# Interests of the Company as a whole: An Economic Appraisal of Fiduciary Controls

**Sen Hwei Chan** BCom (Hons) LLB (Hons) (UQ), Analyst, Andersen Consulting, Sydney

**Larelle Law** LLB (Hons) (QUT) LLM (UQ), Lecturer, Commerce Department, The University of Queensland

'The interests of the company as a whole' — this is the traditional formulation of the fiduciary duty imposed on company managers. The fiduciary duty has a function in controlling agency costs that arise from the separation of ownership and control of corporate resources. This article employs a law and business economics approach to assess the continuing usefulness of the traditional formulation of the fiduciary duty. It is concluded that the traditional formulation is outdated and inefficient, and it is suggested that the formulation be extended to 'the interests of the company as a going concern'. The ways in which this extended formulation may be defined and applied are explored in the article.

## 1. The Corporate Law Economic Reform Program and Fiduciary Duties

The third reform paper of the Corporate Law Economic Reform Program ('CLERP') addresses corporate governance issues.[1] The reforms to directors' duties proposed therein were specifically assessed against 'key economic principles' including:

* cost/benefit analysis;
* reduction of transaction costs;
* balance between government regulation and self regulation.[2]

Draft legislation, the *Corporate Law Economic Reform Program Bill* 1998 based on the paper's reform proposals, was released in December 1998. One of the reforms is the proposal to align s 232(2) *Corporations Law* more closely with fiduciary law. Instead of the current section: the duty of officers to 'act honestly', the reform suggests the section (cl 181(1) of the Bill) should specify that the duty of officers is to exercise their powers:

(a) in good faith in what they believe to be in the best interests of the corporation; and
(b) for a proper purpose.

The formulation 'the best interests of the corporation' is not defined, as CLERP's intention is to adopt the existing meaning. However, the meaning of this formulation is examined to determine whether it is consistent with the economic goals articulated by CLERP.

## 2. Economic Analysis Framework

The corporation is a business enterprise usually characterised by a separation between management and ownership.[3] Fiduciary duties imposed on the managers of corporations operate as a means of aligning the managers' interests with the shareholders' requirement

1 Corporate Law Economic Reform Program, Proposals for Reform: Paper No 3, *Directors' Duties and Corporate Governance*, AGPS, Canberra, 1997.

2 Note 1 at 5.

3 Berle A & Means G, *The Modern Corporation and Private Property*, Revised ed., Harcourt, Brace & World, New York, 1967. The terms 'directors' and 'managers' are used interchangeably herein to denote those upon whom the fiduciary duty to the company is imposed.

for profit maximisation. The costs of providing incentives to managers to achieve this alignment, and of monitoring of their performance, are referred to as agency costs.

However, alternative mechanisms, such as private contracting arrangements and market constraints are available to reduce agency costs. Fiduciary principles have a role in reducing agency costs, as fiduciary principles offer a comparative advantage over private contracting arrangements or *ex post* settling up in the markets. This argument is reflected in the following comment by Easterbrook and Fischel:[4]

> *Socially optimal* fiduciary rules approximate the bargain that investors and managers would have reached if they could have bargained (and enforced their agreements) at no cost. Such rules preserve the gains resulting from the separation of management from risk bearing while limiting the ability of managers to give priority to their own interests over those of investors. (Emphasis added)

Fiduciary principles are only effective to reduce agency costs if the principles are socially optimal. 'Socially optimal' refers to a measure of the 'efficiency'[5] of the control on management behaviour. We suggest that the traditional formulation of the fiduciary duty (ie. directors have a duty *to act bona fide in the interests of the company as whole*) is not socially optimal because conceptual problems associated with the elements of that expression result in the formulation being unsuited to the late twentieth century corporation. The research question addressed in this article is 'does the traditional formulation of the directors' fiduciary duties still have a role in modern Australian company law in reducing agency costs?' This question is addressed from the dual perspectives of:

* how the formulation has been articulated in the cases;[6] and
* what it should mean considering the circumstances of the modern corporation.[7]

A reassessment of the traditional formulation of the directors' fiduciary duty is timely due to corporate governance pressures from external disciplines. The evolution of the corporate enterprise is at the stage where it is questioned whether shareholders ought to be the sole constituency of corporate managers. The strategic management literature suggests that managers of corporations today must not only satisfy the needs of the shareholders but the success of the corporate enterprise also depends on a successful management of the corporation's stakeholders — the shareholders being only one of these stakeholders.[8] Other potential stakeholders have also been identified from the legal literature as including:[9]

* existing and future members;

4 Easterbrook FH & Fischel DR, *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge, 1991, at 92.

5 Economic efficiency exists where resources are used to produce goods and services that consumers want at least cost: McEwin RI, 'Law and Economics as an Approach to Corporate Law Research' (1996) 3 *Canberra Law Review* 40 at 40.

6 This material is largely informational content only for the purpose of developing the main hypothesis that the traditional formulation is outdated from an economic perspective. This article does not purport to revisit the substantial analysis contained in the recent literature on the legal meaning of 'the interests of the company as a whole'. The authors wish to acknowledge the body of work by other commentators, including: Nicoll G, 'Recognition of Proprietorial Interests in Management and Corporate Governance' (1996) 7 *AJCL* 80; Whincop M, 'Gambotto v WCP Ltd: An Economic Analysis of Alterations to Articles and Expropriation Articles (1995) 23 *ABLR* 276; Nicoll G, 'The Changing Face of the Company as a Whole and Directors' Responsibilities to Members in the Exercise of Management Powers' (1994) 4 *AJCL* 287; Dabner J, 'Directors' Duties — The Schizoid Company' (1988) 5 *C&SLJ* 105; Heydon JD, 'Directors' Duties and the Company's Interests' in Finn P (ed.) *Equity in Commercial Relationships*, Law Book Co, Sydney, 1987; Sealy SL, 'Directors' Wider Responsibilities — Problems: Conceptual, Practical and Procedural' (1987) 13 *Monash Law Review* 164.

7 Three flowcharts outlining the structure of the article and the central arguments adopted in addressing the research question are provided in the appendix.

8 Freeman RE, *Strategic Management: A Stakeholder Approach*, Pitman, Boston, 1984 at 46. 'Stakeholder' refers to any group or individual who can affect or is affected by the accomplishment of the firm's goals.

9 Ford H, Austin R & Ramsay I, *Principles of Corporations Law*, (Looseleaf ed.), Butterworths, Sydney, 1995 at para [8.090].

* creditors;
* beneficiaries under a trust where the corporation is the trustee;
* employees, customers, contractors; and
* the community.

The CLERP paper strongly endorses the shareholder model of corporate governance (vis-a-vis the stakeholder model adopted in civil law jurisdictions), although it recognises global pressure for harmonisation. The CLERP paper's prediction is that the shareholder model of corporate governance will prevail, 'because of the external accountability involved and having regard to the rising dependence on external equity, particularly institutional equity investment, to finance the operations and expansion of corporations. Moreover, in focusing on maximising shareholder wealth, the *shareholder approach* may make a company more flexible and responsive to change in its environment.'[10]

Whilst neither CLERP'S prediction nor policy choice are challenged, the argument developed adds value to the CLERP proposal by suggesting further expansion of the pivotal 'interests of the company as a whole' concept.

From a corporate governance perspective, there is a genuine disparity between what the law requires and permits managers to consider in exercising their management powers and what is required in practice for managers to consider to run a successful enterprise. The conclusions are aimed at reducing this disparity.

The analysis utilises the economic concept of agency costs as a benchmark for assessing the usefulness of the fiduciary principle of good faith. Such an approach contributes to the literature for two reasons. First, as outlined, this is consistent with the overall CLERP agenda.[11] Secondly, there is an indication that this is a useful paradigm for legal research to adopt, from the following observation by Professor Tomasic:[12]

> It is generally acknowledged that it is possible to understand corporate law problems by reference to concepts drawn from the burgeoning body of law and economics literature, although we have yet to see this possibility fully developed in Australian corporate law research.

## 3. Agency Costs and the Corporation

There are costs associated with the choice of the corporate form of economic organisation. Agency costs[13] result where there is an effective separation of ownership and control of the corporation's resources because:

(a) the interests of the managers (who control the resources) and the owners of the resources are not always aligned; and

(b) the managers only hold a minority equity stake in the corporation. The implication is that the managers are willing to appropriate the corporation's resources for their own consumption because they bear only a fraction of the resulting loss suffered by the corporation. The quantum of the agency costs of the corporate form (also referred to

10 Note 1 at 61.

11 Company law readily admits an economic analysis, as reflected in a recent speech delivered by the Treasurer, Mr Peter Costello to the Business Council of Australia in which he commented:
'The Corporations Law is particularly suited to increased economic analysis . . . I am convinced that the Government's economic approach to business regulation will result in better policy decisions and a regulatory environment more sensitive to the importance of business activity. An increased economic analysis of regulatory proposals should result in better laws.' Reported in *The Australian Financial Review*, 22 October 1996.

12 Tomasic R, 'A Note on Law and Economics Thinking About Corporate Law' (1995) 2 *Canberra Law Review* 155 at 155.

13 Jensen MC & Meckling WH, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

> as the 'agency costs of equity'[14]) is the sum of *monitoring expenditures* ostensibly incurred by the shareholders to reduce management's opportunity to consume perquisites, *bonding expenditures* incurred by managers to guarantee to the shareholders that management opportunistic behaviour would be limited and a *residual loss* to the corporation.[15]

The residual loss to the corporation results from two sources: incomplete contracting and passivity in shareholder control.[16]

### *3.1 The incomplete contract*

The contracts between the managers and the shareholders are incomplete because (a) there is a difficulty of limiting *ex ante* in the contracts all forms of divergent managerial behaviour where the period of the contract is lengthy — this is the condition of 'bounded rationality';[17] and (b) it is undesirable to specify to the letter what the managers are expected to do because this will significantly restrict their ability to exercise their professional skills for which the managers are retained.

### *3.2 Shareholder passivity: failure to monitor managerial activity*

The powers to manage the corporation are vested in the board of directors who are entitled to exercise these powers independently of shareholder direction.[18] Shareholders are able to exercise some control through their right to vote in a general meeting and their power to appoint and dismiss members of the board, but there is evidence that such monitoring is only effective in a closely held corporation. Ramsay and Blair[19] found that: 'Where an ownership structure is concentrated (for example, a company has a few shareholders who each hold a relatively large proportion of issued shares), shareholders have greater incentive to monitor the actions of managers ... concentrated ownership may mean that agency costs are lower.'

Shareholder passivity is attributed to diffuse ownership for three reasons. First, within a diffused ownership structure there are significant organisational costs involved in disseminating information regarding the abuse of management powers and mobilising the shareholders to take collective action.[20] Secondly, shareholders are reluctant to act within a diffused ownership structure as there is the prospect of other shareholders free-riding[21] on the efforts of those who act. Shareholders who fund monitoring of management are unable to exclude the other shareholders from sharing in the benefits. Thirdly, shareholders do not have the incentive to study the corporation's affairs and vote intelligently at a general meeting if none of the shareholders expect their vote to be decisive.[22]

14 Note 13.

15 It is assumed that the bonding and monitoring expenditure components of agency costs are efficient outcomes because such expenditures are incurred to bring about a reduction in managerial consumption of perquisites. See Chart 1, appendix.

16 See Chart 2, appendix.

17 Butler HN & Ribstein LE, 'Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians' (1990) 65(1) *Washington Law Review* 1 at 28.

18 *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

19 Ramsay I & Blair M, 'Ownership Concentration and Institutional Investment' (1993) 19 *Melbourne University Law Review* 153 at 157.

20 Alchian AA, 'Corporate Management and Property Rights' in Manne H (ed.), *Economic Policy and the Regulation of Corporate Securities*, American Enterprise Institute for Public Policy, Washington, 1969.

21 'Free-riding' occurs when individuals benefit from the actions of another without paying a commensurate charge. See Note 19 at 158.

22 Note 4 at 66–7.

## 4. Fiduciary Principles as a Response to Agency Costs

Identifying the existence of the agency costs associated with the use of the corporation to organise economic activity may give the impression that the corporation is an inefficient allocation of society's resources. Agency costs, if left unchecked, result in the corporate form being a sub-optimal and inefficient use of society's resources. The corporation has a major role in the modern society; its popularity and longevity (ie if the corporate form was inefficient, it would have been displaced by a more efficient alternative) reflects this. Posner[23] is of the view that separation of ownership and control is efficient but requires some machinery for discouraging management from excessive consumption of the company's resources. The accounting literature is replete with private arrangements to align managerial interests with shareholder interests, such as the use of executive compensation contracts.[24] Divergent managerial behaviour is also constrained by market forces, such as competition in the managerial labour market (this concerns the reputation effects of opportunistic managers), competition in the product markets (excessive consumption of perquisites will result in the corporation being uncompetitive and will eventually be unable to survive) and the market for corporate control (poorly performing managers will be replaced).[25]

The primary legal mechanism by which divergent managerial actions are curtailed is the imposition of fiduciary controls on managerial discretion and the exercise of managerial powers. Fiduciary duties are imposed on corporate managers not because the managers are trustees of the corporate resources (by definition, a trustee has a vested legal interest in the property of the trust, whereas corporate property is vested in the corporation as a separate legal entity) but rather because such managers accept an appointment of 'trust' and are accountable for the 'breach of trust'.[26] 'Trust' is used not in its strict legal connotation, but in its ordinary meaning:

> The feature which distinguishes these fiduciaries [ie. company directors] is that while they are entrusted with discretions to be exercised for another's benefit, they are not subject to the immediate control and supervision of that other in their exercise. Because of this autonomy ... [Equity has intervened to require that he acts] honestly in what he alone considers to be the interests of those for whose benefit his position exists.[27]

Recall that the residual loss component of the agency costs faced by corporations is partly due to incomplete contracting between managers and shareholders.[28] From an economic perspective, the corporation is theorised as a 'nexus of contracts'.[29] Fiduciary duties operate as implied terms to complete otherwise incomplete contracts, reducing transaction costs by removing the need for the parties to draft for remote contingencies.[30] Part five examines the formulation of the fiduciary duty to assess whether, in application, it is effective in 'completing the contract'.

23 Posner RA, *Economic Analysis of Law*, 4th ed, Little Brown and Company, Boston, 1992 at 411.

24 Smith CW & Watts RL, 'Incentive and Tax Effects of Executive Compensation Plans' (1982) *Australian Journal of Management* 139; Dechow PM & Sloan RG, 'Executive Incentives and the Horizon Problem' (1991) 14 *Journal of Accounting and Economics* 51.

25 We do not discuss private and market incentives further as the focus of the present article is on the legal machinery available to reduce agency costs.

26 Sealy LS, 'The Director as Trustee' [1967] *Cambridge Law Journal* 83 at 85. See also the comments of Clarke and Sheller JJA in *Daniels v Anderson* (1995) 16 ACSR 607 at 664–665 distinguishing the position of director from the classic trusteeship.

27 Finn PD, *Fiduciary Obligations*, Law Book Co, Sydney, 1977 at 8.

28 Note 13.

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

30 Note 17 at 29; Parkinson JE, *Corporate Power and Responsibility*, Oxford University Press, New York, 1993 at 181.

## 5. 'Interests of the Company as a Whole'

### *5.1 The derivation of the formula*

The formulation commonly accepted as the legal expression of the directors' fiduciary duty is that they owe a duty to act 'bona fide in the interests of the company as a whole'. This phrase was coined by Lord Lindley MR in *Allen v Gold Reefs of West Africa Ltd*[31] almost a century ago. It was subsequently adopted by Lord Greene MR in *Re Smith and Fawcett Ltd*[32] as the fiduciary constraint on the exercise of the directors' powers. Accordingly, confusion may have arisen as the formulation has been applied in two different contexts:

* the exercise by majority shareholders of their voting power, for example, minority interest squeeze-outs: *Gambotto v WCP Ltd*;[33] and
* the exercise by directors of management powers, for example the exercise of management's powers such as to thwart an impending takeover: *Howard Smith v Ampol Petroleum Ltd*,[34] or to engage in socially responsible activities: *Parke v Daily News Ltd*.[35]

This traditional formulation of the directors' fiduciary duty has been subsequently applied with minimal regard to its continued relevance given the evolution of the nature and structure of the corporation.[36]

Is this formulation appropriate to the actions of the modern corporate manager? This issue is approached first by reviewing the authorities in which this expression of the directors' fiduciary duty has been interpreted by the courts and determining whether such interpretations accord with the circumstances faced by the modern corporate manager. Secondly, the circumstances under which fiduciary principles offer comparative advantage as a mechanism to reduce agency costs in today's corporate environment is examined.

### *5.2 The meaning of 'the company as a whole'*

*Allen v Gold Reefs* did not concern the exercise of the directors' powers but it related to the alteration of articles by the majority shareholders in general meeting. The two separate applications of the expression 'the company as a whole' give rise to at least two possible meanings: either the company as a separate legal and commercial entity, or the company as an association of shareholders. According to Whincop,[37] in the case of majority shareholder powers, such distinction is largely specious, as it will be rare in that a decision in the interest of the commercial entity is not in the interest of the hypothetical shareholder. Majority shareholders do not owe a fiduciary duty to the company when exercising voting power. However, in the case of the exercise of management powers in conformity with directors fiduciary duty, explicit recognition ought to be attributed to both meanings.

The two meanings are explored below in the context of the specific applications.

#### *5.2.1 Exercise of majority shareholder voting power: the alteration of articles cases*

*Allen v Gold Reefs* involved a company resolution to change the articles to extend the lien for unpaid calls over both partly paid shares and fully paid shares. This alteration had the intended effect of prejudicing one member who had fallen into arrears in meeting calls on

31 [1900] 1 Ch 656.
32 [1942] Ch 304 at 306.
33 (1995) 182 CLR 432
34 [1974] AC 821.
35 [1962] Ch 927.
36 Such changes were recognised in the Cooney Report where it was observed that, 'the corporate culture we know today is not the corporate culture of a century ago': Senate Standing Committee on Legal and Constitutional Affairs, *Report on the Social and Fiduciary Duties and Obligations of Company Directors*, AGPS, Canberra, 1989 para 2.1. See also Wedderburn KW 'Trust, Corporation and the Worker' (1985) 23(2) *Osgoode Hall LJ* 211 at 219.
37 Whincop, n 6, at 297.

his partly paid shares and who was the only holder of fully paid shares. Thus this case involved a conflict between the company's interest (in recovering the debt) and the interest of a member of the company. Within this context, it has been suggested that Lord Lindley MR had the company as a legal entity in mind when he used the expression 'the company as a whole.'[38] A series of English cases that followed *Allen v Gold Reefs* had similarly relied on the expression as meaning the company as a separate entity.[39]

On the surface, the High Court's decision in *Peter's American Delicacy Co v Heath*[40] marked a departure from the English approach, as Dixon J said that 'company as a whole' referred to 'a corporate entity consisting of all the shareholders.'[41] Latham CJ was of the view that an alteration to the articles is valid if it was made for the benefit of the company but this apparent endorsement of the English approach was qualified with the statement that, 'the benefit of the company as a corporation cannot be adopted as a criterion which is capable of solving all the problems in this branch of the law.'[42] In particular, Latham CJ regarded the expression as being inappropriate where the alteration affected the relative rights of different classes of shareholders. This case involved an alteration of the articles that was claimed to have the effect of discriminating holders of partly paid shares in favour of holders of fully paid shares in calculating their entitlement to distributions. The alteration was ultimately held valid. The distinguishing feature of *Peter's* case is that unlike *Allen's* case, it involved a conflict of the interests of members *inter se* and therefore is not necessarily inconsistent with *Allen's* case. It was in this context that the High Court attributed to the expression 'the company as a whole' the meaning of the interest of the general body of members.

The approach taken by the High Court in *Peter's* case found support in England in *Greenhalgh v Arderne Cinemas Ltd*,[43] Evershed MR made the definitive statement that, 'the phrase, 'the company as a whole', does not . . . mean the company as a commercial entity, distinct from the corporators, it means the corporators as a general body.'

The most authoritative judicial consideration of this formulation is in *Gambotto v WCP Ltd*,[44] a case involving an expropriation of minority shares by the majority. In that case, the articles were altered to allow any member who was entitled to 90% or more of the issued shares to compulsorily acquire the minority's shares. (It was conceded that the price intended to be paid for the minority's shares exceeded market value.) The minority was successful in arguing that the alteration was invalid. The High Court followed *Peter's* case and ruled that the expression 'the company as a whole' was no longer appropriate in the context of the alteration of articles which had a redistributive effect on the members' rights. However the court noted that, 'the expression is still in vogue in the context of the exercise by directors of their powers, particularly the power to issue or allot shares.'[45]

*5.2.2 Exercise of directors' powers cases*

The expression 'the company as a whole' has also been applied in cases concerning the exercise of directors' powers, particularly where the exercise of directors' powers affected the interests of shareholders. In cases such as *Ngurli v McCann*[46] and *Whitehouse v Carlton*

38 Rixon FG, 'Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association' (1986) 49(4) *Modern Law Review* 446 at 448.
39 *Sidebottom v Kershaw Leese & Co* [1920] 1 Ch 154; *Dafen Tinplate Co v Llanelly Steel Co* [1920] 2 Ch 124; *Shuttleworth v Cox Brothers & Co (Maidenhead)* [1927] 2 KB 9.
40 (1939) 61 CLR 457.
41 (1939) 61 CLR 457 at 512.
42 (1939) 61 CLR 457 at 481.
43 [1951] Ch 286 at 291.
44 (1995) 182 CLR 432.
45 (1995) 182 CLR 432 at 444, per Mason CJ, Brennan, Deane & Dawson JJ.
46 (1953) 90 CLR 425.

*Hotels Pty Ltd*,[47] the High Court considered that the exercise of the directors' power to issue shares required a consideration of the interest of the company as a whole, which was held to mean the corporators as a general body. In *Russell Kinsela Pty Ltd v Kinsela*, Street CJ held that, 'the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise.'[48]

The apparently settled debate as to the proper interpretation of the expression 'the company as a whole' within the context of the exercise of the directors' powers was reinvigorated by the decision in *Darvall v North Sydney Brick and Tile Co Ltd*.[49] The case involved the directors' decision to commit a subsidiary company to a joint venture agreement subsequent to receiving a takeover offer from the plaintiff (an existing shareholder) for the subsidiary company. Under the agreement, land held by the subsidiary was acquired by a joint venture company and developed. At first instance, Hodgson J equated the interests of the company with the interests of the shareholders. His Honour said:

> I think that the directors did believe that in the circumstances of the existence of the offer, the joint venture agreement was in the best interests of the company and of its present shareholders. . . . In my view, in general, the directors thought that acceptance by shareholders of an offer of $10 would not be in the best interests of shareholders.[50]

The court on appeal did not expressly state the interpretation to be given to the formulation, but the tenor of their judgments suggests that an entity-based interpretation is appropriate:

> It is not correct that, as a matter of generality, a company has no legitimate interest in who are its shareholders or the price paid for its shares. . . . [t]he interests of a company as a whole may extend beyond the conduct of its business and the security of its assets. . . . It may therefore have an interest in, and be entitled to expend its funds in relation to, the achievement of a proper understanding of the company's worth.[51]
>
> A decision to involve the company in a joint venture was one which properly lies within the sphere of management. Directors are concerned to take all such steps in the management of the company which, in their opinion, advances its interests.[52]

A significant aspect of the dispute in *Equiticorp Finance Ltd v Bank of New Zealand*[53] revolved around the honesty of directors in using the liquidity reserves of two companies in the Equiticorp group to satisfy a third company's indebtedness to the Bank. The decision was made in a climate involving the Bank's increasing concern over its exposure to the group in failing financial circumstances. Clarke and Cripp JJ accepted that the directors were justified in considering the welfare of the group where group welfare was intertwined with the welfare of the individual companies.

### *5.2.3 'The company as a whole': a fresh approach for the fiduciary duty*

The use of the 'company as a whole' formulation so far demonstrates uneasy inconsistency: it may mean the company as a commercial entity or it may mean the collective interests of the shareholders comprising the company depending on the context of the case and the nature of the power being exercised.[54]

Uncertainty in the law suggests inefficiency: the counter argument is that uncertainty welcomes flexibility or 'fluidity'[55] of the formulation. The essence of the argument is that

47 (1987) 162 CLR 285.
48 (1986) 10 ACLR 395 at 401.
49 (1989) 16 NSWLR 260.
50 (1989) 16 NSWLR 260 at 327.
51 (1989) 16 NSWLR 260 at 325 per Mahoney JA.
52 (1989) 16 NSWLR 260 at 337–8 per Clarke JA.
53 (1993) 11 ACLC 952.
54 See Chart 3, appendix.
55 The Cooney Report, n 36, at para 4.24.

this flexibility in the construction of the rule allows a better response by the law to the diverse range of arrangements that confront a corporation.[56] The uncertainty is reduced by reforming the parameters. The parameters could be linked to the exercise of the power, such as where the exercise of the powers affects the proprietary interests of shareholders (eg. the issue of shares), then the 'company' should be treated as the collective interests of the members. Where the power exercised is primarily an incident of the directors' powers of management (eg. the entering into a joint venture agreement or the granting of a lease), then the interests to be considered by directors should be interests of the company as a separate entity. Where there is overlap (eg. a share issue to facilitate a managerial decision such as an acquisition) apply a causation test as employed in fiduciary law;[57] viz, 'but for the company as a separate entity's interest, would the directors exercise the managerial power'?

*5.3 The meaning of 'interests' of the company as a whole*

The definition of the 'interest' that the directors have to consider is itself problematic, given that it may further reduce the efficiency of the Lindley formulation as a control on agency costs. Whether the interests of 'the company' is to be equated with the interests of the members depends upon the question: 'by what standards are the shareholders' interests to be measured?'[58] The shareholder model endorsed by CLERP regards the shareholders' interests to be exclusive. The interests of other stakeholders in the corporation are only relevant to the extent that such consideration furthers the interests of the shareholders.[59] The interests of the shareholders equates to maximising distributions to shareholders. There is no direct case authority endorsing this model in Australia: distribution disputes have arisen in the context for remedies or relief under s 260 or s 461.[60]

The interpretation of the expression 'the interests of the company as a whole' as meaning 'the pecuniary interests of the shareholders' creates a disparity between what the corporate managers are permitted by law to consider in the performance of their duties and what is required to be considered in the modern corporate environment in order to succeed as a corporate manager: 'there is a need for law makers and others to consider ways in which the law can respond to "the demands of the modern corporation".'[61] The strategic management literature has shown that modern corporations are of such a scale that to be successful, the managers need to consider the interests of groups who are affected by and who have ability to affect the attainment of the corporation's objectives (ie. the *stakeholders*).[62] Similarly, Dr Sealy argues that there is a need for a 'recognition within company law of the view that the providers of share capital are not the only contributors to the wealth making process.'[63]

The interpretation of the Lindley formulation that best accords with commercial practice is that which ascribes to the expression 'the interests of the company as a whole' the

56 Nicoll, 1996, n 6, at 289 and 298.

57 *Whitehouse v Carlton Hotels Pty Ltd* (1987) 162 CLR 285.

58 *Teck Corporation Ltd v Millar* (1973) 33 DLR (3d) 288, per Berger J at 314.

59 *Hutton v West Cork Railway Co.* (1883) 23 ChD 654 at 671; Parkinson, n 30, at 81; The Cooney Report, n 36, para 5.8.

60 For example *Re City Meat Co Pty Ltd* (1983) 8 ACLR 673; *Sanford v Sanford Courier Service Pty Ltd* (1989) 10 ACLR 549; *Re Bagot Well Pastoral Co Pty Ltd* (1992) 11 ACLC 1. This point is also noted by Farrar J, 'Australia's Dividend Laws: The Case For Mandatory Disclosure of the Dividend Decision' (1998) 20 *Syd LR* 42 at 44. In England, a proposal to apply the balance of the proceeds of sale of machinery as *ex gratia* payments to employees made redundant following the cessation of the enterprise was held to be invalid in *Parke v Daily News Ltd* [1962] Ch 927 due to the paramountcy of shareholder returns.

61 Kennan J, 'Comments on "Directors Wider Responsibilities — Problems: Conceptual, Practical and Procedural"', paper presented at AULSA Conference, Monash University, 25 August 1987, cited in the Cooney Report, n 36, para 5.2.

62 Note 8.

63 Sealy, n 6 at 170.

meaning of the company as a separate legal and commercial entity. Under this interpretation, 'interest' is not restricted to the pecuniary interests of the shareholders but rather the interests of the company as a going concern. Within the rubric of the 'interest of the company as a going concern', directors are able to indirectly consider the interests of the other stakeholders (such as creditors, employees and customers).

CLERP fails to acknowledge the tension within the shareholder model: Mason CJ in *Walker v Wimborne*[64] explicitly referred to the interests of the company as including the interests of *creditors*.[65] *Walker v Wimborne* was applied in *Kinsela v Russell Kinsela Pty Ltd* where Street CJ said that, 'the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors.'[66] These cases do not establish a principle that the directors owe an independent duty to creditors in insolvency situations but rather that the directors in discharging their duty to the company, must also consider the interests of the creditors.

The Cooney Report contains a concise debate as to the need to widen the scope of the fiduciary duty formulation.[67] Ultimately, the Report only recommended that the companies legislation be amended to allow the interests of the company's employees to be taken into account by directors in managing the company. As regards other potential stakeholders — such as consumers and the environment — the Report made no specific recommendation. Such an explicit proposal is inconsistent with the CLERP agenda. Rather, if the 'interests of the company as a whole' is interpreted as referring to going concern issues, this provides sufficient inherent flexibility for a range of interests if the directors believe it furthers the longevity of the enterprise.

*5.4 Fiduciary duty as controlling agency costs: market failure?*

The previous discussion has identified conceptual difficulties associated with the traditional formulation of the directors' fiduciary duty.[68]

It is axiomatic within the business economics paradigm that in ideal markets, the market participants will contract to secure the most efficient outcome. Market failures, however, act to prevent efficient outcomes and regulation is a response thereto.[69] The purpose of regulation is to approximate the efficient outcomes that would have been achieved in an ideal market. Part three, argued that in the context of corporate governance, two conditions of market failure existed which rendered the private and market based agency costs controls less efficient than fiduciary principles:

* incomplete contracting; and
* shareholder passivity in terms of exercising control over the directors (this is limited to voting in a general meeting to elect and remove directors and to bring a derivative suit).

The condition of incomplete contracting is of a hybrid nature. Incomplete contracting is a condition of market failure where it results from the difficulty in specifying *ex ante* all forms of permissible managerial conduct. However, incomplete contracting may be perceived as an efficient outcome if the desire of the contracting parties is *not* to unduly limit the range of managerial conduct and to allow the managers to exercise their professional skills. In the market failure sense of the condition, Lord Lindley's MR

64 (1976) 137 CLR 1.
65 (1976) 137 CLR 1 at 7.
66 (1986) 4 NSWLR 722 at 732.
67 The Cooney Report, n 36, ch 6. At para 6.24: 'The advantage of making it clear that the interests of a company's employees are a legitimate matter for directors to take into account is that it would make it clear that the approach of Justice Plowman in *Parke v Daily News Ltd* was no longer part of company law.'
68 See Chart 2, appendix.
69 Riley CA, 'Understanding and Regulating the Corporation' (1995) 58(4) *Modern Law Review* 595 at 599; Watts RL & Zimmerman JL, *Positive Accounting Theory*, Prentice Hall, Englewood Cliffs, 1986 at 162–3.

formulation has been effective in curbing managerial excesses but it has done so inefficiently by straying into the efficiency sense of the condition. The courts by interpreting the formulation to mean 'the pecuniary interests of the shareholders' have imposed too strict a constraint on the range of matters that directors are allowed to consider and to act upon in the discharge of their duties. This is an undesirable effect of the fiduciary controls. The Privy Council recognised in *Howard Smith v Ampol Petroleum Ltd*[70] that the purpose of corporate power should not be interpreted too narrowly such as to hamper the ability of management to engage in legitimate business activities. Anderson[71] expressed a similar view:

> . . . if managerial discretion is restricted not by individual contract, but by corporation codes which prohibit or require specified behaviour by management. Such standardized restrictions on managerial discretion are undesirable, however, if they are likely to limit managerial flexibility to act in the interests of the shareholders.

Three reasons were forwarded in part three to explain the apparent shareholder passivity in corporate governance affairs:

(a) the free-rider problem — shareholders are reluctant to expend money on costly derivative suits against the management because they are unable to exclude the other shareholders from sharing in the benefits where such shareholders have not contributed to the legal costs;

(b) the shareholders do not expect their vote to be decisive on any issue because of the relatively small individual shareholdings; and

(c) there are significant organisational costs involved where ownership is diffused. The reasons for shareholder passivity are becoming less relevant.

The first disincentive to shareholder action is the legal barriers involved. The Lavarch Report recommended that the *Corporations Law* be amended to introduce a form of statutory derivative action.[72] CLERP has proposed this amendment in the *Corporate Law Economic Reform Program Bill* 1998 by inserting new Part 2F.1A 'Proceedings on behalf of a company by members and others'. Costello encourages this reform as he asserts it will result in 'more efficient and effective regulation.'[73] Shareholder passivity on this ground is expected to be neutralised.

The second ground for shareholder passivity relates to the ability of shareholders to influence the issues being considered in general meeting. This ground is also rendered irrelevant with the increasing prevalence of institutional investors in the equity structure of the modern corporations. Ramsay and Blair[74] documented evidence of increasing institutional investment in Australian listed companies. However, increased institutional shareholding alone does not negate the possibility of shareholder passivity. It has been argued that the institutional investor has not exercised power over management.[75] However, Ramsay and Blair[76] also noted that there was anecdotal evidence both overseas and in

70 [1974] AC 821 at 835, cited in McCabe B, 'The Roles and Responsibilities of Corporate Directors in a Takeover' (1994) 4 *AJCL* 36 at 49.

71 Anderson AG, 'Conflicts of Interest: Efficiency, Fairness and Corporate Structure' (1978) 25 *UCLA Law Review* 738 at 781.

72 The House of Representatives Standing Committee on Legal and Constitutional Affairs, *Report on Corporate Practices and the Rights of Shareholders*, AGPS, Canberra, 1991 para 6.3.33.

73 Reported in the *Australian Financial Review*, 22 October, 1996.

74 Note 19. See also Stapledon G, 'Australian Share Market Ownership' in Walker G, Fisse B & Ramsay I (eds), *Securities Regulation in Australia and New Zealand* 2nd ed. LBC, Sydney, 1998.

75 Wedderburn KW, n 36 at 219; Stapledon G, 'The Structure of Share Ownership and Control: The Potential for Institutional Investor Activism' (1995) 18 *UNSWLR* 250; Stapledon G, 'Disincentives to Activism by Institutional Investors in Listed Companies' (1996) 18 *Syd LR* 152.

76 Note 19 at 179–80.

Australia that suggested an increase in institutional shareholder activism. The incentives for active monitoring by institutional investors include:

* as large shareholders, institutional investors have the influence and resources to more effectively organise a successful vote;[77]
* because of the size of their shareholding, such investors cannot readily sell their stock without depressing the share price;[78]
* their larger shareholding will allow them to capture more of the benefits that result from controlling agency costs.[79]

The concentration of shares in the hands of the institutional investors decreases in organisational costs involved in mobilising shareholder action. Therefore the second and third grounds for shareholder passivity are also effectively neutralised.

Consequently, the 'interests of the company' formulation is useful as a 'test', but needs to be redefined to ensure its long term usefulness. That is, the fiduciary duty still operates to reduce incomplete contracting between management and the company, but managers ought to accord with current notions of the corporation's function.

## 6. Conclusion and Propositions for Change

### *6.1 The interests of the company as a going concern*

The assessment of the economic efficiency of the traditional formulation of directors' duties as a legal mechanism to control agency costs requires a two-pronged approach. First, the component elements of the formulation (the ***interests*** of ***the company as a whole***) were assessed in terms of certainty of definition and whether the formulation could still be appropriately applied to the actions of the modern corporate manager. Inefficiencies are created by the uncertainty generated both by the legal parameters of the formulation and by external pressures from other literature to expand the corporate horizon.

A better interpretation of the formulation would be: 'the interests of the company as a going concern'. This does not conflict with the CLERP endorsed shareholder model, but we suggest that the shareholder model is more flexible to accommodate a longer term view of shareholder wealth which does not just concentrate on short term gains.

Secondly, the continued applicability of the formulation to the modern corporation in terms of whether it still operates to reduce agency costs is asserted. Although the condition of 'shareholder passivity' is less relevant and the proposed introduction of a statutory derivative action procedure mitigate agency costs, fiduciary duties still have a role in completing the managerial contract. The condition of 'incomplete contracting' is composed of both market failure and efficiency components. Whilst the formulation effectively addresses the market failure component, it has done so in a manner which transgresses into the efficiency component. Efficiency arguments are addressed by proposing a more modern and flexible interpretation of the interests of the company.

### *6.2 Defining the company as a going concern*

How should the notion of 'the interests of the company as a going concern' be defined? Three possible approaches may be adopted.[80]

First, this notion could be equated with a duty of the directors to maximise the present value of the corporation.[81] Maximising the value of the corporation does not require the

77 McCabe B, 'Are Corporations Socially Responsible? Is Corporate Social Responsibility Desirable?' (1992) 4 *Bond Law Review* 1 at 6.
78 Note 77; Chamberlain NW, *The Limits of Corporate Responsibility*, Basic Books, New York, 1973 at 183.
79 Note 19 at 180.
80 See Chart 3, appendix.
81 Parkinson JE, n 29, at 90.

managers to balance the interests of the present and future members explicitly because it is assumed that the corporation's present value equals the expected future income stream of the corporation after deducting the cost of capital.[82]

Secondly, could the collective interests of all the primary stakeholders of the firm, such as the shareholders, creditors, employees and customers be related? This approach is unrealistic to sustain in Australia, given the CLERP proposals. Dr Sealy[83] argues that:

> [w]ithout some system of legally ordered priorities between the different groups . . . 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.

A third possible approach and the one we favour, in construing the meaning of 'the interests of the company as a going concern' is to focus not on the results to be achieved but on the behaviour of the directors that the notion is designed to encourage. This is expressed by Kubler:[84]

> Thus the notion of the 'interest of the enterprise' has the quality of a legal norm; but this norm can only require that corporate management adequately respects different needs and interests; . . . Directors' duties and liabilities cannot be expressed in terms of results, but only in terms of behaviour.

The procedurisation of directors' duties is encouraged through:

* the protection of business judgments; and
* the requirement that the directors exercise their powers fairly as between the different classes of stakeholders.

*6.2.1 Protection of business judgments*

The formulation of the fiduciary duty already protects business judgments.[85] Management has the duty to exercise powers for a proper purpose; the designation of what is 'proper' is a question of law. The High Court in *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* stated:[86]

> Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.

As the law already demonstrates a judicial reluctance to scrutinise the merits of business decisions in fiduciary cases, modernising the formulation of the fiduciary duty should not impose a greater risk of litigation. In any event, the *Corporate Law Economic Reform Program Bill* 1998 proposes a statutory business judgment rule in s 180(2).

82 The capital asset pricing model (CAPM): Fama EF & Miller M, *The Theory of Finance*, Dryden Press, Hirsdale, Illinios, 1972; Sharpe WF, 'Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk' (1964) 19 *Journal of Finance* 425.

83 Sealy, n 6, at 176.

84 Kubler FK, 'Dual Loyalty of Labor Representatives' in Hopt KJ & Teubner G (eds), *Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility* Walter de Gruyter, Berlin, 1985 at 440.

85 Redmond P, 'Safe Harbours or Sleepy Hollows: Does Australia Need a Statutory Business Judgment Rule?' in Ramsay I (ed.), *Corporate Governance and the Duties of Company Directors* Centre for Corporate Law and Securities Regulation, Melbourne, 1997.

86 (1967) 121 CLR 483 at 493.

*6.2.2 Fairness*

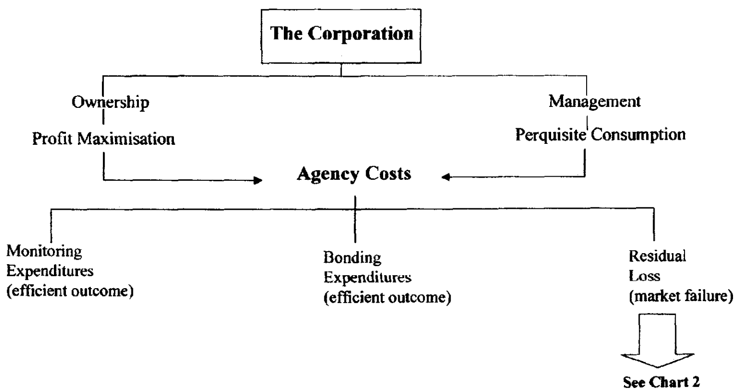
The common law has established the principle that directors are required to treat members of the same class of shares equally and to treat the members of different classes fairly when taking decisions which affect the rights of such members *inter se*.[87] For actions by majority shareholders, the High Court in *Gambotto v WCP Ltd* endorsed a requirement of fairness. There is no reason why such a requirement should not be extended to encompass the actions of directors where such actions affected the rights of the stakeholders *inter se*. The High Court in *Gambotto* followed an American authority, *Weinberger v UOP Inc*[88] and held that fairness required procedural as well as substantive fairness. In the context this article, procedural fairness requires directors to make adequate disclosures of their actions where such actions have the effect of advantaging or disadvantaging different groups of stakeholders. Substantive fairness would require the directors to justify such action as being action in the interests of the company as a going concern.

In conclusion, remodelling the current formulation to one that emphasises

(a) the paramountcy of the company's interests and its continued existence; and

(b) the procedural aspects of the directors' duties enables the fiduciary mechanism to continue its role as a check on agency costs while being in touch with the concerns of the directors, that is, achieving an alignment of law and practice.

Chart 1. Agency Costs of the Corporation




87 *Mills v Mills* (1938) 60 CLR 150 at 164; Note 27 at 64–5.

88 (1983) 68 457 A 2d 701.

Chart 2. Treatment of Residual Loss Component of Agency Costs

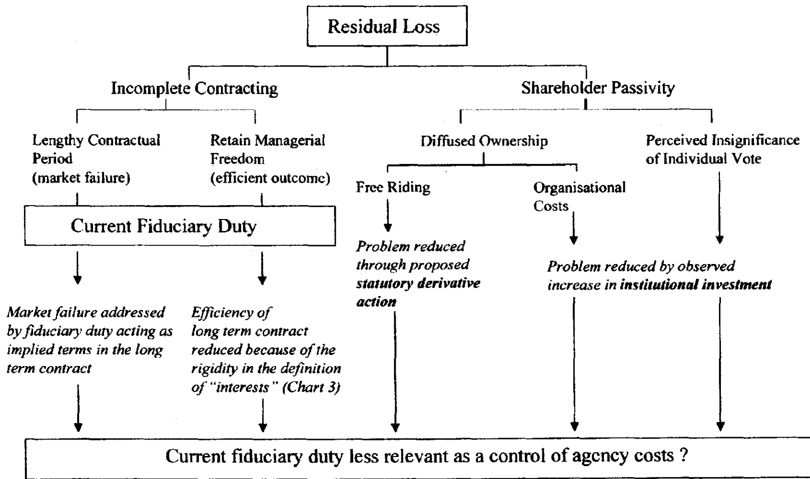



Chart 3. Current and Proposed Formulations of the Fiduciary Duty