Corporate Governance and Fiduciary Duties

A Multi-Jurisdictional Review of the Directors’ Relationship to the Corporation

The International Developments Subcommittee is in the process of preparing an
analysis of the board of director’s relationship to the corporation, comparing concepts of
fiduciary duty and other concepts of director duties in civil law and common law jurisdictions.

This compilation contains draft papers from eleven jurisdictions, based on the
propositions and template attached as Schedule A. Each paper is a working draft; the drafts are
not yet complete, let alone conformed and edited. We expect that the papers will be
significantly different in their final form. (We may also add other jurisdictions as this project
progresses.)

AS WORKS IN PROGRESS, THESE DRAFTS SHOULD NOT BE RELIED
UPON AS THE BASIS FOR LEGAL ADVICE.

We welcome comments and further contributions.
SCHEDULE A

1.1 In common law jurisdictions fiduciary duties are the cornerstone of the relationship between directors and officers and the corporations they serve.

1.2 Therefore what fiduciary duty means - what obligations and restrictions it imposes on directors and officers – is crucial to understanding corporate governance practice in a particular jurisdiction.

1.3 To appreciate how corporate governance in non-common law jurisdictions may differ we need to investigate whether a similar fiduciary duty exists (or if some other concept is utilised) and what obligations and restrictions it imposes upon the conduct of directors and officers in those jurisdictions.

TEMPLATE

A. What does fiduciary mean?

The corporate model separates ownership from control. Fiduciary duties deal with the delegation of control to non-owners, giving them significant discretionary powers over the corporation that cannot be constrained by other legal devices (for example the requirements of trusteeship) without undermining the objectives of the corporation (for example, to accept a level of risk necessary to achieve a particular return).

A fiduciary relationship implies vulnerability and dependency on the part of the beneficiaries (the corporation and its owners) and the potential for the fiduciaries (the directors and officers) to manipulate the powers of the corporation for their own benefit. So the fiduciary has the power to control the corporation and its assets but the exercise of that power is conditioned by a duty to use it in the best interests of the corporation and thereby its owners.

Contributors might consider completing this section with a contemporary description of the fiduciary duty of directors in their jurisdiction. Such descriptions could include landmark case law as well as any statutory or regulatory innovations that have elucidated current understandings of the fiduciary duties of directors.

B. How did the concept of fiduciary duty develop and apply to directors of business corporations?

Understanding the historical antecedents of fiduciary duty helps in understanding its function in modern corporate governance. For example, common law antecedents of the legal nature of the office of director include "agent", "trustee" and "managing partner".

Whether these constitute direct forbears of fiduciary duties for directors or are better construed as analogies will depend upon the jurisdiction in question and the theoretical preference of the author(s). The central aim of this part of the project is to provide an account of the historical development of the concept of fiduciary duties in the jurisdiction concerned.
C. To whom are these fiduciary duties owed?

Many jurisdictions formulate these obligations as owing to the corporation itself. Thus, although shareholders elect directors, the directors owe a fiduciary duty to the company itself rather than the generality of shareholders or those who supported the directors' candidacy for office.

Other legal traditions, statutory interventions and developments in case law modify that position. For example, statutes may require an exclusive focus on creditors if certain financial conditions occur and case law in various jurisdictions recognize the role of derivative and minority actions under the rubric of "oppression remedies" in certain circumstances. Also, any special treatment of substantial or majority shareholders in listed companies could be detailed in this section.

D. How does the fiduciary duty manifest itself?

Matters for discussion under this section could center on the avoidance of conflicts of interest. These could include prohibitions against directors utilizing corporate opportunities for their own benefit, abiding by various rules of confidentiality and duties to disclose various kinds of information to the corporation and its shareholders. If directors of a corporation hold office at another company or institution they may find their fiduciary duties compromised by similar duties at these other entities.

How sub-committee members' jurisdictions view such "conflicts", whether by forethought about the potential for them, by resignation from one or both offices where such conflicts occur, or by disclosure or recusal from affected decisions on corporate action will provide a key point for comparative analysis when sub-committee contributions are collated.

Finally, if relevant to their jurisdiction, contributors might consider how concepts of fiduciary duty might develop in the future, particularly where innovations in or recasting of corporate law statutes has sought to codify these duties. For example, the UK is considering codification in a new UK Companies Act as a means of simplifying the law.

However, that raises the issue of how courts will interpret and apply these codes in future cases. Will the courts facilitate importing core aspects of the codes (for example the presence of a strong independent element on the board) into the concept of fiduciary duties? Might an unintended consequence be an expansion rather than rationalization of case law relating to fiduciary duties?
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Corporate Governance and Fiduciary Duties

A Multi-Jurisdictional Review of the Directors’ Relationship to the Corporation

INTRODUCTION

Carol Hansell and Laurence Hazell

I

The corporate model separates ownership from control. The delegation of control over the corporation’s assets by its owners means that effective corporate governance comes down to the appropriate motivation and good behavior of a company’s board and management. The imposition of fiduciary duties is how the common law responds to this delegation of authority to those two groups: to ensure that they act in the best interests of the company and its shareholders when making decisions about the actions the corporation will take.

So a fiduciary relationship implies vulnerability and dependency on the part of the beneficiaries (the corporation and its owners) and the potential for the fiduciaries (the directors and officers) to manipulate the powers of the corporation for their own benefit. It is a balance between principles of trust upon which the fiduciary duty is based and the need to allow the board and management to take risks with the corporation’s assets to fulfill the expectations of the investor owners who made their investment in the expectation of profiting from it.

II

Although fiduciary institutions existed in Roman law (fiducia) and in Germanic customary law (Treuhand) these legal traditions did not give rise to separate courts of equity or to a distinction between legal and equitable title to property as these developed in English law. Consequently the fiduciary duties developed by the law of trusts in common law countries, and more particularly as these relate to the duties of directors, are essentially unknown in civil law jurisdictions. But, not surprisingly, there are parallels between the responsibilities that corporate directors owe to companies in these traditions and those developed by their common law cousins.

Indeed, the Latin root of the word fiduciary – fiduciarius - means one in whom trust – fiducia - repposes. Legal usage in many jurisdictions also developed an overlay - an implication - of a particular relationship of confidence between the fiduciary and those who had placed their trust in that person. Examples of such relationships in either
system include guardianship, curatorship and the relationship between a lawyer and her client. Special obligations were imposed upon these fiduciaries to ensure that no improper influence affected their decisions as they administered the property or the confidences of those who reposed their trust in them.

III

As the papers in this collection will illustrate, recent initiatives in corporate governance reform in a number of civil law countries emphasize the same basic governance precepts encompassed by their common law counterparts. While many think the jury is still out on whether this amounts to an emerging consensus on what constitutes good corporate governance, there does appear to be a growing accord about what counts as best practice in the modern corporation. In this regard it is important to note that while we provided a ‘template’ to assist contributors in organizing their thoughts we have not sought to homogenize these contributions through the editorial process. Rather, their individual styles of expression tell their own story about how fiduciary duties - or their civil law equivalents - are perceived in each contributor’s country.

What we have tried to do is demarcate and clarify where other areas of law, such as the closely related duties of skill and care, or insolvency law, securities law, the law of contract and matters like workplace safety and environmental issues impinge upon the corporation and its stewards. However, it has to be borne in mind that in the particular case of this jurisdiction or that, these distinctions may not amount to a difference where the duties of a company’s stewards are concerned. But, since that is a part of the story, it needs to be told as well. What the authors try and elicit in each of these studies is how the individuals who fall within the purview of these duties rank and/or reconcile the often-competing interests faced by the corporation, its shareholders and other stakeholders.

It is time to let the studies speak for themselves. Readers may ask why is this or that country not included? It is a fair question. This project really has been a coalition of the willing, but we see it as the first act of an ongoing effort. So those with an interest in contributing new jurisdictions are welcome, in fact we there are some still in the pipeline, and of course, those already represented here will need to be updated - as ideas become initiatives and then become law, regulation, accepted wisdom and perhaps later still, the wrongheaded thinking of heretofore.
I. Introduction

A. The U.S. Corporate Form

In the United States, a corporation is a legal entity, separate and distinct from the persons who own it, created by law for the purpose of carrying on business. The owners of the corporation are its shareholders. In a public company, unless the owners choose otherwise, shares in the corporation ordinarily are freely transferable.

The shareholders elect the board of directors of the corporation. The directors, who have a fiduciary relationship with the corporation and its shareholders, are responsible for the overall direction and management of the corporation. The board of directors delegates the duties of day-to-day management of the corporation to various executives, who the board (not the stockholders) select and who are accountable to the board of directors, and in some circumstances, have a direct fiduciary relationship with the shareholders.

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1 David Murgio and Jane Pollack of Weil, Gotshal & Manges LLP assisted in preparing this submission, and they have the authors’ gratitude.

2 For example, Section 141(a) of the Delaware General Corporation Law provides that “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . .”
B. The Role of State Law and the Preeminence of Delaware

In the U.S., the corporation exists only by virtue of law and owes its existence to its state of incorporation. Thus, the corporation has only those powers conferred upon it by the general corporation law of its state and its articles of incorporation. Statutory corporation law, however, is “incomplete” in the sense that neither it, nor most statutory law, can explicitly cover all the contingencies and varying factual circumstances that occur in every day corporate activity. For example there are a myriad of means by which minority shareholders can be oppressed or taken advantage of by “controlling” shareholders. If the law is to be “complete” -- that is, available to redress wrongs not explicitly covered by the words of the statute but nevertheless within the purport of the statute -- the courts must be available, and there must be some standard by which to judge whether a complaint is actionable. The standard evolved in most U.S. jurisdictions is a “fiduciary duty” standard that is a duty owed to the shareholders by the management and the board of directors.

As U.S. corporations are creatures of the law of the state of their incorporation, fiduciary duties, in theory, are different in every U.S. jurisdiction. But because over 40 percent of the corporations listed on the New York Stock Exchange and a majority of the publicly traded Fortune 500 companies are incorporated in Delaware, Delaware is the preeminent state in corporate law and fiduciary duties, and has been for

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4 By definition, a controlling shareholder possesses either: (1) ownership of or the unrestricted power to vote more than 50 percent of the corporation’s outstanding voting securities; or (2) actual control over a majority of the board of directors. See Emerald Partners v. Berlin, 726 A.2d 1215, 1221 n.8 (Del. 1999).
the last century.⁵ As a result, the Delaware court system often is viewed as “the Mother Court of corporate law,” with many states adopting or looking to Delaware law to govern transactions involving non-Delaware corporations.⁶ Accordingly, Delaware law forms the backbone of U.S. fiduciary duty law.⁷

As in all U.S. jurisdictions, Delaware corporate law is a function of both statutory and common law. For over one hundred years, the Delaware state legislature has created and maintained a modern, flexible corporate code – the Delaware General Corporation Law (“DGCL”) – which continuously is revised to make corporate transactions easier to accomplish. The large variety of transactions permitted by the DGCL also have created numerous fiduciary obligation questions, which the Delaware courts have been called upon to resolve.⁸ Sometimes, the Delaware courts, by their fiduciary duty opinions, restrict corporate transactions that would otherwise be permissible under the DGCL. It is against this juxtaposition of statutory and common law that Delaware, as well as most other U.S. jurisdictions, has created a contemporary framework for fiduciary duties.


⁶ BJR at 3 (citing *Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990), rev’d on other grounds, 500 U.S. 90 (1991)).

⁷ It should be noted that there have been attempts to “federalize” the law of fiduciary duties, at least to the extent of establishing “minimum standards” of corporate behavior, but such efforts have failed. In the wake of the collapses of Enron, Worldcom and other disasters, however, the U.S. Congress passed and the president signed into law the Sarbanes-Oxley Act of 2002, which has intruded upon the internal affairs of U.S. corporations – areas which traditionally were governed by state law. The self regulatory organizations (“SROs”), such as the NYSE and the NASDAQ, also have created stricter listing standards which have affected the internal affairs of all listed companies. While these governance reforms do not directly alter the basic fiduciary obligations of directors, they are influencing the judicial climate, and have more “sharply focused” court decisions on the expectations of director processes when measured by the traditional duties of care, good faith and loyalty. See E. Norman Veasey, “Some Current Corporate Governance Issues for Directors of Delaware Corporations,” Remarks prepared for the National Association of Corporate Directors, Oct. 21, 2003, at 3-4.

⁸ Balotti at F-2.
II. The Meaning of Fiduciary Duties And How Fiduciary Duties Manifest Themselves In The U.S.

A. The Role Of Directors As Fiduciaries

In general, a fiduciary is “one who owes to another the duties of good faith, trust, confidence, and candor” or “one who must exercise a high standard of care in managing another’s money or property.” The fiduciary concept encompasses the director/shareholder relationship and agency law, which involves the delegation of powers to others to act on behalf and for the benefit of another. In the most basic sense, a director’s fiduciary duties require him or her to act prudently and in the best interests of the corporation and its shareholders. In practice, this boils down to three major roles:

“Big-Picture” Decision Making. The board of directors decides what operations the corporation will pursue, its long term business plans, which officers will run those corporations, where and how they will run the business and how the corporation will organize itself to benefit the shareholders.

Delegation. Directors have the ultimate responsibility for the management of the enterprise, but may satisfy their obligations by thoughtfully appointing qualified, honest officers, establishing or approving goals and plans and monitoring performance.

Oversight. Directors have a duty to oversee and to supervise the management of the corporation. At a minimum, directors must take steps to ensure that the officers of the corporation are properly managing its business and affairs, and may rely in good faith upon information provided by the officers. Directors also have a duty

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9 Black’s Law Dictionary.
10 Balotti at 4-5.
11 Balotti at 4-36.
to create reporting systems designed to discourage and detect the fraudulent, illegal or
criminal activities of subordinates.\textsuperscript{12}

B. The “Triad” of Fiduciary Duties

In the U.S., the “triad” of fiduciary duties is most commonly referred to as the duties of due care, good faith and loyalty.\textsuperscript{13} These duties are derived principally from the common law of Delaware, though other states have created by common law and code a general standard of conduct for directors.\textsuperscript{14} The directors’ duties are constantly changing to reflect the evolving expectations of corporate directors.\textsuperscript{15} An understanding of fiduciary duties also requires knowledge of the various forms of judicial review with which courts will evaluate director activity -- most notably, the “business judgment rule” -- as the determination of the appropriate standard of judicial review frequently is determinative of the outcome of the litigation.\textsuperscript{16} These standards of review are intertwined with the directors’ fiduciary duties, and thus, are set forth below and in Section III, infra.

\textsuperscript{12} See, e.g., \textit{In re Caremark Int’l Derivative Litig.}, 698 A.2d 959, 970 (Del. Ch. 1996).


\textsuperscript{14} Model Bus. Corp. Act § 8.30(a).

\textsuperscript{15} See Paul W. MacAvoy and Ira M. Millstein, \textit{The Recurrent Crisis in Corporate Governance}, 102-13 (2003). The evolving expectations of directors are most evident in the recent developments relating to the concept of “good faith,” discussed, infra, Section II.B.3.

1. The Duty of Care and the Business Judgment Rule
   a. The Business Judgment Rule

   The duty of care and the “business judgment rule” are two related judicial concepts that affect the directors’ role in managing and overseeing corporate affairs. The business judgment rule is a standard of judicial review for director conduct, not a standard of director conduct.\(^\text{17}\) The business judgment rule is a presumption that business decisions are made by:

   (1) disinterested, independent directors;
   (2) with informed due care; and
   (3) with a good faith belief that the decision will serve the corporation’s best interests.\(^\text{18}\)

   Under the business judgment rule, if the party challenging director activity cannot overcome the presumption (which is rarely overcome), courts will not second-guess decisions made by the board.\(^\text{19}\) That is, a court will not impose its own views upon those of the directors, if the directors’ decision can be “attributed to any rational purpose.”\(^\text{20}\) In other words, where the board undertakes a suitable decision-making

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\(^{17}\) BJR at 10.

\(^{18}\) See Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987); BJR at 110; see also Rattner v. Bidzos, 2003 WL 22284323, at *7 (Del. Ch. Sept. 30, 2003). According to the American Law Institute, a director or officer who makes a business decision fulfills his or her fiduciary role as long as he or she: (i) is not interested in the subject of the decision; (ii) is informed with respect to the subject of the decision to the extent the director reasonably believes to be appropriate under the circumstances; and (iii) rationally believes the decision is in the best interest of the corporation. ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, § 9.01.

\(^{19}\) See Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995) (the “business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments”) (citing Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).

process, the court will not apply an objective reasonableness standard to examine the acumen of the business decision.\textsuperscript{21} The business judgment rule, however, does not protect director activities which constitute fraud, illegality, ultra vires conduct (\textit{i.e.}, not within corporate power) waste, or that were not taken in good faith.\textsuperscript{22}

b. \textbf{The Duty of Care}

The duty of care requires that, in managing the corporation’s affairs, directors:

1. act 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 the director reasonably believes to be in the best interests of the corporation.\textsuperscript{23}

To satisfy the duty of care, at a minimum, directors must have reasonable knowledge of the company’s business, act on an informed, good-faith basis, obtain credible information on each issue, adequately deliberate the relevant issues, and understand the consequences that will flow from each decision before making the decision.\textsuperscript{24} Often times, this will require the advice of legal or financial experts.\textsuperscript{25}

The duty of care has been considered to involve both \textit{process} and \textit{substance}.\textsuperscript{26} That is, the Delaware courts would review whether the decision made by directors was informed (procedural due care) as well as the substance of the transaction.

\textsuperscript{1998/99} (“the business judgment rule will normally apply to decisions within an officer’s discretionary authority”); \textit{BJR} at 21.

\textsuperscript{21} \textit{BJR} at 21-22.

\textsuperscript{22} See \textit{BJR} at 110; \textit{In re Walt Disney Co. Derivative Litig.}, 825 A.2d 275 (Del. Ch. 2003).


\textsuperscript{24} See \textit{Moran v. Household, Int’l Inc.}, 500 A.2d 1346 (Del. 1985).

\textsuperscript{25} See \textit{DGCL} § 141(e), discussed \textit{infra}.

\textsuperscript{26} See, \textit{e.g.}, \textit{Grobow v. Perot}, 539 A.2d 180, 186 (Del. 1988); \textit{Balotti} at 13-57.
(substantive due care). Procedural due care, which is intertwined with the business judgment rule, involves the shifting of the burden of proof from the plaintiff to the director defendants to prove a breach of the duty of care when the plaintiff can establish facts to overcome the business judgment rule presumption. Substantive due care pertains to the standard of care and the standard of culpability for the imposition of liability for a breach of the duty of care.\(^{27}\)

With respect to procedural due care, a plaintiff must first set forth particularized facts sufficient to overcome the presumption raised by the business judgment rule that the directors acted with due care.\(^{28}\) To overcome the presumption, the plaintiff is required to plead particularized facts that, if proven, would demonstrate that the directors or officers “reach[ed] their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.”\(^ {29}\) If the plaintiff can overcome the presumption, the burden then shifts to the directors or officers to prove that they did in fact exercise the requisite degree of care.\(^ {30}\) If the plaintiff is unsuccessful, the directors’ or officers’ business decision remains protected by the rule’s presumption

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\(^{27}\) One must be careful not to confuse the concept of “substantive due care” with the requirements of the business judgment rule. “Substantive due care” is not an element of the business judgment rule. This is because when the rule applies, “Courts do not measure, weigh or quantify directors’ judgments.” Rather, in the context of the business judgment rule, “due care in the decisionmaking context is process due care only.” \textit{Brehm v. Eisner}, 746 A.2d 244, 264, 259 & n.66 (Del. 2000), \textit{see also} \textit{Ash v. McCall}, 2000 WL 1370341, at *8 (Del. Ch. Sept. 15, 2000); Balotti at 13-57 n.300. That is, when the rule applies, the only issue the courts will consider is whether the directors acted in an informed, good faith manner, and employed the proper processes to come to their business decision. The courts will not decide if the directors’ decisions were “reasonable” when the business judgment rule applies. \textit{Id.}

\(^{28}\) \textit{See Cede & Co. v. Technicolor, Inc.}, 634 A.2d 345, 360-61, 367 (Del. 1993); BJR at 112.

\(^{29}\) \textit{Brehm}, 746 A.2d at 264 n.66. For purposes of overcoming the presumption of the business judgment rule, director or officer liability is predicated upon alleging “gross negligence.” \textit{Malpiede}, 780 A.2d at 1089; \textit{Levine}, 591 A.2d at 207; \textit{Grobow}, 539 A.2d at 190; \textit{Aronson}, 473 A.2d at 812-13.

\(^{30}\) BJR at 110-11.
and the plaintiff’s claim is dismissed.\textsuperscript{31} If, however, plaintiff is able to rebut the business judgment rule presumption and the directors are not able to establish that they acted with the requisite degree of care (assuming the shareholders never ratified the transaction), the plaintiff will prevail on a duty of care claim only if: (a) the directors fail to prove that the challenged conduct was “fair” to the corporation; and (b) the plaintiff proves proximate causation and entitlement to damages and/or the necessity for injunctive relief.\textsuperscript{32}

The Delaware Supreme Court recently held that when the presumption of the business judgment rule applies, there is no inquiry into the substance of the directors’ or officers’ business decision:

\begin{quote}
As for plaintiffs’ contention that the directors failed to exercise ‘substantive due care,’ we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors’ judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is \textit{process due care only}.\textsuperscript{33}
\end{quote}

Thus, so long as there is no other breach of fiduciary duty (or violation of law), a director who performs his duties in compliance with the requisite standard of procedural due care faces no liability as the result of a decision that turns out to be unwise or a mistake in judgment.\textsuperscript{34} A director who fails to comply with the applicable standard of care,

\textsuperscript{31} See Kahn v. Roberts, 21 Del. J. Corp. L. 674, 684 (Del. Ch. Dec. 6, 1995) (“If the plaintiff cannot show a \textit{prima facie} case, or if the plaintiff does make the case, but the balance of the evidence does not indicate . . . gross negligence, there is no basis for liability.”), \textit{aff’d}, 679 A.2d 460 (Del. 1996).

\textsuperscript{32} BJR at 112; Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162-63 (Del. 1995); Cede & Co., 634 A.2d at 361.

\textsuperscript{33} Brehm, 746 A.2d at 264, 259 & n.66 (emphasis in original); see also Ash, 2000 WL 1370341, at *8 (“substantive due care [is] a concept that is foreign to the business judgment rule . . . Due care in the decision making context is \textit{process due care} – whether the board was reasonably informed of all material information reasonably available at the time it made its decision”).

\textsuperscript{34} See Cheff v. Mathes, 199 A.2d 548 (Del. 1964). Accordingly, under the “gross negligence” standard, it is not sufficient for a plaintiff to merely allege that directors or officers “consistently made poor decisions” or that the corporation “suffered losses” because of those poor decisions;” Andreea v. Andreae, 1992 WL
however, will not necessarily have acted with the degree of culpability (i.e., gross negligence) required to impose liability for money damages to the corporation or the shareholders. Then again, directors may be held liable for a breach of duty of care when they neglect to perform their duties responsibly, in good faith, and in a reasonably prudent manner according to the circumstances.

At a minimum, the duty of care requires that directors approve the company’s significant business plans and extraordinary actions. What constitutes a major or extraordinary action requiring the board’s attention depends on the financial costs of the action (relative to corporate assets and income), the risks involved, and the time span for the action, and the costs of reviewing it. The American Law Institute suggests that significant and extraordinary plans requiring the board’s direct attention include:

- long-term strategic and investment plans or expenditures, including the creation or retirement of significant debt and the reacquisition of significant amounts of equity;

43924, at *7-8 (Del. Ch. Mar. 5, 1992); or that “there are costs, even great costs, associated with a business decision,” Silverzweig v. Unocal Corp., 1989 WL 3231, at *3 (Del. Ch. Jan. 19, 1989), or “a corporation loses a large amount of money.” Weiland v. Ill. Power Co., 1990 WL 267364, at *12 (C.D. Ill. Sept. 17, 1990); see also Wilson v. Tully, 243 A.D.2d 229, 238 (N.Y. App. Div. 1st Dep’t 1998) (“That, in hindsight, such action or inaction may turn out to be controversial, unpopular or even wrong is insufficient to excuse plaintiffs’ failure to make a demand.”); BJR at 109. Such allegations improperly challenge the substance of the directors’ or officers’ decisions – not the process – and thus are “foreign” to the business judgment rule. Brehm, 746 A.2d at 259, 264 & n.66; Ash, 2000 WL 1370341, at *9-10 (“this Court has stated on several occasions that mere allegations that directors made a poor decision – absent some showing of self-dealing or suspect motivation – does not state a cause of action . . .”).

35 BJR at 109; Digex, Inc. Shareholders Litig., 789 A.2d 1186, 1194 (Del. Ch. 2001) (holding that although courts “encourage directors to aspire to ideal corporate governance practices, directors’ actions need not achieve perfection to avoid liability”).

36 See, e.g., Smith v. Van Gorkum, 488 A.2d 858, 874 (Del. 1985) (holding that the directors had not adequately informed themselves about a proposed merger and were grossly negligent in “approving the ‘sale’ of the Company upon two hours’ consideration, without prior notice, and without the exigency of a crisis or emergency”).

• business combinations, including those effected for cash;
• entry into new lines of business;
• significant acquisitions of stock in other corporations; and
• actions that would foreseeably expose the corporation to significant litigation or significant new regulatory constraints or problems.\(^{38}\)

Examples of instances in which directors failed to observe their duty of care involve haste in decision making include lack of preparation;\(^ {39}\) lack of questioning;\(^ {40}\) lack of involvement or “rubber stamping” management,\(^ {41}\) lack of a meaningful record,\(^ {42}\) lack of due care in dealing with reviewing and understanding relevant documents, and failure to attend board meetings consistently.

**Reliance and Delegation.** To comply with their duty of care, directors are empowered to reasonably rely upon, and delegate board functions to, board committees, corporate officers and independent advisors, provided the decision to delegate is an informed one.\(^ {43}\) For example, DGCL §141(e) permits the board to rely in good faith on officers, employees, committees of the board of directors or competent outside advisors, provided that due care is exercised in selecting those upon whom reliance is placed.\(^ {44}\) In doing so, the board of directors “is entitled to the presumption that it exercised proper business judgment, including proper reliance on the expert.”\(^ {45}\) Directors may not,

\(^{38}\) ALI, Principles of Corporate Governance, at § 3.01, Reporter’s Note at 85.

\(^{39}\) *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).


\(^{42}\) *EAC Indus., Inc. v. Frantz Mfg.*, C.A. No. 8003 (Del. Ch. June 28, 1985), aff’d, 501 A.2d 401 (Del. 1985).

\(^{43}\) See DGCL § 141(e), *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985); BJR at 198.

\(^{44}\) See DGCL § 141(e) (directors are “fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors . . .”); see also N.Y. Bus. Corp. Law § 717; BJR at 199.

\(^{45}\) *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).
however, blindly rely on even a carefully selected and qualified expert. Rather, “directors have some oversight obligations to become reasonably familiar with an opinion, report, or other source of advice before becoming entitled to rely on it.”

Further, directors may not delegate duties which lie at the “heart” of the management of the corporation. That is, directors may not delegate tasks which have the effect of stripping them of their duty to use their own best judgment on management matters or which the directors themselves are required to perform by statute, the by-laws or the articles of incorporation. The decision in *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003), discussed infra, is a recent example of a situation where the allegations, if true, indicate that the directors may have wrongfully abdicated their duties by failing to inform themselves about a particular transaction for which they were solely responsible.

After Enron, Worldcom and other corporate downfalls, directors have greater responsibilities to investigate the possible wrongdoing of their officers and subordinates. If suspicion is aroused, or should have been aroused, the director may have a further duty to act reasonably in light of the information gained. But any director

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46 *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985); BJR at 204.

47 Balotti at 4-31, 33.


49 The Securities & Exchange Commission (“SEC”) already has taken the first step toward making key officers and the board of directors accountable for false financial statements in corporate releases. A 2002 SEC Release, No. 34-46070, entitled “Certification of Disclosure in Companies’ Quarterly and Annual Reports”, requires that Chief Executive Officers and Chief Financial Officers, in connection with the filing of quarterly and annual reports, certify under oath that: (a) he or she has read the report; (b) that to the best of his or her knowledge, the information in the report is true in all important respects as of the last day of the report covered by the report (i.e., for a 10-Q, the last day of the quarter, for a 10-K, the last day of the fiscal year); (c) that the report contains all information about the issuer of which he or she is aware that he or she believes is important to a reasonable investor; (d) that the officer has reviewed the results of the evaluation of the issuer’s internal reporting procedures (for annual reports only).
who has actual knowledge of facts suggesting a material problem in the company has a
duty to promptly initiate board or management consideration of the trouble-spot.\(^{50}\) To
what extent, however, directors have the duty to “ferret out” wrongdoing or to uncover
“hard core” fraud by officers, is still unsettled under the case law. Nonetheless, to avoid
problems in this area, directors should install systems designed to discourage and detect
the fraudulent, illegal or criminal activities of subordinates, as well as other directors.
Indeed, under existing case law, the duty to be reasonably informed already includes “a
duty to attempt in good faith to assure that a corporate information and reporting system,
which the board concludes is adequate, exists, and that failure to do so under some
circumstances may, in theory at least, render a director liable for losses caused by non-
compliance with applicable legal standards.”\(^{51}\)

**Director Protection Statutes.** In 1986, Delaware enacted DGCL §102(b)(7), which is an enabling provision that authorizes shareholders in the certificate
of incorporation to adopt a “provision eliminating or limiting the personal liability of a
director to the corporation or its stockholders for monetary damages for breach of
fiduciary duty as a director.” Section 102(b)(7) was enacted in response to a landmark
Delaware Supreme Court decision, *Smith v. Van Gorkum*, which held that directors had
breached their duty of care in connection with a merger transaction that, even though
provided shareholders a substantial premium above the market price for their shares, was
improperly approved by directors who had not adequately informed themselves about the

\(^{50}\) Balotti at 4-37.

\(^{51}\) *In re Caremark Int’l Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996); *see also* E. Norman Veasey,
“State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors,” 21st
Annual Federal Securities Institute, at 12 (Feb. 20, 2003). (“Although Caremark is dictum . . . my personal
view is that the expectations of directors, therefore, had progressed in the thirty-plus years from *Allis-
Chalmers* to Caremark.”).
merger, and were grossly negligent in “approving the ‘sale’ of the Company upon two hours’ consideration, without prior notice, and without the exigency of a crisis or emergency.”

Section 102(b)(7) protects directors acting only as directors, and not officers. Although a Section 102(b)(7) provision shields directors from liability for breach of the duty of care, it does not shield them from liability for actions involving: (1) breach of the duty of loyalty; (2) “acts or knowing omissions not in good faith or which involve intentional misconduct or knowing violation of law”; (3) unlawful payments of dividends or unlawful stock purchases or redemptions; and (4) “any transaction from which the director derived an improper personal benefit.”

2. The Duty of Loyalty

The duty of loyalty is a duty imposed on those with a fiduciary relationship to a corporation to take only those actions that are within the best interests of the corporation, and not in the fiduciary’s own interest. Engaging in self-dealing, misappropriating corporate assets or opportunities, having conflicts of interest, or otherwise profiting in a transaction that is not substantively or “entirely fair” to the corporation are all considered breaches of the duty of loyalty. Directors, and in some circumstances, “controlling shareholders” owning a majority interest in a corporation or

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52 488 A.2d 858, 874 (Del. 1985). Section 102(b)(7)-type statutes have been enacted in most states to ensure that corporations can attract and retain qualified directors by protecting them from claims of gross negligence. See Resolution Trust Corp. v. CityFed Fin. Corp., 57 F.3d 1231, 1239 (3d Cir. 1995).

53 BJR at 228.

54 BJR at 228; see also In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

55 See Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (“the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally”); Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939); BJR at 263.

exercising actual control over the board, have a duty of loyalty to the corporation and its shareholders. From the outset, it should be noted that, unlike for breaches of the duty of care, a director’s personal liability for breaches of the duty of loyalty cannot be limited by a corporate charter or by-law provision.

The duty of loyalty is implicated by transactions in which a director or controlling shareholder is not independent and has a substantial self-interest which is not consistent with the interests of the corporation. Accordingly, the concepts of independence and interestedness are key to the duty of loyalty. The term “independence” means “that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences” that would “convert an otherwise valid business decision into a faithless act.” A director is not independent where he or she is dominated or beholden to or affiliated with an individual or entity interested in the transaction at issue “or so under their influence that their discretion would be sterilized.” Similarly, the term “interestedness” relates to when a director will “receive a personal financial benefit from a transaction that is not equally shared by the stockholders.” A director will not be considered disinterested if he or she acted while having an interest other than as a director of the corporation, acted with the goal of

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58 DGCL § 102(b)(7).
60 Rales v. Blasband, 634 A.2d 927, 936 (Del. 1993).

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remaining in office, or is dominated or controlled by another party interested in the transaction.  

Methods of restricting the influence an interested director may exert on the disinterested director approval process include: (1) refusal of the interested director from participation in board meetings; (2) resignation from the board by the interested director; and (3) abstention from voting on the interested transaction by the interested director. Further, in certain circumstances, interested-director transactions can be “sanitized” where certain procedural mechanisms are satisfied. For example, Delaware (DGCL § 144) and certain other states have adopted “safe harbor” statutes that set forth the precise means by which interested transactions can be approved:

(1) where the self-interest of the director in the transaction is disclosed to and approved by a majority of disinterested directors;

(2) where the self-interest of the director is disclosed to and approved by the shareholders entitled to vote thereon; or

(3) where the contract or transaction is found to be “fair” as to the corporation.

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63 Green v. Phillips, 22 Del. J. Corp. L. 360, 369 (Del. Ch. June 19, 1996). Note that while a goal of entrenchment does disqualify a director from being disinterested, it requires a showing that entrenchment was the sole or primary purpose of the director’s action.

64 Benerofe v. Cha, 1996 Del. Ch. LEXIS 115, *20 (Del. Ch. 1996) (a showing that a director was “nominated by or elected at the behest of those controlling the outcome of a corporate election” is not enough to show that the director is not independent); Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1985).

65 BJR at 272.

66 But note that unlike Delaware, certain other states do not provide safe harbor protection for interested transactions based on disinterested director approval alone. For example in California approval is only sufficient if the transaction is “just and reasonable.” Cal. Gen. Corp. Law § 310(a)(2). In New York, the approval of disinterested directors must be unanimous where the a vote by disinterested directors not constitute an act by the board. N.Y. Bus. Corp. Law § 713(a)(1).

67 Note that while disinterested shareholder ratification is a complete defense to a duty of care claim, it is not a complete defense to a claim for a breach of the duty of loyalty. Thus, courts will still review the duty of loyalty claim using the business judgment rule, provided that the challenged decision is not tainted with a conflict of interest. See Wheelerott Techs. Inc. Shareholder Litig., 663 A.2d 1194, 1204 (Del. Ch. 1995); In re Santa Fe Pacific Corp. Shareholder Litig., 669 A.2d 59 (Del. 1995).

68 See DGCL § 144; see also Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985).
Corporate Opportunity Doctrine. The duty of loyalty is implicated in situations where opportunities rightfully belonging to a corporation are taken instead by one with a fiduciary relationship to the corporation, such as a director. The "corporate opportunity doctrine" creates issues that are analogous to those involved in interested-director transactions. Under the test applied by the Delaware courts, an opportunity belongs to the corporation if:

1. the opportunity is within the corporation’s line of business and would be of practical advantage to the corporation;
2. the corporation has an interest or a reasonable expectation in the opportunity; and
3. the corporation is financially able to take advantage of the opportunity.

If the test is met, the opportunity must first be offered to, and rejected by, the corporation before it can be taken by a fiduciary. Approval by fully-informed disinterested directors, or a committee thereof, of the taking of an alleged "corporate opportunity" will make it more likely to pass judicial scrutiny.

The Duty of Candor. The duty of loyalty (as well as the duty of care) also includes a duty of candor, which requires that a director disclose the full extent of his or her interest in a given matter, and abstain from voting on that matter when it is brought to the full board’s attention, if his or her interest in a certain matter conflicts with that of the corporation. While directors are expected to share information with each other, at the

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69 See Guth v. Loft, 5 A.2d 503 (Del. 1939).
71 See Guth v. Loft, 5 A.2d 503 (Del. 1939).
72 See, e.g., Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991); Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987); DGCL § 144; BJR at 271, 300.
same time, they are also excepted to keep all matters involving the corporation confidential unless or until there has been a general public disclosure.

**Controlling Shareholder Transactions.** By definition, a “controlling shareholder” possesses either “ownership of or the unrestricted power to vote more than 50 percent of the corporation’s outstanding voting securities, or actual control over a majority of the corporation’s board of directors.”74 In such circumstances, the controlling shareholder takes on the status of a fiduciary.75 A transaction between a corporation and its controlling shareholder is treated as an “interested” transaction. Accordingly, the business judgment rule never applies in a controlling shareholder transaction. Instead, controlling shareholder transactions are reviewed for “entire fairness” to the corporation.76

Despite these constraints, controlling shareholders are allowed to act and vote in their own economic interest, and “are not to be disenfranchised because they reap a benefit from corporate action which is regular in its face.”77 A controlling shareholder is not under any obligation to sell his or her shares simply because that sale would benefit the minority shareholders.78 Similarly, a controlling shareholder may sell his or her

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74 *See Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 n.8 (Del. 1999) (“[A] shareholder who owns less than 50% of a corporation’s outstanding stock, without some additional allegation of domination through actual control of corporation conduct, is not a ‘controlling stockholder’ for fiduciary duty purposes.”); *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987); BJR at 344.

75 BJR at 342-44.

76 *Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1115-17 (Del. 1994). The “entire fairness” standard of review is discussed in greater detail, Section III.B, infra.


78 BJR at 349.

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shares at a premium not available to other shareholders. Indeed, there is nothing inherently improper about a transaction between a company and its controlling shareholder.\footnote{Thorpe v. CERBCO, Inc., 676 A.2d 436, 442 (Del. 1996); BJR at 350.}

Nonetheless, controlling shareholders owe fiduciary duties to the corporation and its minority shareholders, and thus, may not exercise that control to the minority’s detriment.\footnote{Bershad v. Curtis Wright Corp., 535 A.2d 840 (Del. 1987); In re MAXXAM Inc./Federated Dev. Shareholders Litig., 1997 WL 187317, at *22 (Del. Ch. Apr. 4, 1997).} Thus, when a controlling shareholder stands on both sides of a transaction, the conduct of the parties will be viewed under the more exacting standard of judicial review – “entire fairness” – which requires both “fair dealing” and “fair price.”\footnote{Pepper v. Litton, 308 U.S. 295, 306 (1939); Weinberger, 457 A.2d 701 (Del. 1983).} Ordinarily, the onerous burden of proving entire fairness will be on the controlling shareholder. To shift the burden of proof to the shareholder challenging the transaction, however, the corporation usually will seek approval for controlling-shareholder transactions by either: (i) a well-informed majority of the disinterested (minority) stockholders,\footnote{See Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985); BJR at 275.} or (ii) a diligent, properly-functioning committee of disinterested and independent directors.\footnote{BJR at 274. Cf., e.g., Weinberger, 457 A.2d at 709 n. 7; Lynch I, 638 A.2d at 1117; Tremont, 694 A.2d at 429-30. In a transaction where the controlling shareholder is on both sides, a special committee used to review and approve the transaction must operate at “arm’s length,” meaning it is truly independent, fully informed and had the freedom to negotiate, or else the standard of review will not shift to the more deferential “business judgment” standard. See, e.g., In re Trans World Airlines, Inc. Shareholders Litigation, 1988 WL 111271 (Del. Ch. Oct. 21, 1988); BJR at 404.} When such approval is given, the Delaware courts have been apt to approve controlling shareholder transactions as “entirely fair.”\footnote{Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997).}
Further, directors may not cause the corporation to purchase a dissident’s stock solely to perpetuate themselves in office if such purchase is not fair and in the best interests of the corporation. \(^{86}\) Where, however, the board believes that buying out a dissident shareholder (\textit{i.e.}, “greenmail”) is necessary in order to maintain what the board believes to be a proper business practice or corporate policy, the action may be protected. \(^{87}\)

3. \textbf{The Duty of Good Faith}

As a result of the corporate failures and scandals in the U.S. over the past two years, the duty of good faith recently has become a focal point in Delaware corporate jurisprudence. \(^{88}\) The Chief Justice of the Delaware Supreme Court, E. Norman Veasey, has remarked on numerous occasions that the duty of good faith “is likely to emerge as a central issue of the directors’ standard of conduct,” \(^{89}\) as “it must be considered when one looks at the directors’ processes and motivations to be certain they are honest and are not disingenuous or reckless.” \(^{90}\) Good faith “requires an honesty of purpose and eschews a disingenuous mindset of seeming to act for the corporate good, but not caring for the well being of the constituents of the fiduciary.” \(^{91}\) Stated differently, “[w]here a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director’s actions are either ‘not in good faith’ or ‘involve

\(^{86}\) \textit{Bennett v. Propp}, 187 A.2d 405 (Del. 1962).

\(^{87}\) \textit{Polk v. Good}, 507 A.2d 531 (Del. 1986).


intentional misconduct.” If a directors’ decision is irrational or so beyond reason that no responsible director would credit it, then bad faith may be inferred.

Traditionally, the duty of good faith has been closely related to the concept of loyalty, which, as explained above, prohibits self-dealing, self-interest, or serving any interest except that of the corporation and its stockholders. Chief Justice Veasey has noted, however, that, in some cases, it may be “accurate to consider the duty of good faith as an additional duty beyond the duty of loyalty.” According to Chief Justice Veasey, while the case law is not fully developed in this area, “an argument could be made that reckless, irresponsible or irrational conduct – but not necessarily self-dealing or larcenous conduct – could implicate concepts of good faith.” For example, according to Chief Justice Veasey, “the utter failure to follow the minimum expectations of Sarbanes-Oxley or the NYSE or NASDAQ Rules might likewise raise a good faith issue.”

This declaration regarding the duty of good faith has implications for the transmission of information in the corporation. Courts long have held that “in making business decisions, directors must consider all material information reasonably

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92 In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 290 (Del. Ch. 2003).
94 See MacAvoy & Millstein, supra note 15, at 107 (citing Guth v. Loft, 5 A.2d 503 (Del. 1939)).
95 Veasey, supra at 5.
96 Id. at 5-6; see also In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).
98 See MacAvoy & Millstein, supra note 15, at 108.
available.” Under Delaware law, directors are fully protected when relying in good faith upon records, opinions, reports, and statements made by officers, employees, committees, or experts. That is, such a condition applies to directors dealing with issues within their expert or professional competence and who have been selected “with reasonable care by or on behalf of the corporation.” But what if the facts show that the director’s reliance on others was not in good faith because the information provided was not all they should have had and that was evident at the time? According to Chief Justice Veasey, “the director will have fallen short of an expected standard of conduct.”

A finding of liability based on lapses in the duty of good faith would be particularly significant in light of Section 102(b)(7) charter provisions, which have been adopted by shareholders of most corporations. As explained above, DGCL § 102(b)(7) permits shareholders to protect directors from liability for money damages for breaches of the duty of care but not “acts or omissions not in good faith.” According to Chief Justice Veasey, the very language of Section 102(b)(7) “seems to treat the duty of good faith as separate from the duty of care and the duty of loyalty,” thus providing a basis for the theory that the two standards – good faith and loyalty – may be different in some respects.

101 See Veasey, supra, at 14 (citing DGCL § 141(e)); Brehm v. Eisner, 746 A.2d 244, 261 (Del. 2000).
102 See Veasey, supra, at 14.
103 See MacAvoy & Millstein, supra note 15, at 111; see also Disney, 825 A.2d at 286.
104 See Veasey, supra, at 16.
The Delaware Court of Chancery recently issued an opinion in *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) which highlights the importance of the duty of good faith in the context of a Section 102(b)(7) charter provision. In *Disney*, the court held that, in connection with a $140 million severance payment made to former Disney President Michael Ovitz, the plaintiffs had alleged facts that, if true, “give rise to a cognizable question” whether disinterested and independent directors “should be held personally liable to the corporation for a knowing or intentional lack of due care.”105 The court reached this conclusion notwithstanding a Section 102(b)(7) charter provision protecting directors from liability for violations of the duty of care because the allegations in the case put “in question whether the board’s decision-making processes were employed in a good faith effort to advance corporate interests.”106

In *Disney*, the plaintiffs alleged that the directors had abdicated their responsibilities by (1) failing when hiring Ovitz to inform themselves about the termination clause in the employment agreement and attendant costs; and (2) allowing the CEO, whom they knew to be a friend of Ovitz, to negotiate severance benefits greater than those called for in the termination clause. Since the Delaware Supreme Court had already ruled on whether the directors were disinterested and independent (they were), the Court of Chancery’s decision focused on whether they deserved the protection of the business judgment rule (*i.e.*, had the directors acted honestly, in good faith, and on an informed basis).

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105 *In re Walt Disney Co. Derivative Litig.*, 825 A.2d at 278.
106 *Id.*
The court found that the allegations, if true, showed that the directors had not "exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholder."\(^{107}\)

\[\text{T}he\ facts\ alleged\ .\ .\ .\ suggest\ that\ the\ defendant\ directors\ consciously and\ intentionally\ disregarded\ their\ responsibilities,\ adopting\ a\ "we\ don't care about the risks"\ attitude\ concerning\ a\ material\ corporate\ decision.\ .\ .\ .\ \text{T}he\ alleged\ facts,\ if\ true,\ imply\ that\ the\ defendant\ directors knew\ that\ they\ were\ making\ material\ decisions\ without\ adequate\ information\ and\ without\ adequate\ deliberation,\ and\ that\ they\ simply\ did\ not\ care\ if\ the\ decisions\ caused\ the\ corporation\ and\ its\ stockholders\ to\ suffer\ injury\ or loss.\(^{108}\)

These allegations, the court held, "sufficiently allege[] a breach of the directors’ obligation to act honestly and in good faith in the corporation’s best interests."\(^{109}\) The court further held that "[a]llegations that Disney’s directors abdicated all responsibility to consider appropriately an action of material importance to the corporation puts directly in question whether the board’s decision-making processes were employed in a good faith effort to advance corporate interests."\(^{110}\) The court found that the alleged conduct fell outside of the Section 102(b)(7) charter provision because "acts or omissions not undertaken honestly and in good faith, or which involve intentional misconduct, do not fall within the protective ambit of § 102(b)(7).\(^{111}\) Since the litigation is still in its early stages, it is unclear whether Disney’s directors ultimately will be found liable, but the decision makes clear that satisfying the duty of good faith will be of utmost importance for directors in the future, or they may risk personal liability for their actions.

It is also important to note that the issue of good faith may be measured not only by the evolving expectations of directors in the context of Delaware common law, but also, by the new U.S. governance requirements embodied in the Sarbanes-Oxley Act and NYSE/NASDAQ listing rule amendments recently approved by the Securities and Exchange Commission.\(^{112}\) These new federal reforms have heightened the public’s

\(^{107}\) \text{Id.}\n
\(^{108}\) \text{Id. at 289.}\n
\(^{109}\) \text{Id. (emphasis added).}\n
\(^{110}\) \text{Id. at 278.}\n
\(^{111}\) \text{Id. at 286 (emphasis added).}\n
\(^{112}\) \text{See Ira M. Millstein, “A Self-Correcting Course for Governance,” First Annual Directors’ Institute on Corporate Governance, at 16 (2003); MacAvoy & Millstein, supra note 15, at 109-12; Leo E. Strine, Jr., Tor #: 1308665.3}
expectations about the role directors play in mitigating, uncovering, and preventing risks to the corporation. If a director fails to meet these expectations, it is possible that that failure could give rise to claims, under Delaware law, that the director did not act in good faith. As Chief Justice Veasey has remarked, “it is arguable – but not settled – that the issue of good faith may be measured not only by the evolving expectations of directors in the context of Delaware common law fiduciary duty, but also it may well be measured against the backdrop of Sarbanes-Oxley and the SRO requirements, even though there may be no express private right of action.” It presently is not known whether courts will continue to follow this line of reasoning, and if so, whether legislatures will amend current statutory prohibitions on charter provisions limiting liability for acts or omissions not made in good faith.

III. Judicial Standards of Review For Fiduciary Duty Issues

Judicial standards of review are critical when analyzing fiduciary duty issues because, as the Delaware Supreme Court has noted, “the determination of the appropriate standard of judicial review frequently is determinative of the outcome of the litigation.” 113 There are three standards of review Delaware courts employ in reviewing the actions of directors: (i) the business judgment rule; (ii) entire fairness; and (iii) intermediate standards in sale and merger transactions.

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A. The Business Judgment Rule

As explained above, the business judgment rule is a presumption that business decisions are made by (i) disinterested, independent directors; (ii) on an informed basis; and (iii) with a good faith belief that the decision will serve the corporation’s best interests.\textsuperscript{114} If the party challenging director activity cannot overcome this presumption, courts will not second-guess decisions made by the board.\textsuperscript{115} The presumption is rarely overcome.

B. Entire Fairness

Where the business judgment rule presumption is overcome, however, the directors bear the onerous burden of showing that their action was “entirely fair” to the corporation and its shareholders. The entire fairness test places the burden on the directors to prove:

1. “fair dealing” – the process that the board followed was fair and reasonable; and
2. “fair price” – the price the shareholders received was within a range of fair value.\textsuperscript{116}

While the entire fairness standard is not impossible to meet, it nevertheless is a heavy and exacting one, which, while not always “implicat[ing] liability on the conflicted corporate decision-maker,” is seldom found to be met.\textsuperscript{117}

In \textit{Cinerama v. Technicolor, Inc.}, the court applied the entire fairness test to a transaction in which the board agreed to an acquisition of the company, and held that it was entirely fair to the corporation and its shareholders.\textsuperscript{118} \textit{Technicolor} involved a duty of care claim for which the plaintiff had successfully rebutted the presumption of the

\textsuperscript{114} \textit{Aronson v. Lewis}, 473 A.2d 802 (Del. 1984); see Section II.B.1.a., supra.

\textsuperscript{115} \textit{Id.}; \textit{Sinclair Oil Corp. v. Levien}, 280 A.2d 717, 720 (Del. 1971).

\textsuperscript{116} \textit{Weinberger v. UOP, Inc.}, 457 A.2d 701, 711 (Del. 1983).


\textsuperscript{118} 663 A.2d 1156, 1163 (Del. 1995).
business judgment rule, and thus, entire fairness was applied. With respect to the fair dealing prong, the court considered: the timing of the transaction, the initiation of the transaction, the negotiation of the transaction, the structure of the transaction, disclosure to directors, approval by directors, disclosure to shareholders, and approval by shareholders, and concluded that the process the board followed was fair and reasonable. 119 In reviewing fair price, the court considered the premium paid over the company’s market value, senior management support, major shareholders’ support, expert opinions, the absence of evidence that the transaction was unfair, and the lack of competitive bidders, and found that the price obtained was the highest price reasonably available. The court thus concluded that the transaction was “entirely fair” to the corporation and its shareholders.120

C. Intermediate Standards in Sale and Merger Transactions

Recognizing that the interests of directors and stockholders may not precisely coincide in the case of mergers and acquisitions (for example, some transactions may be more likely than others to provide continuity of employment for management) and that the duties of the directors may be quite different in a sale transaction (maximizing immediate value) than in a merger of equals (maximizing the likelihood of long term value), the Delaware courts have developed standards of review which are intermediate between the deferential business judgment rule and the more exacting entire fairness standard.121

119 Id. at 1172-76; BJR at 159-162.
120 Id. at 1179.
121 See Greg A. Danilow and Mark J. Gentile, Deal Protection Measures in Merger and Acquisition Transactions, at 3-5 (Feb. 25, 2002).
1. **Revlon: The Sale of Control**

In cases where the board of directors proposes to sell the corporation in a transaction which amounts to a “change of control” or a breakup of the company, an intermediate standard of review is used. A “change of control” is the movement of voting power from the fluid, unaffiliated public stockholders to a single stockholder group. There are two ways to trigger a change of control:

- a purchaser pays cash for more than 50% of a corporation’s stock; or
- a corporation under the control of a single shareholder exchanges its stock with another corporation, and, as a result, the controlling shareholder will own more than 50% of the shares of the merged entity.

In a change of control transaction, there is no long term interest of the stockholders to protect and their only interest becomes one of obtaining the highest value currently available. Therefore, when a change of control occurs, the courts have recognized that the board’s fiduciary duty *shifts* from protection of the long-term corporate interests to the “maximization of the company’s value at a sale for the shareholder’s benefit.”\(^{122}\) These so-called “Revlon duties” grow out of the principle, that a fiduciary selling trust assets must sell them at the highest price reasonably available.\(^{123}\) Under this standard, only those director actions which are taken for the purpose of obtaining the highest value reasonably available will be upheld. Conversely, actions which inhibit realization of the best immediate price or which seek to serve the interests

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of non-stockholder constituencies at the expense of the stockholders (e.g., employees, bondholders, or local communities) will be stricken down.\textsuperscript{124}

2. \textit{Unocal: Judicial Review of Defensive Measures}

A second intermediate standard of review exists where directors adopt defensive measures to deter or preclude a hostile acquisition or contest for corporate control. When a board of directors adopts a defensive measure, such as a “poison pill,”\textsuperscript{125} that is later challenged in court, the board will be required to bear the initial burden of demonstrating that the directors reasonably believed that a threat to corporate policy and effectiveness existed, and that the defensive measure they adopted was reasonable in relation to that threat.\textsuperscript{126} This so-called \textit{Unocal} level of enhanced judicial scrutiny is justified by the “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders” in preserving its own control and deterring the potential acquirer.\textsuperscript{127}

The first prong of the \textit{Unocal} test – a “reasonably perceived threat to corporate policy” – may include: (1) coercion; (2) price inadequacy; (3) insufficient time or information to assess price adequacy; (4) failure to provide shareholders an option to remain equity holders; (5) change of corporate culture; and (6) antitrust and other regulatory issues. Directors can satisfy the first element of their burden under the Unocal test if they are able to demonstrate “good faith and reasonable investigation.”

\textsuperscript{124} See Section V.A., infra.

\textsuperscript{125} Examples of other defensive tactics may include “tilting the playing field” (i.e., providing company information or access to the board) to the advantage of a “white knight,” the inclusion of certain “break-up” fees, “no-shop” or “window shop” provisions in a merger agreement, or other mechanisms designed to ward off an unwanted aggressor.

\textsuperscript{126} \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946, 954-55 (Del. 1985).

\textsuperscript{127} Id.

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The second prong of the Unocal test – whether the response was “reasonable in relation to the threat posed” – requires the court to evaluate the importance of the objective threatened, alternative methods for protecting that objective and impacts of the defensive action. If the defensive action is “draconian” or falls outside a “range of reasonableness” it will not pass the test of reasonableness, notwithstanding the “latitude in discharging its fiduciary duties…when defending against perceived threats” which the courts acknowledge the directors have.128 If the board meets its initial burden of demonstrating a reasonable perception of threat to the corporation’s (i.e., stockholders’) interests and a proportionate response, the business judgment rule applies to the directors’ decision and the burden of rebutting the rule’s presumption shifts to the party challenging the board’s action.129

IV. The Development of Fiduciary Duties in the U.S.

The concept of fiduciary duties in the U.S. originated from the law of trusts.130 Under the law of trusts, a trustee who holds title, but not ownership, to a given property is required to act faithfully in managing that property for a beneficiary, who lacks title, but could in equity assert the benefits of ownership. The trustee is also forbidden from using the trust property for his or her own personal interests, even if those interests do not conflict with the beneficiary’s interests.

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129 Id. at 1390.
130 More recently, some scholars have advanced an economic theory to explain directors’ fiduciary duties to shareholders. These scholars view the relationships between shareholders, managers, directors, and others in large corporations as governed by contract. Shareholders, in pursuing their interests, must act through their agents, who are the managers and directors. Yet, managers and directors do not always act as diligently for their principal, the shareholders, as they would for themselves. This in turn leads to agency costs which are reduced in part by market forces, yet because market forces alone are insufficient, fiduciary duties have formed part of the “standard form contract” between shareholders, managers, and directors and are designed to reduce agency costs. See David Millon, Redefining Corporate Law, 24 IND. L. REV. 223, 231-2; Melvin Avon Eisenberg, Contractual Freedom in Corporate Law, 89 COLUM. L. REV. 1461.
Over time, as corporations grew in size, ownership by the shareholders became more widely dispersed, thereby creating a dichotomy between the interests of managers and directors, on the one hand, and shareholders on the other. To realign these interests, courts began to apply the trustee-beneficiary concept to corporate law. Directors and officers were treated as trustees, who had common law obligations to act in the interest of the corporation’s beneficiaries, the shareholders – although, as was true under trust law, they were given broad discretionary powers to satisfy this objective.

This position was explained by the Delaware Supreme Court in the seminal case, Guth v. Loft, 5 A.2d 503, 510 (Del. 1939):

Corporate officers and directors are not permitted to use their positions of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy . . . has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated.

Despite the commonalities between the duties owed by trustees and corporate fiduciaries, over time, courts applying the fiduciary duty concept to directors have relaxed the absolute prohibition against self-dealing transactions under trust law. Now, as discussed above, there is even a statutory “safe harbor” for corporate directors to
engage in self-dealing transactions, provided that it has been approved by a majority of disinterested directors, or the shareholders, after full disclosure.\textsuperscript{131}

The origins of the business judgment rule and the judicial reluctance to interfere with directors’ decisions dates back to English law in the 1700s.\textsuperscript{132} In the U.S., the concept underlining the rule was first adopted by the Louisiana Supreme Court in 1829.\textsuperscript{133} In \textit{Percy v. Millaudon}, 8 Mart. (n.s.) 68, 78 (La. 1829), the court wrote that the “test of responsibility [for directors], therefore, should be, not certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the [director] is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it.” During the 1800s and early 1900s, courts throughout the U.S. began to articulate early versions of the rule, leading to today’s expansive jurisprudence on the subject.\textsuperscript{134}

\section*{V. To Whom Fiduciary Duties Are Owed}

In Delaware and certain other jurisdictions, directors owe their fiduciary duties to the corporation and its common shareholders.\textsuperscript{135} As described below, however, there are other circumstances in which the general rule that directors owe fiduciary duties to the corporation and its common shareholders does not apply. For example, different rules may apply in certain change of control transactions, when the corporation has multiple classes of shareholders, including preferred shareholders, or when the corporation enters the “zone of insolvency.”

\textsuperscript{131} \textit{See, e.g.}, DGCL § 144, discussed \textit{supra}, Section II.B.2.

\textsuperscript{132} BJR at 9.

\textsuperscript{133} \textit{Id}.

\textsuperscript{134} \textit{Id.} at 10-11.

A. Consideration Of Non-Shareholder Constituencies In Certain Change Of Control Transactions

When considering issues involving a change of control (or competing offers to purchase the company), the Delaware courts have stated that directors, in certain circumstances, may consider factors other than the adequacy of the price offered to the company’s shareholders. In *Unocal*, for example, the Delaware Supreme Court explained that the impact upon non-shareholder constituencies is a factor boards reasonably may consider in evaluating “the nature of the takeover bid and its effect on the corporate enterprise.” But the board’s consideration of non-shareholder constituencies is *limited* to the extent “there are rationally related benefits accruing to the stockholders.” Accordingly, in a *Revlon* situation, “concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.” In such circumstances, the interest of non-shareholder constituencies such as “employees or communities that might be adversely affected by a change of control” are “of little, if no relevance, under Delaware corporate law.”

Many states -- but not Delaware -- have enacted statutes that permit directors to consider non-shareholder constituencies, such as employees, suppliers, creditors, consumers, the local and national economies and society as a whole, when

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136 BJR at 808-09.
138 *Revlon*, 506 A.2d at 182.
139 Id. at 182.
140 *Chesapeake Corp. v. Shore*, 771 A.2d 293, 328 & n82 (Del. Ch. 2000).
responding to contests for control.\textsuperscript{141} It is important to note, however, that most of these statutes do not require that directors consider such non-shareholder interests. Rather, the statutes are permissive.\textsuperscript{142}

B. Preferred Shareholders

Although directors usually owe their fiduciary duties to all shareholders, different rules apply when the corporation has multiple classes of shareholders, including preferred shareholders. Unlike the rights of common shareholders, the rights of preferred shareholders are fixed by the contract which created the class of preferred stock.\textsuperscript{143} Thus, the rights of preferred shareholders depend on their contracts with the corporation (typically their stock certificates), which like most contracts, usually include the implied duty of good faith and fair dealing, but do not include fiduciary obligations.

C. Creditors And The Zone Of Insolvency

Generally, the duties of loyalty and care do not extend to a corporation’s creditors because creditors do not have an existing property right or an equitable interest which supports these duties when a corporation is solvent.\textsuperscript{144} Rather, the relationship between a solvent corporation and its creditors is contractual in nature.\textsuperscript{145} When a

\textsuperscript{141} See, e.g., N.Y. Bus. Corp. Law § 717(b); Nev. Gen. Corp. Law § 78. 138 (3); see also BJR at 812-22.

\textsuperscript{142} BJR at 595-6; 812-22.

\textsuperscript{143} BJR at 570-1.

\textsuperscript{144} See Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988) (affirming dismissal of class action suit because appellants, holders of convertible debentures, did not have standing to bring breach of fiduciary duty claims against a solvent corporation and its directors).

\textsuperscript{145} See Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. 1986) (holding that relationship between plaintiff debt holder and solvent corporation was defined by the terms of their contractual agreement).
corporation becomes insolvent or comes within the “vicinity of insolvency,” however, the directors’ duties shift dramatically. 146

The general rule in Delaware is that “where foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where corporation is in the vicinity of insolvency, an independent board may consider impacts upon all corporate constituencies in exercising its good faith business judgment for benefit of the ‘corporation.’” 147 This includes creditors – but query the use of “may” instead of “must” in such formulation. The rationale behind this shift is that while shareholders own a solvent corporation, upon insolvency, the creditors, as the only parties with an interest in the corporate assets, become its equitable owners. 148

With no bright-line test, the “vicinity of insolvency” standard has been widely criticized as being an imprecise and ambiguous standard. First, it raises the question of what is “insolvency.” Second, the courts have not clearly defined what constitutes the “vicinity” of insolvency. Third, it is unknown to what extent the directors’ duties simultaneously flow to the creditors, on the one hand, and/or the shareholders, on the other, when the directors’ obligation during insolvency is to the “benefit of the ‘corporation.’”


While the term “insolvency” has been defined, the Delaware courts have yet to provide a definition for when a corporation is operating in the “vicinity of insolvency.” The rule in Delaware appears to be that a corporation’s insolvency or near-insolvency expands the scope of directors’ duties to cover both creditors and shareholders:

While it is true that a board of directors of an insolvent corporation or one operating in the vicinity of insolvency has fiduciary duties to creditors and others as well as to its stockholders, it is not true that our law countenances, permits, or requires directors to conduct the affairs of an insolvent corporation in a manner that is inconsistent with principles of fairness or in breach of duties owed to the stockholders.

Therefore, the board “is obliged to act not in the best interests of shareholders, but rather in accordance with ‘the community of interests that sustain[s] the corporation.’” Other courts have followed Delaware’s approach, finding that when a corporation is insolvent or near insolvency, the fiduciary duties of its directors expand to include creditors as well as shareholders.

Courts should provide directors of nearly insolvent companies with ample latitude to exercise good faith business judgment in an effort to devise a business plan to save the corporate enterprise. During the period of insolvency or near insolvency, it is

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149 The term “insolvency” has been defined as either of two circumstances: (1) when the corporation “is unable to pay its debts as they fall due in the usual course of business” (i.e., the “equity” definition); or (2) “when it has liabilities in excess of a reasonable market value of assets held” (i.e., the “balance sheet” definition). Geyer v. Ingersoll Pub’ns Co., 621 A.2d 784, 787-89 (Del. Ch. 1992).

150 Adlerstein v. Wertheimer, 2002 Del. Ch. LEXIS 13, at *35 (Del. Ch. Jan. 25, 2002) (finding that although company was operating in insolvency or near insolvency, the board owed fiduciary duties to controlling stockholder because the interests of all parties had to be taken into account; the fact that company was operating in insolvency or near insolvency was not enough to obviate fiduciary duties to controlling stockholder); see also Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del.), 274 B.R. 71 (D. Del. 2002); Credit Lyonnais, 1991 WL 277613, at *34; Geyer, 621 A.2d at 789; see also Donald S. Bernstein & Amit Sibal, Current Developments: Fiduciary Duties of Directors And Corporate Governance In The Vicinity Of Insolvency, 767 PLI/Comm 167, 176 (1998).

151 BJR at 620 (citing Credit Lyonnais, 1991 WL 277613); Geyer, 621 A.2d at 789.


153 See, e.g., In re RegO Co., 623 A.2d 92, 109 n.35 (Del. Ch. 1992) (holding when directors of a dissolved corporation, “during the course of winding-up corporate affairs, [are] required to make decisions affecting various classes of interest holders, they are protected from liability in doing so, as long as they act
likely that a disinterested director will be protected from the dilemma of divided loyalties so long as the director exercises his or her good-faith and informed business judgment to protect the value of the enterprise for all stakeholders.\textsuperscript{154} Thus, so long as the Board properly divides its duties among the various corporate constituencies, the court likely will analyze the transaction under the most favorable business judgment form of review. But where the court finds that the directors did not act in an informed, good-faith manner towards the creditors – \textit{i.e.}, where the directors did not “shift” their duties – the business judgment rule will not be applied to protect their actions, and instead, the transaction likely will be reviewed for “entire fairness.”

Finally, in connection with their duty to act in the best interests of the “corporate enterprise,” directors of insolvent corporations also have a “duty of candor” with respect to the creditors (as well as the shareholders) of the corporation.\textsuperscript{155} “In insolvency cases, the duty of candor applies when directors negotiate on behalf of the corporation with a creditor (especially in communications concerning the condition and prospects of the corporation).”\textsuperscript{156} In negotiating with creditors during insolvency, directors must be forthright and accurate in providing financial data and information with respect to the company’s prospects and plans, or risk legal recourse for violations of the


\textsuperscript{155} See Section II.B.2., \textit{supra}.

\textsuperscript{156} Corinne Ball & Robert L. Messineo, “Fiduciary Duties Of Corporate Officers And Directors Of The Financially Troubled Company: A Primer,” 971 PLI/Corp 171, 189 (1997).
duty of candor. Thus, a company in the “vicinity of insolvency” should take care to provide its creditors with truthful representations and accurate financial data in order to avoid subsequent liability for breach of the duty of candor.

VI. Conclusion

In the wake of the sensitized environment resulting from recent corporate failures and scandals -- and in light of the new federal reforms -- fiduciary duties will continue to evolve to meet the higher expectations of corporate directors. State court litigation, mainly in Delaware, likely will arise out of claims for breach of fiduciary duty based on failure to comply with the new federal reforms, as well as claims for breach of fiduciary duty based on a new, more aggressive interpretation of the good faith obligation -- such as in the Disney decision. As a result of the courts’ increasingly sharp focus upon director conduct, directors should continue to increase their understanding of fiduciary duties and “best practices” of corporate governance, doggedly question management’s premises and factual support so as to distinguish management self-interest from the corporate good, anticipate trouble spots and put in place adequate policies, practices and procedures to safeguard corporate assets and ensure proper monitoring of corporate activity, and above all, always act honestly, on an informed basis, in with due care, while giving good faith consideration to actions of material importance to the corporation.

157 See id.; see generally Malone v. Brincat, 722 A.2d 5, 9-12 (Del. 1998) (recognizing a “duty of disclosure” or “duty of candor” with respect to shareholders even in the absence of a request for shareholder action); Arnold v. Soc’y For Savings Bancorp, Inc., 650 A.2d 1270, 1276-77 (Del. 1994) (recognizing a duty of disclosure with respect to shareholders when they are asked to vote or otherwise act); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (same).

158 See MacAvoy & Millstein, supra, note 15, at 103.
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The United Kingdom

Laurence Hazell and Richard Smerdon

Foreword

Although the United Kingdom comprises three distinct law districts (England and Wales, Scotland and Northern Ireland), the law relating to companies and their officers are for most practical purposes identical. In September 1999 the Law Commission (Law Com No 261 Scot Law Com 173) produced a report entitled Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties. The recommendations in that report became part of and ancillary to a much broader review of company law undertaken by the Department of Trade and Industry (DTI) and published in a final report in June 2001 (Modern Company Law for a Competitive Economy).

One year later some of the report’s proposals on the duties of directors were included in a White Paper. In the UK a White Paper sets out the government’s views on revising the law or the provision of services that will require legislative action. Usually it paves the way for tabling new legislation but ‘Modernising Company Law’ ©Crown Copyright 2002 (Cm 5553) acknowledges that much of it has yet to be fully drafted and throughout, requests comments and replies upon a large number of questions. Given the scope of the reforms - this is said to be the most comprehensive modification of company law since the creation of the joint stock company in the nineteenth century - that is, perhaps, hardly surprising.

In July 2003, the Government concluded that the recasting of such a large and significant area of law exceeded the resources and time that could be devoted to it for the time being. In its place, legislation would be introduced that would address specific changes in the law recommended by various reviews undertaken in the aftermath of the Enron, WorldCom and other corporate meltdowns in the United States. On 3 December 2003, the Companies (Audit, Investigations and Community Enterprise) Bill (the Audit Bill) was presented to the upper chamber of the UK Parliament, the House of Lords. It is an omnibus piece of legislation but nevertheless contains specific new duties for directors regarding disclosure of corporate information to auditors and others.

However, it does not contain the White Paper’s codification of directors’ duties, which was such a centerpiece of the proposed company law reforms. Nevertheless we will review and reproduce the Schedule from the White Paper in
this essay because of its importance to contemporary thinking about director fiduciary duties in UK law. Lastly, two other significant reports were produced in 2003, which will also shape the contours of director duties in the UK. The Higgs Report reviewed the role and effectiveness of non-executive directors and made a large number of suggestions eventually incorporated into the latest iteration of the UK’s Combined Code on Corporate Governance. The Smith Report focused on the role of Audit Committees and its recommendations have also seen the light of day in Combined Code and also flavored the Audit Bill currently before the upper chamber of the UK Parliament.

A. The Meaning of Directors’ Fiduciary Duties in United Kingdom Law

Current legislation does not explicitly define what a director is. But the Companies Act 1985 includes a general provision that the expression ‘director’ includes ‘any person occupying the position of director by whatever name called’ (s. 741(1)). Case law holds that the meaning of ‘director’ is to be derived from the words of the Act as a whole and can include someone who acts as a director even though they have not been formally appointed to the office or someone from whom the formally appointed directors themselves take direction (a shadow director). A nineteenth century case puts the matter broadly:

…it does not much matter what you call them so long as you understand what their true position is, which is that they are really commercial men managing a trading concern for the benefit of themselves and all the other shareholders in it.

Re Forest of Dean Coal Mining Co (1879) 10 ChD 502 451 at 453 per Jessel MR.

Those words - and indeed their order - ‘for the benefit of themselves and all the other shareholders in it’ - take us to the nucleus of fiduciary duties as these are understood in UK law. ‘Other shareholders’ depend upon the probity and the skill of these ‘commercial men’ because they have to delegate control to these individuals - granting them significant discretionary power over the assets of the corporation - if the enterprise is to flourish. If the risks inherent in business are going to deliver the requisite level of return to investors, that will require a significantly looser set of constraints upon these managers than those imposed by other legal devices such as a trust, where ownership and control are separated as well.

Success of the enterprise also requires some means of restricting investors’ exposure to the risks and liabilities, which commercial adventures almost invariably attract. These were ameliorated to a significant degree by the development of the joint stock company in the early nineteenth century. It permitted shareholders to limit their liability to the investment they had made in
such a corporation. This limitation, inscribed on the stock certificate itself, in turn only required the law to develop a means to condition the powers of the corporation’s controllers to use them in the best interests of the company itself. Therefore the point of imposing fiduciary duties upon directors is to prevent the utilization of the advantages of control at a cost to the company through a duty to act bona fide in the interests of the company.

Fiduciary duties are meant to ensure that the director seeks the promotion of company objectives – the pursuit of proper rather than any collateral purpose - for example one connected with a director’s interests that lie outside the company. Board members in fulfilling their fiduciary duties thereby further the interests of all shareholders. These duties are meant to maintain a level playing field between the company’s board and those who have assigned their assets - in the expectation of profit - to their care. A corollary of this relationship between the directors, company and investors is that these duties are not construed as owing to individual shareholders but rather to the collective of company members as shareholders, in other words to the company itself. That is why individual shareholder remedies, where permitted, are identified as derivative actions.

Since directors have been given the discretion “as commercial men” to manage the company “for the benefit of themselves and all the other shareholders in it” the courts will rarely tolerate their actions being questioned by disgruntled investors absent compelling reasons for such an inquiry. Consequently, if a court finds that the director has acted in good faith i.e. as a fiduciary, the cases show a marked reluctance to second guess that exercise of the directors’ discretion. This remains the case even if the court finds that exercise did not in fact entail acting in the company’s best interests.

B. The Development of the Concept of Directors Fiduciary Duties in United Kingdom Law

As the previous section indicated, the common law concept of directors’ fiduciary duties is intimately bound up with the nature of the limited liability joint stock company, which itself was created to respond to the need for capital accumulation to drive Britain’s industrial revolution. But the office of director, and the fiduciary duties by which that director is bound, have their own antecedents in other kinds of legal relationship where owners of property cede control over its management and use. Contrasting directors’ fiduciary duties with salient features of these relationships provide a means for outlining their genesis in the common law.

The role of the company director has been compared with that of agents on the basis that when directors contract with other parties, they do so without themselves assuming liability, provided of course that they act within their authority and do not expressly adopt it. Their authority resembles agency
because the company’s articles of association circumscribe their powers in much the same way that an agent assumes specific responsibilities delegated by the principal. But in practice the authority accorded to directors is fuller, since on this analogy their principals, the company itself as represented by the shareholders, are unlikely to be in a position to even know, much less take the kind of action that a delegating principal can.

If the comparison with agents fails to capture the extent of the power and control exercised by directors another line of cases contrasts their position with that of the managing partner of a firm. However, the problem with this analogy is that directors do not have the practically unlimited discretion afforded managing partners because the control of the directors is limited, and capable of being strictly limited, by any restrictions contained in the memorandum and articles of association. Also a director, unlike a managing partner, does not generally have the power to bind the other directors or the company because his or her authority is exercised collectively with the other directors on the board on behalf of the company as its servants.

A further line of authorities notes the similarities between directors and trustees. This comparison proved particularly helpful because it highlighted the role of the director as a fiduciary. However, these cases also emphasized that directors are not really equivalent to trustees because the trustee owns trust property and deals with it as principal. By contrast, the legal title to company assets is vested in the company and, as we just noted, can only be dealt with in the company’s name by the directors acting as its servants. But, despite such differences, the courts in the process of adjudication saw noticeable similarities because of the degree of practical control that board members actually exercised over company assets.

So, although the legal title to trust property vested in the trustee he or she was nevertheless subject to an equitable obligation to account for it to the trust’s beneficiaries. The courts looked for a way to similarly restrain the power directors had over the company and its assets without undermining their need to control the enterprise in order to achieve its entrepreneurial objectives. Accordingly, while equity placed a fetter upon the trustee’s legal ownership of property through obligations to beneficiaries, company case law analogously bounded directors’ control of corporate assets by the imposition of fiduciary duties. The point was succinctly made in one case:

However much the company’s purposes and the directors’ duties, powers and functions may differ from the purposes of a strict settlement and the duties, powers and functions of its trustees, the directors and such trustees have this indubitably in common – that the property in their hands or under their control must be applied for the specified purposes of the company or the settlement.
C. **Under United Kingdom Law to whom are these Fiduciary Duties owed?**

The way the courts have interpreted existing statutory provisions and earlier case law make clear that the fiduciary duties of a director are owed to the company. They are not owed to associates of the company (e.g. a holding company or subsidiary) nor can these duties benefit someone because he or she is a person to whom the company itself has obligations. Moreover, directors’ duties are not construed as owing to individual investors in the enterprise, but rather collectively to company members (as shareholders). However, the Companies Act 1985 and the Insolvency Acts of 1986 and 2000 expressly include employee and creditor interests in certain circumstances.

In the case of creditors under the current law the directors’ duty to look after their interests becomes overriding only when the company is on the brink of - or has become - insolvent. Once more though, the cases indicate that the duties are not owed directly to the creditors but to the company, which in the event of liquidation, can be enforced by the liquidator for the benefit of the company’s creditors.

In the case of employees s.309 of the 1985 Act states that the matters to which the directors of a company are to have regard in the performance of their functions “shall include the interests of the company’s employees in general as well as the interests of its members.” However, that section also states that this duty is owed to the company and not to employees directly. Practically speaking, that means that so long as the directors take into account employee interests in their deliberations these may be subsumed to the interests of the company since they are of overriding importance.

The proposed, but for the moment shelved, new Companies Act would arguably have expanded the matters that directors would have to take into account as fiduciaries. The proposed codification of director’s duties (set out in the addendum to this article) would include, under the general rubric of fostering business relationships, not only employee interests but also those of suppliers and customers, together with the “need to have regard to impact of its operations on the communities affected and the environment” (2.2(b)).

The Code also states that the promotion of company objectives must at all times “maintain a reputation for high standards of business conduct” (2.2(c)) as well as the need “to achieve outcomes that are fair as between its members” (2.2(d)). But, like the current legislation and case law, these matters will remain subject to the need “to promote the success of the company for the benefit of its members as a whole”(2.a).
However, in its current form the Schedule of director’s duties drew the line at incorporating insolvency issues directly into the Statement of Directors’ Duties. Various reasons were given for this. At the outset the White Paper draws a distinction between company law, which regulates the way companies are organized and run and matters like insolvency law, taxation of profits and the ways they may buy and sell goods and services. More specifically, it was felt that the incorporation of a special duty related to the possibility of insolvency could have a chilling effect. Directors might well run down or abandon an enterprise at the first hint of trouble if such a duty was included, thereby conflicting with the overall aim of the legislation to promote a greater risk and enterprise culture in contemporary Britain.

Nevertheless, the Audit Bill currently under consideration by the UK Parliament does specifically incorporate the part of the codification of director duties regarding the care, skill and diligence a director must utilize in the preparation of reports about the company. It will require that they expressly state they are not aware of any relevant information that has not been disclosed to the company’s auditors (proposed s.234ZA Companies Act 1985). In other words, there will be a positive duty to communicate all relevant company information to the auditors, who in turn must report it to shareholders, regulatory authorities and the wider public.

**D. How are fiduciary duties manifested in United Kingdom Law?**

The foregoing sections identify two central duties - to act *bona fide* in the interests of the company and to act for a proper rather than any collateral purpose. Ways that these duties manifest themselves in UK statutory and case law center upon directors avoiding a conflict of duty to the company and self-interest arising. A nineteenth century case in the House of Lords, the UK’s highest court, puts the matter thus:

> “...no one having such a duty 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 he is bound to protect."

*Aberdeen Ry Co v Blaikie (1854) 1 Mac 461 at 471-472 HL (SC) per Lord Cramworth LC*

This principle also applies in a situation where the director has duties to another outside body, for example another company, which collide or are otherwise at odds or inconsistent with his or her fiduciary duties to the company. More specifically, the law developed from the above case to impose a duty on a director to disclose to shareholders in general meeting the nature of any interest he or she might have in a contract to which the company is a party. It is a
noteworthy feature of the case law that developed this principle that disclosure to the board alone was thought insufficient because its members would not be in a position to give an independent and unbiased judgment on the merits of the contract.

Statutory provisions reenacted in or introduced by the 1985 Companies Act have supplemented that requirement. Section 317 makes it the duty of every director interested directly or indirectly in any way in any contract, proposed contract, transaction or arrangement with a company of which he is a director to declare the nature of the interest at a full board meeting. The matter must be presented to the board for its consideration and approval, rather than a *fait accompli* or mere formality. The required recording in board minutes of any such decision is meant to draw the attention of the directors to the duties that the law imposes upon them and the interested director in the discharge of their fiduciary obligations. An additional noteworthy feature is that only disclosure to the full board will suffice. Disclosure to a board committee is insufficient.

Section 317 cannot be watered down or nullified by any contrary provision in a company’s constitution, memorandum and articles of association or even by a special resolution of the shareholders. In fact a recent case established that the procedure, which the section invokes, must be followed even where a private company has only one director. Finally, with certain exceptions, the ‘interested’ director of a public company may not vote upon any board resolution to approve his or her interest or even be counted for the purposes of establishing a quorum on the issue. The White Paper in Schedule 2, under the heading ‘Transactions involving conflict of interest’, reaffirms the duty in broad terms.

Even if the disclosure of an interest is properly and timely made the contract in which the director has an interest is still voidable if it conflicts with the two principal duties to act *bona fide* in the interests of the company and to act for a proper purpose. Certain types of interest are subject to further restrictions. These include a ban on substantial property transactions between directors and the company (s. 320) and the prohibition of loans and similar benefits (s. 330) unless they fall below a statutorily fixed amount or are made in furtherance of the company’s business (with a statutorily fixed upper limit). All these restrictions also apply to anyone who is a ‘connected person’ within the meaning of s.346 of the 1985 Act. Such persons include a director’s spouse, child, another corporate body or a partner of such a director or connected person.

Another broad manifestation of the duty, developed from the law relating to trustees and agents, requires any profit made by a director through his office as a director to be accounted for to the company. In other words, it is a duty not to make *secret* profits. Their retention by the director can therefore only be sanctioned by the company in general meeting or by appropriately worded provisions of the articles of association which company members are deemed to have notice of. Thus, no board member can make a profit acquired as a result of
their fiduciary position, or if they do they must account for it to the company, and receive the appropriate authority to retain it.

This general prohibition is applicable to a wide variety of situations. It is capable of rendering a director liable to account, where being aware of confidential information that arises from the office of director, a profit is made. Examples could include the purchase or sale of securities as a result of an impending takeover or the utilization of some knowledge or opportunity, which as a director, he or she is privy to. It would also cover the situation where any secret commission or bribe is received by a director in the course of negotiating business transactions or in respect of voting a certain way at a board meeting. It hardly needs saying that some of these activities would also attract other kinds of penalty, including criminal penalties. Third parties involved in transactions of this kind, although not fiduciaries of the company, may nonetheless be required to disgorge any kind of profit, emolument or pecuniary advantage that accrues to them as constructive trustees of the company’s assets.

This discussion leads to a fuller consideration of situations noted at the outset of this section where a director may breach his or her fiduciary duties by virtue of identification with or involvement in interests outside those of the company. It is important to note that the mere existence of such relationships does not necessarily entail the director being in breach of a fiduciary duty, since these outside interests must at a minimum touch upon matters that legitimately concern the company. Of course a situation could arise where a director’s time was so consumed by these matters that he or she paid insufficient attention to company business. However, that is probably best understood as a failure to perform his or her fiduciary duties at all, rather than as a breach of them.

In fact, various cases have held that a company director is, on the whole, free to take up a board position with another company even where they are in the same field of business or even competitors. As a practical matter though separating and fulfilling the fiduciary duties owed to each could be problematic, particularly where competition is fierce or new markets arise for exploitation. Obviously, where there is any express agreement to the contrary, such as in an executive director’s contract of service, the court would likely find that the director should not perform any kind of service for a competitor. Much turns on the circumstances of each case: how far will service to the other company cause harm to the plaintiff company – were the services rendered deliberately concealed – how likely is it that confidential information will filter through to the competitor and so forth.

One fairly common situation that can occasion a breach of fiduciary duties is where a director sits on the board to explicitly represent ‘outside’ interests. Here ‘outside’ is flagged with quotation marks to illustrate the fact that such interests could include those of share or debenture holders in the company, or a situation where a holding company has ‘nominees’ on the boards of its subsidiaries.
Although such arrangements are perfectly lawful great care has to be taken to avoid leaving the director with no independent discretion to consider the company’s interests, echoing the point made at the outset of the previous section that under current law fiduciary duties are owed to the company alone.

In sum, a director of a company - without any concealment of an ‘outside’ or representative capacity - may act on behalf of the interests of the outsider so long as a sufficient degree of independent discretion is preserved, so that their fiduciary duties to the company can be properly fulfilled. In fact this example of dealing properly with a director’s outside interests illustrate the central meaning of the concept of directors’ fiduciary duties as they are understood in UK law.

**Addendum: The Statement of Directors’ Duties in Schedule 2 of the Draft Clauses attached to the White Paper.**
Clause 19 General principles by which directors are bound

1. Schedule 2 sets out:
   (a) the general principles applying to a director of a company in the performance of his functions as director; and
   (b) the general principles:
      (i) applying to a director of a company in relation to his entering into transactions with the company; and
      (ii) applying to a director or former director in relation to the use of property, information and opportunities of the company and to benefits from third parties, and has effect in place of the corresponding equitable and common law rules.

2. A director of a company owes a duty to the company to comply with that Schedule, and a former director owes a duty to the company to comply with paragraphs 6 and 7 of that schedule.

3. Nothing in that Schedule authorises the contravention by a director (or former director) of any prohibition or requirement imposed on him by or under any other enactment or rule of law.

Schedule 2

General principles by which directors are bound

Obeying the constitution and other lawful decisions

1. A director of a company must act in accordance with:
   (a) the company's constitution; and
   (b) decisions taken under the constitution (or by the company, or any class of members, under any enactment or rule of law as to means of taking company or class decisions),
   and must exercise his powers for their proper purpose.

Promotion of company's objectives

2. A director of a company must in any given case:
   (a) act in the way he decides, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (excluding anything which would breach his duty under paragraph 1 or 5); and
   (b) in deciding what would be most likely to promote that success, take account in good faith of all the material factors that it is practicable in the circumstances for him to identify.

Notes

(1) In this paragraph, "the material factors" means:
(a) the likely consequences (short and long term) of the actions open to the director, so far as a person of care and skill would consider them relevant; and
(b) all such other factors as a person of care and skill would consider relevant, including such of the matters in Note (2) as he would consider so.

(2) Those matters are:

(a) the company's need to foster its business relationships, including those with its employees and suppliers and the customers for its products or services;
(b) its need to have regard to the impact of its operations on the communities affected and on the environment;
(c) its need to maintain a reputation for high standards of business conduct;
(d) its need to achieve outcomes that are fair as between its members.

(3) In Note (1) a "person of care and skill" means a person exercising the care, skill and diligence required by paragraph 4.

(4) A director's decision as to what constitutes the success of the company for the benefit of its members as a whole must accord with the constitution and any decisions as mentioned in paragraph 1.

**Delegation and independence of judgement**
3. A director of a company must not, except where authorised to do so by the company's constitution or any decisions as mentioned in paragraph 1:
(a) delegate any of his powers; or
(b) fail to exercise his independent judgement in relation to any exercise of his powers.

**Note**
Where a director has, in accordance with this Schedule, entered into an agreement which restricts his power to exercise independent judgement later, this paragraph does not prevent him from acting as the agreement requires where (in his independent judgement, and according to the other provisions of this Schedule) he should do so.

**Care, skill and diligence**
4. A director of a company must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both:
(a) the knowledge, skill and experience which may reasonably be expected of a director in his position; and
(b) any additional knowledge, skill and experience which he has.
**Transactions involving conflict of interest**

5. A director of a company must not—
   (a) in the performance of his functions as director, authorise, procure or permit the company to enter into a transaction, or
   (b) enter into a transaction with the company,
   if he has an interest in the transaction which he is required by this Act to disclose to any persons and has not disclosed the interest to them to the extent so required.

**Personal use of the company's property, information or opportunity**

6. A director or former director of a company must not use for his own or anyone else's benefit any property or information of the company, or any opportunity of the company which he became aware of in the performance of his functions as director, unless:
   (a) the use has been proposed to the company and the company has consented to it by ordinary resolution; or
   (b) the company is a private company, the use has been proposed to and authorised by the board, and nothing in the constitution invalidates that authorisation; or
   (c) the company is a public company, its constitution includes provision enabling the board to authorise such use if proposed, and the use has been proposed to and authorised by the board in accordance with the constitution.

**Notes**

(1) In this paragraph "the board" means the board of directors acting without the participation of any interested director.

(2) This paragraph does not apply to a use to which the director has a right under a contract or other transaction that he has entered into with the company, or that he has in the performance of his functions authorised, procured or permitted the company to enter into.

**Benefits from third parties**

7. A director or former director of a company must not accept any benefit which is conferred because of the powers he has as director or by way of reward for any exercise of his powers as such, unless the benefit is conferred by the company or—
   (a) acceptance of the benefit has been proposed to the company and the company has consented to it by ordinary resolution; or
   (b) the benefit is necessarily incidental to the proper performance of any of his functions as director.
FIDUCIARY DUTIES OF CANADIAN DIRECTORS

Carol Hansell
Davies Ward Phillips & Vineberg LLP

A director's fiduciary duty is the cornerstone of his or her relationship with the corporation. Legislation, stock exchange requirements and best practices introduced in the last several years are grounded in this relationship. Concerns with board independence, conflicts of interest and standards of due diligence which have emerged from the ashes of Enron, fit into the framework of responsibilities and restrictions that flow from the fiduciary relationship.

Fiduciary Duty – Summary

Directors of Canadian companies are required to exercise their authority in accordance with two basic duties. The first is the fiduciary duty – the duty to act honestly and in good faith, with a view to the best interests of the corporation. This concept developed in common law and has been codified in many of the corporate statutes in Canada.

The second basic duty, the duty of care, requires directors to exercise the care diligence skill that a reasonably prudent person would exercise in comparable circumstances.

In Canada, the consequences of a director breaching his or her fiduciary duty are significant. The director can be sued by the corporation (or by certain other parties on behalf of the corporation) for any damage the breach of that duty caused. The corporation will be prohibited under most corporate statutes from indemnifying a director for legal and other costs in connection a breach of his or her fiduciary duty. Most Canadian corporate statutes also prohibit the corporation from taking out insurance for the benefit of the director against liability relating to the director's breach of fiduciary duty.

A. Why Are Directors Fiduciaries?

A fiduciary relationship implies vulnerability and dependency on the part of the beneficiary (in this case the corporation) and an ability on the part of the fiduciary (in this case the directors) to exercise discretion. The law protects the party who is vulnerable and dependent by imposing high standards of conduct on fiduciaries and by dealing with breaches of the fiduciary duty harshly. The classic example of a fiduciary relationship is the relationship between trustee and trust, although the courts have recognized a fiduciary duty between other parties, for example, between bankers and their customers, and even in some cases between parties to a commercial relationship.

Why should directors be considered fiduciaries of the corporations they serve? The statutes under which Canadian corporations are formed separate ownership from control.

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1 Draft paper prepared in connection with the Publication Project on Fiduciary Duty of Corporate Directors undertaken by the International Developments Sub-Committee on Corporate Governance of the Business Law Section of the American Bar Association.
Shareholders own the equity in the corporation, while the board has the authority to manage (or supervise the management of) the business and affairs of the corporation. The legal impetus for characterizing the director's relationship with the corporation as being fiduciary in nature stems from the need for a corporation's stakeholders to be confident that the members of its board and management team will not manipulate the corporation for their own benefit. Unless the stakeholders can have confidence that the board will not operate the corporation in their own self-interest, the corporation would therefore not be a reliable investment vehicle.

The Supreme Court of Canada set out the rationale for application of the equitable principles of loyalty, good faith and avoidance of a conflict of duty and self-interest as follows:

Strict application against directors and senior management officials is simply recognition of the degree of control which their positions give them in corporate operations, a control which rises above day-to-day accountability to owning shareholders and which comes under scrutiny only at annual, general or special meetings. It is a necessary supplement, in the public interest, of statutory regulation and accountability which themselves are at one in the same time an acknowledgement of the importance of the corporation in the life of the community and of the need to compel obedience by it and its promoters, directors and managers to norms of exemplary behaviour.

Each individual director has a fiduciary duty to the corporation acting honestly and in good faith with a view to the best interests of the corporation, regardless of how fellow directors may conduct themselves. By influencing the behaviour of individual directors who collectively, as a board, control the corporation, the law seeks to influence the conduct of the corporation itself.

B. **What Does the Fiduciary Duty Mean?**

The Canadian corporate statutes codify the director's fiduciary duty by providing that in exercising his or her authority, a director must:

> act honestly and in good faith with a view to the best interests of the corporation.

Each of the components of this standard, acting "honestly", "in good faith" and "with a view to the best interests of the corporation" has antecedents in the common law. The meaning of these terms is grounded in English case law and has been further developed by the Canadian courts.

The requirement that directors act "honestly" is self-explanatory. “Good faith” is typically described with reference to what it is not, rather than what it is. For example, the Supreme Court of Canada has held that self-dealing and preference of one shareholder group over the shareholders as a whole, represented a lack of good faith by the directors. A lack of intention to commit fraud, or a *bona fide* belief that one was complying with the articles of the corporation, will not necessarily be sufficient to convince a court that a director was acting in good faith.
From a comparative perspective, the requirement that Canadian directors act "with a view to the best interests of the corporation" is the most interesting aspect of this test. These words were chosen by the drafters of the legislation in an attempt to dispel from Canadian corporate law, the "collateral purpose" test that had developed in English law. The "collateral purpose" test (also known as the "proper purpose test") takes the perspective that power is conferred on directors for a particular purpose (e.g. the power to issue shares to raise capital), and that if directors exercise those powers for any other purpose, it would result in an abuse of power. The doctrine is often applied in circumstances where directors issue shares in order to effect a change of control of the corporation. The other approach is to allow the directors to exercise their power for any purpose they deem appropriate, so long as they are taking into account the best interests of the corporation. Canadian courts have found it difficult to give up the proper purpose test entirely, particularly in the context of a change of control. The case law in this area is therefore somewhat uneven.

C. How Did the Concept of Fiduciary Duty Develop and Apply to Directors of Business Corporations?

The characterization of a director as a fiduciary under Canadian law was adopted and further developed from 19th and early 20th century English case law.

Directors have been variously categorized as the agents of the corporation, trustees of the assets of the corporation, quasi trustees of the capital of the company and "managing agents". While the nature of the relationship between directors and the corporation they serve is similar to these other types of fiduciary relationships, as the House of Lords noted in *Regal (Hastings) Ltd. v. Gulliver*, “…directors of a limited company are the creatures of statute and occupy a position peculiar to themselves.” For example, directors resemble trustees in that they are prohibited from appropriating opportunities which they learned of through their relationship with the corporation (the trust, in the case of a trustee). However, directors are not subject to the same duty of care as trustees. Although the law does not generally require of a trustee, a higher degree of diligence in discharging the duties of a trustee than that person would exercise in the management of his or her private affairs, the trustee will likely not have the same degree of discretion to take risks with the assets of the trust as he or she would have in dealing with his or her own assets. Directors are not subject to the same restrictions. Managing a business involves risk, and it is the directors (and management to whom they delegate authority) who decide how much risk is appropriate for the business over which they have oversight.

D. To Whom Is These Fiduciary Duties Owed?

Directors of Canadian corporations have a fiduciary duty to the corporation they serve. Their relationship to shareholders, creditors and other stakeholders is discussed below.

(i) Duty to Shareholders

Rather than referring to the duty of directors to the corporation, Canadian courts have sometimes referred to a duty to shareholders “taken as a whole”. This reflects the presumption that the objective for every corporation is to enhance shareholder value and that best interests of the corporation are therefore aligned with enhanced shareholder value. Canadian courts have not
found that any duty to shareholders “taken as a whole” is distinct from the duty to the corporation. Canadian courts have found that the directors owe no duty to individual shareholders or groups of shareholders.

(ii) Duty to Creditors

Whether directors owe a duty to creditors of the corporations remains an unsettled question in Canada. Courts in other jurisdictions, including the United States and Australia, have dealt with this issue extensively and have found that, in some cases, the directors owe a fiduciary duty to the creditors. While the courts in Canada have considered applying the same reasoning, they have clearly had some difficulty in doing so. This may be in large part because of the differences between the law in Canada and the law in other jurisdictions, including the fact that the oppression remedy (discussed below) is available to creditors in Canada. There have been several lower court decisions referring to the existence of a duty to creditors. One of those decisions had been overturned on appeal, with statement by the court that there is no basis for finding that such a duty exists in Canada. However, there are several significant actions currently working their way through the system that will give the courts an opportunity to consider this issue again. Most significantly, the Supreme Court of Canada is expected to hear the appeal in the Peoples decision late in 2004. This decision may lead to the law on directors’ duties to creditors being finally settled in Canada.

(iii) Duty to Other Stakeholders

There has been very little said by Canadian legislators or courts about whether directors may take into account the interests various stakeholders of the corporation (such as employees or creditors). Canadian corporate statutes do not include any of the "constituency provisions" that appear in many U.S. state corporate statutes. The only Canadian decision that really dealt with whether directors may have regard to the interests of other stakeholders was a lower court decision in British Columbia that is now almost 30 years old. In that decision, the court noted that “…if [the directors] observe a decent respect for other interests beyond those of the company’s shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.”

E. How does the fiduciary duty manifest itself?

A director’s fiduciary duty to the corporation manifests itself in a number of ways. The most significant are discussed below.

(i) Nominee Directors

In Canada, the vast majority of the corporations listed on the Toronto Stock Exchange have controlling shareholders, who have sufficient voting power to determine who the directors will be. Canadian courts have been very clear that directors may not prefer the interests of their nominee to the interests of the corporation itself. In one decision, an Ontario court noted: “It may well be that the corporate life a nominee director who votes against the interest of his “appointing” shareholder will be neither happy not long. However, the role that any director must play (whether or not a nominee director) is that he must act in the best interests of the corporation.”
(ii) **Conflict of Interest**

Conflict of interest is one of the most significant issues for directors as fiduciaries. It is important for there to be clear boundaries that a director may not cross, since it will very difficult for others to know whether a director’s actions were motivated out of regard for the interests of the corporation or out of self interest. Accordingly, the law dealing with director conflicts encompasses potential as well as actual conflicts.

A directors’ fiduciary duty prohibits him or her from having any interest in a contract or transaction to which the corporation is a party. The common law principle is articulated in the leading English case of *Aberdeen Railway v. Blaikie Brothers*:

…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 will conflict with the interests of those whom he is bound to protect.2

At common law, the consequences of a director having any personal interest in a contract with the corporation are significant. The corporation has the right to void the agreement, whether or not the director has actually profited from it. If the director has made any profit, the corporation could seek relief from the courts to have such profits paid over to it. These rights may be enforced by the corporation directly or by certain other stakeholders pursuant to a derivative action or an oppression remedy (discussed below).

Canadian corporate statutes have recognized that an absolute prohibition against a corporation doing any business with a director or an entity with which the director has an interest is impractical, and in some instances, perhaps even detrimental to a corporation. An absolute restriction would preclude the corporation from doing business with key customers, suppliers and service providers (or from having individuals connected with customers, suppliers or service providers serving on the board). In addition, such a restriction would drive away a potential pool of applicants whose very usefulness to the board (i.e., expertise in the business) would prohibit them from acting on the board. To address these issues, most of the Canadian corporate statutes provide a procedure for the director to follow which will allow the corporation to enter into contracts in which the director has an interest without any of the negative consequences which the courts historically imposed, provided that the deal is fair to the corporation.

In most cases, procedure for dealing with a conflict of interest situation requires the director to give written notice of the conflict and to abstain from voting in most circumstances. Even if these requirements are satisfied, the contract or transaction must also be fair and reasonable to the corporation at the time it was approved. Under certain statutes it is possible to "cleanse" the transaction by having the shareholders ratify it by special resolution. The shareholders must have received appropriate disclosure and the contract must still be fair and reasonable to the corporation.
(iii) Appropriation of Corporate Opportunity

A director's fiduciary duty also precludes him or her from appropriating from the corporation a business opportunity which the director learned of through his or her relationship with the corporation. For example, if the corporation is considering an investment in a particular business, a director may not use the knowledge of that opportunity acquired as a result of his or her relationship with the corporation to take that opportunity away from the corporation and make the investment on his or her behalf. Scenarios where appropriation of corporate opportunities arise include soliciting customers and employees upon termination of employment from the corporation, the acquisition of assets, the use of corporate assets, bidding on a contract in which the corporation had an interest and soliciting suppliers of the corporation.

The concept of "appropriation of corporate opportunity" developed from 19th century trust law, which established a standard of unimpeachable conduct on the part of a trustee dealing with trust assets. There is no bright line test for when an idea has become a corporate opportunity. Some courts have extended the protection to opportunities which they have referred to as having advanced or "ripened". Other courts have referred to a "maturing business opportunity, which the corporation is actively pursuing".

Unlike conflicts of interest where corporate statutes have provided a framework whereby a director can avoid liability if the conflict is properly disclosed, if the director does not vote and if the arrangement is fair to the corporation, there is no such statutory scheme to avoid liability for corporate opportunity in Canadian law. Typically, Canadian courts will order a fiduciary to "account for" (i.e., pay over to) the corporation all profits realized as a result of the appropriated corporate opportunity.

(iv) Duty of Confidentiality and Duty to Disclose

Directors owe a duty to the corporation to protect information about the corporation which is confidential or proprietary to the corporation. Canadian courts have also held that there are circumstances where directors may be under an obligation to disclose information to the corporation, which the director has by virtue of another relationship. There is no requirement that directors must share everything they know with the corporation. However, if the information affects the corporation in a "vital aspect of its business", the courts have found there to be a duty to disclose. There are no bright line tests in this area that will tell a director definitively that certain information goes to the corporation's vital interests and must therefore be disclosed to the corporation. As in many matters relating to the discharge of a director's fiduciary duties, it is a question of judgment.

F. Other Points of Interest

(a) Oppression Remedy

In Canada, certain of the corporation's stakeholders can take action against the directors (and against officers and the corporation itself) under the oppression remedy. Under the provisions of the corporate statutes, if a court finds that the powers of the directors of a corporation or any of its affiliates are or have been exercised in a manner that is "oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor,
director or officer", the court may make any order it thinks fit to rectify the situation. The breadth of the remedy allows the court to grant a wide range of relief.

In order to commence an action to seek the oppression remedy, an individual must fall under the definition of "complainant". Courts have consistently found shareholders to fall within this definition, and several courts have also found the term to extend to creditors. Generally, two factors must be present in order for the directors to be held personally liable. First, there must be some specific action or inaction on the part of the director that is directly linked to the oppressive conduct. Second, it must be appropriate for the directors to personally compensate the aggrieved party. This may be the case, for example, where directors personally benefited or furthered their control over the company through the oppressive conduct. If a director has virtually total control over the corporation (as is often the case in a private company, the shares of which are held by one person, who also acts as sole director), that director may also be held personally liable to rectify oppressive conduct on the part of the corporation.

(b) The Business Judgment Rule

The courts in Canada will generally not substitute their own business judgment for that of the directors of a corporation, as long as the directors acted in a manner consistent with their fiduciary duty and duty of care in reaching their decision. This is commonly referred to as the "business judgment rule" and serves to protect the decisions of directors from judicial second-guessing, provided such business decisions were made honestly, prudently, in good faith and on reasonable grounds. As long as such parameters are adhered to, a Court will not subject a board's decisions to "microscopic examination and the court will be reluctant to interfere and usurp the board of directors' function in managing the corporation".

The Canadian business judgement rule is different from the business judgement rule that has developed by the U.S. courts. In the United States, there is a presumption that directors' decisions have been made on an informed basis, in good faith and with the honest belief that the action taken was in the best interests of the company. To overcome this presumption, a plaintiff must show not only that the director failed to exercise his or her duty of care, but that the director was "grossly negligent" in failing to do so. In other words, the onus is on the plaintiffs to rebut the presumption that the directors acted properly. This is different from the approach taken by Canadian courts, which do not assume that the directors behaved appropriately, but instead review the processes followed by the directors in reaching their decision to determine whether those processes were in fact appropriate.
1. What does Fiduciary mean?

1.1 General fiduciary duties in Australia

A fiduciary relationship in Australian law may be described as one in which there is a special element of trust and confidence between the parties. Generally, the 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. 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 essential characteristic of a fiduciary relationship is "that the fiduciary undertakes or agrees to act for or on behalf of or in the interest of another person..." (Mason J in Hospital Products Ltd v United States Surgical Corporation (1984) 156 CLR 41 at 96-97).

Generally, Australian courts are unwilling to prescribe general principles or indicia of the fiduciary relationship, preferring to examine each case on its facts. Therefore in Australian law, the concept of fiduciary is generally understood through case law and through an understanding that equity seeks to provide redress where it is warranted in the circumstances.

The accepted fiduciary relationships are sometimes referred to as relationships of trust and confidence (Phipps v Boardman [1967] 2 AC 46 at 127) and include trustee and beneficiary, agent and principal, solicitor and client, employee and employer, director and company and business partners. The critical feature of these relationships is that the fiduciary undertakes or agrees to act for or on behalf of, or in the interests of, another person in the exercise of a power or discretion which will affect the interests of that other person in a legal or practical sense. The relationship between the parties is therefore one which gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that

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1 With assistance from Kristie Brown, Peter Long and Amanda James
other person who is accordingly vulnerable to abuse by the fiduciary of his position.

It is partly because the fiduciary’s exercise of the power or discretion can adversely affect the interests of the person to whom the duty is owed and because the latter is at the mercy of the former that the fiduciary comes under a duty to exercise his power or discretion in the interests of the person to whom it is owed.

1.2 Fiduciary duties and directors

A director of a company in Australia is in a fiduciary relationship with that company. Therefore, directors must act honestly in good faith and to the best of their ability in the interests of the company.

The general law in Australia requires that directors at least:

• take reasonable steps to place themselves in a position to guide and monitor the management of the company;

• acquire a working knowledge of the fundamentals of the business of the company, lack of knowledge is no defence;

• keep informed about the activities of the company and assess whether the business practices of management are safe and proper;

• generally monitor corporate affairs and policies, though a detailed inspection of day to day activities need not be undertaken;

• be able to read and understand the company’s accounts and maintain familiarity with the financial status of the company by regularly reviewing the financial statements; and

• make enquiry into matters revealed by the financial statements which call for enquiry.

1.3 Statutory and regulatory innovation

(a) Corporations Act 2001 (Cth) (the Act)

The general law duties of a director in Australia to exercise care and diligence are codified in the Act. Recently, amendments to the director’s duty of care and diligence in the Act have also been introduced by the Corporate Law Economic Reform Program (CLERP) Act 1999.
Section 180(1) of the Act provides that a director must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

(i) were a director of a corporation in the corporation's circumstances; and

(ii) occupied the office held by, and had the same responsibilities within the corporation as, the director.

In the past, Australian courts have also considered the actual knowledge and experience of the director.

It seems that the standard of care for a particular director could increase where a person is appointed to the board because of particular skills (Vrisakis v ASC (1993) 11 ACLC 763). However, it is doubtful that the standard can be adjusted downwards where a director lacks skill and experience. Reducing the standard of care in this way would be inconsistent with recent recognition that directors must fulfil a minimum role.

In AWA Limited v Daniels (1992) 7 ACSR 759 Rogers J indicated that a lower standard of care was imposed by section 180 upon non-executive directors than upon executive directors. Doubt was cast on this notion by the Court of Appeal and it became unclear whether it was appropriate to distinguish between the nature of the duty owed by non-executive directors and that owed by executive directors. Despite this, it should be noted that whilst some subjective consideration of the role played by the non-executive director may be required, all directors are subject to a common law duty of care and can be held liable as tortfeasors in negligence.

Although section 180 does not expressly distinguish the respective positions of executive and non-executive directors, reference to "the office held by" and "same responsibilities within the corporation" ought to permit the recognition of the different roles played by non-executive directors as distinct from executive directors.

(b) Business Judgment Rule

The CLERP Act introduced a statutory business judgment rule. Under section 180(2) a director will be taken to have met the requirements of the duty of care and diligence in subsection 180(1) and the equivalent duty at common law or in equity in respect of a business judgment made by them if they fulfil the following requirements:
• the business judgment was made in good faith for a proper purpose;
• the director did not have a material personal interest in the subject matter of the business judgment;
• the director informed themselves about the subject matter of the business judgment to the extent they reasonably believed to be appropriate; and
• the director rationally believed that the business judgment was in the best interests of the corporation.

The section presumes that a director's belief that the judgment is in the best interests of the corporation is a rational one unless no reasonable person in the position of the director could hold that belief.

The explanatory memorandum to the CLERP Bill states that the business judgment rule provides a clear presumption in favour of the director's judgement. However, the onus appears to remain on directors to establish at least the first 3 elements of the rule.

The rule relates only to a director's duty of care and diligence. It does not apply to a director's duty to act in good faith and for a proper purpose. Nor does it affect the insolvent trading duties placed on directors, misleading or deceptive conduct or other specific areas of liability.

Finally, the rule is restricted to "any decision to take or not take action in respect of a matter relevant to the operations of the corporation". Thus a significant range of conduct, such as decisions relating to takeover or prospectus documents, appears to fall outside the protection of the rule. As the rule requires a decision, it also appears that conduct such as failure to monitor or review the conduct of delegates will not be protected by the rule.

2. How did the concept of fiduciary duty develop and apply to directors of business corporations?

2.1 Formulation of the duty in Australian law

The first formulation of a directors fiduciary obligations in Australian law was set out by Dixon J in Mills v Mills (1938) 60 CLR 150 at 188. He said:

"Directors of a company are fiduciary agents, and a power conferred upon them cannot be exercised in order to obtain some private advantage or for any purpose foreign to the power. It is only one aspect of the general doctrine expressed by Lord Northington in Aleyan v Belchier (1758) 1 Eden
132 at 138. "No point is better established than that, a person having a power, must execute it bona fide for the end designed, otherwise it is corrupt and void."

2.2 Specific development of directors fiduciary duty

As discussed, fiduciary relationships exist between persons who stand in such a position of trust and power over another that the law requires the former to act in the latter's best interests. Accordingly, directors are considered to stand in a fiduciary relationship with their company and are subject to the duties that stem from that relationship: *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134. These duties require directors:

- to act bona fide in the company's best interests;
- not to fetter their discretion;
- to exercise their powers for their proper purpose; and
- to avoid conflicts of interest.

*Duty to act honestly and in the best interest of the company*

Directors must do what they honestly believe to be in the company's best interest. The courts have held that it is for the directors to determine what is in the company's best interests and the courts cannot substitute their own view, formulated with the benefit of hindsight: *Re Smith v Fawcett Ltd* (1942) Ch 304 at 306. However, the law has inserted a degree of objectivity into this prima facie subjective test.

The test is whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company. *Charterbridge Corp Ltd v Lloyds Bank Ltd* (1970) 1 Ch 62 at 74 per Pennycuick J.

Directors must act in good faith for the benefit of the company as a whole and not for a collateral purpose. In order to carry out the duty to act honestly or in good faith under the general law (*Chew v R* (1991) 4 WAR 21), directors must:

(a) exercise their powers in the interests of the company and they must not misuse or abuse their powers;

(b) avoid conflict between their personal interests and those of the company;

(c) not take advantage of their position to make secret profits; and
(d) not misappropriate the company’s assets for themselves.

**Duty not to fetter their discretion**

As directors are bound to act for the company, their decision-making authority cannot be limited to accommodate another's interests. This means that directors cannot agree to exercise their discretion in a particular matter (*Davidson v Smith* [1989] 15 ACLR 732). Any contract or resolution purporting to fetter a director’s discretion in this way will be ineffective.

**Duty to exercise their powers for their proper purpose**

The duty of good faith of a director arises at general law and is also reflected in section 181 of the Act. This section requires officers to exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose.

In examining the conduct of directors the Privy Council observed in *Howard Smith Limited v Ampol Petroleum Limited* [1974] AC 821 at 835 that:

> "[the court] will necessarily give credit to the bona fide opinion of the directors, if such is found to exist, and will respect their judgment as to matters of management; having done this, the ultimate conclusion has to be as to the side of a fairly broad line on which the case falls."

In other words it is unlikely that a court would find that a director has breached their duty of good faith if the director has done what they believed to be right for the company.

**Proper purpose**

As directors of a company are fiduciary agents the powers given to directors may only be exercised for the purposes for which they are given. In particular, those powers may not be exercised in order for the directors to obtain a private advantage.

Australian courts have held that whether a particular act by directors, as fiduciaries, is an exercise of their power in good faith for the benefit of the company as a whole should be determined by ascertaining the substantial motivating purpose for which the power is exercised. It should then be determined whether that purpose is proper or not. If that purpose is proper, the fact that other consequences eventuate will not render the exercise of power improper.
In general terms, the courts may judge the primary purpose as the motive "but for" which a particular action would not have been taken (Whitehouse v Carlton Hotel Pty Ltd (1987) 162 CLR 285).

Many of the prominent cases within the Australian jurisdiction where the propriety of exercise of powers has been called in question have related to contests for corporate control of public companies. For example, an allotment of shares may be set aside if it is made with a view to destroying an existing majority, preventing them from taking over the company, while enabling another party to do so (Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821; Southern Resources Limited v Residues Treatment and Trading Co Limited (1990) 56 SASR 455). However, an allotment might be permitted in order to secure the financial support of a larger company which was expedient for the company's business, even if as a (welcome) consequence a takeover would be thwarted (Harlowe's Nominees Pty Ltd v Woodside Oil Co NL (1968) 121 CLR 483).

In the case of proprietary companies the courts have similarly invalidated allotments of shares made to deprive shareholders, who would otherwise be a voting or economic majority, of the effective enjoyment of their rights (Whitehouse v Carlton Hotel Pty Limited (1987) 162 CLR 285).

Particular care must be exercised in the case of contested elections for directors. Directors are not entitled to spend an unreasonable sum of the company's funds, or to spend anything on questions only of personality as distinct from policy (Advance Bank Australia Ltd v FAI Insurances Ltd (1987) 9 NSWLR 464).

**Duty to avoid conflicts of interest**

Under both the common law and the Corporations Act, directors are bound to avoid any conflict between their personal interests and those of the company. This duty extends to avoiding being placed in a position where such a conflict is even possible. (Hospital Products Ltd v United States Surgical Corp (1984) 156 CLR 41 at 103).

The duty prevents directors from:

(a) contracting with the company without making full and proper disclosure of their interest in the contract; and

(b) making "secret profits" through the director's position in the company.

**Contracting with the company**

The courts have declared that "a director of a company is precluded from dealing, on behalf of the company, with himself, and from entering into engagements in
which he has a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound by fiduciary duty to protect." (North-West Transportation Co Ltd v Beatty (1887) 12 App Cas 589.

At common law, directors directly or indirectly interested in a contract with the company must disclose to the general meeting the nature of their interest and the extent to which they stand to profit from the contract, (Gray v New Auguarita Porcupine Mines Ltd (1952) 3 DLR 1). Disclosure to the board alone is ineffective.

If the contract is not ratified, it is voidable at the company's option (AM Spicer & Son Pty Ltd (in liq) v Spicer (1931) 47 CLR 151 at 175. Any moneys or property received by the directors under such a voidable transaction are held on constructive trust for the company. (Paul A Davies (Aust) Pty Ltd v Davies (1983) 8 ACLR 1.

In Payne v The Adelaide Steamship Co ltd (1988) 6 ACLC 1, 175, two directors sold their shares to a potential bidder. Under the contract of sale, the directors agreed to "do all that was proper" to impress upon the shareholders their belief that the proposed takeover offer was adequate. The directors made full disclosure of this agreement. It was held that the directors had not breached their fiduciary duties, the Court commenting that, had a better offer been made by a third party, the clause would not have required the directors to lobby on behalf of the buyer of their shares, since that would no longer have been "proper".

**Use of position for personal profit**

As a result of the director's fiduciary relationship, any profits they receive as a result of their position in the company, are regarded as belonging to the company. Under both the common law and the Act, directors are prohibited from using company property, company information, corporate opportunities or their positions in the company or inside information for personal profit.

Under the strict approach (Regal (Hastings) Ltd v Gulliver (1967) 2 AC 14), directors may breach this duty even though:

- the directors were acting bona fide;
- the company suffered no corresponding loss;
- the transaction benefited the company; or
- the company was unable to make the profit itself.

However, this strict approach has been significantly weakened in two leading cases. These cases suggest that a director may usurp a corporate opportunity
where the company has rejected the proposal and the director is approached in a private capacity (Peso Silver Mines v Cropper (1966) 58 DLR (2d) 1) or the company has acquiesced in the usurpation (Queensland Mines Ltd v Hudson (1978) 18 ALR 1). Accordingly the courts have suggested that opportunities adopted outside the fiduciary relationship will not amount to a breach of the directors' duties.

3. **To whom are these fiduciary duties owed?**

Traditional categories of fiduciary relationships are well defined. Such fiduciary relationships were set out by Justice Mason in Hospital Products Limited v United States Surgical Corporation (1984) 156 CLR 41, and include:

- partners;
- agent and principals;
- employers and employees;
- companies and directors; and
- solicitors and clients.

Other generally accepted fiduciary relationships include:

- trustees and beneficiaries;
- promoter and company;
- banker and customer;
- receivers in bankruptcy and creditors; and
- liquidators and contributors.

Fiduciary relationships are rare in commercial transactions and generally only arise where one party is the representative of the other, for example, joint venturers. The High Court in the leading case on fiduciary relationships, Hospital Products Ltd v United States Surgical Corp (1984) 156 CLR 41, confirmed this reluctance to impose fiduciary obligations between commercial parties.

**The Company**

In Australian law directors' duties are owed to the company however, in discharging those duties, the director should have regard to the interests of creditors, employees and others with whom the company deals. This will lead them to indirectly benefit the company.
However, when a director is facing a conflict of interest, it is clear that the duties are owed to the company and not to the parties with whom the company deals, such as creditors and employees.

**Individual members**

*Percival v Wright* (1902) 2 Ch 421 is often cited as authority for the proposition that directors do not owe their fiduciary duties to individual members. In this case, the court held that the directors owed no duty of disclosure to a shareholder, who was selling his shares in the company, since directors are not in a fiduciary relationship with individual shareholders.

In the recent case of *Charlton v Barber and Others* 47 ACSR 31 (15 August 2003) the Supreme Court of NSW (Equity Division) confirmed that fiduciary duties with identical content can not be owed by directors both to the company and to one or more shareholders. Fiduciary duties owed to shareholders are limited and may only exist where they would not compete with a duty owed to the company. The Court held that:

"The company remains the beneficiary of the comprehensive fiduciary duties to which directors are subject by virtue of their office; and parallel duties in corresponding form are not owed to any shareholder, although particular circumstances may give rise to a particular duty owed by a particular director to a particular shareholder or particular shareholders".

Any such duty must be determined on a case by case basis and is limited to situations where such a fiduciary duty is deemed necessary to negate the effect of a director unconscionably taking advantage of their superior position as against the shareholder or shareholders.

An example of where such a fiduciary duty has been held to exist is in the case of *Galvanics v Brunninghausen* (1996) 19 ACSR 204. In this case the Court of Appeal od New South Wales determined that the existence of a fiduciary obligation to a shareholder includes:

- that shareholders dependence upon information and advice;
- the existence of a relationship of confidence;
- the significance of some particular transaction for the parties; and
- the extent of any positive action taken by, or on behalf of, the directors to promote the transaction and the structure of shareholdings in the company.

The reasoning in *Charlton v Barber and Others* was followed in the case of *Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd & Ors* [2003] QSC 402,
even in circumstances where the relevant company, established as a joint venture, held its assets on trust for the joint venturers.

4. **How does the fiduciary duty manifest itself**

   In recent times in Australia, corporate governance and directors' duties have come under much public scrutiny. An example of such an event has been the collapse of the HIH Insurance Group. On 15 March 2001 provisional liquidators were appointed to the HIH Insurance Group. The estimated $3.6 to $5.3 billion collapse of HIH is reported to be the largest corporate failure in Australian history. The Federal Government appointed the Hon Justice Neville Owens in August 2001 to investigate the failure of HIH. On 17 April 2003, the Federal Government released a report of the HIH Royal Commission.

   The HIH Report criticises directors and executives for failing to act ethically, to give full disclosure both internally and to the market, to take personal responsibility for the standard of corporate decisions, to act independently and to tell the truth.

   The Report of the Royal Commission has provided Australian directors, and other persons who owe fiduciary duties, many lessons in current practices and corporate governance. Specifically, those who are involved in the running of companies, and their advisers, will be required to follow the following practices:

   1. implement adequate procedures for identifying and, if necessary, resolving conflicts of interest;

   2. need for the chairperson to act independently from senior executives;

   3. importance for the board not to solely or unquestionably rely on the information provided to it by management;

   4. importance of the role of an effective and independent nomination committee;

   5. proper and independent analysis by the board of all decisions or significant proposals.

**BLAKE DAWSON WALDRON, AUSTRALIA**

20 January 2004
FIDUCIARY DUTIES
OF DIRECTORS
IN HONG KONG

GOODMANS
HONG KONG
JANUARY, 2004

Goodmans
11th Floor
9 Queen’s Road Central
Hong Kong
lseewald@goodmans.ca
A. What does fiduciary duty mean?

The history of fiduciary duties of directors in Hong Kong can, not surprisingly, be traced back to the English common law. As espoused by Lord Greene MR in *Re Smith & Fawcett Ltd.*, directors’ duties can be conveniently expressed as falling into three categories:

(i) to act honestly, bona fide for the benefit of the company;
(ii) to exercise their powers for a proper purpose; and
(iii) to avoid any conflict of interest.

These three categories of duties continue to form the basis of fiduciary duty in Hong Kong, however, subsequent case law, both in Hong Kong and in other commonwealth jurisdictions have lead to refinements in the concept of fiduciary duty. Likewise, various statues in Hong Kong have also incorporated aspects of these duties. In particular, the Hong Kong Companies Ordinance, Cap 32, (the “Ordinance”) and the Hong Kong Securities and Futures Ordinance, Cap 571, (the “SFO”) both place duties on directors that enhance a director’s existing common law fiduciary duty. This paper examines the development of these duties on Hong Kong directors.

B. How did the concept of fiduciary duty develop and apply to directors of business corporations?

Although these three duties were first set out in the *Re Smith & Fawcett* case, their subsequent treatment should considered separately.

(i) **Bona Fide for the Benefit of the Company**

This duty can be considered as the broadest expression of a director’s fiduciary duty which overlaps with the other two categories. As noted in Gore-Browne, the duty of honesty and good faith in the exercise of a director’s powers is in fact the primary fiduciary duty of a director. Furthermore, this duty to act bona fide for the benefit of the company is a subjective duty. In other words, directors are required to act for what they think, and not what the court thinks, are the benefits of the company. Therefore, there is no breach where the directors act for what they honestly believe to be the benefit of the company.

Whether a director is acting honestly and bona fide are questions of fact. However, whether the director’s actions are for the benefit of the company is a more problematic issue.

The first problem revolves around the question of what constitutes an action that is “for the benefit” of the company. In *Re Smith & Fawcett*, Lord Greene MR held that directors’ acts

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1. [1942] Ch. 304, at 306.
2. *Re Smith & Fawcett Ltd.*, supra at note 1
need to be bona fide “in the interests” of the company. However, subsequent decisions have referred to the need to act bona fide “in the best interests” of the company.

In _Lee Tak Samuel v. Chou Wen Hsien et al._, the Privy Council heard an appeal from a decision of the Hong Kong Court of Appeal where directors were expelled from the board. Commenting on the exercise of the directors’ powers, Lord Brightman held that each director must “act in accordance with what he believes to be the best interests of the company.” (author’s emphasis). It is often argued that Lord Brightman’s decision imports this higher standard on directors in that they must always make the best possible decisions for the company. However, given the purely subjective standard, it may not matter whether “interests” or “best interests” is the correct yardstick.

(ii) Proper Purpose

Having a fiduciary duty to act bona fide for the benefit of the company’s directors must also which exercise their powers for proper purposes. In Lord Greene MR’s judgment in _Re Smith Fawcett Ltd._, he stated that directors’ powers must not be exercised for any “collateral purpose”.

As a result, even if a director is acting bona fide for the benefit of the company, he may still be in breach of his fiduciary duty to the company if he is acting for an improper purpose.

The onus for establishing that directors exercised their powers for improper purposes rests with he who alleges this breach of duty, and courts are generally reluctant to interfere in the internal management of a company unless improper purposes are clearly demonstrated.

As noted in Arjunan, most cases involving allegations of directors acting for improper purposes have concerned the issuance of shares. Perhaps the most-oft cited case dealing with this issue is _Hogg v. Cramphorn Ltd._.

In _Hogg v. Cramphorn_, the court considered a challenge to a directors’ allotment of shares to prevent a takeover. Despite the court’s finding that directors acted bona fide, the court overturned the share allotment as it held that the directors’ power to allot shares was not exercised for a valid purpose for which they were given the power, namely to raise capital.

However, this approach was not followed by the British Columbia Supreme Court in _Teck_. In this case, the directors issued shares to manipulate voting power. Finding that the directors acted bona fide for the benefit of the company, Berger J validated the issuance.

In effect, Berger J had effectively reduced the test of whether a director breached his fiduciary duty to a simple one of whether he acted bona fide for the benefit of the company.

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7 _Re Smith & Fawcett_, supra note 1.
8 _Australian Metropolitan Life Assurance Co. Ltd. v. Ure_ (1923) 33 CLR 199.
9 _Arjunan & C.K. Low, Lipton & Herzberg’s Understanding Company Law in Hong Kong_ (Sydney: LBC Information Services, c.1996), at 199 (“Arjunan”).
10 [1967] Ch. 254.
The Privy Council revisited this issue a year later in *Howard Smith*12. Similar to *Teck*, directors issued shares to overcome the majority shareholders’ rejection of a takeover bid. Considering this “proper issue” test, Lord Wilberforce rejected Berger J’s approach in *Teck* and held that the court must determine whether the directors acted for an objectively proper or improper purpose.

Similarly, in *Howard Smith*, Lord Wilberforce affirmed that where the directors are motivated by more than one purpose, regard is to be had to their “primary” or “substantial purpose” in determining whether the court will intervene. This has been confirmed in Hong Kong in *SCIC Ltd. et al. v. Tomei International (Holdings) Ltd. et al.*13 where Rogers J held that “it is settled law that if the primary or substantial purpose of a rights issue is for an improper motive or to benefit one of more directors, then the rights issue may be set aside.”

Directors should therefore be mindful of exercising any of the powers vested in them by the company for any purposes other than those for they were conferred the powers.

(iii) Conflict of Interests

The classic statement that directors are in general bound by the broad principle, affecting all persons who are subject to fiduciary duties, 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” was made by the House of Lords in *Aberdeen Railway*14. The duty to avoid a conflict of interest is strictly applied; this duty is breached whether or not the directors had fraudulent motives.

In *Bray v. Ford*15, Lord Herschell explained that this rule is “founded on principles of morality…[and] based on the consideration that, human nature being what it is, there is danger…of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect…. But [he was] satisfied that it might be departed from in many cases, without any breach of morality, without any wrong being inflicted and without consciousness of wrong-doing.”

This strict fiduciary duty is applicable to a wide range of circumstances where a director has placed himself in a position where he puts or may have put his own interests ahead of those of the company. As noted by Lord Upjohn in *Boardman*16, “[r]ules of equity have to be applied in such a diversity of circumstances that they can be stated only in the most general terms and applied with particular attention to the exact circumstances of each case.”

At common law, there is a general prohibition against directors being allowed to contract with the company, either directly or indirectly. A director who contracts personally with the company has a direct interest whereas an indirect interest comes about when the director is a director or shareholder of another company which contracts with the company17.

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14 *Aberdeen Railway Co. v. Blaikie Bros.* (1854) 1 Macq. 461 (“*Aberdeen Railway*”).
15 [1896] AC 44.
16 *Boardman v. Phipps* [1967] 2 AC 46 (“*Boardman*”).
17 Arjunan, supra note 9, at 233.
This duty is applied strictly because of the principle that directors should obtain the best agreement for the company and not be seen to put themselves in a position where they may further their own interests. This is clearly illustrated in the court’s decision in *Transvaal Lands*.

In *Transvaal Lands*, the court applied the rule in *Aberdeen Railways* strictly to a director who had a conflict of duty but not necessarily a conflict of interest. The director of the company held shares of NB as trustee. The company purchased shares of NB without knowledge of the director’s interests. Notwithstanding that the director had no beneficial interests in the NB shares he held as trustee (though it appears that his wife had a 10% interest in them, but this fact did not seem to factor in the court’s decision), Swinfen Eady LJ held that “…it is immaterial whether this conflict interest belongs to him beneficially or as a trustee for others. He is bound to do as well for his *cestuis que trust* as he would do for himself.”

However, the court in *Transvaal Lands* did leave open the possibility that this strict rule against directors contracting with the company may be modified by the articles of the company. The effect of an article authorizing a director to have an interest in a contract with the company was considered in *Re Automotive & General Industries Ltd.* and approved of, notwithstanding that the contracts made with directors gave rise to conflicts of interests.

The strictness of the *Aberdeen Railways* rule is further mollified by the fact that the duty is breached only if the directors have a material interests in the contract with the company. This is statutorily recognized by s.162(1) of the Ordinance. Furthermore, the interest of the director must be certain and enforceable rather than merely a prospect.

As discussed, directors have both common law and statutory duties to disclose to the board their interests in any contract with the company. However, directors must be aware that such disclosure, while relieving them of a breach of their duties under s.162 of the Ordinance, does not serve to validate the contract. If the director’s interests in the contract would amount to a conflict of interest, the common law principles still apply and the contract may be voidable at the request of the members of the company unless the articles had so provided for directors to contract with the company notwithstanding any potential conflicts of interests, or if there is specific approval by the shareholders of the contract.

However, there are certain types of contracts for which the general authorization provided in the articles will not suffice to satisfy all of the director’s obligations.

For management contracts between the company and any director or a company in which a director is interested, s.162A of the Ordinance imposes an obligation on the director to include a statement detailing such contract in the annual directors’ report. Failure to comply may result in a fine of HK$5,000 and a daily default fine of HK$200 for continuing default.

Similarly, prior company approval based upon full disclosure to the members of the company is required by s.163 of the Ordinance before any payment may be made to a director or past director where such payment is made as compensation for loss of office or as consideration.

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18 *Transvaal Lands Co. v. New Belgium (Transvaal) Land & Development Co.* [1914] 2 Ch. 488.
for retirement from office. Sections 163A and B impose similar approval requirements for payment in connection with transfer of company property and of shares in the company respectively, to a director or past director for loss of office.

However, under s.163D, a bona fide payment to a director by way of damages for breach of contract (or a pension or similar payment) does not require the sanction of the company.

Specific examples of conflict of interest emerge in the following circumstances:

(a) Corporate Opportunities

As noted in Halsbury HK\textsuperscript{21}, a director is under a duty to account to the company for, among other things, all profits which he has acquired by reason and in the course of acting as director of the company or by the use of opportunities or knowledge gained by him while acting as such director.

This flows from the rule of equity first espoused by the House of Lords in Regal (Hastings)\textsuperscript{22} where Viscount Sankey\textsuperscript{23} laid down the general rule that no one who had duties of a fiduciary nature to perform was allowed to enter into engagements in which he had or could have had a personal interest which conflicted with the interests of those of whom he was to protect. The House of Lords further affirmed that this equitable rule is strict and absolute and does not depend on fraud or absence of bona fides or whether the profits would or could otherwise have accrued to the company or whether the company suffers any damage or obtains a benefit as a result of the director’s actions.

Furthermore, in Boardman\textsuperscript{24}, a trust case, despite a finding of good faith and honesty by the defendant trustee as well as the fact that the trust had no legal capacity to engage in the project in question, the House of Lords nevertheless held the defendant liable. The reasoning was that the trustee used his position of authority to gain information or knowledge, which he then turned to his own use to make profit. The House of Lords noted that it was irrelevant that neither the trust nor its beneficiaries suffered any damage. The basis for liability was that the trustee gained an unjust benefit by use of his position and must account for it.

This equitable rule that liability of the director flows regardless of damages to the company has been explicitly adopted in Hong Kong. In Kishimoto\textsuperscript{25}, the Court of Appeal applied both Regal (Hastings) and Boardman in the course of its judgement.

In Canaero\textsuperscript{26}, the juridical basis for relief was that equity would not allow a fiduciary to profit from his own wrong. This unjust enrichment basis was prevalent also in Regal (Hastings). Though Canaero was distinguished in Kishimoto, this was not because of a more lenient standard in Hong Kong. Instead, Canaero was distinguished on the basis that there


\textsuperscript{22} Regal (Hastings) Ltd. v. Gulliver (1942) [1967] 2 AC 134n, [1942] 1 All ER 378 (“Regal (Hastings)”).

\textsuperscript{23} Ibid., 2 AC 134n, at 137g, 1 All E.R. 378, at 381.

\textsuperscript{24} Boardman, supra note 16

\textsuperscript{25} Kishimoto, supra note 21.

was no corporate opportunity in the first place. Thus, the standards required of directors and the basis of liability espoused in *Regal (Hastings)* and *Canaero* remain valid.27

Finally, in *Chinese United Establishments Ltd. v. Cheung Siu Ki & Anor*28, Rogers J. followed *Regal (Hastings)* and held that the proposition that directors were only prohibited from making their own investment if knowledge of the investment opportunity came to them by reason of their directorship was too narrow a statement of the law.

Clearly, it is irrelevant whether the company would have taken up the opportunity or not. If the director had obtained the information and knowledge as a director of the company and used it to his personal advantage, he will be in breach of his fiduciary duties to the company and will be liable to account. This means that it would still be a breach of the director’s fiduciary duty even if the transaction was fair from the company’s point of view. As noted in *Gower*, “[g]ood faith must not only be done but must manifestly be seen to be done”. Thus, directors cannot place themselves in such position where it may appear they are motivated by considerations other than what is in the best interests of the company.30

However, the director is arguably not in breach of his fiduciary duty to the company if he merely takes up an opportunity which the company had expressly turned down for itself.

A collateral question is whether it is sufficient for a fully-informed board of directors to reject the proposed project after bona fide consideration or whether informed consent of the shareholders for the rejection is also required.

In *Peso*31, a proposed project was rejected by the board acting in good faith and with sound business reasons. This project was subsequently taken by three of the six directors. Bull JA of the British Columbia Court of Appeal held that the firm’s interest ceased to exist when it rejected the offer, thus yielding no conflict of interest. This decision was affirmed by the Supreme Court of Canada.

This approach was also adopted in *Queensland*32. The Privy Council noted that while the opportunity arose from the director’s use of his position as director, he had fully informed the board which had resolved to renounced the company’s interest in the opportunity. The Privy Council held that the disclosure by the director to the board of the company was sufficient as they represented the company’s shareholders.

However, Arjunan33 notes that the view that disclosure to the board is sufficient was not adopted by *Furs Ltd. v. Tomkies*34 nor *Regal (Hastings)* which indicated that disclosure by a

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27 See also Stott, *Hong Kong Company Law*, 8th edition (Hong Kong, Pitman Publishing Asia Pacific, 1998), at 217 to 225.


30 See also *Man Luen Corp. v. Sun King Electronic Printed Circuit Board Factory Ltd.* [1981] HKC 407 where the court held, at 413-14, that “The foundation [of these general law equitable rules] is that directors must not place themselves in a position where a conflict with their private interest might arise and to a certain degree their position is not far different from that of trustees… . [T]he rule is so strict that the court is prohibited from going into questions of the fairness or unfairness of a relevant contract.”


32 *Queensland Mines Ltd. v. Hudson* (1978) 18 ALR 1, 52 ALJR 399 (“*Queensland*”).

33 Arjunan, supra note 9, at 241.
director must be to the shareholders at a general meeting in order for a breach of duty to be ratified. But this argument may be irrelevant because in Queensland, it was held that there was no breach of duty after the board rejected the project, so there would be no need for shareholder approval, even under Regal (Hastings). In any event however, the director will also likely be prohibited from voting on the decision to reject the proposal as it is a matter in which he has an interest.

Article 86 of Table A of the Ordinance prohibits a director with material interest in any contract or arrangement with the company from voting on the matter at the board meeting. While s.11 of the Ordinance provides that a company may opt out of Table A, companies who exercise this option will often incorporate a similar prohibition in their articles.

As noted by Stott, since directors’ fiduciary duties are owed to the company, the majority of the members in a general meeting may, after full disclosure of all the material circumstances, waive a breach of duty by a director.

In Bamford v. Bamford, the directors convened a general meeting ratifying the allotment of some shares. While finding such allotment to not be bona fide in the interests of the company and in breach of the general duty of the directors, Russell LJ for the court held that “impropriety by the directors in the exercise of their undoubted powers is a proper matter for waiver or disapproval by ordinary resolution.”

In contrast with the prohibition against an interested director from voting on a matter of his interest, there is no such prohibition against such director, who is also a shareholder, from voting at a general meeting on the matter of his interest. However, the shareholder approval must also be bona fide. In Cook v. Deeks, three of the four directors by virtue of their majority holdings in the company, rejected a project against the objection of the fourth director. The three directors subsequently formed a new company to take up the project. The Privy Council held that the three directors’ personal interests in the newly-formed company conflicted with their duties owed to the old company. Lord Buckmaster LC stated that “…men who assume the complete control of a company’s business must remember that they are not at liberty to sacrifice the interests which they are bound to protect, and while ostensibly acting for the company, divert in their own favour business which should properly belong to the company their represent.” The court also invalidated the shareholder resolution rejecting the project as a fraud on the minority.

In addition, ratification will not be effective if the relevant act is ultra vires the powers of the director. In Aveling Barford Ltd. v. Perion Ltd., the court found that the sales arrangement in question concerning one of the company’s asset was not a genuine exercise of the company’s power to sell its property and was thus ultra vires and unratifiable.

34 (1936) 54 CLR 583.
35 Stott, supra note 27, at 222.
36 [1970] Ch. 212.
37 See North-West Transportation Co. v. Beatty (1887) 12 App. Cas. 589. Art. 102(L) does prohibit an interested director from voting his shares to ratify a breach by him of Art. 102, but there does not appear to be any prohibition against such director voting to ratify a breach of his fiduciary duty generally.
38 [1916] 1 AC 554 ("Cook").
40 See also Ching Tung Futures Ltd. (in liq.) v. Lai Cheuk Kwan, Arthus [1994] 1 HKLR 95 where the court held that the event jeopardized the very existence of the company and thus was not capable of ratification.
Section 358 of the Ordinance also provides a statutory relief against, among other things, a breach of duty. Subsection (1) states that during the course of legal proceedings for, among other things, breach of duty, the court hearing the matter is empowered to excuse, in whole or in part, the defendant from liability where the court concludes that to do so would be fair. Alternatively, the director may apply for such relief under subsection (2).

Section 358(4) limits this section to officers of the company and persons employed by the company as auditors. As directors are included in the definition of “officer” in s.2(1) of the Ordinance, they may be able to rely on this section to excuse themselves from liability.

The requirements for relief for a director under s.358 was set out by Foster J in Dorchester Finance Co. Ltd. v. Stebbing\(^\text{41}\), dealing with Australia’s equivalent of s.358. Foster J explained that the director must have acted honestly, reasonably and that he ought fairly to be excused. As evidenced by the decision in Ching-Tung Futures Ltd.\(^\text{42}\), all three factors are required and the deficiency in any one is sufficient to deny s.358 relief.

In summary, while subsequent ratification by the company may relieve a director of his breach of duty, it is unclear whether ratification by the board of disinterested directors is sufficient or if shareholder ratification is required. Either way, however, case law suggests that ratification can only be for breaches of duties involving acts which were within the powers given to the director in the first place.

(b) **Secret Profits**

Even where the director has not made use of any corporate opportunity, he remains under a duty to account to the company for all profits which he has acquired by reason and in the course of acting as director of the company.\(^\text{43}\)

As with the appropriation of corporate opportunities, this duty against secret profiting by the director is not dependent on his fault or lack of good faith\(^\text{44}\) and any profits so acquired by the director are considered to be held on a constructive trust for the company.\(^\text{45}\)

Similar to the discussions above with respect to corporate opportunities, it is unclear whether full disclosure to the board and subsequent approval by the board will be sufficient for the director to escape liability to account for the profits. Assuming that it is within the powers of the company, fully informed approval by the shareholders in a general meeting may suffice to relieve the director from liability to account for the profit.

(c) **Loans to Directors**

The notion that directors approval of loans from the companies to themselves raises inherent conflicts of interest. As such, the Ordinance contains complex rules prohibiting loans and similar transactions in favor of directors.


\(^{42}\) Ching-Tung Futures, supra, note 40.

\(^{43}\) Halsbury HK, supra note 21.

\(^{44}\) See Man Yuen Corporation, supra note 30.

\(^{45}\) See Carrian Investments Ltd. v. Wong Chong-po et al. [1986] HKLR 945.
The general prohibition, contained in s.157H(2) of the Ordinance, is that a company cannot make a loan to a director nor enter into any guarantee or provide any security in connection with a loan made by any person to a director. The section also prohibits a company from making a loan to another company controlled by one of its directors or entering into any guarantee to provide security in connection with a loan made by any person to such a company.

Subsection 157H(3) provides for exceptions but they are subject to lengthy provisions set out in subsections 157H(4) to (8) relating to disclosure in the financial statements and accounts of the company and, where applicable, the consolidated accounts of the group.

For example, s.157H(3)(b) exempts loans by a private company that is approved in its general meeting; s.157H(3)(c) exempts loans provided for the director to meet expenditures incurred for the purposes of the company; s.157H(3)(d) exempts loans to the director for the purpose or improvement of his only or main residence if the company ordinarily makes such loans to its employees on no less favorable terms; s.157H(3)(e) exempts loans by any company whose ordinary course of business includes lending money and giving guarantees.

All of the above exemptions are further to an overriding qualification. Under s.157H(7), a company may not enter into any such transaction if, at that time, the total liability of the company under all its loans, guarantees and provisions of security made under these exemptions exceeds 5% of the company’s net assets as shown in its latest balance sheet.

Even where such transactions are not prohibited by the Ordinance, s.161B requires their disclosure in the accounts of the company, including details of guarantees entered into and security provided by the company if the liability of the company for them has not been discharged by the end of the preceding financial year.

In the event of a breach of these sections, the director in receipt of the loan may be liable to repay it to the company under s.157I(1).

Section 157I(4) also requires all directors to jointly and severally indemnify the company for any loss or damage resulting from the illegal transaction if such director(s) willingly or knowingly authorized or permitted the transaction or if the transaction was to his benefit.

Finally, the director may also be subject to criminal penalties under s.157J including a fine of up to HK$100,000 and imprisonment for up to six months.

Therefore, unless the contemplated transaction falls clearly within one of the enumerated exceptions in s.157H, directors must refrain from making loans of company money to themselves. To do so would leave them open to onerous civil and criminal liabilities.

(d) Insider Dealing

A notable example of a director obtaining secret profits from his directorship is where such director engages in insider dealing.

Insider dealing has been defined as “the conscious use for the purpose of profit or of the avoidance of loss of confidential price-sensitive information to buy or sell shares to which
that information relates, or the disclosure of confidential price-sensitive information to a person likely to use that information for that purpose.”

Insider dealing gives insiders such as directors an unfair advantage over the investing public and the company’s shareholders and allows them to profit with information obtained from their position of directors of the company. As is discussed below, insider dealing is governed by the SFO which imposes heavy penalties on persons found in breach of its provisions.

C. To whom are these fiduciary duties owed?

(i) Duties Owed to the Company

As stated above, the general principle regarding the exercise of powers conferred on directors was stated by Lord Greene MR in *Re Smith and Fawcett*. Essentially, directors must act in the interests of the company. Notwithstanding the discussion over what constitutes “interests” and whether directors must act in the “best interests” of the company, another difficulty arises over what is meant by “the company”.

The traditional view is that directors owe their duties to the company, meaning shareholders as a collective group. Despite the fact that a company is regarded as a legal entity separate and distinct from its shareholders, the courts take the view that the directors do not owe a duty to the company as a distinct commercial entity *per se*, but rather to the shareholders.

In *Greenhalgh v. Arderne Cinemas Ltd.*,[47] Evershed MR stated that the phrase “the company as a whole” does not mean the company as a commercial entity distinct from the corporators. Instead, Evershed MR held that it means the corporators as a general body. However, this does not mean that directors owe their fiduciary duty to individual shareholders.

In *Percival*,[48] directors failed to advise shareholders whose shares the directors purchased, that the board was negotiating a takeover bid at a price well above that they had agreed to pay for the shares. The court dismissed the selling shareholders’ argument that the directors stood in a fiduciary relationship towards them as shareholders and held that there is no such relationship between directors and shareholders individually.

Nevertheless, in particular circumstances, directors may owe fiduciary duties to individual shareholders as a result of some representation or agreement.

In *Allen v. Hyatt*,[49] the directors of a company who were negotiating an amalgamation induced their shareholders to give them options to buy their shares, representing that this would assist their negotiations. When the terms of the amalgamation were agreed upon, the directors exercised their options and reaped a substantial profit. The Judicial Committee of the Privy Council held that the directors were required to account to the shareholders for the

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47 [1951] Ch. 286.
48 *Percival v. Wright* [1902] 2 Ch. 421 (“*Percival*”).
49 (1914) 30 TLR 444.
profit made because the directors had undertaken to sell the shares of the shareholders in an agency capacity and thus had put themselves in a fiduciary relationship with the shareholders.

The duty to shareholders may arise where the directors are in a position of trust as regards the shareholders. This is illustrated in the New Zealand case of *Coleman v. Myers*. The company was a private company with shares held largely by members of one family who had looked to the directors for business advice. One director made a takeover offer to all shareholders without disclosing information that affects the true value of the shares. Woodhouse J of the New Zealand Court found the directors liable. In addition, he noted the factors which gave rise to such a duty to individual shareholders:

“They include, I think, dependence upon information and advice, the existence of a relationship of confidence, the significance of some particular transaction for the parties and, of course, the extent of any positive action taken by or on behalf of the director or directors to promote it.”

This decision was subsequently approved of by the South Australian Supreme Court in *Hurley v. BGH Nominees Pty Ltd. (No. 2)*.

A further difficulty arises where a nominee director is appointed to represent the interests of particular shareholders. Given that directors owe their duties to the company as a whole, it is difficult to reconcile with his duty to act in the interests of those who appointed him.

Where the interests of the company and the interests of those who appointed the nominee directors are consistent, case law suggests that the nominee can properly act in the interests of his appointers.

Where these interests diverge however, courts have held that the directors must act in the interests of the company. In *Scottish Co-op*, Lord Denning held that where the interests of the appointors and the company do not coincide, a nominee director is bound to put the interests of the company ahead of the sectional interests he represents.

The paramountcy of the interests of the company was also evident in the High Court of Australia decision of *Wimborne*. Here, the directors were on the boards of several companies which were administered as a group. Mason J rejected the idea that the directors could consider the interests of the “group” ahead of those of their own company. Mason J emphasized that each company of the group was a separate and independent legal entity.

However, some courts have held that nominee directors who act in the interests of their appointers may not breach their fiduciary duties if the articles of the company had contemplated that such directors will act in their appointer’s interests. In *Levin*, two nominee directors were appointed, and the articles of the company had been altered to provide for their appointment. Jacobs J held that the amendment to the articles implied that

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50 [1977] 2 NZLR 255.
52 *Re Broadcasting Station 2GB Pty Ltd* [1964]1965] NSWR 1648.

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the nominee directors were expected to protect their appointer’s interests. In effect, the amendment to the articles had narrowed the fiduciary duties of the two directors.

This idea that articles may determine the legitimate parameters of directors’ behavior was followed by the High Court of Australia in *Whitehouse*. The 3-2 majority judgement stated that the articles “may be so framed that they expressly or impliedly authorize the exercise of the power of allotment of unissued shares for what would otherwise be a vitiating purpose.”

Since the directors’ fiduciary duties are owed to the company as a whole, shareholders have no ability to enforce the fiduciary duties of a director as it is the company who can sue the directors. This is the well established rule from *Foss v. Harbottle*. However, as noted by Jessel MR in *Russell v. Wakefield Waterworks Co.*, the *Foss* rule “is not a universal rule...[and is] subject to exceptions [which] depend very much on the necessity of the case; that is, the necessity of the Court doing justice.”

In Arjunan, the authors listed five general exceptions to the rule in *Foss* which have been recognized by common law. An individual member can bring an action where:

- the act of the company is ultra vires;
- the act of the company requires a special resolution;
- a member’s personal rights are infringed;
- the majority perpetrate a fraud on the minority; and
- the interests of justice require.

In addition, though unlike Canada, New Zealand and most of the U.S., Hong Kong company law does not provide for a statutory derivation action, s.168A of the Ordinance does provide that a court may order that an action “be brought in the name of the company against such person and on such terms” as it sees fit. A law on derivative actions is however currently being considered in discussion papers dealing with the next revision to the Companies Ordinance.

It is noted that the 1997 Consultancy Report criticized this form of derivative action as being completely ineffectively as it requires two full court hearings and recommended that a statutory derivative action be included in the Ordinance.

Nevertheless, where the directors have breached their duties to the company, individual shareholders may, subject to important restrictions, commence proceedings against directors to enforce the rights of the company. At least one court has held that directors may stand in a fiduciary relationship with another director. In *Beamish v. Sulnac*, Galligan J of the Ontario

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56 *Whitehouse v. Carlton Hotel Pty Ltd* (1987) 5 ACLC 421 (“*Whitehouse*”).
57 For an example of this prohibition in Hong Kong, see *Extramoney Ltd. et al. v. Chan, Lai, Pany & Co.* (unreported, 15 January 1994, HCA No. A8437 of 1987) (“*Extramoney*”). Individual shareholders may be able to commence legal actions for the company if the articles of the company had provided them with such powers. However, the wide powers of management generally conferred on directors will likely include the power to commence legal actions for the company.
58 (1843) 2 Hare 461; 67 ER 189.
59 (1875) LR 20 Eq. 474.
60 Arjunan, *supra*, at 314.
High Court held that the wronged director may bring a personal action against a director who “knows or ought to know that his conduct not only is against the best interests of the corporation, but would also subject another director to a risk of special harm or damage quite apart from the damage to be suffered by the Corporation.”

While it does not appear that the Hong Kong judiciary has dealt with this issue, directors are advised to be aware of the broadening of persons to whom they may owe fiduciary duties.

(ii) Duties Owed to the Creditors of the Company

Traditionally, directors were considered not to owe any duty to creditors of the company. However, there are some judicial comments suggesting that directors do owe a duty to the company’s creditors.

In *Winkworth v. Edward Baron Development Co. Ltd.*63, Lord Templeman stated that “…[a] company owes duty to its creditors, present and future…the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered….”

In the Hong Kong decision of *Chingtung Futures Ltd. (In Liquidation) v. Lai Cheuk Kwan Arthur et al.*64, Bokhary J seemed to quote with approval the dicta of the England Court of Appeal that “those conducting the affairs of the company owe a duty to creditors.”65

However, the weight of judicial authority remain with the traditional proposition that directors do not generally owe a duty to creditors of the company.

Nevertheless, where the company is in financial trouble, various cases have held that directors of such a company must consider the interests of the company’s creditors.

In *Wimborne*, Mason J stated that “it should be emphasized that the directors of the company in discharging their duty to the company must take account of the interest of its shareholders and its creditors.” In addition, the Court noted that when a company is insolvent or on the verge of insolvent, but not otherwise, it is the creditors’ interests that are paramount.

This decision was followed by the New South Wales Court of Appeal in *Kinsela*66. Street CJ held that where a company is insolvent, the interests of creditors intrude and creditors become entitled, through mechanisms of liquidation, to displace the power of shareholders and directors. The Court held that in a practical sense, the company’s assets are those of creditors and not shareholders.67

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63 [1987] 1 All ER 114.
64 [1992] 2 HKC 637.
65 *Re Horsley & Weight Ltd.* [1982] 3 All ER 1045, per Cumming-Bruce and Templeman LJJ.
67 *Kinsela* was subsequently cited with approval in *west Mercia Safetywear Ltd. (In Liquidation) v. Dodd* [1988] BCLC 250, at 252-3 and applied by the Hong Kong court in *Extramoney, supra* note 57.
There is also American authority support this extension a director’s fiduciary duties. In *Credit Lyonnaise*\(^{68}\), The Delaware Chancery held that were a company is operating “in the vicinity of insolvency”, directors owe their fiduciary duties to the larger community interests and not the interests of shareholders.

Given the intrinsic conflict of interests among creditors and shareholders in an insolvent company, the extension of directors’ fiduciary duties seem to make it impossible for the board to fulfil its duties. Where a company is experiencing financial difficulties, it is in the interests of shareholders, whose liability is limited to their investments and who will be accorded lowest priority in the distribution of assets if the company becomes liquidated, that the company engages in ventures that offers any positive upside. Since the shareholders will likely receive little to nothing of their investment upon the liquidation of the company, even the riskiest venture with 1% probability of success will be a better alternative for the shareholders than if the company simply wound up. On the other hand, creditors’ interests demand that the company’s assets be preserved as much as possible.

There is support for the notion that there is no fiduciary duty *per se* owed by the directors to creditors. Instead, adhering to the traditional notion of directors’ fiduciary duties, it can be argued that the duty remains owed to the company, which in the event of liquidation can be enforced by the liquidator for the benefit of the creditor.\(^{69}\)

In any event, recent development in company law in many jurisdictions have drawn support for the notion that where a company is “in the vicinity of insolvency”, its directors will be well advised to be mindful of the interests of the creditors.

(iii) **Duties Owed to Other “Stakeholders”**

In addition to the interests of creditors, Gore-Browne noted that modern management often takes the view that the interests to be taken into account by directors in running a company should include the interests of the company’s employees, customers and in the case of large public companies at least, the State and the general public.\(^{70}\)

However, from the point of view of strict law, directors may find it difficult to justify actions which benefit the interests of stakeholders at the expense of the interests of the company as a whole. This point was made clearly in *Parke v. Daily News Ltd.*\(^{71}\).

In *Parke*, the company sold some assets and intended to distribute surplus proceeds to its employees by way of compensation for dismissal. In an action brought by a shareholder, the Court held that however laudable and enlightened from the point of view of industrial relations, directors may not take into account the interests of employees, irrespective of any consequential benefit to the company.

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\(^{71}\) [1962] Ch. 927.
However, in *Teck*, Berger J offered that facts of modern life means that if directors consider the interests of its employees, or consequences to community of any policy, it could not be said that they have not considered bona fide interests of the shareholders.\textsuperscript{72}

In *Evans v. Brunner, Mond & Co.*\textsuperscript{73}, rejecting the challenge by shareholders, the Court allowed a contribution by the company to universities and scientific institutions. However, Eve J held that the advantages to accrue to the company from the contribution are direct and substantial and not too speculative or too remote. In fact, he specifically made it known that he was not departing from the traditional view that the expenditure must be incidental or conducive to the attainment of the main object of the company.

Also, s.309(1) of the UK Companies Act 1985 requires directors to have regard to the interests of the company’s employees as well as the interests of its members. No such analogous provision is contained in the Ordinance. In fact, the 1997 Consultancy Report had referred to such provisions in the US and recommended that similar provisions not be included in Hong Kong company law as being inappropriate.\textsuperscript{74}

Nevertheless, paragraph 7 of the Seventh Schedule of the Ordinance does empower companies to establish and support various facilities calculated to benefit present and past employees and their dependents. But s.5(5) of the Ordinance allows companies to modify or exclude the Seventh Schedule. Therefore, arguably, directors in Hong Kong are not subject to any fiduciary duties to any stakeholders other than the shareholders and where the company is “in the vicinity of insolvency”, possibly the creditors of the company.

**D. How do these duties manifest themselves?**

The provisions of the Ordinance and other related statutes also impose further duties on directors towards creditors, minority shareholders and, for publicly listed companies, to the public share markets in general.

**(i) Companies Ordinance**

To comprehensively review all statutory obligations of directors under the Ordinance would be an exhaustive endeavor that is beyond the scope of this paper. However some of the more important provisions are described below.

Section 162 requires directors to disclose to the board their interests (either directly or indirectly) in contracts that the company is making or proposes to make. However, under s.162(5), a declaration of interest by a director under s.162 will not of itself relieve him from the operation of the rules against profiting and against conflict of interest and duty. Disclosure merely removes the possibility that the director will be fined under this section.

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\textsuperscript{72} *Teck*, supra note 11.

\textsuperscript{73} *Evans v. Brunner, Mond & Co.* [1921] 1 Ch. 359.

\textsuperscript{74} 1997 Consultancy Report, *supra* note 61 at 124.
Section 162 does not itself deal with the effect of non-compliance on a contract. However, in *Man Luen Corporation v. Sun King Electronic Printed Circuit Board Factory Ltd.*, the Hong Kong High Court suggested that lack of disclosure renders the contract voidable at the option of the company. This view follows the approach of Lord Denning in *Hely-Hutchinson v. Brayhead Ltd.*, which was approved of in Lord Templeman’s *obiter dictum* in *Guinness*.

This view is challenged by Professor Gower who argued that the correct position is as stated by Lord Goff in *Guinness* that breach of s.162 disclosure requirements does not of itself affect the validity of the contract.

In any event, any director who fails to comply with these disclosure requirements under s.162 may be guilty of a criminal offence and subject to a fine of HK$25,000.

Sections 161 and 163 contain further disclosure obligations on directors under specific circumstances. For example, directors have extensive disclosure obligations in relation to their emoluments and activities under s.161 while s.163 requires disclosure by directors and shareholders approval if payments are to be made to directors for loss of office in connection with a transfer of the company’s undertaking or on a takeover.

In addition to disclosure obligations, there are a number of duties imposed upon the director in relation to the administration of the company.

Section 92 requires the directors to maintain a registered office and s. 93 imposes a duty on directors with respect to the letterhead and publication of the company name.

The duty to call and hold meetings are found in s.111 and s.113 respectively and ss.121-140 as well as Schedules 10 and 11 impose a duty on directors to prepare and maintain accounts and records and their filing with the Registrar of Companies.

Directors’ duties to issue and allot shares are contained in s.57B whereas duties in relation to the distribution and dividends are found in s.79.

Rules concerning a company purchasing and redeeming its owns shares, outlined in ss.49 and 49A to 49S. Rules regarding financial assistance for the acquisition of such shares are contained n ss.47A to 48.

Directors are faced with duties in the course of winding up of the company. Under s.275, the directors may be personally liable to make contributions to the assets of the company if, in the course of the winding up, it appears that they were knowingly a party to fraudulent trading.

The above does not represent an exhaustive list of directors’ obligations under the Ordinance. It is also interesting to note that unlike the Company Law Review Steering Group of the Department of Trade and Industry of Britain, the Standing Committee on Company Law

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76 [1968] 1 QB 549.
Reform of Hong Kong issued a consultation paper stating its view that it is unnecessary to expressly codify directors’ common law fiduciary duties. Its conclusion was based on a number of reasons that can be paraphrased as follows:

- It would not be possible to encapsulate all the separate duties that comprise the common law notion of fiduciary duty;
- The concept of fiduciary duty would have to be framed very generally and would have to be supplemented with detailed guidelines of a non-statutory nature. This type of general description would not be of use to directors in clearly identifying their duties;
- There would be a danger that statutory could be regarded as exclusive and it would be inflexible by not allowing for judicial developments;
- A broad statement of principles is unlikely to be of any additional assistance to shareholders; and
- There is not intention to create criminal penalties for a breach of fiduciary duties.

The Standing Committee considered that it would be more appropriate to adopt a code of best practices.

(ii) Securities and Futures Ordinance (“SFO”)

The SFO was newly enacted in April of this year and reflects a significant improvement on previous Ordinances. Its drafters have made a concerted effort to consolidate a number of previous Ordinances dealing with the various aspects of securities and futures. The most relevant to this discussion was the repeal of the Securities (Disclosure of Interests) Ordinance and Securities (Insider Dealing) Ordinance. The provisions covered in these two ordinances are now set out in Part XIII (Market Misconduct Tribunal) and Part XV (Disclosure of Interests)

Under the SFO, directors of listed companies are required to disclose their interests and dealings in shares or debentures in the company. Sections 310-311 of the SDIO require the directors to further disclose all dealings in shares and debentures of listed and associated companies. Moreover, ss.316(1) specify that the interests to be disclosed include those of the families of the directors, being interests of his spouse or child under 18 years of age.

Under the SFO, the duty to disclose is to the company as well as to the Stock Exchange in Hong Kong. Failure to comply with this requirement exposes the director to a fines and imprisonment upon conviction.

The SFO also contains strict guidelines on so-called insider dealing. Under s.270 of the SFO, a person connected with a corporation, which includes directors, are prohibited from dealing in securities of that corporation or any related corporations if he possesses relevant information about the corporation or the related corporations and he is also prohibited from counseling others to deal in such listed securities.

80 Ibid. at 16.
81 Over ten Ordinances were repealed and replaced by the Securities and Futures Ordinance in April 2003.
While proving insider dealing is very difficult, it is noted that at least three cases have been successfully brought since the enactment of the SIDO in 1991. In a decision in November 1996, the Insider Dealing Tribunal levied a penalty in excess of HK$6 million.

SFO also places an express duty on directors to

"Every officer of a company [which includes directors] shall take all reasonable measures from time to time to ensure that proper safeguards exist to prevent the corporation from acting in a way which would result in the corporation perpetrating any conduct which constitutes market misconduct."

The author is unaware of any case where this particular section has tested in the courts.

(iii) Listing Rules

A company listed on the Stock Exchange in Hong Kong will also be subject to the provisions set out in the Listing Rules. Like the Ordinance, the Listing Rules set out numerous obligations on the company and its directors to ensure that the public and investors are kept fully informed and to ensure fair and equal treatment among all holders of listed securities. Set out below are several of the major obligations on directors of a listed company.

Section 2 of the Listing Agreement (set out as Appendix 7 of the Listing Rules) requires a listed company or its subsidiaries to divulge any information which is price-sensitive, is necessary to avoid a false market in the securities of the company, or is necessary for the Stock Exchange, existing shareholders and the public to properly appraise the position of the listed company and its subsidiaries. This is a blanket disclosure obligation for directors, requiring disclosure of any material which falls within the scope of this section.

Chapter 3 of the Listing Rules reiterates the legal duties and responsibilities of company directors under the common law, namely the duty of care and skill and fiduciary duties. In addition, Rule 3.09 requires directors of listed companies to satisfy the Stock Exchange of their character, experience, integrity and competence commensurate with their positions as directors of a listed company. Rule 3.12 also imposes full responsibility of the company’s compliance with the Listing Rules on the directors.

Additional duties for the directors are contained in the Code of Best Practice, set out as Appendix 14 of the Listing Rules. Among other things, the Code provides guidelines with respect to board meetings and the terms for non-executive directors. Since April 1998, the Code also requires the establishment of an audit committee. Section 9(4) of the Listing Agreement requires companies to document their compliance with the Code.

Appendix 10 contains the Model Code for Securities Transactions by Directors of Listed Companies, setting out a minimum standard of good practice against which companies should measure their own code. For the most part, the Model Code deals with issues such as insider dealing and disclosure of interests.

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83 See P. Smart, supra not 46 at 283.

84 SFO, s.279.
Similar to the Code of Best Practice, the Model Code explicitly states that the rules contained therein are intended to be guidelines rather than rigid rules. However, it is noted that Rule 3.13 requires every director to comply with the Model Code or a code of the company in no less exacting terms.

(iv) Guide for Directors of Listed Companies

Finally, the Guide for Directors of Listed Companies\(^{85}\) encapsulates the concept of fiduciary duty by requiring directors to

- act honestly and in good faith in the interest of the company;
- act for the proper purpose;
- be answerable to the company for the application or misapplication of its assets;
- avoid conflict of interest;
- disclose fully and fairly his interests in contracts with the company; and
- apply such degree of skill, care and diligence as may reasonably be expected of a person of his knowledge and experience and holding his office within the company.

The above reflect the general duties on directors of listed companies, however, the Guide for Directors also sets out many other specific duties.

\(^{85}\) Guide for Directors of Listed Companies. Published by the Stock Exchange of Hong Kong (First printing in 1996 and second printing in 1997).
Fiduciary Duties of Directors in Malaysia*

Part I Development of Directors’ Fiduciary Duties

As a legacy of colonial rule, Malaysian company law traces its origin to English and Australian company law. In areas of company law where no written law has been made in Malaysia, subject to certain criteria and cut-off dates, English common law and rules of equity continue to apply in Malaysia. Further developments after the cut-off dates in the English common law and rules of equity are highly persuasive in Malaysian courts. Due to historical reasons, decisions of company law cases from England, Australia and Singapore are highly persuasive and are frequently consulted in areas where there are no decided Malaysian cases.

Barring some legislative and regulatory interventions or supplements, the nature and scope of directors’ fiduciary duties in Malaysia, originally transplanted from the English company law during the colonial days, remain uncodified and are largely similar to those in England, Australia and Singapore.

From the mid-1990’s, the duties and responsibilities of directors of public listed companies have been increased and clarified by the Securities Commission’s initiative to promote higher standard of corporate governance through enhanced corporate disclosure. This initiative was intensified by the financial crisis in 1997–1998, and accelerated the introduction of new legislative and regulatory provisions, many of which enhanced the duties and responsibilities of directors.

* By Tan Kiat Jane, BA(Stir), LLB(Lancs), LLM(LSE), CLP, Advocate & Solicitor of the High Court of Malaya, Senior Associate with Jeff Leong, Poon & Wong

1 The earliest company law statute introduced into the Straits Settlements (comprising of Singapore and some parts of the territory now known as Malaysia) was the Indian Companies Act 1866. The Companies Act 1965 currently in force throughout Malaysia was based on the Companies Act 1961 of Victoria, Australia – see Walter Woon Company Law (1997, 2nd Edition) p. 4; company legislation in Australia in turn has its origins from local adoptions of English legislation by the colonies – see H. A. J. Ford, R. P. Austin & I. M. Ramsay Ford’s Principles of Corporations Law (2001, 10th Edition) p. 42

2 Eg. when “circumstances of the States of Malaysia and their respective inhabitants permit” and “subject to such qualifications as local circumstances render necessary” – Section 3 of the Civil Law Act 1956; see also Section 5 of the Civil Law Act 1956

3 For West Malaysia, the applicable English common law and rules of equity are those as administered in England on 7 April 1956; for the State of Sabah, 1 December 1951; for the State of Sarawak (subject to certain conditions), 12 December 1949

4 Singapore took the Malaysian Companies Act 1965 as its first Companies Act 1967

5 See para 3 in Part II, below, for some instances of statutory interventions and supplements

6 In 1995, the Securities Commission began a programme to shift from merit based (where regulators assess the merits of an investment for offering to investors) to disclosure based regulation (where the investors are provided with the information to assess for themselves the merits of an investment). The programme began with the Securities Commission’s “Policies and Guidelines on Issue/Offer of Securities” (“Policies Guidelines 1995”) in December 1995 – see the speech on 20 August 1999 by Ali Abdul Kadir, Chairman of the Securities Commission The Corporate Governance Trends in Malaysia: February 1999 Finance Committee Report by Corporate Governance; Policies Guidelines 1995 have been revised in 2003

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responsibilities of directors in public listed companies.⁷ Directors (along with various other groups of people), are required to ensure higher standards of disclosure by the company and to undertake an expected degree of professional responsibilities.⁸

These new legislative and regulatory developments that were born of the push for good corporate governance now supplement the fiduciary duties, which were imposed on directors by the traditional legal model of the company to legitimise the vesting of broad discretionary power in the directors to manage the company.⁹

In Malaysian context, corporate governance is “the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of other stakeholders.”¹⁰ On the other hand, the traditional legal model (recognising the need to give the directors wide discretionary powers to effectively manage the company) concentrates on balancing the desirability of giving wide discretionary powers to the directors and the need to minimise the danger of abuse of these powers by the directors.¹¹

The emphasis of good corporate governance is thus wider than the concern of the traditional legal model. Process and structure in directing and managing the company are important for good corporate governance, as are the interests of other “stakeholders”. Fiduciary duties operate in a narrower scope of requiring the directors acting in a certain way (bona fide and to disclose potential conflict of interests) and to be accountable only to the company.

Reflecting the wider emphasis of good corporate governance, the new legislative and regulatory developments (mainly in relation to public listed companies) supplement the fiduciary duties by, inter alia:-

(a) installing processes and structure to enhance accountability of directors, such as specifying the circumstances where disclosure and shareholders’ approval are compulsory, and prescribing the form and contents of disclosure. Many of these requirements relate to potential

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⁷ Insider trading regulations were tightened in amendments made in 1997 to the Securities Industry Act 1963, the Malaysian Code On Take-Overs and Mergers 1998 (“Take-Over Code”) came into effect on 1 January 1999, the Malaysian Code on Corporate Governance (“Corporate Governance Code”) was issued in March 2000, the Securities Commission Act 1993 was amended in July 2000 which ushered in new fund-raising guidelines (these guidelines were revised in 2003), the Listing Requirements of Kuala Lumpur Stock Exchange (“Listing Requirements”) were revamped in 2001

⁸ Mainly connected to improving disclosure, such as the provision of full, accurate and timely disclosure, but also requiring adherence to “good practices of corporate governance” and having “a deeper understanding of the Securities Commission’s policies, rules and regulations” – see Securities Commission’s Disclosure-based Regulation – What Directors Need to Know (1999)


¹⁰ As defined by the Finance Committee on Corporate Governance in the Report on Corporate Governance (February 1999)

conflict of interest situations and treatment of corporate information; and

(b) extending the accountability of directors to persons other than the company.

This article will proceed to examine the current position of directors’ fiduciary duties in Malaysia, then a more focused discussions on conflict of interests and the persons to whom the directors are or are potentially accountable. The article will end with a review of possible developments in fiduciary duties of directors.

Part II What Does Fiduciary Mean?

1. Introduction

A fiduciary relationship is the relationship of trust and dependency with one person in a position of trust acting for the benefit for another. The fiduciary duties of the directors are analogous to those of trustees but despite informal or judicial references of directors as trustees, they form a class separate from the trustees.

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12 Krishnan Arjunan & Low Chee Keong Lipton & Herzberg’s Understanding Company Law in Malaysia (1995) p. 223
14 For example, per Raja Azlan Shah CJ (Malaya) PJTV Denson (M) Sdn Bhd & Ors v. Roxy (Malaysia) Sdn Bhd [1980] 2 MLJ 136 at 138 (Federal Court) (where the directors registered under their own names a piece of land bought by the company); per James Foong J Industrial Concrete Products Bhd v. Concrete Engineering Products Bhd [2001] 2 MLJ 332 at 361 (High Court) (where a director acted beyond his power in dealing with the company’s assets and thus had committed a breach of trust). Directors are regarded as trustees in the application of assets entrusted to them, see Walter Woon Company Law 2nd Edition p. 291
15 “The authorities contain much guidance as to the duties of one who is in a fiduciary relationship with another, but provide no comprehensive statement of the criteria by reference to which the existence of a fiduciary relationship may be established. The archetype of a fiduciary is of course the trustee, but it is recognized by the decisions of the courts that there are other classes of persons who normally stand in a fiduciary relationship to one another – for example, partners, principal and agents, director and company...” per Gibbs CJ Hospital Products Ltd v. United States Surgical Corporation & Ors [1984] 58 ALJR 587 at p. 596, quoted with approval by Richard Talalla J Avel Consultants Sdn Bhd v. Mohd Zain Yusof & Ors [1995] 4 MLJ 146 at pp. 158–159

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2. Content of Directors’ Fiduciary Duties

As stated in Part I above, the rules on directors’ fiduciary duties that were inherited from colonial times are not codified but must be gleaned from decided cases, many of which are English, Australian or Singaporean.

2.1 Fiduciary duties of directors consist broadly of the following duties to:-

i) act *bona fide* in the interests of the company as a whole;

The duty to act *bona fide* is a subjective one and depends on the facts of each case. The court is not concerned with whether a director has made the correct decision but whether “an honest and intelligent man in the position of the directors, taking an objective view, could reasonably have concluded that the transactions were in the interests of the [company]”. [Words in brackets substituted.]

To satisfy the duty to act *bona fide*, a mere general sense of honesty of purpose is not enough: there must be a proper consideration of the views or of relevant material and facts. The fact of being rushed into a meeting, ignorance, the lack of detailed explanation of the implication of the issues under consideration, the failure to exercise an independent discretion and the mere doing of what was thought that a third party or the majority shareholder wanted are not bona fide exercise of a director’s discretion.

The Supreme Court in *Paidiah Genganaidu v. Lower Perak Syndicate Sdn Bhd & Ors* [1974] 1 MLJ 220 adopted the explanation in *Greenhalgh v. Arderne Cinemas* [1951] Ch 286 that the phrase “the company as a whole” does not mean the company as a commercial entity as distinct from the corporators but that it referred to the corporators as a general body.

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17 In the case of *Lim Ow Goik & Anor v. Sungei Merah Bus Co Ltd* [1969] 2 MLJ 101, BTH Lee J said, “The court has not overlooked or ignored the principle laid down by Lord Greene in *Re Smith and Fawcett* that the directors must exercise their discretion *bona fide* in what they consider – not what a court may consider – *in the interests of the company* …”; *Re Smith & Fawcett, Ltd* [1942] 1 All ER 542 was also cited with approval by Ismail Khan J in *Kesar Singh v. Sepang Omnibus Co Ltd* [1964] 1 MLJ 122 and Wan Suleiman FJ in *David Hey v. New Kok Ann Realty Sdn Bhd* [1985] 1 MLJ 167
18 Thean J’s view in the Singapore Court of Appeal case of *Intraco Ltd v. Multi-Pak Singapore Pte Ltd* [1995] 1 SLR 313,325. The Malaysian position should be similar.
20 Judith Prakash J *Rajabali Jumabhoy v. Ameerali R Jumabhoy* [1997] 3 SLR 802 (Singapore High Court)
22 The views of Cohen J and Judith Prakash J were cited with approval by James Foong J, *Industrial Concrete Products Bhd v. Concrete Engineering Products Bhd* [2001] 2 MLJ 332, pp. 358–359
23 This is consistent with the position in *Re Smith and Fawcett Ltd* [1942] 1 All ER 542 which held that the term “company” meant, not the company as a commercial entity that was distinct from the corporators but the corporators as a general body. Ismail Khan J in *Kesar Singh v. Sepang Omnibus Co Ltd* [1964] MLJ
Pak Cheong v. Global Insurance Co Sdn Bhd [1995] 1 MLJ 64, p. 76, however, the directors were said to owe the fiduciary duties to the company and its shareholders. Nonetheless, the general view is that directors do not owe any fiduciary duties to individual shareholders pursuant to the English case of Percival v. Wright [1902] 2 Ch. 421.

ii) exercise powers for the proper purposes for which the powers were conferred;

A director may be acting bona fide but fail to exercise his or her powers under the articles of association for proper purposes. Most of the Malaysian cases relate to the directors’ exercising their discretion under the articles to refuse registration of a transfer of shares. Although these cases generally require the court to examine the objective for which the relevant powers were given and the motives behind the exercise of those powers, the courts are reluctant to disturb the decision of the directors in the absence of evidence of mala fide.

In Kwality Textiles (Malaysia) Sdn Bhd v. Arunachalam & Ors [1990] 3 MLJ 361, at the material time, the percentage equity holding of non-Malaysian in the company had exceeded and breached the condition imposed on the manufacturing licence issued under the Industrial Coordination Act 1975. The court upheld the exercise of the directors’ absolute discretion under the articles to refuse registration of transfer of shares due to the real likelihood of the company losing its manufacturing licence if the transfer was registered.

The exercise of directors’ discretion for the sole purpose of endorsing governmental policy (such as to ensure the percentage equity shareholding of Bumiputras (indigenous people) conforms to governmental guidelines) may also be proper exercise of power, perhaps more so when non-compliance “can obviously have adverse consequences especially to a private company”.

iii) retain and not fetter the powers given to the directors; and

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122 applied Re Smith and Fawcett Ltd (ibid.) by saying that the latter held that directors’ discretion “should be exercised bona fide in the interests of the company.” Ismail Khan J did not confirm whether he agreed but in applying Re Smith and Fawcett Ltd (ibid.) presumably had agreed with the definition for the term “company” given by the latter.

24 In the earlier case of Lim Ow Goik & Anor v. Sungei Merah Bus Company Ltd [1969] 2 MLJ 101, p. 104, it was said that, “the directors are in a fiduciary position both towards the company and towards every shareholder in it.” [Emphasis added.]

25 Krishnan Arjunan Company Law in Malaysia Cases and Commentary (1998) p.198
26 Kwality Textiles (Malaysia) Sdn Bhd v. Arunachalam & Ors [1990] 3 MLJ 361

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A director must exercise his or her power for the benefit of the company. Constraints must not be imposed on his or her exercise of discretion.

In *Industrial Concrete Products Bhd v. Concrete Engineering Products Bhd* [2001] 2 MLJ 332, a nominee director was found in breach of his fiduciary duty as he had acted “solely towards the benefit and interest of the group that nominated him”.

iv) avoid conflicts of interests.

Directors are precluded from acting in a manner which will bring his personal interest into conflict with that of his company, such as when directors in the appellant companies formed a competing company which canvassed for work and was appointed in place of the appellant companies.

There is a dearth of Malaysian cases in this area. However, the position should be similar to that set forth in *Aberdeen Railway Co v. Blaike Bros* [1854] 23 LT 315, i.e. a conflict of interest includes not only actual conflict but possibility of conflict of interests, where a reasonable man looking at the relevant facts and circumstances of the particular case would think that there was real and sensible possibility of conflict.

For potential conflicts, a director may avoid breaching fiduciary duties by making full disclosure to the company of the proposed transaction.

Usage of corporate information for personal gains may also be a breach of fiduciary duties.

2.2 Fiduciary duties are owed individually by each director on the facts and circumstances that are particular to his case.

3. Statutory or Regulatory Requirements

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29 Citing *Bouling v. Association of Cinematograph, Television and Allied Technicians* [1963] 2 QB 606, Winslow J in the Singapore case of *Raffles Hotel Ltd v. L Rayner v. Malayan Banking Ltd* [1965] 1 MLJ 60 stated that “a company is entitled to the undivided loyalty of its directors. A director who is a nominee of someone else should be left free to exercise his best judgment in the interests of the company he serves and not in accordance with the directions of his patron.”

30 Per Salleh Abas LP *Avel Consultants Sdn Bhd & Another v. Mohamed Zain Yusof & Ors* [1985] 2 MLJ 209 p. 210 (Federal Court)

31 *Avel Consultants Sdn Bhd & Another v. Mohamed Zain Yusof & Ors* [1985] 2 MLJ 209 (Federal Court)

32 Where Lord Cramford LC said, “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 whom he is bound to protect.”

33 *Boardman v. Phipps* [1966] 3 All E.R. 721 p. 756


35 Krishnan Arjunan & Low Chee Keong *Lipton & Herzberg’s Understanding Company Law in Malaysia* (1995) p. 225

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The case-law position of directors’ fiduciary duties discussed in paragraph 2 above is modified or supplemented by statutory or regulatory provisions mainly from the Companies Act 1965, the Securities Industry Act 1983, the Listing Requirements and the Take-Over Code.

3.1 Duty to Act Honestly

Section 132(1) of the Companies Act 1965 requires that:

“A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.”

This provision was derived from Australian companies Acts. It is not an exhaustive statement of a director’s duties but “is in addition to and not in derogation of any other written law or rule of law relating to the duty or liability of directors or officers of a company.” Thus the case-based law on fiduciary duties of directors is still applicable.

It has been commented that the exact scope of the word “honestly” used in Section 132(1) of the Companies Act 1965 is unclear but may be a restatement of the duty to act bona fide. This comment found support in Industrial Concrete Products Bhd v. Concrete Engineering Products Bhd [2001] 2 MLJ 332.

Walter Woon when referring to the corresponding section in the Singapore’s Companies Act, regards the word “honestly” as covering all fiduciary duties. This can be reconciled with James Fong J’s view if all fiduciaries duties categorised in paragraph 2.1 above are regarded as sub-sets of the duty to act bona fide in the interest of the company.

3.2 Anti-conflict Provisions

i) Use of corporate information

(a) Requirements applicable to all companies

Section 132(2) of the Companies Act 1965 is a general codification of the equitable rule that a director must not profit from the confidential corporate information of the company.

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36 Section 132(5) of the Companies Act 1965
37 CCH Asia Pte Limited Malaysian and Singapore Company Law & Practice para. 20-540
38 Where James Foong J explained Section 132 of the Companies Act 1965:

"Regarding the extent of the meaning of "honesty", the case of Multi-Pak Singapore Pte Ltd (in receivership) v. Intraco Ltd & Ors [1994] 2 SLR 282 explains that this does not mean that the director had acted fraudulently; it means that he must act bona fide in the interests of the company and that in exercising his discretion, the director should act only to promote and advance the interest of the company."

39 Walter Woon Company Law (1997, 2nd Edition) p. 265; this seems to coincide with the view that fiduciary duty can be summed up in one word – honesty, see CCH Asia Pte Limited Malaysian and Singapore Company Law & Practice para. 20-520

40 It prohibits, inter alia, a director of a company to “make improper use of any information acquired by virtue of his position as [a director of the company] to gain directly or indirectly an advantage for himself or for any other person or to cause detriment to the company.” [Words in brackets substituted.]
company but is wider than the equitable position by including situations when the profits are enjoyed by some third parties other than the director, eg. when the director is acting as trustee for third party.\footnote{See Loh Siew Cheang \textit{Corporate Powers Accountability} (2002, 2\textsuperscript{nd} Edition) p. 577}

Non-compliance is an offence against the Companies Act 1965. The defaulting director is only liable to the company for non-compliance.

(b) Requirements applicable to only public listed companies

(1) Section 132A of the Companies Act 1965\footnote{It renders an offence the improper use by, \textit{inter alia}, directors of \textit{"specific confidential information"} to gain, directly or indirectly, an advantage for themselves or any other persons. The \textit{"specific confidential information"} must be acquired by virtue of the directors' position as director and which if generally known, might reasonably be expected to materially affect the price of the securities to which the information relates. See para. 2.1(i), Part II, above} aims to reverse the decision in \textit{Percival v. Wright} \footnote{Section 89E(1) of the Securities Industry Act 1983 defines an \textit{"insider"} as a person who:-
(1) possesses information that may reasonably have a material effect on the price or value of the securities concerned; and
(2) knows or ought to know that the information is not generally available} [1902] 2 Ch. 421\footnote{Section 90 of the Securities Industry Act 1983} so that in respect of dealing in shares, a director is held accountable to any person suffering losses (and not only the company following \textit{Percival v. Wright} [1902] 2 Ch. 421) as a result of the improper use of price-sensitive information. A director is liable even if the dealings in shares are executed by or the profits therefrom are enjoyed by a third party other than the director.

Non-compliance is an offence against the Companies Act 1965.

(b) Section 89E of the Securities Industry Act 1983 goes further than Section 132A of the Companies Act 1965 to cover trading in and procuring trades of securities and communicating information that will materially affect the price of the securities concerned by an \textit{“insider”}\footnote{Section 90A of the Securities Industry Act 1983}. The Securities Commission is empowered to institute civil proceedings against suspected offenders\footnote{Tor #: 1270026.1} and any persons who have suffered loss may recover against the suspected offender by civil proceedings.\footnote{Tor #: 1270026.1}

ii) Disclosure
Under the fiduciary model, disclosures are required to deflect liabilities of conflict of interests. To be effective (subject to contrary provisions in the articles), disclosure must be made to the company in general meeting. Whether the interested director may vote or be counted towards the quorum depends on the provisions in the articles.

The extent and operation of disclosure requirement under the fiduciary model are thus subject to the private arrangement and bargain (culminating in the articles of the company) between members of the company, rather than mandatory as a requirement of law. The mandatory requirements come from statutory provisions, for example:-

(a) Section 131(1) of the Companies Act that requires a director to disclose interest in contract to the board of directors. This requirement is in addition to and does not erode the disclosure obligation under the fiduciary model.\(^47\)

(b) Section 131(5) of the Companies Act 1965 that requires a director to disclose to the board of directors any office or any property that he or she holds or possesses which may lead to conflict of interest. This requirement is in addition to and does not erode the disclosure obligation under the fiduciary model.\(^48\)

(c) Section 132E of the Companies Act 1965 that requires substantial property transaction between a director and the company.

(d) Section 134(1) of the Companies Act 1965 that requires the company to keep a register of directors’ interests in the securities of the company. Section 135(1) of the Companies Act 1965 has a corresponding requirement on the director to give notice to the company of the interests referred to in Section 134(1) of the Companies Act 1965.

Non-compliance with these requirements of the Companies Act 1965 is an offence by the relevant director.

The financial crisis of 1997–1998 highlighted conflict of interests as one of the factors that compounded the severity of the crises. It is said that the conflict of interests arises due to the close relationship between the

\(^{47}\) Section 131(8) of the Companies Act 1965 states that the obligations in Section 131 of the Companies Act 1965 are “in addition to and not in derogation of the operation of any rule of law or any provisions 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.”

\(^{48}\) See footnote 45
Asian firm and the State or family groups. According to the OECD White Paper on Corporate Governance in Asia (June 2003), in Asia, two-thirds of listed companies and substantially all private companies are family-run. Thus, for the regulators, the problem of conflict of interests is an important issue to address. Due to the attention that regulators paid to the problem of conflict of interests, the resulting relevant new legislative and regulatory developments are listed separately in Part III, below.

Part III Conflict of Interests

1. Recognising the Problem

“[T]he practice of operating businesses in competition with the listed entity, taking advantage of contracts belonging to the listed entity, disposition of non-performing assets into the listed entity while taking over performing assets at below market value and the practice of interested parties voting on transactions in obvious conflict of interest” were instances of conflict of interests in Malaysian directors’ practices noted in the Report on Corporate Governance.

The “very real concerns” that conflict of interests “engender[s] excessive or imprudent risk-taking at the expense of both the public and minority shareholders” [words in brackets added.] led to the conclusion that a strong and effective framework for corporate governance regulation that may achieve, inter alia, the following broad objective is required:-

● Fair treatment of all shareholders and protection of minority shareholder rights, with particular emphasis on enhancing the rights and remedies of minority shareholders;

● Transparency – through the timely disclosure of adequate, clear and comparable information concerning corporate financial performance, corporate governance and corporate ownership;

● Accountability and independence of the board of directors.

2. Part of the Solution to the Problem

As part of the effort to address the broad objectives identified, during and after the financial crisis of 1997–1998, the following legislative or regulatory enactments were, inter alia, made:-

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50 Taken from speech on 11 August 2003 by Ybhg Datin Zarinah Anwar, Deputy Chief Executive of the Securities Commision Board of Directors: Performance Beyond Compliance
51 Finance Committee On Corporate Governance Report on Corporate Governance (February 1999)
52 Speech on 3 April 2002 by YBhg Datuk Ali Abdul Kadir Can Corporate Governance Lead the Way to Global Competitiveness?
2.1. Section 99B of the Securities Industry Act 1983 were amended, requiring the chief executive or directors of a public listed company to disclose their interests and the interests of their spouse, child and parent in securities of the public listed company and associated companies. Non-compliance is an offence against the Securities Industry Act 1983.
2.2 In the Listing Requirements:-

i) Paragraph 6.11 provides that an issue of shares (except when pro-rata to shareholders) to directors or connected person must be approved in general meeting. In the general meeting, interested directors and connected person must not vote.

ii) Paragraph 7.27 prescribes that the articles of association of the listed company must include provisions to prevent directors from voting on contracts in which they are interested.

iii) Paragraph 8.11 sets out the standard required of the contents of circular eg. the circular must be factual, clear, unambiguous, accurate, not false, misleading, balance and fair, and avoid re-phrasing of statements to create positive implication, and use of over-technical language etc. The circular must contain information to enable the making of informed decision by the securities holders and their professional advisers.

iv) Chapter 10 requires certain measures be taken for transactions involving related parties (including directors and persons connected to them):-

(a) that immediate announcement (containing the prescribed information) to be made to the Kuala Lumpur Stock Exchange;

(b) depending on the size (determined by “percentage ratios” calculated from eight alternative tests) of the transactions, that circular to shareholders be approved by the Kuala Lumpur Stock Exchange and issued to shareholders, independent adviser be appointed to advise the shareholders on the fairness and reasonableness of the transactions, or a “main adviser” be appointed to ensure fairness and reasonable of the transactions, the transactions are not detrimental to the minority shareholders’ interests, compliance with all laws, regulations and guidelines and the making of full disclosure.

v) Chapter 11 requires that in take-overs and mergers, secrecy be observed during the discussion stage and notice of take-over offer be immediately announced.

vi) Paragraph 14.04 imposes restriction on dealings by directors during “closed period” that is a set time limit commencing from a defined time preceding the announcement and ending 1 full day thereafter.
The Listing Requirements are enforced by either the Securities Commission or the Kuala Lumpur Stock Exchange. Nonetheless, the Kuala Lumpur Stock Exchange must refrain from taking action if the Securities Commission has taken action.

2.3 The Take-Over Code came into force on 1 January 1999. In administering the Take-Over Code, the Securities Commission is required to ensure, inter alia, the directors of the offeree and acquirer must act in good faith and that minority shareholders are not subject to oppression or disadvantaged by the treatment and conduct of the directors. In respect of the directors of the offeree, the Take-Over Code specifically prohibits, unless shareholders’ approval is obtained in a general meeting, certain tactics be undertaken to frustrate a take-over offer. Further, no person may disseminate false and misleading information or information with material omission or acting in misleading or deceptive conduct.

Part IV To Whom are Fiduciary Duties Owed?

1. “Company as a Whole”

As stated in paragraph 2.1(i) above, the directors owe a duty to the “company as a whole” and not to individual shareholders. However, in some exceptional cases, the directors may owe fiduciary duties to individual shareholders, such as when there are “dependence upon information and advice, the existence of a relationship of confidence, the significance of some particular transaction for the parties and, ... the extent of any positive action taken by or on behalf of the director or directors to promote it.” The onus is on the shareholder to establish the exceptional circumstances justifying a departure from Percival v. Wright [1902] 2 Ch. 421.

For nominee directors, the fiduciary duties towards the company override the fiduciary duties towards their principals. Within a group of companies, each company is regarded as a separate entity and its directors’ fiduciary duties must still be towards the company and not to the group.

When the company is in financial difficulties, the directors must take into account of the creditors interests but their fiduciary duties are still towards the company, subject to statutory provisions to the contrary.

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53 Section 11 of the Securities Industry Act 1983
54 Section 11 of the Securities Industry Act 1983
55 Section 33A(5) of the Securities Commission Act 1993
56 Section 35 of the Take-Over Code
57 Section 38 of the Take-Over Code
58 Woodhouse J Coleman v. Myers [1977] 2 NZLR 297
59 See para 2.1(iii), above
60 Tan Ah Tah J Re Syed Ahmad Alsagogg [1960] MLJ 147
61 Walker v. Wimborne [1976] 137 CLR 1
62 Walker v. Wimborne [1976] 137 CLR 1
As regards the interest of employees, the Malaysian position should be the same as that decided in *Parke v. Daily News Ltd* [1962] 2 All ER 929, ie. need not be considered by the directors.

2. **Statutory and Regulatory Provisions**

As seen in paragraph 3 of Part II and Part III, non-compliance with statutory and regulatory provisions usually lead to criminal liability, ie. liability to the State. In some cases, the regulators are given the right to institute civil proceedings, while in some, any persons suffering losses due to the non-compliance are given the right to claim against the defaulting directors. Statutory and regulatory provisions thus expanded the parties to whom the directors are accountable. Nevertheless, none of the statutory and regulatory provisions (and the Finance Committee on Corporate Governance made no such recommendations in the *Report on Corporate Governance* (February 1999)) recognise or require the directors to consider the interests of employees when discharging their directors’ duties.

On the liquidation of a company, Sections 295 and 304 of the Companies Act 1965 recognise that the principles underlying the directors’ duty to avoid conflict of interests must prevent the interests of the creditors being compromised by the directors’ default.\(^{65}\) Section 295 of the Companies Act 1965 allows the liquidator to examine a cash transaction (made within a period of two years preceding the commencement of winding-up) for the sale or purchase of any property, business or undertaking between the company and a person who was at the material time, a director of the company. Section 304 imposes unlimited liability on the directors for fraudulent trading and claims may be made by the liquidator, creditors or contributory of the company.

\(^{64}\) For example Section 304 of the Companies Act 1965

\(^{65}\) For further details see Low Chee Keong *Recovery From Directors of Insolvent Companies: A Case For Reform* [1996] 1 MLJ xlix
3. **Actions by the Company or Shareholders**

3.1 As fiduciary duties are owed by the directors to the company, the company is the proper plaintiff to bring an action against the directors in the event of breach of the fiduciary duties. This is known as the "proper plaintiff rule" or "rule in Foss v. Harbottle".

3.2 Nonetheless, if any exceptions\(^{66}\) to the rule in *Foss v. Harbottle* apply, a shareholder may commence a derivative action on behalf of himself and other shareholders (except the defaulting shareholders, if any) and join the company as a nominal defendant.

3.3 As the rule in *Foss v. Harbottle* and its exceptions may not always be helpful to an aggrieved shareholder, Section 181 of the Companies Act 1965 was introduced to enable an “oppressed” or “unfairly discriminated” member or debenture holder to apply to the court for relief. The court can make any order as may be required to end the “oppression” or “unfair discrimination”. Conduct caught under Section 181 of the Companies Act 1965 includes autocratic conduct by the board, appropriation of business, property or corporate opportunities at the expense of the company or its minority shareholders, unjustifiable failure to pay dividends or fair dividends or the directors’ neglect of the duty of care, skill and diligence where it affects the shareholder personally.\(^ {67}\)

3.2 A holder of fully-paid shares may also petition under Section 218 of the Companies Act 1965 to wind-up the company based on grounds including the directors have acted in their own interest instead of the interests of the members, the directors have acted unfairly or unjustly, that it is just and equitable to dissolve the company.

3.3 A shareholder may bring action in his or her personal capacity when the wrong affects his or her personal capacity (such as under the memorandum and articles of association).

\(^{66}\) Such as when the complaints relate to ultra vires acts, fraud on the minority, when a simple majority was accepted for an approval requiring special majority (under the Companies Act 1965 or the articles), where the member is suing to enforce personal rights, and where the justice of the case so requires

\(^{67}\) Finance Committee on Corporate Governance Report on Corporate Governance (February 1999) p.183
Part V  Proposed Reform to Rules of Fiduciary Duties

The Finance Committee On Corporate Governance proposed several reforms in relation to the directors' fiduciary duties, all of which involve codification of various fiduciary principles. Briefly, the proposals include:-

1. To amend Section 132(1) of the Companies Act 1965 to “re-formulate” the “duty to act honestly” to the “duty to act bona fide in the best interest of the company”.

2. To enact statutory clarification of the duties and position of nominee directors to act in the best interest of the company and that his or her duty to the principal must always be subject to the best interest of the company.

3. To codify the common law fiduciary duty to avoid conflict of interest by setting out clearly the obligations of directors in their dealings with the company in conflict situations. The proposed new statutory provisions on conflicts of interests should reflect the following minimum elements:-

3.1 That the provisions should embrace the following conflict situations:-

i) Misuse of corporate information, property or position;

ii) The taking of corporate opportunity;

iii) Engaging in business in competition with the company.

3.2 That there should be full disclosure of the conflict of interests as well as material facts of the transaction.

3.3 That the transaction should be authorised following disclosure concerning the conflict of interests and the transaction by disinterested directors. Great emphasis should be placed on the desirability of providing a company with disinterested representation as a technique for dealing with conflicts of interests. In the case of authorisation by disinterested directors, there should be clear guidance as to the minimum standards of conduct expected of him in exercising his or her business judgment. For example, that he or she:-

i) is not interested in the subject of the business judgment;

ii) is informed in respect of the subject of the business judgment to the extent that the director or officer reasonably believes to be appropriate under the circumstances; and

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68 Finance Committee on Corporate Governance Report on Corporate Governance (February 1999) p.116–126

69 See para. 3.1, Part II, above
iii) rationally believes that the business judgment is in the best interests of the company.

3.4 That the ability of the court to enquire as to the fairness of a transaction should be preserved at all times. The effect should be such that even when a transaction has been approved by the disinterested directors, the challenging party may still hold the director liable if he is able to establish that the disinterested directors could not reasonably have concluded that the transaction approved by them was fair to the company. The advantage of such a provision is that it addresses issues pertinent to the Malaysian corporate landscape, where it is common to find the so-called independent members of the board to be friends and invitees of a controlling shareholders.

The proposed codifications should perhaps be subject to further discussions. Codification of broad common law principles and rules of equity may just operate to remove the ambiguity stemmed from unwritten law to the ambiguity in statutory interpretation. Further, how does codification affect the cases that previously constituted the common law principles and rules of equity – should their usefulness be continued along side the codified law or subordinated to the codified law? If these cases are allowed to develop along side the codified law then this may render redundant the effort to codify the principles and rules.

Moreover, the advantages of codification may not be widely enjoyed. Bear in mind that the majority of companies in Malaysia are small, privately and closely owned entities. In the meantime, the recommendations for law reforms in the Finance Committee on Corporate Governance’s Report on Corporate Governance were made from the objective to strengthen the overall regulatory framework for public listed companies.70 Any implementation of the recommendations for law reforms should thus only be undertaken after a thorough examination of its impact on small, privately and closely held companies. For small, privately and closely held companies, the relationship between the shareholders and directors may be close and informal. The relationships in these small companies may best be left to the private arrangements and bargain between the parties concerned. Uncodified common law principles and rules of equity may be more suited than mandatory statutory provisions to allow the freedom of contract required by parties in small companies.71 The formal and mandatory statutory provisions recommended by the Report on Corporate Governance are more suited to large companies with diverged ownerships where real separation exists between the ownership and management.

[END]

70 See Foreword dated 9 March 1999 by Datuk Dr Aris Othman, Secretary General of Treasury and Chairman of the High Level Finance Committee on Corporate Governance, in the Finance Committee on Corporate Governance’s Report on Corporate Governance (February 1999) p. ii

71 For further discussions on the respective nature of rules required by widely and closely held corporations, see Melvin Aron Eisenberg The Structure of Corporation Law from The Law of the Business Enterprise edited by Sally Wheeler (1994)
Preliminaries

1. The concept of fiduciary duty as such is not known in Dutch law. As in other countries of the European continent, trusts are not part of domestic law. However, the duties of directors are expressed in other concepts which are laid down in the Civil Code. The practical effects of these concepts are rather similar to those of fiduciary duty.

2. It should be kept in mind that in principle an optional two-tier board structure applies in the Netherlands. Companies (both public, "N.V.", and private, "B.V.") must have a Management Board which consists of executives, and may have a Supervisory Board. In practice, most smaller and many large companies have only one board. Some companies have a single board composed of both executives and non-executives (e.g. the insurance and banking company Fortis N.V., and Unilever N.V.).

Companies of a certain size (share capital plus reserves not less than EUR 13 million, not less than 100 employees in the Netherlands, and a Works Council) must have a Supervisory Board as well. The Works Council of these "structure companies" has a certain influence on the composition of the Supervisory Board, which has special powers including the power to appoint and dismiss the members of the Management Board. However, where the company forms part of a group the majority of whose employees work outside the Netherlands this latter power is vested in the shareholders' meeting. Where the company acts only as a holding and/or financing company (usually the top company of the group) it is exempted from this so-called "structure regime" provided that a group company below is a "structure company". For example, Unilever N.V. is exempted from the regime, but its subsidiary Unilever Nederland B.V. is a "structure company". It should be noted that a Bill is pending in Parliament to mitigate the "structure regime". The Dutch "structure regime" is unique in Europe.
Most Dutch companies whose shares are listed on a stock exchange have a Managing and a Supervisory Board, either voluntarily or because they are subject to the structure regime.

3. Dutch legal writers generally assume that the relationship between the company and the members of its Management Board is a dual one. It is based both on company law and on contract law. Where the member receives a remuneration from the company the contract is characterised as an employment contract. The duties resulting from a directorship under contract law are rather vague and therefore not interesting in this context. The duties under company law are laid down in Book 2 of the Civil Code and the company's Articles, and have been further developed by the courts. The relationship between the company and its Supervisory Directors is generally considered to be governed by the relevant rules of Book 2 of the Civil Code and the company's Articles. The relevant rules of Book 2 are set out below.

The Duties Owed by Directors

4. Book 2 of the Civil Code describes the duties of directors in general terms. Article 2:129(1) simply provides that the Management Board is charged with managing the company. This simple phrase has very recently been given a more specific content by the Tabaksblat Committee. This broadly-based committee was formed in March 2003 on the invitation of the Government, and published a discussion draft Dutch Corporate Governance Code for listed companies on 1 July 2003. A few weeks later the Minister of Finance announced that the Government accepted the principles laid down in the draft and would prepare legislation to enforce it on a "comply or explain" basis. The Tabaksblat Committee (named after the former CEO of Unilever) proposes that the Code provide that the Management Board be responsible for the realisation of the company's objectives, its strategy and policy and the results thereof. It is also responsible for controlling the risks connected with the company's activities and for financing the company. The Management Board reports to, and discusses the internal control systems with, the Supervisory Board and its Audit Committee. It must provide the Supervisory Board timely with all information that Board may need. Only the Management Board and (in most cases) its members can act on behalf of the company.

5. As to supervisory directors, Article 2:140(2) provides that their task is to supervise management and the general course of events in the company and the business conducted by it, and to give advice to the Management Board. In doing so, the supervisory directors must be guided by the interests of the company and the business conducted by it. According to the Tabaksblat Committee, the general task of the Supervisory Board includes the supervision of, inter alia:

- the realisation of the company's objectives,
- the strategy and the risks connected with the company's activities,
- the organisation and operation of the internal control systems,
- the financial reporting process, and
- compliance with laws and regulations.
It should be noted that either by law (the "structure regime") or under the company's Articles important decisions of the Management Board require the approval of the Supervisory Board.

The Tabaksblat Committee also proposes that each supervisory director must be capable of judging the outlines of the totality of management and have the specific expertise necessary for his task within the profile of the Supervisory Board. Supervisory directors will have to follow a special training with respect to the company's business and the responsibilities of a supervisory director. The number of supervisory directorships in listed or other large companies will be limited to five (with a chair counting for two) and supervisory directors can be appointed for no more than three periods of four years each.

6. Article 2:9 provides that each member of the Management Board is bound towards the company to properly discharge himself of his obligations. By reference to Article 2:9, Article 2:149 provides the same for supervisory directors. No distinction is made between executive and non-executive members of the Management Board.

Although by its wording Article 2:9 is addressed to individual directors, it follows from other provisions of Book 2 that the task of board members is a collective one. This does, of course, not mean that they cannot divide the work among themselves.

7. Article 2:9 also deals with the liability of directors for shortcomings in the discharge of their duties. Such liability is in principle joint and several. However, shortcomings do not necessarily result in liability. In order for a director to be liable for damages to the company his shortcomings must be serious. It should be noted that in the event of bankruptcy of the company the trustee can sue the directors for clearly improper discharge of their obligations. The liability referred to in Article 2:9 is not towards creditors or any other third parties, not even to shareholders. Derivative suits are unknown under Dutch law. Where a shareholder suffers a loss due to improper management resulting in a reduction of the value of his shares it is up to the company to sue the directors for compensation, thus making good the loss. Only if the improper management constitutes at the same time a tort towards the shareholder can the latter sue the directors. This could be the case where the directors issue shares with the intent to dilute a specific shareholder.

8. As mentioned above, Article 2:9 is couched in general terms. It is generally accepted that whoever accepts appointment as a director vouches for his capacities to undertake the job. A proper discharge of his obligations implies that he must exercise due care in all his actions on behalf of the company.

There are very few provisions in Book 2 which impose more specific duties upon directors. It is generally accepted that the members of the Management Board must be guided by the interests of the company and the business conducted by it (see Article 2:140(2) referred to above which specifically applies to supervisory directors). This means that the members of both Boards must not allow themselves to be guided by the interests of any particular shareholder, or even exclusively by
the interests of the sole shareholder or all shareholders where other interests, e.g. of employees or creditors, are also involved. This means that directors must, when making important decisions, be able to show they have weighed the interests of all parties involved with the company. In practice, this has been relevant in rather extreme cases, e.g. where (non-Dutch) parent companies instructed their Dutch subsidiaries to close their Dutch plants resulting in collective dismissals. Generally, where a Dutch company forms part of a larger group the directors of the Dutch company must weigh the interests of the group against those of the company and its business. Although the former interests may weigh heavily they must not be the only interests taken into account.

9. Another generally phrased rule is laid down in Article 2:8 which provides that a company and the persons who by law or the company's Articles are involved with its organisation must in their behaviour towards each other observe the requirements of reasonableness and fairness (good faith). These persons include both shareholders and all directors. This rule implies that when exercising their powers the directors must always take into account the justified interests of the other persons involved with the company, such as shareholders and other directors. One example of a breach of this rule occurred when in 1999 the Management Board of Gucci Group N.V., while engaged in negotiations with LVMH about cooperation between them, suddenly announced it had concluded a strategic alliance agreement with PPR under which effective control of Gucci was transferred to PPR without stipulating that PPR should make a public offer for Gucci's shares or pay a control premium to the other shareholders. Resolutions in breach of Article 2:8 can be annulled by the courts.

10. Interestingly, most standards of proper management and supervision have been laid down in decisions concerning enquiries into the affairs of companies. Such enquiries can be petitioned for by shareholders holding not less than 10 per cent of the issued share capital (or a minimum nominal value of EUR 225,000) or by trade-unions. Such petitions are addressed to the Enterprise Chamber of the Amsterdam Court of Appeal which may order an inquiry and, where mismanagement is established, take various measures including annulment of decisions and dismissal of directors and even dissolution of the company.

11. The standards developed by the Enterprise Chamber and/or the Court of Cassation in enquiry proceedings include, inter alia, the following:

- Directors must exercise special care with respect to minority shareholders, in particular where there could be a conflict of interests between any director and the company. The nature and the degree of care depends upon the circumstances.
- Directors must deal with the utmost care with conflicts of interests. The Civil Code is rather sketchy on this issue. The Enterprise Chamber and the Court of Cassation have developed more detailed rules (e.g., full disclosure, directors must be seen to weigh advantages and disadvantages of the transaction, advice from independent experts).
- Directors may not pass on corporate opportunities to a (major) shareholder.
• Directors must observe the company's structures for policy and decision-making.
• Directors must effectively control the company's subsidiaries and not allow them to duck out of their supervision.
• Directors must not grant loans to shareholders or directors without adequate security.

12. The Tabaksblat Committee made some new proposals with respect to conflicts of interests, distinguishing between members of the Management Board and supervisory directors. The proposed rules for members of the Management Board are as follows:

• They shall not:
  (a) compete with the company,
  (b) demand or accept any (material) gifts for themselves or their next of kin (including, in good Dutch fashion, "registered partner or other companion in life"),
  (c) grant third parties any unjustified benefits, or
  (d) take any corporate opportunities for themselves or their next of kin.
• They shall forthwith report any (potential) conflict of interests to the Chairman of the Supervisory Board and the other members of the Management Board, and provide full information to them, whereupon the Supervisory Board will, in their absence, decide whether there is a conflict of interests.
• They shall not take part in the discussions and decision-making on an issue or transaction with respect to which they have a (potential) conflict of interests.
• Any transactions involving (potential) conflicts of interests shall be concluded on terms which are customary in the industry concerned. Such transactions require the approval of the Supervisory Board and must be published in the annual report. The same applies to any transactions with holders of not less than 10 per cent of the company's shares.

The proposed rules for supervisory directors are similar. The Committee proposes some very strict rules about the independence of supervisory directors. It also proposes some special responsibilities for the chairman of the Supervisory Board.

13. Directors do not owe any specific duties to third parties outside the company. However, they may be liable to such parties in tort (Article 6:162 Civil Code), both for acts committed while they were discharging their duties as directors and for acts in other capacities. In the former event, the company will be liable in the first place, either for breach of contract or in tort. On a number of occasions, directors have been held personally liable for assuming an obligation on behalf of the company while they were aware or should have been aware that the company was unable to meet its obligations within a reasonable period and that there would be no recourse against it. The onus of proof of this (constructive) knowledge rests in principle on the third party. Where a director is at the same time a controlling shareholder of the company his duty of care towards third parties is heavier.

14. Finally, three particular issues will be briefly dealt with.

Tor #: 1270481.1
(a) **Whistleblowers**

The Tabaksblat Committee proposes for the first time to offer whistleblowers special protection. The Management Board must ensure that internal whistleblowers are able without jeopardizing their legal position to report on irregularities of a general, operational nature within the company to the CEO or an officer designated by him. The Supervisory Board must enable them on the same conditions to report on irregularities with respect to the financial reporting, the internal risk control systems and the audit and to file complaints about members of the Management Board to the Chairman of the Supervisory Board.

(b) **Insurance**

It is generally accepted that the company can take out and pay for an insurance policy for the benefit of its directors against liability towards third parties. Such a policy cannot cover intentional misconduct (*opzet*).

(c) **Indemnification**

There has been quite some discussion as to whether the company can validly indemnify its directors. It is currently accepted that the company can do so, but not for intentional misconduct. There is still uncertainty about gross negligence (*grove schuld*) and conscious recklessness (*bewuste roekeloosheid*). Some authors are of the opinion that the consequences of these somewhat lesser forms of negligence, although capable of being covered by insurance, must not be borne by the company. Others write that companies can agree to bear these consequences, provided the director's negligence to the third party does not also constitute such negligence towards the company itself.

31-07-03
MEMORANDUM

Reference: Fiduciary duties of officers and directors of German stock corporations (AG)

To: American Bar Association (Sub-committee Corporate Governance)

Von/From: Wolfgang M. Kau

Datum/Date: October 7, 2003

The following remarks follow the template request as requested by the coordinators.

A. What does fiduciary duty mean?

Under German Corporate law ("AktG") the German stock corporation ("Aktiengesellschaft") has 3 different organs:

a) the shareholders
b) the supervisory board ("Aufsichtsrat")
c) the executive / management board ("Vorstand")

The Vorstand has the duty in right to manage the business of the corporation. The supervisory board has the right and duty to control the actions of the Vorstand.

Under German law, the member of the Vorstand cannot at the same time be a member of the supervisory board, and vice versa. Thus German corporate law provides for a dualistic control system for German corporations.

1) Fiduciary duty of the Vorstand

The fiduciary duties of the Vorstand are set forth in § 88 I AktG, § 93 I AktG which read as follows:

§ 88 I
Members of the management board may not without the consent of the supervisory board engage in any trade or enter into any dealings in the company’s business sector either on their own behalf or on behalf of others.
may they without consent be a member of the management board, nor a manager or general partner of another commercial enterprise. The consent of the supervisory board may be granted only for a specific trade or commercial enterprise, or for specific kinds of dealings.

§ 88 II:
If a member of the management board breaches such prohibition, the company may claim damages. In lieu thereof the company may require the member to treat any dealing made on his behalf as having been made on behalf of the company and forward any remuneration received for the dealings made on behalf of himself or another person or assign his rights to the company.

§ 93 I AktG reads as follows
In managing the business the members of the management board shall employ the care of a diligent and conscientious manager. They shall not disclose confidential information and secrets of the company, in particular trade and business secrets which come to their knowledge as a result of their service on the management board.

§ 93 II AktG reads:
Members of the management board who breach their duties shall be jointly and severally liable to the company for any resulting damage. In the event of a dispute as to whether or not they have employed the care of a diligent and conscientious manager the burden of proof shall lie with them.

§ 93 III AktG reads:
The members of the management board shall in particular be liable for damages if, contrary to this Act:

1. capital is repaid to shareholders;
2. shareholders are paid interest or profit participations;
3. the company’s own shares or shares in another company are subscribed, acquired, taken by way of pledge or redeemed;
4. definite share certificates are issued before the issue price has been fully paid;
5. assets of the company are distributed;
6. payments are made after the company has become insolvent or it has become apparent that it is over indebted;
7. remuneration is paid members of the supervisory board;
8. credit is extended;
9. in connection with a conditional capital increase, new shares are issued other than for the specified purpose or prior to receipt of the full consideration.

According to § 93 I AktG the members of the management board have to exercise the reasonable care of a prudent and diligent business executive. § 93 I AktG has thereby two different implications:

a) it generally describes the duty of care which a member of the management board must exercise; and
b) it specifies certain duties which must be exercised, unless such actions are – which is generally required by the Aktiengesetz (AktG) – approved
by the shareholders and implemented as and if specifically set forth otherwise in the AktG.

From the duty to exercise the reasonable care of a prudent and diligent executive the possibility is given, to evaluate on a case by case basis, if in a given situation the member of the management board has applied such diligence and care.

In connection therewith it is recognized that each member of the management board has a fiduciary duty to act in the interest of the company (but so far not in the interest of the shareholder directly). The fiduciary duty is not only based on the provisions of the AktG. It is recognized that in addition to the statutory fiduciary duty, such fiduciary duty is also implied by the employment contract of the member of the management board and in essence is based on the fact that the management board is managing property owned by others (the company) and thus has to act in the best interest of the owner of the property. The German Civil Supreme Court has already in a decision in 1956 stipulated that the relations between Vorstand and supervisory board must be based on mutual trust and therefore imply a fiduciary duty for each to act in the interest of the company.

2) Fiduciary duty of members of the supervisory board

The fiduciary duty of members of the supervisory board is not specifically regulated in the German corporate code. § 116 AktG provides only that the members of the supervisory board have the same fiduciary duties and duties of care as the members of the members of the management board.

3) Reversion of the burden of proof

§ 93 AktG reverses the burden of proof in case a member of the Vorstand or supervisory board is accused of a breach of his fiduciary duty. In this case the claimant must only prove the relevant facts; but the member of the Vorstand or supervisory board has to prove that he did not breach his fiduciary duty but exercised it. This shifts to the member the burden of proof as to what fiduciary duty was owed in the specific case and that he did fulfil it.

4) German Corporate Governance Codex

The German Corporate Governance Codex ("Codex") attempts to provide for German listed companies (a) statutory rules for the management and supervision of the company, and (b) contains non-statutory but recognized standards for good and responsible governance. The Codex intends to “improve” the rights of shareholders, under the German Corporate Code. But it is yet unclear, to what extend the non-statutory provision of the Codex will be enforceable; probably non-compliance with these provisions will only imply a failure to exercise reasonable duty of care. However, with few exceptions, the shareholders have not yet a right to assert claims or damages for themselves, but only for the company. The management board is responsible for managing
the company. Its members are jointly accountable for the management of the company.

The supervisory board appoints the members of the management board and is directly involved in the decisions of fundamental importance of the enterprise.

The recommendations embodied in the Codex, aside from statutory obligations, which are “must provisions”, are indicated by the word “shall” and the use of the term “should” or “can”. When the Codex specifies that a company “shall” act in a certain manner, then the company may deviate from such provision, but is then obligated to disclose this deviation in its annual reports.

Whenever the Codex uses the terms “should” or “can” the company may deviate from such suggestions without disclosure.

The Codex tries to implement duties of care and fiduciary duties beyond the statutory duties. The implication of the Codex is that the members of the management board and/or supervisory board should be liable to the company if they violate any of the “shall” or statutory obligations. Members of the management board are required to act in the company’s interest and may not pursue personal interest, which conflicts with the interests of the company. They may not use a business opportunity, which the company could use. The Codex further requires that all business relations between the company and the members of the management board and persons or entities related to them or associated with them must be done on an arm’s length basis. Further, members of the management board and supervisory board may not take or request any remuneration or other advantages from third persons for any action they undertake in connection with or for the company, which would give the member of the management board an unfair and unjustified advantage. The Codex prescribes further that all members of the management board shall disclose conflicts of interest to the supervisory board without delay and inform the other members of the management board thereof. This applies also with respect to dealing with persons or entities, which are associated with the member of the management board.

For the members of the supervisory board the Codex provides that they shall act in the best interest of the company and that no member of the supervisory board may pursue personal interests in his actions for the company or use business opportunities of the company for himself. The members of the supervisory board are also required to inform the supervisory board of any conflicts of interest which may result from a consultant’s or director’s function with clients, suppliers, lenders or other business partners. Further, the supervisory board is required to inform the general shareholders meeting of any conflicts of interest which have occurred during the last fiscal year and how the supervisory board resolved such conflicts of interest. Material conflicts of interest and those which are not merely temporary in respect of a member of the supervisory board shall result in a termination of such members mandate.

While the German case law on fiduciary duties of members of the management board and supervisory board so far presents very little guidance, the legal literature implies that the members of the management board and supervisory board have an active duty to further the business and management of the
company. From such duty it is implied, that the fiduciary duty is very broad and requires the members to act always in the best normal interest of the company. The German Supreme Civil Court, in its decision published in WM 1985, 1443, confirms such duty and wrote that a member of the management board may act only in the interest of the company and not in his own interest or in the interest of third parties. The supervisory board may not grant the Vorstand a relief from such fiduciary duty, if such relief is not in the best interest of the company. Otherwise the supervisory board itself would breach its fiduciary duties to the company.

With respect to monetary advantages German cases provide also, that the fiduciary duty implies that a member of the management board or supervisory board does not take advantage of assets or money of the company to which he is not entitled under his employment contract or which has not been expressly authorized by the supervisory board (in case of a member of the management board) or the shareholders (in case of the member of the supervisory board). In general, German cases have held that the compensation and fringe benefits of a member of the management board must be reasonable in the view of an objective observer (BGH BFHE 154, 218).

Thus, the remuneration of a member of the management board must be reasonable. This subject currently profiles civil and criminal cases pending against the former managers of Mannesmann, which were paid high bonuses upon the public take over of Mannesmann by Vodafone.

Further, the fiduciary duty implies that the members of the management board and supervisory board may not use corporate assets for private purposes, such as company car or airplanes, without paying the company adequate compensation for such use.

The fiduciary duty also prohibits the members of the management board to use the money of the company for sponsoring politics, sport or other activities, unless such sponsoring is in the interest of the company, which means that it is reasonable and likely to further the business of the company.

The fiduciary duty of care thus implies the duty to use the assets of the company prudently and not to waist them for activities which do not further the companies business.

The courts have also considered stock option plans for managers as unreasonable and thus struck them down, with the reason that there was a violation of the fiduciary duty of the management board and supervisory board to grant "excessive" stock option plans to themselves, in particular without conditioning the exercise of the options on an increase in the companies assets.

The fiduciary duty of care also prohibits the members of the management board and supervisory board to fix the annual financial statement solely in consideration of increasing their profit sharing participation under their employment agreements. The members of the management board and supervisory board must set up the financial statements solely in the best interest of the company. Further, in the event of the management buy-out, the members of the management board and supervisory board involved in the buy-
must fully disclose to the company and shareholders all information relevant to the determination of the value of the company.

The fiduciary duty of a member of the management board continues to exist after he has left the employ of the company. They are for example prohibited to use their knowledge from managing the company to obtain personal advantages from parties dealing with the company, or to compete with the company, or to hinder the company in pursuing its business. In particular, members of the management board and supervisory board may not use their knowledge to provide information to a competitor or use such information for themselves.

B. How did the concept of fiduciary duty develop and apply to directors of business corporation

The concept of fiduciary duty was embodied already at the beginning of the 20th century in the corporate laws of Germany. It has, however, steadily been developed by case law. The Codex, which for most listed companies in Germany became operative only this year, tries to further and enlarge fiduciary duty of officers and directors on the basis of the OECD principle for corporate governance of May 1999.

Recently, management compensation which has been viewed as “excessive” and spectacular failures of companies listed on the so-called “new market” have started an intense debate on the duties of officers and directors. The current trend is to increase the duties of officers and directors and their personal liability. In this context an increased personal liability of the officers and directors is being under discussion, as well as granting the shareholders the right to sue officers and directors. Currently, the shareholders of a corporation can only in very limited circumstances sue officers or directors, who violated their duties, but this means only that those officers and directors reimburse the company – but not the shareholders for any damages the company may have sustained.

C. To whom are these fiduciary duties owed?

The duties are owed to the corporation, but not the shareholders directly. With few exceptions, the shareholders may only bring derivate actions claiming that officers or directors who breached their duties shall reimburse the company.

In certain instances where the breach of a fiduciary duty hinders a creditor’s ability of being paid by the company, the creditor may also sue the officers and directors claiming for payment of damages to the company.

D. How does the fiduciary duty manifest itself?

(see section A. above)

Currently, it is expected that in consideration of the Codex German case law will increase fiduciary duties of officers and directors. Legislative commissions are also discussing to provide shareholders with a claim against officers and directors who have breached their fiduciary duties, giving such shareholders a right to demand
damages payable to them. Currently, shareholders may file such direct law suits against officers and directors only in very limited circumstances, namely when such officers and directors have made statements or taken actions which directly damage the shareholders; so far this has only been allowed if such action or statement had a direct influence on the value of the shares of such particular shareholder and such shareholder could prove that he acted on it. So far, typically such cases were limited to situations where officers and directors made statements with regard to the value of the shares of the company and a shareholder could prove that based on such statements he took certain actions and suffered damages.

Lately, criminal cases are being filed against officers and directors if there is a suspicion that they have used company assets improperly, in particular have paid themselves excessive compensation or have wasted corporate assets.
AMERICAN BAR ASSOCIATION

International Developments Sub-Committee on Corporate Governance

FIDUCIARY DUTY PUBLICATION PROJECT

ALFREDO L. ROVIRA

BRONS & SALAS

Maipú 1210

Fifth Floor

(C1006ACT) Buenos Aires

FAX:

(54) 11-4311-7025

(54) 11-4314-0399

E-MAIL: arovira@brons.com.ar
FIDUCIARY DUTY UNDER ARGENTINE LAWS

By Alfredo L. Rovira
BRONS & SALAS
Buenos Aires - Argentina

1. Introduction. Distinction between “Directors” and “Officers”.

Under the Argentine Companies Law (“ACL”) in order to describe the duties and responsibilities of directors and officers it is relevant to make some previous considerations as to the legal meaning of the words “directors” and “officers”.

“Directors” are individuals whose duties are ruled by the law as well as by the company’s by-laws and regulations. Thus, under the ACL, officers (in the sense of US laws) such as the President or Vice President must be members of the Board of Directors. The By-laws may also provide for other officers, such as the Secretary or the Treasurer, to be named amongst the Board’s members. However, these officers are very seldom appointed by Argentine companies’ Board of Directors. Therefore, when commenting the ACL it should be borne in mind that when the ACL refers to both officers and directors, they are referred to, in general, as directors. The directors, as members of the Board, acting collectively, pursuant to the required majority, set forth the general management policies of the company.

“Officers” are individuals under employment relationship with the company, discharging managerial duties. The ACL refers to them, generally, as “managers”. Therefore, officers, individually and technically only execute decisions adopted by the Board of Directors. In general, therefore, the word “officer” is used in Spanish legal language to refer to employees with management positions. Their functions arise, mainly, from the nature of their employment relationship vis-à-vis the corporation by which they are engaged, but also from the law and sometimes, from the company’s by-laws though under certain circumstances, the ACL extend to them liability generally applicable to directors. Therefore it should be highlighted that ACL would differentiate directors from managers, these latter being employees with executive functions.

Both the ACL and case law have welcomed such technical legal discrimination between the concept of “director” and “officer” by making a distinction in rank arising from the fact that officers execute the decisions taken by the Board of Directors, as a body, and not by each individual director on its own. From this standpoint, a clear example of a director, also being an officer, is the case of the President, who not only must be a Board member but, in addition, by specific provision of the ACL is the “legal representative” of the company. Standard By-Laws of a “Sociedad Anónima” would, as an example,
indicate “the President or, in his/her absence, the Vice-President shall exercise the legal representation of the company”. Under this example, both officers (President and Vice-President) are also directors, since to fill in those positions they must be members of the Board of Directors.

This distinction notwithstanding, Argentine law also permits directors to enter into an employment relationship, which normally exists when they also discharge executive functions. When this situation occurs then, directors, technically, also become officers (“managers”) of the company.

Section 270 of the ACL provides that the Board may appoint general or special managers, whether directors or not, to whom the Board may delegate executive functions.

Nevertheless, Argentine legal experts and authors have called for a clearer discrimination of directors’ duties as opposed to those of officers discharging managerial functions.

Although the aforesaid difference is important for purposes of determining the minimum duties and standards of conduct that each of the directors, or, when pertinent, the above mentioned officers must honor, hereinafter the word “director” shall be hereinafter used indiscriminately to also refer to those persons who may or may not be members of the Board of Directors but discharge managerial functions or duties, as managers or, in general sense, officers under employment relationship.

2. A General Description of the “Fiduciary Duty” under ACL

Under Argentine Companies Law No. 19,550 (“ACL”) a company is an entity different from its partners and administrators. ACL follows the general corporate model of other legislations that separates ownership from control as well as deals with the problems entailed by the delegation of management functions by the shareholders to non-owners, since ACL does not require that directors be also shareholders.

The general principle is that administrators are not personally liable for acts performed in the name of the company in the ordinary discharge of their duties. Such acts are exclusively imputed to the company.

Nonetheless, the duties and responsibilities of directors and officers in charge of administering a company stem from the breach of certain “standards of conduct” which are generically set forth by Sections 58 and 59 of the ACL.

Section 58, ACL, states that “the administrator or legal representative who, in accordance with the partnership contract or the law is vested with the legal representation of the company binds the company for all its acts to the extent they are not notoriously alien to the corporate purpose...”.

Argentine legal scholars have concluded that this Section 58 of the ACL introduces into the

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1 Law 19,550 enacted in 1972, as thereafter partially amended several times.
Argentine legal system the “ultra vires” principle whereby duties and responsibilities of directors and officers are directly linked to the scope and extent of the corporate purpose. This interpretation is further supported by the fact that Section 11 of the ACL specifically requires that the corporate purpose needs to be precisely described in the articles of incorporation, by-laws and/or partnership contract, depending on the legal format being used. Further, Section 59, ACL, states that “administrators and representatives must act with loyalty and the diligence of a good businessman. Whomever acts otherwise becomes unlimited and jointly and severally liable (with the company) for damages stemming out of their actions or omissions.” Although these “standards of conduct” are common to officers in charge of administering all kinds of companies, this paper will only make reference to duties, liabilities and “standards of conduct” of directors and officers of corporations (“Sociedades Anónimas” or commonly referred to as “S.A.”, a legal format that could be deemed equivalent to the “corporations” under U.S. laws). The “Sociedad Anónima” legal business organization is the legal format most commonly used in Argentina.

3. Development in defining directors’ fiduciary duties.

Prior to the enactment of the ACL in 1972, corporations were ruled by the Argentine Code of Commerce, as amended in 1889, whereby administrators of companies were considered the company’s agents. Furthermore, Sections 1681 and 1694 of the Argentine Civil Code expressly state that provisions regarding agency were applicable to those individuals representing a company. Under this line of argument, Argentine legal authors sustained that the nature of the office of directors finds its background in the Agency agreement. The Agency agreement imposes on agents the duty to act loyally (Section 1908 of the Civil Code) and breach of such obligation shall occur if his/her interests were to prevail over the corporate interests. Furthermore, Section 1905 of the Argentine Civil Code requires agents to act within the boundaries of their empowerment doing no less than what has been requested by his principal, further providing that the nature of the business determines the extension of the empowerment. This criteria evolved to consider directors as members of a corporate body rather than agents, thus applying the “ultra vires” rule. Under this

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2 Broad language used by the ACL to comprise “directores” of Sociedades Anónimas, or “gerentes” in Sociedades de Responsabilidad Limitada or, simply administrators in general partnerships.
3 Under the ACL there are seven legal formats available for a business organization, which could be categorized in three groups namely: 1) Sociedad Colectiva, Sociedad en Comandita Simple, Sociedad de Capital e Industria y Sociedad Accidental o en Participación, all those could be deemed equivalent to a General Partnership with some specific features since not all of the partners are personally liable. 2) Sociedad de Responsabilidad Limitada, also called “SRL”, that could be deemed equivalent to a Limited Liability Partnership and, 3) Sociedad Anónima, also called “SA” that could be deemed equivalent to a Corporation and the Sociedad en Comandita por Acciones, also called “SCA” that could be deemed equivalent to a Joint Stock Company, with both general partners and shareholders.
new doctrine, accepted by the ACL, directors perform their duties as a body by reason of the powers the law, the partnership contract or articles of incorporation and the company’s by-laws have granted the body, while subjectively. In this sense, when the company decides to act, it does so through its corporate management body; in the case of corporations such body is the Board of Directors.

Therefore, the company’s management decisions are adopted by the Board of Directors which resolves provided board members constitute a quorum and resolve in accordance with the favourable vote of those meeting the majority requirements specified in the company’s by-laws or, otherwise, by the law (ACL).

Having set aside the “Agency” doctrine, commentators of the ACL, including those who drafted the ACL, coincide that directors duties and responsibilities depend on whether they meet the standards of conduct set forth in Section 58 and 59.

4. Duties and Responsibilities of Directors and Officers as “Standards of conduct”.

As a general principle, meeting the standards of conduct specified in Sections 58 and 59 of ACL cause directors and officers of corporations to avoid being personally liable for the consequences of their actions.

The duty to “act with loyalty and the diligence of a good businessmen” as well as “to act within the scope of the corporate purpose” works as a general principle applicable to all kinds of business organizations and as a boundary of empowerment taking into account that directors and officers have the power to administer assets which do not belong to them. Those directors who fail to comply with these standards of conduct shall be held “…unlimitedly, jointly and severally, liable for the damages arising from their actions or omissions” (Section 59 of the ACL).

4.1 The Duty to Act with Loyalty: Argentine jurisprudence has considered the duty “to act with loyalty” as the duty to act in favor of the “interests of the company”.

Such interpretation, however, has opened a debate both in case law and legal doctrine, as to how should the “interests of the company” should be defined.\(^5\)

In principle, legal scholars and certain case law have interpreted that “the corporate interest” should coincide with the interest of the shareholders, while it should be deemed to be that set forth by the

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4 Word used under ACL to comprise all persons in charge of the company’s management, including “directors” in Sociedades Anonimas or S.A. (corporations), “managers” in Sociedades de Responsabilidad Limitada or SRL, and administrators or managers in general partnerships.

5 A leading case was rendered by the National Commercial Court of Appeals, Room D, March 1, 1996 in re “Abrech, Pablo A. et al v. Cacique Camping S.A. s/ sumario”, El Derecho, Vol. 168, p. 546. In such case it was pointed out that definition of what should the “interest of the company” be was very imprecise thus opening the possibility for each dissident shareholder to claim that the “interest of the company” was detrimentally impacted taking advantage of such a confusing and undefined concept.
majority of the shareholders, as opposed to the interest of certain shareholders (including the controlling shareholders)\(^6\).

Unfortunately the corporate governance rules provided by Decree 677/01, in principle only applicable to public companies\(^7\), rather than clarifying the debate has made it even more confusing. In effect, there is a contradiction between the Whereas Clauses of Decree 677/01 which define the “corporate interest” as the interest of all the shareholders and Section 8, subpar. a),l) which, when describing directors and officers duties and responsibilities state that they should give “priority to the common interest of all the shareholders over any other interest, including the interest of the controlling shareholder(s)”.

Moreover, certain scholars have considered that the “corporate interest” comprises not only the interest of all the shareholders, but also taking into account the interests of the employees and even the general interest\(^8\), depending upon the circumstances under which directors act.

What is undisputed, however, is that the duty “to act with loyalty” will require directors to uphold and pursue the corporate interests over their own. It is precisely on the grounds of the duty “to act with loyalty” that directors are forbidden to participate in deliberations at board meetings when matters to be dealt with entail a conflict of interests with theirs or those of third parties directly or indirectly related to them.

Argentine scholars usually refer to the following provisions of the ACL as rules which are sourced in the duty resulting from the obligation “to act with loyalty”:

- **The prohibition for directors to contract with the company (Section 271).** The general principle is that directors may not contract with the corporation. However, directors may enter into contracts with the company when (i) those contracts concern the ordinary business which the corporation engages; and (ii) the contracts are entered into under market conditions. Contracts that do not fulfill these requirements may only be executed with prior approval granted by the Board of Directors, or by the statutory auditors when the Board may not act due to lack of quorum. Furthermore, the Stockholders' Meeting must be informed of those transactions and should the Stockholders' Meeting disapprove those contracts, the directors or the statutory auditors (should they approve them), as the case may be, shall be jointly and severally liable for damages caused to the company.

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\(^7\) Since enactment of Decree 677/01 there is a trend in legal scholars to extend the principles set forth by Decree 677/01 not only to directors and officers of public companies but also to privately held companies.

There is however a debate as to whether the breach of Section 271 ACL shall cause those contracts to be null and void.

In regards to the definition of “market conditions”, Argentine legal authors consider that the ACL requires that the terms and conditions of the agreements entered into by directors and the company for which they serve must be under the same terms and conditions of the contract under which the company would have contracted with any third party, meaning features such as price, discounts, form of payments, guarantees, etc.

- The obligation to abstain from all corporate deliberations when a conflict of interest arises (Section 272). When a Director has a conflict of interest with the company, he or she shall inform the Board of Directors and the statutory auditors and refrain from taking part in deliberations at any Board meeting where the matter is to be dealt with, under penalty of incurring in the liability set forth in Section 59, ACL.

- The obligation not to compete with the company (Section 273, ACL and Sections 8, 63 through 77 of Decree 677/01): A Director may not be a party, on his own account or that of third parties, to activities which compete with the corporation for which he or she serves, save for express authorization granted by the Stockholders’ Meeting, under penalty of incurring in the liability set forth in Section 59 ACL. Argentine legal authors consider that a duty not to compete arises when there is a current or potential collision of interests which may cause damages to the company. Case law has not developed so far, at least in a substantive and consistent manner, this obligation as a basis to penalize directors from utilizing corporate opportunities for their own benefit although legal scholars have pointed out that this obligation not to compete coped with the duty of loyalty results in a concept, broad enough, so as to be a valid ground to claim from the director violating the obligation not to compete for compensation for damages caused or profits lost. Decree 677/01 supports this conclusion as Section 77 specifically establishes that the following obligations fall within the duty of loyalty owed by directors: (i) the prohibition to use corporate assets or confidential information for private purposes; (ii) the prohibition to take advantage, or allow third parties to take advantage, may it be by action or omission, of business opportunities of the corporation and further emphasized by rule that imposes on directors and officers the obligation to refrain from obtaining any personal benefit except for being remunerated for his or her services.

- The Directors’ confidentiality obligation regarding corporate information.

Although this duty has not been expressly stated under the ACL, Argentine legal authors have considered that directors are required to observe a discrete and confidential conduct

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regarding corporate information, which antecedent is the duty of discretion of the agent in the performance of the agency\textsuperscript{11}. This interpretation has been further ratified by Decree 677/01, for public companies. Section 7 of Decree 677/01 provides for the duty of confidentiality to all parties involved in a public offering, including public officers and, in general to all people who by reason of their office may have access to confidential information.

4.2 The Duty to Act with the Diligence of a Good Businessman: This duty is a further development of the diligence imposed to a “\textit{pater familiae}” under Roman law, which required an ordinary man’s conduct (in order to judge his level of diligence) to be consistent with that of an average ordinary man. However, case law and legal scholars have agreed upon the conclusion that the appreciation of the standards set for a common man are subjective and will vary in accordance with time, social and economic conditions, culture and place where actions are to be conducted. The ACL further elaborates this concept and requires directors to possess a certain specific professional ability, common to people who manage businesses of the same or similar nature\textsuperscript{12}. In general, this qualification implies demanding from the director a much higher degree of intellectual qualification than that which would be expected from an ordinary person. In this sense, the ACL requires a specific aptitude in regards to the industry or business within which the company develops. It is on the grounds of this legal standard that the “improper performance of their office” mentioned in Section 274 of the ACL is judged and comprises all breaches of legal, statutory or regulatory rules of the company to which each individual director belongs. However, Argentine case law has many times stated that the lack of business ability is not sufficient to disqualify a director if it does not derive in the inability to meet duties inherent to his or her behaviour as director of the company\textsuperscript{13}. Furthermore, even if directors’ lack of business ability derives in the company’s insolvency it does not necessarily imply that directors would be personally liable; to the contrary, in general, directors should not be held liable for the company’s insolvency or bankruptcy.


Breach of the standards of conduct provided under Section 59 of the ACL shall turn directors liable in the terms of Section 274 of the ACL which reads: “\textit{Directors are unlimitedly, jointly and


severally liable vis-à-vis the Company, the shareholders and third parties for the improper performance of their office, according to the principles of Section 59 and likewise for breaches of the law, by-laws or regulations and for any damage caused by fraud, abuse of powers or gross negligence”.

Section 274 of the ACL, in order to hold directors liable for damages caused to the company, requires the “improper performance of their duties” and such performance will be judged “improper” upon it becoming perfidious or lacking the diligence of a good businessman.

Furthermore, Section 274 of the ACL enables a director to be held liable for any damages caused by acting negligently or fraudulently. In fact, certain Argentine legal authors consider that the stockholders that backed the appointment of an insufficiently qualified director, may be held liable in case of gross negligence. Such consideration arises from the wording of Section 274 of the ACL and from Section 1109 of the Argentine Civil Code, providing a generic liability rule for damages, reading as follows: “Any person performing an act which, through his fault or negligence causes damage to another, is obliged to repair the damage...”.

Nonetheless, a distinction should be made between the system of liabilities for violation of the law, by-laws or regulations, from damages caused by the improper performance of duties and even for any damage caused by fraud, abuse of powers or gross negligence.


The liability of directors arising from violation of the law, by-laws or regulations may not be exempted by the corporation nor even by the stockholders, except it is expressly and validly excused by a resolution of a validly summoned and held shareholders’ meeting, as explained hereinbelow.

The Argentine ACL establishes four courses of action in order to hold directors liable towards the company, the shareholders and third parties. Those may result from:

(1) the legal action the company may bring, upon the prior pertinent resolution by the Shareholders’ Meeting (Art. 276, ACL);
(2) the legal action the bankruptcy estate, through the Trustee, or if he or she fails to act, through any of the company’s creditors (Art. 278, ACL);
(3) the legal action the shareholders who opposed to certain acts of directors and officers of the corporation may bring (Art. 275, ACL); and,
(4) the legal action shareholders and third parties may institute on the grounds of the damages caused to them or to the company (Art. 279, ACL).
7. **Exculpation of Directors.**

As an exception to the general principles set forth above, the ACL provides for specific mechanisms allowing directors to be either exempted from liability, or avoid assuming liability. This may be achieved (a) when one or more directors (who all together constitute a minority) express disagreement with the decision or act resolved or approved by the majority of the directors when, in the belief of the dissenting director(s) such decision or act could derive in incurring liability for breaching the directors’ standards of conduct, provided such disagreement is reported to the statutory auditors, if any, or, in default thereof, to the Shareholders’ Meeting prior to any third party claiming breach of such specific director(s) duties; (b) directors obtain an express ratification or approval of their performance by the Shareholders’ Meeting; provided, however, that such exculpation shall not release the director from being held liable if such approval were against the law or the by-laws or if shareholders holding 5% of the corporate capital opposed it or if the company is declared bankrupt and, as a result thereof, the company is liquidated (Section 275, ACL); or (c) when directors are assigned specific duties to be individually performed by he, she or them, in which case only those being nominated for such purpose may be held liable for breach of duties, thus having the indirect effect that the remaining Board members would be deemed exculpated (Section 274, ACL).

Furthermore, if in doubt regarding the compliance of a director’s duty to act with loyalty, the burden of proof will correspond to that particular director to prove that his or her conduct was in compliance or consistent with the duty to act with loyalty, in the terms of Section 59 of the ACL and, if it were the case of a public company, as further provided by Decree 677/01.

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15 This exculpation cause was introduced to the ACL in 1983 by the amendment thereto ruled by Law 22.903 which enables the allocation of liability based upon the individual performance of duties individually assigned to one or more directors, either, according to the provisions of the by-laws, regulations or resolutions adopted by the Stockholders Meeting duly registered with the Public Register of Commerce.
AMERICAN BAR ASSOCIATION

Fiduciary Duty Publication Project-Thailand

By Douglas D. Mancill and Parveen Thakral*

Introduction

Thailand had the world’s fastest growing economy in the early 1990s, but by the summer of 1997 Thailand was in financial crisis. The benchmark composite Stock Exchange of Thailand (SET) index, which had climbed to a high of 1,700 in 1994, fell ultimately to below the 300 mark, 1 56 of the 58 finance companies operating in Thailand were closed by the government 2 and Thailand’s GDP contracted by 1.4 percent in 1997, and a massive 10.8 percent in 1998. 3 In August 1997, the International Monetary Fund (IMF) put together a US$17.2 billion bailout package for Thailand. 4 Although debate continues over responsibility for the collapse, few dispute that poor corporate governance played a major role. 5

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*Mr. Mancill is a member of the California Bar and is a partner with Deacons in Bangkok, Thailand. Ms. Thakral is a member of the New York Bar and is an associate with Deacons in Bangkok, Thailand. The authors are grateful to Mr. Mongkol Vutthithanakul and Mr. Kitti Thaisomboon, both senior associates with Deacons in Bangkok, Thailand, for their assistance in preparing this Article.

5 “The Asian financial crisis six years ago demonstrated the risks that companies run by ignoring the concerns of international investors, as capital fled from a region seen to be infected by ‘crony capitalism’.” International Herald Tribune (New York Times), 26 September, 2003, p.1.

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As is common with most civil law jurisdictions, the concept of fiduciary duty is not prevalent in Thai law. Thailand instead primarily relies on a developed body of agency law, and specific statutes, particularly for listed public companies, that are intended to address many of the problems that the fiduciary duty concept covers. Although the concept of fiduciary duty as expressed in Thai law is not always recognizable to those from an Anglo-American legal tradition, it exists, and there is a growing realization of the need for further reform in the area of corporate governance.

**Development of Fiduciary Duty in Thailand**

The historical development of fiduciary duty-like concepts in Thailand is reflected in the differences between the two principle forms of corporate entities in Thailand, private limited companies and public limited companies. Private limited companies are the older of these two types of corporate entities, and are generally governed by agency theory. Public limited companies are a more recent legal creation in Thailand, and statutes embodying fiduciary law concepts are more prevalent in the laws governing public limited companies.

Private limited companies have traditionally been founded and managed by family members. The shareholders, directors and management of private limited companies have traditionally been the same group of people. Unlike many developed countries, the same is also true of public limited companies, even listed public limited

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6 “…[M]ost civil law jurisdictions, including many transition economies, either lack the procedural rules that would enable parties to bring such cases to courts, or have not developed a sufficient body of case law to determine the contents and meaning of [the] concept [of a fiduciary].” Pistor and Xu, *Fiduciary Duty in Transitional Civil Law Jurisdiction Lessons from the Incomplete Law Theory* (2002) © Katharina Pistor and Chenggang Xu 2002. All rights reserved.

7 There are other forms of “juristic entities” in Thailand, such as registered ordinary partnerships, unregistered ordinary partnerships and limited partnerships, but this Article focuses on only private limited companies and public limited companies.
In practice, fiduciary duties have traditionally played a limited role in the corporate governance of both private limited companies and public limited companies.

Private Limited Companies

The laws governing private limited companies in Thailand are set forth in Thailand’s Civil and Commercial Code (“CCC”). The CCC was first adopted by Thailand in 1923, and not only governs private limited companies, but also governs a wide variety of other civil law matters, such as contract law, agency law, partnership law, basic mortgage law, basic property law and family law.  

Section 5 of the general provisions stipulated in the General Principles of the CCC states that “Every person must, in the exercise of his rights and in the performance of his obligations, act in good faith.” Although general in its application, this provision is regarded by some Thai legal scholars as theoretically a building block of the Anglo-American fiduciary duty of care. In practice, however, there is virtually no evidence of its application in relation to directors of private limited companies.

The CCC provides that the relations between directors, the company and third persons are governed by the CCC’s agency provisions. Although the specific duties and liabilities of an agent under the law are relatively few in number, the principles are

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8 Only public limited companies can be listed on the SET. Many, but not all, public limited companies are listed.
9 There are additional Acts and laws that amplify upon the basic principles found in the CCC on these areas of civil law.
10 Thailand is a Buddhist country, and Thai Buddhism includes an obligation to act in good faith and consider the interests of others. This is reflected, for example, in Section 5 of the CCC’s requirement that parties exercise their rights and perform their obligations in good faith.

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well-entrenched and consistently applied as a result of the relatively large number of Thai Supreme Court decisions concerning such duties and liabilities. In contrast, there are very few Thai Supreme Court judgments deciding cases concerning breach of directors’ duties in private limited companies. Conflicts between shareholders and management do occur and agency theory can be applied to directors, but there are few Thai Supreme Court judgments addressing such conflicts because of the lack of incentives and the generally poor procedural framework for shareholders to bring an action against directors (see below).

Aside from agency theory, other laws exist which are more narrowly tailored to address possible abuses of position by directors in private limited companies. Section 1168 of the CCC states that directors must, in their conduct of business, apply the diligence of a careful business person, and specifically, that directors are jointly responsible and liable, without exception, for (i) the payment of shares by the shareholders being actually made, (ii) the existence and regular keeping of books and documents prescribed by law, (iii) the proper distribution of dividends as prescribed by law, and (iv) the proper enforcement of the resolutions of general meetings of shareholders. Section 1168 also states that a director must not, without the consent of a general meeting of shareholders, engage in commercial transactions of the same

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11 Judicial precedent as a source of Thai law has a unique definition, lying somewhere between the English common law practice of precedent being binding and the continental practice of relying only on a long line of strongly held decisions for authority.

12 For example, Thai Supreme Court judgment number 673/2511 (1968) invoked Section 810 of the CCC, which requires an agent to hand over to the principal all money and property received by him by virtue of the agency relationship. The same judgment also invoked Section 812 of the agency provisions of the CCC, which provides that an agent is liable for any injury resulting from his negligence, his failing to observe the agency relationship, or his acting outside the scope of his authority. (Thai Supreme Court decisions are not identified by the parties’ names, but instead by a case number followed by the date on the Thai Buddhist calendar that the decision was rendered.)
nature as, and competing with that of, the company.\footnote{13} These specific provisions are intended to fulfill the role, although in effect much more limitedly, of judge-made law in Anglo-American jurisdictions which “carves out a subset of specific obligations and standards of conduct derived from [the] principle [of a fiduciary]”.\footnote{14}

Public Limited Companies

Public limited companies are commonly thought of as companies that are generally listed on a public exchange and owned by a disparate group of public shareholders. In Thailand, families generally control all the shares of a public limited company, and up to eighty percent of the voting rights of a listed company. This reality has influenced the manner in which public limited companies are managed in practice.\footnote{15}

The formation and operation of public limited companies is governed by the Public Limited Companies Act B.E. 2535\footnote{16} (“Public Companies Act”). Listed public limited companies are also subject to an additional body of law, the Securities and Exchange Act B.E. 2535 (the “Securities and Exchange Act”),\footnote{17} and regulations of

\footnote{13}{In the last fifty years, there have been less than ten Thai Supreme Court cases concerning Section 1168 of the CCC.}
\footnote{15}{For example, commentators on business practices in Southeast Asia have observed that families which control listed companies often cause “their” listed companies to engage in uneconomic business transactions with privately owned companies under the control of the same family group, to the detriment of the listed company. Backman, M., \textit{Asian Eclipse, Exposing the Dark Side of Business in Asia} (2001). The authors’ experience in conducting legal due diligence on numerous public limited companies in Thailand is consistent with this observation.}
\footnote{16}{Thai legislation is dated according to the Thai Buddhist Calendar. The year 2535 correlates to 1992 on the Gregorian calendar.}
\footnote{17}{\textit{Id.}}

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the Securities and Exchange Commission (SEC) and the SET.

There are numerous provisions in the Public Companies Act that impose fiduciary-like duties on directors, but the most important provisions are contained in Section 85, Section 80, Section 86 and Section 87 of that Act. These provisions embody principles of due care and loyalty, and try to preclude self-dealing. Section 85 of the Public Companies Act requires directors to act with care, and in good faith, in conducting business in the interests of the company. There have not, however, been many cases demonstrating the good faith requirement or the level of care expected.

The Public Companies Act also imposes duties of loyalty on directors. Section 80 prohibits a director from voting on a matter in which he or she has an interest, and Section 86 prohibits a director from operating a business of the same nature as, or which is in competition with, the business of a company unless the director has notified the shareholders meeting prior to the resolution of his or her appointment.

Section 87 of the Public Companies Act provides that if any director buys property from, or sells property to, the company or conducts any other business with the company, those deals are not binding on the company unless approved by the board of directors. Section 88 of the Public Companies Act requires a director to inform the company if he or she has a direct or indirect interest in any contract entered into by the company during a fiscal year. The penalty for failing to do so, however, is only a maximum fine of Baht 20,000 (approximately US$500).\(^{18}\)

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\(^{18}\) Section 203 of the Public Companies Act.

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Section 89 of the Public Companies Act prohibits a company from granting loans or guarantees to any of its directors or employees, or to companies in which those directors or employees own more than fifty percent of the shares. There are exceptions for loans or guarantees in a welfare scheme or in the normal course of business of a company that is a financial institution.

In spite of all these provisions however, which cover at least the basic concept of a fiduciary as espoused under Anglo-American law, going so far as to carve out specific applications of directors’ duties, there is no effective compliance monitoring scheme and no satisfactory interpretations of “direct” and “indirect” interests in the relevant provisions of the Public Companies Act. This has much to do with the fact that courts have not historically played a role in determining the parameters of corporate conduct, due largely to the procedural obstacles discussed below.

The Securities and Exchange Act imposes on directors a duty to disclose truthfully all material facts in the registration statement and draft prospectus filed with the SEC in connection with the sale of securities to the public. The failure to observe this duty is punishable by imprisonment for a term not exceeding five years and a fine not exceeding two times the price at which all securities were offered for sale, but not less than five hundred thousand Baht (approximately US$12,200). This is a severe penalty, which in practice, generally succeeds in forcing directors to comply with their duties of disclosure.

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19 Section 82 of the Securities and Exchange Act.
20 Section 278 of the Securities and Exchange Act.
To Whom Are These “Fiduciary” Duties Owed?

Corporate governance commonly refers to the managerial regime of a company tasked with ensuring its best interests reign supreme, synonymous in Thailand, as in numerous other jurisdictions, with ensuring the maximization in the long-term of the value of shareholder investments. Accordingly, directors’ duties are ultimately owed to the shareholders in both private limited companies and public limited companies.

It is evident thus far that, as a practical matter, the check-and-balance mechanism achieved by the creation and imposition of fiduciary duties on directors in Anglo-American jurisdictions is almost non-existent in Thailand. As most companies have developed from family businesses, the shareholding and management structure is usually concentrated in family members, often referred to as “inside shareholders”. Investment decisions of “outside shareholders”, meaning those not related to the core family, are usually based on their confidence in the inside shareholders. This structure is conducive for inside shareholders to take advantage of, or abuse, outside shareholders’ rights.

There is no requirement in the Public Companies Act to appoint independent directors. The SEC however requires listed companies to appoint at least two directors who are independent from the major shareholders and the management. The intended role of these independent shareholders is to safeguard the interest of minority shareholders against any abuses of position by management. In practice however,

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21 Working Group, Office of the Securities and Exchange Commission, Enhancing Good Corporate Governance of Thai Listed Companies (July 1999), as updated on 30 April 2002.
22 Id.
23 Id.

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because the requirement of two independent directors is an absolute requirement regardless of the total number of board members or the proportion of shares held by outside shareholders, these directors are not in a position to vote out management when all of the remaining board members are related to major shareholders.\(^{24}\)

Further, in practice, an independent director will often resign when the board acts with impropriety. A survey of Thai listed companies conducted by Price Waterhouse Management Consultants Ltd. revealed that most companies have outside directors solely to fulfill the regulatory requirement, and only a mere fifteen percent of the companies surveyed believed that the independent directors added value to their companies and had more than two independent directors.\(^{25}\)

Section 85 of the Public Companies Act provides that in conducting the business of the company, the directors shall comply with all laws, the objects of the company, the articles of association or by-laws, and shareholders’ resolutions, with care and in good faith in order to preserve the interests of the company. As discussed above, there is no clear interpretation of what constitutes the duty of care. There are currently no specific laws resembling the business judgment rule\(^{26}\) prevalent in U.S. state law.

\(^{24}\) Id.

\(^{25}\) Id.

\(^{26}\) “This rule, well-established in caselaw, protects a disinterested director from personal liability to the corporation and its shareholders, even though a corporate decision the director has approved turns out to be unwise or unsuccessful. The business judgment rule presumes that, in making a business decision, directors acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the corporation.” Committee on Corporate Laws, ABA Section of Business Law, Managing Closely Held Corporations: A Legal Guidebook, The Business Lawyer (2003), Vol. 58, No. 3, p. 1077.
either. Finally, there are practical reasons to doubt that directors will act in the best interests of all shareholders.

There are however signs that regulatory authorities in Thailand are beginning to crack down on the more egregious examples of corporate malfeasance. A recent example involves Roynet Public Co., Ltd. ("Roynet"), a listed company. Roynet was suspended from trading on the SET in mid-January when it was revealed that the Yaoprukse family, which held a sixty percent stake in Roynet as of April 2002, sold off its entire holdings by December without properly notifying securities regulators. The former managing director of Roynet currently faces criminal charges for insider trading, disclosure violations and accounting fraud. The SET had previously ordered Roynet to hold a shareholders meeting to form a new board of directors following the ongoing refusal by directors to inform minority shareholders about the company’s financial and operational situation. The order by the SET came after Roynet ignored a March request by 27 shareholders to convene an extraordinary meeting of shareholders. The SET had threatened to blacklist Roynet directors from holding any positions in a listed company if they failed to call the meeting. At a shareholders’ meeting held on 27 June 2003, shareholders appointed replacements for the directors representing the Yaoprukse family, formerly Roynet’s major shareholders. The former managing director has been banned for 10 years from holding a board position with any listed company, the largest penalty imposed by the


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SET in its twenty-eight year history. The other Roynet directors were not blacklisted after they agreed to “voluntarily” resign from the company.

**Enforcement By Shareholders**

Shareholders are permitted to monitor the performance of directors and to seek redress under various provisions of Thai law, the most important of which include Sections 85, 100, and 108 of the Public Companies Act, and Sections 82-85 of the Securities and Exchange Act.

Section 85 of the Public Companies Act (discussed above) enables shareholders holding not less than five per cent of the total number of shares to issue a written notice directing the company to initiate a lawsuit against the defaulting directors. If the company fails to initiate a lawsuit as directed by the shareholders, the shareholders may initiate an action for compensation on behalf of the company. In the event that shareholders exercise their rights under Section 85 of the Public Companies Act, there are no Thai Supreme Court decisions that determine whether or not shareholders may be indemnified for costs by the company. Consequently, shareholders are reluctant to initiate lawsuits and prefer that other shareholders bear the burden of costs. There is therefore no significant threat to directors for not observing the requisite duty of care.

Section 100 of the Public Companies Act provides that shareholders holding not less than 20% of the shares of a company, or numbering not less than twenty-five persons and holding at least ten percent of the shares, may request the board of directors to convene an extraordinary general meeting at any time. If the board of directors fails to convene a general meeting in accordance with the request the penalty is a mere fine.

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not exceeding Thai Baht 20,000 (approximately US$500), and the only remaining option for the aggrieved shareholders is to obtain an injunction, which can take weeks and sometimes even longer. It is notable that given the less developed legal framework of directors’ duties in private limited companies, the Public Companies Act may provide even less shareholder protection than the CCC which permits shareholders of private limited companies to convene among themselves if the board of directors refuses to act in accordance with their request to convene a shareholders’ meeting.  

Section 108 of the Public Companies Act enables shareholders numbering five or more, or shareholders representing not less than twenty percent of the total number of shares of a company, to request the court to revoke a resolution passed in contravention of the articles of association and the provisions of the Public Companies Act, including resolutions passed at meetings convened in contravention of the articles of association and the Public Companies Act.

Sections 82-85 of the Securities and Exchange Act permit shareholders who in buying shares in a public offering, suffered damages as a result of fake or misleading statements contained in the registration statement and draft prospectus filed with the SEC, to claim compensation from the directors and other persons responsible for certifying the accuracy of the information contained in those documents. This duty of disclosure is generally accorded with because of the severe penalty inflicted for non-compliance (see above).

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32 Working Group, Office of the Securities and Exchange Commission, Enhancing Good Corporate Governance of Thai Listed Companies (July 1999), as updated on 30 April 2002.
Over the past few years, the SET and SEC have made some attempts to strengthen the protection of shareholders’ and particularly, minority shareholders’ rights. For example, in 1998 the SEC formed a working group to study the possibility of allowing minority shareholders to initiate class action lawsuits against management. Present laws and regulations remain unchanged in this regard however. In practice, minority shareholders rarely exercise their rights because many are still not aware of their rights and because of procedural obstacles.

Procedural Obstacles

Separate and apart from substantive law issues, shareholders in Thai companies face difficult procedural obstacles when they seek to enforce their rights in the Thai court system. There are at least three such procedural obstacles.

First, the rules of civil procedure that govern civil proceedings in Thailand (for example, the Thai Civil Procedure Code B.E. 2477), including any suit a shareholder might bring to enforce its rights in a Thai court, do not allow for anything remotely similar to the broad discovery permitted in U.S. legal proceedings. In theory, a party is entitled to request specific identified documents, but in practice, it is difficult, if not impossible, to obtain useful evidence employing the procedural mechanisms provided for in the rules and statutes that govern civil proceedings in Thailand. Consequently, a shareholder with a strong hunch and circumstantial evidence of corporate malfeasance who might be able to ultimately obtain substantiating evidence through discovery in a U.S. legal proceeding will probably not be able to do so in a Thai legal proceeding.

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33 Saravuth Pitiyasak, Corporate Governance in Family Controlled Companies: A Comparative Study between Hong Kong and Thailand.

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Second, the remedies available to plaintiffs in Thai legal proceedings are much more limited than the remedies available to plaintiffs in both U.S. and English legal proceedings. As a matter of practice, it is much more difficult to obtain injunctive relief from a Thai court than it is from a U.S. or English court. Further, damage awards from Thai courts tend to much lower than damage awards from U.S. and English courts. In practice, Thai courts are much less willing to consider or award “economic damages” based on expert testimony than are U.S. courts.

Third and finally, although many U.S. lawyers complain about the slow pace of civil justice in the U.S., U.S. civil proceedings move at lightening speed compared to Thai civil proceedings. Compounding this problem, it is substantially more difficult to enforce judgments in Thailand than it is in most states of the U.S.

These procedural impediments should not be underestimated. They present shareholders in Thai companies with a substantially different set of economic incentives than those available to shareholders in U.S. companies, and these differing incentives have contributed substantially to differences in corporate governance between the U.S. and Thailand.
Conclusion

The basic concept of a fiduciary exists under Thai law but the real challenge lies in restructuring the legal framework so that shareholders’ rights can be effectively enforced under the existing law. Although the SEC continues to urge listed firms to improve their corporate governance and financial disclosures before enforcement becomes real, routine and costly, it is likely to take some time before any effective structural changes to the existing legal framework for corporate governance are implemented.

Kala Anandarajah
Partner

Contact Details
Direct: (65) 6232 1111
Fax: (65) 6557 0901
E-mail: kala.anandarajah@rajahtann.com

Qualifications
* LLB (Hons) NUS, 1989
* MBA (Banking and Finance) NTU, 1997
* Advocate and Solicitor, Supreme Court of Singapore, 1990

Citation
* Leading Corporate Governance Lawyer in An International Who’s Who of Leading Corporate Governance Lawyers 2002 and again in 2004
* Euromoney Guide to the World’s Leading Corporate Governance Lawyers 2003
* Corporate Counsel Corporate Governance Lawyers 2003/4

Industry Specialisation
* Corporate Governance
* Competition Law
* Environmental Law
* Corporate Law
* Banking Law

Language Ability
* English
* Tamil
* Malay

Professional Experience

Kala Anandarajah is a Partner in Rajah & Tann. She is Head of the Knowledge & Risk Management Group, and the Lead Partner of the Corporate Governance Practice Group.


Kala practices in the field of Corporate and Banking advisory, Competition Law and Environmental Law. She has wide exposure on all aspects of corporate / commercial transactions. Her prior experience includes litigation and insolvency.

Kala’s practice on corporate advisory and governance has seen her involved in CG implementation projects, including ensuring proper documentation for CG, advising on internal controls and key committees, reviewing CG Audits, performance appraisals, providing cross border advise on CG and conducting tailored training. Her practice of corporate governance sees a unique unfolding of experience in risk management, systems management, internal controls, employment, and fraud management to provide a holistic advice.

Kala, who did her MBA thesis in tax, has also been involved in bank compliance work and setting up the frameworks for compliance, and advising on Basel Principles, the impact of Sarbanes-Oxley and various global CG issues.

She has conducted a number of lectures regionally and internationally, including the United Kingdom, the United States, South Africa, Japan, Hong Kong and Malaysia. She has also written widely, including regularly for the Singapore Business Times and the Singapore Exchange in its official publication, PULSES. She is author of the only Singapore book on corporate governance titled Corporate Governance – A Practical Approach 2001, updated as a looseleaf titled Corporate Governance Compliance 2003. She was also primary editor for the Corporate & Securities Law in Singapore Comparative Analysis Series 2002.

Kala was awarded the National University of Singapore Law School Colours Award and the Raffles Girls’ School Merit Award for her contributions to the respective institutions. She was the first Law School representative to the Australasian Law Students Association Paper Presentation Championship held in Melbourne in 1988.
Professional Background

1. Equity Partner and Head of Knowledge & Risk Management (2001 to present); Concurrently Lead Partner, Corporate Governance Practice (2002 to present)

2. Partner and Head of Knowledge Management, M/s Rajah & Tann (1999 - 2001)


4. Senior Legal Assistant, M/s Allen & Gledhill (1994 - 1997); Head of Research from 1995

5. Legal Assistant, M/s Allen & Gledhill (1992 - 1994)


Memberships / Appointments

1. Chief Examiner, Corporate Governance Stream of the Singapore Chapter of the Institute of Chartered and Administrators, 2003-2004

2. Fellow, Singapore Institute of Directors, 1 March 2003 (By Invitation)

3. Panelist, Lexis-Butterworths Professional Education Corporate Advisory Panel, 2003 to current

4. Member, Publications Sub-Committee, Singapore Institute of Directors, 2003

5. Member, Singapore Institute of Directors, 2002 - 2003

6. Member, American Bar Association, 2002 to Current

7. Member, ASEAN Law Association - Current

8. Member, The Singapore Academy of Law, 1990 to Current

9. Member, The Law Society of Singapore, 1990 to Current

10. Singapore Business Federation – Ad Hoc Committee on Review of proposed Companies Amendment Act, August-September 2003


15. International Editor for the Singapore / South East Asia Section of the Journal of Banking and Finance Law and Practice – 2001 to present

16. Country Correspondent of Capital ASIA, Hong Kong Based Publication by
ISI Publishers, 1999 - Current


18. Secretary, Corporate Practice Committee of Law Society of Singapore – 1999 - Current


20. Member, Practice Management Committee of Law Society of Singapore – 2000 - 2001


Publications / Papers / Conferences

1. Books Authored

1. Corporate Governance Compliance, 2003 – A looseleaf version to be updated annually (Updated 1st book by this author in Singapore) (Published by Butterworths-Lexis)

2. Professional Liability in Singapore and Malaysia — Accountants and Auditors, 2003 (Published by CCH Pte Ltd)

3. Corporate & Securities Law in Singapore Comparative Analysis Series 2002 – primary editor (Published by CCH Pte Ltd):
   - Securities And Futures Act 2001
   - Financial Advisers Act 2001
   - Singapore Code on Take-overs and Mergers

4. Halsbury’s Laws of Singapore Banking and Finance Volume, 2002 - Co-author (Published by Butterworths-Lexis)

5. Corporate Governance – A Practical Approach, 2001 (1st book in Singapore) (Published by Butterworths-Lexis)

6. Law and Practice of Bankruptcy in Singapore and Malaysia, 1999 (Only book in Singapore) (Published by Butterworths-Lexis)


2. Chapters Written For International / Singapore Books

1. The Role Of Independent Directors – Chapter On Who Can Become An Independent Director, 2003 – Co-Published by the Malaysian Institute of Corporate Governance and the Malaysian Securities Exchange Commission (By Invitation)

2. Singapore Civil Procedure – The White Book 2003 – Several Orders (Published by Sweet & Maxwell)

3. Corporate Governance: An Asia-Pacific Critique, 2002 – Author of Singapore Chapter and Co-author of Malaysian Chapter (By Invitation) (Published by Sweet & Maxwell)


6. International Insolvency (Published by Juris Publishing) – Co-authored Singapore chapter, 1998


10. Laws On Funds, published electronically on the Internet by Linklaters & Paines in 1999, and which is updated regularly.


3. Papers / Articles Written


- A detailed list will be provided on request.
4. Conferences Presented At

(a) International / Regional

1. Enterprise Risk Management in Corporate Solvent And Insolvent Restructuring – Asia Business Forum – 1-2 October 2003 - Malaysia


4. Corporate Governance in the Asia Pacific Region – 18th Biennial Conference of LAWASIA 2003 – 1-4 September 2003 - Japan


6. Governance & Regulation: Challenges & Prospects International Conference On Regulating The Regulators & Governance And Regulation In The Era Of Demutualisation – Co-Organised By MICG and MAICSA – 5-6 March 2003 - Malaysia


8. Corporate Governance & Global Competitiveness – International Conference on Corporate Governance in Asia - MICG, AIM, FPLC & MROC, 2 & 3 April 2002 - Malaysia

9. Knowledge Management presented at High Level KM Seminar organised by Universiti Technology Malaysia et al, 1 April 2002 - Malaysia

10. 3rd Symposium on Corporate Governance and Disclosure: The Impact of Globalisation – The Chinese University of Hong Kong and Other Regulatory bodies, 1 & 2 February 2002 - Hong Kong

11. Federation Of Public Listed Companies – Malaysian Institute Of Corporate Governance, Independent Directors And Corporate Governance, 24 October 2001 - Malaysia

12. Knowledge Management - Practical Implementation, 7 November 2001 – Bangkok, Thailand

13. Knowledge Management - Practical Implementation and Issues That Block, Hong Kong in May 2001 - Hong Kong

14. Participant in Roundtable Discussions on Corporate Governance at Invitation of UNDP, 28 November 2000 - Malaysia

15. Facilitator and Panelist at Practice Management Course for New Managers,
16-21 July 2000 - St Charles, Chicago - USA


18. Whether Singapore is a Tax Haven – Centre for International Legal Studies held at Kaprun, Austria in May 1997 – Austria

(b) Singapore

2004

1. Recent Developments in Corporate Governance – Temasek Holdings Ltd – 26 February 2004

Several more upcoming.

2003


5. The Impact of the Recent Companies Act Amendments on Directors – The Law Society of Singapore & the Singapore Institute of Directors – Chairman – 12 November 2003

6. How To Effectively Manage and Handle Corporate Transparency and Risk Management – Asia Business Forum – 6-7 November

7. Understanding Corporate Governance and Implementing a Model Most Appropriate for your Company (Workshop) – Asia Business Forum – 5 November


9. Corporate Governance In Corporate Restructuring To Enhance Internal Control And Accountability – Asia Business Forum – 13-14 October 2003

10. Achieving Corporate Governance Compliance – Power Seraya Singapore Ltd – 30 September 2003


13. Legal Issues In Executive Remuneration & Practical Guidelines For Effective Annual General Meetings – Lexis-Butterworths Conferences supported by Singapore Institute of Directors, 10 September 2003

14. Oracle Executive Summit – Corporate Governance for Chief Information Officers – 20 August 2003

15. Directors Duties & Responsibilities and Disclosures – Nanyang Technological University – 19 August 2003


17. Directors Duties & Liabilities And Understanding Corporate Governance – HDB Corporatised - Directors – 29 July 2003

18. Disclosure Obligations, Shareholder Activism and the In-house Counsel's Role and Obligations – SIA Legal, SIAEC Legal and SATS Legal – 27 June 2003


20. Critical Issues in Singapore Corporate Governance – Accountability and the Role of the Inhouse Counsel as a Strategic Adviser to Good Corporate Governance – Fortress Intelligence – 19 June 2003


25. Shareholder Activism – Beware the Sleeping Giant’s Impact on Corporate Governance & Disclosure: What All Directors & Officers Must Know – 28 March 2003


27. Business Intelligence Conference – Customer Contact World: CRM & Contact Centres, 14 March 2003


29. The Nuts & Bolts of Implementing Corporate Governance – The Singapore Association of the Institute of Chartered Secretaries & Administrators, 10 January 2003
2002

30. The Business Week CFO Forum, 12 and 13 November 2002
31. Company Directors & Officers Executive Submit – 3 & 4 September, 2002
32. Corporate Fraud Implications and Preventive Measures for Directors – Temasek Management Services Pte Ltd, 21 May 2002
33. Effective Implementation Of Corporate Governance – Temasek Management Services Pte Ltd, 29 January 2002
34. Knowledge Management for Singapore Attorney-General’s Chambers, 24 January 2002

2001

36. Effective Corporate Governance – Butterworths Professional Conferences, 30 November 2001
37. Panelist – Corporate Governance Seminar Jointly Organised By The Singapore Institute Of Directors And Andersen, 12 November 2001 - Singapore
38. Knowledge Management - Practical Implementation, IQPC, 28 September 2001
39. Directors Duties And Responsibilities Including Corporate Fraud, Private Client Seminar, 26 September 2001
40. Corporate Fraud And Corporate Governance – Temasek Management Services, 11 September 2001
42. Paper on Securities Litigation And Governance In Singapore – Conferencing Board Seminar, 23 July 2001
43. Corporate Fraud - Control And Prevention, Singapore Institute of Directors, 11 May 2001
44. Challenges in Corporate Governance in the Asian Region, Asia Business Forum, 21 April 2001
46. The Proposed Corporate Governance Code and The Shareholder - An Innocent Bystander, Butterworths, 17 January 2001

2000 & Pre-2000

48. Monitoring Internal Controls – Asia Pacific Institute in 1999
49. Directors' and Officers' Liability – Asia Business Forum in 1999
50. Section 7 Companies Act and Scope of the Meaning of Interest for Corporate Clients 1999
51. Money Laundering – Scope and Implications for Bank Clients in 1999
52. Changes in Stamp Duties and Implication thereof for Clients in 1998

**Media Interview and Publication**

*a) Interviews*

1. CNBC Interview – Live Interview - Corporate Governance in Indonesia vis-à-vis Asia Pulp and Paper – 29 September 2003
2. Channel News Asia – Interview Singapore's Legal Services Need To Be Reinvented To Stay Competitive – 17 September 2002
3. Bloomberg News – Interview and quoted in article titled SingTel Chairman's Investment in Rival Raises Ire – 9 June 2003
6. International Herald Tribune – Interview and quoted in article titled Singapore gets tougher in its fight against SARS - 12 June 2003
7. The Business Times – Interviewed and quoted on article title Outsourcing For Services – August 2003
8. The Straits Times – Interviewed and quoted in article titled $270k: PSC’s fee to John Chen raises eyebrows; Non-exec deputy chairman was paid for consultancy work done by his firm – 5 December 2003
9. The Straits Times – Interviewed and quoted in article on Natsteel matter and whether SGX was right - October 2003
11. The Straits Times – Interviewed and quoted in article titled Best Of Both Worlds With New Company Category (Limited Liability Partnerships And Limited Partnerships) - 19 June 2003
12. The Straits Times – Interviewed and quoted in article titled Push to split chairman and CEO posts meets resistance – 14 June 2003
13. The Straits Times – Interviewed and quoted in article titled Top-Posts Split Not For All Firms – 26 February 2003
14. The Streats – Quoted in article on Singtel chairman – 9 June 2003
15. The Star (Malaysia) – Quoted (from comments made in conference in Kuala Lumpur) in article titled MICG: Govt Agencies And Companies Should Take The Lead – 4 March 2002

b) Contributions

HOLLY J. GREGORY  
Partner  
WEIL, GOTSHAL & MANGES LLP  
767 Fifth Avenue  
New York, NY  10153  
Telephone: (212) 310-8038  
Fax: (212) 310-8007  
E-mail: holly.gregory@weil.com

Holly J. Gregory, a partner in the Corporate Governance Group of Weil, Gotshal & Manges LLP, counsels corporate directors, trustees, managers and institutional investors on a range of governance issues, including director and trustee responsibilities, conflicts of interest, board and committee structure, board audits and self-evaluation processes, institutional investor initiatives, and international governance "best practice." In the public policy arena, Ms. Gregory has worked with Ira M. Millstein in various projects for the OECD, the World Bank, the European Commission and the U.S. Securities and Exchange Commission, related to corporate governance.

In addition to her legal practice and policy efforts, Ms. Gregory has lectured on corporate governance topics at programs sponsored by the SEC, the Conference Board (U.S. and Canada), the U.S. State Department (in Japan and Turkey), the PIRC (U.K.), the National Association of Corporate Directors, the American Corporate Counsel Association, the American Society of Corporate Secretaries, the National Association of Public Pension Attorneys, and Institutional Shareholder Services, among others. She has helped organize corporate governance programs for the OECD, the World Bank, the Global Corporate Governance Forum, Yale’s International Institute for Corporate Governance, Transparency International, the SEC, and Columbia University School of Law's Institutional Investor Project. She served as Counsel to the Egon Zehnder International Institutional Investors Advisory Group, and served on the Secretariat of the OECD Business Sector Advisory Group on Corporate Governance. She is Co-Chair of the Subcommittee on International Developments of the Corporate Governance Committee of the Business Law Section of the American Bar Association, and has served as a member of both the Nominating and Bylaw Committees of the International Corporate Governance Network. She was named to the International Who’s Who of Corporate Governance Lawyers, 2002.

Ms. Gregory has authored and co-authored a number of publications on corporate governance, including as a featured columnist in Dow Jones’ Corporate Governance publication. Other recent writings include:

- “Global Overview,” in Corporate Governance -- in 22 Jurisdictions Worldwide 2003 (Law Business Research ‘Getting the Deal Through’ Series, 2003), and United States Chapter (co-authored with David Murgio and Jane Pollack (also Contributing Editor);  
- “Corporate Social Responsibility,” Global Counsel (March 2002)
- "Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States," on behalf of the European Commission, Internal Market Directorate General (January 2002)
- "Building an Infrastructure for Financial Stability," Federal Reserve Bank of Boston, Conference Series No. 44, June 2000
- "Get it Right From the Start: Global Governance Guidelines for the Emerging Company," *Ernst & Young LLP/Directorship, Governing Entrepreneurial Companies* (Fall 1998); and "Organizing the Board's Oversight Functions Through Committees," *Ernst & Young LLP/Directorship, Governing Entrepreneurial Companies* (Fall 1997).

Ms. Gregory received her J.D. *summa cum laude* from New York Law School in 1986, where she was Executive Editor of the *New York Law School Law Review*. Upon graduation, she served as a law clerk to the Honorable Roger J. Miner, United States Court of Appeals for the Second Circuit, until her association with Weil, Gotshal & Manges LLP in the summer of 1987. She is a founding member of the Board of Legal Advisors of the NOW Legal Defense & Education Fund.
Carol Hansell is a senior partner with Davies Ward Phillips & Vineberg LLP, practising corporate, commercial and securities law. She acts for both private and public corporations on a variety of matters, including acquisitions, financings and reorganizations. She is recognized in the Canadian Legal LEXPERT Directory in the areas of mergers and acquisitions and corporate and commercial law and has been awarded the Martindale Hubbell Law Directory's highest accolade, an AV rating.

Carol has a particular expertise in corporate governance and is recognized as a leading practitioner by Law Business Research's International Who's Who of Corporate Governance Lawyers. She regularly advises boards and their committees in the context of transactions and on their governance practices generally. She has written and published a number of papers, articles and commentaries on this topic and has also spoken widely in the area. Carol is the author of What Directors Need to Know: Corporate Governance, a resource for corporate directors, and Directors and Officers in Canada: Law and Practice, a loose-leaf service, and is a contributing editor to Corporate Governance, a quarterly journal published by Federated Press. She served as a member of staff for The Toronto Stock Exchange's Committee on Corporate Governance in Canada (which produced the Dey Report) and provided advice to the Joint Committee on Corporate Governance (which produced the Saucier Report). Carol is also Co-Chair of the Corporate Governance (International Developments) subcommittee of the American Bar Association.

Carol serves on the board of directors of the Public Sector Pension Investment Board, a crown corporation that invests cash flows from the pension plans of the federal public service, Canadian Forces and R.C.M.P. She also sits on the corporate governance committee of the board of directors of Toronto East General Hospital and of Altruvest Charitable Services as well as on the Advisory Board of the Literary Review of Canada. She is a director and Vice Chair of the Institute of Corporate Directors, a past director of the Centre for Ethics and Corporate Policy in Canada and a member of the faculty of the National Association of Corporate Directors, a Washington-based organization focussing on board leadership issues.
Carol has had extensive involvement in the development of public policy. She is a member of the Securities Advisory Committee ("SAC"), which provides advice and assistance to the Ontario Securities Commission. She was a member of the "Five Year Review Committee", the Advisory Committee established by the Minister of Finance to review securities laws in Ontario. She has also served as a Commissioner on the Blue Ribbon Commission on the role of the board of directors in corporate strategy established by the National Association of Corporate Directors in Washington, D.C. and on the working group considering issues of directors' liability in connection with proposed reforms to the Bankruptcy and Insolvency Act.

Carol teaches in the Directors Education Program jointly offered by the Institute of Corporate Directors and the Rotman School of Management. She is a course director and member of faculty for the National Securities Law LLM Program at Osgoode Hall Law School. In 2002, Carol was appointed as an Adjunct Professor of Osgoode Hall Law School. Carol has taught courses on corporate and securities law, financial statements, transactions and negotiation skills and has chaired and spoken at conferences on a variety of corporate and securities law topics for a number of law schools, business schools and conference organizations. She serves on the Canada-Russia Corporate Governance Advisory Council established by the Schulich School of Business.

Carol received a B.A. in History from the University of Western Ontario in 1981, an M.A. in International Relations from the University of Toronto in 1982 as well as an LL.B. from Osgoode Hall Law School and an M.B.A. from the Schulich School of Business at York University in 1986.
Laurence Hazell is a Director in the Governance Services Group of Standard & Poor's in New York. Formerly, the senior global analyst at Proxy Monitor before its merger into Institutional Shareholder Services he also worked with GovernanceMetrics International. Called to the English Bar by the Honourable Society of Gray's Inn, he practiced from Chambers in London and York before emigrating to the United States. He earned bachelor and doctoral degrees from the University of Durham, England.
Elizabeth Johnstone, Partner

LLB, MA (Hons), BA (Hons), ACIIC
Partner - Corporate Advisory Group, Blake Dawson Waldron,
National Segment Leader: Corporate Law and Governance

Qualifications and Memberships

Elizabeth joined Blake Dawson Waldron in 1992 after 14 years as a senior executive and consultant specialising in corporate advisory, restructuring and legal compliance work. Elizabeth gained an LLB at the University of Sydney and an MA (Hons) and BA (Hons) from the University of New England. In 1985 Elizabeth was selected as the BPW Business Woman of the Year. She is an Associate of the University of Sydney's Centre for Innovation and International Competitiveness (ACIIC). Elizabeth served as an appointed Public Member of the Australian Press Council for ten years, and has served as a director for a number of organisations. She has been appointed to the American Bar Association's Corporate Governance Committee and the Australian Stock Exchange's Corporate Governance Council – Integrity of Reporting and Board Composition and Independence Working Parties.

Elizabeth practises in the Corporate Advisory group - advising on corporate law and governance, restructuring, privatisation, strategic issues in mergers and acquisitions, and competitive tendering and contracting including probity issues. Elizabeth's previous legal practice experience has included corporate and commercial, employment and industrial, and trade practices law.

Professional and Management Experience

- Advising a number of companies on corporate governance issues including directors' duties, disclosure, board processes and governance practices.
- Advising various corporate clients on strategic and governance issues associated with proposed mergers and acquisitions.
- Conducting corporate governance board briefings for a member of corporate and government clients.
- Advising on governance and probity issues in relation to government procurement, outsourcing and competitive tendering and contracting - Australian, NSW, Victorian, South Australian governments.
- Retained by the Asian Development Bank on a major Governance and Privatisation Program in State Owned Enterprises in Indonesia.
- Retained by Australian Auditor General to develop Principles and Better Practices – Corporate Governance in Commonwealth Authorities and Companies and development of socialisation capacity building program related to governance in Australian bodies.

Publications and Papers

Mr. Seewald is a registered foreign lawyer in Hong Kong and a barrister, solicitor and notary public in his home jurisdiction of British Columbia, Canada. He has experience servicing both public and private companies in their ongoing business matters, as well as in assisting them to raise financing. He has worked extensively in Asia, both in the business and legal aspects and speaks Mandarin and Cantonese in addition to German. He sits on boards of directors of three wholly owned foreign enterprises in the P.R.C.


Mr. Seewald has taught the legal aspects of information technology law at the British Columbia Institute of Technology in their highly regarded Executive Information Technology Program. He is president of the University of Alberta Alumni Association in Hong Kong as well as a director of the Canadian Chamber of Commerce in Hong Kong.