in the traditional "fraud on the minority" cases, alterations of articles, and such apparently anomalous decisions as *Clemens* v. *Clemens Bros. Ltd.* [1976] 2 All E.R. 268 and *Pennell Sutton and Moraybell Securities Ltd.* v. *Venida Investments Ltd.* (1974, unreported, noted (1981) 44 M.L.R. 40). See generally Ford, para. 1732.

[81] As, in effect, was done by Oliver J. in *Re Halt Garage (1964) Ltd.* [1982] 3 All. E.R. 1016.

PROCEDURE AND REMEDIES

It is settled at common law that a creditor of a company has no standing[82] to take the company to court to have it made to comply with its obligations under company law or with the terms of its own constitution, and this would also be true of an employee.[83] These considerations, coupled with the lack of any established class action on the American pattern, make it virtually unthinkable that an action to have the rights or interests of creditors, employees or other groups directly enforced by law would be regarded as competently brought. This is acknowledged and, indeed, confirmed by the U.K. Act, section 309(2), which stipulates that the duty to have regard to the interests of employees is "owed to the company alone", and is enforceable "in the same way as any other fiduciary duty owed to a company by its directors." In practical terms, this means a corporate action brought with the authority of an organ of the company, a derivative action brought by a minority shareholder (if he can surmount the obstacle of *Foss* v. *Harbottle*[84]), or an action by a liquidator (or, in Australia, any other "prescribed person" authorised under section 542 of the Code).

It is very difficult to conceive of circumstances in which an action in any of these forms might be successfully brought to vindicate the employees' interests. The suggestion which has most often been made with regard to U.K. section 309[85] is that an employee or a trade union might acquire a few shares and thereby become qualified to bring an action, either *qua* member to have the company observe the rules of company law and the terms of the corporate constitution, or in derivative form as representing the company. But the former could be met by the objection that a personal action lies to enforce only rights enjoyed *qua* member and not in any other capacity,[86] while the latter would call for an extension of the "fraud on the minority" exception to the rule in *Foss* v. *Harbottle*, and the disowning of recent English rulings that effectively bar any derivative action that does not have the approval of a majority of shareholders other than those who are defendants.[87] Further, a derivative action does not lie when a company is in liquidation,[88] and a liquidator's own brief would not extend to protecting the

[82] *Mills* v. *Northern Rly. of Buenos Ayres Co.* (1870) 5 Ch. App. 621. There is a limited statutory exception to this rule, confined to breaches of the *Code* itself, in s. 574 of the *Companies Code* (Aus.).

[83] Cf. *Forbes* v. *N.S.W. Trotting Club Ltd.* [1977] 2 N.S.W.L.R. 515 ("worker", though not strictly an employee).

[84] (1843) 2 Hare 461; 67 E.R. 189.

[85] See, e.g., supplement to the fourth edition of L.C.B. Gower et al, *Principles of Modern Company Law* (1981), note to p. 579.

[86] *Hickman* v. *Kent or Romney Marsh Sheep-Breeders' Assn.* [1915] 1 Ch. 881. (The enlarged wording of the *Companies Code* (Aus.), s. 78 (as amended) does not affect the present discussion).

[87] *Taylor* v. *N.U.M. (Derbyshire Area)* [1985] B.C.L.C. 237; *Smith* v. *Croft (No. 3)* (1987) 3 B.C.C. 218; following *Prudential Assurance Co. Ltd.* v. *Newman Industries Ltd. (No. 2)* [1982] Ch. 204.

[88] *Fargro Ltd.* v. *Godfroy* (1986) 2 B.C.C. 99, 167.

interests of employees (otherwise than as creditors for any remuneration outstanding).

Creditors are more favourably placed, in that they have a statutory class action available through their representative, the liquidator; and it is almost certainly only in a liquidation that any claim in respect of their interests would arise. For the reasons discussed above,[89] any claim brought by a liquidator should be for the benefit of the liquidation assets generally, to be distributed among the creditors and members in accordance with their statutory ranking and entitlement. For this reason, it is probably unsound and a potential source of erroneous reasoning to formulate the directors' duty with reference to any stated category of creditors (e.g. existing creditors): the proper object of any duty, as emphasised above, should be the corporate estate. It would also run counter to established insolvency policy considerations if the law were to give remedial advantages to particular creditors.[90]

Evidence

Any review of corporate decisions based on a "proper purpose" test must call for some evidence of the state of mind of those responsible for the decision. Chancery courts may in the past have been ill equipped to assess this sort of question (and this, coupled with rules which put the onus of proof on the objectors, probably meant that the courts intervened relatively infrequently). There are clear indications that the courts of today are not reluctant to undertake an inquiry of this kind;[91] and they will be helped by the fact that in most cases the controllers of the company will be very few in number. There is also, of course, the objective threshold of unreasonableness to fall back on, which will necessarily have to be the test when the number of votes is at all large.[92]

Policy Considerations

It is rare for a judge in a company law case to make any reference to the policy implications of the ruling he is giving, or even to acknowledge an awareness that his decision may be helping to shape policy for the future. One of the advantages of a test for liability which calls for an evaluation of the purposes for which a given power may "properly" be exercised may well be that thought will be directed and expression be given to these policy issues.

It is submitted that any development in the law which more explicitly recognises directors' obligations towards creditors should reflect the fundamental principle of insolvency law that (statutory exceptions apart) it is a class action for the benefit of creditors generally. A duty which purports to

[89] Supra, pp. 177-8.
[90] Infra, p. 186.
[91] The directors were heard and cross-examined as their state of mind in *Mills* v. *Mills* (1938) 60 C.L.R. 150; *Howard Smith Ltd.* v. *Ampol Petroleum Ltd.* [1974] A.C. 821; *Pine Vale Investments Ltd.* v. *McDonnell and East Ltd.* (1983) 1 A.C.L.C. 1294; *Permakraft* [1985] 1 N.Z.L.R. 242; and *Kinsela* (1986) 4 A.C.L.C. 215. See also *Kelly* v. *Raymor (Illawarra) Pty. Ltd.* (1981) 6 A.C.L.R. 135 (interrogatories).
[92] Supra, fns. 15, 73.

relate to existing creditors only, or any other section of creditors, or a remedy which favours some creditors at the potential expense of others[93] runs counter to this principle. A rule which put a liquidator in the position of representing a section of the creditors only, or rival sections of the creditors competing against each other (as could well happen if tort were made the basis of liability) would create impossible conflicts. And if individual creditors are put by the law into a position where they may use threats to sue directors personally as a form of pressure to have the company pay their debts in priority, the object of the insolvency law is undermined.

The Cork committee in its report on the reform of U.K. insolvency law[94] put high on its list of the priorities when a company had become, or was becoming, insolvent the salvage of the enterprise as a going concern. It makes economic and social sense to keep plant intact, not to destroy established work teams, to avoid job redundancies and to preserve business connections. If existing debts have to be written off or subordinated to new borrowings to help towards this end, this may often be a price worth paying. Some of the amendments to U.K. insolvency legislation in 1985–86 have sought to pursue this objective. A body of judge-made law which showed solicitude primarily for a company's existing creditors would undermine such a policy.[95]

Power carries responsibility, and directors are rightly made answerable for abusing it. But directors at large should not be exposed to risk of personal liability without good cause or, as experienced in some countries has shown,[96] there is a risk that people with the necessary experience and ability to fill non-executive directorships will be reluctant to take office, and professional corporate rescue experts will seek work in other jurisdictions. The cost of liability insurance for directors is far from negligible: it must not be allowed to become prohibitive. In the light of these considerations there should be some resistance to any extension of the traditional directors' liability based in misfeasance and into more loosely conceived and potentially open-ended areas of liability.

Cooke J. in the *Permakraft* case[97] appeared to be willing to contemplate a broader principle of directors' liability to creditors (or, at least, existing and continuing creditors) based on the neighbour principle of tort. It will be apparent from much of what I have said above that I believe there are very strong arguments against any such development.

In my view, private law can accommodate only the limited degree of change which I have outlined above, while remaining inherently consistent. Legislation, of course, can impose further liabilities on directors undeterred by any such constraints, and there are many examples in the companies and

[93] As do *Companies Code* (Aus.), ss. 556(1), 557(1).

[94] Insolvency Law and Practice. Report of the Review Committee: Cmnd. 8558 (1982).

[95] It might also have other undesirable consequences – e.g. inducing directors to take prepayments from consumers and others in an endeavour to boost an ailing cash-flow.

[96] Compare, for example, the recent history of the director-disqualification laws in Singapore.

[97] [1985] 1 N.Z.L.R. 242, 249.

insolvency codes of the jurisdictions we are studying of provisions which proscribe wrongful trading,[98] preferences,[99] undervalue transactions,[100] etc., in explicit terms and provide for appropriate remedies in such situations.[101] Most of the instances of irregular conduct by directors in the key cases we have been studying could have been dealt with under one or other of these statutory provisions had it been in force at the relevant place and time. Up to a point, therefore, the judicial hints of a possible wider basis for directors' liability may be construed as signals that legislative change is overdue. Even so, I believe that there is a creative role for the common law – or rather equity – to play here as well as for statute, though if legislation can deal specifically with the worst of the perceived abuses that role need only be a residual one.

SUMMARY

(i) Under the traditional rules of company law, directors' duties are regarded as being owed to the company and to the company alone; and for this purpose the company's interests are equated with the interests of the members collectively. Directors on this view are not entitled, still less bound, to consider the interests of other groups, such as the company's employees, creditors, customers and suppliers, or to have any concern for such matters as the community, the environment, welfare and charity, unless what they do has derivative benefits for their shareholders.

(ii) The trust principles upon which the rules relating to directors' duties are based can be made to accord fairly well with this concept of the company, i.e. the collective membership. In particular, there is no difficulty in accommodating the view that irregular acts of the directors (short of ultra vires or illegal acts) can be ratified or condoned by the shareholders' own votes, and that in voting on such an issue the shareholders are not constrained by fiduciary or other duties.

(iii) There are widely-held views that the law on directors' duties should now be changed so as to recognise the role played in the modern business by groups other than shareholders, and particularly by its employees. The view has also been expressed in some recent cases that, at least in a situation of insolvency or near-insolvency, directors should be under a duty to have regard to the interests of the company's creditors as well as its members.

(iv) To extend directors' duties so as to embrace the interests of employees and similar groups (and *a fortiori* so as to include more general concerns such as the environment) is to deny any effective role for the law and

[98] See, e.g., *Insolvency Act* 1986 (U.K.), s. 214; and cf. *Companies Code* (Aus.), ss. 556, 557.

[99] See, e.g., *Insolvency Act* 1986 (U.K.), s. 239; *Companies Code* (Aus.), s. 451; *Companies Act* 1955 (N.Z.), s. 309.

[100] See, e.g., *Insolvency Act* 1986 (U.K.), s. 238; *Companies Code* (Aus.), s. 453.

[101] See also the special provisions dealing with "related companies" in insolvency proceedings in the *Companies Act* 1955 (N.Z.), ss. 315A–315C, inserted by the *Companies Amendment Act* 1980, s. 30.

the courts. The concept of "duty" ceases to be justiciable, and company law lacks proper enforcement procedures. At best, these enlarged "duties" can only provide directors with a defence against self-centred claims brought by shareholders.

(v) Company law can, however, adjust to accept the notion of a duty to take account of creditors' interests in a situation of doubtful solvency. But this is only likely to be achieved if the courts are prepared to accept a more interventionist role than has been traditional and to review directors' commercial and policy decisions. Shareholders' resolutions can and should be subject to similar powers of review, whether these purport to be ratifying decisions or corporate acts in their own right.

(vi) There are dangers in seeking to go further and base a new remedy on a duty owed directly by directors to creditors in tort. This would clash with established principles of company law and with the underlying policy of insolvency law.

(vii) Legislative changes may make the need for new common-law rules less urgent. Nevertheless, there will be a role for this developing case-law to play.