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THE FIDUCIARY DUTIES OF COMPANY DIRECTORS

by

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(ZURA BTE YAHYA)

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PREFACE

As our business world is getting more developed and complex, Legislatures have developed legislations to regulate and control the companies which are being incorporated. This can be seen in several countries such as Malaysia, Singapore, Australia, Great Britain and Ghana. In the Companies Acts of these countries, there are provisions on the director's duties. This is because the role of a company director is critical in the effective and efficient operation of the company. However not all aspects of the director's duties are codified. This project paper attempts not only at pointing out the director's duties which have received statutory recognition but also other duties which arise from conflict of duties and interests. As will be seen from the discussion in this paper, a company director is a fiduciary. Therefore he cannot occupy a position where his duties and interests conflict. Any profits which are obtained from this conflict must be disgorged. However at present it is still arguable whether the rule against non-profiteering should be strictly adhered to or not.

This paper also attempts to analyse the various fiduciary duties of a director. The aim is to show the importance of the equitable principles for the purpose of regulating the conducts of the director in managing the affairs of the company. It is hoped that fiduciary duties of directors should not be disregarded just because of the availability of the statutory provisions. The enforcement of the equitable rules will ensure that the director will not obtain secret profits from the company.

Lastly, I will like to express my gratitude to my supervisor, Encik Shaukat Ali, for his kind and patient guidance in the preparation of this project paper.

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INTRODUCTION

In this project paper, an examination is made in regard to the long established equitable principle that a person in a fiduciary position must not occupy a position in which there will be a conflict of duties and interests. If the person does occupy such a position he will be in breach of his fiduciary duty. As a result action can be taken against him, and one would be entitled to be awarded with one of the several remedies available. However the scope of the above-mentioned principle is limited to the position occupied by the company directors. Thus the purpose of this project paper precisely is to see the consequence of the above equitable principle in regard to the company directors.

Since the above equitable principle is applicable to persons in fiduciary position, thus in Chapter I, discussion is centred around the issue whether the director is in a fiduciary relationship with the company. So an historical development of the word 'fiduciary' is being traced. From the examination of decided cases, it has become certain that directors, though they may be called trustees or agents of the companies, are indeed in fiduciary relations with their company. Since directors are fiduciaries, so in Chapter II, the question whether the equitable principle should be strictly adhered to or not is discussed.

The consequences which ensue concerning the fiduciary duties of directors when they place themselves in a position of a conflict of interest and duty are dealt with from Chapter III to Chapter VII. The fiduciary duties which are involved are those in regard to confidential information, corporate opportunities, competing interests, contracts with the company, and also the dealings with the company's properties. In all these five chapters, besides examining these duties as provided by equity, references are also made to statutory provisions concerning these duties.

Chapter VIII deals with the defence in which the directors can put forward when they act in breach of any of their fiduciary duties. This chapter also provides for remedies in which one is entitled to ask in court when the directors are in breach of their fiduciary duties.

In this project paper the rigidity of the equitable principle of conflict of duty and interest in regard to the company directors will be exposed. This can be seen in all the chapters dealing with the directors' fiduciary duties. In all these chapters too, the adverse effect which the company would face when this principle is strictly adhered to, are also pointed out. Thus with this project paper it is hoped that the court will reconsider its attitudes concerning the fiduciary duties of the directors. This equitable principle should not be strictly adhered to at the expense of the efficiency and the smooth functioning of the company in particular and the commercial world in general.

CHAPTER I

ORIGIN AND DEVELOPMENT OF THE TERM "FIDUCIARY"

A lot of discussion has ensued as to the position which are occupied by the company directors. From these discussions two schools of thought have evolved. One school of thought regards them as being the trustees for the company. The other school says that directors are agents for the company. But whether the directors are trustees or agents, they are in fiduciary relationship with their company. The existence of the fiduciary relationship between the directors and their company was established in Regal (Hastings) Ltd. v. Gulliver.[1]

Before going any further into the various fiduciary duties of the company director, a knowledge of the development of this fiduciary concept would be of a great help. The development of this concept is going to be traced according to the following headings:-

(A) Background and development of the concept.

(B) Its position in the Modern Law.

(C) Its extension to the post of the company director.

(A) Background and development of the concept

The term "fiduciary" is a recent terminology. In the eighteenth and nineteenth centuries the phrase "fiduciary relationship" was not used. Instead such a relationship was described as one in which the

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[1] [1967] 2 A.C. 134.

persons were in the position of trust or confidence. Thus in many matters of confidence, they were called "trusts" regardless of whether there were any strict trusts of property or not. This could be seen in Charitable Corporation v. Sutton.[2] In this case Lord Hardwiche said that the board of "committee-men of the corporations were most properly agents to those who employ them in this trust". Another case in which this matter can be observed is Duke of Beaufort v. Berty.[3] Here the chancellor was asked to interfere in the choice of schools which had been made by the infant's guardians. During the proceeding, it was reported that the chancellor had interrupted the counsel to say that the guardians were trustees. In his judgement he said that:-

> ".... as the court would interpose where the estate of a man was devised in trust, so would it a fortiori concern itself on the custody of a child being devised to a guardian, who was but a person entrusted in that case... That if any wrong had been done .... the court would interpose and order the contrary; and that this was grounded upon the general power and jurisdiction which it had over all trusts, and guardianship was most plainly a trust."

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[2](1742) 2Atk. 400.

[3](1721) IP. Wms 70.

From the two cases mentioned above, it can be said that during that period when relationship of confidence existed between the parties, they were in trust position. The acceptability of the position of trust was recognised in Gartside v. Insherwood.[4] In this case the principle laid down was that "if a confidence is reposed and that confidence is abused, a court of equity shall give relief." This clearly shows the words "confidence" and "trust" are the only terms used during that time to describe the present fiduciary relationship.

At times however, discretion based on broad principles gave way to concrete rules with a standard technical vocabulary. Descriptive words like "trust" and "confidence" which once dominated this field gave way to precise terms which were better suited to the formulation of fixed rules. The word "trust" comes to be recognised as a formal term with its modern technical meaning. This means situations which were formerly described vaguely as "trusts" were now left without a name. This had resulted in uncertainty. The uncertainty could be seen in several reported cases of the early nineteenth century. For instance in York Buildings Co. v. Mackenzie[5], the counsel was obviously put to pain to express himself when he pleaded for the application of the traditional principles. His pleading is as follows:-

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[4](1788) 1 Bro. C.C. 558.

[5](1795) 8 Bro. PC 42 at p. 64.

> "The office of a common agent has already been described in this case, and it is needless to enter into refinements or niceties as to the nature of trusts or the specific name of trusts. No magic in the term: He is a trustee (in technical style) who is vested with property in trusts for others, but every man has a trust to whom a business is committed by another or the charge and care of any concern is confided or delegated...."

Besides giving an explanation in the pleading like what the counsel in the above case had done, another method was also in existence at this time. This other method was by qualifying the use of the language of trust or trustee. This was done by invoking terms like "quasi-trust" or by saying that the relationship was "in some respects" or "for limited purposes" one of trusteeship.

Until 1821, no terms had yet evolved to describe the relationship which could not fall within the ambit of the term "trust". The search for a term to name the relationship could obviously be seen in <u>Cholmondeley v. Chinton</u>[6]. In this case Lord Eldon said that:-

> ".... there is a vast difference between things to which we give the same denomination, I mean trusts. You have a trust expressed, have a trust implied; you have relations formed between individuals in the

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[6](1821) 4 Eli.1, at p. 96.

matters in which they deal with each other in which you can hardly say that one of them is a trustee and the other a cestui que trust; and yet you cannot deny that to some intents and some purposes one is cestui que trust and the other a trustee."

Eventually as a consequence of Cholmondeley v. Chinton, it became fashionable to say that there is no trust, but the relationship is similar to that between trustee and cestui que trust. The word "fiduciary" (which earlier had received very little judicial support) is adopted to describe situation which falls short of the present strictly defined trust.

(B) Position in the Modern Law

Today the term "fiduciary" is still used in an indefinite and descriptive sense. No determining elements have been formulated to distinguish the term "fiduciary". In fact one lawlord preferred to have the word used "loosely and comprehensively".[7]

An attempt has been made to deal with the term "fiduciary". This can be seen in Exp. Dale and Company.[8] According to Fry J. in this case, a fiduciary relationship is "one in respect of which

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[7] Reading v. Att.-Gen. [1949] 2 K.B. 232 Per Asquith L.J. at p. 236.

[8] (1879) 11 Ch. D. 772 at p. 729.

if a wrong arises; the same remedy exists against the wrongdoer on behalf of the principal as would exist against a trustee on behalf of the cestui que trust." This point, made by Fry J., could not be regarded as the definition for the words "fiduciary relationship". Fry J. was only emphasising a common feature of the relationship. This feature is the common remedy which could be sought against the fiduciary and the trustee. This could not be of any help for the purpose of recognising a fiduciary relationship. At present it can only be said that fiduciary relationship is one which embraces trust-like position. But it needs not necessarily be a trust proper. This is because fiduciary relationship can either be a contractual or a gratuitous one.

Fiduciary relationship is governed by rules and principles laid down in the law of trusts. But not all the rules and principles of trusts would be applicable to everybody standing in a fiduciary relationship. To assume that all rules and principles of trusts should be applicable to those in fiduciary relationships can lead to absurdity. This is because the word 'fiduciary' is not definite of a single class of relationships. Fiduciary relationship for instance can exist in the trust-like positions of a doctor and his patient, a priest and the follower. Since there are various types of trust-like positions, it is impossible to have a fixed set of rules and principles. Each equitable remedy is available only in a limited number of fiduciary situations. The mere statement that one is in a fiduciary position does not warrant the inference that any particular fiduciary principle or remedy can be applied. It only means that the parties are in trustee-like positions. Since not all trust principles and rules are applicable to the fiduciary, every interference in the fiduciary relationship must be one which should be justifiable by the nature of the relationship.

Similar situation and view as mentioned above prevail in the USA. This can be seen in SEC v. Chenery Corporation.[9] In this case Justice Frankfurter stated that:-

> "To say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry - to whom is he a fiduciary; what obligation does he owes as a fiduciary; in what respect has he failed to discharge these obligations; and what are the consequences of his deviation from the duties."

This goes to a great extent to show that when one is said to be a fiduciary, it does not automatically mean all the trust principles and rules apply. It is necessary to inquire about the nature of the relationship and takes into consideration those points made by Justice Frankfurter.

Thus it is obvious that there is no general definition of a fiduciary relationship. In fact there are cases which simply decided that the relationship is fiduciary without stating why there existed such a relationship.

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[9] 401 F. 2d. 833 at p. 85-86.

Concerning the extent of the rules and principles of law of trust applicable to persons occupying a fiduciary relationship, it is submitted that they depend on the intensity of the relationship. Where the independent authority to be exercised by the fiduciary is great, then the scope of his fiduciary duty is greater. Hence strict rules should be imposed. Thus a trustee is under a stricter duty of loyalty than an agent who is conferred with limited authority. Both the trustee and agent are fiduciaries and are subjected to the fiduciary principle of loyalty. However they are not subject to the same extent of the principle. This shows why different sets of rules have to be applied to different classes of fiduciary relationships.

(C) Extension of the fiduciary concept to company directors.

It has long been established that directors are in fiduciary relationship with their companies. The relationship arises because the person has undertaken or is under an obligation to act on one's behalf or for another's benefit. In fact the fiduciary relationship exists "whenever the plaintiff entrusts to the defendant a job to be performed."[10] This phrase is very extensive and it easily covers the post of a director.

Even though the position of a director has clearly been established to be fiduciary, there is divisibility of opinion as to which class of fiduciary the post of director belongs. At present directors are often classified as being either the trustees or the agents of the companies.

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[10] Reading v. R [1949] 2 KB. 232.

The view that a director is a trustee finds support in the decision in Charitable Corporation v. Sutton.[11] In this case Lord Hardwiche held that the committee-men or directors who had misapplied the corporation's funds were liable as trustees for the breach of trust. Also in the case of York and North Midland Ry. v. Hudson,[12] Romilly M.R. had held that directors occupied the office of trust. The view that directors were trustees still persisted in the early twentieth century. This can be seen in the case of Alexander v. Automatic Telephone Company.[13]

During this early period, the directors were held to be trustees because during this period, companies were unincorporated and the validity of their existence depended on the deeds of settlement. The deeds vested the properties of the companies to the directors. Owing to these vestings, the directors became trustees. The reason why directors were regarded as trustees might also be explainable by the fact that in those days the legal vocabulary was limited. Since there were no other words to use, the courts described directors as trustees. The courts felt that it was sufficient for them to reason that since the directors had accepted the appointment of trust, they were trustees and therefore accountable for breach

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[11] (1742) 2 Atk. 400.

[12] (1853) 16 Beav. 485.

[13] [1900] 2 Ch. 56.

of trust. However, at present, with the availability of the term "fiduciary" it is submitted that this term should be used instead. This should be so because the position of director does not fall under the modern legal term of trust.

Judges however have made comments on the view that directors are trustees. For instance in Smith v. Anderson[14], it has been laid down that:-

> "The distinction between a director and a trustee is an essential distinction founded on the very nature of things. A trustee is a man who is the owner of the properties and deals with them as principal, as owner and as a master, subject only to an equal obligation to account to some persons to whom he stands in the relation of trustee and who are his cestui que trust. The office of director is that of a paid servant of the company. A director never enters into a contract for himself, but he enters into contract for his principal, that for the company of which he is a director and for whom he is acting. He cannot sue on such contracts, nor be sued on them unless he exceeds his authority."

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[14](1880) 15 Ch.D. 247.

From this extract it is submitted that the judge felt that it was more appropriate to regard a director as agent for the company.

In Ferguson v. Wilson[15], Cairn L.J. directly expressed the view that directors were agents. In answering the question of what was the position of directors to a public company, he said they were agents for the company. According to him "the company itself cannot act in its own person, for it has no person, it can only act through directors, and the case is, as regards those directors, merely the ordinary case of principal and agent."

A case has also been decided which rejected the application of the duties of trustees to the company directors. Such a case is often known as the Marzetti's case.[16] In this case the court had refused to hold the directors liable upon the same rules applicable to trustees.

Romer J. in Re City Equitable Fire Insurance Company[17] also refused to accept the view that directors are trustees. His view is as follows:-

> "It has sometimes been said that directors are trustees. If this means no more than that directors in the performance of their duties they stand in a fiduciary relationship to the company, the statement is true enough. But if the statement is meant to be an

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[15](1866) L.R. 2 Ch. 77.

[16][1880] W.N. 50.

[17][1925] Ch. 407.

> indication by way of analogy of what those duties are, it appears to me to be wholly misleading. I can see but little resemblance between the duties of a director and the duties of a trustee of a will or of a marriage settlement."[18]

Romer M.R's view is indeed a correct one to be taken. This is because there is a clear difference between the functions and duties of the directors from those of the trustees. The directors besides protecting the interests of their companies, are also responsible for the advancement of the companies' enterprises. But the trustees' duties are solely to see to the protection of the beneficiaries' interests. Since the duties of the directors and trustees are different, the strict rules applicable to trustees should not be imposed on the directors. Furthermore by imposing the strict duties of the trustees on the directors, it might fetter the actions of the directors. When actions of directors are fettered, the companies would be in a disadvantaged position.

However at present it is best to regard the directors as fiduciaries and equitable principles are applicable to them. It is not necessary to classify the directors as agents, trustees or managing partners because those expressions cannot be used exhaustively for the powers and responsibilities held by the directors.

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[18] Ibid., at p. 426.

Analogies should not be made between the posts of directors to that of trustees or agents. Since analogies are not possible, it is best to say that directors are fiduciaries and are subjected to the equitable principles.

The view that it is unnecessary to classify directors into trustees or agents has also been perceived by Sir George Jessel M.R. in <u>In Re Forest of Dean Coal Mining Co.</u>[19] According to him "it does not matter what you call them (that is, the directors), so long as you understand what their true position is, which is that they are really commercial men managing a trading concern for the benefit of themselves and all other shareholders in it." This approach is indeed a plausible one since it allows us to choose the best features of the relationships of both the trustees and the agents and to apply the same in order to promote the interests of the companies.

[19](1878) 10 Ch.D. 450 at p. 451, 452.

CHAPTER II

CONFLICT OF DUTY AND INTEREST

Since directors are in fiduciary relations with their companies, fiduciary duties are imposed on them. Their fiduciary duties centre on the equitable principle that there should not be a conflict of interest and duty. Such principle has been laid down by Lord Cranworth in Aberdeen Railway Co. v. Blaikie Brothers.[1] In this case his lordship said that when the duties to be discharged were of a fiduciary nature, then it was "a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagement in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect." A more direct authority to show the existence of this principle can also be seen in Imperial Credit Association (Liquidator) v. Coleman[2]. In this case it was implicitly provided that:-

> "... it is the duty of the directors of companies to use their best exertions for the benefit of those whose interests are committed to their charge, and that they are bound to disregard their own private interests whenever a regard to them conflict with the proper discharge of such duty."

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[1](1854) 1 Macq. 461.

[2](1873) L.R. 6H.L. 189.

As the result of this principle it can be concluded that directors owe a duty of loyalty towards their companies. This should be so because good faith and confidence have been reposed on them. Hence there should not be any disloyalty or conflict with the interests of the company.

The fiduciary duties which have evolved from the above equitable principle are in regard to:-

(a) confidential information

(b) corporate opportunity

(c) company's contracts

(d) competing interests

(e) self-dealings with properties and assets of the company.

(All these matters will be discussed in detail in the following chapters).

The reason why the directors would breach any one of the above five fiduciary duties is because of the profits which they could obtain. When profits are obtained from their breach of duty, the directors always regard the profits as theirs. This should not be so because the information, opportunity or other matters which are being used by the directors are not theirs. They belong to the company. Thus any profits made should go to the company and not to the directors' personal accounts. This has often been the basis of decisions reached by the courts when they ordered the directors to disgorge the profits obtained. The principle underlying these decisions has now become so deeply entrenched in our equitable rule. The court will not hesitate to order the directors to disgorge whatever profits made if they are obtained from the conflict of interest and duty. Mere conflict of interest and duty would be sufficient to fix liability. Such an attitude should be reconsidered because several consequences would follow if liability is fixed just because of the presence of a conflict of interest and duty. Therefore this chapter will deal with the issue of the application of the principle of conflict of interest and duty.

The English courts have taken a very strict attitude in regard to this principle. In England it is recognised and accepted that this principle is an inflexible one. This rule has been inexorably applied by the courts. No evidence or argument is allowed to be made to show that the transactions are entered into fairly, bona fide, without fraud, or has not resulted in any injury. The mere fact that profits have been obtained would make the directors liable. This can be seen in Regal (Hastings) Ltd. v. Gulliver.[3] In this case Lord Russel held that "liability arises from the mere fact that profits have been made". According to him "the profiteer however honest and well-intentioned cannot escape the risk of being called upon to account."[4]

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[3] [1967] 2 A.C. 134.

[4] at p. 145.

However in Canada, the view on profit-making is more relaxed. This can be seen in Peso Silver Mines Ltd. v. Cropper.[5] The decision in this case has deviated from the rigidity of the rule in Regal (Hastings) Ltd. case. However it can be argued that such decision has been reached in Peso's case because the profits obtained by them were from the offer which had been rejected by the company, whereas in Regal (Hastings) case there was no such rejection. But this argument can be put aside because the inability of the company to subscribe for the shares of the two other cinemas could be rightly said to be a rejection of the offer too. Thus in Regal (Hastings) Ltd. case the rejection was indirect since the company did not expressly say so as in Peso's case. Since both were rejection of the offers made to the companies, the decisions in both courts should be similar. But as can be seen they were not so. Even though it is stated in Peso's case that the court followed the dicta of Lord Greene in Regal (Hastings) Ltd. case, the court did not adhere rigidly to the non-profiteering rule. The court there gives allowance when the transaction is entered into bona fide.

A very good reason why this rule should be strictly adhered to was given by Norris J.A. in his dissenting judgement in Peso's case. According to him because of the complexities of the activities of the director, it is necessary that the fiduciary principles should be strictly enforced. If this is not done, then the

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[5](1966) 58 D.L.R. (2d) 1.

complexities might be used as a "smoke-screen or shield behind which fraud might be perpetrated". This view also received support from Hahlo, an academic writer. He felt that the relaxation of the principle would not only open the door to fraud, but would also weaken the confidence which ordinary people should have in their dealings with the companies.[6] According to him in order to ensure the people of protection against the improper acts by the directors, it is necessary that their activities be circumscribed within the rigid limits. Furthermore he is also of the opinion that no great hardship is imposed on directors by the enforcements of the rules.

However the opinion of Hahlo concerning the hardship cannot be accepted. This is because the rigidity of adhering to the rule could cause hardship when the director is not conscious of his wrong-doing. It is also unfair to make the director liable when he enters into the transaction honestly or when no harm is done to the company. In all these situations the rigidity of the rule should be departed from. This departure has been recognised and accepted in Bray v. Ford[7]. In this case the judge held that the strictness of the rule "might be departed from in many cases without any breach of morality, without any wrong being inflicted and without any consciousness of the wrong-doing." But these words have been ignored by the majority

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[6] Hahlo, A case book on Company Law at p. 399.

[7] [1896] A.C. 44.

of the judges in Regal (Hastings) Ltd. and other subsequent cases. Judges continue to adhere strictly to the rule that when profit is obtained because of conflict of interest and duty, it must be accounted for. This is indeed causing a hardship to the directors.

One way in which it would be helpful to determine whether the profit made should be accounted or not is by looking at the acts done by the directors. This is to see whether the act is done bona fide in the interest of the company or not. If it is not done bona fide, then the profit made is an unjust enrichment. If it is an unjust enrichment, the director should not be allowed to retain it. Instead he should be made to disgorge the profit.

However the argument that the profit earned should be decided on whether or not it is made bona fide would fall short on the basis of human nature and the complexities of the human personality. The complexities of the human personality make it very difficult to accept the assertion that the person is acting in good faith. This would specially be so when the person has to decide questions of profit on behalf of others. In this situation it is very difficult to believe that the person is free from being motivated by self-interest. Such an inquiry into good faith could not be satisfactorily performed even by the court of law. The impossibility of inquiring about good faith was recognised by Lord Eldon in Ex parte James.[8]

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[8](1802) 8 Ves. 337 at p. 345.

He said that "... no court is equal to the examination and ascertainment of the truth ...." According to him this is the reason why the rule concerning profit should be strictly enforced.

For James L.J. this rule should be rigidly adhered to for the sake of the safety of mankind. This view has been expressed by him in Parker v. McKenna[9]. His attitude in this case is as follows:-

> "... that the rule is an inflexible rule and must be applied inexorably by this court which is not entitled, in my judgement, to receive evidence or suggestion, or argument as to whether the principal did or did not suffer any injury in fact by reason of the dealing of the agent; for the safety of mankind requires that no agent shall be able to put his principal to the danger of such an inquiry as that."

However it is felt that the above-mentioned difficulty and danger would be groundless when the director is able to show that his "integrity is not in doubt."[10] This can be done by proving that the benefit has resulted from his own act and that the profit is not obtained at the expense of the company. He needs not prove his act beyond doubt. To compel him to prove his honesty beyond

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[9](1874) 10 Ch. App. 96.

[10]SEC v. Texas Gulf Sulphur Co. 401F 2d. 833.

doubt would be treating the innocent with the same severity as the guilty. Once the integrity of the director is not in doubt, then the profit obtained is not an unjust enrichment. Therefore he has the right to keep it.

Another approach which can be taken to determine the liability arising from conflict of duty and interest is by adopting the suggestions of Gareth and Jones. Their approach is a flexible one. It would give a fair treatment to those who have worked hard to obtain the profit. They agreed that there might be situation when it is absolutely necessary to punish the fiduciary who has unjustly enriched himself. Also it is a wise public policy to remove the fiduciary from all temptations and all possibilities of profits. But according to them, the decision to deprive the fiduciary of the profit should only be taken "after due and careful regard has been paid to the relevant policy considerations, to the nature of the responsibilities which the particular fiduciary owes his principal and to the question whether it is necessary to make an example of the innocent and conscientious that others may learn from their fate."[11] By accepting this approach, the directors would not be easily made liable when profits are obtained. This is because besides proving that directors have made some profits, other matters

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[11] Jones and Gareth: "Unjust Enrichment and Fiduciary's Loyalty" 84 LQR 1968 p. 502.

like policy considerations and the nature of enrichment (i.e. whether it is a just or unjust enrichment) must be taken into consideration in determining the directors' liabilities. This approach is a great departure from the prevailing English attitude which fixed liability from the mere fact that profit has been made. By adopting Jones and Gareth's approach, the directors would have less fear to enter into new business ventures. These new ventures might not only bring profit for themselves but also for their companies.

Furthermore if stringent obligations are imposed on directors, they may inhibit the directors from holding more than one directorship. This would cut down the flow of entrepreneurial talent. This would have a repercussion on the business enterprises because talents and knowledge would be wasted.

By imposing such a strict rule it would also be adding hazard and risk to the directors. This would manifest into a hardship. This would act as a deterring factor for the people to accept such posts. This would be against public interest for when there are not many directors, the efficiency and administration of the company be affected. This could lead to an adverse effect on the public interest.

To continue to fix liability on the basis that profit has been obtained from conflict of interest and duty is a very strict equity. Though the strict enforcement of this rule would see that the company interests are being protected, it does drive away people from accepting the posts of directorship. This would affect the companies since the smooth functioning of a company depends a lot on the work done by the directors. Therefore to attract them to stay on in their posts and to encourage them to work hard for the benefit of the companies, the directors should only be made liable for the unjust enrichment which is obtained at the expense of their companies.

CHAPTER III

CONFIDENTIAL INFORMATION

During the course of directorship, directors receive various types of information. But the type of information which is relevant to the director's fiduciary duty is that information which is confidential. This fiduciary duty is different from that provided in Section 132 of the Malaysian Companies Acts, 1965 or Section 124 of the Australian Uniform Companies Acts 1961. According to these countries' statutory provisions, a director would be liable for making use of any information which is acquired from his position. Under these statutory provisions, the word "information" is given an extensive meaning. It covers any type of information which could be confidential as well as non-confidential. Such provisions would not be appropriate when we are dealing with the director's fiduciary duty. This is because the word "fiduciary" connotes the element of confidence which is being reposed on the other. Hence it should follow that for such fiduciary duty, its breach should only be the breach of confidential information and not for all kinds of information.

However there is the possibility that the director could be made liable for making use of non-confidential information which he acquired. This is because of the decision in IDC v. Cooley[1]. In this case it was held that any information which came to the director while he was the director must be passed over to the company since the information belonged to the company. However

[1] [1972] 2 All ER 163.

there was no mention as to whether the information concerned was confidential or not. Since this decision is silent on this matter, it can be assumed that the information would include both confidential and non-confidential information. This would be so because the court of Equity has always interpreted matters concerning Equity strictly so as to prevent any enrichment on the part of the fiduciary. Hence there is the possibility that if any case is to come before the court, it would give an extensive meaning to the word 'information'.

The decision in IDC v. Cooley should not be used as an authority to explain what amounts to 'information'. This case should be appropriately considered as one involving the exploitation of the corporate opportunities. But the English court has to decide on the same line as utilization of the company's information because the doctrine of corporate opportunity, which is essentially American, is absent in United Kingdom. Hence with the absence of this doctrine, the court in Cooley's case has to decide on the basis of utilization of the company's information. Thus it is strongly felt that Cooley's case should be classified as one falling under the duty not to exploit opportunities which belong to the company. Further discussion on this corporate opportunity doctrine can be seen in Chapter IV.

(A) When is information confidential?

Just like the term 'fiduciary', the judges have concluded that an idea, communication or a technique is or is not confidential without defining or describing it. This can be seen distinctly in the case of Phipps v. Boardman[2]. The main issue in this case

[2] [1967] 2 A.C. 46.

concerned the information which had been used by the trustees for their own personal gain. None of the judges considered whether the information was confidential or not. Since the trustees had made use of the information, there was a conflict of duty and interest and thus they must account for the profit made.

Nevertheless from the observations in the decided cases, it is possible to say that confidential information usually has the following characteristics:-

(i) some degree of secrecy

(ii) need not be novel

(iii) cannot embrace the individual's ordinary skill.

(i) Some degree of secrecy

Confidential information is information which is not known to the public. It is information which has been obtained in confidence. The information becomes public knowledge when the "secret as a secret has ceased to exist". However information is not a public knowledge if the person takes into his confidence a restricted group of people like his employees or pupils. By this act, it cannot be said that he has made his information public. In the situation where the employer has confided to the employees, it is necessary that the secret should be readily separable from the general knowledge and acquired skills the employees are entitled to utilize.

In one case it was held that the information was confidential even though the separate features or ingredients of the process "have been published or capable of being ascertained by actual inspection by any member of the public."[3] This would be so when the whole result is not known and this result has been communicated to the other party in confidence. It can be concluded that the nature of the confidential information is such that no one, save the person who imparted it, may realise that it has been communicated in breach of confidence.

(ii) Novelty

Information which the law regards as confidential need not possess that degree of novelty which is essential to the success of a patent application. The limit which the law could impose is simply that the information must not be a public knowledge. The element of novelty is only relevant as a factor which may persuade the court to hold that the particular information is not known to the public.

(iii) Cannot embrace the ordinary skill

Ordinary skill or know-how which is acquired during the course of employment cannot be regarded as confidential information. It is contrary to public policy to restrain an employee or ex-employee from "making use of all his ordinary skills, experience and ability, and carrying them forward somewhere else." This is the "know-how

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[3] Under-water Welders and Repairers Ltd. v. Street and Longthorne [1968] R.P.C 498.

of an employee" and it is "the expression of his individual skill and experience".[4]

Hence the distinction between "know-how" and confidential information, though often thin, is a real one. This distinction is of importance because breach of fiduciary duty is committed only in regard to confidential information. Confidential information and "know-how" has been distinguished by Lord Atkinson in Herbert Morris Ltd. v. Saxelby.[5] According to him the use of confidential information

> "…. does not mean that an employer can prevent his employee from using the skill and knowledge in his trade or profession which he has learnt in the course of his employment by means of directions or instructions from the employer. That information and that additional skill he is entitled to use for the benefit of the public who gains the advantage of his having such admirable instruction. The case in which the court interferes for the purpose of protection is where use is made not of the skill which the man may have acquired but of the secrets of the trade or profession which he had no right to reveal to anyone else - matters which depend to some extent on good faith."

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[4] Stevenson, Jordan and Harrison Ltd. v. Macdonald and Evans [1952] 1 T.L.R. 101.

[5] [1916] 1 A.C. 688 at p. 704.

Thus it can be said that "know-how" are means evolved by a person or group of persons, to accomplish or help in accomplishing manufacture or providing services. Hence it is more of an acquired skill, knowledge and accumulated experience of a person which are obtained in the course of employment, and are inseparable from him.

The distinction between "know-how" and confidential information can be illustrated in a case of an employee who has terminated his service with a company. This employee may after the end of his employment canvass for "the custom of his late master's customers, whose names and addresses he has learnt bona fide and accidentally during the period of his service."[6] This information has become part of his individual skill and experience. The employee must not, however, deprive the master of his property by taking away or copying any books containing the names of his master's customers. Nor can he make use of information which he has dishonestly acquired. If the employee has dishonestly acquired information it should be irrelevant that he has simply memorised it, and not committed it to paper, for information so acquired cannot be part of his individual skill and experience. Thus he may be enjoined from disclosing this information. If he does disclose, he would be liable to account for profits made through the use of the information.

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[6] Robb v. Green [1895] 2 Q.B.1.

Although this principle has been laid in cases concerning employees generally, it could be extended to directors. This is because both ordinary employees and directors are people who work for the advancement and benefit of the company.

In the USA, this principle of confidential information has been applied even where the information has been acquired more or less accidentally, and not in connection with the performance of the employee's duty. Such a principle can be found in the case of Massachussett Essex Trust Company v. Enwright.[7] In this case a newspaper reporter learned that his employer had a leasehold interest in the premises which was going to expire. He went to the owner of the property and managed to have the lease conveyed to him. It was held that his employer could charge him as constructive trustee of the lease and compel him to surrender it at the price which he had paid.

Very often contracts or agreements have to be entered by the employees with their employer whereby they are restrained from making use of the trade secrets which they might acquire. But even with the absence of these contracts or agreements, the employees would be liable for making use of confidential information. The imposition of this liability has been established by the Court of

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[7] (1913) 214 Mass. 507.

Appeal in Saltman Engineering Company Ltd. v. Campbell Engineering Co. Ltd.[8] In this case Lord Greene said that "... if two parties make a contract, under which one of them obtains for the purpose of the contract or in connection with it some confidential matter, then even though the contract is silent on the matter of confidence, the law will imply an obligation to treat that confidential matter in a confidential way, as one of the implied terms of the contract, but the obligation to respect confidence is not limited to cases where the parties are in contractual relationship." Lord Greene went on to say at p. 213 that ".... the law .... correctly stated in a formula .... if a defendant is proved to have used confidential information directly or indirectly obtained from a plaintiff, without the consent, express or implied, of the plaintiff, he will be guilty of an infringement of the plaintiff's right." In this case the court considered that there was a confidential obligation owing by the defendant to the plaintiff which had arisen from the receipt by the defendant of certain confidential drawings. This case appears to suggest that a fiduciary duty may arise from the mere receipt of information which is known to be confidential. Thus any use of this information is a breach of the fiduciary duty.

(B) The basis of liability for the breach

When a fiduciary communicates confidential information, he would be liable for a breach of duty since his act is a disloyal

[8] (1948) 65 RPC 203 at p. 211.

act. In fixing liability, the court regards the use of the information as the use of any of the properties of the company. This has been done by the courts in cases like Aas v. Benham[9] and Phipps v. Boardman.[10] In both these cases the information was held to be property since it was of value to the partnership (in the case of Aas v. Benham) and the trust (in the case of Phipps v. Boardman). Since the information were properties, the partners and the trustees respectively, were entitled to bring actions for misuse of the information.

However the approach of first determining whether the information is valuable and thus could be categorised as property, is not a satisfactory one. This is because it is sometimes impossible to determine the value of the information. A better approach which can be taken to determine liability is by considering whether the use of the information amounts to a breach or abuse of confidence. This approach is more appropriate since confidential information is information which has been communicated on reliance of good faith and confidence. Hence it should follow that liability should be based on whether there has been a breach of confidence or not.

The approach of fixing liability by determining on the basis of the breach of confidence has been adopted in the U.S.A. This

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[9] [1891] 2 Ch. 244.

[10] [1967] 2 A.C. 46.

can be seen in E. I. du Pont de' Nemours Powders Company v. Masland.[11] In this case Justice Holmes had remarked that:-

> "The word 'property' as applied to trademarks and trade secrets is an unanalysed expression of certain secondary consequences of the primary fact that the law makes some rudimentary requirement of good faith. Whether the plaintiffs have any valuable secrets or not the defendant knows the facts, whether they are, through a special confidence that he accepted. The property may be denied but the confidence cannot be. Therefore the starting point for the present matter is not property or due process of law, but that the defendant stood in confidential relations with the plaintiffs or one of them. These have given place to hostility and the first thing to be made sure of is that the defendant shall not fraudulently abuse the trust reposed in him. It is the usual incident of confidential relations. If there is any disadvantage in the fact that he knew the plaintiff's secrets, he must take the burden with the good."

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[11] [1917] 244 U.S. 100 at p. 102.

This same line of approach has been advocated by Lord Upjohn in his dissenting judgement in Phipps v. Boardman.[12] According to him "The true test is to determine in what circumstances the information has been acquired. If it has been acquired in such circumstance that it would be a breach of confidence to disclose it to another, then the courts of equity will restrain the recipient from communicating it to another." Lord Upjohn rejected the opinion that confidential information is the property of the donor. According to him ".... the real truth is that it is not property in any normal sense but equity will restrain its transmission to another if in breach of some confidential relationship."[13]

Since confidential information is information which is not of public knowledge, but is that which is known to the recipient confidentially, the best way to fix liability would be on the ground of the breach of confidence. Also by adopting this approach, it would act as a deterrent to the fiduciary from utilizing the information for personal benefit or for other third parties' benefit. This approach is not as restrictive as the "property approach". The "property approach" is only concerned with confidential information which is of accountable value. But confidential information is much more than that. Confidential information is not only information which is stated to be confidential, but also information

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[12] [1967] 2 A.C. 46 at p. 127-128.

[13] Ibid., at p. 128.

which should not be revealed to others or used in competition. Confidential information also includes unique business methods, trade secrets, lists of names and all other matters which are peculiarly known in that business only. These are the information which are known confidentially because of the position held. Hence any use of this information for one's own benefit or any communication to the third parties would amount to a breach of confidence. So if the company director uses this information, he would be in a position of a conflict of duty and interest. His interest would be the making use of the confidential information for his own personal benefit. But his duty towards the company is to use the information for the protection and also the advancement of the company. Thus if the director uses the information a conflict of interest and duty arises. When this occurs, an action can be taken against the director.

(C) Inside Information

Another aspect of information which has to be noted is that which concerns inside information. Inside information is information which is not known to the public at large, for example trade secrets or the customers' lists. As such it can be classified as confidential information. Since the information is confidential, the directors should not be permitted to use this information for his own benefit.

But surprisingly in the decision of Percival v. Wright,[14] the

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[14] [1902] 2 Ch. 421.

court has held that directors are not prohibited from using inside information to gain advantages in their share-dealings with the company's shareholders or in the open-market. Such a decision which allows the director to make use of inside information is contrary to commercial morality. This is because there is no fair dealing, since the directors are in a more advantageous position than the shareholders. The directors having wider access to the information can make use of it for their own gain. A further reason why directors should not be allowed to utilize inside information is because such an act would be inconsistent with the general fiduciary duty. Under the general fiduciary duty, the fiduciary is not allowed to make use of the properties of the beneficiary for his own benefit. Hence if the directors are permitted to use the inside information, this would be contrary to the general fiduciary duty.

Another result which would follow when the directors are allowed to deal with share-trading by making use of the inside information would be that which concerns the public confidence in the company. This is because insider trading on undisclosed information may constitute a grievous insult to the preservation of the capital market. This capital market depends on liquidity, which in turn rests on the investor's confidence that current quotation accurately reflects the objective value of his investment. When the public loses confidence in the trustworthiness or reliability of the management, damages would be incurred by the company since it is now forced to seek alternate financing at higher cost. This would be contrary to the function of directors to promote the company's interests to an advantageous and profitable level.

(D) Statutory Provisions

Provisions concerning the fiduciary duty in relation to information have been incorporated in several Company Acts. In Malaysia the provision can be found in S. 132(2) of the Company Act 1965. This provision is as follows:-

> "An officer or agent of a company shall not make use of any information acquired by virtue of his position as an officer or agent of the Company to gain directly or indirectly an improper advantage for himself or for any other person or to cause detriment to the company."

This provision is applicable to directors because the word 'officer' in the provision includes a director too. This is by virtue of the definition given in Section 4 of the Act.

The provision in Section 132(2) is a very extensive one. This is because it deals with any type of information which is acquired by virtue of the position as a director. The information would include both confidential and non-confidential information. This shows that this statutory provision embraces a greater area of information than what is required under the fiduciary duty. Therefore this statutory provision should not be taken into consideration to determine whether the director has breached his fiduciary duty or not.

A further support to show that the word 'information' has an extensive meaning is provided in this section itself, that is in sub-section 5. This sub-section provides that "this section is in addition to and not in derogation of any ... rule of law relating to the duty or liability of directors". This sub-section can be interpreted to permit a greater scope of duty besides the fiduciary duty which has developed from rule of law. So sub-section 5 includes other types of information besides the information which the fiduciary (i.e. the director) receives confidentially.

With the availability of such statutory provisions, it becomes easier to bring an action against the director for the use of information which he acquires from his position. This is because there is no longer any necessity to show that the information used is of confidential nature. Thus the action for breach of fiduciary duty concerning confidential information which necessitates the proving of its confidential nature would be ignored. Owing to the difficulty involved in having to prove the nature of the information, there is the possibility that a cause of action under this equitable rule would slowly disappear.

However a serious consequence would ensue from the non-usage of this equitable rule. This consequence would have an adverse effect on the directors. This is so because by making a director liable for the use of every type of information a very stringent duty would be imposed on him. The result of imposing such a strict duty has already been discussed in Chapter II. Though Chapter II is concerned with the strict imposition of the fiduciary duty, the same consequences would also follow when a strict statutory duty is being imposed upon the director. Therefore to enable the company to progress and achieve a higher rate of efficiency and profit, such statutory duty should not be imposed. It is better that the director's liability be confined to confidential information only. In this way the director will have greater freedom to utilize his knowledge for other companies which may need it. This would result in the availability of more talent and entrepreneurial abilities for use in the business enterprise.

CHAPTER IV

CORPORATE OPPORTUNITY

The director's fiduciary duty in relation to corporate opportunity is one under which he is not allowed to appropriate for his own benefit an economic opportunity which is considered to belong rightly to his company. This duty exists because of the nature of the fiduciary relationship itself. This relationship is one in which its "generality betokens loyalty, good faith and avoidance of conflict of duty and self-interest".[1] It therefore precludes "a director .... from usurping for himself .... a maturing business opportunity which his company is actively pursuing."[2]

The doctrine of corporate opportunity is one which is developed by the American courts. However there are several English cases which could quite easily be analysed in the light of corporate opportunity doctrine. Regal (Hastings) Ltd. v. Gulliver[3] and Cook v. Deeks[4] are but two instances. This doctrine is ignored by the English courts presumably be because it would be "supererogatory to develop a doctrine of corporation opportunity to embrace the situations in these cases as they fall squarely within the ambit of

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[1]Canadian Aero Service Ltd. v. O'Malley (1973) 40 DLR at p. 382.

[2]Ibid., at p. 382.

[3][1967] 2 A.C. 134.

[4][1916] 1 A.C. 554.

the principle proscribing the making of profits by a fiduciary from his position."[5] But this principle that a fiduciary should not make any profit from his position is only providing for a general duty. It does not lay down a specific duty for the fiduciary. A specific duty is more advantageous since it provides clarity to what a fiduciary should or should not do. Therefore by having a specific duty not to exploit the corporation opportunity it would help to comprehend the general duty not to make profits from one's position. By having this specific duty, it helps a great deal in pointing out another situation in which a fiduciary is not entitled to obtain any profit. Thus it can be said that there is in fact a doctrine of corporate opportunity in the English courts. But this doctrine has been overriden by a general duty not to make any profit from the position occupied. However this should no longer be the case. The doctrine of corporate opportunity should now come into play since it can act as a check on the director's wilful or careless disregard of the company's interests.

(A) What is corporate opportunity?

Several kinds of test have developed for determining what is corporate opportunity. However three tests have gained wide recognition and have been applied by judges in several cases.

[5] D.D. Prentice : The Corporate Opportunity Doctrine 1974 MLR 465.

The first kind of test has been put forward in Legarde v. Anniston Lime and Stone Company.[6] In this case, the court held that the opportunity should not be appropriated where "... the property wherein the corporation has an interest already existing or in which it has an expectancy growing out of an existing right ....." This means that a director cannot seize an opportunity which is of major importance to the company. Such an appropriation of opportunities which are so intimetely related to the company's activities would constitute a sufficiently direct interference with the company.

The "line of business" test is another criterion to use in determining whether an opportunity belongs to the company or not. This test is widely used in the USA. It is also being used in the recent Canadian case of Canadian Aero Service Limited v. O'Malley.[7]

When the "line of business" test is used, inquiries are made to determine whether the opportunity is closely associated with the existing and prospective activities of the company. This criterion has been laid down in Rosenblum v. Judson Engineering Corporation.[8] In this case the court said that "... the issue to be determined ..... is whether .... [the opportunity] was so closely

[6](1900) 28 So. 199.

[7](1973) 40 DLR.

[8]109 A. 2d. 558.

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associated with the existing and prospective activities of the corporation that the defendants [i.e. the directors] should fairly have acquired that business for or made it available to the corporation." The reason why this criterion was used was also given in the case. According to the judge presiding over this case, another test to determine the company's opportunity had to be taken because "the opinions in Lagarde ... appear to adopt too lax a conception of the requirement of fiduciary duty."

The "line of business" test does not stop at the boundary of the company's current operations. It also extends to areas into which the corporation might naturally or easily expands. But this later area is so unclear. But the requirement that the director should determine whether the opportunity is so sufficiently linked to the current operation would serve as an adequate guidance in the action to be taken by him.

The third kind of test to determine corporate opportunity is very different from the two tests mentioned earlier. In the earlier two tests corporate opportunity is related to property-rights of the company. It is against this basis of property-rights rule that this third kind of test comes about. Criticisms are made about the test basing on property-rights rule. It is felt that this basis is too narrow for sustaining the fiduciary duty not to usurp the company opportunity.

The third test which has been formulated by Ballantine is as follows:-

".... the true basis of the doctrine should not be found in any expectancy or property interest concept, but in the unfairness on the particular facts of a fiduciary taking advantage of an opportunity when the interests of the corporation justly call for protection. This calls for the application of ethical standards of what is fair and equitable to particular sets of facts."[9]

With this approach the test is no longer a "mechanical one". (source of the opportunity or property interest in regard thereto). Instead in its place another test is laid, that is "What is fair and equitable" but at the same time must have special regards "to particular sets of facts." But this test too brings us nowhere since what is corporate opportunity is still unidentifiable.

(B) The Extent and Exceptions to doctrine of corporate opportunity

Several recognised exceptions have been accepted under this doctrine. The acceptance of these exceptions are inevitable because there is the danger that if this doctrine is applied inflexibly, it may impose an impossible burden on the director. This burden on the fiduciary has been realised by Lord Cohen in Phipps v. Boardman.[10] He stated that:-

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[9] Ballantine Corporation, 204 (1946).

[10] [1967] 2 A.C. 46 at p. 102.

> "..... it does not necessarily follow that because an agent acquired information and opportunity while acting in a fiduciary capacity he is accountable to his principal for any profit that comes his way as the result of the use he makes of that information and opportunity. His liability to account must depend on the facts of the case."

This shows that there may be occasions when the director can exploit the opportunity which comes in his way. But this may be contrary to the recent decision in <u>IDC v. Cooley</u>.[11] In this case the court held that when a director was presented with an opportunity which came to him by reason of his position, he must not take it when it was within the scope of his fiduciary duty. The opportunity must not also be exploited when it was given in his personal capacity. This means that at no time can a director exploit any corporate opportunity which comes in his way during the course of his directorship.

However a different attitude prevails in the USA. In the USA there has not yet been any case which held a director liable solely because he takes an opportunity which comes to him by virtue of his position. This can be seen in the case of <u>Johnson v. Greene</u>.[12] In this case the Supreme Court of Delaware did not give much emphasis

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[11] [1972] 2 All ER. 162.

[12] 121 A. 2d. 919.

to the fact that the opportunity was presented to the director in his private capacity. Instead the court relied on the fact that there was not a close connection between the business of the company in whose name the action was filed and the business of the company to which the patents were related. In this case it was held that it was true that the company attempted to obtain investment opportunities through the director, but it did not follow that the company had "a specific interest attaching in equity to any and every business opportunity that may come to any of its directors in his individual capacity." This approach is an equitable one. By this approach the director is not completely barred from taking any corporate opportunity. He has the chance to exploit any opportunity which is given in his personal capacity. This shows that there is no stringent duty existing in the USA.

However the doctrine of corporate opportunity as developed in the USA cannot be made used of satisfactorily in situations where the director is told of an opportunity because his company has shown an interest in that area, or in the event of an outsider offering a business chance to both or either the company or the director. Here the third party offering the opportunity does not care which one (i.e. either the company or director) would in the end take up his offer. This opportunity as can be seen arises by reason of the director's position. Hence in the United Kingdom this opportunity must not be exploited at all. In the USA if the opportunity is outside the line of business, by right the director can exploit it.

But when the offer is made in the above situation, it can be argued that the third party intends to use the director as a medium for communicating the offer. As the result the subsequent appropriation of the opportunity without disclosure might be held as one involving the misuse of opportunity which has been received in a fiduciary capacity. Also under the American doctrine, it is still uncertain whether the director's obligation terminates and he is then entitled to compete for the opportunity after he has disclosed the offer to the company.

Another situation which involved the corporate opportunity doctrine is when the director holds several posts. As such there are more corporate opportunities open to him. This means that he is in a situation of great temptation which often has the unfortunate effect of confronting the director with a conflict of loyalties. The conflict of loyalties can be resolved by making use of the "line-of-business" test. This can be done by determining which of the companies has under the line-of-business test a prior claim to the opportunity. If one company has the prior claim but the director delivers the opportunity to another company, he thus violates his duty to the first company. But sometimes the opportunity can be within the line-of-business of more than one company. In such a situation several suggestions have been forwarded to avoid liability under the corporate opportunity doctrine. One method is to determine whether the director should ever be permitted to resolve the conflict by delivering the opportunity to one of the companies, rather than disclosing it to the companies and letting them compete for it. The second method is to see the extent of the director's obligations towards all the companies. Under this method one has to see whether within the area of the line-of-business, there are degrees of obligation in which their existence will compel the director to recognise a paramount duty to one of the companies. In this situation the company claimant can be distinguished by the functional criterion which determines whether the opportunity is essential to the successful performance of the present operations of one of the companies. Another criterion for recognising the paramount duty is by looking at the opportunity itself and see whether it can relieve one company from serious financial difficulties or it would merely augment the profits of the other claimants. But this criterion is a questionable one since profit and loss are on the same continuum. Furthermore to the company and its shareholders, the loss of a possible profit is no different from the company falling into insolvency.

Sometimes even where the criterion used is the "extent of obligation," there will be cases where all the potentially interested companies fall within it. Under this situation it seems that it is fairest that the disclosure be made to all. But this disclosure may result in competitive bidding which will drive up the cost of the opportunity. This would not be in the best interest of the companies. Thus it has been suggested that for the interest to be best served, the company should permit a common director to allocate the opportunity at his discretion. But he must do so in good faith. However this will only be permissible where there is provision in the Articles of Association of the company. In this provision there must be a stipulation that the director can hold several other positions as director and his effort to advance such companies will not constitute a breach of fiduciary loyalty when no bad faith is involved. This kind of provision would ordinarily be effective to relieve a director from his obligation to make disclosure to all the companies with which he is connected.

Even though the corporate opportunities are exploited for purposes within the scope of the directorship, the director can escape liability without making any disclosure by certain recognised exceptions to this doctrine. Such a defence for the exploitation of the opportunity is when the company is financially unable to undertake the enterprise. The financial inability defence will be accepted only when the company is in that state and its condition is ascertainable and not easily feigned. This has to be so because of the fear that the judgement of those who determined whether the company is financially able to undertake the enterprise might be warped by the temptation to act for themselves. Therefore in <u>Irving Trust Company v. Deutsch</u>,[13] financial inability short of insolvency was rejected as a defence. However difficulty will arise when this exception is extended to cases where the company is in serious financial difficulty or lacks liquid assets but it may still

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13 73 F. 2d. 121.

be a going concern. This is because in neither case will it be entirely clear that given the knowledge of the opportunity, the company will be unable still to secure the needed financing with reasonable rapidity. Hence in the American case of Hart v. Bell,[14] the court has articulated a rule that the officer of a corporation is precluded from appropriating the opportunity where the corporation is allegedly unable to obtain the required funds. This step is taken by the court because of fear that anything less than a prophylactic rule would discourage the officers from expanding their full effort to obtain finances for the corporation.

When the company utilisation of an opportunity is barred by any written law or by the company Articles of Association, then there is no necessity to disclose the opportunity to the company. This is so even when there is a provision in the Articles of Association which permits the Article concerned to be amended so as to enable the company to take advantage of such a desirable opportunity. This provision is ignored because such an action would presumably be so slow that both the company and its director would eventually lose the opportunity.

The director may take away the opportunity without having to make any disclosure to his company when his company is barred either by the Memorandum of Association, Articles of Association or any written laws from utilizing the opportunity. This is

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[14] 222 Minn. 69.

because the director only undertakes to advance the company purposes as laid down in the Memorandum of Association and only to the extent permitted by the written law. Therefore until the memorandum or the written law changes, the director's obligation extends no further. This is because the opportunity would either be ultra-vires the memorandum or illegal in the eyes of the law. But the justification given for ultra vires could severely restrict the company in its operation since there is no implied term in the director's contract that the company should not expand.

There is no necessity for any disclosure where the opportunity in question has been rejected by the company. The rejection can be analysed as having the consequence of either removing the conflict of interest problem or it can be interpreted as being tantamount to condonation or authorisation of the director's conduct. Laskin J. in Canadian Aero Service Limited v. O'Malley[15] was of the opinion that the distinguishing factor in Peso Silver Mines Ltd. v. Cropper[16] was the removal of the conflict as the result of the rejection of the offer. According to Laskin J. when the company rejected the opportunity, its interest in the opportunity terminated. Therefore Cropper the respondent, had a right to take the mining offer which previously been offered to the company.

Rejection of the opportunity by the company can also be interpreted as being a condonation or authorisation of the director's

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[15](1973) 40 D.L.R.

[16](1966) 58 D.L.R. (2d) 1.

conduct. This is because when the company turns down an opportunity, it does not mean the director cannot take the opportunity for his own interest. Instead the refusal by the company means a permission for the director to take up the opportunity himself. But for the rejection to be effective it must be a recent rejection. When it is in this manner it means the opportunity rejected is the same as the one which the director accepts. This is because when it is only a short interval, there cannot possibly be a change in circumstances. Besides the rejection being recent, it must also be one which is made by the company when the company is in full appreciation of the operative facts.

Another exceptional defence which has been recognised is the refusal of the third party to deal with the company. In this situation the company has no right at all to the opportunity offered to its director. But it is submitted that allowing the assertion of this exception as an affirmative defence is undesirable. This is because of the difficulty in verifying the unwillingness of the third party. Also there is the risk of encouraging the director to induce unwillingness from the third party.

When the director is able to come within any of the exceptions mentioned above, he will no longer be liable for usurpation of corporate opportunity. He is no longer in a conflict of interest and duty. Hence it is strongly felt that utilization of corporate opportunity should be treated as a distinct fiduciary duty. It is a duty which a director must undertake. If otherwise he will be in a situation of a conflict of interest and duty. This would be contrary to the equitable principle.

CHAPTER V

COMPETING INTERESTS

In Re Thomson[1], a fiduciary principle was established by which a trustee must not have a competing interest with his beneficiary. In the case, the judge said that it was a rule of universal application that a fiduciary "shall not be allowed to enter into any engagement in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect." But this principle has been narrowed down. A fiduciary would only be held to be in competition with his beneficiary when the type of business is highly competitive or when the market is restricted.

Company directors are also under a fiduciary duty not to have competing interests with their companies. This duty can cause a lot of complication. This is because this duty is contradictory of the common law principle which allows a person to be director of several companies. The permission that a director can also be director of the other companies can be seen in cases like Bell v. Lever Bros.[2] and in London and Mashonaland Exploration Co. Ltd. v. New Mashonaland Exploration Co. Ltd.[3] In the later case it was

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[1] [1934] Ch. 342.

[2] [1931] 1 All E.R. Rep. 1.

[3] [1891] W.N. 165.

held that where there was no regulation in the company that the director's services must be rendered to that company and no other company, he was at liberty to become a director even of a rival company. When a director becomes a director of another company, there would be competing interests. This is an unavoidable consequence.

To overcome the above consequence it can be suggested that one of the two principles has to go. If a director is only allowed to be the director of one company alone, then there would not be any possibility of competing interest. But there are several advantages which accrue when a director is allowed to be director of several other companies. For instance by holding several posts as director, he would be able to get more ideas and information. This can lead to an increase in the level of the general management and efficiency of the company. But as was said earlier there is the risk of competing interests when one holds several posts. To do away with the principle of competing interest would also be impractical. This is because this principle is a sort of restraint to the director's activities. When a director is allowed to be director of other companies, without any restraint, he would disregard his role to protect all the companies' interests which he is bound to do. He would only further the interests of the company which he thinks would be the most successful. He would use all the knowledge, opportunities which he obtains from the rest of the companies to further the company in which he is interested most. Owing to this a check is necessary. The duty not to compete would be an appropriate restraint on the directors. But when imposing this duty, its liability for the breach should not be merely because there is a competing interest. Other grounds should be taken into consideration too, so that there would not be a glaring contradiction with the rule that allows a director to be director of other companies as well.

So far the courts have always ignored other circumstances when deciding whether there is a conflict of interests or not. The courts will impose liability in situations where there are competing interests even though the interests are so remote that it is improbable that the fiduciary acts or would have acted for his own benefit. Liability is also imposed when there is a close conflict of interest, but it is still improbable that the fiduciary does in fact act for his own benefit. In all these situations, the courts do not inquire whether the competition taken is fair or not, or whether there is any loss or damage. Inquiry will stop when the relationship shows there is a competing interest. This approach is popularly known in the USA as the "no-further-inquiry" rule. The primary purpose of this rule is to deter fiduciary from occupying position in which he might be tempted to violate his trust. With this purpose there is thus a requirement for an indiscriminate application of the rule to all situations in which such temptation is possible. But such a strict application of the rule is impractical as stated earlier[4].

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[4] ante Chapter II.

A better approach for determining liability of a competing interest is to examine the situation in which the director does the act. This is to see whether he does it in good faith or not. The lack of good faith as the determining factor for liability in conflict of interest would be a helpful one when the situation involved the sale and purchase of assets. In this dealing, profit could be obtained. Following the established equitable principle, the director would be liable since he is in position of conflict of interests and he has obtained profit. If this conclusion is reached, it shows that one has not realised a practical point. The practical point is that more often than not the dealings entered into by the directors are more probably motivated by considerations of convenience rather than a desire to make a profit. Hence it is more equitable to determine the profit gained on the basis whether it is made in good faith or not.

In other situations of competing interest such as the purchase of securities from an affiliate of the director's company, it is generally more difficult to determine whether the director acts in good faith. Although there is difficulty in determining this question, it does not mean that the inquiry should be precluded. The added difficulty of proving good faith would sufficiently protect the interests of those whom the director is supposed to protect. This is because it makes it more difficult for the director to discharge the burden of justifying his actions.

As was mentioned earlier, the primary purpose of the "no-further-inquiry" rule is to protect the beneficiaries. The rule also seems to have a secondary purpose of preserving the integrity of the trust institution by deterring trustees from occupying position which appear suspicious in the eyes of the community. Having to prove good faith when one is in a conflict of interest situation would be sufficient to deter the trustee from occupying such a position. The same would go to the company directors. Since it is very difficult to prove good faith, the director thus has to see that he does not occupy such position which would seem to be a suspicious one. Furthermore since the director must attract future investments, he has an economic interest in avoiding situations which would damage his reputation in the community. It would therefore be unlikely that he will allow such a conflict to arise.

Another approach which can be taken to deal with competing interests of a director is by looking at it in the light of the remoteness of the conflict. This approach has been used in the American case of <u>Phelan v. Middle States Oil Corporation</u>.[5] In this case the court held the receiver not liable when he sold a large block of shares in the company in which he was the officer. In refusing to hold the receiver liable, the judge said that:-

> ".... in a number of situations, courts have held that the rule (i.e. the no-further-inquiry rule) does not apply, not only where the putative

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[5] 220 F. 2d. 595.

> interest, though in itself strong enough to be an inducement, was too remote, but also when though not too remote, it was too feeble an inducement to be a determining motive."

By adopting this approach, the liability arises only when there is actual conflict of interests. Mere possibility of conflict must be ignored since the conflict is too remote for determination. The conflict must also be of a kind which is really competitive and is so closely linked with each other's business interests.

An article in The University of Chicago Law Review[6] has interpreted the two factors mentioned by the learned judge in Phelan's case as a good faith approach too. According to the article, when the factors (that is, "remoteness of conflict" and "feebleness of the inducement") are considered together, they determine the simple question of whether the particular facts of the case indicate a substantial possibility that a trustee would violate his trust. Where no such possibility exists the trustee should not be held liable, unless the beneficiary can sustain the burden of showing bad faith.

It is submitted that the approach on the basis of the remoteness of conflict should not be incorporated into a good faith approach. The good faith approach involves an inquiry into the motive of the

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[6] The Corporate Trustee's Conflict of Interest, 25 The University of Chicago Law Review, p. 382.

director. But the "remoteness of conflict" approach is more concerned with an examination of the competitive situations. When the interests are highly competitive then there is conflict of interests. When this happened and the director obtained profit out of it, he must account for it. Between these two approaches, the "remoteness of conflict" approach is recommendable. This is because in making the decision, reliance should be on facts whether there is really competing interests. Inquiry into the director's good faith would not result in a convincing and satisfactory judgement since inquiry as to the truth of a motive is very difficult to ascertain.

Even though the principle has generally been accepted that a director can hold the same post in another rival company, this principle is not extended to an executive director under a contract of service with his company. The principle has been laid down in Hivac Limited v. Park Royal Scientific Limited.[7] Why such a decision has been reached in Hivac's case could only be explained by the reason that being only a managing director he is an employee and hence not entitled to the privileges given to those in the board of directors. But there is no rule that prohibits an employee to work for another employer in his spare time. Though there is no such rule, common sense requires an employee to be loyal to his employer and should not compete with the employer's interests.

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[7] [1946] Ch. 169.

A director's loyalty to the companies will be divided when he is allowed to be director of several companies. This divided loyalty could be a serious problem especially when the companies are rival. To overcome the danger of competing interests could be done by removing the common law situation. This would be by having provisions in the Articles of Association which forbid all the directors from being directors in any other companies, or in companies which are doing a substantial amount of business which are in competition with the company which they are already directors.

Another way to prevent competition is by making a provision requiring the director to devote the whole of his time and attention during usual office hours to the company's business. However this provision would only be effective for managing or executive directors. It would not be effective for other members of the board of directors who are not bound to give continuous attention to the affairs of the company.

Even when a director is leaving one company and joining a rival company, he must not reveal any confidential information and trade secrets to his new company. If he does so, or is induced to do so by the rival company which employ him, both he and that company may find themselves liable to the former company for damages resulting from the use of the information or trade secrets.

There is also a conflict of interests where the director in anticipation and in preparation for establishing a competing business jump the gun and start his business before resigning from his position with the first company. In such a situation, the director always keeps his connection secret until he is ready to leave. Such conduct involves a failure to act bona fide in the interest of the first company. In some cases such a conduct can amount to an improper use of the company's properties like confidential information and trade secrets.

Hence even though a director is allowed to be director of other companies, it does not mean that he can make use of the information, opportunities and contracts which come in his way for any of the companies. He should bear in mind that anything which come in his way for the purpose of one company should only be used exclusively for that company. Thus a director cannot use for the benefit of one company confidential information which comes to him as director of a rival company. Being possible to be director of several other companies would still subject him to the equitable principles which are applicable to a fiduciary.

CHAPTER VI

CONTRACT WITH THE COMPANY

(A) The general rule

A rule has been clearly established concerning contracts entered into by the director with his company. The rule is that the contract is voidable at the option of the company. This rule has been established in cases like Aberdeen Railway Co. v. Blaikie Bros.[1] and North-West Transportation Company v. Beatty.[2] The general rule laid down in the later case is as follows:-

> "..... a director of a company is precluded from dealing on behalf of the company with himself and from entering into engagements in which he has a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound by fiduciary duty to protect."[3]

This rule applies not only to contracts made directly with the directors but also to those in which the directors are (indirectly) "interested". This rule is strictly adhered to so that "... no question is allowed to be raised as to the fairness or unfairness of a contract so entered into ...."[4] This rule is inflexible so

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[1](1854) 1 Macq. 461.

[2](1887) 12 App. Cas. 589.

[3]Ibid., at p. 593.

[4]Aberdeen Ry. Co. v. Blaikie (1854) 1 Macq. 461.

that no inquiry is permitted even when the terms on which a trustee has dealt or attempted to deal with the estate or interest of those for whom he is a trustee, have been as good as could have been obtained from any other person. However one exception has been recognised as a qualification to the absoluteness of this rule. This qualification has been provided by Lord Cranworth in Aberdeen Ry. Co. v. Blaikie Bros.[5] In this case he stated that an adequate disclosure by the fiduciary of his interest may render the parties free to make a binding contract.

The consequence of failing to disclose his interest in the contract would make the contract voidable at the option of the company. The company has a right to bring proceeding for the recovery of any secret profit which the director has made. The company can also apply for the rescission of the contract made. Proceeding for the recovery of the secret profit can proceed on the similar ground as done in an action for usurpation of the corporate opportunity or the utilization of the confidential information. Since the director has obtained personal gain and profit by placing himself in position of conflict of duty and interest, he must account to the company for the profit made.

As to the right of rescission of the contract, this must be exercised on normal contractual principle. Under this principle

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[5](1854) 1 Macq. 461.

the company must have done nothing to show an intention to ratify the contract after finding out about the non-disclosure. Also restitutia in integrum must still be possible. But this right of the company to rescind a contract in which one or more of its directors are interested can be waived either by the Articles of Association or by the members in the general meeting. However even if the Articles of Association expressly allows the directors to be interested in the contract, the directors are not absolved from their duty to act primarily in the company's interest when entering into such a contract. Consequently the company may still rescind the contract on the ground that the interested director has abused his position.

The rationale for not allowing the director to enter into a contract with the company is because of the right of the company to have his undivided loyalty, his entire service and opinion of each of the directors.[6] By allowing the director to enter into contracts with the company it becomes impossible to measure the influence which one director might have over his associates. This is so even though he obstensibly abstains from participating or voting on the issue. In view of this difficulty, it is pointless to ask the court to determine whether or not the decision of the "independent board was impartial". Furthermore when directors are asked to approve a transaction of one of their fellow directors,

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[6] Benson v. Heathorn (1842) 1 Y and C Ch. 326.

they are placed in the embarassing and invidious position of having to pass upon, scrutinize and check the transaction and the account of one of the members of their own body. They may be consciously or unconsciously influenced by factors like friendship, mutual respect or reciprocity. As the result, under the common law, disclosure to the board is ineffective even if the interested director refrains from attending or voting at the meeting and the contract is approved by a disinterested majority of the directors. The only way that such transactions may be validated is by approval in the general meeting after full disclosure. But the disclosure in the general meeting does not ensure that the company has been offered the best terms which the interested directors would have been able to negotiate on its behalf if they have no personal stake in the contract. When the shareholders of a company are asked to ratify a transaction made by interested director, they cannot as a practical matter negotiate for the company. This is because they are given the limited option of either approving or rejecting the proposal formulated by the interested directors. The shareholders thus do not have complete freedom. They are only allowed to direct their minds to proposals put before them by the directors. Therefore they cannot really consider whether the contracts to be entered by the directors are for the best interest of their company. It is because of this situation that strict obligation should be imposed on the directors. Only by this way it will be certain that the directors will negotiate the best possible arrangement for their companies.

But this strictness of the fiduciary principle can be seen to conflict with commercial practice and necessity. It is common to find persons who are directors in two or more companies which do business with each other. This is especially so in the case of a holding company joined by interlocking directorship to its subsidiaries. In such a company the common directors could not be expected to negotiate the best possible deal for each company. Their function from the business point of view would thus be to balance or arbitrate between the conflicting needs of each business.

At present courts have accepted as valid contracts entered into by the director with its company. Also the contracts are regarded as valid when they are entered into by a company with another company in which the director of the former company is also the director of the later company. The acceptance of the validity of these contracts are dependent on the company's Articles of Association. If the Articles of Association permits such contracts to be made, then the contracts are valid. Besides the provisions in the Articles of Association, there are also statutory provisions concerning director's contract. Such provisions can be found in the Company Acts of Malaysia, Australia, Singapore and England. Though there are provisions in the Articles of Associations or in the statutes, the equitable principle concerning director's contract is still existing and has not yet been ignored by the court.

(B) Provisions in Articles of Association

As the result of common law prohibition on contracts to be entered by the directors with their own companies and also by interested directors, provisions are made in the Articles of Association to waive this prohibition. Usually the provisions are drafted to permit a director to contract with the company on condition that the interest of the director concerned is disclosed. The provision may also state as to the behaviour of the director during the meeting which is held to examine the director's contract with the company. For instance, the articles can provide that an interested director, when disclosing his interest to the board, should not be counted in determining whether a quorum is present or not; and shall not vote. But there are also articles which enable an interested director to attend and vote just as if he is not interested. But whatever provisions are provided, if they are complied with, the contract will be fully effective and the director will not be bound to account for any profit made.

With regard to contracts entered into between two companies in which the director is a common director, the conduct of the director would be examined closely. Since a director is forbidden from using confidential information for his own personal gain as to cause detriment to the company, his action may be closely scrutinized by both companies. If one of the companies has made an exceptionally good bargain and this lead to speculation about it having access to inside information, suspicion will naturally fall upon the common director. If an action is brought against him, the court will draw adverse inferences from the fact that the unusual has occurred. Furthermore if one company co-operates with the director to the detriment of the other, it may be held as a conspirator to the breach. The principle applies not only to contracts made between a company with common directors but to all areas of co-operation with directors involving a potential breach of trust.

(C) Disclosure of interests in the contract

When the director's interest in the contract has been disclosed, then only would the contract be binding and effective. The necessity for disclosure has been laid down at common law. It may also be provided in the Articles of Association. The requirement for disclosure has also been given statutory recognition. For instance in Malaysia, this provision is in Section 131 of the Company Act 1965.

The disclosure of interest can be made at the board of directors' meeting or at the general meeting. At common law disclosure to board of directors is ineffective even if the interested director refrains from attending and voting, leaving an independent quorum to decide. The reason for this is to enable the company to have a right to the unbiased voice and advice of every director. But the submission to the general meeting often causes delay, embarrassment and frustration which is unacceptable to the business community. Hence this common law position very often is waived or modified by the Articles of Association making it only necessary to disclose the interests to the board of directors. This position too is provided by the Malaysian Company Act 1965.[7]

Disclosure of interest must also be made when the director is interested as a member in another company, in the contract made between that company and the other company in which he is a director. In this situation, the director is only required to give a general notice to his fellow directors that he is interested in all such contracts. Subsequently he needs not disclose his interests each time such a contract is proposed.

When disclosing an interest in the contract it is not sufficient to declare that one has an interest in the contract. An interest is sufficiently declared when the nature of interest is disclosed. In fact it is laid down in Liquidator of Imperial Mercantile Association v. Coleman[8] that "a man declares his interest not when he states that he has an interest but when he states what his interest is." Normally this involves the disclosure of the exact extent of the profit which the director will make as the result of the contract. However this nature of declaration does not extend to situation when the director is interested as a member of another company in the contracts made between that company and the company of which he is a director.

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[7] Section 131.

[8] (1873) L.R. 6 H.L. 189.

In this situation a general notice that a director is a member of a specified company and that he is to be regarded as interested in any contract made with it, shall be deemed to be a sufficient declaration of interest.

The statutory provision in Section 131 of the Malaysian Company Act 1965 concerning disclosure of interests in contracts is a very useful provision. With this provision it will ascertain that the interests of the directors are made known and this will enable everyone to see that the directors are not making any personal profit out of the contract with the company. This provision serves to highlight the fiduciary principle concerning contracts made by the directors. This is because with the provisions being silent as to the validity of the contracts which are made without any disclosure of interest it is submitted that this means the contracts are continued to be regarded as voidable. Section 131 only serves to impose a statutory penalty on the director who fails to disclose his interest in the contract with the company.

Recently there are two cases which ignore the issue of the validity of the contracts even though there are statutory provisions which are equivalent to our Section 131. From these two cases, it seems that the statutory provision on disclosure deals only with penalty to be imposed on failing to disclose the interest. The provision is not concerned as to what will happen to the contract where the director's interest is not disclosed to the company.

This can be seen in Hely-Hutchinson v. Brayhead Limited.[9] The case dealt with a disclosure provision which is equivalent to our Section 131.[10] In this case it was held that failure to disclose the interest rendered the director liable to a fine as stated in the provision. Another case on this point is the Australian case of Castlereagh Motels Ltd. v. Davies Roe.[11] In this case the court held that Section 125 of the Australian Uniform Company Act (which is in pari materia with our Section 131) does not give the company a personal cause of action for general damages arising out of a director's failure to disclose his interest in the contract. The case also stated that the main effect of the provision was to create a criminal sanction to enforce the general equitable duty upon directors to disclose their interests in the transactions with the companies. The court felt that the sanction was designed to prevent secret profit from being made by the directors. It was not to prevent losses to the company from unfavourable contract. In the light of these two cases, it becomes clear that statutory provisions concerning director's contract in Malaysia, England and Australia are not concerned with the issue of the validity of the contract. Since the provisions are silent on the validity, it can be assumed that the necessity of making the disclosure as existing under the equitable principle still prevails.

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[9] [1968] 1Q.B. 549.

[10] Section 199 of English Companies Act, 1948.

[11] [1966] 2 N.S. WR. 79.

A glance at Table A in the Fourth Schedule[12] would not be of much help in solving the question about the validity of the contract. Table A does not expressly authorize a director not to have an interest in a contract with the company. Regulation 72(h) and Regulation 81 of this Table deal with contracts made by the directors with their companies. Regulation 72(h) requires the director to disclose his interests (direct or indirect) as required by the Act, that is, in our Section 131. Failure to do so results in the offending director's position becoming vacant. This regulation just like Section 131 gives no guidance on whether the contract is voidable in any event or only if he fails to declare his interests. Regulation 81 prohibits and nullifies any vote made by the director in respect of any contract with the company in which he is interested. This may by implication, indicate that provided he declares his interests, the contract is voidable. Hence Table A could not be used to settle the dispute concerning the validity of the contract. Since the validity of the contract is unsettled, it would thus be very difficult to bring an action for damages on contracts which are entered into by the directors.

It is submitted that since the statutory provision is silent with regard to the validity, the contract made by an interested director who has complied with Section 131 should continue to be governed by the common law. Therefore the contract should remain voidable at the option of the company. But this situation can be

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[12] Companies Act 1965.

overcome by making provisions in the Articles of Association. Even though the articles permit the directors to do so, the directors are still required to disclose their interests in the contracts. This disclosure must be like the one which is provided in Section 131 which has incorporated the common law standard as what should amount to complete disclosure of interests.

In Malaysia, as in Australia, once articles are drafted to permit the directors to contract with their companies, the directors can enter into any kinds of contracts with the companies. The directors can do so as long as they disclose their interests in the contracts, and their contracts are met with approval by the board of directors. But in the USA, the directors can only enter into contracts when they could prove that the making of the contracts is fair for the company. As to what is fair for the company, different tests have been adopted. There is no clear guide as to its meaning. With the requirement to prove "fairness", besides disclosing the interests in the contracts, the directors in the USA are more restricted in their contractual relationship with the companies. The restriction is to see that directors do not easily obtain personal gain from their companies. This should be the attitude because by making it more difficult for the directors to enter into contracts with the companies, the conflict of interests and duties would be reduced. There would thus be less temptation for them to obtain a personal profit. Hence this would protect the interests of the companies which they are bound by their fiduciary duty to protect.

CHAPTER VII

DEALINGS WITH THE COMPANY'S PROPERTIES

Control of the properties of the company is in the hands of the directors. Consequently the directors are free to deal with them as they like. But these properties are not theirs. The properties in equity belong to their company. As such equity has developed rules to regulate the directors' dealings with these properties. Such dealings are the self-dealings by the directors with the properties. Self-dealings are not to be allowed because these would give rise to conflict of duty and interest. The various aspects of self-dealings are:-

(A) Sale of company's properties

(B) Purchase of properties for the company

(C) Renewal of leases.

(A) Sale of the company's properties

When the properties of the company are put up for sale, the directors are prohibited from purchasing them. If the directors purchase them, the purchase would be voidable. The rule concerning prohibition of such a purchase is laid down in Ex p. Lacey.[1] The prohibition has to exist because of the general principle of policy and morality which forbid a fiduciary to place himself in a situation where there is a conflict between his self-interest and

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[1](1802) 6 Ves. 625.

his duty to others. In the case of a director, since he has control over the properties, he might fix a low price for the properties which he purchases from the company. This he does for his own interest. But this would be contrary to his duty towards the company, that is, to obtain the highest possible price for the properties which are put up for sale. Hence there is a conflict of interest and duty. For this same reason also director violates his fiduciary duty when he sells the properties to another company in which he has a substantial interest.

Even where the prices of the properties are fixed by other members of the board of directors, not any one of them could purchase the properties. This is because of the presence of the danger that he would obtain an interest conflicting with that of the company. Though the danger here is not as great as when the director himself fixes the price, it is still great enough to make it improper for him to make the purchase. Also when the price is fixed by an independent valuation, this could not sufficiently allow the director to purchase the properties. This is because the director could himself fix the time at which the properties are to be valued. This could clearly have a substantial effect on the prices ultimately given to the properties.

When the sale of the properties are made in a competitive bidding like during an auction, a director cannot properly purchase the properties. This is because the duty of the director when conducting this auction is to see that the properties receive the highest prices possible. But if he is allowed to purchase them at the sale, it would be to his interest to have the properties sold at the lowest possible prices. Furthermore if the director is allowed to purchase, this could dampen the sale. This is brought about since it discourages the attendance of prospective bidders. This would discourage and minimize prospective bids. But it is the duty of the director to encourage the bids so that the properties could be sold at the highest prices. Thus there would be a conflict of duty and interest. In view of the danger of the conflict, it is best that the sale is set aside even though it appears that the director does his best to sell them at the highest price.

The sale of the properties would also be voidable when there is an agreement between the director and the third party who purchased the property. The agreement concerned is one in which the third party would purchase the properties and then reconvey them to the director. This should not be allowed because the director is indirectly selling the properties to himself. Only when there is an absence of agreement would the re-transfer by the third party to the director be effective. However when the director has entertained hope that he would get the properties from the third party and later he manages to get the third party to sell them to him, the director then can effectively own the properties. But at times agreement can be implied between the director and the third party. This would be so when the third party is the director's wife or husband. The prohibition on the purchase has been laid down in Wright v. Morgan[2] where the trustee's wife was not permitted to purchase the trust property. This principle should be extended to the director's wife too. This is because like the trustee's wife the purchase by the director's wife would amount to an indirect gain for the director too. But when the purchase is made by other director's relatives, it is very difficult to say whether that could also amount to self-dealing and thus an improper dealing. In this situation, it is necessary to determine whether the sale entered by the director with his relatives is of the best interest for the company. If it appears that the director sold the property at a price less than he could have obtained from others, or he has abused his discretion in making the sale, then the director is guilty of a breach of fiduciary duty.

The director could also be liable for dealing with the company properties even though he has ceased to be the director of that company. The liability would continue when the director resigns from his position for the purpose of purchasing the properties. But if the director resigns without any idea of purchasing the property and subsequently purchases it, and there are no circumstances to show that he is using any information acquired by him while being a director, the sale will be valid.

However it is recognised under the fiduciary principle that it is not at all times that the purchase of trust property is

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[2] [1926] A.C. 788.

prohibited. If the fiduciary can show that the transaction is fair, the best price is given, there is a full and proper disclosure and that he takes no advantage of his position, then the purchase could be upheld. This would be applicable to director too.

(B) Purchase of property for the company

A director also violates his fiduciary duty when he sells his own property to his company. For instance he violates his duty when he is entrusted with money to invest and he invests it by purchasing property from himself. Such a purchase has to be set aside because there is the danger that he would forward his interest by inflating the price of his property. The purchase is voidable even when the price paid is a fair one. Hence if the director makes a profit, he is accountable for it and if a loss results to the company, he must make good the loss.

There would also be a breach of fiduciary duty even though the property sold is not owned entirely by the director. It is sufficient if he has an interest in the property of such a substantial nature that it might affect his judgement in making the purchase.

When the director purchases the property individually whereas he should do it for the company he has thus breached his duty. In fact every purchase by the director which is of interest to the company could raise a liability on the director. This is because of the presumption that he purchases the properties for the company. Hence he is estopped from showing that he bought them bona fide for himself.

(C) Renewal of leases

The principle concerning renewal of leases is established in Keech v. Sandford.[3] The principle is that any renewal of lease by a trustee is looked upon as a continuation of the original lease. Though in this case, the principle which is laid down concerns the relationship of a trustee and the beneficiary, this principle has also been used in other fiduciary relationships. For instance in Re Biss,[4] Romer L.J. said:-

> ".... where the person renewing the lease does not clearly occupy a fiduciary position, [he] is only held to be a constructive trustee of the renewed lease if in respect of the old lease, he occupied some special position and owed by virtue of that position, a duty towards the other persons interested."

From this extract, a person would be deemed to be a constructive trustee of the renewed lease even though he only occupies some special position which is not necessarily in a fiduciary position. Thus if a person is in a fiduciary position there should not be any possibility at all that the renewed lease should belong to him.

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[3] [1726] Sel. Cas.

[4] [1903] 2 Ch. 40 at p. 61.

Hence in the case of a director who is a fiduciary to the company, it would naturally mean that the renewed lease must be held by him for his company.

There is no possibility that the rule laid down in Keech v. Sandford[5] would be relaxed. This is because this decision is based on a principle of public policy. This can be seen in that case itself where Lord King L.C. said:-

> "This may seem hard that the trustee is the only person of all mankind who might not have the lease; but it is very proper that the rule should be strictly pursued and not in the least relaxed; for it is very obvious what would be the consequence of letting trustees have the lease on refusal to renew to the cestui qui use."[6]

Owing to this public policy factor, the ratio decidendi of Keech v. Sandford[7] has been vigorously applied even when the old lease has already expired,[8] or that the terms of the old lease was different from the new.[9]

In the case of director it is submitted that the principle in

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[5] [1726] Sel. Cas.

[6] (1726) Sel. Cas. 61 at p. 62.

[7] (1726) Sel. Cas. 61.

[8] Edwards v. Lewis (1747) 3 Atk. 538.

[9] Eyre v. Dolphin (1813) 2 Ball and B. 290.

Keech v. Sandford[10] should be applicable too. This is because owing to his position he has access to the lessor and it would be dangerous to permit him to make use of that access for his own benefit. The benefit which a director might gain would be by raising the rent of the lease which he now holds. The company has no choice but to accept the new rent because a refusal would interrupt the smooth functioning of the company. Thus here the director is furthering his interest instead of the company.

(D) Bribes and Commissions

This topic is of no relevance to the dealings made by the director with the property of the company. However this topic should appropriately be under this chapter since bribes and secret commissions are given to the directors because of their control over the properties of the companies. These bribes are inducements given to directors so that the directors when making dealings and transactions would perform them in favour of the offerors of the bribes. Bribes and commissions are also given to directors because of their position.

The fiduciary principle concerning bribes and commissions has been laid down in Reading v. R.[11] In this case it was held that an army personnel who had made use of his uniform and position to obtain commissions for delivering goods to another country was not

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[10](1726) Sel. Cas. 61.

[11][1949] 2 K.B. 232.

entitled to retain the commissions. Since then this principle is applicable to all who are in fiduciary relationship. The bribe and commission may be claimed even when no contractual relationship exists or is contemplated. It can also be claimed against those who are not acting within the course of his employment.

A fiduciary is not allowed to retain the bribe because it is inconsistent with his duty. Furthermore to allow the fiduciary to keep the bribe would mean an unjust enrichment. Where a bribe is accepted by the fiduciary, he is making a personal gain out of his position. This gain even though has not resulted in any loss or damage to the principal should not be kept by the fiduciary. This is because by allowing it, the confidence which has been reposed on the fiduciary would be jeopardised. Also when the bribe is given, the fiduciary would be influenced to perform the task which is rewarded by the bribe and hence has failed to make the best considerations of other interests. This would be an abuse of confidence which he undertakes as a fiduciary to protect. For these very reasons the director should not be allowed to retain the bribe he received. The application of this principle to the directors can be seen in <u>The Metropolitan Bank v. Heiron</u>.[12] In this case the director was ordered to account for the amount of commission he had received.

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[12](1880) 5 Ex. D.

Another case which showed that the principle concerning bribes and commissions is applicable to directors is Pearson's case.[13] In this case it was held that the bribe taken by the director rendered him liable in an action by the company for the amount of the bribe received. The liability would be fixed even though the director does not realise that he is accepting a bribe. Bribe given can be in many forms. It can be in cash or in kind. This must be given to the director without the knowledge and consent of the company. Thus a director can be held liable to the company as a result of an indemnity given to him by a promoter against any loss upon his qualification shares[14] or for any form of gift from a vendor or otherwise.

When the court orders the fiduciary to account for the bribe or commission received, he needs only to account the exact amount which he has received. If the fiduciary has used the bribe or commission for other purposes, like making an investment and as the result he has obtained a profit out of it, there is no necessity for him to account for this profit. This principle has been laid down in Lister and Co. v. Stubbs.[15] In this case the Court of Appeal held that the secret commissions did not belong in equity to the

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[13] (1877) 5 Ch. D. 336.

[14] Archer's Case [1892] 1 Ch. 322.

[15] (1890) 45 Ch. D. 1.

principal. The agent was merely under a duty to account for them to his principal because their relationship was merely that of the creditor and debtor. The principal was therefore not allowed to follow the commissions into their products, that is, the investments made by the agents. The decision in this case is unsatisfactory. It has no deterrent effect at all especially on the director. The director can easily set-off the amount of bribe or commission which he has received from profit obtainable when he successfully speculates the bribes or commissions. The deterrent effect would only be felt when no distinction is made between profit obtained from speculating bribes or commissions from profits obtained out of usage of confidential information or usurpation of the company opportunity. Both the two types of profit are unjust enrichment and thus should be accountable.

CHAPTER VIII

DEFENCE AND REMEDIES

(A) Defence

A defence which the director can put forward when his act is contrary to the fiduciary duty is by showing that a disclosure has been made. The disclosure should be made either to the board of directors or during the general meeting of the shareholders. At common law, disclosure to the board of directors is insufficient disclosure since the other directors very often give their consent for the act out of respect and reciprocity. The directors do not dwell very deeply about the interests of the company which would be affected when permitting the other director to act in circumstances where there are conflict of duties and interests. As such it is better that disclosure is made during the general meeting of the shareholders for it provides for a better protection and advancement of the interests of the company. When the shareholders have to decide whether the director should be permitted to pursue the act or not, they are not deciding it on the basis of respect and reciprocity. Instead they will see that their interests in the company would not be adversely affected by the director's act. Hence more independent considerations are being made by the shareholders. But more often this disclosure is not very effective since the shareholders always give much freedom to the directors by permitting them to perform any acts for the company.

At present due to commercial needs, disclosure needs no longer be made during the general meeting. Disclosure can now be made to the board of directors. This switch over from the general meeting to the board is because of the long delay before a general meeting can be held. It takes a long time to inform the shareholders to gather for a meeting to discuss the matter. The long delay will have an adverse effect on the expediency of the business. Owing to this it is more practical to have the board of directors to approve the act when disclosure about it is made.

For a disclosure to be valid, the director must make full disclosure. He must disclose the nature and extent of the act. The board of directors or the shareholders must have full knowledge of the transaction that is going to be entered by the director. After having gained full knowledge and they have given their assent, then only the director can pursue the act which involve the conflict of duty and interest. Only then could the director be exempted from liability for the breach of fiduciary duty.

The necessity of making a disclosure to exempt the director from liability was established in Regal (Hastings) Ltd. v. Gulliver.[1] Here Viscount Sankey stated that the directors could protect themselves by setting up a resolution to assent the purchase of the

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[1] [1967] 2 A.C. 134.

shares. Thus only when full disclosure is made would the director be protected when his act is in conflict of duty and interest.

(B) Remedies

(i) Accountability of profit made

The remedy which can be sought against the director when he commits a breach of fiduciary duty is by making him accountable for the profit which he has made. This remedy can be sought when the director makes use of the company confidential information, usurping the company's opportunity or when making dealings with the company properties. This fiduciary principle concerning accountability of profit has been laid down in several cases. In Regal (Hastings) Ltd. v. Gulliver,[2] it was stated that:-

> ".... they [the directors] may be liable to account for the profit which they have made, if, while standing in a fiduciary relationship to Regal, they have by reason and in course of that fiduciary relationship made a profit."[3]

Similarly in Parker v. McKenna,[4] accountability of the profit was ordered by the court for the amount which had been obtained. To ask for the remedy of accountability of profit, the company must bring a personal action against the director concerned. But a

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[2] 1967 2 A.C. 134.

[3] Ibid., at p. 143.

[4] 1874 10 Ch. App. 96.

portion of the profit could be retained by the director as compensation for his skill and work when exceptional profit is being made. This is allowed as can be seen in Phipps v. Boardman.[5]

An action for an account of profit could be successfully obtained if the company can establish that the director consciously breach his fiduciary duty. For instance in Peter Pan Manufacturing Corp. v. Corsets Silhouette Ltd[6], the principle laid down is that when the information is given in confidence to the defendant, and later he utilises the information, then he can be ordered to account for the profit. This principle can be extended and be applied to company directors too.

Accountability for the profit made can be refused by the court when the director has acted honestly but foolishly in believing that he is not in breach of confidence. This point has been established in Seager v. Copydex Ltd[7] where the court refused to grant an order to account the profit when the defendant had acted honestly but foolishly in delivering the confidential information.

(ii) Constructive Trust

Another remedy which can be sought against the director is by imposing a constructive trust on the profit gained. A

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[5] [1967] 2 A.C. 46.

[6] [1964] 1 WLR. 96.

[7] [1967] 1 WLR. 923.

constructive trust arises out of the operation of law. It disregards the intention of the parties concerned. This type of trust should be imposed because allowing the director to retain the profit would be an unjust enrichment for him. By imposing a constructive trust, the director is made to surrender the profit to his company. This remedy is more widely used in the USA. There the court does not give relief because a constructive trust has been created but because otherwise the defendant would be unjustly enriched. When the court gives this relief it declares that the defendant is chargeable as a constructive trustee.

However a different attitude is shown by the English courts in regard to constructive trust. The English judges prefer to treat constructive trust as a substantive institution and not a remedial one. This can be seen in the statement made by Professor R.H. Maudsley. According to him, "English law has always thought of a constructive trust as an institution, a type of trust".[8] But recently there is a change in the attitude of the English court. This can be seen in the decision of <u>Binions v. Evans</u>.[9] In this case it was held that a statement in the contract of sale of an interest in the land created an interest which could be enforced

[8] 75 Law Quarterly Review 234 at p. 237.

[9] [1972] Ch. 359.

by a constructive trust. This shows that the court has regarded the institution of constructive trust as a kind of remedy. But this has not yet received much popularity among the English judges.

A constructive trust should only be used to force the director to disgorge the profit when no other remedy is available. It is unsatisfactory to impose a constructive trust on the director merely because some of the actions are inequitable. This is because a constructive trust places a considerable liability on the trustee. It is to some extent a "penal remedy".[10] Therefore such a remedy should only be imposed when it is justifiable to do so. This means policy matters must be taken into consideration. Constructive trust should not be imposed just because it happens to be convenient.

(iii) <u>Tracing</u>

Sometimes the profit which is obtained by the director is being used by him for some other purposes. This profit can still be claimed against the director. This can be done by the method known as tracing. When the court gives this proprietary remedy the company can "follow" the properties which have been obtained by the director from the profit which he received. When the properties have been traced, the company has the option either to take the properties purchased or to hold it as a security for the amount of profit laid out in the purchase. However when the profit money is mixed with the director's own money, or the properties obtained are

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[10] Goff and Jones, 84 Law Quarterly Review 472 at p. 480.

also mixed with his own personal properties, then the company can only obtain those money or properties which the director has failed to prove that they are his.

(iv) Restoration of Property

This is another remedy which can be obtained by the company against the director. The court will make such an order when the director personally purchase the company properties, or when the director instead of purchasing the properties for the company, purchase for himself. Order for the restoration of the property will also be made against a third party when he purchases the property for himself but there is an agreement that he will re-transfer the property to the director.

(v) Injunction

An injunction can also be sought by the company against the director's breach of fiduciary duty. This equitable remedy can be employed where a breach is threatened but has not yet occurred. An injunction is also an appropriate one to ask where the breach has already occurred and is likely to continue, or to avoid the adverse consequence which would follow. This remedy can be asked for in all circumstances when there is a breach of the director's fiduciary duties like utilizing the confidential information, usurping the company opportunity, competing with the company and other fiduciary duties mentioned in the earlier chapters.

This remedy is popularly used to enjoin the use of confidential information. In this aspect, there is a generally accepted rule that the court will have no hesitation in enjoining the dishonest defendant, any puppet company he controls and to which he has assigned confidential information, and any third party who consciously participates in a breach of confidence. But if the director has acted in good faith and has changed his position to his detriment, the court may refuse to grant an injunction even though he has acted foolishly in believing that he was not in breach of confidence. However the court may enjoin the honest fiduciary even though he acts in good faith when there is no evidence of any irrevocable change of position. This decision has been reached in Stevenson, Jordan and Harrison Ltd. v. Macdonald and Evans.[11]

Besides the above conditions, there are other considerations which may be taken into account by the court in determining whether an injunction should or should not be issued. For instance when the information contributed minimally to the development of his industrial process or the mechanical device, the courts will be reluctant to enjoin a dishonest defendant. This has been established in Coco v. A.N. Clark (Engineers).[12] From this case it can be said that injunction will not be granted when it will result in a unique disability or would result in injustice to the defendant.

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[11] [1951] 68 R.P.C. 190.

[12] [1969] R.P.C. 41.

Among the several remedies available, the most popular remedy which is sought against the director is to ask him to account for the profits made. The order for the accountability of profit can easily be obtained because of the courts' attitude in strictly adhering to the equitable principle that no profit should be retained if it is obtained from a conflict of interest and duty. Though the company may benefit from this type of remedy, in the long run the company will face an adverse effect. This is because the strict adherence to the rule would not provide any incentive for the director to work harder for the company. This can lead to deterioration of the company.

CONCLUSION

At present there are various statutory provisions concerning the duties of the director. For instance in Malaysia in the Companies Act 1965, there is Section 132 which deals with the use of company information by the director. Also in Section 131 there is the provision about contracts entered with the company. With the availability of these statutory provisions, equitable principles concerning director duties might be ignored. This can be seen in the case of the use of the company information. Due to the extensive provision, it becomes easy to bring an action successfully against the director under this provision rather than relying on the fiduciary principle. But as can be seen in Chapter III, the effect of such an extensive provision is not beneficial to the company. Hence it is suggested that this provision should be interpreted in the light of equitable principle. If this is done there will be a just situation since the fiduciary will be liable only when he makes use of confidential information.

The statutory provisions concerning director's contract and the necessity to disclose the interests so as to validate the contracts are merely the codification of the equitable principles which govern the fiduciary's contract. Other duties of the directors like usurpation of corporate opportunity, competing interests and dealings with the properties of the company, have not yet received statutory recognition. If these duties are to be codified, it is tost that the provisions are made with reliance on the equitable principles. If it is not so, then a saving section as provided in Section 132(5) should be made. The saving section should state that the section is in addition to and not in derogation of any rule of law. This means the equitable principle is still applicable

It is strongly advocated that director's duties in regard to company information, corporate opportunity, contract, competing interests and dealings with the company properties should contimue to be governed by the equitable principles. This is because equitable principles have distinctive ethical quality and also they have a wide and elastic nature. This has been recognised by Spry. His view on this matter is as follows:-

> "…. the maxim of equity are of significance for they reflect the ethical quality of the body of principles which tended not so much to the formation of fixed and immutable rules to which all occasions might be referred and which would provide the certainty which is necessary in commerce and the carrying on of affeirs, as rather to the conscionability or justness of the behaviour of the parties according to recognised moral principles. This ethical quality remains, and its presence explains to a large extent the

> adoption by courts of equity of elastic and flexible principles which may be applied to fresh situations as they arise."[1]

This should be the attitude in regard to the director's duties. There should not be any fixed rules. By having flexible rules governing the duties, these duties would be adaptable to the constant changes in the commercial world. The flexibility of the director's fiduciary duties would in the long run be profitable to the company. This is because where the director is not fettered with rigid and strict duties, he will be able to perform his work well. He will be progressive and this can lead to increased efficiency in the management of the company.

Furthermore it is felt that the making of a profit is not per se sufficient to constitute a breach of the fiduciary duty. There is no point in strictly adhering to the rule that any profit from the conflict of duty and interest should be disgorged. Instead liability should be determined on the basis of abuse of confidence. If the director is in a conflict of duty and interest, and profit is obtained, he should only be ordered to disgorge the profit after taking into account all matters which tend towards the justice or injustice of granting that remedy. This means that one has to consider whether the remedy granted would result in hardship, laches or unfairness. Then only can one say whether the profit

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[1] Spry, Equitable Remedies at p. 7.

obtained is an unjust enrichment or not. If it is so then the profit obtained should be disgorged. This way the director would not be in fear in the discharge of his functions and duties. He will do his work well and will have incentive to make improvements for the betterment of his company.

Though there are statutory provisions about the director's duties, these should not be considered in isolation. The breach of these duties must be looked into in the context of the equitable principles. This is unavoidable because of the nature of the relationship between the director and his company. It is a relationship in which confidence is reposed by one party to another. As such the breach of this relationship should be determined on whether there is an abuse of confidence or not. This means equitable principles must not at all be disregarded as the determining factors.

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