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SOUTH AUSTRALIA

SIXTIETH REPORT

of the

LAW REFORM COMMITTEE
of
SOUTH AUSTRALIA

to

THE ATTORNEY-GENERAL

RELATING TO LOCUS STANDI IN COMPANY LAW

1980

The Law Reform Committee of South Australia was established by Proclamation which appeared in the *South Australian Government Gazette* of 19th September, 1968. The Members are:

THE HONOURABLE MR. JUSTICE ZELLING, C.B.E., *Chairman.*

THE HONOURABLE MR. JUSTICE WHITE, *Deputy Chairman.*

THE HONOURABLE MR. JUSTICE LEGOE, *Deputy Chairman.*

D. W. BOLLEN, Q.C.

M. F. GRAY, S.-G.

J. F. KEELER.

D. F. WICKS.

The Secretary of the Committee is Miss J. L. Hill, c/o Supreme Court, Victoria Square, Adelaide, 5000.

The Honourable Mr. Justice White was on long service leave and the Honourable Mr. Justice Legoe was on circuit and accordingly neither of them signed this report.

SIXTIETH REPORT OF THE LAW REFORM COMMITTEE OF SOUTH AUSTRALIA RELATING TO LOCUS STANDI IN COMPANY LAW

To:

The Honourable K. T. Griffin, M.L.C.,
Attorney-General for South Australia.

Sir,

One of your predecessors referred to us the question of what reforms in the law are necessary to permit a person with a genuine interest in a disputed matter to have access to the Courts as of right. We have in fact prepared a draft report on all *locus standi* issues in actions in Court. However as you have referred to us for urgent consideration the question of the reform of company law, we thought it better to disjoin the question of *locus standi* in relation to company law from the much larger question of *locus standi* in all cases, so that when the question of redrafting the Companies Act comes before you for consideration you will have, at a much earlier date than would otherwise have been possible, the report of this Committee upon that very important area of company law which deals with standing to sue in the Courts.

When a wrong (using that term in a non-specific sense) is done to a company whether by the directors of that company, its shareholders or by outside parties, the company is the proper plaintiff (or "legal person") to sue for the wrong. Therefore, although a shareholder may have a substantial financial or other interest in seeing the wrong remedied, he does not normally have *locus standi* to sue for his proportionate share of any remedy where the wrong is done to the company alone nor to see that the company receives damages or compensation for the cause of action if the company does not choose to sue: see *Hawkesbury Development Corporation Limited v. Landmark Finance Pty. Ltd. (1969) 2 N.S.W.R. 782.* This is the principle known as the rule in *Foss v. Harbottle (1843) 2 Hare; 67 E.R. 189,* after the original case which laid down the rule.

The rationale of the rule has two limbs:—

(i) Courts will not interfere with the internal management of companies acting within their powers; and

(ii) until a general meeting of the company has determined an issue one way or the other, and the company acts or threatens to act improperly, i.e. in the interests of some members of the company to the exclusion of others or for a purpose not authorised by law or beyond the powers of the company, there is no reason to depart from the principle that the company is the proper plaintiff. Generally speaking a company is well competent to judge for itself what is for the good of the company. This decision is made by the appropriate organ of the company as identified in its memorandum and articles—usually the Board of Directors or the shareholders in general meeting.

If, however, the decisions of the Board or of the general meeting (as the case may be) are unfair, illegal, unreasonable, *ultra vires,* or fraudulent (either in the legal or in the equitable sense of fraud) the law will allow an exception to the "proper plaintiff" principle and will permit a derivative action, i.e. the individual member of the company sues in his own name on behalf of the company but he cannot have a larger right to

relief than the company would have had as plaintiff. Therefore, the member sues on behalf of himself and all of his fellow members against those alleged to be wrongdoers. The company is joined as co-defendant so that any judgment will bind it and so that it may enforce orders against the wrongdoers, but the judgment is actually given in favour of the company.

One should note at the outset that the rule in *Foss v. Harbottle* applies only in proceedings to remedy a wrong to the company alone. If the wrong is an infringement of a right of a member *qua* member he may bring a personal action *suo nomine* to remedy that "private" wrong.

The law does appear to admit of a derivative suit by a shareholder (instead of by the company) in five circumstances:—

(i) when it is complained that the company is acting or proposing to act *ultra vires* or illegally;

(ii) when the act complained of, though not *ultra vires* of the company, would be effective only if resolved upon by more than a simple majority vote, e.g. when a special resolution is required and this has not been validly passed;

(iii) when it is alleged that the personal rights of the plaintiff shareholder have been or are likely to be infringed (though this may not be a true exception as indicated supra);

(iv) where those who control the company are perpetrating a fraud on the minority; note however the recent case of *Daniels v. Daniels (1978) 2 W.L.R. 73* which seems to go further. This case states the principle that where the controllers or directors of a company are grossly negligent and actually profit by such gross negligence then, because this smacks of fraud, a shareholders' derivative suit will still be allowed; and

(v) where the justice of the case otherwise requires an exception.

These limited exceptions are seen to be just that—limited and unsatisfactory. Although a decision such as that in *Daniels* is or appears to be wider than cases such as *Pavlides v. Jensen 1956 Ch. 565* the scope for judicial innovation is restricted in this important area of the law. The judiciary appear to be altering their previous approach to internal company affairs (witness *Clemens v. Clemens (1976) 2 All E.R. 268*) but legislative assistance is nevertheless needed.

There are two ways in which this reform of the law can be achieved: either by abolishing the rule in *Foss v. Harbottle* entirely or by replacing the rule with a discretionary bar in relation to proceedings by individual shareholders.

No satisfactory principle has been arrived at to differentiate the cases in which the rule in *Foss v. Harbottle* (supra) has been applied from those in which it has not. Perhaps the nearest approach to a satisfactory principle of differentiation is suggested by Professor Gower: ". . . a shareholder can always sue notwithstanding the rule in *Foss v. Harbottle,* when what he complains of could not be validly effected or ratified by an ordinary resolution". (Gower: Modern Company Law, 3rd Edition, p. 585). This is sometimes said to be one of the four exceptions to the rule. But, as Gower points out, it really comprehends the other three. There are, however, cases that will not yield to rationalisation. In some cases the rule has been applied notwithstanding that the impugned action could not have been authorised or ratified by ordinary resolution. For example, in *MacDougall v. Gardiner (1875) 1 Ch.D. 13* the refusal of the chairman to conduct a poll at the request of

the shareholders could have been legally justified only by retrospective alteration of the articles of the company, yet the court refused to entertain an action at the instance of individual members. Similarly, in *Cotter v. National Union of Seamen (1929) 2 Ch. 58,* the irregularities in the convening and conduct of the meeting could have been overcome only by retrospective alteration of the rules of the union. Conversely, *Catesby v. Burnett (1916) 2 Ch. 325* is a case in which an individual action was permitted notwithstanding that the impugned action could have been authorised by the general meeting. In that case the two defendants who had been directors of the company were to retire by rotation. In fact one of them formally tendered a letter of resignation, although it is doubtful whether that was strictly necessary because the articles appear to have provided for automatic retirement at the general meeting. The chairman declared that the notice proposing the election of new directors was irregular, and he refused to conduct an election in which the persons nominated in the notice were candidates. He left the meeting, whereupon the remaining shareholders proceeded to elect certain persons who had been nominated in the notice. An individual shareholder brought an action to restrain the two defendants from acting as directors. The action succeeded. It is quite clear that a regularly convened general meeting of shareholders could, by a simple majority, have re-elected the defendants although it did not, in fact, do so. It follows that, if Professor Gower's exposition is correct, the action by individual shareholders should have been dismissed. The cases thus remain in intractable conflict and there is no satisfactory principle of reconciliation.

The confusion is compounded by one of the more recent cases. In *Daniels v. Daniels (1978) 1 All E.R. 89* a husband and wife were the major shareholders and the sole directors of a company. They sold a valuable asset of the company to themselves at a substantial undervalue. This was later sold at a huge profit. The minority brought an action alleging apparently that the directors were negligent in accepting an inadequate consideration for the asset. That was a strange and hazardous basis upon which to found the action. Indeed the case ignores the principles requiring directors to account for profits derived from contracts with the company. There was no evidence of ratification of the contracts by the company in general meeting. The plaintiffs should therefore have moved at a general meeting to require the directors to account to the company for their profits. If the directors had then used their superior voting power to defeat the motion, that may well have constituted a fraud on the minority. But, as it was, the proceedings were premature and should have been dismissed.

If one first seeks solutions to the problems of imposing satisfactory standards of conduct upon promoters, directors and major shareholders, then solutions to the subsidiary problems of *locus standi* should follow logically and naturally. One major source of difficulty with the rule in *Foss v. Harbottle* is that, in purporting to be a general rule, it attempts to do too much. Common sense suggests that there should not be one rule of *locus standi* in company law but several: a claim by a shareholder that he has suffered discrimination at the hands of directors, or other shareholders, involves considerations bearing upon the question of *locus standi* that are quite different from those raised by a claim alleging negligence on the part of directors.

If this view be taken then the proper solution is to abolish the rule in *Foss v. Harbottle* and to provide that *locus standi* in company law be

tested, as in every other case, by asking one question: has the plaintiff a real interest in litigating the cause of action which he seeks to bring before the Court?

Reform of the rule in *Foss v. Harbottle* is therefore desirable, partly because it causes injustice and partly because of its inconsistency of application. But before discussing the reforms to it which have been proposed in other jurisdictions and offering our own proposals we wish to comment on the substantive law that provides the context against which any procedural principles must operate. Sir Douglas Menzies, in an article at *33 A.L.J. 156,* describes the law as requiring a high standard of honesty from a director, but only a low standard of diligence. Despite *Daniels v. Daniels* the latter point is very well established; in the view of the Committee it is less clear that the former is wholly true. This is not because of any lack of stringency in the fiduciary obligations attaching to a director, but because of an inconsistency in their application which stems from the principle that directors owe them to the company rather than the shareholders. We attach an Appendix on this point, based almost exclusively on a paper kindly prepared for the Committee by Mr. G. A. Hackett-Jones, of Parliamentary Counsel, before the reference of the uniform Companies Bill to us. We are inclined to agree with him that the substantive law in this area requires a thorough overhaul, and that if a satisfactory basis for the substantive law is found solutions to problems of *locus standi* may well follow naturally. It may well be that there should not be one rule of *locus standi* in company law, but several: a claim by a shareholder that he has suffered discrimination at the hands of directors, or other shareholders, involves considerations bearing upon the question of *locus standi* that are quite different from those raised by a claim alleging negligence on the part of directors. The Committee has not, however, been able to pursue these matters within the very severe time constraints that have been imposed upon it in considering the Companies Bill. It commends them very firmly to the early consideration of the proposed National Companies and securities Commission.

In the expectation, however, that so major an examination would inevitably be protracted and believing that the present situation should be alleviated as far as possible immediately, the Committee has considered less drastic approaches to the rule in *Foss v. Harbottle.*

Canadian and American jurisdictions have led the way in amending it. Section 99 of the Ontario Business Corporations Act (C. 53 1970) and Sections 231 and 232 of the Canadian Federal Business Corporations Act are both illustrative of the new approach: (compare also British Columbia Business Corporations Act Section 222 C. 18 1973). The American law is embodied in Rule 23 of their federal rules of civil procedure. The relevant part of the Canadian Act is set out:

"231. In this part;

'action' means an action under this Act;

'complainant' means

(*a*) a registered holder or beneficial owner and a former registered holder or beneficial owner of a security of a corporation or any of its affiliates

(*b*) a director of an officer or a former director or officer of a corporation or of any of its affiliates

(*c*) the Director (of Corporations), or

(*d*) any other person who, in the discretion of a court, is a proper person to make an application under this Part."

(This is to be contrasted with the much narrower wording of the Ontario Act which restricts actions to "a shareholder" only).

"232. (1) Subject to subsection (2) a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or of any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purposes of prosecuting, defending or discontinuing the action on behalf of the body corporate."

Section 99 subsection (3) of Ontario and Section 232 (2) of Canada both manifest a return to the internal management principle by requiring a demand by the shareholder or complainant to the directors or general meeting as the case may be to cause the Corporation to commence or prosecute the action on its own behalf. Again note a difference: the Provincial Act requires the shareholder to cause "the corporation" to sue whereas the Canadian Federal Act speaks of a demand on "the directors". The implications of this difference are noted by *Beck* in his article "The Shareholder's Derivative Action" 52 Can. Bar. Rev. 159 especially at 204. The implications of the demand rule are shown in an article by Bayne "A Flaw in the Law: The Demand Rule: A Brief" 22 St. Louis L.J. 69.

A comparative study by *Barak* in 20 I.C.L.Q. 22 shows the similarities and differences among English, American, German, and Israeli jurisdictions (see also an article by Linehan in 1974 Ir. Jur. 265). Reference may also be made to the British Columbia case of *Re North West Forest Products Ltd. (1975) 4 W.W.R. 724* which arose from an application for leave to commence a derivative action pursuant to Section 222 (1) of the British Columbia Corporations Act. The action was based on allegations of self-serving negligence by the directors which were similar to those in question in the *Daniels case*. The application for leave to commence the action was granted. In British Columbia at least, the derivative suit section can be seen to increase the substantive rights in shareholders' suits as well as access to the forum. The necessity for close drafting of the definition as to who is entitled to commence suit is illustrated by the Delaware Chancery case of *Harff v. Kerkomin* referred to in *50 Tulane L.J. 178*. Under American Federal Security Law the holder of a convertible debenture is a "stockholder"—so enabling him to commence a derivative suit under Federal Civil Rule of Procedure Section 23.1. But the Delaware Court concluded, for the purposes of its derivative action section, that convertible debenture holders were creditors of the corporation, not stockholders, and were thus disentitled to sue derivatively.

A further way in which a shareholder can obtain standing emerges from a consideration of the statutory contract established by Section 33 (1) of our Companies Act. The equivalent section in England Section 20 (1) is considered by Goldberg in an article in *(1972) 35 M.L.R. 362* and in Canada by *Beck* (op. cit.—especially at pages 192-194).

Section 33 (1) stipulates that the articles of association constitute a contract between a member and the company and among members inter se. It therefore, in theory at least, creates personal contractual rights—but as a matter of practice, the enforcement of these rights is fraught with pitfalls, e.g. a company member has no right under Section 33 (1) to have enforced a right or power bestowed by the articles or

memorandum on a person otherwise than in his capacity as a member of the company (e.g. as a solicitor to the company).

Again Ontario and Canada have sought to "give teeth" to the statutory contract, thereby enhancing the enforcement of these contractual rights—see Ontario Act Section 261 and the Federal Act Section 240.

These sections allow a shareholder to obtain an order for compliance by certain specified persons (again a broader class in the federal Act) with inter alia the articles and by-laws of a corporation. As *Beck* (op. cit. page 194) indicates, Section 261 of the Ontario Act shows a glaring weakness—a shareholder is not one of the specified class of persons. This is unfortunate. It means that there could still be non-compliance by shareholders (whether alone or as a class) with the articles to the detriment, of say, a minority shareholder. Recent judicial trends have shown (especially in American law—e.g. *Jones v. Ahmanson (1969) 1 Cal. 3d. 460* that majority shareholders are bound, in their deliberations and actions, by substantially the same fiduciary duties as directors vis-a-vis the company and minority shareholders.

If this solution is adopted our recommendations would be as follows:—

1. That a shareholder have standing to sue in his own name with the leave of the Court and on behalf of himself and all other shareholders.
2. In order to proceed, the shareholder must show some existing or impending damage to his position as a shareholder or his pecuniary interests as a shareholder (and *mutatis mutandis* for debenture holders and other holders of interests in a company). Further, provision should be made for a Court to require a shareholder in a proper case to tender an indemnity for costs to the company before allowing the action to go forward.
3. The procedure would be the conventional one of suing the company and the directors as defendants.
4. In order to see that all possible parties were before the Court it should be enacted that anyone entitled to a transmission of a share by death, bankruptcy or lunacy and entitled to be registered in a representative capacity should be entitled to join in such litigation on either side.
5. As this proposed amendment means that the new type of action becomes in a sense public property, there should be the same provision as now exists in relation to a winding up petition, so that one plaintiff could apply to be substituted in place of another who did not wish to proceed further with the litigation. Such a substitution order would have to be made on the usual terms now applying in winding-up proceedings.
6. There should be an exception from the general rule where the matter in issue is a contract about to be entered into between a company and a director. In such a case it should be possible for a general meeting of shareholders conclusively to sanction such a contract or alternatively for a general meeting to ratify any such contract which would otherwise be in excess of power. In both cases any interested parties including directors should not be entitled to vote on the resolution for sanction or ratification.

We append the letter from Mr. Hackett-Jones as an appendix to this Report.

We add, as we have said earlier in this Report, that if lack of time prevents a redraft of the Companies Bill at this stage to include so fundamental question of principle as this undoubtedly is, that it would in the Committee's opinion be proper and, we would hope, helpful if you were to suggest to the National Committee that the topic be referred back to this Committee for a full examination and report, with a view to uniform legislation on the topic being prepared following the receipt of the further report.

We have the honour to be

HOWARD ZELLING
D. W. BOLLEN
M. F. GRAY
J. F. KEELER
D. F. WICKS

Law Reform Committee of South Australia.

19th June, 1980.

23rd April, 1980

The Hon. Mr. Justice Zelling, C.B.E.,
The Chairman,
Law Reform Committee of South Australia,
Judges' Chambers,
Supreme Court,
1 Gouger Street,
Adelaide, S.A. 5000

Dear Judge,

I read with interest the Committee's proposals relating to the abolition of the rule in *Foss v. Harbottle* and its replacement with a discretionary bar to proceedings by individual shareholders. I am very much in agreement with the proposal to abolish the rule, but I doubt the efficacy and adequacy of the proposed reforms that are suggested as a substitute.

The rule was originally conceived as being a procedural device which could be waived at the discretion of the court if the interests of justice so required. (See *Foss v. Harbottle (1843) to Hare 461 at 492).* It later assumed a more uncompromising aspect: Lord Davey thought it operated to oust the jurisdiction of a court in any matters of internal management of a company lying within its juristic competence. (See *Burland v. Earle (1902) A.C. 83 at 93).* In any event, the rule is a procedural or jurisdictional excrescence that has grown up upon company law. It is certainly one of the obstacles that a shareholder must face if he has the temerity to believe that directors and major shareholders of a company should act decently towards him, and seeks to uphold that belief in court. But it is not the major obstacle. That lies in establishing a breach of the substantive principles governing the conduct of directors or holders of majority interests. It seems artificial and unsatisfactory to consider the rule in *Foss v. Harbottle* in isolation from those principles. Of course, I recognise that the Committee has not entirely done so: it has referred to the problem of establishing an action in negligence against a director. But that is merely an aspect of a problem that deserves more extensive treatment.

The early cases, while perhaps lacking in some respects a sense of reality, demanded fairly high ethical standards of directors. For example, *Bennett's case (1854) 5 DeG.M. & G. 284* decided that a director must use his powers for the purposes for which those powers were conferred, and not for a collateral purpose. In *Frazer v. Whalley (1864) 2 H. & M. 10* directors were prevented from exercising their powers of allotting shares in order to increase their own voting power at the expense of an antagonistic faction of shareholders. *Harris v. North Devon Railway Co. (1855) 20 Beav. 384* decided that a director cannot fetter by contract the discretions that he is bound to exercise in accordance with his fiduciary obligations. In *Benson v. Heathorn (1842) 1Y. & C.C.C. 326* a director was prevented from acting as an employee or commission agent in the affairs of his company on the ground that, by so doing, he would impair the independence of his judgment in the administration of the company's affairs.

These early cases were based upon the idea that a director owes fiduciary obligations to each and every shareholder of the company. That principle, and the line of authority previously established, were however almost entirely subverted by the decision of Lord Lindley in *Allen v. Gold Reefs of West Africa (1900) 1 Ch. 656.* In that case a

company had purchased property in consideration for which it had allotted fully paid shares to Zuccani, a nominee of the vendor. Zuccani also applied for, and was allotted, shares that were not fully paid up. The articles provided for a lien upon contributing shares in order to secure payment of calls, but the lien did not extend to fully paid shares. Zuccani died, and his assets were not sufficient to meet the unsatisfied obligations upon his contributing shares. A meeting of the company was called at which a resolution altering the articles to extend the lien to fully paid shares was passed. This resolution was clearly directed at Zuccani, who was the only holder of fully paid shares in the company, and hence the only shareholder affected by the resolution. The resolution clearly prejudiced the interests of those interested in Zuccani's estate, but Lord Lindley upheld its validity nevertheless on the ground that it was passed bona fide in the belief that it was in the best interests of the company as a whole. This was the first case in which a distinction was clearly drawn between the interests of the metaphysical corporate entity, and the interests of its shareholders. The case related specifically to the duties of shareholders rather than directors; but the principle enunciated was soon to be adopted as the criterion for testing the propriety of acts of directors. That occurred in *Percival v. Wright (1902) 2 Ch. 421,* a case of "insider trading". In this case, the directors were engaged in negotiations likely to enhance the value of shares in their company and purchased shares from shareholders in the company without disclosing the prospective augmentation in value of the shares. The defrauded shareholders brought an action against the directors to require them to disgorge their profits. In a disgraceful decision, Swinfen-Eady J. held that the duty of directors lay towards the company and not towards individual shareholders. He therefore dismissed the action.

While *Allen's case* and *Percival v. Wright* mark a decided divergence from the older authorities, the old principles have anomalously survived in certain cases. *Punt v. Symons (1903) 2 Ch. 506, Piercy v. Mills (1920) 1 Ch. 77, Ngurli v. McCann (1954) 90 C.L.R. 425* and *Ansett v. Butler Air Transport (1958) 75 W.N. (N.S.W.) 299* are all cases in which directors issued shares in order to obtain, or retain, control of the general meeting of a company. In each of those cases the issue was invalidated without regard to the question of whether the directors believed that they were acting in the best interests of the company. In the Ansett case, Myers J. expressly treated that question as an irrelevance.

On the other hand *Re Smith and Fawcett (1942) 1 Ch. 304* and *Mills v. Mills (1938) 60 C.L.R. 150* (which is generally recognised as the leading Australian authority on the subject) are both cases in which directors were permitted to exercise their powers for the purpose of manipulating control of the company because they believed that, by so doing, they were acting in the best interests of the company as a whole. *Mills v. Mills* arose from a power struggle within a family company in which Neilson Mills issued shares in order to forestall a challenge to his authority by his nephew Ainslie Mills. Apart from holding a substantial interest in the company in his own right, Neilson had controlled other shares by virtue of trusts. These trusts had recently expired, and Neilson obviously feared that the beneficiaries might be inclined to align themselves with his hostile nephew at a general meeting of the company. The effect of the resolution, which Neilson passed in his capacity as director, was to maintain his own relative position in the company notwithstanding that he no longer controlled the trust shares. In a mind-boggling judgment, Dixon J. (as he then was) argues that the

issue was rendered less exceptionable by the fact that it was partially motivated by a desire to improve the position of holders of ordinary shares in the event of a winding-up of the company. (Neilson Mills held ordinary shares, while his nephew Ainslie held preference shares). In other words the naked grab for power was, in His Honour's opinion, ameliorated by the fact that it was a sophisticated form of stealing as well. Presumably, according to Dixon J.'s system of ethics, a thief who robs a man of his coat may expiate the offence by taking his purse as well.

Perhaps the utter futility of the principle is best illustrated by the case *In re Broadcasting Station 2 G.B. Pty. Ltd. (1964-5) N.S.W.R. 1648.* This case arose from the takeover of a company that owned and operated a wireless broadcasting station by the Fairfax Companies. The Fairfax Companies exerted their influence to secure the appointment of their own nominees to the board of directors. A minority of shareholders complained that these directors had ignored their interests and acted purely in the interests of the Fairfax Companies. Jacobs J. examined the position of these directors,

> "I am satisfied that these additional directors were, to all intents and purposes, the nominees of the Fairfax Companies who would be likely to act, and who would be expected by the Fairfax interests to act, in accordance with the latter's wishes. At this point I feel that a crucial stage in the analysis is reached. It is my view that conduct of the kind which I have related is not reprehensible unless it can also be inferred that the directors, so nominated, would so act even if they were of the view that their acts were not in the best interests of the company. This is not a conclusion which can lightly be reached and I see no evidence in the case upon which I can reach that conclusion. It may well be, and I am inclined to regard it as the fact, that the newly appointed directors were prepared to accept the position that they would follow the wishes of the Fairfax group without close personal analysis of the issues. I think that at the early board meetings of early August that is what they did, but I see no evidence of a lack in them of a bona *fide belief that the interests of the Fairfax group were identical* with the interests of the company as a whole. I realize that, upon this approach, I deny any right in the company as a whole to have each director approach each company problem with a completely open mind, but I think that to require this of each director of a company is to ignore the realities of company organization. Also such a position would, in effect, make the position of a nominee or representative director an impossibility."

The learned judge thus found that the directors did not trouble themselves with a close analysis of the resolutions before them, but acted at the direction of the Fairfax interests. Nevertheless His Honour found "no lack in them of a bona fide belief that the interests of the Fairfax group were identical with the interests of the company as a whole". If that is correct, it seems to follow that a director is under no personal obligation to his shareholders or to anyone or anything else. He may agree with an outsider to act as an automaton at a board meeting and may perform that agreement. Because he is insensible to the issues with which he is confronted, his conduct is beyond the reach of the law, for having no conception of what he is doing, he cannot be said to disbelieve that it is for the benefit of the company. It is perfectly apparent from the judgment that that standard amounts to no standard at all. One might well contrast this decision with the earlier cases in *which directors were prevented from fettering their fiduciary discretions* by extraneous agreements. Jacobs J. apparently believed that the

"realities of company organisation" justify or require the abandonment of those earlier principles. With respect, I fail to see the practical justification. If, as in this case, a shareholder has a very large stake in a company, then his influence in the councils of the company will be correspondingly great. The Fairfax companies could, and did, exercise a decisive influence in the constitution of the board of directors. But they wanted something additional to this: the right to determine the manner in which those directors would exercise their discretion. That meant that the remaining shareholders were deprived of the advantage of having their interests fairly and dispassionately considered by the directors. Any such understanding or agreement between the directors and a shareholder would, under the old authorities, have been regarded as exceptionable upon that ground. It seems to me that the grounds upon which the courts previously refused to countenance such an agreement are as valid now as they were then.

In more recent cases, moral obliquity seems to have been supplanted to some extent by utter confusion. *Howard Smith Ltd. v. Ampol Petroleum (1974) 3 A.L.R. 448* is a very curious case. It concerned a contest between Howard Smith and Ampol Petroleum to take-over R. W. Miller (Holdings) Ltd. Competing offers had been made by Ampol and Howard Smith when Ampol announced that it had secured the support of Bulkships, another major shareholder in Miller, and that between them they controlled 55 per cent of the shares. This naturally frustrated the attempted take-over by Howard Smith. However, the directors of Miller then decided to issue shares to Howard Smith, thus diluting the interest controlled by Ampol and making it possible for the take-over offer by Howard Smith to proceed. The directors all claimed in evidence that the new issue was principally motivated by a desire to raise more capital for Miller. (The evidence did lend a degree of verisimilitude to this claim: Miller had been chronically short of funds). However, Street C.J. in Equity rejected the evidence of the directors as to their motive in issuing the new shares. In view of the fact that the question was hardly one upon which the directors could have been honestly mistaken, the rejection of their evidence is tantamount to finding that they had perjured themselves (and presumably at great length: the trial lasted for 28 days). Nevertheless the learned Chief Justice found that the directors were not motivated by any purpose of personal gain or advantage, or by any desire to retain their position on the board (p. 451). These findings are difficult to reconcile. If the directors were prepared to perjure themselves *en masse* on the question of their motive in issuing the shares, it is not easy to resist the conclusion that their motive must have been related to some dishonourable purpose, personal to themselves, which they therefore sought to conceal from the court. The finding that the directors were more influenced by what was happening to the company's shares in the market place than by the need to raise further capital is not surprising. But the rejection of the directors' evidence on this point left the court in the position of having to suggest a plausible motivation for the new issue which could be tested against established principle. To accord with the Chief Justice's finding on the point, this motivation had to be honest and uncontaminated by self-interest. The Chief Justice in fact concluded that the directors, worried by the extent of a joint holdings of Ampol and Bulkships, issued the shares to Howard Smith with the "ultimate purpose" of procuring the continuation by Howard Smith of its take-over offer. (People. 453). The Privy Council interpreted this as meaning that the directors issued the shares "simply and solely . . . to enable a then minority of shareholders to sell their shares more advantageously". (p. 457) If that is a correct interpretation of the Chief Justice's finding, then I think we

must conclude that it exhibits a degree of implausibility rarely attained even by Chief Justices. It requires us to believe that the directors, acting in a spirit of disinterested altruism, issued 4·5 million shares to Howard Smith at $2·30 per share in order to allow a minority of shareholders to get rid of their shares at $2·50 each rather than $2·27 (notwithstanding that the price at which the shares were issued to Howard Smith shows conclusively that the directors thought the price offered by Ampol represented more or less the fair value of the shares). It would be charitable to believe that the Privy Council misinterpreted the Chief Justice's findings. He actually said that the "ultimate purpose" of the issue was to procure the continuation by Howard Smith of the take-over offer made by that company. But would that course of action necessarily vitiate the new issue? Both the Chief Justice and the Privy Council cite *Mills v. Mills* as a leading authority on the subject. That case clearly establishes that directors may favour one faction of shareholders above another provided that their action is directed towards some higher corporate purpose. In the present case, the directors of Miller may well have thought that it would be advantageous to have Howard Smith as a major shareholder, and disastrous for the company to fall under the control of Ampol. If so, then according to the principle of *Mills v. Mills* the issue should have been upheld. But the question of whether the directors had reason to prefer, in the interests of the company, a take-over by Howard Smith to a take-over by Ampol was not discussed, or at least not treated as being of any particular relevance. In fact, it was the crucial question and the decision in this case is, as a result of the failure of the primary court and the Privy Council to deal with it, incoherent and unsatisfactory.

It is interesting to contrast the case of *Harlowe's Nominees v. Woodside (1968) 42 A.L.J. R. 123.* The facts of that case are almost identical to those in *Howard Smith v. Ampol.* The only salient difference is that Woodside was clearly in no immediate need of further funds (apart from substantial reserves, a large amount remained uncalled upon its contributing shares) whereas Miller had been suffering financial difficulties over an extended period. There was thus a much stronger justification for Miller to raise extra capital than for Woodside to do so. Nevertheless the High Court accepted the rather improbable explanation of the Woodside directors that they had acted primarily for the purpose of raising extra capital, and upheld the validity of the issue. It seems that Mr. Aickin Q.C. (as he then was) who represented the unsuccessful appellants in *Howard Smith v. Ampol* may have made the cardinal error of directing his clients into the wrong court of appeal.

Sir Douglas Menzies in the article to which the committee refers claims that the law requires a high standard of honesty from a director (although only a low standard of diligence). He cites cases like *Furs v. Tomkies (1936) 54 C.L.R. 583* and *Regal (Hastings) Ltd. V. Gulliver (1942) 1 A.E. 378* as proof of the supposedly high ethical standards required of directors. These cases involve the principle that a director must account to his company for profits made in the course of carrying out his fiduciary duties. The principle is perhaps most dramatically illustrated by the Regal (Hastings) case in which directors personally subscribed to shares in a subsidiary in order to make possible a transfer of the holding and subsidiary companies to a purchaser who required the subsidiary to have a certain amount of paid-up capital. The directors received a windfall profit when the transaction finally went through, and the company which was then controlled by the purchaser brought on action requiring them to account for the profit (notwithstanding the prior agreement by the purchaser that the directors should have the profit). The case went against the directors and Sir Douglas justly

remarks that the decision was, in the circumstances, rather harsh. But it is not, as Sir Douglas suggests, an example of high principles operating to the point where they hurt. In fact the gods of English jurisprudence poured out their wrath upon the directors in the Regal (Hasting) case not because of any moral lapse on their part, but because they failed to take the precaution of calling a general meeting of the company to authorise the transactions before they lost control of the company. Their fault (if it was a fault) was to place too much confidence in the honesty of the purchaser. As the Regal (Hastings) case shows, the rules governing the conduct of directors are, in this respect capable of operating with all the bizarre logic of the execution-machine in Kafka's Strafkolonie.

I should like to return now to the rule in *Foss v. Harbottle*. In view of the fact that the committee proposes to abolish the rule, it is unnecessary to dilate at length on the subject. It is important, however, in view of the Committee's recommendations, to observe the failure of the courts to apply the rule in a uniform and consistent manner. No satisfactory principle has been arrived at to differentiate the cases in which the rule has been applied from those in which it has not. Perhaps the nearest approach to a satisfactory principle of differentiation is suggested by Professor Gower: ". . . a shareholder can always sue notwithstanding the rule in *Foss v. Harbottle,* when what he complains of could not be validly effected or ratified by an ordinary resolution". (Gower, Modern Company Law, 3rd Edition, p. 585). This is sometimes said to be one of the four exceptions to the rule. But, as Gower points out, it really comprehends the other three. There are, however, cases that will not yield to rationalization. In some cases the rule has been applied notwithstanding that the impugned action could not have been authorized or ratified by ordinary resolution. For example, in *MacDougall v. Gardiner* the refusal of the chairman to conduct a poll at the request of the shareholders could have been legally justified only by retrospective alteration of the articles of the company, yet the court refused to entertain an action at the instance of individual members. Similarly, in *Cotter v. National Union of Seamen,* the irregularities in the convening and conduct of the meeting could have been overcome only by retrospective alteration of the rules of the union. Conversely, *Catesby v. Burnett (1916) 2 Ch. 325* is a case in which an individual action was permitted notwithstanding that the impugned action could have been authorized by the general meeting. In that case the two defendants who had been directors of the company were to retire by rotation. In fact one of them formally tendered a letter of resignation, although it is doubtful whether that was strictly necessary because the articles appear to have provided for automatic retirement at the general meeting. The chairman declared that the notice proposing the election of new directors was irregular and he refused to conduct an election in which the persons nominated in the notice were candidates. He left the meeting, whereupon the remaining shareholders proceeded to elect certain persons who had been nominated in the notice. An individual shareholder brought an action to restrain the two defendants from acting as directors. The action succeeded. It is quite clear that a regularly convened general meeting of shareholders could, by a simple majority, have re-elected the defendants although it did not, in fact, do so. It follows that, if Professor Gower's exposition is correct, the action by individual shareholders should have been dismissed. The cases thus remain in intractable conflict and there is no satisfactory principle of reconciliation.

The confusion is merely compounded by one of the more recent cases. In *Daniels v. Daniels (1978) 1 All E.R. 89* a husband and wife

were the major shareholders and the sole directors of a company. They sold a valuable asset of the company to themselves at a substantial undervalue. This was later sold at a huge profit. The minority brought an action alleging (apparently) that the directors were negligent in accepting an inadequate consideration for the asset. That was a strange and hazardous basis upon which to found the action. Indeed the case proceeds in complete ignorance of the principles requiring directors to account for profits derived from contracts with the company. There was no evidence of ratification of the contracts by the company in general meeting. The plaintiffs should therefore have moved at a general meeting to require the directors to account to the company for their profits. If the directors had then used their superior voting power to defeat the motion, that may well have constituted a fraud on the minority. But, as it was, the proceedings were premature and should have been dismissed.

I have written at some length in order to establish the kind of context in which the Committee's reforms would operate. The rule in *Foss v. Harbottle* has contributed little but uncertainty and injustice. But the substitution of a virtually unfettered judicial discretion seems to me to be a move that would merely replace a form of uncertainty that has at least the charm of antiquity with one that has not. I am sure that if the South Australian judges had the kind of discretion suggested, they would exercise it sensibly and reasonably. But if one considers the law in its wider context (as one must in a Federal system) and in the light of existing authority, the proposal to hand the problem over to the courts seems rather like suggesting the appointment of Al Capone as Superintendent of Licensed Premises.

It seems to me that if one first seeks solutions to the problems of imposing satisfactory standards of conduct upon promoters, directors and major shareholders, then solutions to the subsidiary problems of *locus standi* will follow logically and naturally. One major source of difficulty with the rule in *Foss v. Harbottle* is that, in purporting to be a general rule, it attempts to do too much. Common sense suggests that there should not be one rule of *locus standi* in company law but several: "A claim by a shareholder that he has suffered discrimination at the hands of directors, or other shareholders, involves considerations bearing upon the question of *locus standi* that are quite different from those raised by a claim alleging negligence on the part of directors." Solutions to the various major problems (which, in the interests of not unduly prolonging this letter I have forborne from suggesting) will carry with them solutions to the problems of *locus standi.*

I should like to suggest, in conclusion, that the reform of the law in this area is too important a matter to be buried away in a general report on *locus standi.* The decisions are so contradictory, and many of them so perverse, that a judge who is bound to apply them, or a legal practitioner explaining their effect to a client, must feel rather like Bishop Colenso attempting to justify the massacre of the Shechemites to the Zulu chieftains. A separate report, devoted entirely to these issues, is surely justified.

With kind regards,

Yours sincerely,
GEOFF HACKETT-JONES

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