THE ASCERTAINMENT OF PURPOSE WHEN BONA FIDES ARE IN ISSUE— SOME LOGICAL PROBLEMS

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I propose to start this paper by giving a short explanation of some principles of electrical engineering. I am doing this not to show off my knowledge of this field (which is limited to year nine physics) but because I can think of no better analogy to illustrate the point I seek to make.

If one wishes to illuminate two light globes from a power source, one may connect the globes in parallel or in series. This is demonstrated by the two diagrams below. Figure 1 shows two light globes collected in series; Figure 2 shows two light globes connected in parallel. In the first situation, the two are part of a continuum. If one breaks one light globe, the other will go out. The power must pass through both in order to achieve the result of illumination. In the second situation, however, power passes through the two light globes independently. The smashing of one light globe will not cause the other to go out.

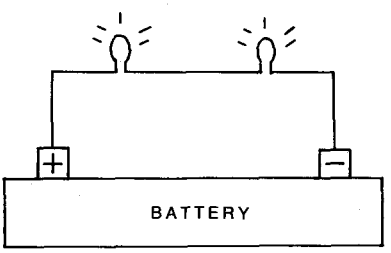

Fig. 1

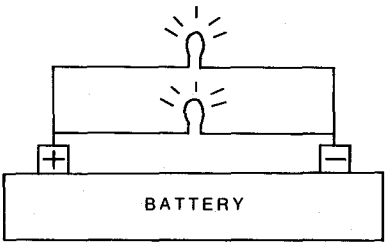

Fig. 2

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This paper is concerned with purpose. My central submission is that, when the courts are concerned with purpose, particularly in the area of company law, they must appreciate that purposes may be connected in series or in parallel and that it is necessary to apply totally different principles to the two types of case. This can be illustrated by the analogy of a person getting into his car in order to travel to a restaurant for dinner with a friend. His purpose in going to the restaurant may be to eat a meal, it may be to enjoy his friend's company or it may be a mixed purpose of partly one and partly the other. On this analysis, it is perfectly meaningful to ask the question "what is his purpose: to enjoy the food or to enjoy the company" and it is perfectly meaningful to answer the question by saying that his purpose is equally divided between the two or that one or the other is his predominant purpose. Indeed, if one thinks mathematically, one may say that his purpose is 70% to enjoy the food and 30% to enjoy the company.

On the other hand, suppose that one asks about a different range of purposes. If he is asked "what was your purpose in opening the door of the car?", he may answer either "to get into the car" or "to go to the restaurant". The central thesis of this paper is that it is meaningless to ask a court to select between these purposes or, if they both exist, to weigh which is the dominant purpose or what proportion should be attributed to the one or the other.

Reverting to my electrical engineering analogy, the purposes: "To enjoy the food" and "to enjoy the company" are connected in parallel and may be compared; the purposes "to get into the car" and "to go to the restaurant" are connected in series and one can neither regard one as exluding the other nor regard one as greater than the other. The current must flow through both to produce the result and, as a matter of logic, neither can be more vital to the circuit, whereas in the first case the current may flow through one or the other or partly through one and partly through the other.

Let me now turn to company law. It is trite law that a director must act bona fide for the benefit of the company. There is a minor gloss to the effect that, in this context, the words "the company" do not mean the entity itself divorced from its members nor do they mean the members divorced from others who may have an interest. If the former were the case, it would always be a breach of director's duty for directors to vote to declare a dividend since a dividend enriches the members at the expense of the company with no corresponding benefit to the company. Similarly, if the second were the case, it would be open to two people who were the sole directors and shareholders of a company to appropriate its assets or to make contracts grossly disadvantageous to the company and then resist claims for restitution by the liquidator. This they cannot do. See *re ABC Plastik Pty. Ltd.*,[1] *Ring* v. *Sutton*.[2]

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[1] (1975) 1 A.C.L.R. 446.

[2] (1980) 5 A.C.L.R. 546.

The matter with which I am principally concerned, however, is not the identity of the party to whom the duty is owed but how one measures its breach when a director is accused of acting with an improper purpose. The two areas in which the present problem has caused the greatest difficulty are issues of shares designed to defeat takeover offers and expenditure of the company's money for the purpose of securing the re-election of directors. In each of these areas, the courts have been led into difficulty on occasions by a failure to appreciate the distinction between purposes "linked in series" and purposes "linked in parallel".

The problem which arises in the takeover area is that directors may have a number of reasons for desiring to resist a takeover offer. Let it be assumed that one of those purposes is to prevent the company from being controlled by persons who, in the honest and reasonable opinion of the directors, would act in a manner detrimental to the company's interests. They therefore issue shares to "friendly" parties for the purpose of causing the takeover offer to fail.

Whether one regards this conduct as in breach of the director's duties depends upon the characterisation of the permissible and the prohibited purposes. If one starts with the proposition that it is permissible to issue shares only for the purpose of raising capital and that it is impermissible to issue shares for the purpose of defeating a takeover offer, the purposes may readily be weighed. It matters not for this argument whether the test is predominant purpose or sole purpose, the two purposes are clearly "linked in parallel" and one may ask whether each director has one purpose, the other purpose, or some and if so what combination of the two.

It is possible, however, to characterise the problem in a different way. One may say ask whether their purpose was the benefit of the company or the defeat of the takeover offer. If one asks the question this way, the purposes are "linked in series" and a person who attempts to weigh them is guilty of the fallacy which I seek to expose. One cannot compare the two because one leads to the other. To ask whether they wish to resist a takeover offer or to act for the benefit of the company is like asking the man who opens his car door whether he wishes to get into the car or to go to the restaurant and, if both, which is his predominant purpose. The question simply cannot be answered.

Of course, even this question can be put in a way which makes it meaningful. If one confines oneself to the motive for resisting the takeover offer, one may ask whether the purpose in resisting the takeover offer is to benefit the directors by retaining their director's fees or whether it is to benefit the company by retaining the benefit of their services (as opposed to the undesirable services of the offeror's intended appointees). These purposes are linked in parallel. One may not ask, however, whether the purpose to maintain themselves in office or to confer upon the company the benefit of their services. These purposes are linked in series. Certainly they intend to maintain themselves in office but they claim that they

intend to do this in order to confer upon the company the benefit of their services. The two are not alternatives but part of the same series of purposes.

The result is that, in a conflict situation like this, there is a tortuous path of purposes through which the current will flow. Some of these purposes are linked in series and some are linked in parallel. Some are in series at one point in the track but in parallel with others at another point in the track (see Figure 3). One must ask carefully at each stage what are the purposes being compared and one may only ask meaningfully "is your purpose x or y or some and if so what combination of them" when those purposes are linked in parallel inter se.

With this introduction, I now turn to the cases.

The first of the English cases is the decision of Byrne J. in *Punt* v. *Simons & Co. Limited.*[3] In relation to the power to issue shares, his Lordship said:[4]

> A power of the kind exercised by the directors in this case, is one which must be exercised for the benefit of the company: primarily it is given to them for the purpose of enabling them to raise capital when required for the purposes of the company. There may be occasions when the directors may fairly and properly issue shares in the case of a company constituted like the present for other reasons. For instance, it would not be at all an unreasonable thing to create a sufficient number of shareholders to enable statutory powers to be exercised; but when I find a limited issue of shares to persons who are obviously meant and intended to secure the necessary statutory majority in a particular interest, I do not think that is a fair and bona fide exercise of the power.

This exposition avoids rather than answers the true question. If the power is simply to act bona fide for the benefit of the company, one cannot exclude all cases where the intention is to secure the necessary statutory majority in a particular interest. On the other hand, if the sole permissible purpose is to raise capital when required, there can be no exceptions. Although the case is frequently cited, logically it does nothing to assist in the solution to the problem.

The next case is the decision of Peterson J. in *Piercy* v. *S. Mills & Company Limited.*[5] His Lordship cited *Punt* v. *Simons & Co. Limited*[6] and expressed the rule in the following terms:[7]

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[3] [1903] 2 Ch. 506.

[4] At pages 515-6.

[5] [1920] 1 Ch. 77.

[6] Supra n. 4.

[7] At pages 84-5.

> The Plaintiff and his friends held a majority of the shares of the company, and they were entitled, so long as that majority remained, to have their views prevail in accordance with the regulations of the company; and it was not, in my opinion, open to the directors, for the purpose of converting the minority to a majority, and solely for the purpose of defeating the wishes of the existing majority, to issue the shares which are in dispute in the present action.

This could be construed as stating the test in a negative way. The proposition in the negative approach may be set out as follows:—

1. The sole legitimate purpose of an exercise of the power to issue shares is to do so bona fide for the benefit of the company.
2. This general purpose of approach is unconfined except for a single exclusion. That exclusion is that the directors may not issue shares for the purpose of defeating an existing majority even if their purpose in defeating that majority is bona fide for the benefit of the company.

The difficulty is that the case does not point to the rule in that way.

The case which does express the rule in that way and, indeed, the case which has caused the most controversy in England is the decision of Buckley J. in *Hogg v. Cramphorn Limited*.[8] His Lordship found[9] that the directors firmly believed that to keep the management of the company's affairs in the hands of the existing board would be more advantageous to the shareholders, the company's staff and its customers than if it were committed to a board selected by a Mr Baxter, who was in the process of making a takeover offer. The board therefore issued certain shares and took certain steps with a view to defeating that takeover offer. His Lordship said:[10]

> It is not, in my judgment, open to the directors on such a case to say, "we genuinely believe that what we seek to prevent the majority from doing will harm the company and therefore are acting arming ourselves or our party with sufficient shares to out vote the majority is a conscientious exercise of our powers under the articles, which should not be interfered with."
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> Such a belief, even if well founded, would be irrelevant.

The difficulty is that, again, the Court has not come to grips with the precise logical problem. There are two possible explanations of the passage to which I have referred. The first is the explanation given above in relation to *Piercy*.[11] The second is that the test for legitimate purpose

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[8] [1967] Ch. 254.

[9] At page 265F.

[10] At page 268.

[11] Supra, note 5.

in relation to an issue of shares is that it be for the purpose of raising capital. Bearing in mind the exceptions referred to *Punt*,[12] the former view is the more likely explanation of what the Court considered itself to be doing.

Before dealing with the most recent English case on the subject, it is convenient to consider briefly a development which occurred in Canada.

As in England, the law in the subject was largely made by trial judges. In 1972, Berger J. of the Supreme Court of British Columbia decided the case of *Teck Corporation Limited* v. *Millar*.[13] In that decision his Lordship disapproved of *Hogg*[14] and held, for the first time, that it was permissible to issue shares for the purpose of defeating a takeover offer provided that this was done for an ultimate purpose which was bona fide for the benefit of the company. His Lordship said:[15]

> My own view is that the directors ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interest if the company is taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorised as improper.
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> I do not think it is sound to limit to the directors' exercise of their powers to the extent required by *Hogg* . . . . but the limit of their authority must be clearly defined.

In the result, the Court refused to upset an issue of shares made for the admitted purpose of defeating an unwelcome takeover offer which the directors believed would result in the company entering into some unattractive contracts.

So far as I have been able to ascertain, prior to the decision of the High Court in *Whitehouse* v. *Carlton Hotel Pty. Ltd.*,[16] *Teck*[17] has never been judicially commented on in Australia. It was accepted as correct by Lieberman J. of the Supreme Court of Alberta in *Northern and Central Gas Corporation Limited* v. *Hillcrest Colliers Limited*;[18] by McKay J. of the Supreme Court of British Columbia in *Shield Development Co. Limited* v. *Snyder*,[19] (in Obiter) and by the Court of Appeal of Manitoba in *Olson* v. *Phoenix Industrial Supply Limited*.[20] It is fair to say that today *Teck* represents received doctrine in Canada.

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[12] Supra, note 4.
[13] (1972) 33 D.L.R. (3d) 288.
[14] Supra, note 8.
[15] At page 315.
[16] (1986-7) 162 C.L.R. 285.
[17] Supra, note 13.
[18] [1976] 1 W.W.R. 481.
[19] [1976] 3 W.W.R. 44.
[20] [1984] 4 W.W.R. 498.

The greatest accolade accorded to *Teck*, however, from our point of view, is a reference which was made to it by the Privy Council on appeal from the Supreme court of New South Wales in the leading case of *Howard Smith Limited* v. *Ampol Petroleum Limited.*[21] That was a take-over case in which the decision of directors to issue shares was set aside. In the course of discussing the authorities, their Lordships[22] referred to *Teck* but concentrated on an aspect of the facts of less relevance for present purposes. That aspect was that the directors ultimate purpose was not so much to prevent the offeror gaining control as to prevent the offeror obtaining a commercial advantage at the expense of the company in relation to a proposed contract. The Lordships referred to this and then said:

> His decision upholding the agreement with Canex on this basis appears to be in line with the English and Australian authorities to which reference has been made.

It is difficult to know what the words "on this basis" mean. The better view would seem to be that they limit the approval of *Teck* to a case where the ultimate purpose is to bring about or prevent a particular commercial result and where the alteration of relative shareholdings is merely done as one step in that process.

If this is the true meaning of what the Privy Council said, it is, with respect, quite illogical. The purposes in the mind of the directors would seem to be (on the hypothesis being considered), first to issue the shares, secondly thereby to alter the voting position of shareholders in the company, thirdly thereby to resist a takeover offer, fourthly thereby to achieve or prevent a particular agreement and fifthly thereby to achieve a result which is bona fide for the benefit of the company. These purposes are linked in series rather than parallel. One cannot say, on the hypothesis I have put, that preventing the takeover offer succeeding is any more or less a purpose than causing or preventing the entry into the agreement. One is a means to the other. It is like getting into one's car to go to a restaurant. The Privy Council, however, purported to contrast the purpose of preventing the disadvantageous agreement and the purpose of obstructing a takeover offer.

The Lordships went on to hold that issuing shares for the purpose of creating voting power is not a legitimate purpose. This conclusion merely makes it more difficult to understand the reference to *Teck* which I have described. In the result it is not really possible to regard *Howard Smith* as making any useful contribution to the law in this area.

The most recent English decision is unreported. It is the decision of Sir Robert Megarry V.C. in *Cayne* v. *Global Natural Resources P.L.C.*[23]

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[21] [1974] A.C. 821.

[22] At page 836.

[23] 12 August, 1982.

The unreported judgment can be obtained on Lexis. An appeal from his Lordship's decision is reported at [1984] 1 All E.R. 225 but the appeal does not deal at all with the present question. This is unfortunate.

At page 4 of the Lexis report there is a passage which is one of the few direct discussions of the central problem. It is worth citing in full.

> I pause there. Most of what I have said is taken from Howard Smith Ltd. v. Ampol Petroleum Limited [1974] A.C. 821 at 834-836 (a case in which the sole purpose in issuing the shares was to alter the majority shareholding: see at page 837), and In re Smith and Fawcett, Limited [1942] Ch. 304. A particular application of these principles which has caused some difficulty is the case of directors who issue shares in order to maintain themselves in office in the honest belief that this is for the good of the company, and not for any unworthy motives of obtaining a personal advantage. In Hogg v. Cramphorn Limited [1967] Ch. 254 [1966] 3 All E.R. 420 it was held that this honest belief did not prevent the motive for issuing the shares from being an improper motive. At the same time, this principle must not be carried too far. If Company A and Company B are in business competition, and Company A acquires a large holding of shares Company B with the object of running Company B down so as to lessen its competition, I would have thought that the directors of Company B might well come to the honest conclusion that it was contrary to the best interests of Company B to allow Company A to effect its purpose, and that in fact this would be so. If, then, the directors issue further shares in Company B in order to maintain their control of Company B for the purpose of defeating Company A's plans and continuing Company B in competition with Company A, I cannot see why that should not be a perfectly proper exercise of the fiduciary powers of the directors of Company B. The object is not to retain control as such, but to prevent Company B from being reduced to impotence and beggary, and the only means available to the directors for achieving this purpose is to retain control. This is quite different from directors seeking to retain control because they think that they are better directors than their rivals would be. I think that Harlowe's Nominees Pty. Ltd. v. Woodside (Lakes Entrance) Oil Company Liability (1969) 121 C.L.R. 483, and Teck Corporation Limited v. Millar (1972) 33 D.L.R. 288, which were both cited with apparent approval in Howard Smith v. Ampol Petroleum Ltd. [1974] A.C. 821, go some way towards supporting such a restriction on the scope of Hogg v. Cramphorn Limited [1967] Ch. 254 [1966] 3 All E.R. 420, though I do not forget the way in which the Teck case was mentioned in the Howard Smith case at page 837. I may add that Mills v. Mills (1938) 60 C.L.R. 150 shows that where the main purpose of the directors' resolution is to benefit the company it matters not that it incidentally benefits a director.

The result was that for this and other reasons the decision of the board was upheld.

Unfortunately, as in most of the other cases, some of the language of this paragraph demonstrates confusion of thought. In particular, it is apparently permissible to issue shares for the purpose of retaining control if the reason why one wishes to retain the control is to secure the welfare of the company by excluding opponents who might otherwise destroy it but it is not permissible to issue shares for the purpose of retaining control if it is merely because the directors think that they are better directors than their rivals would be. It is submitted that this is a distinction without a difference. The approach seems to be that, if one merely thinks that one is a better director than someone else, one may not endeavour to retain control by issuing shares, but if that one can foresee a particular deleterious act which might be done by one's rival (or, perhaps, a particular advantageous act that one might do oneself which one's rival would not do) then the purpose becomes legitimate. If this is indeed the distinction, it will, in practice, be exceptionally fine. It is unfortunate in these circumstances that the Court of Appeal did not take the opportunity to comment on it.

I have left the Australian cases until last although in fact they do not greatly assist in solving the logical problem.

In *Mills* v. *Mills*,[24] the directors issued shares for the purpose of increasing the voting power of one of the directors but they believed that this would be for the benefit of the company. The trial judge posed the question "was it passed in the honest exercise of the directors' discretion, to distribute reserves which were no longer needed, or was it passed with the sole view of creating voting power which would inure for the benefit of Neilson Mills and those supporting him". Latham C.J. thought that this question was inappropriate. He took the view that the ultimate question was "what was the moving cause" of the actions of the directors and if they truly and honestly believed at the time that what they did was in the interest of the company, the actions were valid. This would seem to be an approach closer to that of *Teck*[25] than any other. Rich J. seems to have taken a similar approach. Dixon J. emphasised that the main purpose of the directors was the desire to secure the benefit to ordinary shareholders of the greater part of the reserves of profits in the event of liquidation. Starke J.[26] fell into the logical trap to which I have referred by holding that the resolution was honestly arrived at and that those who were voting in favour thought it was in the best interest of the company "and that that was their main reason for passing the resolution". In other words, his Honour was comparing the purpose

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[24] (1937-8) 60 C.L.R. 150.

[25] Supra, note 13.

[26] At page 179.

of doing something bona fide for the benefit of the company with an incidental purpose along the way.

Overall, little value is obtained from this case although passages in the judgments are regularly cited in the later cases.

The other leading case is the decision of the High Court in *Harlowe's Nominees Pty. Limited* v. *Woodside (Lakes Entrance) Oil Company NL*.[27] The Court held[28] that the raising of capital for immediate needs was not the sole purpose of the power but that one could raise capital for long term future needs.[29] The acceptance of this purpose (which is referred to in more detail later in the judgment[30]) seems to have been the main ratio of the determination. Although the case is sometimes cited as if it reached the same conclusion as *Teck*,[31] a close reading of the judgments shows that it does not. The problem has arisen because passages suggesting that the satisfaction of an immediate need for capital is not the sole necessary purpose have been construed as meaning that any purpose for the benefit of the company is permissible.

The case which offered an opportunity of solving the problem, an opportunity which unfortunately was allowed to pass by, was the recent decision of the High Court in *Whitehouse* v. *Carlton Hotel Pty. Ltd.*[32] The governing director of a family company issued shares to his sons so as to prevent his wife and daughters obtaining control on his death. The majority, comprising Mason, Deane and Dawson JJ., held that a purpose of altering a voting majority was normally an improper purpose, basically because it is no part of the function of directors to be concerned with favouring one group of shareholders over another. Their Honours expressed agreement with various passages from *Ampol* and *Harlowe's Nominees* to this effect.

The difficulty is to characterise the exception. If the rule is based on the directors not being concerned with relative voting rights of shareholders, how can there be exceptions. The whole problem arises because the directors may feel that a particular majority may be detrimental to the interests of the company as a whole or its shareholders as a whole. The majority formulation glosses over this issue.

Brennan J. took a similar approach but reached a different conclusion on the application of the law to the facts and therefore dissented. Wilson J., in the only Australian judgment (unless one includes the Privy Council in *Ampol* in this category) to refer to *Teck*, cited it with approval and held that an ultimate purpose to benefit the company was not improper,

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[27] (1967-8) 121 C.L.R. 483.

[28] At page 492.

[29] At pages 496-7.

[30] At page 498.

[31] Supra, note 13.

[32] Supra note 16.

even if the method involved the use of a share issue to alter an existing majority. He correctly regarded the approach in *Teck* as consistent with what the High Court had laid down in *Harlowe's Nominees.* It is unfortunate that his Honour was in the majority since he alone grappled with the real problem which arises in this type of case.

One analogous area in which the problem has arisen is the question of directors spending money on their re-election. In *The Lawyers' Advertising Company* v. *Consolidated Railway Lighting and Refrigerating Company*,[33] the Court of Appeal of New York held that directors could not spend the company's money in persuading shareholders to vote for their re-election, even if they were of the view that that re-election would be for the benefit of the company. On the last page of the report, Hiscock J., delivering the judgment of the Court, said:

> It may be conceded that the directors who were the cause of this publication acted in good faith and felt that they were serving the best interests of the stockholders, but it would be altogether too dangerous a rule to permit directors in control of a corporation and engaged in a contest for the perpetuation of their offices and control to impose upon the corporation the unusual expense of publishing advertisements, or, by analogy, of despatching special messengers for the purpose of procuring proxies on their behalf.

In the result, the publishing company which had been engaged was unable to recover the cost of printing the advertisements from the company.

The other decision in this area is the decision of the New South Wales Court of Appeal in *Advance Bank Australia Limited* v. *FAI Insurances Limited.*[34] In that case, four candidates associated with FAI Insurances Limited ("FAI") stood for the board of Advance Bank Australia Limited ("the Bank"). FAI held just under 10% of the shares in the Bank (that being the maximum any shareholder could hold) and there was a board of nine. Five were retiring by rotation and all five were standing for re-election. The four outside persons were opposing that re-election.

The board of the Bank spent a considerable sum of money engaging a telephone solicitation company to present arguments to shareholders for the directors re-election. The directors sought to justify their decision to spend the Bank's money on the basis that there was a risk to the Bank's banking licence if four nominees of a single shareholder were appointed to the board. The Court held on the facts that that defence was not made out and that the true purpose was merely to achieve re-election. The Court stressed, however, that there was no absolute prohibition upon the expenditure of the company's money for the purpose of securing the re-election of directors. The example was given of a

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[33] 187 N.Y. 395; 80 N.E. 199 (1907).

[34] (1987) 5 A.C.L.C. 725.

candidate with a criminal record who stood for election to the board of a company which operated a school. In such a case it would be legitimate for the directors to expend the company's money in warning the shareholders of the consequences to the company if that person were elected. Kirby P.[35] set out a series of principles which basically accepted the *Teck* approach. The ultimate test was whether the directors acted bona fide for the benefit of the company and while that conduct would be examined more critically if it involved a benefit to themselves (such as securing their continuance in office), there were no absolute disqualifications.

CONCLUSION

Two lessons are to be learned from this analysis of the cases. First, the law in this area has not been consistent and is still not finally decided. A clear statement of principle by the High Court would be most welcome.

Secondly, in laying down principles the Courts should bear in mind the logical problems to which I have referred and ensure that the tests which they lay down do not contain fundamental fallacies.

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[35] At page 742.