RECOMMENDATIONS

FOR

COMPANY LAW REFORM

BY

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RECOMMENDATIONS FOR COMPANY LAW REFORM

The areas of company law where reform is called for are reasonably well delineated by recent reports. Some of the problems that are being discussed are not new. Some are in fact hardy perennials but they continue to agitate law reformers and bedevil the business community. In the United Kingdom, there have been two reports on company law reform in the past twenty years. The first, known as the Cohen Report,[1] lead to many changes when the Companies Act was passed in 1948. Indirectly, that Report was the inspiration for many of the changes made by our own Act of 1955. The second report, the Jenkins Report,[2] has met with little success. In New Zealand, provision is made in the Companies Act 1955, s.472 for the appointment of an advisory committee; such a committee was responsible for making recommendations concerning take-over offers which were given effect to by the Amendment Act of 1963. This committee made a further report to the Minister earlier this year, but unfortunately the report has not yet been made public and it may not in fact be issued.

A list of company law problems demanding the attention of the law reformer would include:

the doctrine of *ultra vires*;
investor protection
provision for the incorporated partnership;
disclosure in company accounts;
shareholder control;
pre-incorporation contracts;
the duties of directors;
protection of minority shareholders.

It is obviously impossible in a paper such as this to cover adequately any of these topics. Six subjects have been chosen; the paper does little more than introduce the problem and indicate the general approach of the author. It has been assumed that the discussion to follow the paper will cover other aspects of the problems and thereby assist the formation of a balanced judgment on the issues. The following topics have been selected for consideration in this paper:

(1) The doctrine of *ultra vires*;
(2) Disclosure in accounts;
(3) Flat-owning companies;
(4) Shareholder control;
(5) The director's duty of good faith; and
(6) Use of confidential information.

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1 Cmd. 6659 (1945).
2 Cmnd. 1749 (1962).

(1) The Doctrine of Ultra Vires

This is a hardy perennial which nonetheless remains a problem. The doctrine itself need not be stated. It is defended,[3] quite illogically, on the grounds that it protects the subscribers and shareholders on the one hand and the creditors on the other. It is obvious, of course, that the current drafting practice of including a lengthy objects clause in the memorandum diminishes the protection shareholders are thought to derive from the doctrine and that only *intra vires* creditors in fact secure the protection of the doctrine. The Cohen Committee summarised the legal position in these words:

> ... [T]he doctrine of *ultra vires* is an illusory protection for the shareholders and yet may be a pitfall for third parties dealing with the company.[4]

That Committee in effect recommended the abolition of the doctrine *vis a vis* third parties and would have retained it solely as a contract between the company and its shareholders as to the powers of directors. This recommendation was not acted on by the Legislature in the United Kingdom, but in New Zealand certain ancillary objects and powers were implied in memoranda registered after 1 January 1957[5] and a change was made in the law as to the effect of limits imposed in the company documents on borrowing powers of the company and its agents.[6] The Jenkins Committee saw difficulties in giving effect to the recommendation of the Cohen Committee and made a much more limited recommendation (similar in intention to the New Zealand amendment) which would have protected third parties from the operation of the doctrine of constructive notice.[7] A more liberal provision enabling the objects clause to be expanded to include any business in which the company decided to engage, coupled with an extension of s.34(3) to include *ultra vires* trading debts as well as loans, would probably meet the wishes of the commercial community and also satisfy the members of the company. A company rarely invokes the doctrine of *ultra vires* in relation to trading debts. It is more likely to be raised by a liquidator or receiver.

(2) Disclosure in Accounts

Despite the changes made as the result of the

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3 *E.g.*, in *Cotman* v. *Brougham*, [1918] A.C. 514.
4 *Cmd.* 6659 (1945), para. 12.
5 Companies Act 1955, s.16(1) and Second Schedule.
6 S.34(3).
7 Cmnd. 1749 (1962), para. 42.

recommendations of the Cohen Committee, it is probably not an exaggeration to assert that company accounts remain almost unintelligble to the general public, including shareholders and intending investors, and that practices continue which are difficult to reconcile with the statutory obligations that full, true and complete accounts be maintained,[8] that balance sheets give a true and fair view of the company's affairs[9] and that the auditors certify that the accounts give a true and fair view of the company's affairs.[10] In saying this, I am fully aware of my lack of competence in the field of accounting; my assertion is based on the apparently unambiguous words used in the statute and my understanding of accounting practices. I am ready to be proved wrong about what I am about to say. Few will, I imagine, challenge the proposition that franker and fuller disclosure is now made to the Commissioner of Inland Revenue than to the shareholders.

I have chosen as an example of practices not consistent with the legislation the creation and disclosure of secret reserves. Such reserves may be created for a number of quite creditable reasons and lack of good faith need not be assumed. However, I adopt the words of Professor Gower who declares:

> "Provided that these reserves are disclosed this is unobjectionable, but if they are concealed the balance sheet becomes misleading and, as a means of assessing the worth of shares, even more unreliable than it always is. The profit and loss account is also falsified if the profit available for dividend is depleted by excessive provisions and this, too artificially deflates the price of the shares."[11]

It must be remembered that this passage was written subsequent to the changes made as the result of the recommendations of the Cohen Committee.[12] The practice apparently persists, despite the provisions of the new legislation and current teaching.[13]

As was shown in the Kylsant case,[14] there is a

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8 Companies Act 1955, s.151(1).
9 Ibid., s.153(1). As to group accounts, see s.156(1).
10 Ibid., s.166(1).
11 L.C.B. Gower, Modern Company Law (2nd ed., 1957), 424. Professor Gower argues that the practice is contrary to the provisions of the Companies Act and in particular to the Eighth Schedule.
12 Cmd. 6659 (1945), 56, 59 - 60.
13 E.g., T.R. Johnston & G.C. Edgar, The Law and Practice of Company Accounting in New Zealand (2nd ed., 1963), 88 et seq.
14 R. v. Kylsant [1932] 1 K.B. 442; [1931] All E.R.Rep. 179.

tendency for the Courts to adopt current practice as the legal standard. If the following statement correctly represents current attitudes, the changes sought to be effected by the amendments made in 1955 may not in fact (or in law) have been translated into practice:

> I am uneasy when I recognise the complacent if not eager way in which secret reserves are generally accepted by directors, auditors and the accountancy profession. Indeed secret reserves seem to be the goal of well-meaning directors.[15]

Essentially, the question is: are accounts where there has been an undervaluation of assets "true"? In addition to any liability under the Companies Act that may attach to accountants, directors and auditors who fail to present or certify "true" accounts, such persons may be liable to compensate those who have sold shares (either as part of a take-over scheme or otherwise) for less than their true value. The implications of the decision in Hedley Byrne & Co. Ltd. v. Heller & Partners, Ltd.[16] have not yet been determined, but it is quite conceivable that a liability may attach to those whose mis-statements cause loss to those who might be expected to rely on them.[17]

The reform needed here is not in the law which is clear enough. "True and fair" are unambiguous words. Practice needs to conform to the legal obligation.

(3) Flat-owning Companies

An example of the company form being used in circumstances where it was not appropriate is the flat-owning company which grants a lease or licence to, or confers some other right of occupation on, its shareholders. The Court of Appeal in Jenkins v. Harbour View Courts Ltd. (not yet reported) recently declared that this sort of arrangement involved a return of capital to shareholders, contrary to the provisions of the Companies Act. The effect of the

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15 Wallace, J., in a paper delivered to the Commonwealth and Empire Legal Conference, August/September 1965, at p.5.

16 [1964] A.C. 465; [1963] 2 All E.R. 575.

17 Admittedly the Hedley Byrne principle has not yet been applied in a contractual situation, but it is doubtful if it is accurate to describe the relationship between directors and auditors on the one hand and shareholders on the other as contractual.

agreements with shareholders left the company without the assets the shareholders' capital had purchased or created. Although the shareholders were obliged, in terms of the articles of the company, to provide funds to meet the claims of the creditors to whom such a company would be indebted, *e.g.*, the local authority, tradesmen, *etc.*, the sums provided to meet rates, maintenance and other costs are not paid as would normally have been the case, from its "capital".

To meet the situation created by the decision, an amendment to the Companies Act has been introduced which declares that flat-owning companies which grant rights of occupation to its shareholders in terms of its articles shall not be deemed thereby to have returned capital to those shareholders. Obviously, some amendment was necessary because so many companies had been established on the assumption that flat-owning companies, which granted shareholders a right to occupy a flat, did not involve a breach of one of the basic principles of company law. But the question remains: is this the best way of meeting the situation? Should some companies be granted exemption from compliance with one of the fundamental principles established in company law? Other countries have adopted legislation which permits strata titles to be issued to flat owners. Such legislation is consistent with our own system of land title registration and, if adopted here, would have made it unnecessary to press into service for an inappropriate purpose the company form.

(4) Shareholder Control

Though the Companies Act of 1955, embodied many of the recommendations made by the Cohen Committee[18] designed to improve shareholder control, the question remains: should that control be strengthened and if so, how? Those matters which are placed in the hands of a general meeting include appointment and removal of directors (but how often is the latter power exercised?) alteration of memorandum and articles, resolutions to wind up, and approval of payments of compensation for loss of office. Provision has also been made for the circulation of shareholders' resolutions, for shareholders to be able to requisition meetings and to have access to information held at the office of the company. In addition the Stock Exchange has imposed other requirements, requirements which are not as well known as those contained in the legislation.[19]

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18 Cmd. 6659 (1945), para. 124 *et seq.*

19 These requirements are seldom published. A note in [1965] N.Z.L.J. 337 gives details of present re-

The shareholder deserving of sympathy and a measure of protection is the minority shareholder who is being denied a voice in management and is being otherwise discriminated against, but who is unable to bring to an end the state of affairs or even terminate his membership, on satisfactory terms.[20] Provision has been made for cases of oppression,[21] a word yet to be exhaustively defined, but an effective barrier to relief is the doctrine laid down in Foss v. Harbottle[22] which the Jenkins Committee considered, but of which it did not recommend amendment.[23] A paper delivered to the Commonwealth and Empire Law Conference declared:

> "To go back to first principles, to what extent does the minority agree to accept the majority control?
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> Any person who invests in a company is entitled to expect that:
> (a) The company will be managed honestly; and
> (b) Within the scope of its objects; and
> (c) That the management will be efficient; and
> (d) That the management will be adequately, but not more than adequately, remunerated; and
> (e) That proper dividends will be paid if the company can afford them.
>
> It is only the first two of these matters which can be litigated by a minority shareholder; as regards the others he runs up against the rule in Foss v. Harbottle, or the provisions of the articles. This seems unfair."[24]

But it is doubtful if a shareholder will always have a remedy in respect of breaches of the first

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20 Cf. Re Associated Tool Industries Ltd., [1964] A.L.R. 73, where an order for winding up was refused, but an order for the purchase of the petitioner's shares at a determined price was made.
21 Companies Act 1955, s.209.
22 (1843), 2 Hare 461.
23 Cmnd. 1749 (1962), paras 206 - 207.
24 R. Walton & C.H. Scott, Modern Problems of Company Law, 11. It is too late to urge that class rights should be unalterable without the consent of the class shareholders; decisions such as Dimbula Valley (Ceylon) Tea Co., Ltd. v. Laurie [1961] 1 Ch. 353; [1961] 1 All E.R. 769 and Fisher v. Fasthaven Ltd. [1964] N.S.W.R. 261, (cp. Crumpton v. Marienne Pty. Ltd. (1965) N.S.W.R. 240) show that consent is not always required. In the last two cases an attempt was made to deprive a shareholder in a flat-owning company of his rights of occupancy.

proposition.[25] A recent decision, Pavlides v. Jensen,[26] has shown that Foss v. Harbottle will stand in the way of a shareholder who asserts that the property of the company has been sold at a gross undervalue, unless fraud can be established. There is no effective means of securing that management shall be conducted efficiently; the standard of competence demanded by such decisions as Re City Equitable Fire Insurance Co., Ltd.[27] is extremely modest. It is unrealistic to assert that inefficient directors will be removed at a general meeting; few members are sufficiently well informed or capable of rallying enough support to achieve such a result. It is almost impossible also to ensure that the rewards of management are in proportion to its efficiency and the contribution that has been made. To include within the oppression of the minority principle provisions which would enable a shareholder to challenge the directors to establish that there has been adherence to the last three of the five propositions advanced on p.44, supra, would be one means of removing the disabilities under which a minority shareholder suffers and indirectly to achieve a greater measure of compliance with those propositions.

(5) The Director's Duty of Good Faith

The common law position is that directors are in some respects trustees for the company towards which they must act in good faith. This duty has been extended by statute, e.g., as to compensation for loss of office[28] and loans to directors,[29] and it is also expressly provided that an indemnity in respect of liability cannot go beyond s.204.[30]

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25 An earlier part of this paper discusses the possibility of the operation of the principle of good faith being restricted by provisions in the articles.
26 [1956] Ch. 565; [1956] 2 All E.R. 518.
27 [1925] Ch. 407, 427 - 430, per Romer, J.
28 Companies Act 1955, ss.191 - 194.
29 Ibid., s.190.
30 The operative part of this section provides: ... [a]ny provision, whether contained in the articles of a company or in any contract with a company or otherwise, for exempting any officer of the company or any person (whether an officer of the company or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty, or breach of trust of which he may be guilty in relation to the company shall be void ....

The first question to which attention is directed is the extent to which the common law duty of good faith can be defined or circumscribed by the articles and not amount to an exemption from liability within the meaning of s.204. It has already been recognised that the phrase "bona fide for the benefit of the company as a whole" does not mean that shareholders are expected to dissociate themselves altogether from their own prospects when considering what is thought to be for the benefit of the company.[31] Nor presumably need directors ignore their personal interests when exercising their rights as shareholders. But limitations do exist. A director cannot exploit confidential information that he possesses in his capacity as a director to make a profit at the expense of the "company". A most unusual illustration of the operation of this principle is Regal (Hastings), Ltd. v. Gulliver,[32] where the directors of a company took shares in a subsidiary in good faith and in terms of an arrangement approved by the controlling company, but when those shares were later sold to a purchaser at a profit of £2.16.1. per share, the House of Lords held that the directors had to account to the subsidiary company (which had changed hands as the result of the sale) for the profit. In effect, this reduced the consideration paid by the purchaser. Lord Russell of Killowen declared:

> "... I am of opinion that the directors standing in a fiduciary relationship to Regal in regard to the exercise of their powers as directors, and having obtained these shares by reason and only by reason of the fact that they were directors of Regal and in the course of the execution of that office, are accountable for the profits which they have made out of them."[33]

But provisions in articles which permit directors to vote on matters in which they have a personal interest are not unknown and are common in the articles of private companies.[34] Is the next step - the inclusion in the articles of provisions which in effect declare the director's interest or the governing director's interest to be identical with the interest of the company - likely to be treated as an exemption from liability within the meaning of s.204 or as a definition of his duty in such a way that the common law rules as to good faith cease to operate. A number

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31 See, e.g., Greenhalgh v. Arderne Cinemas, Ltd. [1951] Ch. 286; [1950] 2 All E.R. 1120.
32 [1942] 1 All E.R. 378.
33 Ibid., 389.
34 Cf. Companies Act 1955, s.199, Third Schedule, Table A, Art. 84.

of recent Australian decisions show that there is substance in the distinction I am attempting to draw.

In Levin v. Clark,[35] the facts were extremely complicated, so much so that the suitability of the company form of organisation (and the principles it carries with it) for certain business transactions can be seriously doubted. It was argued that the directors in exercising their powers had not acted in the interests of the company but to protect the mortgagee whose nominees they were. The relevant portion of the articles read:

> 81. (3) William Eric Addicoat and Augustus William O'Brien are hereby appointed jointly and severally as governing directors of the company and each shall be entitled to hold office as governing director until he resigns or dies.
>
> (6) A governing director for the time being of the company shall have authority to exercise all the powers authorities and discretions by these presents expressed to be vested in the directors generally or in the company in general meeting and all other directors (if any) for the time being of the company shall be under his control and shall be bound to conform to his directions in regard to the company and the company's business.

Clark and Rappaport had been appointed governing directors by the mortgagee in place of those named in the articles.

Jacobs, J., said at pp. 700 - 701:

> "I consider that Clark and Rappaport did act primarily in the interests of the mortgagee once they resumed the exercise of their powers as governing directors. However, I consider that it was permissible for them so to act. It is of course correct to state as a general principle that directors must act in the interests of the company. There is no necessity to refer to the large body of authority which supports this as a general proposition. However, that leaves open the question in each case - what is the interest of the company? It is not uncommon for a director to be appointed to a board of directors in order to represent an interest outside the company - a mortgagee or other trader of a particular shareholder. It may be in the interests of the company that there be upon its board of directors

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35 [1962] N.S.W.R. 686

one who will represent these other interests and who will be acting solely in the interests of such a third party and who may in that way be properly regarded as acting in the interests of the company as a whole. To argue that a director particularly appointed for the purpose of representing the interests of a third party, cannot lawfully act solely in the interests of that third party, is in my view to apply the broad principle, governing the fiduciary duty of directors, to a particular situation, where the breadth of the fiduciary duty has been narrowed, by agreement amongst the body of the shareholders. The fiduciary duties of directors spring from the general principles, developed in courts of equity, governing the duties of all fiduciaries - agents, trustees, directors, liquidators and others - and it must be always borne in mind that in such situations the extent and degree of the fiduciary duty depends not only on the particular relationships, but also on the particular circumstances. Among the most important of these circumstances are the terms of the instrument governing the exercise by the fiduciary of his powers and duties and the wishes, expressed directly or indirectly, by direction, request, assent or waiver, of all those to whom the fiduciary duty is owed."

The last sentence of this extract can be taken to include the articles of association as a relevant instrument. The articles, taken together with the circumstances in which the governing directors had been appointed, made it clear that the duty of good faith, in the sense of being obliged to act in the interests of the company, had been varied and did not apply.

The second case is Savoy Corporation, Ltd. v. Development Underwriting, Ltd.[36] where again the fact situation was extremely complicated. The arguments presented by the plaintiff were:

(a) that in making a call on the shares the directors were not acting in the interests of the company but to protect their own position as directors and to frustrate the plaintiff's attempt to increase its shareholding; and

(b) that the call was made to facilitate merger proposals with a third company.

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36 [1963] N.S.W.R. 138.

The articles of association were so worded that the directors were not disqualified, by virtue of their shareholding, from voting on the resolution to make a call. Jacobs, J., would have declared the call invalid if it had been shown to have been made to secure the director's personal advantage or gain,[37] but this was not established. He was of the opinion that the directors could not be expected to ignore the infiltration of the company by persons whom they *bona fide* considered not to be seeking the best interests of the company. However, they were not entitled to identify their personal interests with the interests of the company, however much they considered the company to be dependent on their personal presence in its management. He concluded that, although the call had been made by reference to the merger proposals, it was a reasonable exercise of power.

The third case, *Re Broadcasting Station 2GB Pty. Ltd.*[38] introduces the element of oppression of a minority. The petitioner was a director and minority shareholder of the company operating Station 2GB Sydney. It was argued that the majority of the directors had voted to promote the interests of the company whose nominees they were. Jacobs, J., though recognising the principle that each director must govern his acts by his appreciation of the interests of the company as a whole,[39] nevertheless declared:

> "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 interests without a close personal analysis of the issues. I think that at the 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 company 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

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37 *Ibid.*, 145.

38 [1964 - 65] N.S.W.R. 1648.

39 *Ibid.*, 1662. A clear case where the principle was violated is *Re Yorke Stationers Pty. Ltd.*, (in liq.), [1965] N.S.W.R. 446 where the two shareholders (who were also the directors) sold the assets of the company to themselves for a sum much less than the outstanding liabilities. The resolution approving the sale was declared invalid.

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. [Italics inserted] Also, such a requirement would, in effect, make the position of a nominee or representative director an impossibility."[40]

As to oppression of the minority, he continued:

"I do not think that there is any evidence that they have acted otherwise than in what they believe to be the best interests of the company. I do not think that it is sufficient that they have put themselves in a position where their interest and the duty which they have taken directly upon themselves may conflict. It would only be in the event that, on a conflict arising, they preferred their own interest that a situation of oppression could arise."[41]

In cases where a shareholder has a nominee on the board, it would seem that the nominee can vote according to the interest of the person whose nominee he is and those asserting a breach of his duty of good faith will have an extremely heavy onus of proof to discharge.

These cases approach but do not encompass the problem raised earlier. They show that the duty of good faith requires that a director should not exercise his powers to secure personal advantage, but it would seem that he may vote to improve the position of a company whose nominee he is and in which he is a shareholder. Such conduct is not necessarily a breach of his duty to act in good faith. He may clearly vote on issues in which he has a pecuniary or financial interest if the articles so provide. The duty of good faith has been emptied of much of its former content which could, it appears, be reduced still further by appropriate provisions in the articles. If this process is regarded in the abstract as objectionable (because it offends a basic principle of company law) legislation must be sought to curtail or reverse the present trend towards contracting out of the principle. Where members of the general public are minority shareholders, their interests could be sacrificied to the advantage of another company or business represented on the board.

(6) Use of Confidential Information

One particular aspect of the more general topic

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40 Ibid., 1663.
41 Ibid., 1664.

already discussed calls for comment. Persons holding multiple directorships are particularly liable to receive confidential information which they may be tempted to use for their private advantage. The principle applied in cases such as Regal (Hastings), Ltd. v. Gulliver[42] would not cover all cases where confidential information had been used. Even the recommendation of the Jenkins Committee which would make a director civilly liable for carrying on the business of the company in a reckless manner does not go far enough and would rarely cover the sort of situation being discussed. A clear statutory provision, perhaps associated with the one recommended on p.45 , supra, to ensure that directors receive only a reasonable reward for their services, is called for. Any private profit made as the result of the use of confidential information should be held in trust for the company as was done in the Regal Hastings case, supra.

The paper has raised a number of issues where reform is thought to be justified, but changes are not likely to be made unless those most affected, the shareholders and the business community, endorse proposals for reform. The Legal Research Foundation which has conducted this symposium is to be congratulated on its initiative in providing an opportunity for discussion of these issues.

J.F. Northey

42 P. 46, supra. Even Byrne v. Baker, [1964] V.R. 443, where a director was charged with a breach of a statutory obligation to use reasonable diligence in the discharge of his duties, does not take the matter much further than the earlier cases.

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