The Impact of Coleman v Myers on Directors' Duties and the Financing of Takeovers

by

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I. Introduction

It is necessary to make a vital preliminary point on this topic. While it is certain that *Coleman* v. *Myers*[1] has the potential for considerable impact on several areas of company law, it will be some time before the actual impact can be assessed. To take a trite example from another area of law, *Donoghue* v. *Stevenson*[2] had the potential to establish liability for negligent words, though the case itself concerned negligent acts. At the time *Candler* v. *Crane Christmas*[3] was decided, it could have been said that the potential of *Donoghue's* case was spent so far as negligent statement was concerned. However, *Hedley Byrne & Co. Ltd.* v. *Heller & Partners*[4] rediscovered the potential in the source case and brought it to actuality.

This writer's initial concern is to canvass the possibility that owing to the several special features of the relationships between directors, company and members in *Coleman* v. *Myers* the case may possess a potential impact which will not be realised. Of the two broad areas to be examined in this paper, directors' duties and takeover financing, it is clear that the potential impact of each of these will not necessarily be the same. In anticipation of some conclusions, it will become apparent that the former area will develop out of particular facts to which broad rules will apply in the determination of consequences. The latter is more technical and ought to be more easily reducible to permissible and impermissible practices. While it is clear that certain practices are not permissible for directors, the standard of conduct

[1] [1977] 2 N.Z.L.R. 225.
[2] [1932] A.C. 562.
[3] [1951] 2 K.B. 164.
[4] [1964] A.C. 465.

emerges from more subtle factors; motive, personal relationship and expectation, notions of fairness and judicial policy.

For these and other reasons, this paper is an excursion into the realm of the possible and only in limited areas, the probable and near certain. It must also be noted that the two topics of this paper are inextricably intermixed. The issue is directors' duties vis-à-vis shareholders in the context of a takeover offer to be financed in a particular way.

II. Directors Duties

Although it is sometimes said that directors are trustees, their position is only analogous to that of a trustee. As Gower puts it[5]:

> In truth, directors are agents of the company rather than trustees of it or its property.

The agency of a director gives rise to the status of fiduciary. For present purposes the two primary issues are, first, the particular relationship out of which this duty arises and, secondly, the content and proper performance of that duty. To cite Gower again, in skeleton form, for the point as to whom the duty is owed[6]:

> . . . the fiduciary duties are owned to the company and to the company alone . . . in general, the directors owe no duties to the individual members as such. . . . This principle is regarded as firmly established by the much-criticised decision in *Percival* v. *Wright*. . . . This, however, does not mean that directors can never stand in a fiduciary relationship to the members. . . .

The writer then goes on to refer to an instance[7] where, collaterally to the directors' agency with the company, the members also constituted the directors to act as *their* agent. The basic proposition considered to have been established by *Percival* v. *Wright* was that a director, as such and without more, was only in a fiduciary relationship with his principal, i.e. the company. In that case, the plaintiff shareholders sought to establish that negotiations for the sale of the company's undertaking ought to have been disclosed at the time the plaintiffs offered their shares to the directors.

In *Coleman* v. *Myers* one of the principal causes of action brought by the plaintiffs, related to non disclosure of material information where the offer to buy shares was made by the company's managing director. The basic facts are fairly straight forward; they involve a scheme by the non-member managing director of an asset rich family company to purchase the whole shareholding from relations and founders' trusts, to be paid for from the company's cash in hand and by realising free assets. The whole scheme was to be effected without disclosing matters which could cause the members to bargain for a higher price than that originally offered, or to refuse to sell altogether.

[5] Gower, *The Principles of Modern Company Law* (3rd Ed. 1969), 516.
[6] *Ibid.*, 517.
[7] *Briess* v. *Woolley* [1954] A.C. 333.

The facts are gone into voluminously in the report, for reasons which will become apparent later in this paper.

To establish liability for actionable non-disclosure it was of course necessary to find a duty to disclose. *Percival* v. *Wright* was the obvious counter to the claim that such a duty existed on *Coleman* v. *Myers* facts. However, *Percival* v. *Wright*, not a strong case, and never popular, was firmly put in its place in both courts. Mahon J's criticism in the Supreme Court caused one academic commentator to head a casenote, '*Percival* v. *Wright* — Per Incuriam'. What does seem clear after *Coleman* v. *Myers* is that, while Mahon J's straight forward rejection of *Percival* v. *Wright*[8] did not survive the Court of Appeal[9] it is necessary to realise just how limited is the application of *Percival* v. *Wright* now.

It is at this point that the first kind of tentative conclusion can be offered. What virtually the whole of *Coleman* v. *Myers* stands for is an approach to relationships of influence, confidence and potential advantage. What the case shows is the pervasive and persuasive notions of fairness and good faith, more than mere honesty, required between persons in substantially unequal positions. The standard of behaviour expected of persons in authority, whether it be in private or public life is rising (arguably, in the latter, it is rising to unrealistic heights), and the courts are sensitive to this.

What *Coleman* v. *Myers* has done is not so much to cut back *Percival* v. *Wright* but to demonstrate how other factors arising in a different situation, must be taken into account and may substantially alter the final result. The reason for this is that a one dimensional approach to director/member relationships has been replaced by a multi-dimensional one. What those dimensions are will depend upon particular facts, the ingenuity of counsel and the perceptions and values of the judges. What must be looked for are the factors likely to be capable of turning the non fiduciary *Percival* v. *Wright* situation into the fiduciary one presented by *Coleman* v. *Myers.*

Cooke J. in the Court of Appeal neatly identified the factors he thought relevant on the facts before the court[10]:

> Broadly, the facts giving rise to the duty are the family character of this company; the positions of father and son in the company and the family; their high degree of inside knowledge; and the way in which they went about the take-over and the persuasion of shareholders.

He then went on to illustrate these factors; and followed with general references to several leading cases on undue influence,[11] and the con-

[8] Supra, at 227.
[9] Supra, at 324.
[10] Supra, at 330.
[11] *Tate* v. *Williamson* (1866) L.R. 2 Ch. App. 55; *Tufton* v. *Speni* [1952] 2 T.L.R. 516; *N.Z. Netherlands Society (Inc.)* v. *Kuys* [1973] 2 N.Z.L.R. 163; *Lloyd's Bank* v. *Bundy* [1975] Q.B. 326.

stellation of grounds of relief available where equity's extended notions of fraud, oppression and breach of confidence are relevant.

If the present concern is to canvass the impact of *Coleman* v. *Myers,* then the immediately obvious aspect must be the way in which the case merely illustrates established principles applied in a novel situation. What the case has done is to show that there is nothing special about directors' duties vis-à-vis shareholders as such. Further, that because a person is a director he, or she, is not excepted from the effect of general equitable rules, and may in fact be exposed to them more readily through the opportunities directorships offer for influence, confidence, and advantage.

It is a noticeable feature of *Coleman* v. *Myers* that despite the length of the judgments most of the presentation is of facts, not law. Case analysis is secondary to factual analysis. This approach is not surprising. It has been a feature of several recent cases[12] concerning intangibles like undue influence and equitable fraud. The moral for the director must be that such a position offers great potential for unconscionable influence, which, if exercised, will vitiate transactions which, at one time, might have been treated as part of the cut and thrust of economic competition.

The second major aspect to be discussed in this section deals with the related questions of the content of the fiduciary duty and its discharge, and the common law duty of care. Finding the equitable duty is very much a matter of deciding if the particular facts are capable of attracting the very general expressions in the decided cases as to who is a fiduciary. The satisfaction of the duty is capable of a more exacting analysis and in litigation is largely a matter of marshalling the evidence in the light of objective criteria. In one important respect, and despite the several special features of *Coleman* v. *Myers*, it is the consideration of what the managing director/offeror ought to have disclosed that may have the greatest impact.

In reviewing the evidence, it is readily apparent that one of the most telling facts against the offeror on the issue of disclosure was the contrast with what, if an offer, at the same price, had come in from an outside source, ought the directors to have said in making a recommendation on such an offer. Casey J. felt that the same disclosure ought to have been made, in the event[13]:

> . . . as if they [i.e. the directors] were advising them [the members] on an outside bid at arm's length

and,[14]

> . . . the directors' duty becomes clear if one asks what advice they would have given

[12] *Re Craig* [1971] 1 Ch. 95; *Re Brocklehurst* [1978] 1 All E.R. 767.
[13] Supra, at 374.
[14] Supra, at 375.

their shareholders on a similar outside bid, knowing the offeror's intentions and the dimensions of the coup contemplated by use of the company's assets. Can there be any doubt that they would immediately inform the shareholders and point out the implications?

Cooke J. discussed this in the context of duty of care (to be considered below), but it seems to this writer that the following passage would equally apply where it is argued that the directors' duty to members is fiduciary. The judge was commenting on the non disclosure of the high asset backing of the shares and said[15]:

The asset position was thoroughly known to the first two respondents. One can be sure that, if faced with an outside bidder and if prepared to entertain at all the possibility of selling, they would certainly not have recommended acceptance of a first offer of $4.80 without bargaining. In these circumstances I think that at the very least they should have refrained from a positive recommendation; and that the appellants have made out their allegation that the first and second respondents knew or sought to have known that the price of $4.80 per share was not a fair one and should not have been recommended to the shareholders.

These passages have been set out because, in this writer's view, they represent the objective test for discharge of a director's duty when he is an insider offeror, or is in some way privy to an inside offer. Naturally a fiduciary's actual duty to disclose will go further than that of a person owing a mere duty of care. However, as a minimum, this objective test is a usefully precise starting point.

Inevitably, the question of materiality of disclosure then arises. This was discussed by Mahon J. in the Supreme Court in the context of the special knowledge possessed by the director of a company the shares of which are not publicly traded. The judge put materiality in terms of duty this way[16]:

. . . on the facts of this case, where the director of a private company made an offer to shareholders to purchase their shares he had a duty to disclose to such shareholders any material fact of which to his knowledge they were unaware, and which might, from an objective viewpoint, materially affect the decision of those shareholders as to whether they would sell or as to the terms of sale.

In the Court of Appeal this was felt to go too far. Casey J. followed Cooke J's preference for "would" in lieu of "might" in the passage above.[17] In fact, however, Cook J. was less emphatic than Casey J. assumed. Cooke J. acknowledged counsel's preference for "would" to "might", but went on to say[18]:

I think it is often easier to assess whether a statement or omission is in the circumstances truly significant than to propound a watertight test. If forced to a formula, I would select one somewhere between the alternatives just mentioned.

Regrettably he failed to go on to provide an apt word or phrase to express this intermediate point. However, the judge did refer to a recent United States case,[19] from which he cited a short passage

[15] Supra, at 353.
[16] Supra, at 280.
[17] Supra, at 371.
[18] Supra, at 333.
[19] *T.S.C. Industries Inc.* v. *Northway Inc.* 426 U.S. 438 (1976).

prefaced by his own[20]:

> . . . broad test of materiality . . . those considerations which can reasonably be said, in the particular case, to be likely materially to affect the mind of a vendor or purchaser.

This unrevealing tautology however, can be improved by a short supplementary citation from the *TSC Industries* case. The standard of materiality is as follows, (the context was proxy solicitation)[21]:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

This writer regards formulae of this kind as giving *Coleman* v. *Myers* its real impact. As objective tests, a director must make himself aware of, and abide by, standards capable of fairly precise estimation. A director will be well advised to seek professional advice before putting himself in a situation where duty and self interest may conflict. As well, the director must be entirely frank with his expert advisers. In this respect, the director/offeror in *Coleman* v. *Myers* made use of a share valuation prepared by an expert who was only partially privy to the offeror's intentions as to the source of finance for the offer. The report therefore, supplied by the offeror/director in recommending acceptance of the offer, was not fully informative as to a material factor.

It was alleged in *Coleman* v. *Myers* that the offeror/director and his father, the company chairman, were negligent in recommending acceptance of the offer. As a basis for liability this has much to commend it. Despite the fertility of equitable concepts and fiduciary relationships, there are limits. A duty of care may be generated, particularly in the field of care as to words and advice, by the advisee. Is it not likely that a clear question to the insider/offeror: "do you know of any material facts which it might reasonably be expected I, as offeree, would wish to take into account in considering this offer?" could generate such a duty? The offeror might, of course, refuse to answer or might resort to a formula excluding liability.[22] However, either of these courses of action would do the offeror no good and would alert the offeree to the conscious suppression of information or to a real doubt as to the value of the director/offeror's recommendation.

In the Court of Appeal, Cooke J. founded the duty in the alternative.[23] It arose on the facts of *Coleman* v. *Myers* in the statutory requirement in section 5(2) and in the Second Schedule of the Com-

[20] Supra, at 334.
[21] Supra, at 449.
[22] As in *Hedley Byrne & Co. Ltd* v. *Heller & Partners* [1964] A.C. 465.
[23] Supra, at 340.

panies Amendment Act 1963. In making a recommendation on the offer it was, not unreasonably an implied statutory obligation that such a recommendation would be made with reasonable care.

The second source of the duty is more interesting but, since it adds nothing to established principles of tort law it will only be noted here. Having a financial interest in the outcome of his statement, the director/offeror attracted a duty of care under the decision in *MLC Assurance Co. Ltd.* v. *Evatt.*[24] It will not only be in the context of takeover offers that directors will have such an interest and it remains to be seen just how far this ground of potential liability can be taken in subsequent cases. In *Coleman* v. *Myers* the duty of care merely paralleled the fiduciary duty.

III. COLEMAN v. MYERS AND THE FINANCING OF TAKEOVERS

The difference in result between the Supreme Court and the Court of Appeal in *Coleman* v. *Myers,* turned in large part upon whether or not the offeror/director had a definite intention to finance his purchase in a particular way and the consequent duty to disclose that intention. Mahon J. appeared to accept[25] that the actual financing plan may have changed over time. In the Court of Appeal, Woodhouse J. was firmly of the opinion that the offeror/director had a particular mode of financing in view from the outset.[26] Cooke J. gives an extensive review of the offeror's plan,[27] and Casey J. similarly deals with the issue of non disclosure by reviewing that plan.[28]

What then was this plan? Cooke J. expressed the plan, shortly, in this way[29]:

> It was not disputed in argument on [the respondent's] behalf, as I understand it, that in a general sense he intended to finance his acquisition of the total shareholding exclusively by resort to the free assets of the company, including the monies on deposit amounting to about $1.8 million.

The free assets comprised a number of hotel properties and in particular an exceptionally valuable site in central Auckland, the Strand/Coburg. The issues of non disclosure related to intention and to the offeror's knowledge that the book values of the buildings were very much less than their realisable market value, and that the cash in hand was uncommitted. Therefore, by drawing on these resources of the company the latter would, in effect, be paying the price of its own purchase. Outside money was only necessary to bridge the gap between a debt falling due (e.g. paying for a parcel of shares) and funds

[24] [1971] A.C. 793.
[25] Supra, at 265 and at 283.
[26] Supra, at 313-315 and at 320.
[27] Supra, at 341-352.
[28] Supra, at 364-370.
[29] Supra, at 341.

becoming available to the absolute owners (i.e. the offeror/director) from the liquidation of company assets.

Section 62 of the Companies Act 1955 states that, subject to certain exceptions,

> . . . it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security, or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company.

Prima facie, on the facts of *Coleman* v. *Myers,* it appears that what was planned and executed was just such a scheme as to be caught by section 62. The offeror/director and his advisers were aware of this and pending litigation on the point, concerning another company, was being watched for its relevance to the scheme in hand.

It will be observed that the words of section 62[30]:

> . . . provide an instance of legislation which is in terms so wide as to require some degree of limitation in order to avoid results which could never have been in the contemplation of the legislature.

In the case referred to in the previous paragraph, *Re Wellington Publishing Co. Ltd.*,[31] decided while the offer, later the subject of *Coleman* v. *Myers* was proceeding, Quilliam J. recognised that the wide words of section 62 were not unlimited. He referred to the intent of the provision[32]:

> The purpose of the section would seem to be the protection of minority shareholders and creditors. If, therefore, a transaction in question is likely to detract from that protection then the words of the section may the more readily be regarded as extending to embrace that transaction.

It may safely be suggested therefore that where these purposes do not require to be promoted then the courts will not strain to catch transactions otherwise capable of being brought within the literal words of section 62. This will be seen to have been the case in both *Re Wellington publishing Co. Ltd.* and *Coleman* v. *Myers.*

The point must be made that the former case was a Supreme Court judgment *requiring* a decision on section 62, against facts duplicated, to some extent in the latter case. Because of the view he took on the issues of fraud, actionable non disclosure and negligence, Mahon J. in *Coleman* v. *Myers was* required to consider section 62. In the Court of Appeal, however, liability attached to the offeror/director apart from considering section 62. Therefore, it is perhaps not surprising that Woodhouse J. gives no mention of the provision. Cooke J. mentions it only in passing and Casey J. gives it short treatment.

It stretches credulity, however, not to regard the members of the Court of Appeal as having, albeit by a side wind, given approval *sub silento* to the views of Quilliam J. in *Re Wellington Publishing Co.*

[30] Supra, at 287-288.
[31] [1973] 1 N.Z.L.R. 133.
[32] Supra, at 136.

Ltd. and Mahon J. in *Coleman* v. *Myers* at first instance. This writer is of the view that, given the strength of disapproval of the offeror/director's actions in the case, the members of the Court of Appeal would not have failed to mention breach of section 62 if it had been thought to have been made out. For this reason, however, it must be acknowledged that *Coleman* v. *Myers* can hardly, realistically, be expected to have a very great impact on the law relating to the financing of takeovers. Except, that is, in the sense that the case endorses a certain mode of financing takeovers. That is of courses providing that the offeror does not incur a liability for breach of fiduciary or other duties in the process.

What then is this mode of financing a takeover? In *Coleman* v. *Myers* a combination of loans and capital dividends was used. The circumstances and objects of the loans are summarised in Mahon J's judgment.[33] Having benefitted by a bridging loan from his father's trust, from which he was buying shares, the offeror/director procured a loan from the offeree company to repay this indebtedness. Another loan was extended by the company to enable the offeror/director to increase the capital of his own company, the vehicle for the actual takeover offer, and so enable it to pay for the shares it was purchasing on his behalf.

It is clear that the loans were intended only to meet obligations the offeror incurred on his way to achieving control of the company. He would then be in a position to realise the free assets and cash, pay himself capital dividends, and then repay the interim indebtedness.

That the loans were only interim would not avoid the prohibition in section 62. In upholding the capital distribution to the incoming shareholders in *Re Wellington Publishing Co. Ltd.,* Quilliam J. was emphatic in distinguishing that case from others involving loans.[34] However, the first sentence of this paragraph requires to be read in the light of Mahon J's comments on the third and most dubious loan in *Coleman* v. *Myers.* This loan was extended by the company to enable the offeror to repay a loan made by a shareholder for the purchase of its shares in the offeree company. Mahon J. applied something akin to a proximate purpose test to uphold the legality of this loan. The "connection" (note this word in section 62(1)) was seen to be insufficiently close to the purchase of the offeree's shares. This was so since the *immediate* purpose was repayment of the third party loan and this was only required through delay in the offeror's ability to effect the declaration of the capital dividend in favour of himself.[35] And the lat-

[33] Supra, at 284.
[34] Supra, at 139.
[35] Supra, at 289.

ter mode of financing was, of course, approved in *Re Wellington Publishing Co. Ltd.*[36]

This result is certainly one to which a court need not have felt driven. In *Re Wellington Publishing Co. Ltd.* Quilliam J. had acknowledged that[37]:

> . . . the Court may go beyond the form of the transaction in a case such as this and look at the substance of it.

Similarly, in *Coleman* v. *Myers,* Mahon J. observed that:

> . . . section 62 of the Companies Act is one of those special examples of legislation which entitles a court to consider a series of independently valid contracts, whether of loan or otherwise, and see whether the combined effect is such as to bring into operation [the proscription in section 62].

Yet it seems to this writer that despite having recognized this power, the court recoiled from applying its full rigour. While in *Re Wellington Publishing Co. Ltd.* it was at least arguable that the dividend was only caught, if at all, by the general words 'or otherwise' in section 62, in *Coleman* v. *Myers* there were dividends *and* loans. One academic commentator described the former case as one which[38] "will delight the asset strippers". No doubt that delight will increase if, as in fact seems to be the case, *Coleman* v. *Myers* has extended the boundaries of permissible recourse to an offeree company's assets to pay for an offer.

Earlier[39] the view of Quilliam J. in *Re Wellington Publishing Co. Ltd.* as to the legislative purpose of section 62 was recorded. The leading text[40] on the law relating to takeovers identifies two other objects. These concern the avoidance of attempts by directors to increase their control at the company's cost and to the detriment of the ordinary members and also the more general policy of inhibiting takeover activity.

The former of these two objects was not called upon in *Coleman* v. *Myers* since Mahon J. found[41] that the loan by the company to the offeror/director was within the statutory exception; section 62(1)(c). The latter object was not thought relevant and in fact Mahon J. accepted[42] that positive benefits may flow from the rationalizations of company activities often introduced by takeovers. It is perhaps hard to see just what social or economic policy is advanced by permitting the kind of activity pursued by the offeror/director in *Coleman* v. *Myers.* However, that is a matter for the courts in this instance and perhaps, later, the legislature.

36 Supra, at 140.
37 Supra, at 285.
38 Note in (1974) 90 L.Q.R. 452.
39 Ante n.32.
40 Weinberg, *Take-overs and Mergers,* (3rd Ed. 1971) paras 1813-1819.
41 Supra, at 288.
42 Supra, at 287.

It seems to this writer that, given the emphasis on the *Trevor* v. *Whitworth*[43] basis to section 62, when no prejudice is likely to shareholders or creditors, then the self-financing takeover is permissible in this country. Obviously the loan process must be watched carefully. However, even the third loan by the offeree company in *Coleman* v. *Myers* (i.e. the bridging loan) was not thought by the first instance judge to be sufficiently closely connected to the takeover to be caught by section 62. So far as capital dividends are concerned, they can now be treated as entirely acceptable. In fact Casey J. in *Coleman* v. *Myers* in the Court of Appeal, went this far in approving *Re Wellington Publishing Co. Ltd.*[44]:

> I incline to the view that such a dividend is 'normal' for a company in this situation, with ample free assets to dispose of, and the distribution does not amount to that informal reduction of necessary capital, which is one of the things the section is designed to avoid.

The impact of this decision on takeover financing can therefore be briefly described as approving of an established, but perhaps socially questionable, commercial practice.

[43] (1887) 12 App. Cas. 409.
[44] Supra, at 378.