REFORM OF DIRECTORS' FIDUCIARY DUTIES

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The object of this paper is to examine two aspects of directors' fiduciary duties - basic self dealing and the obligation of care and skill. The Law Commission is currently considering the codification of directors' duties[1] and a similar rather complicated attempt has been made in Australia[2]. Before one codifies the law it seems appropriate to consider whether the law to be codified is satisfactory. In my opinion both aspects of this law are very unsatisfactory and should not be codified in their present form. I, therefore, consider not only the causes of dissatisfaction but also certain reforms of the law. However, a threshold question must be considered and that is whether it is appropriate to refer to a director's obligation of care and skill as a fiduciary duty[3]. There has been an increasing tendency in recent years to regard all obligations of care as capable of being subsumed under the tort of negligence.[4] This is a great mistake. Not only is the tort of negligence one of the least satisfactory areas of the law - the late Julius Stone for instance aptly referred to the duty of care as a category of illusory reference[5] - but also such a tendency negates important legal distinctions.[6] A director's obligation of care and skill is part of his/her fiduciary obligations in Equity. There is no question of establishing a duty of care because of the underlying equitable relationship between the director and the company. Equitable defences are available. A director's obligations of care and skill have more in common with a trustee's obligations of due diligence although there are still some important differences.[7] This reason above any other provides justification for the apparently low standard of care required of company directors. However, I shall have more to say about this later.

Basic Self Dealing

I take as a paradigm case of basic self dealing a director contracting with his company. The law on this in both the Commonwealth and the U.S.A. has undergone a complex development.[8] By the middle of the 19th century in Commonwealth countries and the United States it had become recognised that directors were in a position analogous to trustees and thus any contract entered into by them with the company was voidable. This was clearly established by the House of Lords sitting in a Scottish appeal in **Aberdeen Railway v Blaikie.**[9] In that case a company entered into a contract with a partnership which included one of its directors. The House of Lords held that the contract could be avoided by the company notwithstanding that its terms were fair. Lord Cranworth LC said:[10]

> "...This, therefore, brings us to the general question, whether a director of a railway company is or is not precluded from dealing on behalf of the company with himself or with a firm in which he is a partner. The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents, and it is, of course, the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such an agent has duties to discharge of a fiduciary character towards his principal, and it is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into. It obviously is, or may be, impossible to demonstrate how far in any particular case the terms of such a contract have been the best for the cestui que trust which it was possible to obtain. It may sometimes happen that the terms on which a trustee has dealt or attempted to deal with the estate or interests of those for whom he is a trustee have been as good as could have been obtained from any other person; they may even at the time have been better. But still so inflexible is the rule that no inquiry on that subject is permitted."

The position in Equity was that the contract was voidable and any profits made by the directors could be recovered by the company. The position was thus similar to a promoter.[11] However, whereas a promoter could escape liability by making full disclosure of material facts to an independent board of directors or, in certain other cases, all the members, a director was in a more difficult position. It was not possible for the directors to disclose to themselves as some judges thought that the company had a right to the unbiased voice and advice of all its directors.[12] The only way in which the directors could proceed was to make full disclosure to the members of the company and have the contract approved or ratified in general meeting. This was expressly provided for in section 29 of the Joint Stock Companies Act 1844 but the relevant provision did not appear in the Act of 1856.[13] Instead there was a provision in the model articles, article 47 of Table B, that any director, directly or indirectly, interested in any contract with the company (except merely as shareholder of another company) should be disqualified and vacate office. Articles to this effect continued in the model articles under the legislation until the 1948 English Act. However, the practice developed of inserting articles which excluded or modified the standard form.[14] Since 1948 in the United Kingdom and the Companies Act 1955 in New Zealand, Table A has omitted such a clause and instead provided that directors are not disqualified by contracting with the company. Indeed many articles have attempted to modify directors' duties. There are various ways in which this is done in the case of self dealing transactions. Articles regularly provide for disclosure of interest and some provide for exclusion from the quorum and voting. However, others provide for an interested director to be both counted towards the quorum and able to vote. The Greene Committee[15] in 1926 was concerned by the growth of such clauses and recommended provisions for mandatory disclosure of a director's interest. The present New

Zealand provisions are now contained in section 199 of the Companies Act 1955. There are similar provisions in force in section 228 of the Australian Companies Code although these contain certain amendments which I shall discuss shortly. Sections 228-9 of the Australian legislation are set out in the Appendix to this article. Section 199 of the 1955 Act provides for disclosure of the nature of a director's interest at a meeting of the directors. However, under section 199 (3) it is sufficient to give a general notice to the effect that the director is a member of a specified company or firm and is to be regarded as interested in any contract with that company or firm. The sanction for breach of the section is a fine not exceeding $200, which is now much lower than overseas jurisdictions, and section 199(5) provides that nothing in the section shall be taken to prejudice the operation of any rule of law restricting the directors of a company from having any interests in contracts with the company. In other words the contract is voidable and profits can be recovered under the equitable principles. There is a conflict of Australian and English authority on whether there is separate liability in tort for a breach of statutory duty.[16]

A signal weakness of this section, but one which no doubt facilitates business, is that disclosure is to the board and not to the company in general meeting. Indeed, on the face of the section it appears that disclosure is only required if the contract is brought before the board.[17] On the other hand it has recently been held in England that disclosure to a committee of the board is not sufficient and will render the director liable as a constructive trustee of the benefits transferred.[18] The declaration need not be recorded in writing.[19] There is uncertainty surrounding the meaning of the word "interested" for the purpose of section 199. It is arguable that "interested" only means having a pecuniary interest. On the other hand Professor Gower[20] argues that this would be too restrictive an

interpretation and it does not seem to have been the intention of the draftsman of the Act. Thus a more remote connection through a network of companies and in the capacity of an officer of the company will be sufficient.

The Jenkins Report made recommendations in connection with the English section which was the counterpart of our section 199.[21] The report recommended that disclosure should be limited to material interests but should cover all contracts irrespective of whether they came before the board. In all cases the nature and extent of the interest would require to be stated and although a general notice would be allowed this would not be sufficient if the nature of the interest was greater than that stated in the general notice. These reforms have not been enacted but Section 199 of the English 1948 Act was amended in 1980 to extend to transactions and arrangements and the wording modernised in the consolidation in 1985. The corresponding provision in Table A has been substantially revised. The Australian provision now contained in section 228 of the Companies Code adopts the Jenkins idea of material interests although the wording of section 228(2) is badly drafted. Certain matters, which need not be disclosed and are in the new UK Table A, are set out in Section 228(3). In Australia it is now impossible to read section 228 in isolation from section 229 of the Companies Code, which appears to codify directors' duties but whose relationship with section 228 and the caselaw is obscure. Section 229(3) prohibits the improper use of information argued by virtue of a directorship to gain a personal advantage or to cause detriment to the company. This in turn overlaps with section 229(1) (duty to act honestly), and section 229(4) (duty not to make improper use of one's position). There are criminal and civil sanctions under section 229. Section 229(10) provides that the section is in addition to and not in derogation of any duty or liability by reason of the office or employment in relation to the company. Again I find the meaning of this obscure. Last year I had the

privilege of participating in the Sydney Law Review Conference on Company Law with a number of distinguished judges, practitioners and academics. I was particularly struck by the lack of agreement on the meaning of section 229 and its relationship to the caselaw.

On the whole the best drafted section is section 132 of the Ontario Business Corporations Act 1982 which

(i) does not use the wording "directly or indirectly" but spells out clearly who is covered;

(ii) requires disclosure in writing or minuting of contracts and transactions, even those not requiring approval;

(iii) spells out clearly the consequences of non disclosure;

(iv) provides expressly for confirmation by shareholders in certain circumstances;

(v) provides a procedure for setting aside the contract for breach of the section. This gives express locus standi to a shareholder.

The wording of section 132 is set out in the Appendix to this article. The relationship of this to the codification provision in section 134 is clear. Section 134 is more general (much more general than section 229 of the Australian Companies Code) and is subject to section 132 by virtue of section 134(2).

In addition to section 199 the New Zealand and other Commonwealth legislation contains provisions requiring specific disclosure and formality in connection with different types of contract.[22] The English provisions now contained in the U.K.Companies Act 1985 are more extensive than those of the New Zealand Companies Act 1955.[23] However, we will not concern ourselves with these detailed provisions but concentrate on the question of basic principle. Before we do so, however, I will briefly mention the course of development in the U.S. case law as this helps to understand certain aspects of the Ontario reforms.[24] As I have mentioned the U.S. courts in the 19th

century recognised a rule similar to that laid down in **Aberdeen Railway v Blaikie.** In doing so they saw themselves as adopting a sound principle of trust law and were no doubt influenced by the number of railway frauds in the 1860s and 1870s. However, in 1910 a second stage had developed where the general rule was that a contract between the director and his company was valid if it was approved by a disinterested majority of his directors and was not found to be unfair or fraudulent by the court, if challenged.[25] By 1960 a third stage was reached whereby contracts with directors are generally valid unless found to be unfair by a court, if challenged. An American commentator on this development in 1966 was at a loss to provide convincing explanation of the changes in judicial policy.[26] The rationale for the change, where professed, was technical and based on a trustee's ability to deal with a cestui que trust provided he made disclosure and took no unfair advantage. A possible fourth stage was reached in 1975 when California adopted legislation which is capable of the interpretation that contracts properly ratified by shareholders are immune from judicial inquiry into the fairness of their terms. Professor Robert Clark of Harvard in his **Corporate Law**, after mentioning the possible fourth stage discusses a number of possible reasons for the changes.[27] One is the influence of management on the courts and legislature. However, Clark thinks that there are a number of difficulties in this explanation and evidence is lacking. The second explanation is that the changes mark a shift to more flexible rules which was part of a change in judicial attitudes in a faster moving society. Clark finds this more convincing. A further explanation is the legal profession's influence on reform. It was to their professional advantage to have less certain rules. Another interesting explanation mentioned by Clark and which is based on detailed research in the American case law is that by the turn of the century the number of self dealing cases involving close corporations became greater than those involving public

corporations. In such cases it is easier to see how the courts could favour a more flexible attitude since in close corporations there may only be one vendor or source of credit. However, no such research has been done in respect of Commonwealth case law and the matter remains something of a puzzle.

The American Law Institute in its **Principles of Corporate Governance** favours a conjunctive test for self dealing transactions.[28] The director must make full disclosure and the transaction must be fair to the corporation. In an article "Self-interested Transactions in Corporate Law" about to be published in the Summer 1988 issue of the Journal of Corporation Law, Professor Melvin Eisenberg, general reporter of the project, explains the reasoning behind the adoption of this conjunctive test. First, disclosure is not enough. Where for instance the board consists of three members, two of whom are interested in the transaction they could easily approve the transaction over the objections of the third in spite of the fact of it being unfair. Conversely, fairness of price without full disclosure may not be enough either. First, the transaction is with a person who is in a relationship of trust and confidence. Secondly, to raise the matter of fairness alone would be to remove the matter from the company to the hands of the court. Disclosure of the contracting party and the facts may affect the price to be paid. Obviously this would be irrelevant in the case of a homogeneous commodity. However, for a non-homogeneous commodity the matter can be crucially relevant to the determination of what is a fair price. To eliminate disclosure would be to prejudice the company as a contracting party. The director contracting with the company is, by virtue of his position, not only aware of all the material facts concerning the item to be bought or sold but also of the material facts about the company as a seller or buyer. The transaction in those circumstances can only be fair if the company is put in the same position. Another related reason is that fairness is

not only concerned with price but also with the process of negotiation. Because of the difficulty of establishing fairness of price the law necessarily has to seek refuge in intense scrutiny of the fairness of the process as a substitute. Unfairness of process may, therefore, be evidence of unfairness of price. The question then arises as to whether this can be countered by approval by disinterested directors. Professor Eisenberg argues that approval by disinterested directors should not insulate a self-interested transaction from judicial review for fairness. However, in the flexible way in which United States law and law reform approach corporation law it is suggested that approval by disinterested directors should shift the burden of proof. In other words, where the transaction has been approved by disinterested directors the burden of proof is on the complainant; otherwise it is on the disinterested director to show that the transaction is fair. Secondly, approval by disinterested directors changes the standard by which the self-interested transaction is to be measured. The complainant has to show that disinterested directors could not reasonably have believed that the transaction was fair. This is easier for the director to satisfy than a pure fairness test. On the other hand it is harder than the Business Judgment Rule.

The Ontario Business Corporations Act 1982, section 132(7) links disclosure with fairness in a conjunctive test and also links fairness with reasonableness. Provision is made in section 132(8) for ratification by a special resolution provided the director acted honestly and in good faith and there is adequate disclosure in the notice calling the meeting. It is suggested that the Ontario section represents a useful model of reform for New Zealand and Australian law. A rationalisation of the law in these terms is definitely called for.

The obligation of care and skill[27]

Unlike a professional person, a company director is not required to have any special qualifications for his office. All that the law requires is that he should exhibit in the performance of his office the care and skill that may reasonably be expected from a person of his knowledge and experience. Unless the articles or a service agreement provide otherwise the director is not obliged to devote the whole or indeed any particular part of his or her time to the company. Failure to attend board meetings does not necessarily amount to negligence. In the absence of grounds for suspicion a director is entitled to rely on the information and advice given him by the trusted officers of the company.[30] The basic rules are stated in these terms by Romer J in **Re City Equitable Fire Insurance Co Ltd:**[31]

> "(1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. A director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or of a physician. In the words of Lindley M.R.: 'If directors act within their powers, if they act with such care as is reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent they discharge both their equitable as well as their legal duty to the company': see **Lagunas Nitrate Co. v Lagunas Syndicate** ([1899] 2 Ch. 392 at 435). It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment. (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so. (3) In respect of all duties that, having regard to the exigencies of the business and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly..."

A common criticism is that the standard of care is too low.[32] An attempt has been made in some overseas jurisdictions to introduce a more objective element into the basic obligation. Thus section 229(2) of the Australian Companies Code provides "an officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and discharge of his duties". The odd thing about section 229 is that breach of this gives rise to a criminal penalty of $5,000 as well as civil compensation. Section 134 (1)(b) of the Ontario Business Corporations Act 1982 provides that a director shall "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances". The 1978 United Kingdom Companies Bill contained the following clause:

> "In the exercise of the powers and the discharge of the duties of his office in circumstances of any description, a director of a company owes a duty to the company to exercise such care and diligence as could reasonably be expected of a reasonably prudent person in circumstances of that description and to exercise such skill as may reasonably be expected of a person of his knowledge and experience."

The U.S. Revised Model Business Corporation Act which is a model for state legislation codifies the law as follows:

8.30 General Standards for Directors

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

(b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.

It is interesting that this provision avoids the use of words like "diligence", "care" and "skill". The argument in the official comment is that skill in the sense of technical competence should not be a qualification for the office of director and the concept of diligence is sufficiently subsumed within the concept of care. The reference to a "ordinarily prudent person" focuses on the basic attributes of common sense, practical wisdom and informed judgment. The use of the phrase "in a like position" recognises that the care is that which would be shown by the "ordinarily prudent person" if he or she were a director of the particular corporation. The reference to "similar circumstances" emphasises the relativity of the responsibility. The nature and extent of the

responsibility will vary depending on factors such as the size, complexity and urgency of the activities carried on. Section 8.30 (b) seems like an updated version of Romer J's third proposition.

Another point to be noticed is that the Revised Business Corporation Act does not attempt a codification of the Business Judgment Rule. The draftsman of the revised act thought that in view of the continuing judicial development the matter should not be codified but left to the courts and possibly to a later revision of the model act.

The US courts have developed the Business Judgment Rule to a much greater extent than the Commonwealth countries and it will be useful if we pause a moment to consider the nature of the rule and its relationship to the duty of care of directors.

First, one can distinguish between the Business Judgment Rule and the Business Judgment Doctrine.[33] The Business Judgment Rule immunizes individual directors from liability for damages stemming from particular decisions while the Business Judgment Doctrine protects the decision making itself. It recognises the legitimacy of the board as a decision maker and the judicial deference to be accorded to it.

From the 18th century onwards it was recognised that directors were subject to equitable obligations of good faith and reasonable diligence.[34] On the other hand since the 19th century Anglo-American courts have recognised the Business Judgment Doctrine in some shape or form.[35] The rationale of the doctrine is three fold. First, it is a recognition of human fallibility. Second, it is a recognition of the role of risk taking in business decisions. Thirdly, it keeps the courts from becoming bogged down in complex corporate decision making and second guessing management decisions which they are ill equipped to do.[36] In Commonwealth systems the doctrine has featured in alteration of articles,[37] adequacy of consideration for shares,[38] reduction of capital,[39] refusal to register

transfers,[40] schemes of arrangement[41] and takeover[42] cases. It has been similarly pervasive in U.S. Corporation laws which have worked out a clearer formulation of the Business Judgment Rule and have attempted recently to construct a coherent doctrine applicable to takeovers.[43] In doing so they have exposed some weaknesses of both the doctrine and the rule.

Originally the Business Judgment Rule was formulated in connection with the diligence obligation of directors and in its terms it is more appropriate to this kind of question. However, it has since been applied in the more distinctly fiduciary context, where its application is less appropriate.[44] The courts have attempted to deal with this inappropriateness by talking of the Rule in evidential terms. The Rule is sometimes described as a presumption of regularity. This has been reaffirmed by the Delaware Supreme Court in a number of recent cases.[45] Such an analysis has also been adopted in other U.S. jurisdictions.[46] The Business Judgment Rule as such applies where after reasonable investigation disinterested directors adopt a course of action which in good faith they honestly and reasonably believe will benefit the company.[47] There are thus arguably five elements in the rule - a business decision, disinterestedness, due care, good faith and no abuse of discretion.[48]

Let us look at the five ingredients of the rule -

(a) A business decision - the rule only applies to action, not inaction.

(b) Disinterestedness. This is axiomatic. In the U.S. corporation laws where a party challenging transactions establishes personal interest or self-dealing by a majority of the directors the burden shifts to the directors to prove the fairness of the transaction. At first sight it is difficult to avoid the assumption that a target company's directors are inevitably involved in a

conflict of interest in a hostile bid. For this reason the courts have sometimes equivocated as to the application of the Business Judgment Rule in this context and its scope.

(c) Due care. Although there is a duty of due care the standard by which it is assessed is low.

(d) Good Faith. This is closely linked with 2 and 5. It predicates the absence of a collateral purpose.

(e) No abuse of discretion. Again this is linked very closely with the other aspects of the Rule.

In the reform of directors' obligations to care and skill there is much to be said for including some coverage of the Business Judgment Rule. I set out below paragraph 4.10 of the ALI tentative draft which attempts to do so:

4.01 Duty of Care of Directors and Officers; the Business Judgment Rule

(a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

(1) This duty includes the obligation to make, or cause to be made, such inquiry as the director or officer reasonably believes to be appropriate under the circumstances.

(2) In performing any of his functions (including his oversight functions), a director or officer is entitled to rely on materials and persons in accordance with 4.02-.03.

(b) Except as otherwise provided by statute or by a standard of the corporation [1.27] and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling his duty under this Section with respect to any delegated function if his reliance is in accordance with 4.02-.03.

(c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:

(1) he is not interested [1.15] in the subject of his business judgment;

(2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and

(3) he rationally believes that his business judgment is in the best interests of the corporation.

It should be noted that the ALI's draft does not articulate a presumption of regularity.[49] It merely states that by placing the burden of proof on persons challenging conduct it has provided directors with some protection. However, this is questionable.[50]

Many of these sections refer to "the best interests of the company." Professor Gower's draft Ghana Companies Code[51] which relied heavily on the old text of the U.S. Model Business Corporations Code contained the following

subclause:

> In considering whether a particular transaction or course of action is in the best interests of the company as a whole a director may have regard to the interests of the employees, as well as the members, of the company, and, when appointed by, or as representative of, a special class of members, employees, or creditors may give special, but not exclusive, consideration to the interests of that class.

This provision is radical in New Zealand in that it expressly authorises consideration of the interests of employees, something which has now been adopted by statute in the United Kingdom.[51] Conversely it legitimates the existing practice of nominee directors giving attention to the interests of their nominator. At the same time it provides practical guidance - the director may give special, but not exclusive, consideration to the interests of that particular class.[52]

Conclusion

In my opinion these materials represent useful precedents for reform of New Zealand law. If New Zealand adopted reforms along these lines they would be more in tune with what company directors themselves expect. The problem with the law at the moment is that it is remote from business reality. The problem with the Australian provisions in section 228-229 of the Companies Code is that they are too complex, not particularly well thought out and too draconian. This is tempered by erratic enforcement by the states but this is unsatisfactory for its own reasons. The advantage of the North American models is that they are more in tune with the market place. At the end of the day it must be recognised that fiduciary duties represent a compromise between efficiency and fairness.[54] In devising satisfactory fiduciary duties it is necessary to strike a balance between these two objectives. Some New Zealand company directors have provided appalling examples of stewardship in recent years and this has occasioned bad

publicity for the local stock market which has fared worst in the aftermath of the October 1987 crash. While the October 1987 crash was not caused by this the consequent demise of a number of New Zealand listed companies has been due in part to this poor stewardship. The reform and codification of directors' duties would receive widespread support from the general public. In the aftermath of the stock market crash there is a natural tendency to cry out for more regulation. However, we must guard against overzealous regulation and maintain the precarious balance of efficiency and fairness. Efficiency is predicated because the company in an economic sense is a firm. Fairness is predicated because the company is also an association of persons in the real world linked together by a common purpose.

APPENDIX

A. Sections 228-229 of the Australian Companies Code

SECTION 228 Disclosure of Interests in Contracts Property, Offices &c.

228(1) Subject to this section, a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company shall, as soon as practicable after the relevant facts have come to his knowledge, declare the nature of his interest at a meeting of the directors of the company.

Penalty: $1,000 or imprisonment for 3 months, or both.

228(2) The requirements of sub-section (1) do not apply in any case where the interest of a director of a company consists only of being a member or creditor of a corporation that is interested in a contract or proposed contract with the first-mentioned company if the interest of the director may properly be regarded as not being a material interest.

228(3) A director of a company shall not be taken to be interested or to have been at any time interested in any contract or proposed contract by reason only -

(a) in a case where the contract or proposed contract relates to any loan to the company - that he has guaranteed or joined in guaranteeing the repayment of the loan or any part of the loan; or

(b) in a case where the contract or proposed contract has been or will be made with or for the benefit of or on behalf of a corporation that is related to the company

- that he is a director of that corporation,

and this sub-section has effect not only for the purposes of this Code[1] but also for the purposes of any rule of law, but does not affect the operation of any provision in the articles of the company.

228(4) For the purposes of subsection (1), a general notice given to the directors of a company by a director to the effect that he is an officer or member of a specified corporation or a member of a specified firm and is to be regarded as interested in any contract that may, after the date of the notice, be made with that corporation or firm shall be deemed to be a sufficient declaration of interest in relation to any contract so made or proposed to be made if -

(a) the notice states the nature and extent of the interest of the director in the corporation or firm;

(b) when the question of confirming or entering into the contract is first taken into consideration, the extent of his interest in the corporation or firm is not greater than is stated in the notice; and

(c) the notice is given at a meeting of the directors or the director takes reasonable steps to ensure that it is brought up and read at the next meeting of the directors after it is given.

228(5) A director of a company who holds any office or possesses any property whereby, whether directly or indirectly, duties or interests might be created in conflict with his duties or interests as director shall, in accordance with sub-section (6), declare at a meeting of the directors of the company the fact and the nature, character and

extent of the conflict.

Penalty: $1,000 ir imprisonment for 3 months, or both.

228(6) A declaration required by sub-section (5) in relation to the holding of an office or the possession of any property shall be made by a person -

(a) where the person holds the office or possesses the property as mentioned in sub-section (5) when he becomes a director - at the first meeting of directors held after -

(i) he becomes a director; or

(ii) the relevant facts as to the holding of the office or the possession of the property come to his knowledge, whichever is later; or

(b) where the person commences to hold the office or comes into possession of the property as mentioned in sub-section (5) after he becomes a director - at the first meeting of directors held after the relevant facts as to the holding of the office or the possession of the property come to his knowledge.

228(7) A secretary of a company shall record every declaration under this section in the minutes of the meeting at which it was made.

228(8) Except as provided in sub-section (3), this section is in addition to, and not in derogation of, the operation of any rule of law or any provision in the articles restricting a director from having any interest in contracts with the company or from holding offices or possessing properties involving duties or interests in conflict with his duties or interests as a director.

SECTION 229 Duty and Liability of Officers

229(1) An officer of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties of his office.

Penalty -

(a) in a case to which paragraph (b) does not apply) - $5,000; or

(b) where the offence was committed with intent to deceive or defraud the company, members or creditors of the company or creditors of any other person or for any other fraudulent purpose - $20,000 or imprisonment for 5 years, or both.

229(2) An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties.

Penalty: $5,000.

229(3) An officer or employee of a corporation, or a former officer or employee of a corporation, shall not make improper use of information acquired by virtue of his position as such an officer or employee to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

Penalty: $20,000 or imprisonment for 5 years, or both.

229(4) An officer or employee of a corporation shall not make improper use of his position as such an officer or employee, to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

Penalty: $20,000 or imprisonment for 5 years, or both.

229(5) For the purposes of this section, "officer", in relation to a corporation, means -

(a) a director, secretary or executive officer of the corporation;

(b) a receiver, or receiver and manager, of property of the corporation, or any other authorized person who enters into possession or assumes control of property of the corporation for the purpose of enforcing any charge;

(c) an official manager or a deputy official manager of the corporation;

(d) a liquidator of the corporation; and

(e) a trustee or other person administering a compromise or arrangement made between the corporation and another person or other persons.

229(6) Where -

(a) a person is convicted of an offence under this section; and

(b) the court is satisfied that the corporation has suffered loss or damage as a result of the act or omission that constituted the offence,

the court by which he is convicted may, in addition to imposing a penalty, order the convicted person to pay compensation to the corporation of such amount as that court specifies, and any such order may be enforced as if it were a judgment of that court.

229(7) Where a person contravenes or fails to comply with a provision of this section in relation to a corporation, the corporation may, whether or not the person has been convicted of an offence under

this section in relation to that contravention or failure to comply, recover from the person as a debt due to the corporation by action in any court of competent jurisdiction -

(a) if that person or any other person made a profit as a result of the contravention or failure - an amount equal to that profit; and

(b) if the corporation has suffered loss or damage as a result of the contravention or failure - an amount equal to that loss or damage.

229(8) Where a person who contravenes or fails to comply with this section has been found by a court to be liable to pay to a person an amount by reason of a contravention of Part X of the Securities Industry [name of State] Code[1] that arose out of or was constituted by the same act or transaction as the contravention of or failure to comply with this section, the amount of the liability of the person under this section shall be reduced by the first-mentioned amount.

229(9) For the purposes of sub-section (8), the onus of proving that the liability of a person to pay an amount to another person arose from the same act or transaction as that from which another liability arose lies on the person liable to pay the amount.

229(10) This section has effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person by reason of his office or employment in relation to a corporation and does not prevent the institution of any civil proceedings in respect of a breach of such a duty or in respect of such a liability.

B. Sections 132-4 of the Ontario Business Corporations Act 1982

Disclosure: conflict of interest

132. - (1) A director or officer of a corporation who,

(a) is a party to a material contract or transaction or proposed material contract or transaction with the corporation; or

(b) is a director or an officer of, or has a material interest in, any person who is a party to a material contract or transaction or proposed material contract or transaction with the corporation,

shall disclose in writing to the corporation or request to have entered in the minutes of meetings of directors the nature and extent of his interest.

by director

(2) The disclosure required by subsection (1) shall be made, in the case of a director,

(a) at the meeting at which a proposed contract or transaction is first considered;

(b) if the director was not then interested in a proposed contract or transaction, at the first meeting after he becomes so interested;

(c) if the director becomes interested after a contract is made or a transaction is entered into, at the first meeting after he becomes so interested; or

(d) if a person who is interested in a contract or transaction later becomes a director, at the first meeting after he becomes a director.

by officer

(3) The disclosure required by subsection (1) shall be made, in the case of an officer who is not a director,

(a) forthwith after he becomes aware that the contract or transaction or proposed contract or transaction is to be considered or has been considered at a meeting of directors;

(b) if the officer becomes interested after a contract is made or a transaction is entered into, forthwith after he becomes so interested; or

(c) if a person who is interested in a contract or transaction later becomes an officer, forthwith after he becomes an officer.

Where contract or transaction does not require approval

(4) Notwithstanding subsections (2) and (3), where subsection (1) applies to a director or officer in respect of a material contract or transaction or proposed material contract or transaction that, in the ordinary course of the corporation's business, would not require approval by the directors or shareholders, the director or officer shall disclose in writing to the corporation or request to have entered in the minutes of meetings of directors the nature and extent of his interest forthwith after the director or officer becomes aware of the contract or transaction or proposed contract or transaction.

Director not to vote

(5) A director referred to in subsection (1) shall not vote on any resolution to approve the contract or transaction unless the contract or transaction is,

(a) an arrangement by way of security for money lent to or obligations undertaken by him for the benefit of the corporation or an affiliate;

(b) one relating primarily to his remuneration as a director, officer, employee or agent of the corporation or an affiliate;

(c) one for indemnity or insurance under section 136; or

(d) one with an affiliate.

General notice of interest

(6) For the purposes of this section, a general notice to the directors by a director or officer disclosing that he is a director or officer of or has a material interest in a person and is to be regarded as interested in any contract made or any transaction entered into with that person, is a sufficient disclosure of interest in relation to any contract so made or transaction so entered into.

Effect of disclosure

(7) Where a material contract is made or a material transaction is entered into between a corporation and a director or officer of the corporation, or between a corporation and another person of which a director or officer of the corporation is a director or officer or in which he has a material interest,

(a) the director or officer is not accountable to the corporation or its shareholders for any profit or gain realized from the

contract or transaction; and

(b) the contract or transaction is neither void nor voidable,

by reason only of that relationship or by reason only that the director is present at or is counted to determine the presence of a quorum at the meeting of directors that authorized the contract or transaction, if the director or officer disclosed his interest in accordance with subsection (2), (3), (4) or (6), as the case may be, and the contract or transaction was reasonable and fair to the corporation at the time it was so approved.

Confirmation by shareholders

(8) Notwithstanding anything in this section, a director or officer, acting honestly and in good faith, is not accountable to the corporation or to its shareholders for any profit or gain realized from any such contract or transaction by reason only of his holding the office of director or officer, and the contract or transaction, if it was reasonable and fair to the corporation at the time it was approved, is not by reason only of the director's or officer's interest therein void or voidable, where,

(a) the contract or transaction is confirmed or approved by special resolution at a meeting of the shareholders duly called for that purpose; and

(b) the nature and extent of the director's or officer's interest in the contract or transaction are disclosed in reasonable detail in the notice calling the meeting or in the information circular required by section 112.

Court setting aside contract

(9) Subject to subsections (7) and (8), where a director or officer of a corporation fails to disclose his interest in a material contract or transaction in accordance with this section or otherwise fails to comply with this section, the corporation or a shareholder of the corporation, or, in the case of an offering corporation, the Commission may apply to the court for an order setting aside the contract or transaction and directing that the director or officer account to the corporation for any profit or gain realized and upon such application the court may so order or make such other order as it thinks fit. 1982, c.4, s.132.

Officers

133 Subject to the articles, the by-laws or any unanimous shareholder agreement,

(a) the directors may designate the offices of the corporation, appoint officers, specify their duties and delegate to them powers to manage the business and affairs of the corporation, except, subject to section 183, powers to do anything referred to in subsection 127(3);

(b) a director may be appointed to any office of the corporation; and

(c) two or more offices of the corporation may be held by the same person. 1982, c.4, s.133.

Standards of care, etc., of directors, etc.

134. (1) Every director and officer of a corporation in exercising his powers and discharging his duties shall,

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonable prudent person would exercise in comparable circumstances.

Duty to comply with Act, etc. (2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.

Can not contract out of liability (3) Subject to subsection 108 (5), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act and the regulations or relieves him from liability for a breach thereof. 1982, c.4, s.134.

FOOTNOTES

1. See Preliminary Paper No. 5 **Company Law - A discussion paper**, 1987, paras 191 et seq.

2. See generally H Ford **Principles of Company Law** 4th ed.

3. Professor L.C.B. Gower seems to distinguish them. See **Principles of Modern Company Law** 4th ed p 572. However see eg **The Charitable Corporation v Sir Robert Sutton** (1742) 2 Atk 400.

4. See **Standard Chartered Bank Ltd v Walker** [1982] 1 WLR 1410 (CA).

5. **Legal Systems and Lawyers' Reasonings.**

6. See J H Farrar [1982] JBL 132.

7. See generally **Ashburner's Principles of Equity** 2nd ed by D Browne, pp 129-130. The law shows greater latitude to directors because of the element of risk. See Ashburner op cit p 131; **Leeds Estate Co v Shepherd** (1887) 36 ChD 787, 798.

8. See Gower op.cit., pp 584-591; R Clark **Corporate Law** Chapter 5.

9. (1854) 1 Macq HL 461.

10. Ibid, 471-2.

11. Gower op cit 584.

12. Ibid, 585; **Benson v Heathorn** (1842) 1 Y & CCC 326, 341-2; **Imperial Credit Association v Coleman** (1871) LR 6 Ch App. 558, 567-8.

13. Gower op cit 585.

14. Ibid.

15. Cmd 2657 (1926).

16. **Hely-Hutchinson v Brayhead Ltd** [1968] 1 QB 549 (CA); **Castlereagh Motels Ltd v Davies-Roe** [1966] 2 NSWR 79 (NSW CA); **Guinness Plc v Saunders** (1988) 4 BCC 377 at 382. Where the articles allowed voting only if there had been prior disclosure of the conflict of interest failure to disclose rendered the votes invalid and made the resolution a nullity - **Rolled Steel Products (Holdings) Ltd v British Steel Corp.** [1986] Ch 246 at 275E (CA).

17. Gower op. cit. 587. Cf, however, **Hely-Hutchinson v Brayhead Ltd** [1968] 1 QB 549 where the English Court of Appeal assumed that s 199 of the UK 1948 Act applied to a contract in favour of a director made outside a board meeting by the chairman and de facto managing director without the director declaring his interest.

18. **Guinness v Saunders** (1988) 4 BCC 377 (CA). Another problem is that section 199 does not work sensibly where there is only one director or all the directors share a conflict of interest. See **Re Woodware Products Ltd** (1982) 1 BCR 378. **Re David Neil and Company Ltd v Neil** (1986) 3 NZCLC 99,658 and **Movitex Ltd v Bulfield** (1986) 2 BCC 99,403 discussed by Peter Watts in "Some Aspects of the Operation of the Conflict of Interest Principle in Company Law" [1987] 3 Canta L R 239. This article examines some fundamental problems concerning the relationship of s 199 and reg 84 of Table A to the basic equitable principle and repays close study. Peter Watts argues convincingly (1) that s 199 is characterised by a lack of clear headedness by the draftsman, (2) that dicta in **Re Woodware Products Ltd, Re David Neil** and **Movitex** are incorrect, (3) that self disclosure is possible under s 199 and reg 84, (4) that article 84(3) excludes absolutely the conflict of interest principle and substitutes its own code, (5) that s 204 should be interpreted to apply to other breaches of duty.

19. **Re Woodware Products Ltd**, supra at 383.

20. Gower, op cit.

21. Cmnd 1749 paras 95, 99 (e) and (m).

22. The main New Zealand provisions are ss 190 (loans to directors, 191 (loss of office payments), 192 (compensation for loss of office on transfer of assets), 193 (compensation for loss of office on sale of shares).

23. See Companies Act 1985 Part X.

24. Clark op cit (footnote 8).

25. Ibid 160.

26. Marsh, "Are Directors Trustees? Conflict of Interest and Corporate Morality" 22 Bus Law 35 (1966).

27. Clark, ibid.

28. Part V Duty of Fair Dealing.

29. See Michael Trebilcock "The Liability of Company Directors for Negligence" (1969) 32 MLR 477; A L McKenzie "A Company Director's Obligations of Care and Skill" [1982] JBL 460; K Stanton and T Dugdale (1982) 132 NLJ 251; J Birds "Making Directors Do their Duties" (1980) 1 Co Law 67; A. Conard "A Behavioral Analysis of Directors' Libility for Negligence" Duke LJ 895 (1972).

30. **Hahlo's Cases and Materials on Company Law** 3rd ed by H R Hahlo and J H Farrar, p 368.

31. [1925] Ch 407 at pp. 428-9.

32. See eg Hahlo op cit p 375; Gower op cit p 602.

33. Joseph Hinsey IV "Business Judgment and the American Law Institute's Corporate Governance Project; The Rule, The Doctrine and the Reality", 52 George Washington Law Review, 609 (1984).

34. See **Charitable Corporation v Sutton** (1742) 2 Atk 400 at 406.

35. For a discussion of the origins of the Business Judgment Rule see Block, Barton and Radin, The **Business Judgment Rule - Fiduciary Duties of Corporate Directors and Officers**, (Prentice Hall, Clifton N J, 1987), pp 4 et seq.

36. Ibid p 5.

37. See for instance **Shuttleworth v Cox Brothers & Co Ltd** [1927] 2 KB 9 (CA).

38. **Re Wragg Ltd** [1897] 1 Ch 796 (C.A.); **Brownlie & Ors, Practitioners** 1898 6 SLT 249 at 251.

39. **British and American Finance Corporation v Couper** [1894] AC 399.

40. **Re Smith and Fawcett Ltd** [1942] Ch 304.

41. **Re Alabama etc Railway Co** [1891] 1 Ch 213.

42. **Howard Smith Ltd v Ampol Petroleum Ltd** [1974] AC 821 (PC).

43. See Block, Barton and Radin, supra, ch III. The literature on this subject is immense and one must be selective. See too Martin Lipton, "Takeover Bids in the Target's Boardroom" 35 Bus Law 101 (1979); "Takeover Responses and Directors' Responsibilities -An Update" 40 Bus Law 1403 (1985); Victor M Rosenzweig and M Orens, "Tipping the Scales - The Business Judgment Rule in the Anti-takeover Context" 14 Sec Reg LJ 23 (1986-87); Gary P Kreider, "Corporate Takeovers and the Business Judgment Rule: An Update" 11 J of Corp L 633 (1985-86).

44. See Stanley M Beck, Frank Jacobucci, David Johnston and Jacob Ziegel, **Cases and Materials on Partnerships and Canadian Business Corporations** (The Carswell Company Ltd, Toronto, 1983) p 319.

45. See Block, Barton and Radin, op.cit. p 7 for the Delaware authorities.

46. Ibid, pp 7-8.

47. Ibid, p 7.

48. Ibid, pp 9-17.

49. Ibid.

50. Ibid.

51. **Final Report of the Comm. of Enquiry into the Working and Administration of the present Company Law of Ghana** (1961), p 145.

52. Companies Act 1985, sections 309 and 719.

53. For useful comment on this see Jacob Ziegel "The New Look in Canadian Corporation Laws" in **Studies in Canadian Company Law** ed. by J.Ziegel. Vol 2, 1 at pp 42-3.

54. See Alison Grey Anderson "Conflicts of Interest: Efficiency, Fairness and Corporate Structure" 25 UCLA L R 738 (1978).