The Object of the Doctrine of Proper Purpose in the New Proposed South African Companies Act

"There are two reasons for doing anything. There is a good reason and the real reason." J.P Morgan

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ABSTRACT

South Africa is in the process of considering a new Companies Act. It is now anticipated that a Draft of this new Act will be published very soon. My paper for the CLTA conference will compare the current Australian provisions, the current position in South Africa and the new provisions in the proposed Companies Act regarding the proper purpose doctrine. The aim of this comparison is to determine which approach regarding the proper purpose is most suitable for the purposes of a modern Companies Act. Should the proper purpose doctrine be applied in the event of non-declared dividends as a method to complement the general meeting of shareholders' right to dividends, or should the proper purpose doctrine be complementary to directors' fiduciary duties? Should a director who

has breached the proper purpose doctrine be liable to the company for any loss suffered by the company as a result thereof, or should the company be liable for any economic benefit derived from dividends not declared to the shareholders? This interpretation could imply that any benefit derived which is contrary to the doctrine will suffice to protect the shareholders of the company.

1 INTRODUCTION

Arguably, the most important instrument in the commercial world today remains the contract. It is the supreme instrument for disclosing, generally, the intentions of the parties clearly and precisely.[1] It is settled that the law of contract differs from other branches of the law in one remarkable respect – parties are free to make their own rules. This commercial instrument is chiefly concerned with the determination of the limits within which the parties may bind themselves contractually, the construction of the rules agreed upon, and providing remedies for a party where one of the parties has not lived up to the contractual expectation.[2]

Despite the above, however, the contractual theory of cooperation as applied in company law undermines the legal nature of a company's constitution as an

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[1] *Venter v Rex* 1907 TS 910 913-914; *Cinema City (Pty) Ltd v Morgenstern Family Estates (Pty) Ltd* 1980 1 SA 796 (A) 804D; *Rand Rietfontein Estates Ltd v Cohn* 1937 AD 317 326; Reinecke and Van der Merwe *Insurance* (1989) par 7.

[2] *Vasco Dry Cleaners v Twycross* 1979 1 SA 603 (A) 610; *Magwaza v Heenan* 1979 2 SA 1019 (A) 1024.

enforceable contract when the board of directors refuses to recommend a dividend to shareholders.[3] This is surprising owing to the fact that the constitution of a company is required by law and consists of two parts: the memorandum and the articles of association. The main factor which distinguishes between these two documents consists in the fact that the rights of shareholders themselves are regulated within the articles of association, i.e. Tables A and B. Strangely, although the constitution represents a contract, the non-declaration of dividends does not constitute a breach of contract, owing to the process of recommendation to be followed in Tables A or B.[4] A right to a dividend is open for consideration only when the general body of shareholders accepts the board of directors' recommendation. Expressly exempted from the process in Tables A or B is the proper purpose doctrine, which comprises the rest of the discussion in this paper. This doctrine will be analyzed according to the case law of Canada, Britain, Australia and the new proposed Companies Act for South Africa. In this

[3] Kilian "Legal nature of the company's constitution and the incidence of ordinary damages" 2005 *The Company lawyer* 154; Du Plessis "Die persoonlike deliktuele aanspreeklikheid van uitvoerende ampsdraers?" 1994 *THRHR* 135; Kilian and Du Plessis "Possible remedies for shareholders when a company declares or declare inadequate dividends" 2005 *TSAR* 48-68. In this article Kilian and Du Plessis express viewpoints regarding company law remedies.

[4] Table A article 86, which is similar to article 125 in the British case; *Patel v Inland Revenue Commissioners* [1971] 2 All ER 504 (CH) where the court held, on the basis of lack of evidence, that article 125 does not create a debtor-creditor relationship. The directors enjoy an unfettered discretion in this regard.

regard we will also be focusing on the impact of a claim for economic loss suffered when the board of directors refuses to declare a dividend.

To avoid conventional company law principles, our search takes us to the common law principle to constrain the pursuit of self-interest progressively the importance of which is illustrated by making use of the proper purpose doctrine to identify the ability of a company to declare dividends.[5] It is stressed that the focus of our discussion considers only the board's discretion and whether it is possible to challenge the latter.

2 WHY ARE DIVIDENDS IMPORTANT?

The payment or the non-payment of a dividend is equally important in economics from the point of view of the company and that of a shareholder in the company. For a company, not paying a dividend is important owing to the fact that a non-payment contributes favourably to the ability of the company to grow financially

[5] Ferreira *Does the failure of a company to pay some or any dividends entitle a shareholder to a remedy?* LLM *UP* 1998; *In Re Company (no 00370 of 1987), Ex Parte Glossop* [1988] 1 WLR 1068 (Ch); Van Rooyen "Versuim om dividende te verklaar: Onredelik benadelende optrede of likwidasiegrond" 1989 *TSAR* 706. The remedies remain uncertain and no final conclusion has been reached; Regulating South African Commercial Law in a Globalised Environment *7th* (2006) *Annual Workshop* 143. The aim of the paper "Legislative developments in company law" was to highlight some of the new developments in company law.

or to settle its debts during the normal course of business.[6] To a shareholder the payment of a dividend is important since this indicates growth in his or her investment portfolio in terms of the ratio "return on investment".[7] Which of these two (non-payment or payment) should be enjoying preferential treatment in company law? It is frequently argued, that if the board did not recommend a dividend, the shareholder is always able to sell his or her shares on the open market. This statement must be qualified for two reasons: the constitution of a company is a contract, and the law of contract is regulated through implied contractual terms, .i.e. legitimate expectations. The avoidance of contractual principles could imply that company law is superior to that of the law of contract. Irrespective of the latter argument, case law does make provision for a balancing

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[6] Free cash flows of companies are calculated according to the following formula: $V_S=V_F - V_D - V_P$

where

V_S = total value of the firm's shares

V_F = total enterprise value

V_D = total value of debts

V_P = value of preference shares

[7] Return on investment uses the following formula: $r = \frac{D_1 + P_1 + P_0}{P_0}$

where

r = return on investment

D_1 = dividend

P_1 = sell share for a certain price

P_0 = buy share for a certain price

factor when deciding on the principle of cooperation between two or more contractual parties in the company law.

3 THE BALANCING FACTOR: NOT IN PURSUIT OF SELF-INTEREST

To begin with, the vast majority of contracts are terminated by the cooperation or performances of the parties.[8] In the case of a sale, for example, the contract is terminated if the parties have performed their respective reciprocal obligations; the seller has a duty to deliver the thing the moment the buyer pays the agreed price. The performance of both parties must not be in default; otherwise the contract has not been discharged in full owing to the obligation to do all that is necessary to secure the proper performance of the contract.[9]

The basis for breach of contract is largely based on cooperation which, in the law of contract, involves the philosophy that when a person enters into a contract other potential opportunities are lost, and should the said contractual party regain such lost opportunities this is in fact an act committed in bad faith.[10] Cooperation

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[8] *Tuckers Land and Development Corporation (Pty) Ltd v Hovis* 1980 1 SA 645 (A) 650; *Nel v Cloete* 1972 2 SA 150 (A) 159; *Stewart Wrightson (Pty) Ltd v Thorpe* 1977 2 SA 943 (A) 951; *BK Tooling (Edms) Bpk v Scope Precision Engineering (Edms) Bpk* 1979 1 SA 391 (A) 411.

[9] Visser, Pretorius, Sharrock, Mischke and Gibson *South African mercantile & company law* 7th ed (1997) 116; Christie *The law of contract in south Africa* (1996) 505-512;*Vivian v Woodburn* 1910 TPD 1285 1289.

[10] Havenga *Fiduciary duties of company directors with specific regard to corporate opportunities* (1997) LLD thesis, *UNISA*. When a director enters into a contract of employment, secret profits to be made or other corporate opportunities cannot be used to his benefit.

in the law implies that the parties to a contract must perform all such things that are necessary to enable and allow the other contractual party contractual benefit or success.[11] By observing the latter one may arrive at the firm conclusion from the viewpoint of both law and economics that the law of contract forbids the pursuit of self-interest, unless of course the written contract states differently.[12]

The actual priorities in law and economics nevertheless lead to a difficulty in synergizing dividends; or more specifically the general principles of company law. It is convenient to mention here that although textbooks frequently refer to the rights of shareholders, the right to a dividend is only relevant when the company has been able to generate net profits.[13] In legal parlance, the right to a dividend is not embedded in the constitution *per se* but becomes a right when a company did follow the process associated with dividends – as in Tables A or B. The downside of Tables A or B is that this process can only be initiated by the

[11] *Utopia Vakansie–Oorde Bpk v Du Plessis* 1974 3 SA 148 (A) 178; Botha "Section 194 of the Companies Act and *Utopia Vakansie–Oorde Bpk v Du Plessis*" 1978 De Jure 63. A dividend is only a right after it has been declared, but controversy exists regarding the clause "in arrears and unpaid" in the context of section 194(1) and (2).

[12] *Dickinson Motors (Pty) Ltd v Oberholzer* 1952 1 SA 443 (A) 450; *Allen v Sixteen Stirling Investments (Pty) Ltd* 1974 4 SA 164 (D) 166; *Khan v Naidoo* 1989 3 SA 724 (N) 728; *Hillview Properties (Pty) Ltd v Strijdom* 1978 1 SA 302 (T); *Conradie v Rossouw* 1919 AD 279.

[13] The usual Tables A and B, and article 86, allow for a discretionary recommendation of dividends.

discretionary power of the board of directors.[14] Is it possible to argue that cooperation still exists in such an environment where the right to a dividend is ultimately linked to discretionary power? Many company law observers are aware of the common law duties of a director. The problematic view of the common law duties, more specifically, the fiduciary duties of directors, has not, however, been fully explored by South African case law.[15] The placing of the fiduciary duties of a director in perspective is more likely to stem from the field of partnership law in South Africa. The following paragraph offers a general comparison between the fiduciary duties expected of partners in a partnership and those of directors in companies.

4 CURRENT FIDUCIARY DUTIES IN SOUTH AFRICA

In *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 537 the court stated clearly that a company is in essence a partnership, of which the partners constitute the shareholders. Because a partnership is a contract between partners, the rights and duties of individual partners flow from the contract itself

[14] Articles 83 and 84 of the Tables. Article 83 accords the exclusive right to the board to recommend a dividend and article 84 the exclusive right to the general meeting to declare a dividend.

[15] Havenga "Company directors – fiduciary duties, corporate opportunities and confidential information" 1989 *SA Mercantile Law Journal* 124; Kilian and Du Plessis "Possible remedies for shareholders when a company declares or declared inadequate dividends" 2005 *TSAR* 48-68.

or by implied terms.[16] It is an implied term in the law of partnership that all the partners must share in the profits in good faith. If profits are made and one of the partners is to be excluded from participating in the profits, then obviously the cooperation between the parties is in bad faith. Interestingly, profits give rise to a right and should a partner not be participating in the sharing of profits, his or her right to profit-sharing is protected by means of common law remedies – *actio pro socio*.[17] The manner in which a partner shares in the divisible profits largely entails the common law principle that all partners constitute the management of the enterprise. In company law this principle has also formed the basis of modern companies since the turn of the 19th century. In *Isle of Wright Railway Co v Tahourdin* the court then held that the body of shareholders constitutes a personification of the company and that the word company actually implies the body of shareholders.[18] This proposition allowed the body of shareholders to manage the company solely. As a rule today, the body of shareholders is not allowed to do so, owing to the introduction of the articles during the 20th century: The latter (the articles) accords the sole power with respect to managing the

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[16] *Ex Parte Buttner Bros* 1930 CPD 138. The classic cases where the courts were prepared to intervene and set aside decisions taken by directors apparently exercising a particular power "bona fide or in the best interest of the company" deal with the issue of shares; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

[17] Visser, Pretorius, Sharrock, Mischke and Gibson *South African mercantile & company law* 7ed (1997) 245-266.

[18] Cilliers, Benade, Henning, Du Plessis, Delport, De Koker and Pretorius *Corporate law* 3rd ed (2000) 85-86.

company in good faith to the board of directors, *inter alia*, the power to recommend a dividend.[19] The board of directors is not obliged to recommend a dividend during the entire duration of the company but in a partnership each of the partners is entitled to gain financial benefit from the partnership.[20] Is it sensible to ignore the contractual nature of the company's constitution in order to give effect to the division of power between the board of directors and the body of shareholders?[21] In *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 WLD 168 the court decided that management power may be delegated by implication to the body of shareholders, if and when business circumstances demand this. Although delegation of power might be implied by the law, the law will not imply such delegation tacitly when the proposed power is discretionary.[22] This view of discretionary power raises the questions: whether such power could be exercised for an improper purpose in the event of dividends? and, if so, when? To solve these questions, we must firstly discuss whether discretion could be balanced with the issue of financial benefit.

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[19] Davies *Gower and Davies' Principles of modern company law* (2003) 55; Pretorius, Delport, Havenga and Vermaas *Hahlo's South African company law through the cases* 6th ed (1999) 55, 174, 270.

[20] Benade, Henning, Du Plessis, Delport, De Koker and Pretorius *Entrepreneurial law* 3 rd ed (2003) 22.

[21] *Renard Constructions v Minister for Public Works* 1992 26 NSWLR 234. In this case the court held that power or the use of power, even permitted by a clause in a contract, may be deemed unfair and / or beyond the scope of the agreement.

[22] 87; *Barlows Manufacturing Co Ltd v RN Barrie (Pty) Ltd* 1990 4 SA 608 (C) 610F-611A.

5 BALANCING THE SCALES OF DISCRETIONARY POWER

A contemporary case that deals with discretionary power is to be found in *Botha v Swanepoel* [2002]1 All SA 85 (T). [23] In this case an unwritten discretionary liquidators' fee constitutes the legal question of business efficacy, the basis of which is whether a discretionary power to be exercised by a provisional liquidator excludes the implied contractual term of equal participation in liquidators' fees where more than one provisional liquidator is appointed for a certain company. [24] The existence of the oral discretionary power was not in dispute, but rather whether the enquiry into the true consensus would be fruitless owing to the circumstance where one liquidator was solely administering the company.[25] Although an oral agreement indicates, *prima facie*, consensus, the test to be applied by the court in order to establish the business efficacy of the contract is found in the *Techni-Pak Sales (Pty) Ltd v Hall* 1968 3 SA 231 (W) 236 where Colman J held that the true functioning of a contract must not only be desirable but must be a necessary element of that contract although the parties had neglected to express their true intention in writing. The *Botha* case concluded, on the basis of evidence led by the parties, that both the liquidators would be

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[23] *Techni-Pak Sales (Pty) Ltd v Hall* 1968 3 SA 231 (W) 236; *Barnabas Plein & Co v Sol Jacobson & Son* 1928 AD 31.

[24] See in general *Mullin (Pty) Ltd v Benade* Ltd 1952 1 SA 211 (A); *Liquidator of Booysens Race Club Ltd v Burton* 1910 TPD 597.

[25] 89, 91; See in general *Aymard v Webster* 1910 TPD 123; *Cooper v The Master* [1998] 1 All SA 158 (N); *Poynton v Cran* 1910 AD 205.

sharing the liquidators' fee equally in a businesslike or professional manner as a necessary element to justify the business efficacy of their contract.[26] Why did the court not focus on the element of honesty? In fact, the court did. It was concluded from the analysis of the evidence led by the parties, that the evidence established the inescapable inference that the parties had intended to share the fee on a 50/50 basis, irrespective of whether the defendant honestly believed that the fee was to be shared on a 60/40 basis. The relevance of this case to the development of company law when deciding on discretionary power is illustrated further by the Australian case.

In this case, involving the *Burger King Corp. v Hungry Jacks Pty Ltd* 2001 NSWCA 187, the parties had concluded a franchise agreement with each other.[27] A clause in the agreement stipulated that new restaurants were to be built each year and managed solely at the discretion of *Burger King*. Nevertheless, *Burger King* breached the contract by not authorizing the building

[26] Scrutton LJ remarked in *Reigate v Union Manufacturing Co (Ramsbottom)* 118 LT 479 483: "You must only imply a term if it is necessary in the business sense to give efficacy to the contract; that is, if it is such a term that you can be confident that if at the time the contract was being negotiated someone had said to the parties: 'What will happen in such a case?' they would have both replied: 'Of course, so-and-so. We did not had trouble to say that; it is too clear.'"

[27] *Royal Botanic Gardens and Domain Trust v South Sydney City Council* 2002 ALR 289. In this case the court did not expressly endorse the implication of an implied term of proper conduct or its equivalent good faith. The court did recognize the existence of proper conduct and fair dealings in contractual performances.

of new restaurants, although the clause could be interpreted as discretionary power not to manage future restaurants at all. This act was ultimately deemed to be beyond the intentions of the parties and undermined the purpose of the contract when the agreement was first developed. This judgment is reconcilable with that of honesty, as a result of the notion in Australia (Sale of Goods Act) that dishonesty is closely linked to an improper purpose.[28]

To determine whether honesty should also be closely linked to an improper purpose in company law we must focus on the courts interpretation of relevant contracts that regulate internal company matters. To begin with, we will focus on the *Stewart v Sashalite Ltd* [1936] 2 All ER 1481 case. The King's Bench Division experienced some difficulty in interpreting the performance of a contract between Mr. Stewart and Sashalite Ltd owing to the correct interpretation of the word "profits." The agreement states very simply the preferential right of Mr. Stewart: "[O]ut of the first profits of the purchasers and in priority to all dividends payable in respect of any shares of the purchasers' capital." At the end of the financial year the company had showed a profit of £698 11s 10d which the directors used for writing off preliminary expenses and transferring the surplus to reserve funds. The question was whether the directors could properly resolve the use of the

[28] http://www.murdoch.edu.au/elaw/issues/v11n3/harper113.html Found on the Internet 5 June 2006. Honesty is frequently referred to in Australian legislation as part of the definition of "good faith." In the Sale of Goods Act 1923 (NSW), for example, section 5(2) states that a transaction is "deemed in good faith within the meaning of this Act when it is in fact done honestly". For a contract to succeed, honesty must be evident in the respective performances of the parties

£698 11s 10d in writing off preliminary expenses and transfer the surplus to reserve funds yet be ignorant of Mr. Stewart's contractual right. The court attempted to change the focus of the proper purpose test by arguing that the plaintiff's claim was premature in nature because a shareholder is not allowed to receive a dividend unless priority has been given to Mr. Stewart.[29] Indeed, the question of honesty still remains unresolved because it leaves the plaintiff at the mercy of the discretion of the board of directors, who might postpone the payment of £1000 almost indefinitely. Although the postponement benefits the company, conversely, case law in other jurisdictions may have arrived at different conclusions when applying the proper purpose doctrine.

6. OBJECT OF THE PROPER PURPOSE DOCTRINE WITH AND WITHOUT HONESTY

The exact nature or scope of honesty is not very clear in South Africa or in other legal systems. What makes fiduciary duties complicated is that courts are more willing to focus on best interest than on honesty. The reason for this philosophy is simply that a director is allowed in the law a much higher degree of discretion to participate in business risks or business endeavors , which is a more flexible and

[29] 1482. The company was duly registered in 1930. Since 1934 the company was able to make profits; *Scottish Insurance Corporation Ltd v Wilsons and Clyde Coal Co Ltd* [1949] 1 All ER 1068 1074; *Re Duff's Settlements Trusts National Provincial Bank Ltd v Gregson* [1951] 2 All ER 534 539; *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* [1961] 1 All ER 769; *Re Buenos Ayres Great Southern Railway Co Ltd, The Company v Preston* [1947] 1 All ER 729 736. These cases consider the true construction of the company's constitution.

generally presupposes honesty.[30] The latter is also addressed by Professor du Plessis who indicates that honesty might involve multiple definitions, making honesty the most difficult aspect of the doctrine of proper purpose to determine in specific factual situations regarding whether a commercial transaction has breached this doctrine. In this context, we shall concentrate on how relevant case law considers honesty.

To begin our discussion, in *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, the High Court of Australia explained the positive and negative results of the additional allotment of shares.[31] The court held that the allotment will be positive if the company is in dire straits with respect to cash flow compared to when there is no need for additional capital.[32] In this regard, the court indicates that only the directors possess the ability to determine the company's best interests and how the directors should serve these

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[30] JJ Du Plessis "Directors' duty to use their powers for a proper or permissible purposes" *SA Mercantile Law Journal* (2004) 308; *Adam v Dada* 1912 NPD 495, 503; *Boyce v Bloem* 1960 3 SA 855 (T) 858 G; *Regal Hastings Ltd v Gulliver* [1942] 1All ER 378 (HL); *French Hairdressing Saloons Ltd v National Employers Mutual General Insurance Association Ltd* 1931 AD 60, 67; Havenga *Fiduciary duties of company directors with specific regard to corporate opportunities* (LLD thesis, UNISA 1998) 21,262,248, 292,314; Visser, Pretorius, Sharrock, Mischke *Gibson South African Mercantile & Company Law* 7th ed (1997) 366.

[31] Pretorius, Delport, Havenga, Vermaas *Hahlo's South African company law through the cases* 6th ed (1999) 289.

[32] 492-493

interests.[33] It is fair to conclude, though oversimplified, if the director's judgment was exercised in the best interest, then a court would not interfere in deciding objectively what amounts to an honest judgment or dishonest judgment.[34]

To illustrate the relevance of an objective inquiry one may cite the case of *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.[35] In this case, the directors allotted shares to avoid a take-over bid. The court considered that in order to judge whether a proposed action is "not in pursuit of self interest" the actions of the board of directors must be used as a guideline to determine their "purpose" for allotting additional shares owing to the lack of a clear "list" of different corporate actions that could constitute an improper purpose.[36] Although the board of directors honestly believed that the additional allotment was to solve the company's cash flow problems, the court held objectively that this allotment was not to be preferred owing to the fact that the board of directors had altered the composition of the company's shareholders self-interestedly.[37] The reason for this conclusion was based on a very interesting comparison by the court between contemporary methods and methods used in the past to secure finance. In the past the board did not allot additional shares to solve their cash flow

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[33] 125.

[34] *Teck Corporation Ltd v Millar* [1973] 2 WWR 385, 33 DLR (3d) 288, 312.

[35] *Thomas v HW Thomas Ltd* 1984 2 CLC 610, 615-616. In this case the court of New Zealand considered that "oppression" should not be construed as a narrow or very limited principle.

[36] 835.

[37] 838.

problems. In this regard, self-interest constitutes a ground for an improper purpose when the true purpose for the additional allotment is to dilute the majority voting power and or to allow for an opportunity to sell minority shares more advantageously. Lord Wilberforce continues as follows:

> But accepting all this, when a dispute arises whether directors of the company made a particular decision for one purpose or for another, or whether, there being more than one purpose, one or another purpose was the substantial or primary purpose, the court, in their Lordships' opinion, is entitled to look at the situation objectively in order to estimate how critical or pressing, or substantial, or per contra, insubstantial an alleged requirement may have been.[38]

The *Howard Smith* case indicates an additional strategy for lawyers to use, even if fiduciary duties were not breached per se, the proper purpose doctrine. As a result, we conclude, the proper purpose doctrine has a separate objective existence in the law.[39] But this conclusion is not necessarily the Common law in different jurisdictions. The proper purpose doctrine has undergone certain changes in the course of its adaptation in countries where it has been received.

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[38] 832 F-G.

[39] Kilian and Du Plessis "Possible remedies for shareholders when a company refuses to declare or declares inadequate dividends" *Journal for South African Law* 48 – 65.

Although, the above proposition was favoured by the Australian High Court in *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, the High Court did introduce new changes in the adaptation of this doctrine.[40] The facts of the case were simple. Mr. Whitehouse tried to influence the composition of shareholders by allotting additional shares to avoid a future circumstance where his spouse would control the company in the event of his death. This act was done honestly and in the best interest of the company; however, the court used a "but for" test and held that the purpose of this "exercise" was to manipulate the voting power of shareholders, irrespective of whether a valid reason/causation did exist to support the manipulation.[41] It is appropriate to mention here that the minority judgment did not once mention the "but for" test, posing the question whether the "but for" test is a correct statement in company law. [42] Interestingly, the rule in *Harlowe's Nominees* case concurs with the minority judgment.

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[40] Pretorius, Delport, Havenga, Vermaas *Hahlo's South African company law through the cases* 6th ed (1999) 292. Directors may be moved by permissible or impermissible purposes. An allotment of shares will be impermissible if it was causative in the sense that "but for" its presence the power would not have been exercised.

[41] 293 where the court held: "[I]t is simply not the point that Mr. Whitehouse believed that it was in the overall interests of the company that the voting power attaching to the shares held by his former wife be diluted so as to ensure that the control of the company in the period after his death would be in the hands of those whom he favoured. That belief was an explanation of, or reason for the allotment for the impermissible purpose."

[42] JJ Du Plessis "Directors' duty to use their powers for a proper or permissible purposes" *SA Mercantile Law Journal* (2004) 308. The "but for" test is an unnecessary "gloss" to the original developments of the "proper purpose" test.

Further cases that avoided the *Harlowe's Nominees* case include the British case, *Hogg v Cramphorn* [1967] Ch 254. In this case, the board of directors issued additional shares in an attempt to avoid a hostile take-over. Although the directors honestly believed that the allotment was in the best interest of the company, the court nevertheless held that an objective inquiry should be employed when considering the reason for the additional allotment.[43] The court held that the majority of shareholders were acting oppressively towards the minority and/or that powers of directors interfered with the shareholder rights as stipulated in the company's constitution, and this, Buckley J held was not a legitimate exercise of directors' powers.[44]

If we apply this judgment to the example of Mr. Stewart where payment could be postponed indefinitely, in the honest belief that this was in the best interest of the company, then the *Hogg* case offers authority for an objective inquiry, indicating that the non-payment amount to an improper purpose.

Although the High Court of Australia in the *Whitehouse* case endorsed the proper purpose doctrine, this doctrine is also subject to another "test", that of business judgments. What standard of honesty, should be applied when deciding on business judgments? Should honesty be subject to a lower standard of skill and

[43] 265.

[44] 266-267.

care, or should the commercial transaction be objectively investigated by the courts as indicated by the *Hogg* case? [45]

7. BUSINESS JUDGMENTS AND HONESTY

The Corporations Act of Australia regulates business judgments and section 180 (2)(a) states that the judgment should be made "in good faith for a proper purpose". In this regard section 180 (3) provides a definition of how to interpret business judgments as being any decision to take or not to take action in respect of a matter relevant to the business operations of the corporation. [46] Although this definition and description support the principle of "simplification", the exact composition of business judgments is very complicated, as indicated by the case of *Hooke v Daniels and Daniels v Awa Ltd* (1995) 16 ACSR 607. One of the many intriguing and unsolved questions which remain to be investigated, and perhaps the most unexamined area, is the skill possessed by a director. This case involves the Australian Court of Appeal where the court gave a very lengthy judgment concerning what amounts to good business judgments. One of the most important and most controversial features of care and skill is the dictum of Powell JA at 754:

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[45] *Coronation Brick (Pty) Ltd v Strachan Construction Co(Pty) Ltd* 1982 4 SA 371 (D) 386. Interestingly, the law of delict does not require honesty as a justifiable ground to avoid liability for an unlawful act.

[46] http://www.austlii.edu.au/au/legis/cth/num_act/ca2001n502001199/ Found on the internet 2 November 2006.

> [T]he inquiry, therefore, is reduced to want of care and bona fides with a view to the interest of the nitrate company. The amount of care to be taken is difficult to define, but it is plain that directors are not liable for all the mistakes they make, although if they had taken more care they might have avoided them. [T]heir negligence must be not the omission to take all possible care; it must be much more blamable than that; it must be in a business sense culpable or gross. I do not know how better to describe it.

A further noteworthy point made by Powell JA adds that besides the duty to act with care and skill, the director is subject to an objective investigation even if he did act honestly. The court referred to the Supreme Court of New Jersey, *Francis v United Jersey Bank* 432 A 2d 814, in holding that even if a director delegates his duties in the utmost good faith, he has a duty to take steps to know the facts of the business transactions conducted by the company. A director cannot be ignorant of the internal business practices although honesty is present.[47] As a result, the proper purpose doctrine suffers no restriction when considering an honest duty of skill. This analytical difference is of greater interest, it is true, to the theory rather than the practice of law to use a different test or a subjective test when considering skill in the event of no delegation of powers. A vivid

[47] 667

demonstration of how a court should not interpret honesty in this regard is to be found in *Fisheries Development Corporation v AWJ Investments* 1980 4 SA 156 (WLD). The question before this court was whether directors were honestly aware of the financial position of their company that had recently been taken over by another company. The court did not apply an objective inquiry into their skill, but simply compared the evidence given by each director and held that their respective evidence was not in conflict stemming from their honest skill, that the company was on a sound financial footing. The court did not take into consideration whether objectively there had been a possibility of awareness of the insolvent position of the company.[48] Compare this case to the *Coronation Brick (Pty) Ltd v Strachan Construction Co (Pty) Ltd* 1982 4 SA 371 (D) 386, where a defendant damaged the electrical cables of the plaintiff's workshop, and the court held as follows in the law of tort (substitute "cables" with "money"):

> [B]ut for heaven's sake, you knew precisely where the cables were; you knew that if they were cut the plaintiff would suffer a substantial loss of income, surely there was a legal duty on you to take measures to avert the loss.[49]

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[48] 164

[49] Du Plessis "Die persoonlike deliktuele aanspreeklikheid van uitvoerende ampsdraers? " 1994 *THRHR* 135; Du Plessis *Maatskappyregtelike grondslae van die regsposisie van direkteure en besturende direkteure* (LLD thesis 1990) 229-238. Two prominent cases were referred to: that of *"Mersey Dock and Harbour Board" Trustees v Gibs and Penhallow* 1866 LR 1 HL 93 and *Yarborough v Bank of England* 104 ER 991.

Even if the defendant did act honestly he should have known where the cables were, he was obliged to take certain measures to avoid any losses for the plaintiff because of a separate legal duty which the defendant was required to carry out in the law. This dictum directs us to the next paragraph to establish whether company law could also require a higher degree of objectivity.

8. THE "SEPARATENESS" OF THE PROPER PURPOSE DOCTRINE WHEN CONSIDERING AN INDEPENDENT BUSINESS JUDGMENT

In the South African case as well as in the Australian case, dividends are to be recommended by the directors of a company as they themselves see fit.[50] The Australian Corporations Act offers insight into the required procedure to exercise a decision "as they see fit." Section 181 (1) provides the following:

> A director or other officer of a corporation must exercise their powers and discharge their duties: (a) in good faith *what they believe to be in the best interest* of the corporation and (b) for a proper purpose. [51]

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[50] In South Africa, Tables A and B represent the dominant factor in recommending a dividend. In Australia, at present the Tables are no longer a statutory requirement. See http://hometown.aol.com/hernafamous/director_duties.htm. Found on the internet 15 November 2006.

[51] My emphasis; http://www.austlii.edu.au/au/legis/cth/num_act/ca2001n502001199/ Found on the internet 2 November 2006.

In the Australian case the legislature used the word “and” as a link between proper purpose and good faith. When one considers “what they believe to be in the best interest”, the *Harlowe’s* case as discussed above is relevant in these circumstances and it is hardly possible to challenge the board of directors’ decision not to declare a dividend based on the flexible method of honesty as what amounts to the best interest of the company. However, in the *Howard Smith* case we discussed why the proper purpose doctrine should be separated form directors’ duties and is there similar judgments dealing with business judgments? In this regard, in the case of *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 230, 7 ACLC 659 the company was in the process of avoiding a hostile take-over bid to acquire the company for much less than the book value of the company, calculated on the basis of land owned by the company. Furthermore, the company set a scheme in motion to sell the land to a subsidiary for development purposes, by means of which the subsidiary as a partner would challenge the hostile bid to acquire control of the company. The court considered whether the partnership or joint venture agreement was for a proper purpose. In this regard, three different opinions were expressed in the law. Mahoney J focused on the belief of the director that the scheme was in the best interest of the company, whilst Clarke JA distinguished the factual circumstances from the Hogg and Whitehouse cases, since no allotment of shares was made and lastly[52]

[52] (1989) 16 NSWLR 325 – 328,338.

Kirby J concluded that honesty when deciding on the proper purpose of the scheme should be an objective inquiry:[53]

> It would be to ignore the many blunt reminders of their obligation to conduct a thoroughgoing investigation. It would be to sustain a passive conception of the duty of a fiduciary which has no place in company board rooms. Higher standards of vigilance and honesty are required there in dealing with other people's moneys.

The most distinctive feature of the above dictum is the required "higher standards" of honesty when "dealing with other people's moneys" in the event of business judgments. If we focus on the latter sentence within an Australian context, it is worth mentioning that the same objective rationale should be used, otherwise the proper purpose doctrine would be limited in its application in the

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[53] (1989) 16 NSWLR 288; Pretorius, Delport, Havenga, Vermaas *Hahlo's South African company law through the cases* 6th ed (1999) 293; JJ Du Plessis " Directors' duty to use their powers for proper or permissible purposes" *SA Merc Law Journal* (2004) 308. Professor du Plessis discussed why "bona fide" and "proper purpose" doctrines should be differentiated. The author expresses his frustration as to why the courts have not given closer descriptions to a workable method of determining when the acts of directors should be set aside as a result of unlimited definitions to express a bona fide belief. Interestingly, honesty is an abstract word, and the culture where this word is embedded may be different from the embedded meanings in western civilizations. See Cahn *Political philosophy, essential texts* (2005) 278.

event of business judgments.[54] In the next paragraph we will be focusing on the new proposed Companies Bill for South Africa and whether the legislature incorporated the *Darvall*, *Howard Smith* cases differently from the Australian case.

9. NEW PROPOSED LEGISLATION

Section 91 of the Draft Companies Bill 2007, the standard of conduct expected of directors, is regulated by section 91. Section 91(a) regulates the former common law duties of directors. Section 91 alters the common law duty of care and skill by an additional requirement: that of diligence or precision. Section 91 (b) regulates the fiduciary duty of directors with no additional requirements to this common law duty.

Very new to the current form of company law in South Africa is section 91 (2) that uses the following terminology: "director's judgment". Should this judgment be on an equal footing to that of the Australian counterpart "business judgment"? The answer seems to be yes and no. Section 91 (2) states the following:

> A director's judgment that an action or decision is in the *best interest* of, or for the *benefit*[55] of, the company is reasonable if -
>
> (a) the director –

[54] http://hometown.aol.com/hernafamous/director_duties.htm Found on the internet 15 November 2006.

[55] Interpreted as "fiduciary duty".

(1) *has taken reasonably diligent steps to become informed about the subject matter of the judgment having regard to subsections* (4) and (5); and[56]

(2) does not have a personal financial interest in the subject matter of the judgment; and

(b) *it is a judgment that a reasonable individual in a similar position could hold in comparable circumstances*.[57]

In the Australian case, the proper purpose is an additional requirement for business judgments, whilst proper purpose is not a requirement in the new proposed Bill, and vice versa as regards to honesty. In the South African case there is an additional requirement of "reasonableness", making the *Howard Smith* case and to a certain extent the *Darvall* case irrelevant to a South African perspective owing to the uniqueness of section 90(2).

For the requirement of business judgments, one can only wonder whether honesty is a prerequisite for section 91 (2)(b). In this regard, honesty could be incorporated into section 91 (2)(b) by two possible means. Firstly, we use section 91 (1)(b) when interpreting section 91 (2) (b):

[56] Interpreted as "care".

[57] Interpreted as "skill".

> A second, fiduciary, duty to act honestly and in good faith, and in a manner the director reasonably believes to be in the best interests of, and for the benefit of, the company.

It is clear from the above that we will have a unique circumstance, that of "reasonable honesty", being required for ordinary or executive directors when exercising business judgments. To avoid fruitless argumentation over this unique circumstance, it is necessary to make mention of the *Fisheries Development* case. In this case the court did make use of "reasonable honesty" by relying on the *City Equitable Fire Insurance Co* 1925 CH 407, but reasonable honesty is only relevant when considering the care and skill of non-executive directors. In this regard, such an interpretation would dilute the duty of care and skill expected of the executive directors of a company. [58]

A more appropriate proposition is to consider section 93 of the Draft Bill that regulates the liability of a director. It is interesting to see that section 93(4) (a) excuses a director from liability when he/she did in fact act honestly. In this regard we have to assume that honesty is separate from "reasonableness" to avoid an interpretation of "reasonable honesty" when deciding on a business judgment or whether an act was in the best interest of the company. However,

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[58] 165 H – 166 A; For a practical interpretation of South African statutes see *Knop v Johannesburg City Council* 1995 2 SA 1 (A) 31, 33.

the end result would be similar to that of *Harlowe's Nominees* case where the proper purpose doctrine is unnecessary when best interest is evident.

10. CONCLUSION WITH RESPECT TO DIFFERENT LIABILITY

So far we have observed the different approaches in case law. To offer a description of the differences in liability, I shall make use of Mr. Stewart where payment of the amount of £1000 was postponed almost indefinitely. The following scenarios arise:

(1) If the board of directors postponed the payment for the benefit of the company and a court must decide whether it complies with the proper purpose doctrine, then if benefit is found to be evident, there is no breach of fiduciary duty (.i.e.honesty) or the proper purpose doctrine.[59]

(2) If the board of directors postponed the payment, then a court can decide that the proper purpose exists separately when higher levels or an objective inquiry are used as a standard for the fiduciary duties. Even if subjective honesty was evident, then to postpone the payment indefinitely breaches the proper purpose doctrine.[60]

(3) If the board of directors postponed the payment owing to a business judgment, then it is possible to argue there was no breach of the proper purpose doctrine should the business decision comply with the principle of

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[59] *Harlowe's Nominees Pty Ltd v Woodside (Lake Entrance) Oil Co N L* (1968) 121 CLR 483.

[60] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821. The doctrine should be looked at from the point of view that it is "not in pursuit of self interest"; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285; *Hogg v Cramphorn Ltd* [1967] Ch 254.

care and skill. Should it be found that honesty is a flexible method subject to subjective skill then there is no breach of directors' duties, owing to the interpretation of the *Harlowe's* case. In this regard, we have a similar answer to that of (1). Should business judgment be interpreted with higher levels of honesty, the *Darvall* case, than we will have a similar answer to that of (2).

(4) If the board of directors postponed the payment as a result of a directors' judgment, then it is possible to argue that the non payment was in the best interest or a business decision when the director exercised reasonable diligent steps to have been informed about the non-payment of the £1000. If the steps are reasonable, irrespective of whether it they are carried out for an improper purpose, the director could be excused from liability if his judgment complies with the principle of honesty – similar answer to that of (1).[61]

11. SIMILAR LEGISLATION TO THAT OF A "PROPER PURPOSE DOCTRINE" IN SOUTH AFRICA

In South Africa there exists unique legislation regulating the activities of agents. Although a director could be interpreted as being an agent of a company, it is fair

[61] Kilian "Legal nature of the company's constitution and the incidence of ordinary damages" 2005 *The company lawyer* 154. In this article the company's constitution has been identified as a forward contract. This interpretation allows for a claim of damages as the result of a breach of contract.

to conclude that the Prevention and Combating of Corrupt Activities Act 12 of 2004, sub-section 6 is relevant to our discussion; it states that:

> (bb) Any act of the agent that amounts to:
>
> (aaa) the abuse of position of authority; or
>
> (bbb) a breach of trust; or
>
> (ccc) the violation of a legal duty or a set of rules; or
>
> (cc) designed to achieve an unjustified result; or
>
> (dd) that amounts to any other unauthorized or *improper inducement* to do or not to, is guilty of the offence of corrupt activities relating to agents.[62]

The words used in section 6 (dd), "improper inducement", are of relevance to our discussion. The *Concise Oxford Dictionary* explains "induce" as a "cause/reason".[63] Further investigation into the correct meaning of a "cause" leads us to "purpose"; and to establish the purpose of an act, the inquiry should start with "why". The *Concise Oxford Dictionary* describes "why" as a method to establish the "purpose" of an act objectively. In sub-section 6 (aaa) the legislature explained impermissible acts and does not qualify them by the honesty of directors in avoiding liability, .i.e. any illegal act, any unauthorized act, any incomplete act or any biased act etc.[64] In my opinion the *Howard Smith* and

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[62] My emphasis.

[63] See also *An English Usage Dictionary*.

[64] My emphasis. In Australia, section 181(1) and 182 (2)(a) uses the word "and" for a proper purpose when deciding on fiduciary duties. The latter section indicates what they, the directors,

Darvall cases are relevant when a court has to consider sub-section 6 (dd) independently from that relating to honesty in the new proposed Companies Act.

12. PURE ECONOMIC LOSS AND THE PROPOSED COMPANIES ACT FOR SOUTH AFRICA

The Draft Companies Bill 2007 is not an amendment to the current Companies Act of 1973 but is a replacement of the Act. I am of the opinion that the Prevention and Combating of Corrupt Activities Act, as discussed above, should be applied to current/ future companies in South Africa because both Acts have a separate existence in South Africa. In terms of this interpretation relevant case law could be used by shareholders that have been prejudiced by the actions of directors, i.e. in the *Ho*ward case. Besides the latter, the Prevention and Combating Corrupt Activities Act is also an important element when considering a claim for pure economic loss in the event of undeclared dividends, as discussed in the following paragraph.

In *Hooke v Daniels and Daniels v AWA Ltd* (1995) 16 ACSR 607 the Australian Court was to answer the question whether a person has a potential claim in the common law, although section 229 of the Corporations Act provides guidance regarding a claim for damages when a director has breached his duty of care and

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believe amounts to a proper purpose when they have to make business judgments. In South Africa, the Prevention and Combating of Corrupt Activities Act has no “and” or a “subjective belief” as to what amounts to an improper inducement.

skill.[65] The court answered the question in the affirmative and the plaintiff's claim was rejected by the court as a result of insufficient grounds to institute an additional claim for the economic loss suffered.[66] To resolve this difficulty within a South African context, in *Coronation Brick (Pty) Ltd v Stachan Construction Co (Pty) Ltd* 1982 4 SA 371(D) 384, Booysen J held as follows:

> [R]esult in foreseen or foreseeable economic loss was unlawful or wrongful the question is whether it would in all circumstances be reasonable to recognize that the defendant owed the plaintiff a legal duty [statutory, contractual or any other legal duty].[67] [I]n determining whether conduct is of such a nature as to be determined unlawful, the Court must carefully balance and evaluate the interests of the concerned parties, the relationship of the parties and the social consequences of the imposition of liability in that particular type of situation. [68]

It is clear from the above dictum that the defendant could either be the company or the director who should be liable for economic loss. The difficulty in holding a

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[65] 756

[66] 761

[67] My inclusion.

[68] See in general *Dorklerk Investments (Pty)Ltd v Bhyat* 1980 1 SA 443(W); *Ex Parte Lebowa Development Corporation Ltd* 1989 3 SA 71 (T); *S v Harper* 1981 2 SA 638 (D).

company liable stems from whether the Prevention and Combating Corrupt Activities Act created a statutory legal duty for a company regarding any economic benefit derived from non-declared dividends. It is crystal clear that this Act is only relevant in the event that the defendant is an agent. However, Tables A and B constitute a contract between an individual shareholder and a company, allowing for the possibility of giving legal effect to the cooperation of the contract, as required by the law of contract. The downside to the effectiveness of the law of contract is that dividends depend on the board of directors' discretion – this comprises a difficult obstacle to instituting action on the basis of the breach of a forward contract (constitution of the company). In this regard, this discretion should rather be taken from the point of view in the law of tort (delict), to interpret contractual cooperation as a legal duty, where, the law of tort does not require honesty as a standard to determine the lawfulness of the breach.[69]

13. CONCLUSION

This paper has analyzed the fiduciary duties of directors, the duty of care and skill, together with the proper purpose doctrine. It has been stated with some justification that as long as a director acts honestly, carefully, skillfully as he usually does in terms of his own beliefs, to avoid liability he may act without any

[69] Du Plessis "Die persoonlike deliktuele aanspreeklikheid van uitvoerende ampsdraers? " 1994 *THRHR* 135; Du Plessis *Maatskappyregtelike grondslae van die regsposisie van direkteure en besturende direkteure* (LLD thesis 1990) 229-238. Two prominent cases were referred to: that of *"Mersey Dock and Harbour board" Trustees v Gibs and Penhallow* 1866 LR 1 HL 93 and *Yarborough v Bank of England* 104 ER 991

qualification or required proper purpose, or be without any business acumen to fulfill the tasks of his office, or be both inexperienced and lacking in judgment.[70] One may wonder about the circumstances in which what may be regarded as an act completed in terms of a director's own beliefs, will cease to be such when the proper purpose doctrine is applied. The first part of this paper concentrated on the importance of dividends for shareholders and methods to balance the discretionary power of the directors appropriately in the *Botha* and *Burger King* cases, about which there is controversy in the application of company law principles. It is my belief that as long as the board's decision is to be exercised in terms of what it believes is for the benefit of the company, and thus irrelevant for a proper purpose, this may continue to be regarded as a response to minimize correct business judgments, to decrease the power of a court to investigate objectively the interactions between directors, shareholders and business opportunities. This approach brings to mind the value of devising a doctrine of proper purpose separate from other director's duties, in order to determine suspicious commercial actions, as was stated by the *Hogg* and *Howard Smith* cases. The same objectivity should be considered in the event of a directors' judgment such as was followed in the *Darvall* case, although an act which a director may perceive as skillfully completed, the courts should consider whether the commercial transaction is for a proper purpose.

Although there is a striking contrast between the Australian and the South African case, the degree of interpretation required by the *Hogg*, *Howard Smith* and

[70] Beuthin and Luiz *Beuthin's basic company law* 3rd (2000) 179-214.

Darvall cases could complement the South African legislation, .i.e. the Prevention and Combating of Corrupt Activities Act 12 of 2004. Although this Act employs different terminology from that made use of by case law, the interpretation of statutes allows for similar circumstances to that of case law where the proper purpose doctrine was applied. Interestingly, this Act makes no mention of honesty as a prerequisite for the proper purpose doctrine, indicating the separateness of this doctrine from other directors' duties. This proposition imposes a claim for pure economic loss in the event of breach of the proper purpose doctrine in order to protect the legitimate expectations of shareholders to participate in company profits, so as to avoid a similar circumstance as to that explained in the *Stewart* case.[71]

[71] Pretorius, Delport, Havenga, Vermaas *Hahlo's South African company law through the cases* 6th (1999) 593-595, 596, 597.