

9 Conflicts of Interest and Special Cases

Paragraph

Introduction

Conflicts of interest: nature of the directors' duties	[9.010]
The fiduciary rules	[9.020]
Statutory reinforcement of fiduciary doctrine	[9.030]
Who is subject to fiduciary responsibilities?	[9.040]
To whom are the duties owed?	[9.050]
Framework for analysis	[9.053]

The conflict rule

Introduction	[9.057]
Scope of the conflict rule	[9.060]
"Real sensible possibility of conflict"	[9.070]
Extent of interest	[9.080]
Indirect interest	[9.090]
Conflict of duties	[9.100]
The conflict rule and alternate directors	[9.105]

Conflicts of interest in transactions with the company: general equitable considerations

Director dealing with company	[9.110]
Attenuation of directors' duty by constitution	[9.120]

Statutory provisions regarding interested directors

Introduction	[9.125]
Statutory requirement for both proprietary and public companies: s 191 ..	[9.130]
Effect of s 191 on the validity of contracts	[9.140]
No basis for monetary compensation	[9.145]
Additional statutory requirement for a public company: s 195	[9.150]
Consequences of a breach of s 195	[9.160]
Relationship of s 195 to general fiduciary law	[9.190]

Misappropriation of property and information

The misappropriation rule	[9.200]
Misuse of corporate information	[9.210]

Paragraph

The profit rule and corporate opportunities

The profit rule	[9.220]
Diversion of corporate opportunities	[9.230]
Does the company's inability to exploit the opportunity make any difference?	[9.240]
Can directors exploit corporate opportunities which come to them in their "private" capacity?	[9.250]
Can the director retain the benefit of a transaction by establishing that the transaction was fair to the company?	[9.260]
Director resigning to exploit corporate opportunity	[9.270]

Statutory provisions: improper use of office or information

Improper use of information or position	[9.280]
Consequences of contravention of statutory provisions	[9.288]
Relationship of ss 182 and 183 to other fiduciary principles	[9.290]

Curing breaches of duty by company consent

Introduction	[9.320]
Members' authorisation or ratification	[9.330]
Consent of board is usually inadequate	[9.340]

Civil remedies for breach of fiduciary duty

Remedies generally	[9.350]
Rescission	[9.360]
Account of profits	[9.370]
Equitable compensation	[9.380]
Constructive trust	[9.390]
Injunction	[9.395]
Other remedies	[9.400]

Application of fiduciary principles in special cases

Multiple directorships in competing companies	[9.410]
Nominee directors	[9.420]
Nominee directors: conflict between duty and duty	[9.430]
Nominee directors: attenuation of duty by constitution	[9.440]
Nominee directors: corporate groups	[9.450]
Nominee directors: law reform	[9.460]

Financial benefits to related parties

General law principles	[9.470]
Scope of Ch 2E	[9.480]
"Give a financial benefit"	[9.490]
Related parties	[9.500]

	Paragraph
The definition of control	[9.510]
Application of Ch 2E by the courts	[9.515]
Exemptions from s 208	[9.520]
Benefits on arm's length terms	[9.530]
Remuneration of officers	[9.540]
Member approval for financial benefits	[9.550]
Consequences of contravention of Ch 2E	[9.560]
Relationship between Ch 2E and other provisions of the Corporations Act	[9.570]
Benefits for retirement, loss of office and on sale of undertaking	[9.580]

Insider trading

Introduction	[9.600]
Problems of policy	[9.605]
Publicity for directors' transactions in the company's securities	[9.610]
Provisions about insider trading	[9.620]
Structure of Pt 7.10 Div 3	[9.630]
Defences	[9.640]
Consequences of contravention of Pt 7.10 Div 3	[9.650]

Introduction

[9.010] Conflicts of interest: nature of the directors' duties

This is the second of two chapters on directors' duties. In the last chapter the positive or affirmative side of fiduciary responsibilities was explored — the duties to act in good faith in the best interests of the company, for proper purposes and with care. Many of the duties considered in the last chapter arise for consideration when directors are making a decision as a board, rather than individually.

In this chapter duties which, though cast in negative terms, lie in the heartland of fiduciary responsibility are discussed. Though they sometimes refer affirmatively to the duty of loyalty, Australian courts generally formulate the fiduciary's duties in terms of avoidance of conflicts of interest. The rules concerning conflicts of interest typically arise for consideration when an individual director proposes to exploit an opportunity personally, or for the benefit of someone other than the company.

In the introductory part of this chapter is presented the overall shape of the fiduciary doctrine in its application to corporate matters. In the remainder of the chapter we shall look more closely at the application of the fiduciary rules to corporate circumstances, and explore the key statutory provisions.

The principle about conflicts of interest flows directly from classifying company directors as fiduciaries. The central idea in a fiduciary relationship is service of another's interests. A fiduciary relationship arises where one party is entitled to expect that the other will act in the first party's interests or in their joint interests, to the exclusion of the second party's separate interests.¹ The duty to serve another's

interests implies that fiduciaries must avoid placing themselves in a position in which they will be tempted to prefer their own interests or the interests of someone other than their principal.

The fiduciary is free to proceed so long as he or she has the principal's fully informed consent. Since the fiduciary can obtain exoneration in this way, fiduciary doctrine is sometimes presented as a doctrine about disclosure. In the insider trading context, United States cases talk about the "disclose or abstain" rule: *In the Matter of Cady, Roberts & Co* 40 SEC 907 (1961).

The fiduciary idea is easy enough to explain in general terms but very difficult to apply to concrete facts. There is a sense in which "[t]he fiduciary relationship is a concept in search of a principle".² Sir Frederick Jordan's observation, cited by both Deane and Mason JJ in *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 is still relevant:³

It has often been said that a person who occupies a fiduciary position ought to avoid placing himself in a position in which his duty and his interest, or two different fiduciary duties, conflict. This is rather a counsel of prudence than a rule of equity; the rule being that a fiduciary must not take advantage of such a conflict if it arises.

Notes

1. See P D Finn, "Fiduciary Law and the Modern Commercial World", in E McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (1992), p 9.
2. Sir Anthony Mason, "Themes and Prospects", in Finn P D (ed), *Essays in Equity* (1985) p 246.
3. Jordan F, *Chapters on Equity in New South Wales* (6th ed, 1947) p 115; reproduced in *Jordan: Select Legal Papers* (1983).

[9.020] The fiduciary rules

Given the breadth of the fiduciary doctrine,¹ it is necessary to identify the more specific legal principles and sub-rules which bridge the gap between the "counsel of prudence" and the determination of particular cases. Analysis of the case law suggests that equity recognises the following principal rules:²

- company directors must not, in any matter falling within the scope of their service, have a personal interest or inconsistent engagement with a third party, except with the company's fully informed consent (*the conflict rule*) (see [9.057]ff);
- company directors must not misuse their position for their own or a third party's possible advantage, except with the company's fully informed consent, and therefore they must account to the company for any gain which they make in connection with their fiduciary office (*the profit rule*) (see [9.220]ff);
- company directors must not misappropriate the company's property for their own or a third party's benefit (*the misappropriation rule*) (see [9.200]ff).³

These three rules are conceptually distinct from one another, but they are often applied together and in an overlapping fashion.

Corporate opportunity doctrine

A director who diverts a business opportunity from the company for personal benefit may be accountable under both the conflict and profit rules. In dealing with this situation, Australian and British Commonwealth courts are moving towards the adoption of a business opportunity doctrine similar in substance to United States

(2000) 158 FLR 349). In *Highland v Exception Holdings Pty Ltd (in liq)* (2008) 60 ACSR 223; [2006] NSWCA 318, a company granted a charge in favour of two of its directors in their capacity as trustees of an estate. The Court of Appeal of New South Wales held that s 267 applied. As Santow JA observed (at [85]), the test for applying s 267 is not whether the charge favours the company's directors but whether it is in their favour. The section falls far short of preventing what happened in *Salomon v Salomon & Co Ltd* [1897] AC 22 in which the controlling shareholder was able to make himself a secured creditor with priority over external unsecured creditors.

Under s 267 the charge will become invalid if the chargee (who could be the original taker of the charge or a later holder) purports to take a step in the enforcement of the charge within 6 months after its creation without the Federal Court or a Supreme Court of a state or territory having given leave to enforce. Both the charge and any powers which the instrument creating or evidencing the charge purports to confer are void and are to be deemed always to have been void. The chargee can sue for the money owed.

20 Protection of Creditors

	<i>Paragraph</i>
Scope of this chapter	[20.010]
Do creditors require protection?	[20.020]
Provisions of the Corporations Act designed to protect creditors	[20.030]

Protection of creditors by postponing in a liquidation debts due to members as such

Members as deferred creditors	[20.040]
No set-off for debts due to members as such	[20.050]

Self-protection of creditors by subordination of debts due to members

Subordination of debt	[20.060]
Subordination by trust or contract	[20.070]

Protection of creditors by imposing liability on directors for insolvent trading

Directors' duty to prevent insolvent trading	[20.080]
Incurring a debt	[20.090]
Proof of insolvency when the debt was incurred	[20.100]
Presumption of insolvency	[20.110]
Reasonable grounds for suspecting insolvency	[20.120]
The director's state of mind	[20.130]
Statutory defences available to a director	[20.140]
Consequences of contravention	[20.150]
Historical note on the decline in reliance on the maintenance-of-capital doctrine and the shift to imposing liability on directors	[20.160]

Corporate trustee without right of indemnity

Liability of directors of corporate trustees	[20.170]
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Employee entitlements

Interference with employee entitlements	[20.180]
Unreasonable director-related transactions	[20.185]

Holding company's liability for subsidiary's debt

Holding company's liability as a director	[20.190]
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Liability for permitting insolvent trading	Paragraph [20.200]
Defences of holding company	[20.210]
Priority in sharing company's compensation	[20.220]
Departures from what the ALRC recommended	[20.230]

Self-protection of creditor by obtaining a guarantee

Guarantee from controlling shareholder	[20.240]
Liability under cross guarantees	[20.250]

Unlimited liability of persons disqualified from managing

Application to court by liquidator	[20.260]
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Share capital transactions and misapplication of assets

Restrictions on transactions of a limited company adversely affecting share capital	[20.270]
Protection against misapplication of a company's financial resources ...	[20.280]

[20.010] Scope of this chapter

Persons who give credit to a company whose members enjoy limited liability may be thought to need special protection against company transactions outside the ordinary course of the company's business which reduce the company's financial resources for meeting its debts and which would make the company insolvent. This chapter describes some methods of self-protection which creditors of companies commonly adopt and the extent to which the Corporations Act attempts to protect creditors.

One method of self-protection, the obtaining of security over assets, has already been discussed in Ch 19. Secured creditors derive their protection from the general law of secured obligations applicable to all chargors, whether corporate or individual, and, in general, the Corporations Act affects them only incidentally by requiring registration of company charges and by stating some rules about receivers and other persons who enforce charges given by companies. In this chapter the emphasis is on protection of unsecured creditors.

[20.020] Do creditors require protection?

An important question that must be addressed is whether creditors require protection or whether they should be expected to contract to protect themselves. The starting point is a recognition of the conflicts of interest that exist between a company's shareholders and its creditors. Smith and Warner¹ identify four major sources of conflict:

- the payment of excessive dividends;
- claim dilution (through taking on debt with similar or higher priority);
- asset substitution (for example, substituting saleable for non-saleable assets); and
- excessive risk-taking.

Although the first three conflicts are straightforward, the fourth warrants elaboration. A conflict arises because payment to a creditor may be jeopardised where the company engages in high-risk investments. Shareholders in a leveraged company have incentives to invest the company's resources in risky projects: if a project is successful, the excess returns will be distributed among the shareholders as dividends but will not be shared with the creditors who are only entitled to a fixed return on their investment. Company losses, however, are shared among both creditors and shareholders.

Given the existence of these conflicts, shareholders may prefer the company to incur some level of debt. Where this occurs, does it benefit shareholders? A number of empirical studies have been undertaken with a view to evaluating the effects of financial restructurings, such as an increase in debt. A survey of these studies has concluded that leverage-increasing restructurings (for example, the issue of new debt or share repurchases) are generally associated with positive returns to shareholders (measured in terms of the effect of the restructuring on share prices). Leverage-reducing restructurings are generally associated with significant negative returns to shareholders.²

Creditors can generally be expected to contract to protect themselves against actions that reduce the prospect of their being paid. This contracting has two parts to it. First, the interest rate on the loan that is negotiated between the creditor and the company can be expected to reflect the risks that the creditor faces. Second, the contract may contain restrictions on activities of the company. For example, there may be restrictions on the amount that the company can pay out as dividends. There may also be restrictions on the company incurring debt of a similar or higher priority. Restrictions of these types are common in debenture trust deeds.

However, this type of contracting may not always be possible. The theory that creditors charge different interest rates for different levels of risk does not work where the costs of the creditor acquiring adequate information about the level of risk are disproportionate to the amount of the transaction.³ The theory also does not work in the case of involuntary creditors (such as tort claimants or employees in respect of their long service and superannuation entitlements). Moreover, dispersed creditors face a collective action problem and may therefore lack the appropriate incentives to undertake joint action to prevent opportunistic behaviour by the company that threatens payment to creditors.⁴ Finally, even sophisticated creditors cannot foresee all contingencies and contract for protection against them. Significant corporate restructurings, such as leveraged buyouts, have seen transfers of wealth from sophisticated creditors (namely some bondholders) to shareholders.⁵

In addition to contractual protections, there are some constraints upon companies which operate to protect the interests of creditors. First, there is the maintenance of share capital doctrine: see Ch 24. A second constraint which operates to protect the interests of creditors is that of the reputations of the shareholders and the managers of the company with which the creditors are contracting. Shareholders and managers will be reluctant to undertake actions which harm their reputations and which may make it difficult to raise capital in the future. However, as one commentator observes, this constraint applies only when the present value of maintaining the company as a going concern exceeds the value of the benefits derived from taking action that adversely affects creditors (for example, the payment of excessive dividends).⁶

A final constraint is that although shareholders may want to take actions which adversely affect creditors, the shareholders may lack effective control over the

26 Receiverships

	Paragraph
Receiver as agent for the company	[26.010]
Duties of receiver when realising the security	[26.020]
A receiver's liabilities to third persons	[26.030]
Receiver's indemnity against liability	[26.040]

[26.010] Receiver as agent for the company

Most instruments of charge in which the company as chargor authorises the chargeholder to appoint a receiver provide that the receiver shall be an agent of the company but that the receiver may exercise powers without the consent of the company.

To say that the receiver is the agent of the company looks odd seeing that the receiver is appointed by the chargeholder and that the receiver is appointed in the interests of the chargeholder.

Part of the explanation is that the Court of Chancery in England made a secured creditor who took possession of his debtor's business accountable not only for revenue in fact received but also for revenue that would have come in but for neglect of the secured creditor. To avoid this strict accounting, secured creditors advanced money only on terms that any receiver later appointed would be an agent for the chargor. Thus, the chargor for valuable consideration by a provision in the instrument of charge committed the management of its property to an agent with whose appointment and tenure the chargor could not interfere: see the explanation in *Gaskell v Gosling* [1896] 1 QB 669 at 691–3 by Rigby LJ in a dissenting judgment approved by the House of Lords [1897] AC 575.

The receiver's agency for the company also means that any liabilities incurred by the receiver to third persons in the course of the receivership, at least while the company is not in liquidation, cannot be attracted to the chargeholder as the appointor of the receiver.

By contrast a receiver appointed by the court is the agent of neither the chargeholder nor the company: *William H Parsons v Sovereign Bank of Canada* [1913] AC 160 at 167; *Van Reesema v Australian Growth Resources Corporation Pty Ltd* (1987) 75 ALR 311.

[26.020] Duties of receiver when realising the security

Receivers when exercising their powers to realise the security are required by long-standing equitable principle to use those powers not only in the interest of their appointor but also in good faith towards the company.

That means at the least that the receiver when exercising a power to sell the property charged must refrain from deliberately or recklessly sacrificing the property: *Pendlebury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR

676. The company could have an interest in the sale because the proceeds might yield a surplus after the chargeholder is paid out or, if there is a deficiency, the company could be liable under the personal covenant to pay it.

If a receiver manages the company's business, the company could have an interest in its contracts with third persons not being recklessly repudiated by the receiver where there is some prospect of the company trading out of the receivership: see dicta in *Re Diesels and Components Pty Ltd (Recrs and mgrs apptd)* [1985] 2 Qd R 456. A receiver exercising a power to give leases and to grant options may create obligations that will be binding on the company after the receivership ends. In creating those obligations the receiver must act in good faith.

The persons who have standing to complain of a failure of a receiver to act in good faith are:

- the company as owner of the property;
- any later-ranking chargeholder with an interest in the property (*Downsview Nominees Ltd v First City Corporation Ltd* [1993] 2 WLR 86); and
- guarantors of the liability for which the security was given, their interest arising from the possibility that if a guarantor has to discharge the company's liability, the guarantor will be entitled to take over the chargeholder's security.

Taking as an example receivers exercising a power of sale, the steps that they would have to take to satisfy the requirement of good faith would normally include having to:

- identify the appropriate market in which the property should be sold (a sale of cattle on the basis of a value in a market concerned with their weight in meat may fetch less than sale in a market for breeding cattle: *Jeogla Pty Ltd v Australia and New Zealand Banking Group Ltd* (1999) 150 FLR 359, leave to appeal refused *Skinner v Jeogla Pty Ltd* (2001) 37 ACSR 106;
- ascertain the value of the property on which the offering price or reserve price at auction can be based: *Mike Gaffikin Marine Pty Ltd v Princes Street Marina Pty Ltd* (1995) 17 ACSR 495;
- consider adequately whether there is any probability that more would be gained by selling a plurality of items together or by selling them separately: *Champagne Perrier-Jouet SA v H H Finch Ltd* [1982] 3 All ER 713 at 725;
- engage competent selling agents where necessary;
- plan a sale designed to test the market by public auction where an auction sale would be usual for the type of property in question;
- see that the sale is properly advertised with full information about the features of the property likely to attract buyers: *Pendlebury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676; *Mike Gaffikin Marine Pty Ltd v Princes Street Marina Pty Ltd* (1995) 17 ACSR 495;
- allow adequate time for the advertisement to have effect;
- refrain from telling possible buyers a reserve price at auction (*Barns v Queensland National Bank Ltd* (1906) 3 CLR 925) and details of the amount due to the chargeholder: *Mike Gaffikin Marine Pty Ltd v Princes Street Marina Pty Ltd* (1995) 17 ACSR 495.

Under the equitable rule receivers are not obliged to postpone selling in the hope that a higher price might be obtained: *Farrar v Farrars Ltd* (1888) 40 Ch D 395 at 411; *Pendlebury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676 per

the receivership (*Waters v Widdows* [1984] VR 503) pay certain persons before paying the chargeholder: s 433. The priority relates to:

- insurance moneys received in respect of the company's insured liability to a third person that are to be paid to that third person under s 562;
- audit fees due to the company's auditor for services after ASIC refused consent to the auditor's resignation; and
- certain claims of employees of the company referred to in s 556 (dealing with order of payment of claims in a liquidation) and persons who made advances to pay certain of those claims: s 560.

Receivers who neglect to pay preferred creditors can be personally liable to pay those creditors what should have been paid to them. It is a liability in the tort of breach of statutory duty. If they give up the property charged to another person, they remain personally liable but if that person takes with notice that debts owed to preferred creditors have not been paid, the recipient takes the assets subject to a constructive trust in favour of the preferred creditors: *Lumsden v Long* (1998) 12 ACLC 1743.

The reason for giving employees priority lies in the fluctuating nature of the security given by a floating charge and the fact that employees may have augmented that security by their efforts without being paid: *Stein v Saywell* (1969) 121 CLR 529.

[26.040] Receiver's indemnity against liability

A receiver appointed as agent of the company is entitled under the general law of agency to indemnity out of the company's property for liabilities properly incurred while acting as agent and to an equitable lien under which the receiver can retain possession of the company's property as security for the indemnity: *Hill v Venning* (1979) 4 ACLR 555 at 556; *Re Just Juice Pty Ltd* (1992) 109 ALR 334 at 337. If, in an exceptional case, the instrument of charge does not provide that a receiver appointed by the chargeholder is to act as an agent of the company, the receiver's relationship to the appointor is contractual (*Re Just Juice Pty Ltd* (1992) 109 ALR 334 at 336) and there would seem to be an implied right of indemnity against the appointor-chargeholder that would be supported by an equitable lien.

In any event an insolvency practitioner approached to accept appointment will wish to have an express contractual indemnity from the chargeholder in respect of liability properly incurred in the receivership. That indemnity could extend to civil liability for conduct not involving dishonesty.

The impact on a receivership of a Pt 5.3A administration or winding up

As to the effect of appointment of a Pt 5.3A administrator with a view to the company executing a DCA on the right of a chargeholder to begin or to continue enforcement of a charge, see [27.040].

As to the effect of appointment of a liquidator on a chargeholder's right to begin or to continue enforcement of a charge, see [28.210].

27 Voluntary Administration

	Paragraph
Appointing the administrator	[27.010]
Who may be administrator?	[27.020]
Effects of the appointment	[27.030]

The suspension of rights of claimants against the company

Reason for suspension of claimants' rights	[27.040]
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The administrator's liability

Liability for debts generally	[27.050]
The administrator's indemnity	[27.060]

Administration under a deed of company arrangement

Administrator's proposal for a DCA	[27.070]
The DCA is to be executed by the company	[27.080]
A DCA's provisions	[27.090]
Persons bound by a DCA	[27.100]
Termination of a deed of company arrangement	[27.110]

The powers of the court

Powers conferred by Pt 5.3A	[27.120]
Powers conferred otherwise than under Pt 5.3A	[27.130]

What happens upon the ending of an administration or a DCA?

Ending of investigatory administration or DCA	[27.140]
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[27.010] Appointing the administrator

Administration begins when the administrator is appointed: s 435C. The date of commencement of administration is important not only in the time-table for steps in the administration but also in the time table for a subsequent winding up, because in some circumstances it can mark the commencement of that winding up. This will be explained later at [28.080].

Who can appoint an administrator?

Under ss 436A–436C the following can appoint an administrator:

- The company itself at the instigation of its directors. Part 5.3A allows directors to act without referring to creditors or members because of the