



THE UNIVERSITY OF ADELAIDE
ADELAIDE LAW REVIEW ASSOCIATION

CORPORATE AND BUSINESS LAW JOURNAL

VOLUME 10 NUMBER 1

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VOLUME 10

NUMBER 1

JULY 1997

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DIRECTORS' DUTIES, BUSINESS JUDGEMENT AND TAKEOVER DEFENCES: AGENDA FOR REFORM

by James Mayanja*

INTRODUCTION

It is common knowledge that in the performance of their duties, directors are required to act bona fide, in what they consider to be the best interests of the company.¹ They must also bring a certain degree of skill and care to bear upon the discharge of their functions.² The obligations³ thus cast upon them seek to protect the company and, ultimately, investors, by minimising the potential for directors to act in abuse of the immense managerial powers conferred on them.⁴ Another objective which the law sets out to achieve is to ensure that directors do not shirk their responsibilities.⁵

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1 *Mills v Mills* (1937-1938) 60 CLR 150 at 185-186, per Dixon J; *Ampol Petroleum Limited v RW Miller (Holdings) Limited* [1972] 2 NSWLR 850 at 856, per Street CJ; *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 217, per Isaacs J; *Re Smith & Fawcett Limited* [1942] 1 Ch 304 at 306, per Greene MR; *Pergamon Press Limited v Maxwell* [1970] 2 All ER 809.

2 See generally, *Daniels v Anderson* (1995) 13 ACLC 614; and *Re City Equitable Fire Insurance Company Limited* [1925] Ch 407.

3 These obligations, traditionally imposed by the doctrines of common law and equity are now reinforced by statute. The *Corporations Law* s232(2) imposes upon officers of a company (including directors) a duty to act honestly at all times in the exercise of their powers and in the discharge of the duties of their office. Section 232(4) goes on to require officers in the exercise of their powers and in the discharge of their duties to exercise the degree of care and diligence that a reasonable person in a like position would exercise in the corporation's circumstances.

4 For a very illuminating analysis of the fiduciary obligations to which company directors are subject and the objectives of those principles see generally, Gower, Prentice & Pettet, *Gower's Principles of Modern Company Law* (Sweet & Maxwell, London, 5th ed 1992) pp551-572; Ford, Austin & Ramsay, *Principles*

In determining whether the actions of directors, including those taken in response to an unsolicited takeover offer, meet the standards prescribed by the law, the courts are guided by the principle that judges should not question the merits of a business decision taken after due investigation, in the honest belief that it is for the benefit of the company and which involves no self-dealing or personal interest. In the United States, this principle has been formalised in what is popularly known as the business judgment rule. Essentially, the same rule applies in Australia although the courts here do not use the same terminology.⁶

Underlying the business judgment rule is the presumption that in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.⁷ When applied, the rule precludes the courts from reviewing the merits of a decision taken by the directors on a business matter even when the results later show that what the directors did was unwise or inexpedient. The decision is protected so long as it is within the authority of the directors,⁸ was not influenced by personal considerations and the directors' judgment was exercised in good faith.⁹ To justify interference by a court

of *Corporations Law* (Butterworths, Sydney, 8th ed 1997), pp 300-322; Farrar, Furey & Hannigan, *Farrar's Company Law* (Butterworths, London, 3rd ed 1991) pp383-396; Corkery, *Directors' Powers And Duties* (Longman & Cheshire, Melbourne 1987) pp54-130; and Heydon, "Directors' Duties and the Company's Interests" in Finn (ed), *Equity and Commercial Relationships* (Law Book Company, Sydney 1987) pp120-136.

5 See generally, Redmond, "The Reform of Directors' Duties" (1992) 15 *UNSWLJ* 86; Manning, "The Business Judgment Rule and the Director's Duty of Attention: Time For Reality" (1983-84) 39 *Business Lawyer* 1477 at 1479ff.

6 Ford, Austin & Ramsay, *Principles of Corporations Law*, p332; Lipton and Herzberg, *Understanding Company Law* (LBC Information Services, Sydney, 6th ed 1995) pp390-391; National Companies and Securities Commission, *Report on the Cross Investments between The Broken Hill Proprietary Company Limited and Elders IXL Limited* (AGPS, Canberra 1986) Appendix 8.

7 *Lagunas Nitrate Company v Lagunas Syndicate* [1899] 2 Ch 392 at 435, per Lindley MR. See further, Gower, Prentice & Pettet, *Gower's Principles of Modern Company Law*, p586; Baxi, "Note" (1984) 12 *ABLR* 126; Commonwealth of Aust, Parl, Senate Standing Committee on Constitutional and Legal Affairs, *Company Directors' Duties* (1989) para 3.11.

8 *Turquand v Marshall* (1869) LR 4 Ch App 376 at 386, per Lord Hatherley.

9 *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 *ACLC* 1294; *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 *ACLC* 659 at 708, per Mahoney JA and at 714, per Clarke JA; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil NL* (1968) 121 *CLR* 483 at 487; *Howard Smith Limited v Ampol Petroleum Limited* [1974] *AC* 821 at 832; *Hogg v Cramphorn Limited* [1967] Ch 254; *Winthrop Investments Limited*

with a transaction authorised by the directors, the record must disclose at least one of three circumstances or conditions:

- (1) that the directors did not exercise due care before voting to authorise the transaction;¹⁰
- (2) that the directors voted to authorise the transaction even though they could not have reasonably believed the transaction to be for the best interest of the corporation;¹¹ or
- (3) that in some other way the directors' authorisation of the transaction was not in good faith.¹²

The rule thus serves to protect directors against liability for any reasonable mistake of judgment that they may have committed.

v Winns Limited [1975] 2 NSWLR 666; *Peter's American Delicacy Company Limited v Heath* (1939) 61 CLR 457 at 480, per Latham CJ; *Richard Brady Franks Limited v Price* (1937) 58 CLR 112 at 135, per Latham CJ; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 219, per Isaacs J; *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656; *Re Smith & Fawcett Limited* [1942] 1 Ch 304.

10 *Re City Equitable Fire Insurance Company Limited* [1925] Ch 407.

11 *Charterbridge Corporation Limited v Lloyd's Bank Limited* [1970] Ch 62 at 74, per Pennycuik J; *Wayde v New South Wales Rugby League Limited* (1985) 59 ALJR 798 (High Court of Australia); *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659 at 708, per Mahoney JA and 714, per Clarke JA; *Peter's American Delicacy Company Limited v Heath* (1938-1939) 61 CLR 457 at 482, per Latham CJ.

12 *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294; *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659 at 708, per Mahoney JA and at 714, per Clarke JA; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil NL* (1968) 121 CLR 483 at 487; *Howard Smith Limited v Ampol Petroleum Limited* [1974] AC 821 at 832; *Hogg v Cramphorn Limited* [1967] Ch 254; *Winthrop Investments Limited v Winns Limited* [1975] 2 NSWLR 666; *Peter's American Delicacy Company Limited v Heath* (1939) 61 CLR 457 at 480, per Latham CJ; *Richard Brady Franks Limited v Price* (1937) 58 CLR 112 at 135, per Latham CJ; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 219, per Isaacs J; *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656; *Re Smith & Fawcett Limited* [1942] 1 Ch 304. See also the re-statement of the business judgment rule in American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (American Law Institute Publishers, St Paul, Minn 1994) Vol 1, para 4.01(c), pp139 and 141; Arsh, "Fiduciary Responsibilities of Directors, Officers And Key Employees" (1979) 4 *DeJCL* 652 at 660; and Tan, "Delivering the Judgment on a Statutory Business Judgment Rule in Australia" (1995) 5 *AustJCL* 442 at 448.

By protecting directors' decisions, the business judgment rule serves a number of important purposes. It assures directors that their decisions will not be unduly interfered with and allows them the freedom to formulate effective corporate policy. More significantly, it provides a guarantee that directors will not be held personally liable for any genuine or honest mistake of judgment made in the course of performing their duties. In so doing, the rule encourages competent people to become directors. Third, the rule relieves courts of the burden of second-guessing complex corporate decisions, a task for which they often lack the necessary expertise, information and time.¹³

Recognising the important role that a policy of judicial non-interference plays in the efficient functioning of companies, the erstwhile Companies and Securities Law Review Committee mooted the idea of introducing a statutory business judgment rule in Australia.¹⁴ This proposal was supported by the Senate Standing Committee on Legal and Constitutional Affairs (the 'Cooney' Committee).¹⁵ Subsequently, the Companies and Securities Law Review Committee recommended to the Ministerial Council for Companies and Securities that the companies legislation be amended by introducing a provision to the effect that:

A director or officer shall not be liable to pay compensation to a company by reason of [s232] or under the general law in respect of his or her business judgment unless it is made to appear to the relevant court that at the relevant time the director or officer -

- (a) had an authorised interest in the transaction of the company to which the judgment relates;
- (b) had not informed himself or herself to an appropriate extent about the subject of the judgment;
- (c) did not act in good faith for a proper purpose; or

13 Pollock, "Exclusionary Tender Offers: A Reasonably Formulated Takeover Defense Or A Discriminatory Attempt To Retain Control?" (1986) 20 *GeorgiaLR* 627 at 658. See the next section of this article where these issues are explored in detail.

14 Companies and Securities Law Reform Committee, *Company Directors And Officers: Indemnification, Relief And Insurance* (Discussion Paper No 9, 1989) para 108-113, pp47-49.

15 Aust, Parl, Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties* (1989) paras 3.30-3.35, pp29-31.

(d) acted in a manner that a reasonable director with his or her training and experience could not possibly regard as being for the benefit of the company.¹⁶

This recommendation was, however, not implemented by policy makers. They decided, instead, to leave further development of the business judgment rule in Australia to the judiciary.¹⁷

This article examines the propriety of applying the business judgment rule to determine the validity of transactions involving the transfer of corporate control in Australia. While it concedes that a policy of judicial non-interference with directors' decisions in ordinary business transactions makes eminent sense as it accords essential protection which is necessary if directors' initiative is not to be stifled, it is argued that the application of the rule to protect actions taken by directors to impede unsolicited takeover offers is undesirable. Judicial deference to such decisions renders it extremely easy for target management to frustrate any takeover bid unacceptable to them. Because hostile takeover transactions present directors with an inescapable conflict of interest, actions taken by directors to block hostile takeover offers should be excluded from the ambit of decisions protected under the business judgment rule.

The ensuing discussion begins by examining the nature of the business judgment rule, its legal effect and the justification for it. Next, it examines both the rule as applied by Australian courts in contests for corporate control and the implications of this approach for the protection of shareholders. Thereafter, a comparative analysis of the rule as applied in the United States is undertaken. This is followed by some proposals for reform and concluding remarks.

THE RULE, ITS LEGAL EFFECT AND RAISON D'ÊTRE

The business judgment rule, as applied in Australia, has been conveniently summarised as follows:

if, in the course of management, directors arrive at a decision for which there is a reasonable basis and they act in good

16 Companies and Securities Law Reform Committee, *Company Directors And Officers: Indemnification Relief And Insurance* (Report No 9, 1990) para 81, p37.

17 Aust, Attorney-General's Department, *Corporate Law Reform Bill 1992*. Draft Legislation and Explanatory Memorandum (1992) paras 103-104, p278.

faith as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of a corporation, (that is, other than any "improper" consideration) a court will not interfere and substitute its judgment for that of the directors.¹⁸

This principle can be extrapolated from a number of decisions of the High Court of Australia. In *Harlowe's Nominees Pty Limited v Woodside (Lakes Entrance) Oil Company No Liability*¹⁹ the directors of the respondent company which was then subject to an unsolicited takeover bid issued new shares to a friendly party ostensibly to secure the financial backing of that company. The fresh issue had the effect of substantially diluting the appellant's interest in the target company. It was established that at the time of the fresh issue the target was not in need of further capital.

The appellant challenged the fresh issue, arguing that it was not in the interests of the company but was effected simply to foil the appellant's attempt to gain control of the respondent. Giving its judgment, the High Court (Barwick CJ, McTiernan & Kitto JJ) re-affirmed that where an exercise of directors' powers is challenged, "the ultimate question must always be whether in truth the [decision] was made honestly in the interests of the company."²⁰ However, their Honours refused to interfere with the impugned transaction in this case on the ground that:

[d]irectors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and *their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.*²¹

The High Court restated the same position in *Wayde v New South Wales Rugby League Limited*.²² In that case, the court was called upon to set aside a decision of the directors excluding a team from participating in the New South Wales Rugby League championship competition. It was alleged

18 See National Companies and Securities Commission, *Report on the Cross Investments between The Broken Hill Proprietary Company Limited and Elders IXL Limited* (AGPS, Canberra, 1986) Appendix 8.

19 (1968-69) 42 ALJR 123.

20 At 125.

21 At 125 (emphasis added).

22 (1985) 59 ALJR 798.

that the decision was oppressive and unfairly prejudicial. The High Court refused to intervene, holding:

the court may not intervene and hold the decision invalid on the ground that the court thinks the decision unreasonable. ... The validity of an exercise of power cannot be challenged merely because too little weight is given to some matters which properly fall for consideration and too much to others, *for the court will not substitute its discretion for the discretion exercised in good faith by the directors.*²³

A number of justifications have been proffered for this rule. Foremost among these is that the rule gives judicial recognition to the prerogatives of directors to manage the affairs of the company provided that they act honestly and with reasonable diligence and care. It is widely accepted that it is the responsibility of directors, and not the courts, to manage the affairs of companies. As Scrutton LJ remarked in *Shuttleworth v Cox Brothers & Company (Maidenhead) Limited*,²⁴ "it is not the business of the courts to manage the affairs of the company. That is for the shareholders and the directors."²⁵ Indeed, this much has been recognised since the turn of the century. Way back in 1902, Lord Davey postulated that:

[i]t is an elementary principle of the law relating to joint stock companies that the Court will not interfere with the ... management of companies acting within their powers, and in fact has no jurisdiction to do so.²⁶

Similar sentiments have been echoed more recently. In *New South Wales Rugby League Limited v Wayde*,²⁷ the New South Wales Court of Appeal warned that "courts should exercise care in invading the traditional roles of directors and shareholders of companies to determine the management of the corporation."²⁸ According to the court:

23 At 802, per Brennan J (emphasis added). See also *Howard Smith Limited v Ampol Petroleum Limited* [1974] AC 821 at 832.

24 [1927] 2 KB 9.

25 At 23. See also Aust, Parl, Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties* para 3.11, p22.

26 *Burland v Earle* [1902] AC 83 at 93. See also *Edwards v Halliwell* [1950] 2 All E R 1064 at 1066, per Jenkins LJ.

27 (1985) 9 ACLR 465.

28 At 479.

if, having regard to the relevant considerations, the decisions to which the directors did come were decisions to which they might reasonably come ... it is not for the court to involve itself in the administration of the League [company] and come to some alternative decisions which it thinks would be better.²⁹

Given then that it is the directors, rather than the courts that manage the business affairs of the corporation, the courts recognise that:³⁰

it would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of management decision ... if bona fide arrived at. There is no appeal on merits from management's decisions to courts of law; nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.

A further justification for the business judgment rule is that it removes from the shoulders of the courts the responsibility of second-guessing directors in business matters, a field in which judges generally have no expertise and in respect of which they may have no information. This argument has been articulated with great force by the New South Wales Court of Appeal, which has expressed the view that even when authorised to intervene, the courts must not assume

the management of corporations, substituting their decisions and assessments for those of directors, who can be expected to have much greater knowledge and more time and expertise at their disposal to evaluate the best interests of members of the corporation as a whole.³¹

This has the added advantage of saving the courts' time.

Judicial readiness to defer to the judgment of directors has been defended on the ground that, were the position otherwise, the courts might be called upon "on every occasion to take the management of every Playhouse and

29 At 477. See further *Thomas v HW Thomas Ltd* (1984) 2 ACLC 610.

30 *Howard Smith Limited v Ampol Petroleum Limited* [1974] AC 821 at 832.

31 *New South Wales Rugby League Limited v Wayde* (1985) 9 ACLR 465 at 479. See further Gower, Prentice & Pettet, *Gower's Principles of Modern Company Law* p586; and Tan, "Delivering the Judgment on a Statutory Business Judgment Rule in Australia" (1995) 5 *AustJCL* 442 at 443.

Brewhouse in the Kingdom."³² According to the courts, this is untenable. It might promote "futile actions",³³ oppressive litigation³⁴ and a multiplicity of suits.³⁵ As a result, "companies might be torn to pieces by litigation."³⁶

Another argument commonly advanced in favour of judicial restraint is that it is essential in order to encourage commercial risk taking and to stimulate innovation.³⁷ According to proponents, substantial costs are likely to be imposed on society without such a rule. The fear of constant review is likely to lead boards of directors to adopt ponderous, court-like procedures. Overcaution will be likely to lead to missed opportunities. Also, constant review is bound to drive up directors' fees and officers' and directors' liability insurance rates.³⁸ As well, it might make people reluctant to serve as directors.³⁹

The rule finds further support because of its recognition of human fallibility. While directors are expected to discharge their duties loyally, honestly and with due skill and diligence, the success of their policies cannot always be guaranteed. They are not guided by divine prescience. The business judgment rule thus articulates the principle that although shareholders have a right to expect their directors to exercise due care, they cannot expect them to guarantee the success of their decisions.⁴⁰

32 *Carlen v Drury* (1812) 1 V & B 154 at 158; 35 ER 61 at 62, per Lord Eldon.

33 *Foss v Harbottle* (1843) 2 Ha 461 at 494; 67 ER 189 at 203.

34 *Gray v Lewis* (1873) 8 Ch App 1035 at 1050-1051, per James LJ.

35 *Mozley v Alston* (1847) 1 Ph 790 at 799; 41 ER 833 at 837.

36 *La Compagnie de Mayville v Whitley* [1896] 1 Ch 788 at 807, per Kay LJ. See further, Wedderburn, "Shareholders Rights and The Rule in *Foss v Harbottle*" (1957) 15 *Cambridge LJ* 194 at 195.

37 Aust, Parl, Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties* para 3.32, p30.

38 DeMott, "Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices" (1992) 4 *Bond LRev* 133 at 139; Farrar, "Corporate Governance, Business Judgment and the Professionalism of Directors" (1993) 6 *CBLJ* 1 at 23-24.

39 On this see further, *Cook v Deeks* [1916] 1 AC 554 at 563 where the House of Lords warned against "establishing rules as to directors' duties which would impose upon them burdens so heavy and responsibilities so great that men of good position would hesitate to accept office". See also *Daniels v Anderson* (1995) 13 ACLC 614 at 654, per Clarke and Sheller JJA; *Dynamics Corporation of America v CTS Corporation* 794 F 2d 250 at 256, per Posner J (1986); Fischel, "The Business Judgment Rule and the *Trans Union* Case" (1985) 40 *Business Lawyer* 1437 at 1439ff; American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* p443.

40 See generally, Tan, "Delivering the Judgment on a Statutory Business Judgment Rule in Australia" (1995) 5 *AustralianJCL* 442 at 443; Farrar, "Business

In summary, as the American Law Institute has succinctly stated,

the basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to informed business judgment (whether subsequent events prove them right or wrong) in order to stimulate risk taking, innovation, and other creative entrepreneurial activities. Shareholders, with expectation of greater profit, accept the risk that a business decision - honestly and rationally undertaken - may not be vindicated by subsequent success. The special protection afforded business judgments is also based on a desire to limit litigation and judicial intrusiveness with respect to private sector business decision-making.⁴¹

APPLICATION OF THE RULE IN CONTESTED TAKEOVERS - THE AUSTRALIAN EXPERIENCE

The business judgment rule counsels restraint on the part of the judiciary. The reason for this is, partly, that courts should be reluctant to review decisions of directors in situations where the directors' expertise is likely to be greater than the courts'.⁴² Although the rule is intended to apply only in circumstances where there is no potential for conflict of interest,⁴³ it has

Judgment And Defensive Tactics In Hostile Takeover Bids" (1989) 15 *CanadianBLJ* 15 at 19; Siegel, "Tender Offer Defensive Tactics: A Proposal For Reform" (1984-85) 36 *HastingsLJ* 377 at 380ff; Cohn, "Demise of the Director's Duty of Care: Judicial Avoidance of Standards And Sanctions Through the Business Judgment Rule" (1983) 62 *TexLRev* 591 at 602.

41 American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* p135.

42 See generally text accompanying fn31 above.

43 See *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294; *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659 at 708, per Mahoney JA and at 714, per Clarke JA, *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil NL* (1968) 121 CLR 483 at 487; *Howard Smith Limited v Ampol Petroleum Limited* [1974] AC 821 at 832; *Hogg v Cramphorn Limited* [1967] Ch 254; *Winthrop Investments Limited v Winns Limited* [1975] 2 NSWLR 666; *Peter's American Delicacy Company Limited v Heath* (1939) 61 CLR 457 at 480, Latham CJ; *Richard Brady Franks Limited v Price* (1937) 58 CLR 112 at 135, per Latham CJ; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 219, per Issacs J; *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656; *Re Smith & Fawcett Limited* [1942] 1 Ch 304; Tan, "Delivering the Judgment on a Statutory Business Judgment Rule in Australia" (1995) 5 *AustJCL* 442 at 450.

been applied by Australian courts in takeover situations alike. An example of this can be found in *Harlowe's Nominees Pty Limited v Woodside (Lakes Entrance) Oil Company No Liability*, discussed above.⁴⁴

As that case illustrates, it is apparent that where directors adopt a course of action designed to thwart a hostile takeover bid, then in the absence of evidence of fraud or bad faith, (the burden of proving these matters is borne by the plaintiff⁴⁵) the directors' actions will not be interfered with by the courts.⁴⁶ This renders it extremely difficult to challenge transactions entered into for defensive purposes if they can be attributed to any rational corporate purpose.⁴⁷ In such circumstances, a challenge will succeed only if the impugned actions are so unreasonable that no "intelligent and honest person 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."⁴⁸

One particular difficulty is that, on being confronted with an unwelcome takeover offer, the directors can tactically enter into a transaction which blocks the offer while simultaneously serving some other permissible corporate purpose. When actions of this nature are challenged, it must be

44 For a discussion of this case see above fn19-21.

45 When a defensive exercise of directors' powers is challenged, the court will not presume impropriety. The onus is on the plaintiff to show that the directors acted fraudulently or in bad faith in making the decision in question. See *Winthrop Investments Limited v Winns Limited* [1975] 2 NSWLR 666; *Peter's American Delicacy Company Limited v Heath* (1939) 61 CLR 457 at 482, per Latham CJ; *Richard Brady Franks Limited v Price* (1937) 58 CLR 112 at 135, per Latham CJ; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 219, per Isaacs J.

46 See generally, the materials cited in fn7 above. For further instances of the application of this principle, see *Howard Smith Limited v Ampol Petroleum Limited* [1974] AC 821 at 832; *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659.

47 As proof see for example, *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659; *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294; *Winthrop Investments Limited v Winns Limited* [1975] 2 NSWLR 666; *Harlowe's Nominees Pty Limited v Woodside (Lakes Entrance) Oil Company No Liability* (1968) 121 CLR 483. See further, Tan, "Delivering the Judgment on a Statutory Business Judgment Rule in Australia" (1995) 5 *Australian JCL* 442 at 449; and Baxt, "Defeating Takeovers - Business Judgment of Directors and Related Issues" (1984) 58 *ALJ* 290.

48 *Charterbridge Corporation Limited v Lloyd's Bank Limited* [1970] 1 Ch 62 at 74, per Pennycuik J; *Waydev New South Wales Rugby League Limited* (1985) 59 *ALJR* 798 [High Court of Australia]. See also the cases cited above fn47.

proved that they were taken for a purpose collateral to that for which the power was conferred before a court will interfere with the resulting transaction.⁴⁹ Once that is shown, the directors' conduct "is open to challenge, and in such a case it is no answer for them to maintain that they bona fide believed their conduct to be in the interests of the company."⁵⁰

The problem, however, is that where actions which impede an unsolicited takeover bid also serve some permissible corporate purpose, the real purpose of the directors cannot be readily ascertained. The court must thus undertake further analysis to determine whether or not the directors' actions are valid.

Two tests have been adopted by the courts for characterising conduct of directors serving dual purposes: the 'primary/substantial purpose' test and the 'but for' test. Both tests are, however, not very helpful to a party seeking to challenge defensive actions which serve mixed purposes. They depend on proving the motives of the directors for acting as they did.

Under the primary/substantial purpose test, if an exercise of directors' powers serves competing purposes, one proper and the other improper, the court is required to examine the motives for which the directors exercised that power and ascertain "the substantial object the accomplishment of which formed the real ground of the board's action."⁵¹ An exercise of power is invalid if it is demonstrated that the motives of the directors in acting as they did were primarily to serve an improper purpose. In the words of Dixon J, if,

except for some ulterior or illegitimate object, the power would not have been exercised, that which has been

49 *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659; *Re Smith and Fawcett Limited* [1942] 1 Ch 306; *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656 at 671, per Lindley MR; *Greenhalgh v Ardenne Cinemas Limited* [1950] 2 All ER 1120 at 1126, per Evershed MR; *Pergamon Press Limited v Maxwell* [1970] 2 All ER 809 at 813, per Pennycuik J; *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199 at 217, per Isaacs J; *Hindle v John Cotton Limited* (1919) 56 Sc LR 625 at 630, per Viscount Findlay.

50 Boyle & Sykes, *Gore-Browne on Companies* (Jordans, Bristol, 44th ed 1986) Vol 2, para 27.5, p27.011. See further, *Hogg v Cramphorn Limited* [1967] Ch 254; *Whitehouse v Carlton Hotel Proprietary Limited* (1987) 61 ALJR 216 at 219, per Mason, Deane and Dawson JJ; *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659 at 676, per Kirby P, and at 712, per Mahoney JA.

51 See *Mills v Mills* (1937-1938) 60 CLR 150 at 185-186, per Dixon J.

attempted as an ostensible exercise of the power will be void, notwithstanding that the directors may incidentally bring about a result which is within the purpose of the power and which they consider desirable.⁵²

The alternative 'but for' test also depends upon proof of directors' motives. That much can be gleaned from *Whitehouse v Carlton Hotel Proprietary Limited*.⁵³ In that case, the High Court held that if an exercise of directors' powers serves competing (that is, both permissible and impermissible) purposes, then:

[a]s a matter of logic and principle, the preferable view would seem to be that, regardless of whether the impermissible purpose was the dominant one or but one of a number of significantly contributing causes, the [exercise of power] will be invalidated if the impermissible purpose was causative in the sense that, but for its presence, "the power would not have been exercised".⁵⁴

As an examination of motive is always difficult, it will ordinarily be hard to challenge transactions entered into by directors to prevent a change in the

52 As above. See further, *Hogg v Cramphorn Limited* [1967] Ch 254 at 258.

53 (1987) 61 ALJR 216.

54 At 219 (Mason, Dawson and Deane JJ, citing Dixon J in *Mills v Mills* (1938) 60 CLR 150 at 186); *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659 at 708, per Mahoney JA and at 712, per Clarke JA. For a more detailed discussion of the proper purposes doctrine, reference may be made to Corkery, *Directors' Powers And Duties*, pp109-130; Wedderburn, "Shareholders' Control of Directors' Power - A Judicial Innovation?" (1967) 30 *ModLR* 77; Sealy, "Company Directors' Powers - Proper Motive But Improper Purpose" [1967] *CambridgeLJ* 33; Lesser, "Organising Resistance To Take-over Bids - The Legality of Strategic Allotments Of Shares" [1969] *CambridgeLJ* 198; Birds, "Proper Purposes As A Head Of Directors' Duties" (1974) 37 *ModLR* 580; Heath, "The Proper Purposes Doctrine - The Law And Its Implications" (1976-79) 3 *AucklandULRev* 307; Ritson, "The 'Proper Purposes' Duty Of Directors and Defensive Measures Against Company Takeovers" (1985) 10 *SydLR* 627; Prentice, "Expulsion of Members From A Company" (1970) 33 *ModLR* 700; Instone, "The Duty Of Directors" [1979] *JBusL* 221; Farrar, "Abuse Of Power By Directors" [1974] *CambridgeLJ* 221; Ziegel, "Directors' Powers And The Proper Purposes" [1974] *JBusL* 85; Austin, "Takeovers - The Australian Experience" in Farrar (ed), *Takeovers, Institutional Investors and the Modernization of Corporate Laws* (Oxford University Press, Auckland 1993) pp182-183; Sealy, "The Rule in *Foss v Harbottle*: The Australian Experience" (1989) 10 *CoLaw* 52 at 55; and Hannes, "Your Honour, I Honestly Thought It Was In The Best Interests Of The Company" (1987) 5 *C&SLJ* 185.

control of a company. In many cases, it will be rare to find evidence that the directors acted for an improper purpose, let alone proof that the improper purpose was the substantial purpose behind the impugned exercise of power.⁵⁵ This difficulty has indeed been acknowledged by Australia's regulatory authorities⁵⁶ and leading practitioners.⁵⁷

- 55 To illustrate this problem, reference may be made to the 1986 cross investments case between The Broken Hill Proprietary Company Limited (BHP) and Elders IXL Limited (Elders).

In March 1986, Bell Resources Limited (Bell) made a partial takeover offer for BHP. In its endeavours to ward off Bell, BHP entered into an agreement with Elders under which the two companies made defensive cross investments in each other involving almost two billion dollars. This was accomplished within the space of just two days. According to the National Companies and Securities Commission, the erstwhile national corporate regulator, these transactions were the largest ever to be conducted involving the securities of Australian public companies [see NCSC, *Report on The Cross Investments Between The Broken Hill Proprietary Company Limited and Elders IXL Limited* Ch1, para 8, p 3.

Because of their nature, timing and the vast sums of money involved, the transactions attracted widespread publicity and criticism. As a result, the National Companies and Securities Commission held an inquiry to determine whether they were acceptable in terms of s60 of the *Takeovers Code* then in force.

In the course of the Commission's inquiry, Bell challenged the acquisition by BHP of shares, options and convertible notes in Elders. It claimed that those acquisitions were not made in the interests of the company, but merely to secure the alliance of Elders and so dissuade it from selling its parcel of BHP shares to Bell. The BHP directors on the other hand claimed that the investment was made purely on its merits, on a stand alone basis and in accordance with professional advice proffered by its advisers.

In its report, the Commission noted that where an exercise of directors' fiduciary powers was challenged before it, it had several advantages over a court of law in trying to assess the purposes of directors. The Commission had the ability to gain access to any relevant information. Further, it was not constrained by any technical rules of evidence. In addition, it had the advantage of being able to rely on the commercial knowledge and experience of its members.

The Commission went on to state that even with all these advantages, it could not determine with any certainty what the primary motives or substantial objects of the directors of BHP were. [See NCSC, *Report on The Cross Investments Between The Broken Hill Proprietary Company Limited and Elders IXL Limited* Ch8 para 2.6.2, p265.] It then observed, quite correctly, that "as long as the law focusses on motive, it will be very rarely that a private litigant can feel any confidence of success in challenging the propriety of a board decision before the

By applying the business judgment rule to transactions entered into to impede hostile takeovers, thereby raising the presumption that the directors acted in good faith, and casting the burden of pleading and establishing the factors that displace the operation of the rule on the party complaining, the courts render it extremely easy for directors to thwart unsolicited takeover bids. This is undesirable. It is beyond doubt that a decision by directors to resist an unsolicited takeover offer is not an ordinary business decision. A hostile takeover offer presents target management with a potential conflict of interest.⁵⁸ As Easterbrook and Fischel note, "[m]anagers of the target perceive bids as reflecting poorly on their services, since the bidders propose to change the way the target is run."⁵⁹ Further, with the success of a hostile takeover offer, incumbent management often stand to lose their positions and perquisites. Thus, faced with a hostile takeover bid, "there is a great danger that the directors will channel their expertise toward pursuit of personal advantage."⁶⁰ The directors "may try to resist - whether crassly to save their jobs or because they genuinely believe that their program ... is

courts." [See NCSC, *Report on The Cross Investments Between The Broken Hill Proprietary Company Limited and Elders IXL Limited* Ch8 para 2.6.3, p266.]

56 As above.

57 See, for example, Steel, "Defensive Tactics In Company Takeovers" (1986) 4 *C&SLJ* 30 at 31-32; Bennett, "The Ascertainment Of Purpose When Bona Fides Are In Issue - Some Logical Problems" (1989) 12 *SydLR* 5 at 7-8; Santow, "Defensive Measures Against Company Take-overs" (1979) 53 *ALJ* 374 at 375-377.

58 Weinberg and Blank, *Takeovers And Mergers* (Sweet & Maxwell, London, 5th ed 1989) para 3-833; Grantham, "The Content of the Director's Duty of Loyalty" [1993] *JBusL* 149 at 161; Veasey, "Further Reflections on Court Review of Judgments of Directors: Is the Judicial Process Under Control?" (1985) 40 *Business Lawyer* 1373 at 1375; Gilson, "A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers" (1981) 33 *StanfordLRev* 819 at 825; Easterbrook & Fischel, "The Proper Role of A Target's Management In Responding to A Tender Offer" (1981) 94 *HarvLRev* 1161 at 1175ff; Gelfond & Sebastian, "Reevaluating the Duties of Target Management in a Hostile Tender Offer" (1980) 60 *BostonULRev* 403 at 436ff; Gutman, "Tender Offer Defensive Tactics And The Business Judgment Rule" (1983) 58 *NYULRev* 621 at 656; Danziger & Skyoles, "Directors And Takeovers (No 2)" (1984) 5 *CoLaw* 217 at 217; and Lofthouse, "Competition Policies as Take-over Defences" [1984] *JBusL* 320 at 324.

59 Easterbrook & Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, Massachusetts 1991) p162.

60 *Johnson v Trueblood* 629 F 2d 287 at 300, per Rosenn J (1980), citing Gelfond & Sebastian, "Reevaluating the Duties of Target Management in a Hostile Tender Offer" (1980) 60 *BostonULRev* 403.

superior to the bidder's."⁶¹ The application of the rule to protect decisions taken by directors to frustrate hostile takeover offers may thus have the undesirable consequence of promoting self-dealing on the part of target management, to the detriment of the company and the economic order of the community generally.⁶²

Since there is no means of identifying intransigent resistance from honest efforts by the directors to advance the shareholders' interests,⁶³ it is desirable that the protection afforded by the business judgment rule is not extended to actions taken by directors to block unsolicited takeover bids. Instead, the regulatory framework should lay down clear ex-ante rules restricting the competence of target management to thwart hostile takeover offers.⁶⁴ Only by protecting the hostile takeover process will shareholders and society generally be able to harness the substantial benefits associated with that activity.⁶⁵

61 Easterbrook & Fischel, *The Economic Structure of Corporate Law* p162.

62 The following works, which are only representative of the vast literature on the subject, provide some useful insights into the problems arising from the use of defensive tactics in contests for corporate control: Easterbrook & Fischel, *The Economic Structure of Corporate Law* p196ff; Gelfond & Sebastian, "Reevaluating the Duties of Target Management in a Hostile Tender Offer" (1980) 60 *Boston ULRev* 403 at 436ff; Cohn, "Demise of the Director's Duty of Care: Judicial Avoidance of Standards And Sanctions Through the Business Judgment Rule" (1983) 62 *TexLRev* 591 at 615-627; Gutman, "Tender Offer Defensive Tactics And The Business Judgment Rule" (1983) 58 *NYULRev* 621 at 649-658; American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* Vol 1, Part VI; Andre, "Tender Offers For Corporate Control: A Critical Analysis And Proposals For Reform" (1987) 12 *DelawareJCL* 865 at 887-890; Harrington, "If It Ain't Broke, Don't Fix It: The Legal Propriety Of Defenses Against Hostile Takeover Bids" (1983) 34 *SyracuseLRev* 977 at 987-990 and 1017-1022; Liles, "Greenmailing Corporate Shareholders: Is there a Solution?" (1985) 37 *UFloridaLRev* 389 at 394-398; and Gray, "Dual Standards for the Use of Employee Benefit Plans in Corporate Takeovers: ERISA and The Business Judgment Rule" (1985) 59 *St John'sLRev* 751 at 762-770.

63 Easterbrook & Fischel, *The Economic Structure of Corporate Law*, p175.

64 On the need for such restrictions see for example, Gilson, "A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers" (1981) 33 *StanfordLRev* 819; Easterbrook & Fischel, *The Economic Structure of Corporate Law*; Andre, "Tender Offers For Corporate Control: A Critical Analysis And Proposals For Reform" (1987) 12 *DelawareJCL* 865; and Pound & Zeckhauser, "The Economics of Corporate Takeovers and the New Zealand Takeover Code: An Analysis and Proposals For Reform" submission to The New Zealand Securities Commission (unpublished), May 1988.

65 An analysis of the benefits of hostile takeover activity and the reasons for protecting the takeover process is beyond the scope of this article. For that the

It is noteworthy that in the United States of America where the business judgment rule has been most extensively developed, it has been recognised by the courts of several jurisdictions that the reflexive application of the rule to prevent judicial review of actions taken by directors to thwart changes in corporate control is undesirable, as the following discussion will demonstrate.

APPLICATION OF THE RULE IN CONTESTED TAKEOVERS: A COMPARATIVE ANALYSIS - USA

The Governing Principles

In the United States, actions taken by directors in response to a hostile takeover offer are governed by the duties of care and loyalty. These duties are imposed on directors by the corporations laws of the various states.⁶⁶

The duty of care requires directors to act in good faith, in the best interests of the corporation and with such care as an ordinary prudent person would use in similar circumstances.⁶⁷ By the duty of loyalty, directors are

reader may refer to the following works which are merely representative of the substantial literature on the subject: Manne, "Mergers and The Market For Corporate Control" (1965) 73 *JPolEc* 110; Fama, "Agency Problems and the Theory of the Firm" (1980) 88 *JPolEc* 287; Jensen, "Takeovers: Their Causes and Consequences" (1988) 2 *Journal of Economic Perspectives* 21; Dodd & Officer, *Corporate Control, Economic Efficiency And Shareholder Justice* (The Centre For Independent Studies, Sydney 1986); Bishop, Dodd & Officer, *Australian Takeovers: The Evidence 1972-1985*, Policy Monograph 12, (The Centre For Independent Studies, Sydney 1987); Jensen & Ruback, "The Market For Corporate Control: The Scientific Evidence" (1983) 11 *Journal of Financial Economics* 5; Andre, "Tender Offers For Corporate Control: A Critical Analysis And Proposals For Reform" (1987) 12 *DelawareJCL* 865; Gilson, "A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers" (1981) 33 *StanfordLRev* 819; and Pound & Zeckhauser, "The Economics of Corporate Takeovers and the New Zealand Takeover Code: An Analysis and Proposals For Reform" submission to The New Zealand Securities Commission (unpublished), May 1988.

66 See for example the *New York Business Corporations Law*, para 717. As to the content of these duties, see *Hanson Trust PLC v ML SCM Acquisitions Inc* 781 F 2d 264 at 273 (1986); and Veasey, "New Insights Into Judicial Deference To Directors' Business Decisions: Should We Trust The Courts?" (1984) 39 *Business Lawyer* 1461 at 1463ff.

67 *Hanson Trust PLC v ML SCM Acquisitions Inc* 781 F 2d 264 at 273 (1986).

prohibited from entering into any transaction with the corporation in which they have an interest.⁶⁸

To determine whether the obligations thus cast upon the directors have been satisfied, the courts apply the business judgment rule.⁶⁹ According to *Smith v Van Gorkom*⁷⁰ that rule:

is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.⁷¹

Pursuant to this rule, the courts will not enjoin a transaction which involves no self-dealing by or no personal interest of the directors. Also, the directors who authorise such transactions will not be held liable for damages unless it is shown that the directors did not exercise due care, did not act in good faith or did not reasonably believe the transaction to be for the best interest of the corporation.⁷²

The business judgment standard is applied in ascertaining the validity of actions taken by directors to respond to a hostile takeover bid. Indeed, in the early cases, the rule was routinely applied to shield such actions from judicial scrutiny. To appreciate this, reference may be made to *Pogostin v*

68 A useful exposition of the duties imposed on directors under American law can be found in Cary & Eisenberg, *Cases And Materials On Corporations* (The Foundation Press, New York, 6th ed 1988) Ch6; and Truesdell, "Does *Norlin Corp v Rooney, Pace Inc* Preserve for Shareholders Control of a Corporation's 'Ultimate Destiny'?" (1986) 20 *Columbia Journal of Law & Social Problems* 325 at 332ff.

69 *Panter v Marshall Field & Co* 646 F 2d 271 at 293 (1981); *Hanson Trust PLC v ML SCM Acquisitions Inc* 781 F 2d 264 at 273 (1986); Gilson, "A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers" (1981) 33 *StanfordLRev* 819 at 822; Harrington, "If It Ain't Broke, Don't Fix It: The Legal Propriety Of Defenses Against Hostile Takeover Bids" (1983) 34 *SyracuseLRev* 977 at 987-990; Clarke, *Corporate Law* (Little Brown & Company, Boston 1986) p123ff; and McDermott, "The Duties Of The Board Of Directors of A US Business Corporation In The Context Of A Corporate Takeover" (1989) 2 *CBLJ* 119 at 127.

70 488 A 2d 858 (1985).

71 At 872, per Horsly J citing *Aronson v Lewis* 473 A 2d 805 at 812, per Moore J (1980); *Unocal Corporation v Mesa Petroleum Co* 493 A 2d 946 (1985); and *Moran v Household International Inc* 500 A 2d 1346 at 1356, per McNeilly J (1985).

72 See generally Arsh, "Fiduciary Responsibilities of Directors, Officers And Key Employees" (1979) 4 *DelawareJCL* 652 at 660ff.

Rice.⁷³ In that case, the Supreme Court of Delaware, which is one of the most influential courts in corporate matters in the United States, held that "the business judgment rule, including the standards by which director conduct is judged ... is equally applicable in the context of a takeover."⁷⁴

However, it has now been recognised that, in resisting a hostile offer, directors may be more concerned to maintain the independence of the company and so protect their positions, than to promote the interests of the company, including its shareholders.⁷⁵ It has also been recognised that, because of this potential for conflict of interest, it is inappropriate to reflexively extend the protection of the business judgment rule to decisions taken by directors to frustrate an unsolicited takeover offer. That might weaken the protection of shareholders' interests.⁷⁶

To redress this, the courts of several jurisdictions have introduced some qualifications in the application of the rule to takeover transactions. A motive to retain control is now treated as a sufficient interest to taint a decision to resist a hostile takeover offer. Thus the rule will not protect a decision which is shown to have been taken out of a desire by the directors to entrench themselves in power. It must be shown that a decision to resist an offer was taken pursuant to an informed deliberative process before the rule will apply. The following cases illustrate these developments.

In *Norlin Corporation v Rooney, Pace Inc*,⁷⁷ the directors of a corporation subject to a hostile takeover bid set up an Employee Stock Option Plan (ESOP) to which they allotted newly issued shares in the capital of the target. The directors constituted themselves trustees of the plan. Through

73 480 A 2d 619 (1984).

74 At 627, per Moore J. See in addition the comment by Lipton & Brownstein, "Takeover Responses and Directors' Responsibilities - An Update" (1985) 40 *Business Lawyer* 1403 at 1404.

75 On this see for example, *Bennett v Propp* 187 A 2d 405 at 409, per Sutherland CJ (1962); Harrington, "If It Ain't Broke, Don't Fix It: The Legal Propriety Of Defenses Against Hostile Takeover Bids" (1983) 34 *SyracuseLRev* 977 at 998 and 1022; Gilson, "A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers" (1981) 33 *StanfordLRev* 819 at 825; Gelfond & Sebastian, "Reevaluating the Duties of Target Management in a Hostile Tender Offer" (1980) 60 *BostonULRev* 403 at 436; Ragazzo, "The Legitimacy Of Takeover Defense In The 90s" (1992) 41 *DePaulLRev* 689 at 693; Mayanja, *Reforming the Law to Improve the Market for Corporate Control*, unpublished PhD thesis, Monash University 1993, ch4, pp165-166.

76 As above.

77 744 F 2d 255 (1984) [US Court of Appeals, Second Circuit].

these actions, the directors ended up controlling 49% of the voting power of the target company.

The respondents challenged these actions. It was claimed that the directors' purpose in establishing the ESOP was merely to enable them to retain control of the company. The directors countered with the argument that the implementation of the plan was a matter of business judgment. As such, it was not subject to review by the courts.

In the course of ruling on the validity of the impugned transactions, the court noted the timing of the share issue; the fact that the ESOP was created the very same day the stock was issued to it; the fact that no real consideration was received from the ESOP for the shares and the fact that all of the stock transferred to the ESOP was to be voted by the directors.⁷⁸

On the basis of this evidence, the court concluded that the disputed actions were designed solely to enable incumbent management to retain their control of the company.⁷⁹ The court, in undisguised criticism of the directors, stated:

[w]here, as here, directors amass voting control of close to a majority of a corporation's shares in their own hands by complex, convoluted and deliberate maneuvers, it strains credulity to suggest that the retention of control over corporate affairs played no part in their plans.⁸⁰

In light of the prima facie evidence of self-interest, the court ruled that the directors were not entitled to the protection of the business judgment rule. That rule, the court held, "governs only where the directors are not shown to have a self-interest in the transaction at issue. ... Once self-dealing or bad faith is demonstrated, the duty of loyalty supersedes the duty of care."⁸¹

78 At 265-266, per Kaufman J.

79 At 267, per Kaufman J.

80 At 265, per Kaufman J.

81 As above. See also, *Condec Corp v The Lunkenheimer Co* 230 A 2d 769 at 776, per Marvel VC (1967); *Klaus v Hi-Shear Corp* 528 F 2d 225 at 233, per Choy J (1975). See also the discussion by Lipton & Brownstein, "Takeover Responses and Directors' Responsibilities - An Update" (1985) 40 *Business Lawyer* 1403 at 1406; Truesdell, "Does *Norlin Corp v Rooney, Pace Inc* Preserve for Shareholders Control of a Corporation's 'Ultimate Destiny'?" (1986) 20 *Columbia Journal of Law & Social Problems* 325 at 335-338; and Gibson and Campbell, "Fundamental Law for Takeovers" (1984) 39 *Business Lawyer* 1551 at 1552-3.

The courts have also attempted to grapple with the conflict of interest problem by reversing the burden of proof. Under this approach, directors implementing defensive structures bear the burden of showing that their actions are justified, in the sense that they are in the best interest of the corporation and its shareholders. A case in point is *Unocal Corporation v Mesa Petroleum Co.*⁸² There, the Supreme Court of Delaware held that:

[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule will be conferred . . . In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.⁸³

Similar comments were made by the same Court in *Moran v Household International Inc.*⁸⁴

The courts have further ruled that a transaction entered into to block an unsolicited takeover offer will not be protected by the business judgment rule unless it is shown to have been approved with due care, after considering all relevant factors. A determination as to what is reasonable care depends on a great variety of considerations, such as the scale of the decision, the time available to make it, the cost involved and the confidence the director or officer can reasonably have in analyses and recommendations

82 493 A 2d 946 (1985).

83 At 954-955, per Moore J. For a further review of this case see, Lipton & Brownstein, "Takeover Responses and Directors' Responsibilities - An Update" (1985) 40 *Business Lawyer* 1403 at 1410ff; Iorini, "Defensive Strategies and the Business Judgment Rule: Does Almost Anything Go in Delaware?" (1986) 11 *DelawareJCL* 535 at 540-546; Rosenzweig & Orens, "Tipping the Scales - The Business Judgment Rule in the Antitakeover Context" (1986) 14 *Securities RegulationLJ* 23 at 26-27; and Brennan, "New Cases on the Business Judgment Rule: Defending Defensive Tactics Becomes More Difficult" (1986) 14 *Securities RegulationLJ* 245 at 250-256.

84 500 A 2d 1346 at 1356ff, per McNeilly J (1985). For a detailed discussion of this case see Rosenzweig & Orens, "Tipping the Scales - The Business Judgment Rule in the Antitakeover Context" (1986) 14 *Securities RegulationLJ* 23 at 23-26.

by subordinates.⁸⁵ The obligation of inquiry can be gleaned from *Smith v Van Gorkom*.⁸⁶

In that case, the directors of a company (Trans Union) caused it to enter into a merger agreement with another company (New T Company). However, before authorising the sale of the company, none of the directors (of Trans Union), other than the Chairman/Chief Executive Officer read the merger agreement. Further, the directors did not consult any merchant banker to determine the fairness of the merger price, which was fixed solely by the Chairman. Nor did they reserve the right to solicit alternative offers. On the contrary, as part of the merger scheme, they authorised the issue, at market price, of a further one million shares to the purchasing company. The effect of this issue was to block any other offer for the company. The meeting at which this transaction was sanctioned lasted only two hours.

Shareholders of Trans Union commenced a class action challenging the validity of the transaction. They claimed that the directors violated their duty of care and sought an order to have the merger agreement set aside or, alternatively, damages against the directors. The directors retorted that the approval of the merger fell within the protection of the business judgment rule and, as such, was not subject to review by the court.

The Supreme Court of Delaware held that, by virtue of their fiduciary function, directors representing the financial interests of others owe a duty of care and must exercise an informed judgment in protecting those interests. The court found that the directors' actions in this case were not the product of an informed judgment.

In coming to its decision, the court took into account the fact that the directors did not adequately inform themselves as to the Chairman's role in forcing the sale of the company and in establishing the per share purchase price. Secondly, they did not take any step to inform themselves as to the intrinsic value of the company. Finally, although there was no real urgency, they approved the sale of the company upon two hours of consideration, without prior notice.⁸⁷ In view of this, the court ruled that the directors could not invoke the protection of the rule to insulate their

85 Eisenberg, "Aspects of Corporate Governance in the US: Corporate Structure, The Duty of Care, and Self-Interested Transactions" unpublished seminar paper, Melbourne 1992 p 22.

86 488 A 2d 858 (1985).

87 At 874, per Horsey J.

decision from review. The business judgment rule does not protect directors who have made "an unintelligent or unadvised judgment."⁸⁸

The need for directors to properly inform themselves before taking any decision which may result in the frustration of a takeover offer can also be seen in *Hanson Trust PLC v ML SCM Acquisitions Inc.*⁸⁹ In this case, the respondent granted an option over its major assets to a friendly party. The option entitled the grantee, in the event of a third party acquiring one third of the grantor's share capital, to acquire the respondent's most profitable businesses at a pre-determined price. This step was taken in an attempt to ward off an unsolicited takeover offer from the appellant.

In proceedings challenging the validity of the option, the court reiterated that

[t]he law is settled that, particularly where directors make decisions likely to affect shareholder welfare, the duty of care requires that a director's decision be made on the basis of "reasonable diligence" in gathering and considering material information. In short, a director's decision must be an informed one.⁹⁰

Having regard to the evidence in this case, the court concluded that the directors had "failed to take many of the affirmative directorial steps that underlie the finding of due care."⁹¹ This was based on the finding that before approving the option, the directors did not seek any advice regarding the fair value of the business to be sold. Further, although the business put up for sale represented approximately one half of its income, the directors never considered what impact the sale would have on the company.⁹² In addition, the directors did not consider any information concerning the financial affairs of the company.⁹³ The meeting at which the option was

88 At 872-873, per Horsey J. See further Rosenzweig & Orens, "Tipping the Scales - The Business Judgment Rule in the Antitakeover Context" (1986) 14 *Securities Regulation LJ* 23 at 27-30; Fischel, "The Business Judgment Rule and the *Trans Union* Case" (1985) 40 *Business Lawyer* 1437; Kirk, "The *Trans Union* Case: Is It Business Judgment Rule As Usual?" (1986) 24 *American Bus LJ* 467 at 471-474; and Sievers, "Farewell to the Sleeping Director - The Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence" (1993) 21 *Aust Bus L Rev* 111 at 123-123.

89 781 F 2d 264 (1986) [US Court of Appeals, Second Circuit].

90 At 274, per Pierce J.

91 At 275, per Pierce J.

92 At 274.

93 As above.

considered and granted lasted a mere three hours.⁹⁴ In view of this, it was held that the impugned transaction was not protected by the business judgment rule. The directors' "methodologies and procedures" [were] so restricted in scope, so shallow in execution, or otherwise so *pro forma* or half hearted as to constitute a pretext or sham."⁹⁵

Commentary

Several US jurisdictions now recognise that a reflexive application of the business judgment rule in all circumstances works contrary to the purpose of the rule which, basically, is to protect directors against personal liability for decisions honestly made.⁹⁶ Accordingly, while not abandoning it, the courts "have increased the directors' burden to justify their decisions before the rule comes into play."⁹⁷ The rule will not protect directors where their actions are shown to have been taken out of personal interest⁹⁸ (which includes a motive to retain control⁹⁹), in bad faith¹⁰⁰ or with lack of due diligence and care.¹⁰¹ This clearly indicates that US courts are increasingly becoming alert to the conflict of interest problem. Further, "the courts are also becoming more active in scrutinising the "process" by which the Board reached its decision."¹⁰²

The object of the courts' efforts is to ensure that directors do not automatically gain the protection of the rule where a disputed exercise of

94 At 271.

95 As above, citing *Auerbach v Bennett* 47 NY 2d 619 at 629 (1979). For a more detailed discussion of the principles enunciated in these cases, see Farinaro, "Target Directors' Fiduciary Duties: An Initial Reasonableness Burden" (1986) 61 *Notre DameLRev* 722 at 727-735.

96 On this see generally the discussion accompanying fnn24-30 and 41 above.

97 Pollock, "Exclusionary Tender Offers: A Reasonably Formulated Takeover Defense Or A Discriminatory Attempt To Retain Control?" (1986) 20 *GeorgiaLRev* 627 at 663. See also, Kirk, "The *Trans Union* Case: Is It Business Judgment Rule As Usual?" (1986) 24 *AmericanBusLJ* 467 at 467-470.

98 See for example, *Cramer v General Telephone and Electronics Corporation* 582 F 2d 259 (1978) and *Aronson v Lewis* 473 A 2d 805 (1984).

99 *Norlin Corp v Rooney, Pace Inc* 744 F 2d 255 at 265, per Kaufman J (1984).

100 As above.

101 As above. See also, *Unocal Corporation v Mesa Petroleum Company* 493 A 2d 946 (1985); *Smith v Van Gorkom* 488 A 2d 858 (1985) and *Hanson Trust PLC v ML SCM Acquisitions* 781 F 2d 264 (1986).

102 Veasey, "The New Incarnation of the Business Judgment Rule in Takeover Defenses" (1986) 11 *DelawareJCL* 503 at 508. See further, Zalecki, "The Duties of Corporate Directors in a Takeover Context: A Rationale For Judicial Focus Upon the Deliberative Process" (1986) 17 *ToledoLRev* 313 especially at 327-335.

power results in the frustration of a change in corporate control. A preliminary inquiry must first be made by the court to determine whether or not the rule applies. Through that process, it is hoped to minimise the potential for abuse of discretion by target management.

However, these initiatives have not proved wholly effective in curbing the ability of directors to impede unwelcome takeover bids.¹⁰³ Under the approach now taken by the courts a transaction, even though substantially motivated by a desire to retain control, can nevertheless be sustained if it is shown to be fair and reasonable.¹⁰⁴ Indeed, in *Unocal Corporation v Mesa*¹⁰⁵ the court explicitly stated that "a court will not substitute its judgment for that of the board if the latter's decision can be ascribed to any corporate purpose."¹⁰⁶ On this view, the directors will prevail whenever they can show that their actions served some rational business purpose.¹⁰⁷ More must therefore be done if the objective of preventing the frustration of hostile takeovers is to be realised. This much has, indeed, been recognised by several commentators¹⁰⁸ and policy makers.¹⁰⁹

PROPOSALS FOR REFORM

Truly, the business judgment rule "expresses a sensible policy of judicial non-interference with business decisions made in circumstances free from serious conflicts of interest between management, which makes the

103 Compare with Brennan, "New Cases on the Business Judgment Rule: Defending Defensive Tactics Becomes More Difficult" (1986) 14 *Securities Regulation* LRev 245, who suggests otherwise.

104 *Norlin Corp v Rooney, Pace Inc* 744 F 2d 255 at 266, per Kaufman J (1984).

105 493 A 2d 946 (1985).

106 At 954, per Moore J. See further, *Northwest Industries Inc v BF Goodrich Co* 301 F Supp 706 at 712, per Decker J (1969).

107 Ragazzo, "The Legitimacy Of Takeover Defense In The 90s" (1992) 41 *DePaul* LRev 689 at 693.

108 See, for example, Andre, "Tender Offers For Corporate Control: A Critical Analysis And Proposals For Reform" (1987) 12 *Delaware* JCL 865 at 887-890; Gutman, "Tender Offer Defensive Tactics And The Business Judgment Rule" (1983) 58 *NYUL* Rev 621 at 655; Gilson, "A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers" (1981) 33 *Stanford* LRev 819 at 824-831; Harrington, "If It Ain't Broke, Don't Fix It: The Legal Propriety Of Defenses Against Hostile Takeover Bids" (1983) 34 *Syracuse* LRev 977 at 998 and 1017-1022; and Easterbrook & Fischel, "Takeover Bids, Defensive Tactics, and Shareholders' Welfare" (1981) 36 *Bus L* 1733 at 1745-1747.

109 See for instance, US House of Representatives, Sub-Committee on Telecommunications, Consumer Protection and Finance of The Committee on Energy and Commerce, *Corporate Governance* (1987) p96.

decisions, and the corporations' shareholders."¹¹⁰ However, given the notorious potential for conflict of interest which contests for corporate control engender, the application of the rule in such circumstances is undesirable. In order to protect shareholders and the economic order of society more effectively, an approach different to that currently taken by the courts is called for.

One method adopted by the High Court of Australia for grappling with alleged breaches of directors' duties in other areas of corporate law is to reverse the burden of proof.¹¹¹ It would thus be tempting for the courts to follow the same approach with respect to takeover disputes. If Australian courts embraced this course, the burden would be cast upon directors implementing defensive structures to show that their actions are in the best interest of the company.¹¹²

However, a mere reversal of the burden of proof without changing the substantive law governing defensive exercises of directors' powers cannot bring about effective shareholder protection in disputes involving a change in corporate control. Under current law, the validity of transactions involving the transfer of corporate control is basically governed by the fiduciary duty to act in the interests of the company.¹¹³ As interpreted by

110 *Dynamics Corporation of America v CTS Corporation* 794 F 2d 250 at 256, per Posner J (1986).

111 See *Gambotto v WCP Ltd* (1995) 182 CLR 432 at 447, per Mason CJ, Brennan, Deane & Dawson JJ.

112 This course has been adopted in some American jurisdictions. See text accompanying fnn82-84 above.

113 *Mills v Mills* (1937-1938) 60 CLR 150 at 185-186, per Dixon J; *Ampol Petroleum Limited v RW Miller (Holdings) Limited* [1972] 2 NSWLR 850 at 856, per Street CJ; *Whitehouse v Carlton Hotel Proprietary Limited* (1987) 61 ALJR 216; *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659. As pointed out in fn1 above, the directors' common law fiduciary obligations have now been reinforced by s232(2) of the *Corporations Law* which imposes an obligation on an officer of a corporation to at all times "act honestly in the exercise of his or her powers and in the discharge of the duties of his or her office."

On the content of the duty to act honestly, see *Marchesi v Barnes and Keogh* [1970] VR 434; *Australian Growth Resources Corporation Proprietary Limited v van Reesema* (1988) 6 ACLC 529 [Full Court, South Australian Supreme Court]; *Corporate Affairs Commission v Papoulias* (1990) 2 ACSR 655 at 657, per Allen J [Supreme Court of New South Wales]; *Southern Resources Limited v Residues Treatment & Trading Company Limited* (1990) 3 ACSR 207 [Full Court, South Australian Supreme Court]; *Byrne v Baker* [1964] VR 443; Ford, Austin & Ramsay, *Principles of Corporations Law* pp322-323; Lipton &

the courts, any action taken by directors in response to an unsolicited takeover offer is valid if the directors believe it to be for the benefit of the company.¹¹⁴

Under this test, it would still be relatively easy for directors to resist unsolicited takeover bids even if the burden of proof was cast on them.¹¹⁵ With proper professional assistance, directors could easily devise schemes which satisfy the "benefit of the company" test. This test will be satisfied so long as the actions taken serve some rational corporate purpose, for example, to prevent perceived harm to the company's interests,¹¹⁶ to take advantage of a commercial opportunity¹¹⁷ or to promote a higher offer for the company,¹¹⁸ directors could claim that they believed them to be for the best interests of the company. A transaction would have to be plainly

Herzberg, *Understanding Company Law*, pp334-336; and Smith, "The Duties and Liabilities Imposed on Officers of Corporations As Set Out in Section 229 of The Companies (Queensland) Code of 1981" (1985-86) 8 *Queensland Lawyer* 137 at 141-147.

In addition to s232(2), the *Corporations Law* contains a number of provisions which expressly regulate certain types of defensive conduct: ss237 and 740 regulate payments for loss of office s615 deals with voting agreements; ss669-672 regulate charter amendments; while s995 deals with asset revaluations and profit forecasts. The obligations imposed by these provisions are not considered here as they are generally subsumed in the duty to act in the interests of the company.

- 114 See, *Darvall v North Sydney Brick & Tile Company Limited (No 2)* (1989) 7 ACLC 659 at 708, per Mahoney JA and at 714, per Clarke JA; *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294; *Rossfield Group Operations Proprietary Limited v Austral Group Limited* [1981] QdR 279.
- 115 On this see further Andre, "Tender Offers For Corporate Control: A Critical Analysis And Proposals For Reform" (1987) 12 *DelawareJCL* 865 at 891-895; Ragazzo, "The Legitimacy Of Takeover Defense In The 90s" (1992) 42 *DePaulLRev* 689 at 693.
- 116 *The Australian Metropolitan Life Assurance Company Limited v Ure* (1923) 33 CLR 199; *Teck Corporation Limited v Millar* (1973) 33 DLR (3d) 288; *Cayne v Global Natural Resources plc* (unreported, Chancery Division, 12 August 1982). However, see Barret, "Issue Of Shares To Preserve Existing Control: Whether Breach Of Directors' Fiduciary Duties" (1982) 56 *ALJ* 600.
- 117 *Pine Vale Investments Limited v McDonnell & East Limited* (1983) 1 ACLC 1294; *Winthrop Investments Limited v Winns Limited* (1978-80) 4 ACLR 1; *Rossfield Group Operations Proprietary Limited v Austral Group Limited* [1981] QR 279; *Harlowe's Nominees Proprietary Limited v Woodside (Lakes Entrance) Oil Company NL* (1968) 121 CLR 483.
- 118 *Darvall v North Sydney Brick & Tile Company Limited* (1989) 7 ACLC 659 at 702-703, per Mahoney JA.

unreasonable before the court could interfere.¹¹⁹ It is thus apparent that even if the burden of proving that the impugned transaction was in the interest of the company was cast on directors, the courts would be able to interfere with decisions taken by the directors to resist a hostile takeover bid only in extremely limited circumstances. Only an extremely incompetent and unadvised board would enter into a transaction so egregious that a court would feel justified to interfere. Indeed, this much is borne out by the American experience.¹²⁰

To bring about effective shareholder protection, it is desirable that the business judgment rule is not applied at all in contested takeover situations. Instead, the law should be reformed to prescribe a standard of conduct which bars directors from taking any action that has the foreseeable effect of blocking a takeover offer, without the consent of the offeree shareholders, once an offer has been made or is imminent.

This recommendation is consistent with the approach taken in some overseas jurisdictions. For example, the City Panel on Takeovers and Mergers which is responsible for the regulation of takeover transactions in the United Kingdom has adopted a rule aimed at preventing directors from using their managerial powers to thwart hostile takeover bids. That rule relevantly provides that:

at no time after a bona fide offer has been communicated to the Board of the offeree company or after the Board has reason to believe that a bona fide offer is imminent shall any action be taken by the Board of the offeree company without the approval in general meeting of the shareholders which could effectively result in any bona fide offer being frustrated or in the shareholders of the offeree company being denied an opportunity to decide on its merits.¹²¹

A similar rule is also applied as part of the common law of New Zealand. In *Baigent v DMcL Wallace Ltd*¹²² Prichard J, in the course of ruling on the validity of actions taken by the directors of the defendant company with a view to frustrating an unsolicited takeover bid, held that:

¹¹⁹ See further the discussion accompanying fnn46-48 above.

¹²⁰ See generally the discussion at p60, above.

¹²¹ *The City Code On Takeovers And Mergers*, General Principle 7.

¹²² (1984) 2 NZCLC para 96-011 (p 99, 122).

the directors of an offeree company have an obligation not to take measures which are designed to thwart a bona fide takeover offer without first giving the shareholders an opportunity to consider whether defensive measures should be taken. ... The directors' obligation not to take defensive measures during the pendency of a takeover offer extends to cases where, although no formal offer has been made, the directors know that one is impending.¹²³

A rule of this nature defines with a high degree of certainty and clarity what directors may or may not do on becoming aware that their company is, or is likely to be, the subject of a hostile takeover bid. More significantly, it restricts the ability of directors to take any action likely to block an unsolicited takeover offer. This is more likely to protect the takeover process than merely reversing the burden of proof. As such, it provides a helpful model from which Australian policy makers may benefit.

CONCLUSION

The business judgment rule serves a legitimate purpose in protecting directors from liability for their conduct in ordinary business transactions. However, because of the potential for conflict of interest, its application in transactions involving changes in corporate control is inappropriate. In order to bring about more effective shareholder protection in corporate control transactions, it is desirable to reform the law. That reform should see the introduction of a standard of conduct that effectively limits the ability of directors to engage in conduct that has the foreseeable effect of blocking an unsolicited takeover offer.

¹²³ (1984) 2 NZLC 99, 122 at 99,126. In the instant case, Prichard J upheld the transaction. His Honour held that as no formal takeover offer was made to all shareholders in accordance with the provisions of the *Companies Amendment Act 1963* (NZ), the offer was not a bona fide takeover offer. Therefore, the directors were entitled to resist the plaintiff's takeover attempt as it was not in the interest of all the shareholders.