

**The Validity of New Zealand Corporate Transactions
Undertaken Contrary to The Interests of The Company**

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Abstract

New Zealand law relating to the impact on corporate transactions of a breach of the directors' duty to act in the best interests of the company is complex and not well understood. This makes it difficult for parties to commercial transactions to know where they stand.

This thesis sets out and analyses the current law, including uncertainties in the law. It also suggests how the law might appropriately be reformed through amendments to the Companies Act 1993.

The thesis suggests that the security of commercial transactions would be enhanced by clarifying that company directors will not be considered to lack actual authority to enter into contracts as a matter of agency law just because they had a subjective motivation to act contrary to the company's interests.

Such subjective mis motivation will, however, amount to a breach of fiduciary duty, giving rise to the equitable remedy of rescission (avoidance of transactions). That remedy provides the company with the right to avoid the contract except where the contracting third party is unaware of the breach of duty. The thesis recommends that the availability of the remedy of rescission, and the circumstances in which a company loses the right of rescission, should be spelled out in the Act.

In addition, the thesis recommends that the Act also clarifies the circumstances in which a company can effectively ratify (affirm) a contract that is voidable due to a breach of directors' duty. This legislative clarification would include specifying that shareholders associated with the directors in breach cannot vote on a shareholder resolution affirming a voidable transaction.

The suggested legislative amendments will assist in advancing the original objective of the Law Commission in making New Zealand company law more accessible. The amendments would also draw an appropriate balance between policy objectives of enhancing the certainty and security of commercial transactions, and encouraging integrity and honesty in commercial dealings.

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Chapter 1 – Introduction

A significant area of uncertainty in New Zealand law concerns the validity of contracts that are entered into by a director on behalf of a company but which are not in the company's best interests.

Section 131 of the Companies Act 1993 (NZ) ("the Act") requires a director of a company to act in good faith, and in what he or she believes is in the best interests of the company. This fundamental duty of directors is well known. What is less well known and understood is the nature of the remedial consequences of breach of this duty, and in particular, the impact on company contracts entered into as a result of such a breach. There is a lack of clarity and consistency in New Zealand law concerning the validity of such contracts.

The uncertainty in the law exists for several reasons. It exists in large part because of the impact on company contracting in New Zealand of different areas of general law (the law of equity and agency law), each of which developed without the corporate form in mind, and which deal with questions of contractual validity in different ways.

Further, the lack of clarity and consistency is partly due to the specific context of the Act and the reform processes which led to it. While the Act was intended to provide for a wholesale reform of company law, the area of company contracting was largely unchanged from reforms introduced in the mid-1980s as amendments to the Companies Act 1955. A major driver for reforms incorporated in the 1993 Act was concerns about investor protection arising out of the 1987 share market crash. Company contracting received relatively little attention.

The directors' duty to act in the best interests of the company did receive scrutiny as part of the law reform process. A key part of the Law Commission's suggested reform was to make directors' duties more accessible by endeavouring to set those out in the Act. However, the Act does not clarify the remedial consequences of breach of those duties, including the impact of breaches on corporate transactions. Further, the reform of directors' duties suggested by the New Zealand Law Commission in its reports in 1989 and 1990¹ was only partially accepted by the New Zealand Parliament in passing the Act. That, in turn, led to some inconsistency of approach within the Act, and an apparent lack of clarity as to Parliament's intention.

¹ Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989); Law Commission *Company Law Reform: Transition and Revision* (NZLC R16, 1990).

Company contracts in New Zealand depend on applying principles of agency law. The courts originally developed principles of agency law in relation to human persons who sought to use agents to enter into transactions. These principles developed before the corporate form of business organisation became prevalent. However, the courts then applied those principles of agency law to contracts entered into by persons on behalf of companies.²

The application of agency law to a corporate context is not straightforward. How does a corporate entity confer authority on a director or other corporate agent for the purpose of agency law? There are provisions in the Act relevant to that issue (such as s 18(1)), but these provisions lack sufficient clarity.

One specific question is whether, as a matter of agency law, a director can have authority to bind a company to a transaction resulting from a breach by the director of the duty to act in the best interests of the company? There is some case law support for the proposition that authority to act as agent includes only authority to act honestly in pursuit of the interests of the principal.³ While at face value this might sound reasonable, the proposition is concerning when applied in the context of company contracts. It potentially makes the question of authority of directors, and the validity of corporate contracts with third parties, dependent on the subjective motivation of directors. Further, it may impugn the validity of such contracts even where the contracting third party is unaware of the director's mis motivation.

Principles of the law of equity are also relevant to the validity of transactions entered into in breach of the duty to act in the best interests of the company. The law of equity developed principles, such as the remedy of rescission (avoidance of transactions), which applied in relation to transactions entered into in breach of fiduciary duty. The courts subsequently held those principles relevant to certain breaches of directors' duties.

The equitable remedy of rescission applies in the case of breaches of fiduciary duty which have led to the party to whom the duty is owed being bound by a transaction. The remedy of rescission gives the party to whom the duty was owed a right to avoid the transaction unless the contracting third party was unaware of the breach of duty.⁴ There is case law support for

² Ross Cranston "Agents, 'Agents' and Agency" in *Making Commercial Law Through Practice 1830-1970* (Cambridge University Press, 2021) at 129.

³ *Philipp v Barclays Bank* [2023] UKSC 25. See Chapter 6.

⁴ There are other situations in which the remedy of rescission can be lost. See Chapter 3.

the proposition that the remedy of rescission applies in the case of a breach of the duty to act in the best interests of the company.⁵

Applying the law of equity to a corporate context adds further complexity over and above situations where a fiduciary duty is owed to a human person. Where a fiduciary duty is owed to a human person, it will normally be clear who the duty is owed to and for whose benefit, and whether a transaction is in that person's best interests. However, in the case of the directors' fiduciary duty to act in the company's best interests, there is room for argument on the scope of the duty (i.e., what are the "interests of the company") and for whose ultimate benefit the duty is owed. It is now well-established that the company is a separate legal entity. However, commentators and courts have expressed different views as to what is meant by the "interests of the company", and for whose benefit the duty is ultimately owed. Significant differences in approach between the Law Commission and the Department of Justice in the law reform process leading to the passing of the Act have led to a lack of clarity on that question in New Zealand.⁶

Further complications arise in assessing what amounts to a breach of duty that is (or should be) sufficient to give rise to the equitable remedy of rescission in situations where a director has failed to act in the company's best interests. This is particularly the case in situations where the director's actions are negligent rather than deliberate, or where they involve a company that is insolvent or close to insolvency.

The courts have not always consistently applied principles of agency law and the law of equity to corporate transactions involving breaches by directors of their duty to act in the company's best interests. The complexity and inconsistency in this area of the law make it difficult for parties to commercial transactions to know where they stand.

The difficulty for commercial parties to know where they stand is exacerbated by a lack of clarity as to how and when a company can ratify or approve a transaction that is potentially invalid due to a breach of the director's duty to act in the company's best interests. Section 177(4) of the Act preserves case law principles relating to such ratification or approval, but does so without setting out those principles. That is potentially a significant problem as the

⁵ See Chapter 3.

⁶ See Chapter 2.

case law principles relating to when and how a company can ratify or approve a transaction are complex and poorly understood.⁷

The bulk of modern commerce is carried out through the corporate form of business organisation. It is, therefore, important that parties contracting with companies know where they stand in relation to the validity of contracts. Where a company director commits the company to a transaction that is not in the company's best interests, can the contracting third party rely on the contract being valid and enforceable?

The objective of this thesis is twofold.

The first objective is to set out in one place where the current New Zealand law sits on the approach to the validity of contracts entered into in breach of the duty to act in the best interests of the company. This thesis seeks to clarify a complex, and sometimes inconsistent, area of the law, taking into account the impact of the law of equity, agency law and New Zealand company law legislation.

The second objective is to assess whether there is any need for legislative reform to clarify the law, eliminate inconsistencies in the law, make the law more accessible, or better achieve policy objectives (such as security of commercial dealings and integrity in commercial dealings). To the extent that New Zealand law is not currently accessible, or needs clarification or improvement, the thesis will suggest what legislative reform is desirable.⁸ Consideration of such potential reform may be particularly timely given that the New Zealand Law Commission is planning a review of the law relating to directors' duties in 2025.⁹

⁷ See Chapter 8.

⁸ See Chapter 9.

⁹ Law Commission, "Law Commission to undertake project on directors duties" (press release, 4 June 2024) available at <https://www.lawcom.govt.nz/about-us/news-and-media/law-commission-to-undertake-project-on-directors-duties/>.

Chapter 2- The New Zealand Context

In considering the impact on New Zealand corporate transactions entered into in breach of the duty to act in the best interests of the company, it is important to consider the New Zealand statutory context as set out in the Companies Act 1993, and the background to the passing of that legislation.

In 1986, the Minister for Justice asked the New Zealand Law Commission to examine and review the law related to bodies incorporated under the Companies Act 1955, the legislation then governing the operation of companies in New Zealand. The Law Commission reported some three years later in a comprehensive report of some 432 pages, including a proposed draft new Companies Act.¹

New Zealand company law had before then been largely based on United Kingdom company law, with the Companies Act 1955 being “an almost exact copy” of the United Kingdom legislation of 1948.² However, the Law Commission was significantly influenced by North American (Canadian and United States) corporations law.³ Its draft new Companies Act was influenced by the United States Model Business Corporations Act and the Dickerson report which preceded the Canada Business Corporations Act.⁴

However, while the Law Commission report was comprehensive and led to the passing of a whole new Companies Act in 1993, an area of company law left largely unchanged was company contracting. Reforms relating to company contracting, and in particular the application of agency law to company contracts, had been enacted in the mid-1980s.⁵ These reforms were incorporated into the new Act without substantial amendment. Further, with one exception (relating to company contracts in which directors had an interest), the reforms did not address the impact of the law of equity on the validity of company contracts.

The Relevance of the Law of Equity

The Law Commission did acknowledge the relevance of the law of equity to directors’ duties. The Law Commission noted that some directors’ duties were fiduciary in nature, and in

¹ Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989).

² At [29].

³ At [32]-[33].

⁴ Law Commission *Company Law Reform: Transition and Revision* (NZLC R16, 1990) at xvii.

⁵ Companies Amendment Act (No 2) 1983; Companies Amendment Act 1985.

particular referred to the duty to act in the best interests of the company as being not only the fundamental duty of every director but also a fiduciary duty imposed by the common law.⁶

The fact that breaches of fiduciary duties gave rise to remedies in the law of equity, including remedies that impacted on the validity of contracts, was also recognised by the Law Commission. In particular, the Law Commission noted the rule of equity that transactions in which fiduciaries were interested were voidable. The Law Commission proposed a reform of this rule in relation to company directors, making such transactions voidable only when the transaction was not fair to the company.⁷ Parliament eventually enacted that reform as s 141 of the Act.

With the exception of interested transactions, however, the Law Commission did not specifically address the availability of equitable remedies where a company director has breached their fiduciary duties. Equitable remedies, including the remedy of rescission, had been applied by the courts to breaches of directors' fiduciary duties, including the duty to act in the best interests of the company.⁸ As discussed in Chapter 3, a standard remedy for breach of fiduciary duty is the remedy of rescission, which makes a transaction entered into in breach of fiduciary duty voidable unless the contracting third party is innocent and does not have knowledge of the breach of duty.

While an objective of the company law reforms was to make the law more accessible, that objective was not achieved in relation to the *consequences* of breaches of directors' duties. The fact that the Act deals with the remedial consequences of interested transactions but not other breaches of fiduciary duty means that companies, and those contracting with them, may incorrectly assume that a contract is not subject to being set aside just because a director entered into the contract in breach of the best interests duty. The Act provides little guidance in terms of determining the appropriate remedy for a breach of that duty.

The 1993 reforms also do not set out the principles relating to the circumstances in which a transaction that is voidable as a result of a breach of directors' duty can be affirmed by the company. The case law had given shareholders the ability to ratify (affirm) contracts voidable

⁶ Law Commission, above n 1, at [506]. See also at [124] suggesting directors' fiduciary duties should be referred to in the legislation, [217] suggesting it would be wrong to impose fiduciary duties on directors which were owed directly to creditors, and [536] referring to obligations of fiduciaries to preserve confidential information. See also Law Commission *Company Law Discussion Paper* (NZLC PP 5, 1987) at [193]: "The fiduciary duties imposed by the Courts upon directors are to act honestly and in good faith for proper purpose and in the best interests of the company."

⁷ At [524].

⁸ See Chapter 3.

due to a breach of directors' duty.⁹ As discussed further below, the Law Commission suggested removing the right of shareholders to ratify or excuse breaches of directors' duties. Parliament did not adopt the Law Commission's recommendation. Instead, it introduced s 177(4) into the Act, which preserved the law of shareholder ratification of breaches of directors' duties. However, as discussed in Chapter 8, this was done in a way that did not clarify the circumstances in which shareholder ratification would be effective.

The Relevance of Agency Law

The Law Commission approach, and the Act as passed, recognised the relevance of the law of agency to corporate transactions.

Section 180 provides that contracts can be entered into on behalf of a company by a person "acting under the company's express or implied authority". That indicated that ordinary principles of actual authority in agency law would apply to company contracting.

The starting point for who has authority to enter into contracts for a company is s 128 of the Act, which provides that the board of directors has authority to manage the company.¹⁰

The Law Commission was concerned with protecting against company contracts being held invalid just because such contracts were not within the capacity or power of the company (such as where a company's constitution provided that the company should not be involved in a particular industry or field of activity).¹¹ That reform was eventually confirmed in s 17(1) of the Act. Although not part of the Law Commission's proposals, s 17(3) of the Act also clarified that the fact that a transaction was not in the best interests of a company did not affect the capacity of the company to undertake the transaction. Section 17(3) appears to have been based on s 161(3) Corporations Act 1989 (Cth), the current version of which is s 124(2) Corporations Act 2001 (Cth).

It is, however, possible that a transaction could be within the capacity of the company but not within the authority of the board of directors.¹² The Law Commission assumed that transactions that exceeded the best interests of the company would not fall within the powers of management of a board of directors, and therefore their authority.¹³ Whether this is the case

⁹ *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666 (NSWCA). See further Chapter 8.

¹⁰ Section 128 and the statutory authority of a board of directors are discussed further in Chapter 5.

¹¹ Law Commission, above n 1, at [342]-[348] and s 8 draft Act.

¹² *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809 at [31].

¹³ Law Commission, above n 1, at [348].

will be discussed in Chapter 5. It is certainly not clear from the Act itself whether transactions entered into in breach of the best interests duty are within the actual authority of the board (or persons to whom the board has delegated management power).

The Law Commission also noted that it intended to preserve common law principles of apparent authority from agency law subject to the existing statutory gloss on such principles in the case of company contracts provided by s 18C of the Companies Act 1955.¹⁴

The courts originally developed principles of agency law in the context of human principals who had employed agents to contract on their behalf. As discussed in Chapter 5, the law has then struggled to adapt those principles of agency law to the context of corporations who wish to enter into contracts. A purpose for the introduction of s 18C of the Companies Act 1955 was to enhance the ability of third parties contracting with companies to be able to rely on the apparent authority of corporate agents to contract on behalf of companies.¹⁵ Section 18(1) of the 1993 Act essentially adopts the previous wording of s 18C of the 1955 Act. In doing so, the Act adopts a particular test for when a contracting third party's knowledge of potential defects in actual authority will remove the third party's ability to rely on a holding out of authority for the purpose of establishing apparent authority.

In the context of a contract entered into in breach of the best interests duty, this may mean that a form of knowledge test is relevant to both the validity of a transaction in equity (as contracts in breach of fiduciary duty will not be voidable in equity if the contracting third party is innocent¹⁶) and the validity of a transaction as a matter of agency law (as a result of s 18(1)). However, the Law Commission did not consider whether these knowledge tests were consistent and would lead to coherence in the law.

The Best Interests Duty

The content of the directors' duty to act in the company's best interests is therefore relevant in two ways to company contracting. First, if we accept the Law Commission's suggestion that the duty is a fiduciary duty, then equitable remedies such as rescission of contracts apply to a breach of the duty. Secondly, if the Law Commission is correct that actions taken in breach of

¹⁴ At [347] and [349].

¹⁵ Companies Amendment Act 1985. See Chapter 7 and *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 12 at [73].

¹⁶ See Chapter 3.

the best interests duty are not within the actual authority of company directors, then that may make contracts entered into in breach of the duty void as a matter of agency law.

It is important, therefore, to understand the content of the best interests duty, and what Parliament intended in that respect in the setting out of that duty in s 131 of the Act. The reform of the law relating to directors' duties was a major area of focus for the Law Commission, albeit the impact of directors' duties on company contracting was not.

The Law Commission commented that the law relating to directors duties was "inaccessible, unclear and extremely difficult to enforce" and that its reform was "a matter of urgency".¹⁷ It noted that the duties had to be gleaned "from a large volume of complex case law" and suggested that it was desirable to distill the general principles from the cases and express them in legislation to make them more accessible.¹⁸ When it came to directors' duties, it was United Kingdom and Commonwealth case law that formed the background to the Law Commission's deliberations.¹⁹ The Law Commission wanted the law relating to such duties to be made more accessible through being set out in the Act itself.²⁰

In relation to the best interests duty, the Law Commission suggested that there was confusion as to whether "the best interests of the company" required assessment of the company as the collective shareholders or as the enterprise itself.²¹

In most cases, it will not make a material difference to the validity of corporate transactions whether a shareholder-focused or entity-focused approach is taken to the duty. Usually, the interests of shareholders will be consistent with the interests of the company as a separate entity. There are, however, some examples of transactions where there may be divergence between the interests of shareholders and those of the corporate entity. For example, this may be the case with takeovers involving a transfer of shareholding control in a company, and contracts involving the sale of company businesses. Another area where the entity approach and a pure shareholder approach may collide is in the area of dividends and other distributions. A further important issue is the extent to which the interests of creditors should be taken into account as part of the company's interests in addition to, or in place of, the interests of shareholders. A

¹⁷ Law Commission, above n 1, at [184].

¹⁸ At [186].

¹⁹ At [186]-[187], [193], [506]-[507] and see, for example, the references to English case law at [127] and Commonwealth case law at [220].

²⁰ At [121]-[124], [184]-[186] and [193].

²¹ At [188].

requirement to consider creditor interests as part of the best interests duty could have substantial implications for the validity of corporate transactions entered into when a company is insolvent or near insolvency. This would include loans, guarantees or securities entered into by a company when the company is insolvent or near insolvent, but potentially also other imprudent transactions entered into at such a time.²² I discuss these examples in Chapter 4.

The Law Commission was minded to take an approach that treated the interests of the company as its interests as a separate entity, rather than the interests of its shareholders. The Law Commission noted that the line of case law which identified the company with its collective shareholders predated the decision of the House of Lords in *Salomon v Salomon & Co Ltd*, but had not been reassessed.²³

The Law Commission expressed a concern that uncertainty as to what was meant by “the company” meant that there was “considerable scope for directors to rationalise decisions which are against the interests of existing shareholders”.²⁴ It dealt with this concern by proposing protections for existing shareholders in situations where their rights as shareholders were affected (e.g., rights to distributions and voting), cases of fundamental change to the organisation (e.g., major transactions such as sale or purchase of assets worth over half the value of the company’s assets) and situations involving the repurchase of company’s shares or the provision of financial assistance to purchase shares.²⁵ The Law Commission also dealt with the concern about protection of shareholders by proposing that directors owe a separate express duty to existing shareholders.²⁶

The Law Commission proposed a hierarchy of duties.²⁷ Under this hierarchy, s 101 of the Law Commission’s draft Act set out the primary duty of directors to act in the best interests of the company. A proposed duty to existing shareholders in s 102 was expressly subordinate to the duty in s 101.²⁸ The draft Act then provided in s 103 that directors could, in exercising their duties, “have regard to the interests of creditors and employees of the company”, but with this

²² For examples of loan and security transactions, see *Westpac Banking Corporation v The Bell Group* (No 3) [2012] WASCA 157, (2012) 89 ACSR 1; *Mernda Developments Pty Ltd v Alamanda Property Investments No 2 Pty Ltd* [2011] VSCA 392, (2011) 86 ACSR 277. For an example of an imprudent lease transaction entered into at a time of insolvency, see *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA).

²³ Law Commission, above n 1, at [127] referring to *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL).

²⁴ At [189].

²⁵ At [190]-[192].

²⁶ At [508] and [510].

²⁷ At [194] and [505].

²⁸ At [511].

ability being subordinate to both the best interests duty in s 101 and the proposed duty to existing shareholders in s 102.²⁹ The Law Commission repeatedly commented that this hierarchy of duties, and the presence of a separate duty to *existing shareholders*, made it clear that the Law Commission intended the reference to “the company” under s 101 to be a reference to the corporate enterprise itself rather than the collective shareholders.³⁰

The Law Commission also proposed removing the common law ability of the shareholders to ratify breaches of directors’ duties, commenting that this ability to ratify “comes very close to identifying ‘the company’ with the majority of shareholders”.³¹

Accordingly, the Law Commission intended a change of approach from the common law position under which the interests of the company were considered to be the interests of the shareholders as a whole, to an approach under which the interests of the company were simply the interests of the corporate enterprise itself.

A further change to the common law position suggested by the Law Commission was to propose an objective approach to the best interests duty. The Law Commission appears to have intended this objective approach as part of a replacement of the duty to act for proper purposes, which the Law Commission noted had been used “to impose an objective standard where the good faith of directors is accepted.”³² The Law Commission proposed to remove the proper purpose duty, but to address the issues covered in the modern proper purpose cases by imposing a duty on directors in favour of existing shareholders (the proposed s 102) and by introducing an objective element into the best interests duty (the proposed s 101).³³ Section 101 of the Law Commission’s draft Act, therefore, would have provided that the duty of a director was “to act in good faith and in a manner that he or she believes *on reasonable grounds* is in the best interests of the company” (emphasis added).

This formulation of the duty was different from the subjective approach to the best interests duty as set out by the English Court of Appeal in *Re Smith & Fawcett*:³⁴

²⁹ At [218].

³⁰ At [87], [194] and [512].

³¹ At [564]. See also at [219] and s 136(3) of the Law Commission’s draft Act.

³² At [507]. The Law Commission was, however, also influenced by s 8.30 of the United States Model Business Corporation Act, which provided a requirement of reasonableness: Law Commission, *Company Law Discussion Paper*, above n 6, at [198]-[199].

³³ Law Commission, above n 1 at [508].

³⁴ *Re Smith & Fawcett Ltd* [1942] Ch 304 (CA) at 306.

[Directors] must exercise their discretion bona fide in what they consider — not what a court may consider — is in the interests of the company,

Although this does not appear to have been a point that the Law Commission considered, the suggested modification to the best interests duty to adopt an objective approach would have had very significant implications for company contracts. It would have meant that where directors negligently entered into contracts that were not in the company's best interests, those contracts may have been voidable in equity. I discuss the consequences of taking an objective approach to the best interests duty in Chapter 4.

Legislative Changes to the Commission's Approach

The essential foundations underpinning the Law Commission's suggestion that the duty to act in the best interests of the company be based on the enterprise itself were destabilised by changes made by Parliament to the Law Commission's draft Act, with three specific changes impacting the interpretation of the best interests duty.³⁵

First, the Law Commission's suggested hierarchy of directors' duties was removed. Secondly, the Law Commission's suggested separate directors' duty to existing shareholders, which the Law Commission was at pains to say demonstrated that the company meant the entity itself, was also removed. The proposed separate section providing that directors could take into account the interests of creditors was also removed.³⁶ Thirdly, the common law ability of shareholders to ratify breaches of directors' duties was not done away with as suggested by the Law Commission, but in fact *reinforced* by the addition of s 177(4) of the Act (introduced by the Justice and Law Reform Committee at the Select Committee stage of the Bill).

Parliament's refusal to impose a separate stand-alone duty on directors to existing shareholders, combined with its decision to preserve shareholders' common law right to ratify breaches of directors' duties, suggest a different appreciation by Parliament to that of the Law Commission as to how the best interests duty should be conceived.

³⁵ The Parliamentary Debates refer to the delay in introducing the Companies Bill due to the substantial number of differences of opinion between Department of Justice officials and the Law Commission: see NZPD Vol 510, September 1990 (RJS Munro). The debates also refer to the fact that at the Select Committee stage, "most provisions" of the Bill "had been altered in some way or other", albeit that the chair of the committee considered that most of the alterations were relatively minor: see NZPD Vol 532, December 1992 (David Caygill).

³⁶ Section 132 of the Act did preserve the ability of directors to consider employees' interests in certain specific situations.

However, the Act as passed does show some confusion in the conceptual understanding of what is meant by the interests of “the company”. In particular, some provisions originally drafted by the Law Commission in its draft Act, which required directors to consider the interests of the company *and existing shareholders* (implying, therefore, a potential distinction between such interests), were not changed or removed. See, for example, s 47(1)(c), which requires directors who are issuing new shares to resolve that “the consideration for and terms of the issue are fair and reasonable to the company and to all existing shareholders” (wording unchanged from that set out by the Law Commission in s 39(1)(b) of its draft Act).³⁷

Further, the Select Committee added uncertainty by adding qualifications to the best interests duty in the case of subsidiary companies and joint venture companies. The Select Committee amended the relevant clause in the Companies Bill to allow directors of subsidiary and joint venture companies, where permitted by the company constitution, to act in the best interests of appointing shareholders even though that might not be in the best interests of the subsidiary or joint venture company itself.³⁸ These provisions eventually became ss 131(2)-(4). The Law Commission had suggested similar provisions in its second report.³⁹

In relation to a wholly owned subsidiary, s 131(2) enables a director of the subsidiary to act in the best interests of the holding company even if the conduct may not be in the best interests of the subsidiary. This subsection does not make conceptual sense unless the subsidiary’s interests are seen as being something different from the interests of its sole shareholder. It may be that one can rationalise s 131(2) as a provision inserted for the avoidance of doubt.⁴⁰ Still, by itself, the subsection does suggest that the company’s interests are something different from those of the shareholders. This implication that the company’s interests are different from those of its shareholders creates conceptual confusion, especially when the balance of the Companies Act 1993 as passed is so shareholder-focused, as discussed below.

Parliament also did not adopt the Law Commission’s suggestion that the directors’ belief that actions were in the best interests of the company had to be on reasonable grounds.⁴¹ The

³⁷ Law Commission, above n 4, at page 163. See also Law Commission, above n 1, at page 208. The original wording of the Commission in its first report concluded “to the existing shareholders” rather than “to all existing shareholders”.

³⁸ Report of Justice and Law Reform Committee, 15 December 1992 at page 5 suggesting the addition of clauses 109(2)-(4) of the Bill, which provisions subsequently became ss 131(2)-(4).

³⁹ Law Commission, above n 4, at [55] and amended s 101 of draft Act at 195.

⁴⁰ Peter Watts *Directors’ Powers and Duties* (3rd ed., Lexis Nexis, Wellington, 2022) at 176-177.

⁴¹ Companies Bill 1990, Explanatory Note, at vi.

Companies Bill, as introduced into Parliament, reinserted the proper purposes duty from the case law that the Law Commission had proposed omitting, and made the best interests duty a subjective duty to act in “in what the director believes to be the best interests of the company”, consistent with the approach in the previous case law.

Shareholder Focus to the Legislation as Passed

The overall scheme of the Act, as passed, is consistent with an approach to company law that suggests Parliament intended to ensure the achievement of the economic benefits of the corporate form.⁴² It is also very much focused on providing shareholders of companies with extensive rights.

The Parliamentary Debates at the time of the introduction of the Companies Bill provide some insight into this shareholder focus. The Bill was introduced in September 1990 just under three years after the 1987 share market crash, and at a time when business confidence was low.

The Minister of Justice, the Hon WP Jeffries, in introducing the Bill in September 1990, quoted from an economic statement by the Government of 20 March 1990. That statement suggested that New Zealand’s commercial laws:⁴³

need to be expressed in clear straightforward terms, in a way that protects investors whilst encouraging new investment. Clear, fair law is a key part of a business environment that is conducive to economic growth. The foundation of this will be a new Companies Act.

Paul East, from the then opposition National Party (which later that year became the new Government that oversaw the Act’s passing in 1993), made it clear that the opposition strongly supported the proposed reform. Mr East referred to the fact that many investors lost their life savings after the collapse of the Stock Exchange, and commented that such people had “rightly pointed their finger at the Government”, suggesting that reform was required to provide “proper legislative protection for investors”.⁴⁴

Doug Graham, also from the then opposition, noted “New Zealand is still languishing with a business sector that has no confidence whatever...”. Mr Graham referred to the specific

⁴² Companies Act 1993, long title, para (a).

⁴³ NZPD Vol 510, September 1990.

⁴⁴ NZPD Vol 510, September 1990.

proposed provision in the Bill that would require major transactions to be approved by shareholder special resolution and commented:⁴⁵

That provision will also prevent directors from acting against the interests of shareholders, and that is positive. The duties of directors are clearly laid down. Directors must act in the best interests of the company. That has been a major problem in commercial law for some time. I am pleased that the Government has introduced derivative action under which shareholders can bring proceedings against the company at the company's expense to try to ensure that the company follows the law. All of those measures are very positive. I support the concept.

Two years later, when presenting the report of the Justice and Law Reform Select Committee, Rob Munro (from the now National Government) noted that risk was necessary in a commercial community but then said:⁴⁶

However, it is important that those who do wish to take risks are made aware of what they are getting into.

Accordingly, the Bill gives greater protection to minority shareholders...

In summary, the shareholder-focused scheme of the Act, as passed, was consistent with a clearly expressed desire by Parliament to give greater protection to shareholder investors following the 1987 share market crash.

Scheme of Companies Act 1993

The structure of the Act is consistent with shareholders being the persons who can both enforce duties owed to the company and ultimately determine what happens to a company and its assets:

- (a) It is shareholders that appoint and remove directors. The default position is that shareholders can do this by majority resolution (ss 153 and 156).⁴⁷ Shareholders

⁴⁵ NZPD Vol 510, September 1990.

⁴⁶ NZPD Vol 532, December 1992.

⁴⁷ Potentially, if shareholders have signaled that they are going to remove the existing directors, there is even New Zealand case law that suggests that the directors become "caretaker directors" who should not enter into a strategic or significant decision against the wishes of shareholders, and could be the subject of an injunction restraining them should they attempt to do so: *Utilicorp NZ Inc v Power New Zealand Ltd* (1997) 8 NZCLC 261,465 (HC). However, this doctrine seems inconsistent with the general principle that shareholders cannot interfere with management decisions of the board: *Automatic Self-Cleansing v Cunningham* [1906] 2 Ch 34 (CA). The caretaker director doctrine has been doubted in Australia: *Chimaera Capital Ltd v Pharmaust Ltd* (2007) 64 ACSR 332 (FCA).

could vote to appoint themselves as directors⁴⁸ and often do so in smaller companies;

- (b) It is shareholders whose investment is rewarded through the payment of dividends (or following liquidation by distribution of surplus assets);
- (c) Shareholders are able by unanimous resolution under s 107(1)(a) and (c) to themselves ensure the payment of a dividend (including a capital dividend under New Zealand law) or return of capital through a repurchase of shares (subject, in each case, to compliance with the solvency test);
- (d) Shareholders are entitled by special resolution (i.e, shareholder resolution passed by 75 percent voting power) to put a company into liquidation, in which case the surplus assets of the company will then be returned to them (s 241). Shareholders cannot be criticised should they decide to liquidate a company⁴⁹, and this is true even if the company is entirely solvent⁵⁰;
- (e) It is shareholders that determine the extent of directors' powers through control over the form of the company's constitution (which can be altered or replaced by shareholder special resolution). Further, under s 128(3), shareholders can potentially amend the constitution so that shareholders rather than directors become responsible for the management of the company.⁵¹ Alternatively, shareholders can reserve to themselves in the constitution the right to make or approve decisions on key aspects of management, or can reserve to themselves the right to appoint the CEO or other key officers of the company;⁵²
- (f) The company can only enter into major transactions with the approval of a special resolution of shareholders (s 129);

⁴⁸ Peter Watts "Shareholder Primacy in Corporate Law: a Response to Professor Stout" in PM Vasudev and Susan Watson (eds) *Corporate Governance after the Financial Crisis* (Edward Elgar Publishing, Cheltenham, 2012) 42 at 44.

⁴⁹ *Sojourner v Robb* [2007] NZCA 443, [2008] 1 NZLR 751 at [24].

⁵⁰ Watts, above n 40, at 177, [5.6].

⁵¹ Watts, above n 48, at 44; Watts, above n 40, at 177. However, in such a case the shareholders would take on directors' duties under s 126.

⁵² Watts, above n 48, at 44.

- (g) Shareholders can pass resolutions on questions of management (s 109). While the default position is that such resolutions are not binding, the constitution can provide for such resolutions to be binding (s 109(3));
- (h) A shareholder with a five percent stake in the company can, as a matter of right under s 121, require the calling of a shareholder special meeting (which meeting could seek to appoint or remove directors, or propose resolutions under s 109 as discussed above);
- (i) Shareholders can unanimously determine the basis of directors' remuneration under s 107(1)(f), which could (for example) give shareholders the ability to set directors' remuneration on a basis that is tied to the profitability of the company and/or to its share value;
- (j) It is shareholders who are the only party (other than directors) given the ability to enforce directors' duties by injunction (whether of a restraining or mandatory nature) (ss 164, 170 and 172);
- (k) It is shareholders who are the only party (other than directors) given the ability to enforce directors' duties by way of derivative action on behalf of the company (s 165). Further, where a shareholder is granted leave to bring a derivative action on behalf of the company against a director, the court has the power under s 167(d) to direct that any amount ordered to be paid by the defendant be paid to former or present shareholders of the company instead of to the company;⁵³
- (l) Case law principles that allow shareholders to release directors from breaches of duty, and to affirm contracts entered in breach of duty, are preserved (s 177(4)).⁵⁴

It is important, however, to recognise that the Act does also provide important protections for creditors, including the requirement that directors not make distributions to shareholders if that would breach the solvency test (s 52) and duties on directors not to engage in reckless trading (ss 135 and 136).

⁵³ Contrast Margaret Blair and Lynn Stout "A Team Production Theory of Corporate Law" (1999) 85 Va L Rev 247 at 294–295.

⁵⁴ See Chapter 8.

Overall, it is apparent that New Zealand company legislation provides shareholders with substantial control over a company's ultimate direction and the distribution of its surplus assets. The legislation also confers only on shareholders any meaningful ability to hold directors to account.

Bainbridge has suggested that the shareholder-focused approach taken in the New Zealand Companies Act is particularly appropriate for a jurisdiction where almost all companies are small or medium in size.⁵⁵ Most companies in New Zealand are closely held. The Law Commission noted that at the time of its first report (in 1989) companies listed on the New Zealand Stock Exchange accounted for only 209 out of approximately 150,000 registered companies.⁵⁶ If anything, that position has been exacerbated since 1989. There are now only about 125 listed companies out of approximately 726,000 registered companies.⁵⁷

Section 169(3) of the Act makes it clear that the best interests duty is owed to the company rather than directly to shareholders. However, that begs the question of what the "interests of the company" are, and *for whose benefit* the duty to the company is owed.

The shareholder-focused scheme of the Act might potentially lead to the view that the best interests duty should be considered to be a duty owed for the benefit of shareholders as a whole, consistent with the previous Commonwealth case law codified in the Act. However, the Act, in its final form, is not internally consistent. As discussed above, the Law Commission had originally preferred an approach to the best interests duty based on considering the interests of the company as being separate and distinct from those of shareholders. While important changes to the Law Commission's draft Act (such as preserving the common law ability of shareholders to ratify breaches of directors' duties) suggest a departure from the Law Commission's approach, other parts of the Act are consistent with the Law Commission's original approach.

⁵⁵ Stephen Bainbridge "Director versus Shareholder Primacy: New Zealand and USA Compared" (2014) NZ L Rev 551 at 570. The Law Commission itself noted that for a closely-held company, those forming a company may well intend the company be run in the interests of shareholders: *Company Law Discussion Paper*, above n 6, at [206].

⁵⁶ Law Commission, above n 1, at [17].

⁵⁷ <https://sseinitiative.org/stock-exchange/nzx> accessed 13 July 2024 and <https://www.companiesoffice.govt.nz/insights-and-articles/latest-company-statistics/> updated 2 July 2024 and accessed 13 July 2024 showing total companies registered as 726,359.

Developments in the Case Law

Since the passing of the Act, the case law which considers the duty to act in the best interests of the company has continued to develop. While most Commonwealth jurisprudence has continued to take a shareholder-focused approach to the best interests of the company, the judicial justification for that focus has changed.

The case law originally conceived the duty as a trust-like fiduciary duty for the benefit of shareholders. The courts viewed directors as trustees for the shareholders who had appointed the directors to look after shareholder funds. Further, the courts saw shareholders as having the power to forgive or excuse directors for the breach of duty owed to the company.

Dawson explains how the fiduciary duty arose:⁵⁸

It was the shareholders who acting jointly entrusted their moneys to the directors to advance the purposes for which the company was established. And it was the shareholders who agreed to confer the various powers on the directors for the purpose of administering the joint stock, and managing the business. By accepting the office of director, the directors undertook to exercise the powers conferred on them by the shareholders for the purposes set out in the company's constitution. Correspondingly the shareholders necessarily reposed trust and confidence in the directors. In keeping with equity's traditional concerns, courts of equity would ensure that those upon whom powers had been conferred would exercise such powers honestly in what they considered to be in the best interests of the donors of the powers.

The Law Commission suggested that the association of a company's interests with its shareholders was because the corporate form derived from unincorporated joint venture companies.⁵⁹ However, the courts took a shareholder-focused approach to the best interests duty of directors of both corporations incorporated under Acts of Parliament and unincorporated "joint stock" companies.

⁵⁸ Francis Dawson "Acting in the Best Interests of the Company- For Whom are Directors "Trustees"?" (1984) NZULR 68 at 78. See also Julian Velasco "Fiduciary Principles in Corporate Law" in Evan Criddle (ed) *The Oxford Handbook of Fiduciary Law* (Oxford University Press, 2019) at 61; Alan Meese "The Team Production Theory of Corporate Law: A Critical Assessment" (2002) 43 Wm & Mary Law Review 1629 at 1631.

⁵⁹ Law Commission, above n 1, at [189]. To similar effect more recently, see *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2024] AC 211 at [20] per Lord Reed P. Gower also comments that the modern English business corporation has evolved from the unincorporated partnership (joint stock company) rather than from the corporation based on a grant from the state: LCB Gower "Contrasts between British and American Corporation Law" (1956) 69 Harvard Law Review 1369 at 1371-1372. He comments that, by contrast, American corporation law owes less to partnership principles.

It was undoubtedly the case that during much of the 18th century and half of the 19th century many English companies were unincorporated joint stock companies. Unincorporated joint stock companies were common in the United Kingdom until registration of such companies became available as a matter of right in 1844.⁶⁰ Such companies were essentially just a form of partnership (with the partners/ proprietors comprising “the company”) so that it was natural that the managers of such a company would be required to act in the interests of the proprietors. The original “company” may well have been the 12th century Italian “*compagnia*”, which was also a form of partnership. Micklethwait and Wooldridge, in discussing this precursor form of business organisation note, “The word *compagnia* is a compound of two Latin words (*cum* and *panis*) meaning ‘breaking bread together’.”⁶¹

However, the early case law suggesting that directors owed fiduciary duties to act for the benefit of shareholders extended not just to unincorporated joint stock companies but also to *corporations* formed pursuant to royal charters or Acts of Parliament. As noted by Len Sealy, the earliest English cases in which directors were held liable on trust principles concerned corporations rather than unincorporated joint stock companies.⁶²

It is also notable that in many of these early corporations (at least for corporations of a trading nature), directors were required to hold a substantial shareholding. DuBois notes that the director of the 18th century business company was required to have a substantial proprietary interest in the company.⁶³ DuBois gives the example of the charter of the London Assurance Corporation in 1720, which provided that no person should be elected a director who did not hold £1,000 of the capital stock of the company. That was a huge amount of money at the

⁶⁰ Joint Stock Companies Act 1844 (UK).

⁶¹ John Micklethwait and Adrian Wooldridge *The Company A Short History of a Revolutionary Idea* (Weidenfeld & Nicolson, London, 2003) at 18.

⁶² LS Sealy “The Director as Trustee” (1967) 25 CLJ 83 at 84. For an example of the form of oath required by the committee-men (directors) of an early chartered corporation (the East India Company) in favour of the adventurers (shareholders) of the company, see Susan Watson *The Making of the Modern Company* (Hart Publishing, Oxford, 2022) at 52, 62, 85-87, 244 and 257.

⁶³ AB DuBois *The English Business Company after the Bubble Act, 1720–1800* (Commonwealth Fund, New York, 1938) at 292.

time.⁶⁴ This practice of requiring directors to hold a substantial shareholding appears to have been a mechanism for ensuring that directors' interests were aligned with shareholders.⁶⁵

DuBois comments:⁶⁶

In the eighteenth century viewpoint of a director's powers and responsibilities, the catch-word was 'trustee'. Endlessly, it was repeated that the directors were trustees for the proprietors.

This approach, which regarded directors' fiduciary duties as being for the benefit of shareholders (proprietors), was accepted in the early cases as being true for both unincorporated and incorporated companies. There are numerous cases from the 19th century where the directors of companies incorporated by statute were considered trustees for shareholders.⁶⁷ More generally, courts in the 19th century referred to the directors of companies as being trustees for the shareholders, with there being no suggestion that the position was regarded differently as between incorporated and unincorporated companies.⁶⁸ Not only were unincorporated joint stock companies not treated differently from companies incorporated under Acts of Parliament, joint stock companies registered under the Joint Stock Companies Act 1844 were also not treated differently from unregistered companies. Again, the courts regarded directors of such registered joint stock companies as trustees for the shareholders.⁶⁹

⁶⁴ At 324, n 83. According to The National Archives "Currency converter 1270-2017" <www.nationalarchives.gov.uk> (accessed 10 May 2022), £1,000 in 1720 was equivalent to £116,107.50 in 2017 currency. Also, according to the United Kingdom national archives website, the sum of £1,000 in 1720 would have been sufficient to purchase 185 horses or the wages of a skilled tradesman for 11,111 days! By comparison, each director of the London Assurance Corporation in 1720 was granted attendance money of £6 per meeting, and in 1721 was granted a salary of £150 per annum: see DuBois, at 326, n 91.

⁶⁵ Latham CJ in the High Court of Australia in 1938 commented that most articles of association of companies required directors to have an interest as shareholders and suggested that "it is generally desired by shareholders that directors should have a substantial interest in the company so that their interests may be identified with those of the shareholders of the company": *Mills v Mills* (1938) 60 CLR 150 (HCA) at 163.

⁶⁶ DuBois, above n 63, at 293. See also the examples cited by DuBois at 326, n 92.

⁶⁷ *The York and North-Midland Railway Company v Hudson* (1853) 51 ER 866, 16 Beav 485 at 868-870 and 491 and 496; *Harris v The North Devon Railway Company* (1855) 52 ER 651 at 652, 20 Beav 384 at 387; *The Shrewsbury and Birmingham Railway Company v The London and North-Western Railway Company* (1853) 43 ER 451 at 453, 4 De G M & G 114 at 120-121 upheld by the House of Lords in *Shrewsbury and Birmingham Railway Company v North-Western Railway Company* [1857] 7 HLC 114, 4 De G M & G 114. In some such cases, the courts referred to the directors as being trustees for "the company" but in doing so it was clear that by the company, the courts meant the shareholders: See, for example, *Re Newcastle-Upon-Tyne Marine Insurance Company ex parte Brown* (1854) 19 Beav 96 at 104, 52 ER 285 at 288.

⁶⁸ See, for example, *Re Cameron's Coalbrook Railway Company ex Parte Bennett* (1854) 52 ER 134, 18 Beav 338 at 349. Here, Sir John Romilly followed his earlier decision in *The York and North Midland Railway Company v Hudson* without commenting that that earlier case involved a company incorporated under an Act of Parliament.

⁶⁹ For examples of registered joint stock companies, see *Maxwell v The Port Tennant Patent Steam Fuel and Coal Co* (1857) 24 Beav 495, 53 ER 449 where Sir John Romilly MR referred to the directors as "persons who are entrusted to manage the affairs and carry into effect the contracts of a company for the shareholders, who place implicit reliance on them" and *Gaskell v Chambers (No 3)* (1858) 26 Beav 360 at 364, 53 ER 937 at 938 where Sir John Romilly MR considered that the directors were trustees for the shareholders.

It was also clear from the cases that the fiduciary duties of directors to the company could only be forgiven or released by agreement of the shareholders⁷⁰, being the persons for whose benefit the duties were seen as being owed. The United Kingdom Supreme Court recently described this principle of shareholder ratification as being “nearly as old as company law itself”.⁷¹ Sealy comments that the fact that “breaches of [directors’] duty have always been considered capable of being ratified or condoned by the shareholders” was consistent “with the trust principle on which they are based”.⁷²

As in the United Kingdom, in the early decisions of the United States courts involving corporations, the directors were seen as trustees for the shareholders.⁷³ The early United States case law in which the courts referred to directors of corporations as trustees for the shareholders is extensive.⁷⁴ More recent decisions have affirmed that the background to the accepted duty on directors to maximise shareholder value is “rooted in old trust principles”.⁷⁵

In summary, in the early history of companies in the United Kingdom and United States, directors were accepted as owing obligations of a fiduciary or trust-like nature to the company for the benefit of shareholders. The interests of the company were equated with the interests of the shareholders collectively.⁷⁶

The only qualification to that was in the United States, in the context of insolvency, where some early decisions suggested directors of insolvent companies were exercising powers for the benefit of creditors.⁷⁷ In contrast, the position taken in early English case law did not go that far, with the House of Lords concluding in *re Wincham Shipbuilding, Boiler and Salt Co* that directors were trustees only for shareholders, not creditors.⁷⁸ As will be discussed below,

⁷⁰ *The Great Luxembourg Railway Co v Sir William Magnay (No 2)* (1858) 25 Beav 586 at 593, 53 ER 761 at 764; and *North-West Transportation Co v Beatty* (1887) 12 App Cas 589 (PC) at 593–594.

⁷¹ *BTI 2014 LLC v Sequana SA*, above n 59, at [196] per Lord Briggs JSC.

⁷² LS Sealy “Directors’ Wider Responsibilities- Problems Conceptual, Practical and Procedural” (1987) 13 Mon LR 164 at 169.

⁷³ George A Mocsary “Freedom of Corporate Purpose” (2016) *BYU L Rev* 1319 at 1344–1345 and the cases cited at 1319, n 133; and D Gordon Smith “The Shareholder Primacy Norm” (1998) 23 *J Corp Law* 277 at 301. Smith does note the evidence was ambiguous as the courts also treated creditors as the *cestuis que trust* when the corporation was insolvent.

⁷⁴ By way of example see *Verplanck v Mercantile Ins Co* 1 Edw Ch 84 (NY Ch 1831) at 97; *Cumberland Coal & Iron Co v Sherman* 30 Barb 553 (NY Sup Ct 1859) at 570–571; *Koehler v Black River Falls Iron Co* 67 US 715 (1862) at 720–721; *Jones v Terre Haute & Richmond R R Co* 57 NY 196 (1874) at 206; *Hunter v Roberts, Throp & Co* 83 Mich 63 (1890) at 69; *Lord v Equitable Life Assurance Soc* 94 NYS 65 (NY Sup Ct 1905) at 78; and *Dixmoor Golf Club Inc v Evans* 156 NE 785 (Ill Sup Ct 1927) at 787.

⁷⁵ *Re Toys “R” Us S’holder Litigation* 877 A2d 975 (Del Ch 2005) at 999.

⁷⁶ Sealy, above n 72 at 187.

⁷⁷ Smith, above n 73, at 301, and the cases cited at 301, n 117.

⁷⁸ *Re Wincham Shipbuilding, Boiler and Salt Co* (1878) 9 ChD 322 (CA) at 328.

however, that is an area where English law has since moved in the same direction, holding that where a company is insolvent or bordering on insolvency, there is a requirement for directors to take into account the interests of creditors.⁷⁹

The seminal case of *Salomon v Salomon & Co Ltd* establishes the principle that a company incorporated under the Companies Act 1862 (UK) was a separate legal entity from its shareholders. Lord Macnaghten said: “The company is at law a different person altogether from the subscribers to the memorandum”.⁸⁰ To the extent judges and commentators in earlier times viewed the company as comprised of its shareholders (often referring to companies in the plural as “theys”⁸¹), that view has not prevailed.⁸²

A key question then becomes whether the recognition of a company as a separate entity from its shareholders also changed the nature of the directors’ duty to act in the best interests of “the company”? Did the fact that the courts recognised the company as being a separate entity also impact on the nature of the best interests duty, and the question of for whose benefit that duty was owed? As discussed above, the Law Commission tended to that view, suggesting that the line of authority that identified the company with the collective shareholders needed to be reassessed.⁸³

Some commentators take the view that the natural consequence of the finding in *Salomon* is that the director’s duty to act in the best interests of the company should no longer be considered to be a duty owed for the benefit of shareholders.⁸⁴ Instead, it should be viewed as a duty to sustain and maximise the value of the company as an entity, viewed separately from its shareholders.⁸⁵ On the other hand, Grantham argues that the company “as an artificial entity does not have real interests” and that to give justiciable content to the best interests duty “it is necessary for the law to ascribe to the company the real interests of some person or group”.⁸⁶

⁷⁹ *BTI 2014 LLC v Sequana SA*, above n 59.

⁸⁰ *Salomon v Salomon & Co Ltd*, above n 23 at 51.

⁸¹ Paddy Ireland, Ian Grigg-Spall and Dave Kelly “The Conceptual Foundations of Modern Company Law” (1987) 14 *Journal of Law and Society* 149 at 150–151; Paddy Ireland “Company Law and the Myth of Shareholder Ownership” (1999) 62 *MLR* 32 at 39; and Sealy, above n 72 at 165; Len Sealy “Perception and Policy in Company Law Reform” at 25–26 in Feldman and Meisel *Corporate and Commercial Law: Modern Developments* (Lloyds’ of London Press, 1996)

⁸² *BTI 2014 LLC v Sequana SA*, above n 59, at [139].

⁸³ Law Commission, above n 1, at [127].

⁸⁴ Susan Watson “What More Can a Poor Board Do? Entity Primacy in the 21st Century” (2017) 23 *NZBLQ* 142 at 153–154.

⁸⁵ Andrew Keay “Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model” (2008) 71 *Modern Law Review* 663; Watson, above n 84.

⁸⁶ Ross Grantham “The Doctrinal Basis of the Rights of Company Shareholders” (1998) 57 *CLJ* 554 at 577.

As the Law Commission acknowledged, the position that directors owed fiduciary duties to the company for the benefit of the shareholders, and that shareholders could forgive or excuse breaches of directors' duties, continued in the Commonwealth case law following *Salomon*. *Salomon* itself stands for the very proposition that shareholders were entitled to ratify or excuse breaches of directors' duties owed to the company despite the acknowledgment in that case that the company was a separate legal entity.⁸⁷

Leading cases throughout the 20th century continued to take the approach that a breach of directors' fiduciary obligations to the company could be excused by the shareholders in general meeting.⁸⁸ Harman LJ in the English Court of Appeal commented that it was "trite law" that the general body of shareholders could forgive actions by directors which had been actuated by improper motives.⁸⁹

In the United States, where the separate legal personality of corporations had been clear for longer than was the case for companies in the United Kingdom, the academic commentary and case law confirms that the directors' duty to act in the best interests of the corporation continues to be a duty to do so for the benefit of shareholders.⁹⁰ The legal position that directors owe a duty to act in the pursuit of shareholder interests has been described by Chancellor Allen of the Delaware Court of Chancery as a "bedrock principle".⁹¹ George Moscaro similarly comments that it is "black letter law" that corporations exist to maximise shareholder wealth.⁹²

⁸⁷ *Salomon v Salomon & Co Ltd*, above n 23, at 37 and 54.

⁸⁸ For example, see *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 (HL) at 150 per Lord Russell. See also at 157 per Lord Wright.

⁸⁹ *Bamford v Bamford* [1970] Ch 212 (CA) at 237-238. See also *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm) at [288] and [444].

⁹⁰ Leo Strine Jr "The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law" (2015) 50 Wake Forest L Rev 761 at 768; David Yosifon "The Actual Law of Corporate Purpose" in David Yosifon *Corporate Friction* (Cambridge University Press, Cambridge (UK), 2018) at 60; *Dodge v Ford Motor Co* 170 NW 668 (Mich 1919) and *eBay Domestic Holdings, Inc v Newmark* 161 A 3d 1 (Del Ch 2010) at 34; *Katz v Oak Industries, Inc* 508 A 2d 873 (Del Ch 1986) at 879; *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (Del 1985) at 955; *Revlon, Inc v Macandrews & Forbes Holdings, Inc* 506 A 2d 173 (Del 1986) at 182; *Re Trados Inc S'holder Litig* 73 A 3d 17 (Del Ch 2013) at 20, 36-37 and 40-41.

⁹¹ *Freedman v Rest. Assocs. Indus., Inc.*, 13 Del.J.Corp. L. 651 at 661 (1987); Leo Strine Jr "Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit" (2012) 47 Wake Forest L Rev 135 at 155.

⁹² Moscaro, above n 73, at 1320.

Changed Nature of Best Interests Duty

However, the characterisation of the duty in Commonwealth jurisprudence has evolved in recent decisions. In *BTI 2014 LLC v Sequana SA*, Lord Briggs JSC rejected the proposition that:⁹³

the fiduciary duty to advance shareholders' interests has anything to do with the fact that directors are, usually, elected, appointed and removed by shareholders, or that it arises from a sense of trust and confidence between them for that reason.

Instead, the characterisation of the best interests duty appears to have changed to one based on considering the economic interests of the parties potentially entitled to the company's residual assets.⁹⁴ Cases such as *Sequana* suggest that the best interests duty is owed for the benefit of shareholders while the company is solvent (as shareholders are the persons entitled to the residual assets of the company) but potentially for the benefit of both shareholders and creditors when a company is insolvent or close to insolvency. Once a company is close to insolvency, there is uncertainty about whether it is shareholders or creditors who are the persons with the main interest in the residual assets of the company, and so there should be a balancing of shareholder and creditor interests.⁹⁵

Consistent with this approach, the power of shareholders to forgive or excuse directors for a breach of duty owed to the company has also been limited, and held to no longer apply in situations where the best interests duty requires directors to consider the interests of creditors.⁹⁶

The starting point to the changed approach in Commonwealth jurisprudence is the statement by Street CJ in *Kinsela v Russell Kinsela Pty Ltd (in liq)*:⁹⁷

⁹³ *BTI 2014 LLC v Sequana SA*, above n 59, at [143].

⁹⁴ *BTI 2014 LLC v Sequana SA*, above n 59, at [45] and [47]; *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 22, at 730.

⁹⁵ *BTI 2014 LLC v Sequana SA*, above n 59, at [47]-[48] and [56] per Lord Reed P and [130], [147] and [176] per Lord Briggs JSC. While Lady Arden uses the term "residual claimants" (see at [417], which should be read with [386]), this is different from the approach taken in Frank Easterbrook and Daniel Fischel *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, 1991) at 91. Easterbrook and Fischel suggest directors owe fiduciary duties to shareholders because, as residual claimants, shareholders have the best incentives to make optimal investment decisions. In contrast, the UKSC in *Sequana* suggest that directors owe fiduciary duties for the benefit of shareholders because of shareholders' economic interest in the residual assets of the company.

⁹⁶ *BTI 2014 LLC v Sequana SA*, above n 59, at [5] per Lord Reed P and [196] per Lord Briggs JSC.

⁹⁷ *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 22, at 730. For a similar approach in Delaware law (the leading United States jurisdiction for incorporation) see *Prod. Res. Group LLC v NCT Group Inc* 863 A 2d 772, 791 (Del Ch 2004): "The directors continue to have the task of attempting to maximize the economic value of the

In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.

Subsequent Commonwealth jurisprudence has been significantly influenced by *Kinsela*. The general approach taken in *Kinsela* of considering the economic interests in a company (being those of shareholders when the company is solvent, but those of both shareholders and creditors if the company is insolvent) was approved by the United Kingdom Supreme Court in *Sequana*.⁹⁸ In *Sequana*, the Supreme Court suggested that if a company is insolvent or bordering on insolvency the directors must, as part of the duty to act in the best interests of the company, consider the interests of creditors.

Lord Reed P in *Sequana* acknowledged the historical view was that the shareholders entrusted their property to the directors and conferred on them their powers of management.⁹⁹ However, his Lordship said that the ongoing justification for equating the interests of a company with those of its shareholders had changed, and now the justification was that the shareholders have an economic interest in the company's assets, based on their entitlement to its residual assets on liquidation.¹⁰⁰ He commented:¹⁰¹

So long as a company is financially stable, and is therefore able to pay its creditors in a timely manner, the interests of its shareholders as a whole, understood as a continuing body, can be treated as the company's interests for the purposes of the directors' duty to act in its interests.

firm. That much of their job does not change. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders – that of residual risk-bearers. Where the assets of the company are insufficient to pay its debts, and the remaining equity is underwater, whatever remains of the company's assets will be used to pay creditors...". See also *Quadrant Structured Prods Co v Vertin* 115 A 3d 535 at 546-547 (Del.Ch. 2015).

⁹⁸ *BTI 2014 LLC v Sequana SA*, above n 59, at [130]-[131] and [147]-[148] per Lord Briggs JSC and [31]-[35], [44]-[45], [51] and [79] per Lord Reed P.

⁹⁹ At [20].

¹⁰⁰ At [2]. See also Lady Arden at [386(i)].

¹⁰¹ At [47]. For a similar analysis under US law, see *Prod. Res. Group LLC v NCT Group Inc*, above n 97, at 787.

It is the shareholders whose interests are affected by fluctuations in its profits and reserves, as they are the persons entitled to share in its distributions and its surplus assets...

Lord Reed P then noted how the position changed on insolvency:¹⁰²

That situation alters if the company is insolvent or bordering on insolvency. As losses are incurred, and the company's surplus of assets over liabilities disappears, the company's creditors as a whole become persons with a distinct interest (possibly, depending on the gravity of the company's financial difficulties, the predominant interest) in its affairs, as they are dependent on its residual assets, or on the possibility of a turnaround in its fortunes, for repayment.

Lord Briggs SCJ's speech is consistent in adopting this change in trend.¹⁰³ His Lordship rejects the historical rationale from *Re Wincham* (which might equate shareholders with the company)¹⁰⁴, but accepts the approach of Street CJ in *Kinsela* that for a solvent company, the economic interest of shareholders entitles them to be treated as having the main interest in the company, but with this being subject to being displaced on insolvency.¹⁰⁵ He further said that once a company is insolvent then directors should balance the interests of shareholders and creditors based on a realistic appreciation of who has "the most skin in the game" up until the time when insolvent liquidation becomes inevitable (at which time creditor interests become paramount).¹⁰⁶

The Court in *Sequana* said that the case law relating to shareholder ratification of breaches of directors' duties also supported the argument that shareholders could be regarded as the equivalent of the company except where a company was insolvent or facing insolvency.¹⁰⁷

The Court in *Sequana* rejected an alternative justification for taking into account the interests of creditors in the case of an insolvent company suggested by Cooke J in the New Zealand Court of Appeal in *Nicholson v Permakraft (NZ) Ltd*. There, Cooke J suggested that taking into

¹⁰² At [48].

¹⁰³ At [139].

¹⁰⁴ At [134]-[135] and [139].

¹⁰⁵ At [130] and [147]. Following *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 22, at 730.

¹⁰⁶ At [176].

¹⁰⁷ At [136] per Lord Briggs JSC. See also Lord Reed P at [23], [37]-[42] and [91].

account the interests of creditors was justified by the fact that limited liability was a privilege.¹⁰⁸ However, the Court in *Sequana* rejected that justification as unpersuasive, saying:¹⁰⁹

The real rationale of limited liability is not to confer a privilege, but to encourage risk taking as an essential part of commercial enterprise.

The approach based on the economic interests of shareholders and creditors adopted in *Kinsela* and *Sequana* also has judicial support in the United States. For example, Vice-Chancellor of the Delaware Court of Chancery, Travis Laster, has referred to directors having a duty “to strive to maximize the value of the corporation for the benefit of its residual claimants”.¹¹⁰ This supports an approach of the duty being owed for the benefit of the residual risk bearers, which is usually the shareholders but in the case of insolvency can be creditors.

New Zealand Approach

The question then becomes whether New Zealand courts should adopt the same approach as that suggested in *Sequana*. As discussed above, the legislative intention behind the Act is unclear, and some parts of the Act suggest an entity-focused approach to what is meant by the interests of the company.

The company is legally a separate entity from its shareholders.¹¹¹ That has been established since *Salomon* and is now enshrined by statute in s 15 of the Act. In *Sequana*, Lord Briggs JSC rejected the proposition that the company could be seen “as an abstract equivalent of its shareholders” and suggested that instead the company was “a separate entity with its own interests and responsibilities”.¹¹²

¹⁰⁸ *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 at 250.

¹⁰⁹ *BTI 2014 LLC v Sequana SA*, above n 59, at [145] per Lord Briggs JSC. See also *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112; [2019] 2 All ER 784 (CA) at [151] per David Richards LJ. The NZ Law Commission took a similar view in its report leading to the passing of the Companies Act 1993: Law Commission, above n 1, at [22]. See also [11], [23] and [323] as to the Law Commission’s views as the economic and social value of the corporate form in permitting the aggregation of capital and the taking of business risks. The Parliamentary Debates relating to the Companies Bill similarly refer to the importance of the limited liability corporate form in enabling “a great deal of business investment, trade, and economic development to take place that otherwise would not have occurred, because people want to know their exact level of risk when they contribute to a company”: NZPD Vol 532, December 1992 (Hamish Hancock).

¹¹⁰ J Travis Laster “Revlon is a Standard of Review: Why it’s True and What it Means” (2013) Fordham J Corp & Fin L 5 at 25-26. See also *Prod. Res. Group LLC v NCT Group Inc*, above n 97, at 787. For an example of a US decision where the interests of creditors were considered relevant in the case of an insolvent company, see *Credit Lyonnais Bank Nederland, N.V. v Pathe Communications Corp* (1991) Del.Ch. LEXIS 215 at [108]-[109] and n 55.

¹¹¹ Watson, above n 62, at 211, 213 and 221, referring to it as “the central and foundational tenet of corporate law”.

¹¹² *BTI 2014 LLC v Sequana SA*, above n 59, at [139].

But that begs the question of what the interests of the company are. The reasoning of each of Lords Briggs, Reed and Hodge in *Sequana* suggests that directors only need to consider shareholder interests up until a company becomes insolvent, following which directors should balance the interests of shareholders and creditors. The approach in *Sequana* under which the interests of the company are associated with the company's shareholders until the company becomes insolvent was again followed by the United Kingdom Supreme Court in *Stanford International Bank v HSBC* where Lord Leggatt SCJ noted "in ordinary circumstances the interests of a company are equated with the interests of its present and future members".¹¹³

The *Sequana* and *Stanford* decisions of the United Kingdom Supreme Court read together suggest that:

- (a) for a solvent company, the interests of a company can be equated with the interests of the company's current and future shareholders, and;
- (b) for an insolvent company, the interests of a company can be equated with the interests of the company's shareholders and creditors, with those interests being balanced depending on the extent of financial strife of the company, and an appreciation of who has "the most skin in the game".

One potentially important distinction between New Zealand and the United Kingdom is that s 172 of the Companies Act 2006 (UK) (the statutory provision under consideration in *Sequana* and *Stanford*) refers to the duty of directors to "promote the success of the company for the benefit of its members as a whole", while s 131 of the New Zealand Act does not contain an express reference to the company's shareholders. However, as Lord Reed P noted in *Sequana*, the wording of s 172 simply "carried forward" the "common law approach of shareholder primacy" into the 2006 Act.¹¹⁴ Accordingly, to the extent that the New Zealand Parliament intended simply to codify the previous common law duty, the lack of an express reference to the company's shareholders in s 131 may not be significant. The case law in New Zealand

¹¹³ *Stanford International Bank Ltd (in liquidation) v HSBC Bank Plc* [2022] UKSC 34, [2023] AC 761 at [82].

¹¹⁴ *BTI 2014 LLC v Sequana SA*, above n 59, at [65]. See also *Hellard v Carvalho* [2013] EWHC 2876 (Ch) at [88] noting that s 172 "effectively codifies the pre-existing common law position". Section 170(3) of the Companies Act 2006 (UK) also confirms that the directors' duties set out in the Act are based on "common law rules and equitable principles".

applicable to the period before the Companies Act 1993 took effect was consistent with an approach under which a company's interests were associated with its shareholders.¹¹⁵

The New Zealand Supreme Court reserved its position as to the appropriate approach to the best interests duty in New Zealand in *Madsen-Ries v Cooper* (“*Debut Homes*”). There, Glazebrook J noted that the “traditional” view was that the best interests duty was fulfilled by directors acting in the best interests of shareholders as a whole. However, she also referred to competing approaches, being a stakeholder model (allowing directors to take into account the interests of those with some stake in the company alongside those of shareholders) and an entity model focusing on the company itself. However, it was not necessary for the purpose of the case before the Court for the Supreme Court to decide which model was correct.¹¹⁶

There are no New Zealand cases that adopt a stakeholder model.¹¹⁷ There is some relatively recent New Zealand case law at Court of Appeal level that is supportive of an entity-focused approach.¹¹⁸ The only appellate New Zealand authority reviewing the appropriate approach to the best interests duty since the United Kingdom Supreme Court decision in *Sequana* is the New Zealand Supreme Court decision in *Yan v Mainzeal Property and Construction Ltd (in liq)*. Although not a s 131 case, the Court does indicate in obiter that the New Zealand courts are likely to take a similar approach to the best interests duty to that taken in *Sequana*, with shareholder interests being relevant to a solvent company but creditor interests also being relevant in the case of a company that is insolvent or close to insolvency.¹¹⁹

In 2023, s 131 was amended to include a new subsection (5) which provides that “in considering the best interests of a company ... a director may consider matters other than the maximisation of profit (for example, environmental, social and governance matters)”. The potential implications of this amendment will be considered in Chapter 4, although the New Zealand Government has recently announced it intends to repeal s 131(5).¹²⁰

¹¹⁵ *H Timber Protection v Hickson* [1995] 2 NZLR 8 (CA) at 13; and *Pascoe Ltd v DFC Overseas Ltd* [1994] 3 NZLR 627 (HC) at 639. In Singapore, a shareholder-focused approach still applies under the common law: see Luh Luh Lan & Walter Wan “ESG and director’s duties: defining and advancing the interests of the company” (2024) 23 JCLS 537 at 541-543.

¹¹⁶ *Madsen-Ries v Cooper* [2020] NZSC 100, [2021] 1 NZLR 43 at [28]-[31].

¹¹⁷ See, however, the extrajudicial comments of Glazebrook J from the Supreme Court: Susan Glazebrook “Meeting the Challenge of Corporate Governance in the 21st Century” (2019) 34 AJCL 106.

¹¹⁸ *Arnerich v DHC Assets Ltd* [2021] NZCA 225 at [168]-[169].

¹¹⁹ *Yan v Mainzeal Property and Construction Ltd (in liq)* [2023] NZSC 113 at [142].

¹²⁰ Ministry of Business, Innovation & Employment *Modernising the Companies Act 1993 and Making Other Improvements for Business*, 31 July 2024, at [18].

As Glazebrook J noted in *Debut Homes*, the traditional view is to take a shareholder-focused approach to the best interests duty. A shareholder-focused approach is also consistent with cases such as *Kinsela* and *Sequana* which suggest that the duty should be owed for the benefit of the party with the residual claim to the company's assets. Such an approach is also consistent with the largely shareholder-focused scheme of the Companies Act 1993. Therefore, in this thesis, I will assume that a shareholder-focused approach to the best interests duty will likely continue to apply in New Zealand, at least in the case of a solvent company.

Assuming that New Zealand continues to take a shareholder-focused approach to the best interests duty, further consideration is required as to how precisely such an approach should work, consistent with the scheme and structure of the New Zealand companies legislation as set out above.

Connor and O'Beid suggest that scholars who favour shareholder primacy are in broad agreement on six matters;

- (a) First, the requirement for directors to focus on advancing shareholders' interests is only a default rule, and a company's constitution can set other goals for a company;
- (b) Secondly, directors' discretionary management decisions should focus exclusively on benefiting shareholder interests;
- (c) Third, shareholders' financial interests should be the primary interests directors seek to advance;
- (d) Fourth, directors should focus on providing long-term financial benefits to shareholders as a whole;
- (e) Fifth, directors can properly advance non-shareholder interests, provided they do so for the purpose of advancing shareholder interests;
- (f) Sixth, minority shareholders should be protected from oppression by the majority.¹²¹

¹²¹ Tim Connor and Andrew O'Beid "Clarifying Terms in the Debate regarding 'Shareholder Primacy'" (2020) 35 AJCL 276 at 287-288.

These propositions seem largely uncontroversial, though there may be some room for debate as to the extent to which directors should focus on the *long-term* interests of shareholders, particularly in situations involving a proposal for a takeover of a company or the sale of its business assets. Further, in a situation involving a company that is insolvent or near insolvency, there is high-level authority both in the United Kingdom and New Zealand supporting the view that directors must also take into account creditor interests.¹²²

However, as indicated above, there remains uncertainty as to whether a shareholder-focused approach is the correct one in New Zealand under the Act, with the legislation and recent case law providing some support for an entity-focused approach. As explained in Chapter 4, in most cases this will not make a difference to the validity of company contracts.

I turn next to the question of the consequences of a breach of the best interests duty in the context of a corporate transaction. The courts have frequently categorised the best interests duty as a fiduciary duty, and as discussed above, the Law Commission also described the duty as fiduciary. That categorisation leads to particular remedial implications under the law of equity, including remedies that may affect the validity of company contracts.

¹²² *BTI 2014 LLC v Sequana SA*, above n 59; *Madsen-Ries v Cooper*, above n 116, at [31] and [113]-[114].

Chapter 3- The Impact of a Breach of Section 131 in Equity

Breach of Fiduciary Duty gives rise to the Remedy of Rescission

Having discussed the background to the duty to act in the company's best interests, the next question is the impact on a contract entered into in breach of that duty.

A breach of fiduciary duty has important remedial consequences. Ordinarily, the remedy for breach of contract is damages. However, a breach of fiduciary duty gives rise to a number of equitable remedies that are not commonly available for breach of an ordinary contractual obligation.

In particular, rescission (avoidance) of the underlying transaction is one of the standard suite of remedies available in any case of a breach of fiduciary duty (unless the other party to the contract is innocent and gives value).¹ In *Chirnside v Fay*, Elias CJ noted that the pre-eminent remedies for breach of duties of loyalty were "rescission and profit-stripping through account".²

What exactly does the remedy of rescission involve? It gives the party entitled to the remedy, the ability to avoid (or set aside) the contract. The contract is voidable rather than void. It remains in force unless and until the company rescinds it.³

Where the equitable remedy of rescission applies, the party with the potential right to rescind has an election. They can either rescind (or avoid) the contract or affirm it. The election is final, so "once effectively rescinded, a contract cannot be resurrected by affirmation".⁴

Once rescinded, the contract is avoided *ab initio* on the basis that the parties should be put into the position that they were in before they entered into the contract.⁵ In the case of a partially-

¹ Generally, in relation to the remedy of rescission, see Dominic O'Sullivan, Steven Elliott and Rafal Zakrzewski *The Law of Rescission* (3rd ed., 2023, Oxford University Press); Janet O'Sullivan "Rescission as a self-help remedy: a critical analysis" (2000) 59 CLJ 509; Sarah Worthington "The Proprietary Consequences of Rescission" (2002) 10 RLR 28. The right to rescission can also be lost in other circumstances as discussed below at text to n 8.

² *Chirnside v Fay* [2006] NZSC 68; [2007] 1 NZLR 433 at [16]. See also Lionel Smith "Fiduciary relationships: ensuring the loyal exercise of judgement on behalf of another" (2014) 130 LQR 608 at 619-621 referring to rescission as the "primary remedy" for breach of fiduciary duty.

³ *Reese River Silver Mining Co v Smith* (1869) LR 4 HL 64 at 74; *UBS AG v Kommunale Wasserwerke Leipzig GMBH* [2017] EWCA Civ 1567 at [157]; *Nadinic v Drinkwater* [2017] NSWCA 114 at [32].

⁴ *De Molestina v Ponton* [2002] 1 Lloyd's Rep 271 (QB) at 292 ([8.4]).

⁵ O'Sullivan, Elliott and Zakrzewski, above n 1, at [13.01].

or wholly-executed contract, rescission will therefore require the parties to provide restitution of benefits already transferred under the contract.

While there are some differences between rescission at common law⁶ and at equity⁷, the rescission of contracts for breach of fiduciary duty is available only in equity.

The right of a company to avoid a contract for breach of fiduciary duty can be lost in a number of circumstances:⁸

- (a) Where the company has affirmed the contract;⁹
- (b) Where it is not possible to sufficiently restore the parties to their original positions (a concept referred to in the cases as *restitutio in integrum*);¹⁰
- (c) Where the company has delayed in exercising its right to avoid the contract for such a period that the company can be said to have impliedly affirmed the contract, or in such circumstances that the court should in its discretion refuse to grant the equitable remedy of rescission;¹¹
- (d) Where the other party to the contract is innocent i.e. is unaware of the breach of fiduciary duty;¹²
- (e) Where the rights of innocent third parties would be affected by avoidance of the contract (for example, where property the subject of the contract has been on-sold to a bona fide purchaser for value), though such cases may also be seen as one situation where it is impossible to effect restitution;¹³

⁶ Available in particular for fraudulent misrepresentation before the enactment of the Contractual Remedies Act 1979 (see now Part 2 subpart 3 of the Contract and Commercial Law Act 2017).

⁷ See O'Sullivan, Elliott and Zakrzewski, above n 1, at chapter 3 and [10.34]-[10.38].

⁸ *Robins v Incentive Dynamics Pty Ltd* [2003] NSWCA 71, (2003) 45 ACSR 244 at [73]; Andrew Griffiths *Contracting with Companies* (Hart Publishing, Oxford, 2005), at 173 and 296-300; Rosemary Langford *Company Directors' Duties and Conflicts of Interest* (Oxford University Press, 2019) at 12.3.5.

⁹ *Re Cape Breton Company* (1885) 29 ChD 795 (CA) at 803 and 805; *North-West Transportation Co v Beatty* (1887) 12 App Cas 589 (PC) at 593-594 and 600; *Peninsular & Oriental Steam Navigation Co v Johnson* (1938) 60 CLR 189 (HCA) at 248 per Dixon J. See also Chapter 8.

¹⁰ *Peninsular & Oriental Steam Navigation Co v Johnson*, above n 9, at 212-213 per Latham CJ and 246 per Dixon J (HCA). For an example of a case where inability to provide restitution would have led to loss of the right of rescission of a contract entered into in breach of fiduciary duty, see *Maguire v Makaronis* (1997) 188 CLR 449 (HCA).

¹¹ *Peninsular & Oriental Steam Navigation Co v Johnson*, above n 9, at 205 per Latham CJ.

¹² See, for example, *Pine Vale Investments Ltd v East Ltd* (1983) 8 ACLR 199 (Supreme Court of Queensland) at 211. There is an exception where a transaction is not for value, in which case the transaction can be avoided even if the third party is innocent: Ross Grantham "Contracting with Companies: Rule of Law or Business Rules?" (1996) 17 NZULR 39 at 58.

¹³ *Clough v London and North Western Railway Co* (1871) LR 7 Ex 26 at 35; *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700 (Ch) at 762-763; *Estate Realties Ltd v Wignall* [1992] 2 NZLR 615 (HC) at 631; *Latec Investments Ltd v Hotel Terrigal Pty Ltd (in liq)* (1965) 113 CLR 265 (HCA) at 277; *Crystal Palace*

- (f) Potentially, in the wider discretion of the court, such as where the court considers that to rescind a transaction would, in the particular circumstances, be unfair and disproportionate.¹⁴

In terms of the remedies at equity for breach of fiduciary duty, I will focus primarily on the remedy of rescission of a contract. However, potential liability for knowing receipt or dishonest assistance on a party contracting with the company is also of significant importance when considering contractual certainty. Such liability may arise in circumstances where a director has caused a misapplication of company property in breach of fiduciary duty as long as the other party has sufficient knowledge of the breach of fiduciary duty.¹⁵

There is no good policy reason why the standard suite of remedies for the breach of one fiduciary duty (the duty to act in the best interests of the company) should be any different than they are for the breach of other fiduciary duties. In the case of those other fiduciary duties, a commonly accepted remedy is that the transaction is voidable.

The courts have held that a breach of fiduciary duty gives rise to a remedy of rescission (i.e., the breaches make the transaction voidable) in relation to breaches of each of the following fiduciary duties:

- (a) Breach of directors' fiduciary duty to act for proper purposes (discussed further below);
- (b) Breach of directors' fiduciary duty to avoid conflicts of interest (also discussed below, although in New Zealand rescission on this ground is now only available under s 141 Companies Act 1993, and no longer at equity);

FC (2000) Ltd v Dowie [2007] EWHC 1392; [2007] IRLR 682 (where the Court refused rescission of a compromise agreement between Crystal Palace and Mr Dowie because this would interfere with the rights of Coventry City who now employed Mr Dowie); *Tennent v The City of Glasgow Bank and Liquidators* (1879) 4 App Cas 615 (HL Sc) at 620-621.

¹⁴ See *Hurstanger Ltd v Wilson* [2007] EWCA Civ 299, [2007] 1 WLR 2351 at [50]. The discretion to refuse to grant rescission where this would be unfair and disproportionate was also confirmed in *UBS AG v Kommunale Wasserwerke Leipzig GmbH*, above n 3, at [157] and [162] but not exercised in that case by the majority: at [167]-[168]. In dissent, Gloster LJ would have accepted the submission that it was disproportionate to allow rescission: at [374]. See also O'Sullivan, Elliott and Zakrzewski, above n 1, at [28.36]. Contrast *De Molestina v Ponton*, above n 4, at [6.3] where Colman J said the remedy of rescission "is not fettered by some overriding equitable test as to whether the consequences will work unfairly" to the party whose misconduct has caused the contract to be voidable.

¹⁵ *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* (1997) 26 ACSR 544 (Supreme Court of Victoria) at 579; *Robins v Incentive Dynamics Pty Ltd (in liq)*, above n 8.

- (c) Breach of a fact-based fiduciary duty owed by directors to shareholders on the facts of particular cases;¹⁶
- (d) Breach of fiduciary duty owed by the promoters of a company;¹⁷
- (e) Breach of fiduciary duty by broker;¹⁸
- (f) Breach of fiduciary duty by solicitor;¹⁹
- (g) Breach of fiduciary duty by partner;²⁰
- (h) Breach of fiduciary duty by trustees in cases relying on the rule in *Hastings-Bass*;²¹
- (i) Breach by a trustee of a duty of loyalty in the case of self-dealing by a trustee;²²
- (j) Breach of fiduciary duty owed in a family situation.²³

The equitable principles developed as to the appropriate suite of available remedies for breaches of fiduciary duty should be the same in each case. One of those accepted remedies is that the underlying transaction is considered voidable.

Commentators agree that after the passing of the Companies Act 1993, companies continue to have available the full range of remedies for breach of directors' duties, including equitable rights of avoidance of transactions entered into in breach of fiduciary duty.²⁴

¹⁶ *Coleman v Myers* [1977] 2 NZLR 225 (CA).

¹⁷ *Erlanger v New Sombrero Phosphate Co* (1878) 3 App Cas 1218, [1874-80] All ER Rep 271 (HL). See also *Lagunas Nitrate Company v Lagunas Syndicate* [1899] 2 Ch 392 (CA), at 440-441, 450-451 and 460 per Rigby LJ (dissenting) holding that the promoters had breached their fiduciary duty in that case, making the agreement voidable in equity and that the agreement should be rescinded. The majority did not agree that there was a breach of fiduciary duty.

¹⁸ *Daly v The Sydney Stock Exchange* (1986) 160 CLR 371 (HCA); *Estate Realities Ltd v Wignall*, above n 13, at 627 and 631; *Armstrong v Jackson* [1917] 2 KB 822; *Hurstanger Ltd v Wilson*, above n 14, at [34], [38], and [46].

¹⁹ *Maguire v Makaronis*, above n 10, at 467; *Clark Boyce v Mouat* [1994] 1 AC 428 (PC, New Zealand) at 437.

²⁰ *Law v Law* [1905] 1 Ch 140 (CA) at 157.

²¹ *Pitt v Holt* [2013] 2 AC 108 (HL) at [43] and [93].

²² *Fenwick v Naera* [2015] NZSC 68, [2016] 1 NZLR 354 at [70] where Glazebrook J noted that the position at equity where a trustee sold property to him or herself was to make the transaction voidable by a beneficiary.

²³ *D v A* [2022] NZCA 430, [2022] 3 NZLR 566 at [110]-[119] per Collins J. However, the majority (Kós P and Gilbert J) held that there was no fiduciary duty owed at the time of the relevant transaction. The Supreme Court did not address the issue: *A v D* [2024] NZSC 161.

²⁴ Neil Campbell "Does the Companies Act codify remedies?" [2001] CSLB 53 at 54; Grantham, above n 12, at 59.

Campbell has noted that the preservation of the right of avoidance was subject only to ss 18(1) and 141 of the Act.²⁵ He said that s 141 had altered the criteria for the remedy of avoidance in cases where a company seeks avoidance on the ground of a director's interest in the transaction. In relation to s 18(1), Campbell noted that the proviso to s 18(1) codified, and possibly altered, the rules relating to the protection of bona fide third parties in relation to transactions impugned by a breach of directors' duties. Section 18(1)(a) prevents a company from asserting against a third party that the Act has not been complied with. I will discuss the implications of ss 18(1) and 141 in Chapter 8.

Is the Duty to Act in the Best Interests of the Company a Fiduciary Duty?

Millett J has said "The distinguishing obligation of a fiduciary is the obligation of loyalty."²⁶ Millett J's approach was quoted with approval in New Zealand by Elias CJ in *Chirnside v Fay*.²⁷

It is accepted in Commonwealth jurisprudence that not all duties owed by directors are fiduciary duties. In particular, a breach of a director's duty of care is not considered a breach of fiduciary duty.²⁸ As Ipp J commented in *Permanent Building Society v Wheeler*, the duty of care and skill is "not a duty that stems from the requirements of trust and confidence imposed on a fiduciary".²⁹

However, the directors' duty to act in the company's best interests is such a duty. It does stem from the requirement of trust and confidence imposed on a director. As discussed in Chapter 2, the duty developed out of case law under which the courts considered directors to be trustees for the company.

As Langford comments, the duty to act bona fide in the interests of the company is central to the fiduciary loyalty of company directors.³⁰

²⁵ Campbell, above n 24, at 53-54.

²⁶ *Bristol and West Building Society v Mothew* [1998] Ch 1 (CA) at 18. See also at 19-21.

²⁷ *Chirnside v Fay*, above n 2, at [15]-[16].

²⁸ *Bristol and West Building Society v Mothew*, above n 26, at 17 following *Permanent Building Society v Wheeler* (1994) 14 ACSR 109 at 158; *Motorworld Ltd (in liq) v Turners Auctions Ltd* [2010] NZCCLR 30 (HC) at [100]; *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)*, above n 15, at 580; *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2024] AC 211 at [74] per Lord Reed P.

²⁹ *Permanent Building Society v Wheeler*, above n 28, at 158.

³⁰ Rosemary Langford "The Duty of Directors to act Bona Fide in the Interests of the Company: A Positive Fiduciary Duty- Australia and the UK Compared" (2011) 11 JCLS 215 at 234. See also at 217.

English case law refers to the duty as “the fundamental duty to which a director is subject”³¹ and as a fiduciary duty³². Similarly, Popplewell J has said:³³

It is trite law that a director owes a duty to the company to act in what he honestly considers to be the interests of the company. This may be regarded as the core duty of a director. It is a fiduciary duty because it is a duty of loyalty.

Legislation in the United Kingdom has confirmed the duty’s status as a fiduciary duty. Section 178(2) Companies Act 2006 states that the duty in s 172 to promote the success of the company is “enforceable in the same way as any other fiduciary duty owed to a company by its directors”.

The United Kingdom Supreme Court in *Sequana* recently confirmed that the best interests duty is a fiduciary duty. Lord Reed P referred to the duty as “the long-established fiduciary duty to act in good faith in the interests of the company”.³⁴ The Court was aware of the different remedial consequences of a breach of fiduciary duty, referring to “the wide range of remedies available in equity for the breach of a fiduciary duty”³⁵ and specifically referring to the potential liability of third parties for knowing receipt³⁶.

In Australia, the Supreme Court for South Australia (Full Court) has said, “[t]he duty is so fundamental and has been established for so long as a fiduciary duty that it has been described as a trite proposition”.³⁷ In New Zealand, the Supreme Court recently confirmed in *Yan v Mainzeal* that the s 131 duty is the “core fiduciary duty” of directors.³⁸

Accordingly, the modern English, Australian and New Zealand case law consistently describes the duty to act in the company’s best interests as a fiduciary duty. Similarly, the duty is consistently referred to as a fiduciary duty under United States corporation law. For example,

³¹ *Item Software (UK) Ltd v Fassihi* [2005] 2 BCLC 91 (CA) at [41].

³² *Shepherds Investments Ltd v Walters* [2007] 2 BCLC 202 (Ch) at [106]. See also Langford, above n 30, at 220: “The duty is consistently classified as a fiduciary duty in English case law and company law texts”. See also at 234.

³³ *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm) at [188].

³⁴ *BTI 2014 LLC v Sequana SA*, above n 28, at [77]. See also at [1], [74], [79] per Lord Reed P, [207] per Lord Hodge DPSC and [258], [414] and [415] per Lady Arden.

³⁵ *BTI 2014 LLC v Sequana SA*, above n 28, at [94(iv)] per Lord Reed P.

³⁶ *BTI 2014 LLC v Sequana SA*, above n 28, at [101(vii)] per Lord Reed P.

³⁷ *Southern Real Estate Pty Ltd v Dellow and Arnold* [2003] SASC 318; (2003) 87 SASR 1 at [22]. See also Langford, above n 30 at 224: “As in England, the duty to act bona fide in the interests of the company has traditionally been classed as a fiduciary duty in company law texts and commentaries. Many Australian cases have imposed the duty as a fiduciary duty...”

³⁸ *Yan v Mainzeal Property and Construction Ltd (in liq)* [2023] NZSC 113 at [117]. To the same effect, see Goddard J in the Court of Appeal: *Yan v Mainzeal Property and Construction Ltd (in liq)* [2021] NZCA 99 at [210].

in *Unocal Corp v Mesa Petroleum Co*, the Supreme Court of Delaware said, “corporate directors have a fiduciary duty to act in the best interests of the corporation’s stockholders”.³⁹

Argument that Best Interests Duty is not Fiduciary

Nevertheless, Conaglen has suggested that true fiduciary duties are only those that prohibit certain actions, such as a fiduciary’s duty not to allow their interest to conflict with their duty, and a fiduciary’s duty not to make a profit out of their position.⁴⁰ Conaglen suggests that a fiduciary’s duty of good faith, duty to act in a principal’s best interests, and duty to act for proper purposes are not peculiarly fiduciary duties.⁴¹

However, Conaglen conflates the test for a director’s duty to act in the company’s best interests with the test for breach of the duty of care. He suggests that the duty of fiduciaries to act in the best interests of a principal “appears to be another way of stating the duty of care that most fiduciaries owe”.⁴² In relation specifically to company directors, he suggests acting incompetently amounts to a breach of the duty to act in the best interests of the company and asserts that the duty is not a fiduciary duty.⁴³

However, acting incompetently (or even in a way that is grossly negligent) is insufficient to amount to a breach of the duty to act in the best interests of the company (at least in New Zealand or English law).⁴⁴ Instead, what is required is bad faith, acting contrary to the interests of the company, or failing to consider the interests of the company.⁴⁵ That is disloyal conduct that one can properly categorise as a breach of fiduciary duty, and in fact of the fundamental and most important fiduciary duty owed by directors.

³⁹ *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (Del 1985) at 955.

⁴⁰ Matthew Conaglen “The Nature and Function of Fiduciary Loyalty” (2005) 121 LQR 452 at 456-460; Matthew Conaglen *Fiduciary Loyalty* (Hart Publishing, Oxford, New York, 2010), chapter 3. See also Robert Flannigan “The Adulteration of Fiduciary Doctrine in Corporate Law” (2006) 122 LQR 449. Flannigan considers the duty to act in the company’s best interests a duty under agency law and not a fiduciary duty. For criticism of Conaglen’s approach, see Rebecca Lee “In Search of the Nature and Function of Fiduciary Loyalty: Some Observations on Conaglen’s Analysis” (2007) 27 OJLS 327.

⁴¹ Conaglen “The Nature and Function of Fiduciary Loyalty”, above n 40 at 456-458; Conaglen *Fiduciary Loyalty*, above n 40, at 40-44 (duty of good faith), 54-58 (duty to act in principal’s best interests) and 44-49 (duty to act for proper purposes).

⁴² Conaglen *Fiduciary Loyalty*, above n 40, at 55.

⁴³ Conaglen *Fiduciary Loyalty*, above n 40, at 66.

⁴⁴ *Motorworld Ltd (in liq) v Turners Auctions Ltd*, above n 28, at [100]-[101]. See also *Extrasure Travel Insurance Ltd v Scattergood*, [2002] EWHC 3093 (Ch), [2003] 1 BCLC 598 at [89] suggesting even “crass incompetence” does not give rise to a claim for breach of fiduciary duty and *BTI 2014 LLC v Sequana SA*, above n 26, at [74] per Lord Reed P.

⁴⁵ *Madsen-Ries v Cooper* [2020] NZSC 100, [2021] 1 NZLR 43 at [112]-[114].

As Millett LJ has said:⁴⁶

Breach of fiduciary obligation, therefore connotes disloyalty or infidelity. Mere incompetence is not enough. A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty.

Conaglen's view is likely affected by some cases in Australia that suggest an objective approach to the best interests duty, allowing a court to find a breach of the duty when it considers that an intelligent and honest person could not reasonably have believed that action was in the interests of the company.⁴⁷ As discussed in Chapter 4, an objective approach to the duty to act in the best interests of the company is not consistent with the wording of s 131.

In support of his argument that fiduciary duties are only those that prohibit certain actions, Conaglen cites *Attorney-General v Blake* and *Breen v Williams*.⁴⁸ It should be noted that those cases concerned quite different kinds of relationships to that of director and company. *Breen v Williams* involved a failed attempt to impose a positive fiduciary obligation on a doctor to grant access to his notes to a patient. In *Attorney-General v Blake*, the argument was that a former officer of the British Secret Intelligence Service owed a fiduciary duty to submit a manuscript to the authorities for clearance.⁴⁹ Langford comments that the approach taken in *Breen* may not apply to status-based fiduciary relationships such as between director and company.⁵⁰

The case law does not support Conaglen's argument that the best interests duty should not be considered fiduciary. Owen J specifically discussed the argument in some detail in *Westpac Banking Corp v The Bell Group*. He held that the duty to act in the interests of the company and the duty to exercise powers for a proper purpose stemmed from a fundamental requirement for loyalty⁵¹ and that a breach of those duties amounted to a breach of a fiduciary duty.⁵²

⁴⁶ *Bristol and West Building Society v Mothew*, above n 26, at 18. See also *Extrasure Travel Insurance Ltd v Scattergood*, above n 44, at [89]: "Fiduciary duties are concerned with concepts of honesty and loyalty, not with competence."

⁴⁷ See discussion in Chapter 4, and in particular *Mernda Developments Pty Ltd v Alamanda Property Investments No 2 Pty Ltd* [2011] VSCA 392, (2011) 86 ACSR 277 at [32]-[33] and [45].

⁴⁸ Conaglen "The Nature and Function of Fiduciary Loyalty", above n 40, at 474 citing *Attorney-General v Blake* [1998] Ch 439 at 455 (CA) and *Breen v Williams* (1996) 186 CLR 71 (HCA), at 94-95, 113 and 137-138.

⁴⁹ This argument was not discussed by the House of Lords on appeal: *Attorney-General v Blake* [2001] 1 AC 268 (HL).

⁵⁰ Langford, above n 30, at 231. In relation to *Breen*, see also the comments of Lee AJA in *Westpac Banking Corp v The Bell Group* (No 3) [2012] WASCA 157, (2012) 89 ACSR 1 at [900].

⁵¹ *The Bell Group v Westpac Banking Corp* (No.9) [2008] WASC 239 at [4574].

⁵² At [4582].

On appeal, the Western Australia Court of Appeal also accepted that the best interests duty was a fiduciary duty. Drummond AJA concluded that the best interests duty and duty to act for proper purposes were “necessarily fiduciary obligations”.⁵³ Drummond AJA said that “long established authority” requires that the duty of company directors to act bona fide in the interests of the company be accepted as a fiduciary one even though it may require the directors to take positive action.⁵⁴ Lee AJA also on several occasions referred to breaches of the duties to act in the best interests of each company, and not to exercise powers for improper purposes, as being breaches of fiduciary duties.⁵⁵

The courts have commonly held breaches of the director’s duty to act in the best interests of the company give rise to equitable remedies such as an account of profits⁵⁶, the imposition of liability on third parties for “knowing receipt” or “dishonest assistance”⁵⁷, and rescission of contracts⁵⁸.

Nor have the cases in which the courts have considered such remedies are available been limited to cases where directors have had a personal interest in the transaction. For example, in *Cowan de Groot Properties Ltd v Eagle Trust plc*, Knox J accepted that the deliberate or reckless sale of company properties at an undervalue (to a purchaser that the directors were not associated with) amounted to a breach of fiduciary duty, and that the purchaser (who had on-sold the properties) would have had liability under principles of knowing receipt or dishonest assistance if the Court had found the purchaser to have sufficient knowledge of the breach of fiduciary duty.⁵⁹ In New Zealand, in *Bishop Warden Property Holdings Ltd v Autumn Tree Ltd*, the Court of Appeal commented that the sale by a director of a company’s property at substantial undervalue (to a party that the director had no apparent association with) was a

⁵³ *Westpac Banking Corp v The Bell Group* (No 3), above n 50, at [1956]. See also at [1947]-[1954].

⁵⁴ At [1978].

⁵⁵ For example, at [1012] and [1068].

⁵⁶ *Sojourner v Robb* [2007] NZCA 443, [2008] 1 NZLR 751; *City & Suburban Pty Ltd v Smith* (1998) 28 ACSR 328 at 333-334 (FCA).

⁵⁷ *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)*, above n 15; *Cowan de Groot Properties Ltd v Eagle Trust plc*, above n 13; *Madoff Securities International Ltd (in liq) v Raven*, above n 33, at [347]-[373]; *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465 at 472 and 478-479 (NSWCA). See also Langford, above n 30 at 235, and cases at n 100.

⁵⁸ *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA); *Westpac Banking Corporation v The Bell Group* (No 3), above n 50; *Mernda Developments Pty Ltd v Alamanda Property Investments No 2 Pty Ltd*, above n 47, at [47]-[48] and [56]; *Netglory Pty Ltd v Caratti* [2013] WASC 364 at [364], [389]-[391] and [759]; *Australian Growth Resources Corporation Pty Ltd (Recs and Mgrs apptd) v Van Reesma* (1988) 13 ACLR 261 (SCSA) at 271; *Lindgren v L & P Estates Ltd* [1968] 1 Ch 572 (CA).

⁵⁹ *Cowan de Groot Properties Ltd v Eagle Trust plc*, above n 13, at 752 and 760-761.

breach of fiduciary duty which would have made the contract voidable in equity but for the fact that the contract had already been held void for lack of authority as a matter of agency law.⁶⁰

Accordingly, it is well-established that a breach of the duty to act in the company's best interests is a breach of fiduciary duty, and that it gives rise to the standard remedies available for such a breach, including rescission of contracts.

Nor is there any good reason to limit the equitable remedies applicable to a breach of fiduciary duty to situations involving conflicts of interest by directors. Directors' actions can be just as disloyal, and just as damaging, even where they are not motivated by financial self-interest.

Voidable not Void

The remedy of rescission makes a contract voidable. As discussed above, a voidable contract is valid unless and until the company rescinds it.⁶¹ Further, the company loses the right to rescind if it has affirmed the contract or if the parties cannot be put back in their original position. There is also no right to avoid the contract if the other party to the contract was innocent of the circumstance that would otherwise give rise to the remedy of rescission (in this case, if the other contracting party did not know about the breach of fiduciary duty).

However, some commentators take the view that a breach of the best interests duty makes the underlying transaction *void* in equity rather than voidable, which would make a substantial difference in how the transaction is treated. As Arden LJ noted in *Clark v Cutland*, the consequence of holding a contract void is "more serious in law than that which attaches to a transaction which is voidable since the right to rescind a voidable transaction can be lost".⁶²

A void contract has no legal effect unless ratified (adopted) by the company.⁶³ For example, at common law, a contract beyond the actual authority of a corporate agent is void. That invalidity does not depend on the company giving notice.⁶⁴ The contract is at an end, and the third party will be required to return amounts paid under the contract.⁶⁵

⁶⁰ *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809 at n 3.

⁶¹ Griffiths, above n 8, at 278.

⁶² *Clark v Cutland* [2003] EWCA Civ 810, [2004] 1 WLR 783 at [27].

⁶³ Griffiths, above n 8, at 173.

⁶⁴ Griffiths, above n 8, at 173.

⁶⁵ *Guinness Plc v Saunders* [1990] 2 AC 663 (HL).

In *Bowstead and Reynolds on Agency*, the authors claim that “active disloyalty in the agent” makes the contract “void at equity” rather than voidable.⁶⁶ Watts, the general editor of *Bowstead*, expresses similar views elsewhere where he says:⁶⁷

It is suggested that the English approach is to be preferred, that corrupt transactions are void at equity (whatever their status at law) and not just voidable, so that the more restrictive requirements of rescission are not applicable.

Watts relies on an article by Nolan to suggest that a breach of the duty to act in the best interests of the company makes a transaction void.⁶⁸ Nolan does suggest a transaction is void where the third party has knowledge of a director’s bad faith.⁶⁹ However, here Nolan is not asserting that the transaction is void *in equity*. For the proposition that the contract is void, not voidable, where the third party has notice of the director’s bad faith, Nolan cites *Jyske Bank (Gibraltar) Ltd v Spjeldnaes*.⁷⁰ *Jyske* is an actual authority case. Accordingly, Nolan’s proposition must be that actual authority at law is negated when the third party knows that the director acted in bad faith.

The cases cited by *Bowstead*⁷¹ and *Watts, Campbell and Hare*⁷² are either:

- (a) actual authority cases;⁷³
- (b) cases involving illegality, and therefore likely lack of actual authority;⁷⁴
- (c) cases that don’t clearly address the issue of whether a breach of the best interests duty makes a transaction void or voidable;⁷⁵ or

⁶⁶ Peter Watts and FMB Reynolds (ed) *Bowstead and Reynolds on Agency* (23rd ed, Thomson Reuters, London, 2024) at 8-221.

⁶⁷ Peter Watts, Neil Campbell and Christopher Hare *Company Law in New Zealand* (2nd ed, LexisNexis, Wellington, 2016) at [13.6], 429 contrast Peter Watts “Ultra Vires Further Considered: The Rolled Steel Case and the Memorandum of Association in New Zealand Company Law” [1986] NZLJ 270 at 274.

⁶⁸ RC Nolan “Controlling Fiduciary Power” (2009) 68 CLJ 293.

⁶⁹ At 318.

⁷⁰ *Jyske Bank (Gibraltar) Ltd v Spjeldnaes* [1999] EWCA Civ 2018 (cited by Nolan as *Heinl v Jyske Bank* [1999] Lloyd’s Rep Bank 511).

⁷¹ Watts and Reynolds, above n 66, at [8-221] and n 1589.

⁷² Watts, Campbell and Hare, above n 67, at [13.6] and n 190.

⁷³ *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246 (CA); *Guinness Plc v Saunders*, above n 65; *O’Connell v LPE Support Ltd (in liq)* [2022] EWHC 1672 (Ch), [2023] 1 BCLC 382; *Oak Forest Partnership Ltd (in liq) v Mercantile Investment Holdings SA* [2023] EWHC 1903 (Ch).

⁷⁴ *Belmont Finance Corporation v Williams Furniture Ltd (No. 2)* [1980] 1 All ER 393 (CA).

⁷⁵ *JJ Harrison (Properties) Ltd v Harrison* [2001] EWCA Civ 1467; *Houghton v Fayers* [2000] 1 BCLC 511; *Belmont Finance Corporation v Williams Furniture Ltd (No. 2)*, above n 74.

- (d) in one case, a case that relies entirely on earlier commentary by *Bowstead* itself, does not provide independent support for the proposition and is anomalous.⁷⁶

In particular, Watts cites *Belmont Finance Corporation v Williams Furniture Ltd (No. 2)*⁷⁷ and *Houghton v Fayers*⁷⁸ as supporting the proposition that “corrupt transactions are void at equity”.⁷⁹ Neither case directly stands for that proposition. Both are cases involving liability in knowing receipt. I apprehend that Watts argues that each case suggests that the transaction must be considered void in equity because the finding of liability for knowing receipt can only be explained if the transaction is void.⁸⁰ In my view, that does not follow.

In the case of *Belmont*, the transaction was illegal (made in breach of the rules in the Companies Act 1985 (UK) prohibiting financial assistance in relation to the purchase of shares) and therefore likely void for that reason. Even if that were not the case, I am not convinced that liability for knowing receipt depends on the relevant transaction being set aside.⁸¹

The test for knowing receipt requires there to have been a breach of fiduciary duty, for the third party to have received assets that represent the assets of the party to whom the duty was owed, and for the third party receiving the assets to be aware of the breach of fiduciary duty.⁸² That test can be met regardless of whether the underlying transaction happens to be void or voidable. That was also the view of Arden LJ in *Clark v Cutland*, where her Ladyship held that to establish constructive trust liability (for knowing receipt) in that case, it did not matter whether the payments in question were void or voidable.⁸³ All that mattered was that the director in that case (Mr Cutland) had acted in breach of his fiduciary duty to the company, and that the recipients of the fund had notice of the company’s claim.

⁷⁶ *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch).

⁷⁷ *Belmont Finance Corporation v Williams Furniture Ltd (No. 2)*, above n 74.

⁷⁸ *Houghton v Fayers*, above n 75.

⁷⁹ Watts, Campbell and Hare, above n 67, at [13.6], 429.

⁸⁰ Peter Watts “Constructive trusts and insolvency” (2009) 3 *Journal of Equity* 250 at 258.

⁸¹ Olivia Morris “Great Investments and Good Returns: Knowing Receipt as an Equitable Wrong Independent of Contract” (2023) 46 *Melb ULR* 502 at 521, 533-534 and 545. Contrast Matthew Conaglen and Richard Nolan “Contracts and knowing receipt: principles and application” (2013) 129 *LQR* 359. There is some Australian authority suggesting that rescission is required before liability in knowing receipt applies: *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd* (1996) 39 *NSWLR* 143 (NSWCA) at 153; *Robins v Incentive Dynamics Pty Ltd*, above n 8, at [73] per Mason P and [82] per Giles JA; *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6, (2012) 287 *ALR* 22 at [254] and [277]-[279]. However, note the suggestion at [281] that there may need to be a review of the requirement for rescission in this setting.

⁸² *El Ajou v Dollar Land Holdings plc* [1994] 2 *All ER* 685 at 700; *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 *AC* 378 (PC, Brunei).

⁸³ *Clark v Cutland*, above n 62, at [28]. See also *Courtwood Holdings SA v Woodley Properties Ltd* [2018] EWHC 2163 (Ch) at [201] confirming a claim in knowing receipt can arise with a voidable transfer.

The recent decision of the United Kingdom Supreme Court in *Byers v Saudi National Bank* suggests that a claim in knowing receipt cannot occur where the claimant's equitable beneficial interest in property has been extinguished (for example, when a bona fide purchaser for value has taken title to the property).⁸⁴ However, in cases where property is transferred in breach of fiduciary duties by directors, the company is considered to have a continuing equitable interest in the property.⁸⁵ Further, a company's equitable interest in the relevant property is not extinguished where there is a voidable transfer to a person who is not a bona fide purchaser for value.⁸⁶

The only case cited by *Bowstead* and Watts that clearly supports the proposition that a breach of the best interests duty makes a transaction void, rather than voidable, in equity is *GHLM Trading Ltd v Maroo*.⁸⁷ However, the support based on that case is entirely circular. The reasoning in *Maroo* is based almost entirely on the text from the then-current edition of *Bowstead*. The judgment in *Maroo* does not give any principled reason why a transaction should be considered void rather than voidable at equity.

In *Maroo*, Newey J states:⁸⁸

The better view appears to be that, where a director has caused his company to enter into a contract in pursuit of his own interests, and not in the interests of the company, its members or (where appropriate) its creditors as a class, and the other contracting party had notice of that fact, the contract is void rather than voidable.

Newey J cites *Bowstead* in support. The only supporting case law cited by Newey J in *Maroo* is *Jyske Bank (Gibraltar) Ltd v Spjeldnaes* and *Hopkins v Dallas*. Those cases are both actual authority cases (see Chapters 5-6). They do not support the proposition that the transaction should be considered void in equity.

Other English authority supports the proposition that a breach of best interests duty only makes a contract voidable. In *Boulting v Association of Cinematograph, Television and Allied Technicians*, Diplock LJ in the Court of Appeal said:⁸⁹

⁸⁴ *Byers v Saudi National Bank* [2023] UKSC 51 at [2]-[4] and [8] per Lord Hodge, [18]-[27] and [97] per Lord Briggs, and [155]-[156], [171]-[172] and [201] per Lord Burrows.

⁸⁵ At [49] and [60]-[61] per Lord Briggs and [177]-[188] per Lord Burrows.

⁸⁶ At [189]-[196] per Lord Burrows. See also the passage from *Courtwood*, cited by Lord Burrows at [127].

⁸⁷ *GHLM Trading Ltd v Maroo*, above n 76, at [171].

⁸⁸ At [171].

⁸⁹ *Boulting v Association of Cinematograph, Television and Allied Technicians* [1963] 2 QB 606 (CA) at 648.

It is not in my view necessary in the present case to canvass and define the classes of contracts which are affected by the rule of law that it is the paramount duty of a director of a company so as to act as best to promote its interest. But contracts which do fall within these classes are not void- at most they are voidable at the option of the company to whom the duty is owed.

Further English authority suggesting that a breach of the duty to act in the best interests of the company makes a transaction voidable includes *Clark v Cutland* and the famous old case of *Foss v Harbottle*.⁹⁰

Recent New Zealand appellate authority also supports the proposition that breach of the best interests duty makes a transaction voidable in equity. Thomas J said in *Autumn Tree* (admittedly only in a footnote):⁹¹

As discussed at the hearing, on the facts alleged by Autumn Tree, Autumn Tree would have had the right to set aside the transaction as voidable for breach of Tina's fiduciary duty as a director in failing to act in the best interests of Autumn Tree.

There are also many Australian cases supporting the proposition that a transaction in breach of the best interests duty is voidable in equity. In the High Court of Australia in *Richard Brady Franks Ltd v Price*, Dixon J said:⁹²

a transaction carried out by directors for their own or some other persons' benefit and not to further any purpose of the company is voidable but not void.

Numerous other Australian decisions have followed this approach.⁹³ Australian cases in which contracts have been held voidable for breach of the best interests duty have included cases involving a put and call option agreement in relation to shares⁹⁴, securities given to a bank⁹⁵, a

⁹⁰ *Clark v Cutland*, above n 62, at [27]; *Foss v Harbottle* (1843) 67 ER 189 at 203, 2 Hare 460 at 493. See also Lawton LJ's judgment in *Rolled Steel v British Steel*, above n 73, at 308-309.

⁹¹ *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 60, at n 3.

⁹² *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 (HCA) at 142.

⁹³ See, for example, *Grimaldi v Chameleon Mining NL (No 2)*, above n 81, at [254] and *Netglory Pty Ltd v Caratti*, above n 58, at [389]-[391] where Edelman J considered the previous High Court of Australia case law and concluded that the correct analysis was to hold a transaction in breach of directors duties voidable rather than void. Both *Grimaldi* and *Netglory* were cases involving breach of the best interests duty.

⁹⁴ *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd*, above n 81, at 152-153 (NSWCA). However, the company had lost the right to avoid because restoring the parties to their original position was no longer possible.

⁹⁵ *Mernda Developments Pty Ltd v Alamanda Property Investments No 2 Pty Ltd*, above n 47, at [45]-[48]; *Westpac Banking Corporation v The Bell Group (No 3)*, above n 50, at [1129]-[1145] per Lee AJA and [2668]-[2671] per Drummond AJA. At first instance, Owens J considered the question of the appropriate remedy at some length in the context of a claimed breach of the best interests duty. He was of the view that if transactions were brought

lease agreement⁹⁶, loan contracts⁹⁷, an allotment of shares⁹⁸, an agreement to transfer a company's business names and stock in trade⁹⁹ and a redundancy payment to a managing director in a situation where the company had already closed its business and sold its assets¹⁰⁰.

As a general proposition, in *Daly v the Sydney Stock Exchange Ltd*, Brennan J in the High Court of Australia held that where a contract has been entered into as a result of a breach of fiduciary duty, the contract is voidable, not void.¹⁰¹ The approach in *Daly* has been followed on many occasions in Australia including in the specific context of the duty to act in the best interests of the company.¹⁰²

New Zealand case law also suggests that a breach of fiduciary duty makes a contract voidable.¹⁰³

Rescission as a Remedy for Similar Breaches of Directors' Duties

I have already discussed above how rescission is a generally accepted remedy for breach of many different categories of fiduciary duty.

Notably, the breach of fiduciary duties not to act for improper purposes and not to take a secret profit have commonly led to voidability of the underlying transaction. A breach of the duty to act in good faith in the company's best interests often co-exists with breaches of duties not to act for improper purposes or to take a secret profit, and arises from the same factual matters. In those circumstances, it would be anomalous, and lead to confusion, if the remedy for breach of the best interests duty led to a different remedy.

about by a breach of fiduciary duty, then the transactions were voidable rather than void: *The Bell Group v Westpac Banking Corporation (No.9)*, above n 51, at [4782]-[4783] and [9638].

⁹⁶ *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 58, at 733.

⁹⁷ *Robins v Incentive Dynamics Pty Ltd*, above n 8, at [73] per Mason P. The Court held that entry into the loan contract without benefit to the company was in breach of fiduciary duty or its statutory equivalent. Further, in *Hancock Family Memorial Foundation Ltd v Porteous* [2000] WASCA 29 at [178]- [189], the Western Australian Court of Appeal also held that if it had been satisfied that certain loan contracts were in breach of the duty to act in the best interests of the company then they would have been voidable. In *Netglory Pty Ltd v Caratti*, above n 58, at [364], [389]-[391] and [759], Edelman J would have held a loan agreement voidable for breach of the best interests duty had the Court held that the agreement was valid (the Court held that the agreement was not valid and enforceable in any event for several reasons including because it was not supported by consideration).

⁹⁸ *Bailey v Mandala Private Hospital Pty Ltd* (1987) 12 ACLR 641 (NSWSC) at 648.

⁹⁹ *Australian Growth Resources Corp Pty Ltd v Van Reesema*, above n 58, at 271.

¹⁰⁰ *Re Cummings Engineering Holdings Pty Ltd* [2014] NSWSC 250 at [41] and [89].

¹⁰¹ *Daly v the Sydney Stock Exchange Ltd*, above n 18, at 387-388.

¹⁰² For example, *Hancock Family Memorial Foundation Ltd v Porteous*, above n 97, at [183].

¹⁰³ *Estate Realities Ltd v Wignall*, above n 13, at 627 and 631.

Sealy has noted that Australian texts had not always drawn a distinction between the best interests duty and the duty to act for proper purposes and suggested that there is “room for debate whether we are to regard these duties as one phenomenon or two”.¹⁰⁴ This is also apparent from the formulation of the duties by the English Court of Appeal in *Re Smith & Fawcett*.¹⁰⁵

[Directors] must exercise their discretion bona fide in what they consider — not what a court may consider — is in the interests of the company, and not for any collateral purpose.

Given the common history of the two duties, and the fact they are often considered and applied together (or in the alternative), it would be surprising (and confusing) if the remedies for breach of the duties were different. Nor does there appear to be any good policy justification for any difference.

In the case of the duty of directors to act for proper purposes, the law is now well-established that a breach of the duty makes the underlying transaction voidable at equity. Cases relating to breach of the proper purposes duty in both England and Australia consistently suggest a breach of that duty makes the transaction voidable.¹⁰⁶ Even Peter Watts accepts that a breach of the proper purposes duty only makes a transaction voidable.¹⁰⁷

Many of the proper purposes cases involve the issue of shares. Nolan has queried the ability to apply the approach taken to the invalidity of share allotments more broadly.¹⁰⁸ However, a breach of the duty to act for proper purposes has equally led to forms of contract other than

¹⁰⁴ Sealy “Bona Fides and Proper Purposes in Corporate Decisions” (1989) 15 Monash U L Rev 265 at 266-267. See also Langford, above n 30, at 226: “...it can be difficult to separate considerations relevant to the duty to act bona fide in the interests of the company from those pertinent to the duty to act for proper purposes.”

¹⁰⁵ *Re Smith & Fawcett Ltd* [1942] Ch 304 (CA) at 306.

¹⁰⁶ *Tianrui (International) Holding Company Ltd v China Shanshui Cement Group Ltd* [2024] UKPC 36 (Cayman Islands) at [74]; *Bamford v Bamford* [1970] Ch 212 (CA) at 238-239 and 241-242; *Westpac Banking Corporation v The Bell Group* (No 3), above n 50, at [2042] per Drummond AJA and [2923] per Carr AJA (Lee AJA also accepted at [1131] that the claims of breach of fiduciary duty grounded a right to elect to rescind the transactions); *Hogg v Cramphorn* [1967] Ch 254, *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 (HCA) at 294; *Harlowe’s Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 (HCA) at 493-494; *Ashburton Oil NL v Alpha Minerals NL* (1971) 123 CLR 614 (HCA) at 643; and *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666 (NSWCA) at 679-680 per Samuels JA, and 689 and 697-698 per Mahoney JA. There is some earlier case law suggesting a breach of the proper purposes duty makes a transaction void: *Piercy v S Mills & Co Ltd* [1920] 1 Ch 77 at 85.

¹⁰⁷ Watts “Authority and Mismotivation” (2005) 121 LQR 4 at 7.

¹⁰⁸ Nolan, above n 68, at 318-320 and particularly at n 126, where he refers to a “necessary distinction” between cases involving contracts and cases involving the allotment of shares.

contracts for the issue of shares being held voidable, including loan contracts¹⁰⁹, a lease¹¹⁰ and a management agreement¹¹¹. There is a line of cases in trust law where the courts have held that a breach of the proper purposes duty has made actions taken by trustees void rather than voidable.¹¹² However, that line of case law has not been followed in the corporate context.

Another relevant situation is where a director has caused the company to enter into a transaction due to a bribe given to the director. It is well-established that such a transaction is voidable in equity for breach of fiduciary duty.¹¹³ There seems no good reason to apply a different remedial consequence just because the director's conduct leading to the transaction was also seen as a breach of the best interests duty (as would likely be the case). If it were the case that a transaction made in breach of the best interests duty was considered void, the judges in the bribery cases would not have needed the pages of discussion on the need for rescission of the relevant contracts affected by bribery, and the specific requirements for rescission.

For example, in *Logicrose*, Millett J discussed whether the Southend United Football Club had affirmed the transaction so as to lose the right of rescission (holding that there had not been any such affirmation)¹¹⁴ and also whether the other party to the transaction had sufficient knowledge of the breach of fiduciary duty so that rescission should be ordered.¹¹⁵ In *Ross River*, Briggs J discussed the extent to which the party (Ross River) making the alleged bribe to the chief executive of the Cambridge City Football Club was innocent of the breach of fiduciary duty.¹¹⁶ In *Tigris*, Clarke LJ said that if an agent is bribed to enter into a contract, the principal

¹⁰⁹ *Hogg v Cramphorn Ltd*, above n 106, at 270-271 (in addition to voidability of the share issue); *Westpac Banking Corporation v The Bell Group* (No 3), above n 50.

¹¹⁰ *Russell Kinsela Pty Ltd (in liq) v Kinsela* [1983] 2 NSWLR 452 (NSWSC) at 462-463 and 465 per Powell J, affirmed on other grounds in *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 58. The Court of Appeal also held the lease voidable but based on breach of the best interests duty, which breach could not be ratified by the shareholders when the company was insolvent or near insolvency.

¹¹¹ *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22 (CA).

¹¹² *FS Capital v Adams* [2025] EWCA Civ 53.

¹¹³ *Logicrose Ltd v Southend United Football Club Ltd* (No. 2) [1988] 1 WLR 1256 (Ch) at 1260-1262 per Millett J; *Armagas Ltd v Mundogas SA (The Ocean Frost)* [1986] AC 717 at 741-746 per Robert Goff LJ in the Court of Appeal with the particular issue not being addressed by the House of Lords; *Ross River Ltd v Cambridge City Football Club Ltd* [2007] EWHC 2115 (Ch) at [203]-[228] and [248]-[252]; and *Tigris International NV v China Southern Airlines Co Ltd* [2014] EWCA Civ 1649 at [143]. Now, under the Companies Act 1993, s 141 also makes an interested transaction voidable if the company does not receive fair value. Section 141(6) removes the ability to avoid a transaction in equity on the grounds of the director's interest. However, it is unlikely that s 141(6) would remove the well-established jurisdiction under which transactions affected by a bribe are voidable. That jurisdiction stems from the fiduciary duty not to profit from the position as a director, rather than from the mere fact of a director being interested in a transaction.

¹¹⁴ *Logicrose Ltd v Southend United Football Club Ltd* (No. 2), above n 113, at 1262-1263.

¹¹⁵ At 1261-1262.

¹¹⁶ *Ross River Ltd v Cambridge City Football Club Ltd*, above n 113, at [251].

may rescind it provided that counter-restitution can be made and the right of rescission has not been lost e.g. by delay or the intervention of the rights of bona fide third parties.¹¹⁷

In each case, the discussion of these matters would not have been necessary if the Court had considered that the bribe had made the transaction void (rather than voidable) because the transaction also amounted to a breach of the best interests duty.

It was also well-established in the common law that breaches of fiduciary duties (by directors and other fiduciaries) relating to interested transactions gave rise to the underlying transactions being voidable at equity (regardless of the fairness of the transactions).¹¹⁸ Now under the Companies Act 1993, s 141 makes an interested transaction voidable if the company does not receive fair value. In the United Kingdom, s 41 of the Companies Act 2006 makes interested transactions voidable in certain circumstances.¹¹⁹

Whether at common law or under the Companies Act 1993, there is logic in having similar remedies for both the breach of the best interests duty and breaches involving conflicts of interest.

Impact on Innocent Third Parties

The recognition of a given transaction being held void or voidable due to a breach of the best interests duty greatly impacts the outcomes for contracting third parties. Sarah Worthington has commented that a bona fide third party is less likely to be adversely affected if a transaction is merely voidable rather than void.¹²⁰

Importantly, where a transaction is merely voidable, it will not be set aside if the other party to the transaction is innocent and has provided value as part of the transaction.¹²¹ In some cases,

¹¹⁷ *Tigris International NV v China Southern Airlines Co Ltd*, above n 113, at [143].

¹¹⁸ *In re Cape Breton Company*, above n 9, at 803; *Transvaal Lands Company v New Belgium (Transvaal) Land and Development Company* [1914] 2 Ch 488 (CA), *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549 (CA) at 594, *Guinness v Saunders*, above n 65, at 697-698, *JJ Harrison (Properties) Ltd v Harrison*, above n 75, at [18], *Peninsular & Oriental Steam Navigation Co v Johnson*, above n 9, at 213, *Cowan de Groot Properties Ltd v Eagle Trust plc*, above n 13, at 762-763 per Knox J; *Conaglen Fiduciary Loyalty*, above n 40, at 76-79 and cases at n 92.

¹¹⁹ Section 41 only applies where a transaction depends for its validity on s 40. Section 40 provides that in favour of a person dealing with a company in good faith, the power of the directors to bind the company is deemed to be free of any limitation under the company's constitution.

¹²⁰ Sarah Worthington "Corporate governance: remedying and ratifying directors' breaches" (2000) 116 LQR 638 at 660.

¹²¹ See n 12 above, and discussion in Chapter 4.

a Court may also refuse rescission in its discretion such as where it considers such a remedy would be disproportionate.¹²²

By contrast, when a transaction is void the company does not need to take any action to avoid the transaction. Where a transaction is void, it has no effect, and the limitations on when a company can avoid a voidable transaction do not apply. The potential for an innocent third party to be prejudiced is greater. A contracting third party cannot rely on their innocence to prevent the loss of a contract that is void (though an innocent purchaser from the contracting third party may be able to).¹²³

A finding that a transaction in breach of the best interests duty was void in equity would, therefore, be particularly harsh on a third party who is not well placed to assess whether the director is breaching their fiduciary duty.

I discuss in Chapter 7 the rationale for Parliament's decisions in 1985 to make it easier for third parties to rely on apparent authority. In short, Parliament was wary that it would too readily defeat the expectations of third parties if the ability to rely on apparent authority was defeated just because the third party was "put on inquiry" that directors did not have actual authority.

That concern resulted in the amended knowledge test that now appears in the proviso to s 18(1). That legislative reform could, however, be undermined if the result of a breach of s 131 was to make a contract void in equity rather than voidable. The transaction might then be unenforceable even if the third party did not know about the breach of duty. The third party's ability to rely on apparent authority would be protected by the proviso to s 18(1), only for the contract to be lost anyway if it was considered void in equity for breach of s 131.

However, if the contract is only voidable, the company would lose the right of rescission where the third party was innocent and had provided value. That result would seem more consistent with the objective behind Parliament's reform that now appears in the proviso to s 18(1).

¹²² See n 14 above.

¹²³ *Great Investments Ltd v Warner* [2016] FCAFC 85, (2016) 335 ALR 542 at [105]-[108]. The Court had held that a director of Bellpac Pty Ltd, Mr Wong, did not have authority to transfer bonds owned by the company. The Court nevertheless went on to consider whether the transferee (Great Investments) could retain the bonds on the basis of a defence of being bona fide purchasers for value without notice. For several reasons the defence was not made out. In particular, the Court said the defence would not have been available to Great Investments as the original transferee, but only to a bona fide purchaser from Great Investments. Contrast Nolan, above n 68, at 322.

Overall, and as discussed further in Chapter 9, it would seem that the Court is best placed to balance the interests of a company and a contracting third party appropriately in a situation involving a breach of s 131 if the transaction is considered voidable (and therefore the transaction will only be set aside where the third party has knowledge of the breach of duty) than if the transaction was considered void (and rescission is not required).

However, even exposing contracts to the risk of rescission potentially impacts commercial certainty. Courts should be careful not to extend too broadly the circumstances in which the remedy of rescission is available.

Gaudron and McHugh JJ in the High Court of Australia expressed in *Breen* a concern that Canadian case law (which had imposed fiduciary obligations that the High Court considered went beyond what were appropriate) had paid insufficient regard to the fact that the imposition of fiduciary duties often gives rise to proprietary remedies.¹²⁴ As Kirby J noted in *Pilmer v Duke Group Ltd*, that concern may be a reason for restraint in expanding the situations which are considered to attract fiduciary obligations.¹²⁵

The same concern is also relevant when considering the appropriate *scope* of fiduciary obligations in situations where they are accepted to apply (such as in the case of a director who is accepted as owing fiduciary duties to a company). I discuss the scope of the best interests fiduciary duty in the next Chapter, together with other issues impacting on the ability of a company to exercise a right of rescission for breach of the best interests duty.

¹²⁴ *Breen v Williams*, above n 48, at 113.

¹²⁵ *Pilmer v Duke Group Ltd* (2001) 207 CLR 165 (HCA) at [126].

Chapter 4- Scope of Best Interests Duty and Restrictions on Rescission

In this Chapter, I will consider some specific issues relating to the potential avoidance of transactions entered into in breach of the directors' duty to act in the company's best interests.

In particular, I will consider:

- a) the extent to which transactions in which directors are interested can be avoided for breach of s 131;
- b) how to assess whether a breach of s 131 occurs in relation to contracts where there is a divergence of interests between those of shareholders and those of the company as a separate entity;
- c) how to assess whether a breach of s 131 occurs in the context of contracts entered into by an insolvent company;
- d) the extent to which negligent conduct can also amount to a breach of s 131, and lead to rescission of company contracts;
- e) the level of knowledge of a breach of s 131 required of a contracting third party, for the company to preserve a right of rescission.

Interested Transactions

A large proportion of the cases in which courts have held that directors have breached the best interests duty relate to directors acting in their own self-interest, such as causing a company to sell an asset to another company in which the director is interested¹ or causing the company to enter into a guarantee of the obligations of another company controlled by the director².

Historically, transactions in which a director was interested were automatically voidable in equity in the absence of shareholder consent.³ Now, under the Companies Act 1993, they are only voidable on the grounds of the director's interest under s 141. That section provides for interested transactions to be voidable where the company has not received fair value. The transaction is voidable only within three months of disclosure of the transaction to shareholders.

¹ *Sojourner v Robb* [2007] NZCA 443, [2008] 1 NZLR 751 (sale of business at undervalue); *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch) (sale of stock to company associated with directors for purpose of discharging debt said to be owed to the associated company).

² *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246 (CA).

³ *Woolworths Ltd v Kelly* (1991) 22 NSWLR 191 (NSWCA).

However, as discussed in Chapter 3, equity also allows the rescission of transactions entered into in breach of the fiduciary duty to act in the company's best interests. A transaction may be both an interested transaction and a transaction in breach of s 131. Examples of cases where transactions in which directors were interested were held voidable due to a breach of the best interests duty include *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd* and *In re Cummings Engineering Holdings Pty Ltd*.⁴

In *Hedley v Albany Power Centre Ltd (in liq) (No 2)*, Wild J held that ss 140 and 144 dealing with the disclosure of interested transactions did not override a director's duty under s 131.⁵ Similarly, while s 141 provides a code for when a transaction can be avoided "on the ground of the director's interest", there is no reason why the transaction cannot be impugned on the basis of other breaches of fiduciary duty, such as a breach of s 131.

It was reasonable for the legislature to restrict the circumstances in which the pure fact that a director is interested in a transaction gives rise to voidability of a transaction given that the original rule of equity applied "irrespective of the merits of the transaction".⁶ However, the policy driver for the reform does not suggest that the standard equitable remedies for breach of other fiduciary duties should no longer be available. The Act does not suggest an intention to remove remedies (including the remedy of rescission for breaches of other fiduciary duties).⁷

Nevertheless, the fact that avoidance of contracts is available not just under s 141, but for breaches of directors' fiduciary duties (including a breach of the best interests duty) is not well-known. As discussed further in Chapter 9, the availability of the remedy of rescission in the case of breaches of directors' fiduciary duties could usefully be clarified in the Act.

⁴ *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd* (1996) 39 NSWLR 143 (NSWCA) where rescission was only unavailable because it was no longer possible to restore the parties to their original position: at 152-153; *Re Cummings Engineering Holdings Pty Ltd* [2014] NSWSC 250 at [39] and [41].

⁵ *Hedley v Albany Power Centre Ltd (in liq) (No 2)* (2006) 2 NZCCLR 1148 (HC) at [16]; See also *Rusher v Owen*, Auckland Registry, Potter J, 9 June 1999 at 9.

⁶ *Madsen-Ries v Petera* [2016] NZCA 103, [2016] 2 NZLR 500 at n 22. See also Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [524].

⁷ Neil Campbell "Does the Companies Act codify remedies?" [2001] CSLB 53; Ross Grantham "Contracting with Companies: Rule of Law or Business Rules?" (1996) 17 NZULR 39 at 59.

Takeovers and Distributions

I discussed in Chapter 2, the potential difference between an approach to the best interests duty that is based on the interests of the company being associated with the interests of its residual claimants (shareholders, and potentially creditors when the company is insolvent or close to insolvent) and an approach that looks at the value of the company as a corporate entity.

In most circumstances, the approach taken will not make a difference to the assessment of whether there is a right to rescind a corporate transaction as a remedy for breach of the best interests duty.

However, there are at least two contexts in which there is a difference;

- (a) When directors are deciding whether to support the sale of the company's business, or a takeover bid for the company's shares to one or another bidder;
- (b) When directors are deciding whether to enter into a transaction that effectively amounts to a distribution of wealth to the shareholders, including a repurchase of their shares.

Takeover Situations

In most takeover situations, it is the shareholders that principally stand to gain or lose from actions taken by directors in either encouraging or resisting a takeover, or in promoting or obstructing the takeover offer with the best price. In the context of a takeover, an entity approach focused on preserving the value of the corporate entity need not lead to outcomes consistent with shareholder wealth maximisation. Santow has commented that the company "as a commercial entity is in no way benefited because the bidder pays a higher price to replace the shareholders with itself".⁸ If the directors are to assess the matter from the point of view of the company as an entity, then they may be justified in taking no action at all to ensure shareholders get the best price. Further, they may not be considered in breach even when they take action which *prejudices* the shareholders' ability to get the best price.

⁸ GFK Santow "Defensive Measures Against Company Take-overs" (1979) 53 Australian Law Journal 374 at 378 and 380-381 contrast Tony Steel "Defensive Tactics in Company Takeovers" (1986) Companies and Securities Law Journal 30 at 32-34.

However, English, Australian and United States case law suggests that in a takeover situation the interests of the company should be associated with its current shareholders. In *Heron International Ltd v Lord Grade*, Lawton LJ said:⁹

Where the directors must only decide between rival bidders, the interests of the company must be the interests of the current shareholders. ... The directors owe no duty to the successful bidder or to the company after it has passed under the control of the successful bidder.

The directors' duty was to ensure that the shareholders obtained the best price.¹⁰

Similarly, in *Revlon v MacAndrew*, the Delaware Court of Chancery held that when a company or its assets is certain to be sold, directors are required to maximise short-term expected shareholder value.¹¹ In *Revlon*, there were competing offers for the shares of Revlon by Forstmann Little and Pantry Pride. The Board of Revlon granted Forstmann certain rights that were obstacles to the Pantry Pride bid. These were a "lock-up option" which gave Forstmann the option to purchase certain Revlon assets, a "no-shop provision" which required Revlon to deal exclusively with Forstmann, and a cancellation fee requiring Revlon to pay Forstmann \$25 million if Forstmann's transaction was aborted.

Shareholders of Revlon obtained an injunction preventing enforcement of the lock-up option, no-shop provision and cancellation fee. The Supreme Court of Delaware upheld the injunction on appeal, holding that the lock-up agreement constituted a breach of the directors' duty to obtain the highest price for shareholders and that the no-shop provision and cancellation fee were also impermissible.

Revlon has been followed on many occasions in Delaware. The approach taken in that case is consistent with the view that the directors' fiduciary duty to act in the best interests of the company is owed for the benefit of shareholders as residual claimants. On that basis, director action which prejudices the ability of shareholders to get the best price for their shares on a takeover amounts to a breach of the duty.

⁹ *Heron International Ltd v Lord Grade* [1983] BCLC 244 (CA) at [5.11].

¹⁰ At [6.2]. To the same effect, see also *Mincom Ltd v EAM Software Finance Pty Ltd* (2007) 61 ACSR 266 (Supreme Court of Queensland) at [33].

¹¹ *Revlon, Inc v MacAndrews & Forbes Holdings, Inc* 506 A.2d 173 (Del 1986) at 184; George A Mocsary "Freedom of Corporate Purpose" (2016) BYU L Rev 1319 at 1356.

On the facts of *Revlon*, *Revlon as a corporate entity* may have had little to gain or lose depending on which bidder for its shares was successful. However, its shareholders were vitally interested in obtaining the best price for their shares. The fact that the directors of *Revlon* acted in such a way as to undermine that interest was enough for a finding of breach of duty.

However, it may often be the case that the directors enter into transactions which, while protecting the ability of shareholders to obtain the best price for their shares, have no impact on the value of the corporate entity itself. It would be wrong to suggest that transactions of that kind should be potentially set aside as not in the company's best interests. Nor should a transaction that involves a company discontinuing its business be considered a breach of s 131 if it is in the interests of the shareholders.

Take, for example, the situation of a full takeover of a company by a purchaser who does not intend to continue operating the company's business but instead to sell off the company's assets for best value. In relation to an example of this kind, Santow, taking an entity-based approach, has suggested that it is not in the interests of the company to no longer have an ongoing business.¹²

However, consistent with the approach in *Sequana* (discussed in chapter 2), there is no breach of s 131 and no right of rescission, if the directors of a solvent company act in the best interests of the shareholders as a whole. That can be the case for a transaction involving a sale of the company's business that involves a discontinuance of the company's business operations (or a company takeover implemented through the acquisition of the shares of the company where the purchaser intends to close down the business).¹³

The approach in *Sequana* does not require the firm's ongoing existence. Complying with the best interests duty can involve selling or discontinuing the company's business. As Vice-Chancellor Laster commented in one United States case:¹⁴

¹² Santow, above n 8, at 380.

¹³ IA Renard "Commentary on JD Heydon Directors' Duties and the Company's Interests" in Finn (Ed.) *Equity and Commercial Relationships* (Law Book Company, 1987) 137 at 137-138.

¹⁴ *Frederick Hsu Living Trust v ODN Holding Corp* (2017) Del Ch Lexis 67 at [48]-[49].

The directors who managed the proverbial make of horse-and-buggy whips would have acted loyally by selling to a competitor before the new-fangled horseless carriage caught on.

Under Delaware law in relation to a sale of the whole company, the directors are required to consider which offer is in the best interests of the present shareholders, and maximises present share value. The Delaware Court of Chancery noted that for such shareholders:¹⁵

[I]t does not matter that a buyer who will pay more cash plans to subject the corporation to a risky level of debt, or that a buyer who offers less cash will be a more generous employer for whom labor peace is more likely.

If the transaction gives the selling shareholders best value then it is arguable that the directors are doing precisely what they should be doing.¹⁶

However, the position becomes less clear if anything other than a shareholder-focused approach is taken e.g. an approach that allows consideration of “environmental, social and governance matters” to the detriment of shareholders.

Impact of Section 131(5)

The introduction in 2023 of s 131(5) to the Act permits directors to consider, as part of the best interests duty, matters other than the maximisation of profit (such as environmental, social and governance (“ESG”) matters).

The express reference in s 131(5) to environmental and social factors may increase the risk of legal action that seeks to interfere with board policy on matters with an environmental or social dimension. Minority shareholders have already shown a willingness to bring legal action seeking to interfere with board policy on environmental issues such as the reduction of emissions.¹⁷

¹⁵ *TW Servs. v SWT Acquisition Corp.*, 14 Del. J. Corp. L. 1169 at 1184 (Del.Ch. 1989). See also Alan Meese “The Team Production Theory of Corporate Law: A Critical Assessment” (2002) 43 William and Mary Law Review 1629 at 1687-1688, noting that under Delaware law directors have a fiduciary obligation to obtain the highest value reasonably available for shareholders should directors decide to recommend the sale of the company, and that this may be at the expense of the bidder and the company’s other constituencies. See also at 1696.

¹⁶ *Heron International Ltd v Lord Grade*, above n 9, at [6.3]: “The duty of the directors is to protect the shareholders. The identity of the bidder matters not to the shareholders. What does matter is that the shareholders should receive a bid which reflects the true value of [the company] as assessed by competing bidders...”.

¹⁷ *Client Earth v Shell plc* [2023] EWHC 1897 (Ch).

Accordingly, if a director fails to consider some ESG factor in entering into a contract for the company, is there a risk that a minority shareholder takes legal action arguing that entering into the transaction should be considered in breach of s 131? The shareholder might contend that the Court should grant an injunction to prevent the transaction, or make an order that the transaction be set aside.¹⁸

It is, however, important to note that s131(5) does not make it mandatory to consider the ESG matters referred to in the section. Accordingly, a failure to consider such matters is probably unlikely to give rise to a breach of s 131 or lead to the rescission of company contracts.

One potential issue, however, is how would standard remedies for breach of fiduciary duty, such as rescission of contracts, apply when a director deliberately acts contrary to the interests of shareholders in entering into some transaction but seeks to justify the decision based on some ESG consideration? Would, in that situation, the usual remedies for breach of a fiduciary duty of loyalty simply not apply? This is unclear. However, as noted in Chapter 2, the current New Zealand government intends to repeal s 131(5).

Distributions

The second area of tension between the interests of shareholders and an entity approach relates to transactions that effectively amount to distributions to shareholders.

In *H Timber Protection Ltd (in rec) v Hickson International plc*, the Court Of Appeal held that in a solvent company, the directors were free to pay a dividend in the interests of the company's sole shareholder.¹⁹ This suggests that in the case of a solvent company, it is only necessary for directors to take into account the interests of current shareholders in making a distribution decision. The position is different if the company is insolvent. The Act contains a regime for approval of distributions which requires directors to be satisfied that the company meets the solvency test.²⁰

¹⁸ For an example of a (successful) application for an interim injunction to prevent action alleged to be in breach of s 131, see *Shell (Petroleum Mining) Co Ltd v Todd Petroleum Mining Co Ltd* CA 70/05 3 August 2005 (CA) at [93]. For examples of cases where the remedy of rescission (avoidance) of contracts has been sought for contracts said to entered into in breach of the best interests duty, see cases at Chapter 3, n 57. For further discussion of the potential impact of s 131(5) to such arguments, see John Land "Corporate Purpose and the Impact on Equitable Remedies, Economic Growth and Democracy" (2024) 55 VUWLR 497.

¹⁹ *H Timber Protection Ltd (in rec) v Hickson International plc* [1995] 2 NZLR 8 (CA) at 13.

²⁰ Section 52 Companies Act 1993, and definition of solvency test in s 4.

In *Sequana*, the United Kingdom Supreme Court considered whether the payment of a large dividend to the company's sole shareholder amounted to a breach of the best interests duty, due to the failure to consider the interests of creditors. As discussed in Chapter 2, the Court held that the requirement to take into account the interests of creditors only arose if the company was insolvent, insolvency was imminent or if it was probable that the company would go into insolvent liquidation.²¹ In the absence of one of those triggers applying, a dividend could be paid based on a consideration of no more than the interests of shareholders.

Watson has suggested that directors have an obligation to sustain the corporate entity by avoiding making dividends that unduly deplete the corporate fund.²² It is hard to see how directors or courts would draw the line as to what amounted to an "undue depletion" of corporate funds. In *Sequana*, as discussed further below, both the Court of Appeal and Supreme Court rejected a test that would require directors to take account of creditors' interests when there was a "real risk" of insolvency on the basis that such a test would deter entrepreneurial conduct and risk-taking.²³

A contract between a company and its shareholders that effectively amounts to a distribution to shareholders should not be at risk of being set aside just because it depletes the corporate fund except in the circumstances suggested by the Supreme Court in *Sequana*.

Application of Section 131 in Context of Insolvent Companies

It is clear from recent New Zealand Supreme Court decisions, and *Sequana*, that where a company is insolvent the best interests duty includes a requirement to consider the interests of creditors.

The failure to consider the interests of creditors when required will bear real significance to corporate transactions given that the consequence of a breach of the best interests duty is to make the transaction voidable in equity. Transactions that courts have set aside for this very

²¹ *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2024] AC 211 at [203] per Lord Briggs JSC (with whom Lord Kitchen JSC agreed). Lord Hodge DPSC also agreed with this formulation at [227] and Lord Reed P's formulation at [12] and [96] appears to be essentially the same.

²² Susan Watson, *The Making of the Modern Company* (Hart Publishing, Oxford, 2022) at 258.

²³ *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112, [2019] 2 All ER 784 at [199]-[200]; *BTI 2014 LLC v Sequana SA*, above n 21, at [195].

reason include the lease transaction in *Kinsela v Russell Kinsela*,²⁴ and the banking transactions in *Westpac v Bell*.²⁵

It is important, therefore, to understand when and how the requirement to consider creditor interests applies. At least up until the decision in *Sequana*, this was a developing and uncertain area of the law.²⁶ In particular, it was not clear what level of financial strife a company needed to be in before the requirement to consider creditor interests was triggered. In *Debut Homes*, the New Zealand Supreme Court had indicated that the requirement to consider creditor interests arose when a company is “near” insolvency, but did so without considering the appropriateness of that test as the trigger for the requirement.²⁷

Sequana adds clarity to the question of what level of financial distress of a company is sufficient to trigger the requirement to consider the interests of creditors, and the content of the requirement once it exists.²⁸ However, as discussed below, there are some indications that the New Zealand courts may take a different approach to that taken in *Sequana*.

Sequana concerned a company called AWA. In May 2009, AWA’s directors caused it to distribute a dividend of €135M to its only shareholder, Sequana. The payment of the dividend complied with the statutory scheme regulating the payment of dividends in the Companies Act 2006 (UK). The directors authorised and paid the dividend at a time when AWA was solvent on both a balance sheet and cash flow basis. Nor was a future insolvency of the company either imminent or probable, in the sense of being more likely than not.²⁹

AWA was liable to meet future environmental clean-up costs (relating to the pollution of the Fox River in Wisconsin), which could not be precisely estimated. There was also uncertainty as to the value of one class of AWA’s assets (an insurance portfolio). Having regard to these uncertainties, BTI (as assignee of AWA’s claims against the directors) argued that the dividend payment created a real but not remote risk of the company becoming insolvent at some future time.

²⁴ *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA).

²⁵ *Westpac Banking Corporation v The Bell Group* (No 3) [2012] WASCA 157; (2012) 89 ACSR 1.

²⁶ *BTI 2014 LLC v Sequana SA*, above n 21, at [15] per Lord Reed P and [248] per Lady Arden; *Westpac Banking Corporation v The Bell Group* (No 3), above n 25, at [2039] per Drummond AJA.

²⁷ *Madsen-Ries v Cooper* [2020] NZSC 100, [2021] 1 NZLR 43 at [113] and [177].

²⁸ For a more detailed discussion of *Sequana* and its implications for New Zealand, see John Land “Defining the Scope of the Fiduciary Duty to Act in the Best Interests of the Company after *Sequana*: Remember the Remedial Implications” (2024) 27 NZBLQ 227.

²⁹ *BTI 2014 LLC v Sequana SA*, above n 21, at [115], [116] and [178] per Lord Briggs JSC.

The environmental liability ended up being much greater than originally estimated. Eventually, AWA went into insolvent administration in October 2018, almost ten years after the payment of the dividend in question.

BTI sought to recover from the directors an amount equivalent to the dividend on the basis that the directors' decision to distribute the dividend was in breach of a requirement to have regard to the interests of creditors. BTI argued a breach on the basis that the directors had not considered the interests of creditors at a time when there was a "real risk" of the company becoming insolvent at some stage in the future.

The Supreme Court rejected the claim, holding that a "real risk" of the company becoming insolvent was insufficient to give rise to a requirement to consider the interests of creditors.

The Court held that the requirement to take into account the interests of creditors was only triggered when:

- (a) The company was actually insolvent (on either a cash-flow or balance sheet basis);
- (b) The company's insolvency was "imminent" (also referred to as "bordering on insolvency");³⁰
- (c) It was probable that the company would enter insolvent liquidation;³¹ or
- (d) A transaction would lead to a company being in one of three situations referred to above.³²

The Court's overall approach to how the duty to act in the best interests of the company should be applied can be summarised as follows:

- (a) Before a company becomes insolvent or insolvency is imminent, creditor interests need not be separately considered. Naturally, it will be important to a company's long-term success and reputation that a company meet its obligations to creditors

³⁰ At [203] per Lord Briggs JSC. See also Lord Hodge DPSC at [227] and Lord Reed P at [12] and [96]. The phrase "bordering on insolvency" is used by Lord Reed P at [12] and Lord Hodge DPSC at [207].

³¹ At [12] and [96] per Lord Reed P, [203] per Lord Briggs JSC, [227] and [238] per Lord Hodge DPSC and [279] per Lady Arden.

³² At [12] per Lord Reed P and [279] per Lady Arden. See also Lord Briggs JSC at [149] in relation to a situation where a transaction would render a company insolvent.

and maintain good relationships with creditors, but no separate consideration of creditor interests is required;

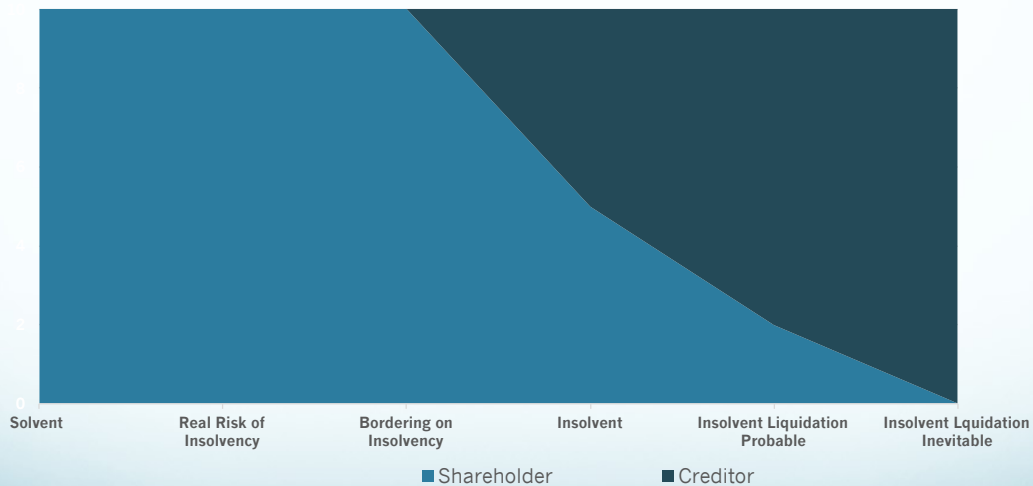
- (b) Once a company becomes insolvent or insolvency is imminent, or if insolvent liquidation of the company becomes probable, directors are required to consider creditor interests separately and to weigh the interests of creditors and shareholders to the extent those interests conflict. The worse the company's financial position, and the closer it is to going into insolvent liquidation, the greater the weight that directors should give to the interests of creditors. The relative balancing of creditor and shareholder interests may depend on an appreciation of who, between creditors and shareholders, has "most skin in the game";³³
- (c) Once the company faces inevitable insolvent liquidation, directors should treat creditor interests as paramount.

This position was based on the analytical approach accepted by the Court based on which parties could be said to be the residual claimants of a company at different stages (as discussed in Chapter 2). In particular, when a company is insolvent (but insolvent liquidation is not inevitable), the Court considered that directors should balance the interests of shareholders and creditors as both parties were potentially residual claimants. Even where a company is insolvent, shareholders still have a potential interest in the residual assets of the company until such time as insolvent liquidation is inevitable.

The Court's position can be diagrammatically shown as follows (with light blue representing shareholder interests and dark blue representing creditor interests) :

³³ At [176] per Lord Briggs JSC.

Balancing Shareholder and Creditor Interests at different stages of Solvency/ Insolvency



Creditor interests not triggered until company is at least "bordering on insolvency"

Creditor interests become paramount once insolvent liquidation is inevitable

A number of important issues arise in considering a potential breach of s 131 in the context of a transaction entered into by a company that is insolvent or bordering on insolvency, given that a breach of the best interests duty will lead to the transaction being voidable in equity.

The first is to clarify when, under New Zealand law, the requirement to consider creditor interests is triggered. If this requirement is triggered at a very early stage (such as where there is merely a "real risk" that a company will become insolvent), there is a much greater potential for company contracts being challenged as invalid when directors have entered into contracts without specific consideration of creditor interests.

Before the decision in *Sequana*, there was substantial divergence in the authorities regarding when the requirement to consider the interests of creditors was triggered. Some cases (particularly in Australia) had suggested a trigger of when there was a "real risk" of insolvency.³⁴ In the English Court of Appeal in *Sequana*, David Richards LJ would have

³⁴ *Kalls Enterprises Pty Ltd (in liq) v Baloglow* [2007] NSWCA 191, (2007) 25 ACLC 1094 at [162] suggesting a test of "a real and not remote risk" that creditors will be prejudiced; *The Bell Group v Westpac Banking Corp*

applied a trigger based on whether a company was “likely” to become insolvent, with “likely” in this context meaning probable.³⁵ As noted above, the New Zealand Supreme Court in *Debut Homes* indicated that the requirement to consider creditor interests arises when a company is “near” insolvency (although the point was not essential for the Court’s decision and was not the subject of any analysis).³⁶

In my view, it is best to avoid a test based on a “real risk” of insolvency. As the Court of Appeal and Supreme Court both suggested in *Sequana*, that is a test that will deter normal commercial risk-taking and entrepreneurial activity. Creditors will naturally be exposed to some risk that a company may become insolvent, but that does not mean that a director should be required to separately consider creditor interests in every situation.

David Richards LJ posed the following scenario in the Court of Appeal in *Sequana*:³⁷

Take the case of a company which is solvent and has cash resources available to meet a liability due to mature in two years' time. The interests of creditors would be served by retaining the cash until the liability matures, investing it in the meantime in risk-free assets. The company has an opportunity to invest the funds in a business venture that carries significant risks and rewards. It would not be a foolhardy investment but, if the real risk of failure occurs, it is the creditors who will lose....

David Richards LJ considered that it would be wrong to prevent companies from taking such business risks. A test that required directors to take into account the interests of creditors based on just a “real risk” of insolvency was a test that “would have a chilling effect on entrepreneurial activity, when such activity is the underlying purpose of most registered companies.”³⁸ It would also seem to unduly impact on commercial certainty if the contracts involved in such a business venture were potentially subject to being set aside on the grounds of breach of the best interests duty.

(No.9) [2008] WASC 239 at [4444]; *Westpac Banking Corporation v The Bell Group (No.3)*, above n 25, at [2046] per Drummond AJA suggesting a test of a “real risk that the creditors of a company in an insolvency context would suffer significant prejudice”.

³⁵ *BTI 2014 LLC v Sequana SA*, above n 23, at [220].

³⁶ *Madsen-Ries v Cooper*, above n 27, at [113] and [177]. See also *Sojourner v Robb*, above n 1, at [25] quoting from *Re New World Alliance Pty Ltd* (1994) 122 ALR 531 (FCA) at 550.

³⁷ *BTI 2014 LLC v Sequana SA*, above n 23, at [199].

³⁸ At [200].

The Supreme Court on appeal agreed with the rejection of the “real risk” test, with Lord Briggs JSC stating:³⁹

I repeat that risk taking is a fundamentally important reason for the recognition of limited liability. There will always be companies formed for the purpose of undertaking a higher risk business than their owners would be prepared to contemplate if failure would leave them personally liable. Such businesses may face a real risk of insolvency for most of their trading existence, without ever becoming insolvent, still less going into insolvent liquidation.

Lord Briggs JSC suggested that a real risk of insolvency was “simply too remote” from the event of insolvent liquidation, “which turns a creditor’s prospective entitlement into an actual one”.⁴⁰

Lord Briggs JSC also regarded as a powerful factor against applying a test based on a real risk of insolvency that no case law had suggested that shareholders lost the right to ratify breaches of directors’ duty just because there was a real risk of insolvency.⁴¹ Instead, the relevant case law had suggested that shareholders only lost the ability to ratify when the company was insolvent or proposed action would render the company insolvent.⁴²

For the law to be coherent, the circumstances in which shareholders can ratify a breach of directors’ duty should be aligned with those circumstances in which directors are required to take creditor interests into account.⁴³ To suggest that shareholders no longer had the right to ratify a breach of fiduciary duty in a situation where there was just a “real risk” of insolvency would be “too great an inroad” into the principle of shareholder ratification, which was a principle “nearly as old as company law itself”.⁴⁴

However, it is not yet clear whether the New Zealand courts will adopt the test suggested in *Sequana* for when the requirement to consider creditor interests is triggered.

In *Yan v Mainzeal*, the New Zealand Supreme Court suggested that there was a policy choice apparent on the face of s 136 (the New Zealand statutory prohibition on incurring obligations without a reasonable belief that the company can meet the obligations) “that in cases of

³⁹ *BTI 2014 LLC v Sequana SA*, above n 21, at [195].

⁴⁰ At [193].

⁴¹ At [196].

⁴² At [149].

⁴³ At [5] per Lord Reed P.

⁴⁴ At [196] per Lord Briggs JSC.

doubtful (or worse) solvency, directors should pay at least substantial regard to the interests of creditors”.⁴⁵ That may be so under s 136, but need not be true in relation to the fiduciary duty to act in the company’s best interests under s 131, with the different remedial consequences arising from such a breach. A test based on “doubtful” solvency appears similar to one based on a “real risk” of insolvency. The Court in *Sequana* also rejected a test based on “doubtful” solvency.⁴⁶

It is important to have regard to the remedial consequences of a breach of fiduciary duty when considering the potential expansion of the scope of such a duty.⁴⁷ Expanding the scope of the circumstances when the s 131 duty is considered breached through failure to consider creditor interests to situations where solvency is “doubtful”, or there is a “real risk” of insolvency, could seriously undermine commercial certainty. That is so given that a breach of fiduciary duty can lead to rescission of contracts, or to parties involved in a transaction incurring accessory liability (e.g. for knowing receipt or dishonest assistance).

A test based on a “real risk” of insolvency, or “doubtful” solvency, would also be hard for directors to apply in the real world. It is impractical for directors, in the course of day-to-day activities, to form views as to whether the ever-changing financial position of the company means that the company is “of doubtful solvency”.⁴⁸

For similar reasons, Lord Reed P in *Sequana* considered a test based on whether a company was “likely” to become insolvent (the test adopted by the Court of Appeal) was a “relatively vague test” that “might impose an impracticable burden upon directors”.⁴⁹

The Court in *Sequana* chose a test based on insolvency, imminent insolvency or probability of insolvent liquidation on the basis that, in those circumstances, directors not considering creditor interests would encourage the taking of commercial risks which are borne primarily by creditors rather than shareholders.⁵⁰ Lord Reed P commented that a shift in economic interests in the company, and risk of loss, was “discernible when insolvency was imminent”.⁵¹

⁴⁵ *Yan v Mainzeal Property and Construction Ltd (in liq)* [2023] NZSC 113 at [246].

⁴⁶ *BTI 2014 LLC v Sequana SA*, above n 21, at [50] per Lord Reed P and [397] per Lady Arden.

⁴⁷ *Breen v Williams* (1996) 186 CLR 71 (HCA) at 113 (HCA) per Gaudron and McHugh JJ; *Pilmer v Duke Group Ltd* (2001) 207 CLR 165 (HCA) at [126] per Kirby J.

⁴⁸ This was an argument raised (albeit unsuccessfully) in *The Bell Group v Westpac Banking Corporation (No.9)*, above n 34, at [4447].

⁴⁹ *BTI 2014 LLC v Sequana SA*, above n 21, at [85] and [89].

⁵⁰ At [59] per Lord Reed P.

⁵¹ At [86].

There are advantages in New Zealand following this approach. Merely taking a risk when a company's solvency is doubtful might be considered reckless trading (in potential breach of ss 135 and 136 of the Companies Act) and might be negligent (in potential breach of s 137 Companies Act), but it is not disloyal. In the absence of true disloyalty, the special remedies that only apply on a breach of fiduciary duty (such as rescission of contracts) should not apply.

A second issue in relation to how the best interests duty applies in a situation of insolvency, relates to the balancing of shareholder and creditor interests required by *Sequana*. This balancing exercise is required for a company that is insolvent or bordering on insolvency, but for which insolvent liquidation is not inevitable.

Such a balancing exercise necessarily involves difficult questions of judgment for the directors involved. The Court in *Sequana* suggested that the nature of the weighing exercise (as between shareholder interests and creditor interests) would depend on how much financial strife a company was in, and an assessment of who had "the most skin in the game: i.e. who risks the greatest damage if the proposed course of action does not succeed."⁵² That is a particularly difficult question of judgment for the directors involved.

There is a threat to commercial certainty if courts are too willing to second-guess the judgments involved by directors and find that the directors have not sufficiently taken into account the interests of creditors. A finding by a Court that directors breached the best interests duty through insufficient weight being given to creditor interests would lead to the consequence that relevant contracts were potentially voidable.

The difficulty of weighing creditor interests with shareholder interests is even more problematic in the United States where in situations of insolvency both creditors and shareholders are entitled to bring derivative actions to enforce directors' duties. Vice-Chancellor Laster in the Delaware Court of Chancery has noted how the ability of creditors to assert breaches of duty could lead to a situation where directors could be subject to legal action regardless of which course they took. On the one hand, they might be accused by creditors of "failing to chart a conservative course that preserved the firm's assets" and on the other hand, accused by shareholders of "failing to chart a sufficiently aggressive course that would generate

⁵² At [176]. See also Lord Briggs JSC at [189] and Lord Reed P at [81] and [96].

a return for the equity”. Laster V-C then commented, “Only the Goldilocks board could escape liability.”⁵³

The Courts should not hold good faith attempts by directors to engage in such balancing to amount to a breach of s 131, and to permit the rescission of contracts as a result. A restrained approach in that respect would be consistent with the Privy Council’s view in *Howard Smith v Ampol*.⁵⁴

There is no appeal on the merits from management decisions to the courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the power of management honestly arrived at.

A third important issue in relation to how the best interests duty applies in the case of an insolvent company, relates to what is meant by the requirement for directors to *consider* creditor interests. In particular, there is a question as to whether it is a breach of the best interests duty to fail to take into account the interests of a single particular creditor.

In *Sequana*, the Court suggested that consideration of the interests of creditors only required the directors to consider the interests of the company’s creditors as a whole rather than to consider the interests of any particular creditors.⁵⁵ It would not, for example, be a breach of duty to pay a particular creditor in preference to others if the directors believed in good faith they were acting in the interests of the company (e.g., if the company needed to pay particular creditors to ensure that the company can continue trading).⁵⁶ Nor would it be necessary to consider separately the interests of creditors in a special position (for example because they are subordinated or the company’s liabilities to them are contingent or long-term).⁵⁷

However, this approach is not consistent with the approach of the New Zealand Supreme Court in *Debut Homes*. There, the Court found that the director of Debut Homes, Mr Cooper, had breached s 131 by causing Debut Homes to complete the construction of four houses in

⁵³ *Quadrant Structured Prods Co v Vertin* 115 A 3d 535 at 546-547 and 554 (Del.Ch. 2015). Hargovan and Todd refer to this possibility as “dueling derivative actions”: Anil Hargovan and Timothy Todd “Financial Twilight Re-Appraisal: Ending the Judicially Created Quagmire of Fiduciary Duties to Creditors” (2016) 78 University of Pittsburgh Law Review 135 at 158.

⁵⁴ *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832 (PC, Australia). See also *Madsen-Ries v Cooper*, above n 27, at [112].

⁵⁵ *BTI 2014 LLC v Sequana SA*, above n 21, at [11], [48] and [77] per Lord Reed P.

⁵⁶ At [101(iii)] per Lord Reed P.

⁵⁷ At [256] per Lady Arden.

circumstances where he knew that the company would not be able to meet Goods and Services Tax obligations to the Inland Revenue that the company would thereby incur. Mr Cooper believed that completing the properties would provide higher returns to the general class of creditors. However, the Court held he breached s 131 by failing to consider the interests of *all* creditors (and in particular Inland Revenue) in an insolvency situation.⁵⁸

That seems a strict and anomalous approach. The duty to act for the benefit of shareholders before insolvency does not require consideration of the interests of each and every shareholder. Instead, the accepted approach is that directors should act for the benefit of shareholders as a whole.⁵⁹

In applying the requirement to consider the interests of creditors, it would make sense to take a similar approach under which the duty on insolvency becomes one to consider the interests of creditors as a whole. Otherwise, one creditor (in this case the Inland Revenue) may effectively be given a veto over action that is in the best interests of creditors as a whole. On the facts of *Debut Homes*, completing and selling the houses was the sensible thing to do if the position of all creditors was considered (as it was likely to improve the overall return for creditors).⁶⁰

Accordingly, the approach in *Sequana* is preferable. Under that approach it is only necessary to consider the interests of all creditors as a class. It is not necessary to consider separately the interests of a creditor in a special position.

However, the recent New Zealand Supreme Court decision in *Yan v Mainzeal* indicates a continuing reservation by the Court on the point of whether creditors should be treated as a class, with the Court noting the different statutory scheme in New Zealand. In particular, the Court said that s 136 “envisages looking at particular obligations and creditors.”⁶¹ Clearly, it will be necessary for the courts to apply s 136 in accordance with its terms. However, a finding of breach of s 136 due to a failure by directors to ensure that the company is able to meet a particular creditor obligation, does not necessitate a finding of breach of s 131 in the same circumstances. The different remedial consequences of s 131 are a factor in considering

⁵⁸ *Madsen-Ries v Cooper*, above n 27, at [116].

⁵⁹ Peter Watts *Directors' Powers and Duties* (3rd ed., Lexis Nexis, Wellington, 2022) at [5.5.1].

⁶⁰ As the Court of Appeal found: *Cooper v Debut Homes Ltd* [2019] NZCA 39 at [61]. I am obliged to Peter Watts KC for the argument in this paragraph.

⁶¹ *Yan v Mainzeal Property and Construction Ltd (in liq)*, above n 45, at [184(b)].

whether that is appropriate. The proper application of s 136 has nothing to do with the duty to act in the company's best interests, and how that duty should be interpreted.

Failing to consider the interests of a single particular shareholder, or a single particular creditor, should not be regarded as a breach of fiduciary duty, which in turn leads to the potential remedy of rescission of contracts. Failing to consider the interests of a particular shareholder or creditor may give rise to other remedies. For example, in the case of prejudice to a shareholder, the shareholder can seek relief for unfairly prejudicial conduct under s 174. In the case of prejudice to creditors, the company (or a creditor following liquidation, under s 301) can seek compensation for breach of s 136 (if directors incurred an obligation to a particular creditor without reasonable grounds to believe the company could meet the obligation). However, the prejudice to individual shareholders or creditors would be unlikely to also amount to a breach of fiduciary duty or lead to the remedy of rescission of the underlying contract.

A fourth important issue arising out of *Sequana* stems from the suggestion of the majority that the requirement to consider creditor interests is triggered when the directors were aware, or should have been aware, of the company's insolvency status. The potential for a failure to consider creditor interests to impact the validity of company contracts increases significantly if a court can find a breach of the best interests duty in situations when the directors were unaware that the company was insolvent. As discussed further below, I consider that the requirement for directors to consider the interests of creditors should not apply unless directors are *actually aware* of the company's insolvency status. Otherwise, conduct that is essentially just a breach of a duty of care is treated as a breach of fiduciary duty, and as giving rise to the special remedies that equity provides for such a breach, including rescission of contracts.

Negligence as a Potential Breach of s131

As discussed in Chapter 3, a breach by a director of a duty of care is not a breach of fiduciary duty. However, Commonwealth case law is not entirely consistent on whether negligent failures by directors to achieve outcomes that are in the company's best interests can be treated as a breach of the best interests duty.

If negligent conduct can be considered a breach of the fiduciary duty to act in the best interests of the company, this will substantially increase the number of contracts potentially subject to the equitable remedy of rescission.

An objective approach to s 131 is inconsistent with the wording of s 131 and its legislative history. The Law Commission did originally propose an objective test, requiring the director to hold on reasonable grounds the belief that their action was in the best interests of the company.⁶² As discussed in Chapter 2, Parliament did not adopt the Law Commission's proposal. The explanatory note to the Companies Bill 1990 recorded a deliberate decision not to follow the Law Commission's suggestion that the belief have to be on reasonable grounds.⁶³

Section 131 sets out a subjective test based on what the director him or herself believes. That test is an adoption of the common law test set out by Lord Greene MR in *Re Smith & Fawcett Ltd*.⁶⁴

[Directors] must exercise their discretion bona fide in what they consider – not what a Court may consider - to be in the interests of the company and not for any collateral purpose.

As the authors of *Gower* note, the courts interpreted this formulation in such a way as to leave business decisions to the directors.⁶⁵

However, despite the clear legislative intention, some New Zealand case law adopted a partially objective approach. In *Sojourner v Robb*, the directors of a company had sold the company's business at an undervalue. At first instance, Fogarty J held that the directors breached s 131 despite the fact that the directors thought they were acting in the interests of the company.⁶⁶

In Fogarty J's view:⁶⁷

The standard in s 131 is an amalgam of objective standards as to how people of business might be expected to act, coupled with a subjective criteria as to whether the directors have done what they honestly believe to be right. The standard does not allow a director to discharge the duty by acting with a belief that what he is doing [is] in the best interest of the

⁶² Law Commission, above n 6, at [195].

⁶³ Companies Bill 1990, explanatory note at page vi.

⁶⁴ *Re Smith & Fawcett Ltd* [1942] Ch 304 (CA) at 304-305; see John Farrar and Susan Watson, *Company and Securities Law in New Zealand* (2nd edition, Brookers, Wellington, 2013) at [15.2.1], 364.

⁶⁵ Paul L Davies Sarah Worthington and Christopher Hare *Gower Principles of Modern Company Law* (11th ed, Thomson Reuters, London, 2021) at 10-029, 279.

⁶⁶ *Sojourner v Robb* [2006] 3 NZLR 808 (HC) at [103].

⁶⁷ At [102].

company, if that belief rests on a wholly inappropriate appreciation as to the interests of the company.

The Court of Appeal upheld Fogarty J's decision on appeal. The Court took the view that the liability of the directors depended on whether the sale of the company was at fair value, essentially the application of an objective standard.⁶⁸

However, in *Debut Homes*, the Supreme Court firmly rejected a composite subjective and objective approach in favour of a purely subjective one:⁶⁹

The test is subjective. This follows from the wording of s 131 (expressed subjectively) and the legislative history (the fact that the Law Commission's reasonableness requirement was not enacted). This aligns with the common law test and policy considerations. Courts are not well equipped, even with the benefit of expert evidence, to second-guess the business decisions made by directors in what they honestly believed to be in the best interests of the company.

The comment about Courts not being well equipped to second-guess the business decisions of directors has its parallel in similar statements made in other jurisdictions.⁷⁰

The Supreme Court, however, having suggested that the test for breach of s 131 was subjective, then potentially muddled the waters by saying case law and commentary suggested four qualifications to the subjective test:⁷¹

- (a) where there is no evidence of actual consideration of the best interests of the company;
- (b) where, in an insolvency or near-insolvency situation, there is a failure to consider the interests of creditors;
- c) where there is a conflict of interest or where the action was one no director with any understanding of fiduciary duties could have taken (although some would suggest these may

⁶⁸ *Sojourner v Robb*, above n 1, at [31]. This approach was later endorsed by the Supreme Court in *Morgenstern v Jeffreys* [2014] NZSC 176 at [8].

⁶⁹ *Madsen-Ries v Cooper*, above n 27, at [112].

⁷⁰ *Kamin v American Express Co* 383 NYS 2d 807 at 810-811 (NY Sup Ct 1976): "The director's room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations, or tax advantages"; Bernard Sharfman "Shareholder Wealth Maximization and Its Implementation Under Corporate Law" (2014) 66 Florida Law Review 389 at 407 and 408; *Howard Smith Ltd v Ampol Petroleum Ltd*, above n 54, at 832.

⁷¹ *Madsen-Ries v Cooper*, above n 27, at [113].

rather be treated as breaches of the duty of good faith (as the High Court did in this case) or of s 133 (powers must be exercised for a proper purpose));

and (d) where a director's decisions are irrational.

It is not clear that the Supreme Court actually endorsed these qualifications. In relation to points (a) and (b), the Court did not see these as exceptions to the subjective test. The Court commented:⁷²

The point is that directors cannot subjectively believe they are acting in the best interests of the company if they have failed to consider the interests of the company or, where required, the interests of all of the creditors, including prospective creditors.

In relation to points (c) and (d), the Court indicated that it did not need to decide whether these factors were qualifications or exceptions.⁷³

The potential qualifications in (c) and (d) have the potential to undermine the previous suggestion by the Court that the test is a subjective one, and that Courts should not too readily second-guess business decisions. How does a Court decide whether an action was one no director with an understanding of fiduciary duties could have taken? Or that an action was irrational? These assessments come close to applying an objective test for the s 131 duty.

English case law has continued to reaffirm that the duty to act bona fide in the interests of the company is subjective.⁷⁴ In comparison, the position in Australia is more mixed.

Owen J in *Bell Group v Westpac* suggested that the test was largely subjective.⁷⁵ Further, in *Darvall v North Sydney Brick & Tile Co Ltd*, the New South Wales Court of Appeal held that as long as directors have a bona fide belief that what is done was for the benefit of the company

⁷²*Madsen-Ries v Cooper*, above n 27, at [114]. For the proposition that a director needs to give actual consideration to the interests of the company see also *Steel & Tube Holdings Ltd v Lewis Holdings Ltd* [2016] NZCA 366 at [30]; *The Bell Group v Westpac Banking Corp (No.9)*, above n 34, at [4619] at point 6; Rosemary Langford "Best Interests: Multifaceted but not Unbounded" (2016) 75 CLJ 505 at 508 and 514.

⁷³*Madsen-Ries v Cooper*, above n 27, at [115].

⁷⁴ *Regentcrest plc (in liquidation) v Cohen* [2001] 2 BCLC 80 (Ch) at [120]. Though see *Hellard v Carvalho* [2013] EWHC 2876 (Ch) at [92(b)] suggesting that where there is no evidence of actual consideration of the best interests of the company, the test is an objective one of whether an intelligent and honest director could have reasonably believed the transaction was for the company's benefit.

⁷⁵ *The Bell Group v Westpac Banking Corporation (No.9)*, above n 34, at [4619], point 1.

the fact that the decision is made in ignorance of relevant facts does not give grounds for avoidance of the relevant contract.⁷⁶

On the other hand, some Australian cases adopt an objective standard.⁷⁷ In *Mernda Developments Pty Ltd v Alamanda Property Investments No 2 Pty Ltd*, the Victoria Court of Appeal even suggested that it was “now generally accepted that an objective test ought to be applied”.⁷⁸ In contrast to *Darvall*, the Court in *Mernda* was willing to set aside a loan facility agreement and associated charge entered into by Mernda Developments in circumstances in which the Court considered that an “intelligent and honest person” in the position of the director could not “have reasonably believed that it was for the benefit of Mernda” to incur the liability under the facility agreement.⁷⁹

The decision by the Court in *Mernda* to order rescission of the relevant contracts based on its own assessment of whether the contracts were in the company’s interests is surprising, given that the trial judge had not held that the director was in breach of duty. The trial judge had held that there were benefits to Mernda in entering into the contracts as Mernda needed to secure funds to complete a property purchase, and the documents ensured that a number of companies under common control were supporting the lending of each other (referred to by the trial judge as “internally cross collateralizing the internal borrowings within the group”).⁸⁰

The Appeal Court disagreed, suggesting that it could not have been in the interests of Mernda on 15 May 2003 to enter into a facility agreement that effectively made Mernda liable for borrowings of other companies (which at that time amounted to \$10,141,125) payable on 31

⁷⁶ *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 16 NSWLR 260 (NSWCA) at 322. Kirby P dissented and would have applied an objective approach to whether the directors were in breach of duty and would, on that basis, have made an order setting aside the relevant contract: at 287-288 and 300-302.

⁷⁷ See, for example, *Re Idylic Solutions Pty Ltd* [2012] NSWSC 1276 at [1487]. See generally Rosemary Langford and Ian Ramsay “Directors’ Duty to act in the interests of the company- subjective or objective?” (2015) JBL 173; Robert Austin and Ian Ramsay *Ford, Austin and Ramsay’s Principles of Corporations Law* (17th ed., LexisNexis, 2018) at [8.070.3].

⁷⁸ *Mernda Developments Pty Ltd v Alamanda Property Investments No 2 Pty Ltd* [2011] VSCA 392; (2011) 86 ACSR 277 at [33].

⁷⁹ At [45]. Hansen J in *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* (1997) 26 ACSR 544 (Supreme Court of Victoria) at 584-585 applied the same test in holding that entering into a loan between related companies was in breach of the duty to act in the best interests of Farrow Finance. That, in turn, led to an order that Farrow Finance had proprietary remedies against the company to whom it made the loan (Farrow Properties) and the related company (Pyramid Building Society) who received the proceeds of sale of a property bought with the loan.

⁸⁰ At [29] setting out paras [12]-[15] of the judgment at first instance.

December 2003, and with an obligation on sale of any property owned by it to disgorge the full amount of the proceeds to meet any such guaranteed amount.⁸¹

The Court then accepted that a transaction procured by a director in breach of fiduciary duty was voidable at the instance of the company, entitling Mernda to restitution of \$7,724,289.46 (being the amount of \$9,574,289.46 paid by Mernda to the lender on 19 December 2003 less the amount which Mernda itself owed the lender).⁸²

This approach, which allows contracts to be set aside based on a judge's views as to whether contracts could reasonably be considered to be in the best interests of a company, is not conducive to commercial certainty. Sarah Worthington has expressed the caution that if a breach of the duty to act in best interests is based on what a reasonable person would believe, this would require "third parties to be unduly wary of attractive bargains".⁸³

As previously discussed, there is significant authority for the proposition that a breach of the directors' duty of care is not a fiduciary duty.⁸⁴ A mere failure to take due care should not be considered a breach of a fiduciary duty of loyalty, or to give rise to the equitable remedies associated with the breach of fiduciary duties.⁸⁵

Hansen J in *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* suggested that a negligent failure by directors to prevent management from entering into transactions that are not in the company's interests should not be considered a breach of fiduciary duty which would lead to the contracts being unwound, or to third parties being liable under principles of knowing receipt.⁸⁶

However, Hansen J himself applied an objective test of how an intelligent and honest director would have acted in deciding whether the directors of Farrow Finance had breached the best

⁸¹ At [45].

⁸² At [47]-[48] and [56]. See also [16] as to the amount paid by Mernda under the agreements.

⁸³ Sarah Worthington "Corporate Attribution and Agency: Back to Basics" (2017) 133 LQR 118 at 137.

⁸⁴ *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 (WASC) at 157; *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm) at [192] and [209]; RC Nolan "Controlling Fiduciary Power" (2009) 68 CLJ 293 at 314-315; *Bristol and West Building Society v Mothew* [1998] Ch 1 (CA) at 16-17; *BTI 2014 LLC v Sequana SA*, above n 21, at [74] per Lord Reed P.

⁸⁵ See, for example, *Motorworld Ltd (in liq) v Turners Auctions Ltd* [2010] NZCCLR 30 (HC) (negligence of director not enough to amount to breach of fiduciary duty for the purpose of establishing claim in knowing receipt).

⁸⁶ *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)*, above n 79, at 580.

interests duty. In doing so, he suggested that the line between breach of the duty of care and breach of the fiduciary duty to act in the best interests of the company was “not an easy one to draw”.⁸⁷ Hansen J commented that in the context of a loan transaction, the assessment of how an intelligent and honest director would act would require consideration of a mix of factors including the level of security for a loan and the likelihood of the borrower repaying the loan.⁸⁸ On the facts of the particular case, the assessment as to the prospects of the borrower repaying the loan was a “difficult question”.⁸⁹

If an objective approach is taken to s 131, then remedies for breach of fiduciary duty such as rescission, or third party liability for knowing receipt, may apply to cases where a director has simply acted negligently rather than disloyally. The result is to put the contracting third party at risk, and to do so when fine judgments may be required as to whether there is in fact a breach of duty.

For example, in *Equiticorp v Bank of New Zealand*, Kirby P in discussing the best interests duty said (albeit in a dissenting judgment):⁹⁰

It is not enough that Mr Hawkins might have had a benign intention. It is necessary to test that intention against the actions of a person both intelligent and honest.

Applying the standard of an intelligent person was essentially the application of an objective test, which Kirby P held was breached. His Honour would then have used that breach of the best interests duty as the platform to impose constructive trust liability (in knowing receipt or dishonest assistance) on the Bank of New Zealand.⁹¹

It is not desirable for contracting third parties to be put at risk of rescission of contracts (as in *Mernda*), or of constructive trust liability (as suggested by Kirby P in *Equiticorp*), in the case of conduct by a director of a company where the director had a “benign intention” even in circumstances where the third party is aware of the nature of the conduct.

⁸⁷ At 580.

⁸⁸ At 581-582 and 584-585.

⁸⁹ At 584.

⁹⁰ *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50 (NSWCA) at 100. The majority (Clarke and Cripps JJA) had reservations about applying such an objective test: at 148.

⁹¹ At 101-106. The majority held there was no breach of duty.

Objective evidence may, of course, still be relevant to a court's assessment of whether to accept a director's assertion that they believed they were acting in the best interests of the company.⁹²

Is there a limit to when courts should accept directors' statements as the genuineness of their beliefs? Bowen LJ in *Hutton v West Cork Railway Co*, commented:⁹³

Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational.

Langford and Ramsay take the view that a court should be able to inquire whether a "decision is one that no reasonable director would consider to be in the interests of the company", arguing that this is necessary to address the problem identified by Bowen LJ.⁹⁴

This is an approach that has received some judicial support. Some case law holds that there can be a breach of fiduciary duties despite the subjective honesty of a director's motives,⁹⁵ and more specifically, some courts have been prepared to find a breach of the best interests duty if the decision was one which no reasonable director would consider to be in the best interests of the company.⁹⁶

In particular, in *Netglory Pty Ltd v Caratti*, Edelman J was prepared to hold a transaction voidable based on such a test.⁹⁷ Edelman J commented: ⁹⁸

There is no apparent benefit to a company of replacing a debt for \$487,000 with a debt for \$800,000 at 20% interest, compounding monthly. No reasonable board could consider that such a transaction was in the best interests of the Hocking Land Company.

⁹² *The Bell Group v Westpac Banking Corporation (No.9)*, above n 34, at [4619] at points 5 and 7; *Regentcrest plc (in liquidation) v Cohen*, above n 74, at [120]; *Extrasure Travel Insurance Ltd v Scattergood* [2002] EWHC 3093 (Ch), [2003] 1 BCLC 598 at [90] and [116], and see also [135]-[137], rejecting the directors' suggestion in that case that they honestly believed a transfer of funds was in the company's interests, having regard to the lack of reasonable basis for considering the transferee could repay the funds.

⁹³ *Hutton v West Cork Railway Company* (1883) 23 Ch D 654 (CA) at 671.

⁹⁴ Langford and Ramsay, above n 77, at 181.

⁹⁵ *Australian Growth Resources Corporation Pty Ltd (Recs and Mgrs apptd) v Van Reesma* (1988) 13 ACLR 261 (SCSA) at 270-271.

⁹⁶ *Netglory Pty Ltd v Caratti* [2013] WASC 364 at [364]-[367]; *Re Southern Counties Fresh Food Ltd* [2018] EWHC 2810 (Ch) at [53].

⁹⁷ *Netglory Pty Ltd v Caratti*, above n 96, at [364]-[367] and [389]-[391].

⁹⁸ At [365].

Edelman J also felt able to reject an argument that there was a benefit to the company because the \$487,000 debt was payable immediately while the substituted debt of \$800,000 with 20% interest was the subject of deferred payment, suggesting that any alleged benefit was illusory.⁹⁹

In contrast, Mr Jonathon Crow (sitting as a Chancery Division judge) in *Extrasure Travel Insurance Ltd v Scattergood* said that the fact a directors' belief that their actions were in the best interests of the company was unreasonable does not put them in breach of their fiduciary duties, as long as the belief was honestly held.¹⁰⁰

It should be for directors to determine what are the interests of the company¹⁰¹, and courts should not substitute their own views about the commercial merits for the views of directors¹⁰². While an unreasonable decision should properly be considered a breach of the director's duty of care (under s 137), it is quite another matter whether it should be considered a breach of the fiduciary duty of loyalty, with all the remedial consequences that flow from that.

The question of whether a subjective or objective approach should be taken to the best interests duty has been the subject of relevant case law in the context of directors of companies within a group of companies and in the context of directors of insolvent companies.

In the situation of groups of companies, there is a divergence in judicial approach following *Charterbridge Corporation Ltd v Lloyds Bank Ltd*.¹⁰³ In *Charterbridge*, Pennycuik J considered the situation that applied in a group of companies where directors had only considered the interests of the group as a whole, and had not considered the interests of a particular company involved in a transaction. Pennycuik J said:¹⁰⁴

⁹⁹ At [367].

¹⁰⁰ *Extrasure Travel Insurance Ltd v Scattergood*, above n 92, at [90] and [97]. For a similar approach in a United States case involving the rescission of a transaction in breach of the best interests duty, see *Wildes v Rural Homestead Co* 53 NJ Eq 425 at 431 (1895, New Jersey Court of Chancery) stating that a transaction "cannot be set aside merely because the directors acted indiscreetly or unwisely".

¹⁰¹ Langford and Ramsay, above n 77, at 181.

¹⁰² *Steel & Tube Holdings Ltd v Lewis Holdings Ltd*, above n 72, at [30]; *The Bell Group v Westpac Banking Corporation (No.9)*, above n 34, at [4619], point 3.

¹⁰³ *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] 1 Ch 62.

¹⁰⁴ At 74.

The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transaction was for the benefit of the company.

However, the particular context in which Pennycuik J applied this test was not whether a director was in breach of the best interests duty. Instead, the Court was assessing whether a transaction was beyond the powers of directors under a company's memorandum, and therefore whether the transaction was void.

That particular context (and the significant consequences that Pennycuik J recognized may arise from a transaction being held void for lack of corporate capacity¹⁰⁵) may make his test less suitable for assessing whether directors should be considered in breach of the duty to act in the best interests of the company.¹⁰⁶

Despite the approach suggested by Pennycuik J being frequently cited and followed,¹⁰⁷ it has also been criticised. In Australia, the New South Wales Court of Appeal¹⁰⁸ and Western Australian Court of Appeal¹⁰⁹ have each given split decisions with the majority in each case being critical of the approach in *Charterbridge*.

The decision in *Westpac v Bell* highlights the complexity that can arise in situations involving groups of companies, and the significant consequences that can result from a finding of breach of fiduciary duty. That case had to address whether security transactions in favour of certain banks involving 70 companies in the Bell group could be considered to be in the interests of Bell group companies, and should be set aside as voidable. The trial of the case took 404 days

¹⁰⁵ At 74.

¹⁰⁶ *Maronis Holdings Ltd v Nippon Credit Australia Ltd* [2001] NSWSC 448, (2001) 38 ACSR 404 (NSWSC) at [305].

¹⁰⁷ See, for example, *Extrasure Travel Insurance Ltd v Scattergood*, above n 92, at [91] and [138]-[139].

¹⁰⁸ *Equiticorp Finance Ltd (in liq) v Bank of New Zealand*, above n 90, at 146-148 per Clarke JA and Cripps JA, contrast 97-101 per Kirby P, who endorsed the test. Bryson J in *Maronis Holdings Ltd v Nippon Credit Australia Ltd*, above n 106, at [185] also doubted the test in *Charterbridge*. The New South Wales Court of Appeal applied the *Charterbridge* test in *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465 (NSWCA) at 471-472 (albeit in circumstances where neither party opposed application of the test).

¹⁰⁹ *Westpac Banking Corporation v The Bell Group (No 3)*, above n 25, at [1012] per Lee AJA, contrast Carr AJA at [2898], who said that the rule in *Charterbridge* "has great utility and is consistent with high and well-established authority".

and led to a first instance judgment of Owen J of 2,643 pages (or 2,511 pages if annexures are excluded).¹¹⁰ Even the appellate judgment of the Western Australian Court of Appeal runs to 344 pages.¹¹¹

On the one hand, the liquidators of the Bell group companies argued that the transactions would materially prejudice the creditors of Bell group companies, and that the transactions were motivated by the interests of the Bond group rather than the Bell group. On the other hand, the defendant banks argued that the directors considered the transactions were necessary to avoid the Bell group companies going into liquidation.

The majority, Drummond and Lee AJA, agreed with the trial judge that the transactions were in breach of fiduciary duty by the directors and should be set aside. Drummond AJA even referred to the breaches as “egregious”.¹¹² By contrast, Carr AJA would have held there was no breach of fiduciary duty. He held that it was unrealistic to isolate the interests of one company in the group from others and said:¹¹³

...In my view the Bell directors did not breach any fiduciary duties when they decided that if the Bell companies did not enter into the Transactions each company would go into liquidation and there would be very substantial asset value losses.

The different views on whether there was a breach of fiduciary duty were determinative of the potential remedies available. The majority in *Westpac v Bell* held that the breach of fiduciary duty gave the relevant companies the right to elect to rescind the relevant transactions.¹¹⁴

As indicated above, the *Charterbridge* test involves assessing whether a director could reasonably have believed a transaction was in the best interests of the particular company. That objective formulation is hard to reconcile with the subjective wording of s 131, which requires a director to believe that action is in the best interests of the company.

¹¹⁰ *Bell Group v Westpac no 9*, above n 34. For an entertaining historical summary of the extent of this litigation, see *Bell Group (UK) Holdings Ltd (in liq)* [2020] WASC 347 per Master Sanderson.

¹¹¹ *Westpac Banking Corporation v The Bell Group (No. 3)*, above n 25.

¹¹² *Westpac Banking Corporation v The Bell Group (No 3)*, above n 25, at [2079].

¹¹³ At [2880].

¹¹⁴ See Lee AJA at [1131] and Drummond AJA at [2668]-[2671]. Carr AJA did in the end agree the transactions should be set aside but on other grounds, as preferential transactions under s 565 Corporations Act (transactions which preferred the banks to other Bell group creditors).

Such a test also means that the validity of a company's contracts (in *Westpac v Bell*, contracts with the company's banks) may depend on a court's assessment of the reasonableness of a director's action. Such an assessment may be necessary when determining whether directors should be liable for damages for breach of a duty of care. However, it is less suitable for determining whether a company should be able to avoid contracts entered into with third parties.

If a director honestly believes that a transaction will be in the interests of a particular group company (including because the director considers that the transaction will be in the interests of the entire group of companies that includes the particular company), the director should not be held to breach s 131, and the transaction should not be subject to the remedy of rescission.

On the question of an objective or subjective approach to the best interests duty, I turn next to the context of insolvent companies. One aspect of the Court's reasoning in *Sequana* suggests a test for the best interests duty which can result in a finding of breach in a case involving mere negligence.

As discussed above, *Sequana* stands for the proposition that where a company is insolvent, or its insolvency is imminent, then the director's duty to act in the best interests of the company includes a requirement for directors to consider the interests of creditors. However, the majority said that for the requirement to consider creditor interests to be triggered, it was necessary that the director "know or ought to know" about the relevant insolvency status of the company.¹¹⁵ Lord Reed P may have gone even further, suggesting that the requirement to consider creditor interests may arise simply when the company is in fact insolvent, regardless of whether directors have actual or constructive knowledge of that insolvency status.¹¹⁶

In my view, given that the requirement to consider creditor interests is part of the *fiduciary* duty to act in the best interests of the company, then it makes more sense that it be necessary for directors to be required to have *actual* knowledge about the insolvency status of the company

¹¹⁵ *BTI 2014 LLC v Sequana SA*, above n 21, at [203] per Lord Briggs JSC. See also Lord Hodge DPSC at [238].

¹¹⁶ At [90].

(albeit that consistent with the approach taken in other contexts, “wilful blindness” would likely also be equated with actual knowledge¹¹⁷).

As discussed above, the best interests duty involves the application of a subjective test.¹¹⁸ Directors will not be considered in breach of the duty unless they are consciously acting contrary to the company’s interests or have failed to consider such interests. A director acting in breach of their duty of care should not be considered to be breaching their fiduciary duty. The courts have resisted applying remedies applicable to a breach of fiduciary duty to cases of simple (or even gross) negligence.¹¹⁹

The suggestion of the majority in *Sequana* that it is enough to trigger the requirement to consider the interests of creditors, that directors “ought to know” that a company is insolvent, is inconsistent with that previous approach. A standard based on what directors “ought to know” is a test suitable for a duty of care, rather than one appropriate for the application of a fiduciary duty that is only breached when directors fail to meet the subjective test required for the best interests duty.

Assume that a director enters into a contract without considering creditors’ interests at a time when the company was insolvent, but the director did not realise the company was insolvent. It can sometimes be hard to recognize balance sheet insolvency. Lord Briggs commented that while directors will normally be aware of an inability to pay debts when they fall due, “balance sheet insolvency may be more insidious”.¹²⁰

If the director should have realised that the company was insolvent before entering into a contract, then the director’s actions could well amount to a breach of his or her duty of care, potentially giving rise to personal liability of the director for damages to the company.¹²¹ In *Sequana*, Lady Arden suggested that the message of the judgment in that case was that directors had a duty to keep themselves informed about a company’s solvency status.¹²² That is no doubt

¹¹⁷ *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809 at [72]; *White v White* [2001] UKHL 9, [2001] 1 WLR 481 at [16] per Lord Nicholls and [34] per Lord Cooke.

¹¹⁸ *Regentcrest plc (in liquidation) v Cohen*, above n 74, at [120]; *Madsen-Ries v Cooper*, above n 27, at [112].

¹¹⁹ *Motorworld v Turners Auctions*, above n 85 at [100]-[101] where the Court held incompetence of a director was insufficient to amount to a breach of fiduciary duty, and therefore declined a knowing receipt claim against Turners Auctions; *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)*, above n 79, at 580.

¹²⁰ *BTI 2014 LLC v Sequana SA*, above n 21, at [201].

¹²¹ Section 137 Companies Act 1993.

¹²² *BTI 2014 LLC v Sequana SA*, above n 21, at [304]. There is no shortage of previous case law suggesting that directors owe a duty of care to keep themselves informed, understand the financial position of the company and be able to monitor the performance of management: *Davidson v Registrar* [2011] 1 NZLR 542 (HC) at [121]; *Daniels v Anderson* (1995) 16 ACSR 607 (NSWCA) at 664.

true, but seems to be more of an obligation to take due care. The real question is whether such conduct should also be a breach of the fiduciary duty under s 131, giving rise to the normal remedies for such breach?¹²³ That would include potential rescission of the contract.

In my view, the answer to that question should be no, unless the director was actually aware of the company's insolvency. Directors who act negligently will still be liable for a breach of their duty of care, but the equitable remedies applicable for a breach of fiduciary duty (including rescission of contracts) would not apply.

The suggestion in the majority judgment of Lord Briggs JSC that constructive knowledge of insolvency by a director could lead to a breach of the fiduciary duty to act in the best interests of the company, in my view is contrary to principle, and would unduly affect certainty of contracts. It goes without saying that the potential position outlined by Lord Reed P (under which there could be a breach of the fiduciary duty without even constructive knowledge of the company's insolvency status) is even more undesirable.

Level of Knowledge by Contracting Party Required for Company to Exercise a Right of Rescission

There is no right to avoid a contract entered into in breach of fiduciary duty if the other party to the contract did not know about the breach of fiduciary duty.¹²⁴ Multilateral agreements will not be capable of rescission if any of the other parties are innocent.¹²⁵

Dixon J in the High Court of Australia has commented in relation to breaches of an agent's duty to act in the best interests of their principal, if the action of the agent:¹²⁶

¹²³ This point was argued in *Hellard v Carvalho*, above n 74, at [94]-[95], but only dealt with briefly as the Court accepted that the relevant director did have the required subjective knowledge.

¹²⁴ *Ashburton Oil NL v Alpha Minerals NL* (1971) 123 CLR 614 (HCA) at 643; *Pine Vale Investments Ltd v East Ltd* (1983) 8 ACLR 199 (Supreme Court of Queensland) at 211; *Whitehorn Brothers v Davison* [1910] 1 KB 463 (CA) at 476; *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666 (NSWCA) at 689; *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700 (Ch) at 765; *Bamford v Bamford* [1970] Ch 212 (CA) at 242; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483 (HCA) at 493-494 and 500; Larelle Chapple and Phillip Lipton *Corporate Authority and Dealings with Officers and Agents* (CCH Australia, 2002) at 152; Grantham, above n 7, at 58.

¹²⁵ Dominic O'Sullivan, Steven Elliott and Rafal Zakrzewski *The Law of Rescission* (3rd ed., 2023, Oxford University Press) at [20.31]; *Re Metal Constituents* [1902] 1 Ch 707 at 710 (claim by shareholder for rescission of contract for shares failed where this would deprive other shareholders of their rights).

¹²⁶ *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 (HCA) at 142.

is otherwise within the scope of his authority it binds the principal in favour of third parties who deal with him bona fide and without notice of his fraud...The rule, no doubt, is the same with respect to the acts of directors.

How do you assess the innocence of a contracting third party when it comes to the question of whether the company has preserved a right of rescission arising from a director's breach of fiduciary duty?

Often, a corporate transaction entered into in breach of a director's best interests duty will be a transaction between the company and a party associated with the director. In such a circumstance, it will be difficult to assert that the associated party is unaware of the breach of duty and can be characterised as an innocent third party.¹²⁷

An example is *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd*. A guarantee given by David Murray Holdings in favour of its parent company, Reid Murray Holdings, was held to breach the duty of the directors of David Murray Holdings to act in the best interests of that company, making the guarantee voidable. Mitchell J held that Reid Murray Holdings was itself responsible for the fact that the directors of David Murray Holdings gave the guarantee to the detriment of David Murray Holdings and without David Murray Holdings receiving any benefit from the transaction. Accordingly, in the Court's view, Reid Murray Holdings was "not in the position of an innocent third party".¹²⁸

Where, however, the third party is independent of the director who was in breach, then a court will more readily accept an argument that the third party was innocent of the breach of duty.

The issue will often arise for a bank that obtains a guarantee and/ or security from a company that is not the same entity as the one to whom the bank has advanced money. James O'Donovan has suggested that to avoid any suggestion of constructive knowledge of a breach of directors' duties, a bank should require the company providing a guarantee of a third-party obligation, or supporting mortgage, to provide an extract from the board meetings at which the board addressed the issue of corporate benefit.¹²⁹ Of course, however, if the disclosed purpose for a

¹²⁷ See, for example, Grantham, above n 7, at 61, referring to transactions within a group of companies.

¹²⁸ *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd* (1972) 5 SASR 386 (SASC) at 404.

¹²⁹ James O'Donovan "Corporate Benefit in Relation to Guarantees and Third Party Mortgages" (1996) 24 ABLR 126 at 134.

transaction does not suggest corporate benefit then the lender will be vulnerable should they proceed with the transaction.¹³⁰

However, case law authority suggests that mere constructive knowledge of a breach of duty is insufficient for a contracting third party to lose its status as an “innocent” third party. Millett J has suggested that actual knowledge by the contracting party of the breach of duty, or wilful blindness by that party as to the fact of the breach, is required for the company still to preserve its rights of rescission of the contract. In his view, it is not sufficient for the contracting party to have mere constructive knowledge of the breach of duty.¹³¹ The English Court of Appeal has more recently taken a similar view, stating:¹³²

Provided that contracting parties act honestly, they will not be affected by what they do not know (provided they do not turn a blind eye to the truth).

However, there is uncertainty in the law as to the form of knowledge that is relevant to fix liability on third parties in relation to a breach of fiduciary duty. For example, in *Great Investments Ltd v Warner*, the Full Federal Court of Australia had to consider the position of third parties who had received bonds transferred by a director of Bellpac, Mr Wong, for Mr Wong’s personal benefit and to the detriment of Bellpac. The third parties unsuccessfully raised defences of bona fide purchase for value. In holding that the defence failed, the Court indicated that the third parties could not rely on the defence in circumstances where they had “knowledge of circumstances which would put an honest and reasonable person on inquiry”.¹³³

Nor is the case law clear whether the test for “notice” should be the same for all forms of third party liability associated with a breach of fiduciary duty. In *Logicrose*, when considering the knowledge of a third party required for a company to preserve the right to rescission, Millett J drew an analogy with the state of mind required for third party liability for knowing assistance in a breach of trust.¹³⁴ By contrast, in *Great Investments*, the Court suggested the “authorities on the degree of knowledge for the purposes of ensuring security of third party transactions

¹³⁰ Chapple and Lipton, above n 124, at 136-137 (point 8).

¹³¹ *Logicrose Ltd v Southend United Football Club Ltd (No. 2)* [1988] 1 WLR 1256 (Ch) at 1261.

¹³² *UBS AG v Kommunale Wasserwerke Leipzig GMBH* [2017] EWCA Civ 1567 at [120] per Lord Briggs and Hamblen LJ.

¹³³ *Great Investments Ltd v Warner* [2016] FCAFC 85, (2016) 335 ALR 542 at [121]. In doing so, the Court followed *Papadimitriou v Credit Agricole Corp and Investment Bank* [2015] UKPC 13, [2015] 1 WLR 4265 and indicated that this was an acceptance that any of the five categories of knowledge discussed in *Baden v Societe Generale pour Favoriser le Developpement du Commerce et de l’Industrie en France SA* [1992] 4 All ER 161 at 242- 243 would be sufficient to amount to “notice”: at [110]-119].

¹³⁴ *Logicrose Ltd v Southend United Football Club Ltd (No. 2)*, above n 131, at 1261.

should not be adjusted to make them consistent with the doctrine of knowing receipt which establishes equitable liability to compensate, make restitution, or disgorge profits”.¹³⁵ One concern with the approach in *Great Investments* is that claims against a contracting third party might be made in the alternative based on knowing receipt and rescission. There does not seem to be a good reason for the outcome of the alternative claims to be different. The contracting third party will no doubt be concerned about losing the benefit of its contract, either directly through an order for rescission, or effectively through an order to repay amounts equivalent to property received under the contract pursuant to knowing receipt liability.

There is currently some uncertainty in New Zealand law regarding the knowledge test required for a party to be liable for knowing receipt. The Supreme Court has held that liability for dishonest assistance in a breach of trust depends on actual knowledge or wilful blindness of the breach of trust.¹³⁶ However, the knowledge test for liability in knowing receipt is less settled. The Court of Appeal has said that liability in knowing receipt should depend on whether it is unconscionable for a recipient to retain the relevant property, and has suggested that the same circumstances of knowledge (namely actual knowledge or wilful blindness) are sufficient to lead to liability.¹³⁷ On the other hand, earlier authority had suggested that constructive knowledge (such as being put on inquiry of a breach of fiduciary duty) might be enough for liability.¹³⁸

There is a potential for incoherence in the law if the knowledge test for knowing receipt liability differs from that which would apply to allow a company to rescind a transaction for breach of fiduciary duty. A third party could, on the one hand, resist rescission of a transaction by not being wilfully blind to a breach of fiduciary duty but, on the other hand, still be liable to the company in knowing receipt because the third party was put on inquiry as to the breach. Lord Neuberger has noted the potential for “confusion and inconsistency” in the law if the test for knowing receipt was different from the test applied to determine the validity of a contract.¹³⁹

¹³⁵ *Great Investments Ltd v Warner*, above n 133 at [119].

¹³⁶ *Westpac New Zealand Ltd v MAP and Associates Ltd* [2011] NZSC 89, [2011] 3 NZLR 751 at [27]; *Sandman v McKay* [2019] NZSC 41, [2019] 1 NZLR 519 at [78].

¹³⁷ *McLennan v Livaja* [2017] NZCA 446, [2018] NZAR 405 at [38]-[45] and [52]-[56]. In Australia, see *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6, (2012) 287 ALR 22 at [249]-[270].

¹³⁸ *Westpac Banking Corp v Savin* [1985] 2 NZLR 41 (CA) at 52-53.

¹³⁹ *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)* [2010] HKCFR 64, (2010) 13 HKCFAR 479 at [135]. Lord Neuberger’s comments were in the context of the knowledge test applicable for determining whether a third party could rely on apparent authority. However, the same argument also seems apposite to whether a contract should be considered voidable in equity.

Maronis Holdings Ltd v Nippon Credit Australia Ltd illustrates a fact pattern involving a breach of directors' best interests duty in the context of banking transactions entered into by a company. Although decided in Australia, the case involved a New Zealand company that was part of a group of companies headed up by an Australian parent company.¹⁴⁰

Maronis Holdings was the New Zealand company in question. It was a wholly owned subsidiary of Girvan New Zealand, also a New Zealand company. Girvan New Zealand, in turn, was owned 74% by Girvan Australia and 26% by other shareholders. Maronis owned a valuable property in New South Wales known as the truckstop site. The transaction at issue in the case concerned the giving by Maronis of a mortgage over the truckstop site to Nippon as security for an A\$15 million loan given by Nippon Credit to Girvan Australia.

The Court held that the transaction amounted to a breach of fiduciary duty by the Maronis directors (Duncan and Ambler) who entered into it. Bryson J commented:¹⁴¹

No person, acting in his own interest or acting as a director of a company and considering its interests, could reasonably regard it as appropriate to proceed with no security of any kind, or decide to do so.

Accordingly, the Court held the directors were in breach of their duty to act in the best interests of Maronis, as the transaction was not in the interests of all the shareholders. The Court gave judgment for Maronis against directors Duncan and Ambler for damages of A\$31million for breach of fiduciary duty.

A claim by Maronis to set aside the mortgage was problematic as Nippon had already sold the mortgaged property. However, the Court said that there was no basis for such a claim as Nippon was unaware of the breach of fiduciary duty. For the same reason, a claim in equity against Nippon for knowing receipt of funds paid in breach of fiduciary duty failed. It was not obvious on the face of the transaction that the transaction involved a breach of fiduciary duty, and Nippon had seen a director's resolution of Maronis resolving that the transaction was in the best interests of the company.¹⁴²

¹⁴⁰ *Maronis Holdings Ltd v Nippon Credit Australia Ltd*, above n 106.

¹⁴¹ At [309]. The way the judge formulated the test could, however, be criticised for being an objective approach to the best interests duty.

¹⁴² At [438], [440] and [442].

The Court concluded:¹⁴³

[To] my observation there was no positive basis on which Maronis could show that it was entitled in equity to have the mortgage set aside or entitled on some restitution principle to have the mortgage and what Nippon Credit has taken under it restored.

The Court commented that for all Nippon knew, the directors of Maronis may have had plans in mind which would have given Maronis “comprehensive protection or large countervailing advantages”, and the directors might have carefully weighed up what Maronis' interests required and made an evaluation that those interests were served by making credit available for Girvan Australia. Even if Nippon had obtained detailed information about the inner workings of Maronis' business, it would have been difficult for Nippon to assess that. Nippon had seen the minutes of the resolution of directors of Maronis stating that the arrangements were in the best interests of the company. There was “no more in all practicality” that Nippon could do.¹⁴⁴

The Court also commented:¹⁴⁵

It was Nippon Credit's business to lend money, and to earn interest by doing so, and to attend to the risks of doing so. It was not Nippon Credit's business to look after Maronis' interests; that was the business of Maronis and its directors.

The judge said there was nothing to prompt further inquiry by Nippon and suggested that people dealing honestly with a commercial organization like Maronis (a subsidiary of a listed company) should be able to take exercises of its powers at face value.¹⁴⁶

However, would rescission of the banking transactions have been appropriate if Nippon had been “put on inquiry” as to a potential breach of fiduciary duty by the Maronis directors, as

¹⁴³ At [438].

¹⁴⁴ At [442].

¹⁴⁵ At [443].

¹⁴⁶ At [443]. For a similar outcome on broadly similar facts, see *Lovett v Carson Country Homes Ltd* [2009] EWHC 1143 (Ch). In that case, one director (Jewson) caused a company (Carson Country Homes), in which Jewson's family interests had only a 66% shareholding, to give securities to the Barclays Bank in support of loans made by the Bank to the Jewson family interests. The securities were held binding on Carson Country Homes on the basis that Jewson had apparent authority to bind the company to banking transactions. No argument was made in that case that the transaction was voidable in equity. However, the upholding of the claim of apparent authority is consistent with the Bank not having been put on notice of the breach of duty by Jewson in entering into the transaction. A claim that the transaction was voidable in equity would have failed for the same reason.

opposed to Nippon having actual knowledge of (or being wilfully blind to) the breach of fiduciary duty?

I will explore further in Chapter 9 the policy considerations of relevance to what level of knowledge of a contracting third party should be sufficient to deprive them of the ability to enforce a contract.

Having discussed in Chapters 3-4 the impact of a breach of the best interests duty in equity, I now turn in Chapters 5-7 to the impact as a matter of agency law.

Chapter 5- The Authority of the Board of Directors

Having first considered the potential impact on a corporate transaction of a breach of a director's duty to act in the best interests of the company as a matter of the *law of equity* (as a result of the breach of fiduciary duty making a transaction voidable), it is also necessary to consider whether the breach impacts on the validity of the transaction as part of the *law of agency*.

The precise question is whether a breach of the best interests duty impacts the authority of a corporate agent to bind the company. If a corporate agent does not have authority to enter into a contract for a company, then that will make the contract void as a matter of agency law (unless the agent has apparent authority).

It has long been held that as an artificial person, a company can only act through the agency of individuals.¹

Some commentators suggest that when directors are acting collectively as the board, they are acting *as* the company (or an organ of the company) rather than as agents.² Watts, by contrast, suggests that directors are always acting as agents of the company, whether acting individually or collectively.³ It is not necessary to resolve that debate as commentators and courts appear agreed that directors (including the whole board) do act as agents when entering into contracts on behalf of the company.⁴

The courts originally developed agency law in the context of human principals who appointed agents to contract on their behalf.⁵ Principals would be bound by transactions entered into on their behalf if the agent had either actual or apparent (ostensible) authority to enter into the

¹ *Yarborough v The Bank of England* (1812) 16 East 6 at 7, 104 ER 991 at 991; *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (CA) at 504; *Bilta (UK) Ltd (in liquidation) v Nazir (No.2)* [2015] UKSC 23, [2016] AC 16 at [183]-[184] per Lords Toulson and Hodge.

² Christian Witting "The Small Company: Directors' Status and Liability in Negligence" (2013) King's Law Journal 343 at 349; Susan Watson "Conceptual Confusion: Organs, Agents and Identity in the English Courts" (2011) 23 Singapore Academy of Law Journal 762 at 764.

³ Peter Watts "Directors as Agents- Some Aspects of Disputed Territory" in Danny Busch, Laura McGregor and Peter Watts (eds) *Agency Law in Commercial Practice* (Oxford University Press, 2016).

⁴ Watson, above n 2, at 787-788 (accepting that directors act as agents when they act externally); Witting, above n 2, at 349 (accepting that it makes sense to "describe the directors who procure contracts for the company as its agents"); *Lee v Lee's Air Farming Ltd* [1961] A.C. 12 (PC, New Zealand) at 26.

⁵ Ross Cranston "Agents, 'Agents' and Agency" in *Making Commercial Law Through Practice 1830-1970* (Cambridge University Press, 2021). Cranston notes at 196 that the courts had developed the general principles of agency law by the end of the 18th century, and at 129 that the company form, which began to proliferate from the second half of the 19th century, "threw up a range of new issues for agency law".

transaction. For actual authority to exist, the principal must have agreed with the agent that the agent could contract on the principal's behalf (either in relation to the particular contract, or generally in a way broad enough to encompass the contract). For apparent authority to exist, the principal must have held out or represented to the contracting third party that the agent had authority to contract on behalf of the principal.

The extension of these rules to company contracts is problematic. How does a company as principal provide agreement that the agent may bind the company for the purpose of actual authority? How does the company as principal effectively represent or hold out to a contracting third party that an agent can bind the company for the purpose of apparent authority?

Relevant to actual authority, s 180 of the Act provides that a company may enter into ordinary contracts by a person acting "under the company's express or implied authority".

Board Authority under Section 128

As the Court of Appeal noted in *Bishop Warden Property Holdings Ltd v Autumn Tree Ltd*, "Authority to bind a company to contracts is primarily reserved to the Board of Directors" under s 128.⁶

Section 128 provides:

- (1) The business and affairs of a company must be managed by, or under the direction or supervision of, the board of the company.
- (2) The board of a company has all the powers necessary for managing, and for directing and supervising the management of, the business and affairs of the company.
- (3) Subsections (1) and (2) are subject to any modifications, exceptions, or limitations contained in this Act or in the company's constitution.

Accordingly, under s 128(1) (subject only to the Act and the company's constitution), the business of the company (which includes all company contracting) *must* be managed by the company's board, and under s 128(2) (again, subject only to the Act and constitution), the company's board has full authority ("powers") for that purpose.

⁶ *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809 at [27].

Section 130 permits the board to delegate its powers to “a committee of directors, a director or employee of the company, or any other person”.

As the contracting authority of all corporate agents derives from the board (and can be no wider than that of the board), it is essential to consider the width of the board’s authority conferred by s 128. How wide does the authority of the board extend, and can it extend to acts that are not in the best interests of the company?

Before the reform of the law relating to corporate capacity⁷, some case law suggested that action not in the best interests of the company might result in a company not even having capacity, resulting in transactions being ultra vires and void. In *Parke v Daily News Ltd*, for example, the Court held that ex gratia payments to employees upon a company ceasing business were ultra vires on the basis that such payments could not be said to be in the interests of the company and were not authorised by the company’s memorandum.⁸

Section 17(3) now provides, “The fact that an act is not, or would not be, in the best interests of a company does not affect the capacity of the company to do the act.” This section makes it clear that earlier case law suggesting that a failure to act in the best interests of the company removes corporate capacity is no longer good law.

However, the need for s 17(3) can be doubted. The cases giving rise to the section were explained and effectively overruled in a series of more modern cases.⁹ Those subsequent cases made it clear that a failure of directors to act in the best interests of the company was not enough to remove corporate capacity.¹⁰

In particular, in *Re Halt Garage (1964) Ltd*, Oliver J held:¹¹

But the test of bona fides and benefit to the company seems to me to be appropriate, and really only appropriate, to the question of the propriety of an exercise of a power rather than the capacity to exercise it.

⁷ In New Zealand, originally through the Companies Amendment Act (No 2) 1983.

⁸ *Parke v Daily News Ltd* [1962] Ch 927. See also *Hutton v West Cork Railway Company* (1883) 23 Ch D 654 (CA); *Re Lee, Behrens & Co. Ltd* [1932] 2 Ch 46.

⁹ *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] 1 Ch 62; *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016 (Ch); *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246 (CA).

¹⁰ Ross Grantham “Contracting with Companies: Rule of Law or Business Rules?” (1996) 17 NZULR 39 at 48, n 54.

¹¹ *Re Halt Garage (1964) Ltd*, above n 9, at 1034.

While the question of corporate capacity is less relevant to company contracting in New Zealand now¹², the historical approach to transactions beyond a company's capacity might still be considered relevant to the question of whether transactions are beyond the *authority* of the board (or of individual directors).

Can directors be said to have actual authority to enter into contracts when doing so would breach their duty under s 131 to act in the best interests of the company? The Law Commission did not think so, saying the following in relation to the exercise of powers:¹³

To the extent, of course, that they exceed "the best interests of the company" they will not be within the powers of management conferred upon directors.

Was the Law Commission's assumption correct? Certainly, the board only has authority (including contracting authority) in respect of "managing ... the business and affairs of the company" (s 128(2)). Actions that it is apparent have nothing to do with the company's business, such as paying personal debts using company funds, will accordingly be outside the board's authority.

Early English cases to this effect include *Re George Newman & Co*¹⁴ and *AL Underwood Ltd v Bank of Liverpool*¹⁵. In *Underwood*, the English Court of Appeal held that a sole director of a company did not have actual authority to pay company cheques into his personal bank account.¹⁶ In rejecting the argument that Underwood had authority, Atkin LJ said:¹⁷

If this means anything it means that a board of directors acting as such have actual authority to defraud the company by using the company's assets to pay debts due to butchers or moneylenders by the individual directors. Such an act is quite outside the class of acts –

¹² New Zealand companies normally have full capacity under s 16 Companies Act 1993. Further, even if a company does have restrictions on capacity in its constitution and goes beyond those restrictions, that will not by itself make a transaction invalid due to s 17(1).

¹³ Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [348].

¹⁴ *Re George Newman & Co* [1895] 1 Ch 674 (CA) at 686.

¹⁵ *AL Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775 (CA).

¹⁶ At 796.

¹⁷ At 796. The Privy Council cited this passage with approval in *EBM Co Ltd v Dominion Bank* [1937] 3 All ER 555 (PC, Canada) at 569. The *EBM* decision is somewhat unsatisfactory, however, as it is unclear whether the Privy Council regarded the security in that case as voidable as an interested transaction or void for lack of authority (or both). The Privy Council relied substantially on the judgment of *Aberdeen Railway Co v Blaikie Brothers* (1854) 1 Macq 461 (HL, Sc), which is a leading authority for the proposition that transactions in which a director is interested are voidable by the company in equity (which principle is now repealed in New Zealand by s 141(6) of the Companies Act 1993).

management of the company's business – authorized to be done by the board. The directors, whether collectively or singly, have not actual authority to steal the company's goods.

The limitation in *Underwood* of the board's power to *the management of the company's business* is consistent with the wording of the board's power in s 128(2). Ross Grantham, commenting on the board's power under s 128, has suggested that "if the board acts for purposes other than those incidental to the company's business it may be held to have exceeded its authority".¹⁸

The general principle that the board of directors does not have authority to steal the company's goods is consistent with the proposition that directors only have such powers as are necessary to manage the company's business.

The facts of *Underwood* are perhaps extreme and clear-cut. The sole director was simply taking the company's money and putting it into his own bank account. That cannot be said to amount to management of the company's business. Saying that the board does not have authority to steal the company's goods does not, however, necessarily mean that there should be no authority to enter into any transaction that the directors know is not in the company's best interests.

Actual Authority for Improvident Transactions?

A more arguable case is *Equiticorp Industries Group Ltd v The Crown (No 47)*, where Smellie J cited *Underwood*.¹⁹ That case concerned a purchase by Ararimu Investments Four Limited (AI4) of a share parcel in Equiticorp Holdings Ltd from the Crown (as part of a transaction under which the Crown had sold its shareholding in New Zealand Steel Ltd to Equiticorp).

The statutory managers of the Equiticorp group of companies sued the Crown, seeking the return by the Crown of the \$327 million purchase price paid by AI4 for the share parcel. This claim was based on a number of grounds, including restitution for money had and received (on the basis of a failure of consideration given that the transaction was alleged to be illegal and unauthorised) and knowing receipt (on the basis that the Crown had knowledge that the transaction amounted to a breach of fiduciary duty by the directors of AI4).

¹⁸ Grantham, above n 10, at 46. See also at 57.

¹⁹ *Equiticorp Industries Group Ltd v The Crown (No 47)* [1998] 2 NZLR 481 (HC) at 720-721.

Smellie J held the transaction was unauthorised by AI4 even though it was entered into by both directors of the company (and therefore by its board). Smellie J held that the transaction was unauthorised because it was illegal (due to breaches of ss 40 and 62 of the Companies Act 1955). However, Smellie J also held the transaction was unauthorised on the basis that the transaction was grossly improvident from AI4's point of view.²⁰

AI4 was a shelf company with no assets and no capacity to generate income. Under the transaction, the directors of AI4 caused AI4 to purchase shares worth at most \$90 million for \$327 million and to do so using borrowed funds which it had no prospect of repaying, and which rendered the company insolvent.²¹

These facts do suggest a breach of fiduciary duty by the directors. However, Smellie J does not provide any reasoning in support of his assertion that the transaction was *unauthorised* because it was grossly improvident. Smellie J does cite *Underwood*. However, *Underwood* involved a director simply taking funds for the director's own benefit and did not involve a transaction that related to the company's business. *Equiticorp*, by contrast, involved a transaction that did relate to the company's business but on grossly unfavourable terms.

Suggesting that a transaction is unauthorised just because it is grossly improvident creates a real risk that third parties will lose the benefit of contracts even if they are innocent.

As it happens in *Equiticorp*, Smellie J considered that the other contracting party, the Crown, had sufficient knowledge of the improvident nature of the contract.²² That might suggest that the transaction could have been considered voidable in equity. But what if that was not the case, and the contracting third party was unaware that a transaction was grossly improvident from the company's perspective? It would be a harsh result to hold that a third party cannot sustain a contract just because the contract was very unwise from the company's perspective.

Lightman J in *Hopkins v TL Dallas Group Ltd* took a similar approach to that taken in *Equiticorp*, finding no authority for an improvident transaction.²³

²⁰ At 551 and particularly 700-701. See also Smellie J's summary of his judgment at [1996] 3 NZLR 586 at 610 lines 32-34, which makes this point clear.

²¹ At 551.

²² At 726-727.

²³ *Hopkins v TL Dallas Group Ltd* [2005] 1 BCLC 543 (Ch) at [88]. However, unlike *Equiticorp*, *Hopkins* did not involve actions of the whole board of directors.

In contrast to the approach in *Equiticorp* and *Hopkins v Dallas* is the approach taken by Millett J in *Macmillan Inc v Bishopsgate Trust (No 3)*.²⁴ In that case, Macmillan Inc, a company incorporated in Delaware, held shares in Berlitz International Inc. These shares were transferred into the name of Bishopsgate Investment Trust plc as trustee for Macmillan pursuant to a resolution of an executive committee of Macmillan's board. Robert Maxwell's purpose in obtaining the transfer of the shares to Bishopsgate was to make the shares available for the raising of funds for his private companies, contrary to the interests of Macmillan. Millett J held that the share transfers were duly authorised notwithstanding Mr Maxwell's fraudulent purpose. Millett J accepted that there was actual authority for the share transfers and that for that purpose, no inquiry could be made into the motives of Mr Maxwell as agent.²⁵

The English Court of Appeal in *Bamford v Bamford* also rejected the argument that a transaction entered into by directors otherwise than bona fide in the interests of the company was a nullity. Russell LJ said:²⁶

In truth the allotment of shares by directors not bona fide in the interests of the company is not an act outside the articles: it is an act within the articles, but in breach of the general duty laid on them by their office as directors to act in all matters committed to them bona fide in the interests of the company.

In my view, the approach taken by Millett J in *Macmillan*, and the Court of Appeal in *Bamford v Bamford*, is preferable to that taken in *Equiticorp* and *Hopkins v Dallas*. It is consistent with the development of the equitable principles that require directors to act in the best interests of the company.

Equity traditionally acted in a supplemental way and provided a remedy where the common law was inadequate.²⁷ If the common law already provided that there was no actual authority as soon as directors did not act in the company's best interests, then there would have been no need for equity to intervene and impose a remedy for breach of the duty to act in the best interests of the company. There would already have been a remedy at law.

²⁴ *Macmillan Inc v Bishopsgate Investment Trust Plc* [1995] 1 WLR 978 (Ch).

²⁵ At 984. There are a number of other cases in which directors who have been held to breach their duty to act in the best interests of the company have nevertheless also been held to be acting within the scope of their authority: see, for example, *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* (1997) 26 ACSR 544 (Supreme Court of Victoria) at 587.

²⁶ *Bamford v Bamford* [1970] Ch 212 (CA) at 242. See also Harman LJ at 238. See also *Rolled Steel v British Steel*, above n 9, at 306H, 303 and the exchange between Browne-Wilkinson LJ and counsel in argument at 256B-D. Contrast Slade LJ at 292A and 297E-F.

²⁷ Andrew Butler *Equity and Trusts in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2009) at [1.3].

The same is true in relation to a breach of the duty to act for proper purposes. The development of the duty would not have been necessary if it was considered appropriate to interpret a fiduciary's power as only authorised if exercised for proper purposes. Lord Sumption confirmed the limitations of the proper purpose rule in *Eclairs Group Ltd v JKX Oil and Gas Plc*. His Lordship confirmed that the proper purpose rule was “*not* concerned with excess of power by doing an act which is beyond the scope of the instrument creating it as a matter of construction or implication”, but rather with “abuse of power, by doing acts which are within its scope but done for an improper reason”.²⁸

As discussed below, some commentators have argued that the House of Lords decision in *Criterion Properties v Stratford UK Properties* suggests that a failure by directors to act in the best interests of the company will remove actual authority. In my view, the case properly considered does nothing of the sort.²⁹

The case involved Criterion entering into a poison pill agreement to deter a takeover bid. Criterion and Oaktree had previously set up a joint venture property company. Criterion discovered that shares in Criterion were being bought up by a party whom Criterion's directors thought would be disruptive to its affairs, including in relation to the joint venture company. Criterion therefore entered into an agreement with Oaktree which was so unfavourable that Criterion's directors hoped it would put off the unwelcome bidder. Under the agreement, Criterion would be obliged to buy out Oaktree's interest in the joint venture at a figure that gave Oaktree a return of 25% per annum compounded over the period of the investment if there was a change of control of Criterion or if either of two named directors of Criterion ceased to be directors. The agreement successfully deterred the takeover bid. However, one of the two named directors of Criterion was later removed from the board. Oaktree opportunistically sought to trigger the poison pill agreement.

Criterion argued that the poison pill agreement was not binding for several reasons. One of these reasons was that the purpose of the agreement was an improper one, and Oaktree was on notice of the improper purpose.³⁰

²⁸ *Eclairs Group Ltd v JKX Oil and Gas Plc* [2015] UKSC 71, [2016] 3 All ER 641 at [15] also followed in *Grand View Private Trust Co Ltd v Wong* [2022] UKPC 47 (PC, Bermuda) at [55]. See also Lord Sales “Fraud on a Power: the Interface between Contract and Equity” Lecture for the Chancery Bar Association Great Hall, Lincoln's Inn, London 2 April 2019; Jessica Hudson “One Thicket in Fraud on a Power” (2019) 39 OJLS 577 at 594.

²⁹ *Criterion Properties v Stratford UK Properties* [2004] 1 WLR 1846 (HL).

³⁰ *Criterion Properties Plc v Stratford UK Properties Llc* [2002] EWHC 496 (Ch) at [12].

In the House of Lords, Lord Scott thought the case turned on whether the directors had actual or apparent authority to conclude the poison pill agreement, which he said had not been addressed in the courts below.³¹ Lord Scott noted that the Courts below had formed the view that the poison pill agreement was “clearly contrary to the commercial interests of Criterion”. His Lordship said that he did not want it suggested that knowledge by Oaktree of this fact was irrelevant to the issue of authority.

Lord Scott then said:³²

Apparent authority can only be relied on by someone who does not know that the agent has no actual authority. And if a person dealing with an agent knows or has reason to believe that the contract or transaction is contrary to the commercial interests of the agent’s principal, it is likely to be very difficult for the person to assert with any credibility that he believed the agent did have actual authority. Lack of such a belief would be fatal to a claim that the agent had apparent authority.

Some commentators have argued that this passage suggests that the House of Lords accepted that if the transaction was contrary to the commercial interests of the company, there would not be actual authority.³³

I do not consider that is the correct interpretation of Lord Scott’s speech. The House of Lords was not suggesting that a failure to act in the best interests of a company negated actual authority. When Lord Scott first discusses actual authority, he does so by discussing whether the board of Criterion in fact authorised the agreement in question, whether the board had the power to do so, and the potential impact of s35A of the Companies Act 1985 (UK) (which section provided that in favour of a third party dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company’s constitution).³⁴

Accordingly, the question of actual authority that Lord Scott was actually concerned with was the more conventional issue of whether the board of directors had properly approved the transaction. Further, the only precedent quoted by Lord Scott on the question of actual authority

³¹ *Criterion Properties v Stratford UK Properties*, above n 29, at [30] and [32].

³² At [31].

³³ Payne and Prentice “Company contracts and vitiating factors: developments in the law on directors’ authority” [2005] LMCLQ 447 at 455. See also at 453 and 465; Peter Watts “Authority and Mismotivation” (2005) 121 LQR 4 at 7.

³⁴ *Criterion Properties v Stratford UK Properties*, above n 29, at [28].

was the decision of the House of Lords in *British Bank of the Middle East v Sun Life Assurance Co of Canada (UK) Ltd*.³⁵ That case discussed ordinary principles relating to whether an insurance company had authorised its officers to undertake insurance or mortgage business. There is no discussion in *British Bank* of a limitation on actual authority based on the improper motivations of the corporate agents in question.

Accordingly, Lord Scott's discussion of the relevance of the motivations of the directors appears limited to the impact of those motivations on the *apparent* authority of the directors.³⁶ It is reasonable to discuss the motivations of the directors in that context as knowledge by a third party of a clearly improper motive of the directors could be said to put the third party "on inquiry" that there is a problem, and at least at common law to potentially negative reliance on apparent authority.

There was certainly prior authoritative support (such as *Northside Developments Pty Ltd v Registrar-General*) for the proposition that where a third party is aware that a corporate agent has entered into a transaction that has no benefit for the company, the third party is put on inquiry as to potential defects in authority with the result that the third party cannot rely on apparent authority.³⁷

In my view, Lord Scott in *Criterion* was saying nothing different from what the High Court of Australia said in *Northside*. Further, if Lord Scott had intended to change the law on the question of actual authority, it is likely he would have done so more clearly.

The Law in Australia and New Zealand

The Australian courts have been clear that an abuse of power by company directors, and in particular a breach of the best interests duty, does not of itself make a transaction void for lack of authority.³⁸ Instead, it only makes the transaction voidable in equity for breach of fiduciary duty. In that sense, the approach taken by the Australian courts is similar to that taken by the English Court of Appeal in *Bamford v Bamford*.

³⁵ *British Bank of the Middle East v Sun Life Assurance Co of Canada (UK) Ltd* [1983] 2 Lloyd's Rep 9 (HL).

³⁶ *Criterion Properties v Stratford UK Properties*, above n 29, at [29] and [31].

³⁷ *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146 (HCA) per Mason CJ at 164-165. See also Mason CJ at 165-166, Brennan J at 182-183 and 188-189, Dawson J (with whom Toohey J agreed) at 205-206, and Gaudron J at 216. See Chapter 7.

³⁸ An exception is *ANZ Executors & Trustee Company Ltd v Qintex Ltd* (1990) 2 ACSR 676 (Supreme Court of Queensland, Full Court) at 687 where the Court suggested that neither the company's directors nor shareholder had the power to give a guarantee that was not for the company's business or benefit. The company in question was insolvent. However, the Court did not address the line of cases discussed below.

This proposition was set out clearly by the High Court of Australia in *Richard Brady Franks Ltd v Price*. There, Dixon J accepted that directors must exercise their powers honestly in furtherance of the powers they have been given. However, Dixon J made it clear that a breach of this duty did not necessarily mean there was no authority for a transaction.³⁹

Directors are fiduciary agents and their powers must be exercised honestly in furtherance of the purposes for which they are given. Under the general law of agency it is a breach of duty for an agent to exercise his authority for the purpose of conferring a benefit on himself or upon some other person to the detriment of his principal. But, at the same time, if his act is otherwise within the scope of his authority it binds the principal in favour of third parties who deal with him bona fide and without notice of his fraud (*Hambro v Burnand* [1904] 2 KB 10; *Lloyds Bank v Chartered Bank of India, Australia and China* [1929] KB at 56, per Scrutton L.J.). The rule, no doubt, is the same with respect to the acts of directors. It follows that a transaction carried out by directors for their own or some other persons' benefit and not to further any purpose of the company is voidable but not void.

In *Richard Brady*, the company challenged the authority of its directors to enter into certain debentures on behalf of the company on a number of grounds, including an allegation that the directors had not acted in the interests of the company but just for the personal gain of the proposed debenture holders. If the factual allegation of not acting in the company's interests was made out, it was necessary to distinguish between whether the debentures were void for lack of authority, or just voidable in equity. An action for trespass against receivers appointed under the debentures could only succeed if the debentures were actually void rather than merely voidable.⁴⁰ Accordingly, the Court's decision that a director acting in their own interests and not in that of the company would only make the transaction voidable in equity (and not void for lack of authority) was of direct relevance to the question at issue in the case.

This approach, under which transactions entered into in breach of the best interests duty are only voidable in equity, and not void for lack of authority, has been applied in Australia on numerous occasions since *Richard Brady*.⁴¹

³⁹ *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 (HCA) at 142.

⁴⁰ At 143.

⁴¹ *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA); *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd* (1996) 39 NSWLR 143 (NSWCA); *Grimaldi v Chameleon Mining NL (No 2)* [2012] FCAFC 6, (2012) 287 ALR 22; *Westpac Banking Corporation v The Bell Group (No 3)* [2012] WASCA 157, (2012) 89 ACSR 1; *Re Cummings Engineering Holdings Pty Ltd* [2014] NSWSC 250 (NSWSC); *Great Investments Ltd v Warner* [2016] FCAFC 85, (2016) 335 ALR 542; *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666 (NSWCA) at 697-698. The Australian view is summarised well by Robert

Another Australian case of potential relevance is *Pico Holdings Inc v Wave Vistas Pty Ltd*.⁴² There, the High Court accepted that Mr Voss, as the sole and managing director of Wave Vistas, had actual authority to bind the company in relation to the giving of a mortgage over company property to Pico Holdings.⁴³ An argument was made in that case that the lack of benefit to Wave Vistas from giving a mortgage to support a loan made by Pico Holdings to a different company (Dominion Capital Pty Ltd) meant that Mr Voss was not exercising his actual authority on behalf of Wave Vistas. The Court rejected the argument.⁴⁴

to seek to infer from the lack of benefit to a particular company that Mr Voss was not intending to act on its behalf is wholly unconvincing: a man whose problems were as pressing and whose actions were as shifty as Mr Voss's were in 2000-2001 is very unlikely to have been guided by scruples of that kind.

Accordingly, the fact that Mr Voss did not intend to act in the interests of Wave Vistas did not remove his actual authority to bind the company.

There is little New Zealand authority on the point. However, the Court of Appeal in *Autumn Tree* suggested that where a director was acting in breach of the duty to act in the best interests of the company, this would make the transaction voidable in equity.⁴⁵ The Court did not suggest that this breach of duty might also have affected the question of whether there was authority at law (the Court instead finding that there was no authority for the transaction because the transaction was a major transaction which had not been approved by shareholder special resolution as required by s 129 of the Act).

The Impact on Commercial Transactions

The law relating to actual authority governs the relationship between the company as principal and corporate agents who purport to enter into transactions on the company's behalf. The law of actual authority is not specifically designed to protect the reasonable expectations of contractual third parties. The law relating to apparent authority more directly fulfills that function. However, an approach to actual authority that allows a corporate principal an option

Austin and Ian Ramsay Ford, *Austin and Ramsay's Principles of Corporations Law* (17th ed., LexisNexis, 2018) at [15.180].

⁴² *Pico Holdings Inc v Wave Vistas Pty Ltd* [2005] HCA 13, (2005) 214 ALR 392.

⁴³ At [54].

⁴⁴ At [57]-[58]. The argument of lack of authority was made by National Australia Bank, a competing mortgagee.

⁴⁵ *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 6, at n 3.

to withdraw from a transaction because corporate agents were subjectively not acting in the company's interests would not be conducive to commercial certainty.

It is useful to consider the implications on three particular categories of transactions where questions of validity have commonly arisen:

- (a) Banking transactions involving the giving of guarantees or provision of securities by a company in a group of companies;
- (b) The sale or purchase by a company of assets on improvident terms; and
- (c) The provision of loans by a company on improvident terms (e.g. without interest or the provision of security).

Banking Cases

There are a large number of cases in which the directors of one company cause the company to give a mortgage or guarantee in support of the obligations of another company, and there is a real question as to whether the transaction had any benefit to the company giving the mortgage or guarantee. That might particularly be the case where the other company being supported is, or might soon become, insolvent.⁴⁶ Yet in most such cases, there is no suggestion that the mortgage or guarantee is void for lack of authority because of this lack of benefit.⁴⁷

The granting by a company of bank security in support of a loan to another group company can reasonably be treated as falling within the management of the first company, and so as being within the authority of the board of that company. The issuing of inter-group guarantees is common commercial practice.⁴⁸

⁴⁶ James O'Donovan "Corporate Benefit in Relation to Guarantees and Third Party Mortgages" (1996) 24 ABLR 126 at 135.

⁴⁷ *Westpac Banking Corporation v The Bell Group* (No 3), above n 41; *Maronis Holdings Ltd v Nippon Credit Australia Ltd* [2001] NSWSC 448, (2001) 38 ACSR 404 (NSWSC); *Brick and Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279 (where Brick & Pipe gave a guarantee which was of no apparent benefit to the company itself but the judgment contains no suggestion that this fact by itself removed the actual authority of Mr Goldberg to manage the business of the company: at 359 and 361-362); *Macmillan Inc v Bishopsgate Investment Trust Plc*, above n 24, at 984 (transfer of shares to enable the granting of security to support lending to other companies controlled by Robert Maxwell). If lack of authority is argued in relation to such transactions, it is usually only for reasons other than the fact that the transaction was not in the interests of the company e.g. *Bank of New Zealand v Fiberna Pty Ltd* (1994) 14 ACSR 736 (NSWCA); *Northside Developments Pty Ltd v Registrar-General*, above n 37. An exception is *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)* [2010] HKCFA 64, (2010) 13 HKCFAR 479 at [77] (The issue of actual authority was not argued before the Hong Kong Court of Final Appeals but the Court considered a concession of lack of authority was rightly made. In *Thanakharn*, the transaction was entered into by a single officer rather than the whole board).

⁴⁸ Danny Spahos "Lenders, Borrowing Groups of Companies and Corporate Guarantees: An Insolvency Perspective" (2001) 1 JCLS 333 at 334-335.

If the transaction is approved by a board resolution, and the contracting third party is made aware of that, there may be apparent authority in any event. However, this is not certain because (as discussed further in Chapter 7) third party knowledge of the lack of benefit to the first company might be argued to remove the third party's ability to rely on apparent authority.

Accordingly, the security of commercial transactions is better enhanced by assuming that there is actual authority for a mortgage or guarantee approved by the board, and that this actual authority is not affected by a lack of benefit to the company. That does not necessarily mean the transaction cannot be attacked. If the bank is aware that the transaction has been entered into in breach of fiduciary duty, then the transaction will still be voidable in equity.

In situations involving the granting of securities to banks in support of the obligations of related companies, different views can often be held as to whether the directors are acting in the company's best interests. For example, in *Westpac v Bell*, the Western Australian Court of Appeal disagreed on this question. Drummond AJA and Lee AJA considered there was a breach of duty⁴⁹, with Drummond AJA describing the breach as "egregious"⁵⁰, while Carr AJA thought there was no breach!⁵¹

In situations of this kind, where there is scope for different views as to whether a transaction is contrary to the interests of the company, it is undesirable to make the transaction automatically void for lack of authority. That would mean that the transaction cannot be enforced even if the bank was innocent of the circumstances that are alleged to amount to a breach of duty.

The fact situation in *Maronis Holdings Ltd v Nippon Credit Australia Ltd* (discussed in Chapter 4 above) highlights this very issue of whether an innocent lender can enforce a security agreement entered into by directors of a company in breach of their duties.⁵² Bryson J regarded the lender Nippon as being innocent and not having been put on inquiry as to the breach of fiduciary duty that the judge held the directors of Maronis had committed. Yet Bryson J's finding that Nippon could rely on its mortgage can only be justified if the clear breach by the directors of the best interests duty only made the transaction voidable rather than void.

⁴⁹ *Westpac Banking Corporation v The Bell Group* (No 3), above n 41 at [1007] per Lee AJA and [2071] per Drummond AJA.

⁵⁰ At [2079].

⁵¹ At [2902].

⁵² *Maronis Holdings Ltd v Nippon Credit Australia Ltd*, above n 47.

If the directors' failure to act in the company's best interests made the transaction void, Nippon's innocence would not have mattered.⁵³ There was, however, no suggestion in the judgment that the breach of duty removed authority for the transaction.

Sale or Purchase of Assets not in Best Interests of Company

The second hypothetical situation I consider involves the sale, lease or purchase of company assets on a basis that is not in the best interests of the company.⁵⁴ In cases where the validity of such a transaction has been challenged, the transaction was held *voidable* in equity for breach of fiduciary duty in *Kinsela v Russell Kinsela*⁵⁵ and *Australian Growth Resources Corporation Pty Ltd v van Reesma*⁵⁶, but to lack authority and be *void* in *GHLM Trading Ltd v Maroo*⁵⁷.

The end result in each case may have been entirely justifiable in a situation where the directors comprising the board were also associated with the party acquiring the assets being sold or leased in breach of duty. However, the approach taken in *Kinsela* and *Australian Growth Resources* is preferable as it allows consideration of whether the third party is innocent (i.e. lacks knowledge of the breach of fiduciary duty).

Consider, for example, an alternative hypothesis where the board is acting in breach of their duty in selling the assets at undervalue not because they are associated with the purchaser but for some other impermissible reason such as spite towards the shareholders of the company⁵⁸ or a completely reckless decision to favour a quick sale rather than a sale for proper value⁵⁹.

In such a situation, it would be possible for the purchasing third party to be quite innocent (albeit obtaining an overly good bargain). Let us also assume that while the company's board approved the transaction, the innocent third party has only dealt with one director so that the

⁵³ Unless Nippon could rely on apparent authority.

⁵⁴ *Sojourner v Robb* [2007] NZCA 443, [2008] 1 NZLR 751; *Re Capitol Films Ltd (in admin) Rubin v Cobalt Pictures Ltd* [2010] EWHC 2240 (Ch); [2011] 2 BCLC 359 (assignment of rights to motion picture films in return for "services" which had no apparent value); *Morgenstern v Jeffreys* [2014] NZCA 449; leave to appeal declined in *Morgenstern v Jeffreys* [2014] NZSC 176.

⁵⁵ *Kinsela v Russell Kinsela Pty Ltd*, above n 41.

⁵⁶ *Australian Growth Resources Corporation Pty Ltd (Recs and Mgrs apptd) v Van Reesma* (1988) 13 ACLR 261 (SCSA) at 271.

⁵⁷ *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch) at [170]-[171] and [179] Alternatively, the transaction would also have been voidable in equity: [170] and [172].

⁵⁸ Similar to *Mordecai v Mordecai* (1988) 12 NSWLR 58 (NSWCA), although that case involved a spiteful closing down of a business rather than the sale of assets at undervalue.

⁵⁹ *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700 (Ch) (although that case involved the sale of properties by two directors of the company rather than the whole board).

third party is not able to rely on any holding out which might justify a finding of apparent authority.⁶⁰

In such a case involving an innocent third party, it would be critical to decide whether the transaction was void for lack of authority (in which case the transaction would be unwound even if the third party was innocent) or only voidable for breach of duty (in which case the transaction might remain in place if the third party was innocent and had provided value, or if it was no longer possible to restore the parties to their original positions).⁶¹

Given the potential consequences to innocent third parties, it is preferable that a sale at undervalue in breach of s 131 be treated as only potentially voidable in equity (in which case there would be no avoidance of the transaction if the contracting party was innocent) rather than void for lack of authority. That approach is also consistent with an appropriate interpretation of directors' powers under s 128 of the Act. The sale of company assets appears to fall within the general scope of management of a company's affairs, even when the company does not obtain full value for the assets.

Loans on Unfavourable Terms

The third potential hypothetical situation involves the making of a loan on terms that are unfavourable to the company (e.g., perhaps without interest or security for repayment).⁶²

There have been situations in which Courts have regarded such a transaction as voidable for breach of fiduciary duty (as in *Robins v Incentive Dynamics Pty Ltd*⁶³) and others where the Courts have treated such a transaction as void for lack of authority (*Jyske Bank (Gibraltar) Ltd v Spjeldnaes*⁶⁴).

⁶⁰ A single director on a multi-director board would not have customary authority to enter into a transaction of any significance: *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 6, at [27] and [50].

⁶¹ For a potentially similar case, consider *Parti v Al Sabah* [2007] EWHC 1869 (Ch), where an agent had sold a property belonging to the Al Sabah sisters at an undervalue where Peter Smith J held that the sisters had an arguable case that the agreement was void for lack of authority because the agent had not acted in the interests of the sisters, or alternatively that the agreement was voidable for breach of duty: see [53] and [55].

⁶² *Robins v Incentive Dynamics Pty Ltd* [2003] NSWCA 71, (2003) 45 ACSR 244; *Walker v Wimborne* (1976) 137 CLR 1 (HCA) (where the payments were made to other companies in a group of companies). *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50 (NSWCA) is also similar to *Walker v Wimborne* but involves the actions of a single officer rather than the board.

⁶³ *Robins v Incentive Dynamics Pty Ltd*, above n 62, at [73].

⁶⁴ *Jyske Bank (Gibraltar) Ltd v Spjeldnaes* [1999] EWCA Civ 2018.

I suggest that the correct question here is how the transaction should be characterised. If the transaction, while dressed up as a loan, on any objective basis is simply a theft of monies (as appeared to be the case in *Jyske Bank*) then it would seem reasonable to describe the transaction as void with no rescission being required. The situation is then similar to the situation in the *Underwood* case, where there is a simple misappropriation of money. Such a misappropriation cannot be considered to amount to the management of the company's affairs, and therefore to fall within the board's powers under s 128.

It appears that in *Robins*, Giles JA would have considered the payment made as simply void if satisfied on the facts that the money had been simply "provided" to the other party in that case rather than truly loaned.⁶⁵ If, however, the transaction was properly characterised as a loan then it was one in breach of fiduciary duty and therefore just voidable (rather than void).⁶⁶

Therefore, the making of a company loan on unfavourable terms in breach of the best interests duty, should make the loan transaction voidable for breach of fiduciary duty, rather than void for lack of authority. Otherwise, the risk is that a loan by the company on adverse terms to the company might not be binding even if the party receiving the loan was innocent of the breach of fiduciary duty.

Of course, if the party receiving the loan is associated with a director, then it is most unlikely that the party will be innocent of the breach of duty. In such a case, the question of whether the transaction is void for lack of authority or voidable in equity may not matter much. However, taking an approach under which a loan on unfavourable terms could be considered to lack actual authority is dangerous, and would adversely impact the security of commercial transactions, as there might be situations where the party receiving the advance is not sufficiently aware that a breach of duty has occurred.

Conclusion on Approach to Authority under Section 128

Overall, I conclude that the actual authority of a board of directors to manage a company under s 128 of the Companies Act 1993 should be interpreted as including authority for transactions where the board has not acted in the best interests of the company except in cases of simple misappropriation of assets by the board. It should be acknowledged, however, that the case law

⁶⁵ *Robins v Incentive Dynamics Pty Ltd*, above n 62, at [83].

⁶⁶ That was the approach of Mason P (with whom Stein JA agreed): at [73].

is not consistent on this point. I will discuss further in Chapter 9 the policy considerations that are relevant to how that inconsistency should be resolved.

I turn in the next Chapter to address considerations of the actual authority of corporate agents (including individual directors).

Chapter 6 –Actual Authority of Corporate Agents

The authority of the board of directors limits the potential scope of delegated authority of individual corporate agents including directors. However, a breach of duty by an individual director might also be argued to impact the question of authority for a particular corporate transaction.

The specific question to address is whether the actual authority of a director can be said to be negated in a situation where they breach their duty to act in the best interests of the company.

Acting in Opposition to Principal's Interests

Bowstead and Reynolds on Agency, and the recent United Kingdom Supreme Court decision in *Philipp v Barclays Bank*, suggest that an agent does not have actual authority when they deliberately act in opposition to the interests of their principal. As discussed below, however, the New Zealand courts have taken a different approach.

Article 23 of *Bowstead and Reynolds on Agency* provides:¹

Authority to act as agent includes only authority to act honestly in pursuit of the interests of the principal.

Bowstead effectively suggests that a failure by an agent to act in the best interests of a principal undermines actual authority.² In the company law context, Lightman J followed the position set out by *Bowstead* in *Hopkins v TL Dallas Group Ltd*.³

Lord Leggatt in the United Kingdom Supreme Court recently endorsed the view set out in article 23 of *Bowstead* in an obiter statement in *Philipp v Barclays Bank*.⁴ Lord Leggatt noted

¹ Peter Watts and FMB Reynolds (ed) *Bowstead and Reynolds on Agency* (23rd ed, Thomson Reuters, London, 2024) at 3-011. See also Peter Watts, Neil Campbell and Christopher Hare *Company Law in New Zealand* (2nd ed, LexisNexis, Wellington, 2016) at [11.5.3], 314.

² A similar view is taken in other leading agency texts, see Dal Pont *Law of Agency* (4th ed, LexisNexis, Australia, 2020) at 7.32: “What can be said is that an agent’s authority cannot extend to acts that are advantageous *solely* to the agent, as this is inconsistent with the agent’s duty to act in the principal’s best interests.” (emphasis in original quote); Roderick Munday *Agency Law and Principles* (4th ed, Oxford University Press, 2022) at 3.13, 55.

³ *Hopkins v TL Dallas Group Ltd* [2005] 1 BCLC 543 (Ch) at [88]. See also *Re Capitol Films Ltd (in admin)* *Rubin v Cobalt Pictures Ltd* [2010] EWHC 2240 (Ch), [2011] 2 BCLC 359 at [53]-[54] and [59]-[62] and *LNOC Ltd v Watford Association Football Club Ltd* [2013] EWHC 3615 (Comm) at [64]-[66].

⁴ *Philipp v Barclays Bank* [2023] UKSC 25 at [72] endorsing the statement in the 22nd edition of *Bowstead*.

that the scope of an agent's authority was a matter of agreement between principal and agent. He then stated:⁵

As is generally the case in commerce, parties to an agency relationship naturally deal with each other on an unspoken common assumption that each will act honestly in relation to the other. It goes without saying that authority conferred on an agent does not encompass acting dishonestly to further the agent's own interests in opposition to the interests of the principal.

Lord Leggatt then accepted, as a clear statement of the legal principle, the statement by O'Connor J in *Lysaght Bros & Co Ltd v Falk* that:⁶

Every authority conferred upon an agent, whether express or implied, must be taken to be subject to a condition that it is to be exercised honestly and on behalf of the principal.

However, the discussion of this important point of agency law was not necessary for the determination of the case in *Philipp*. The case involved whether Barclays Bank owed a duty of care to Mrs Philipp not to implement her instructions to make certain transfers of her funds. Mrs Phillip argued that the bank should have realised that Mrs Philipp was being taken advantage of by a fraudster. However, Mrs Philipp herself provided her instructions to the bank. She did not employ any agent for that purpose. Accordingly, no issue of agency law arose on the facts. The comments of Lord Leggatt referred to above were therefore obiter. Further, the relevant point of agency law was not the subject of contested argument.

There is room for doubt as to whether the proposition set out in *Bowstead*, and by the Court in *Philipp*, is correct as an absolute proposition of law. The judgment of Leggatt J does not consider earlier high authority including *Lloyd v Grace, Smith & Co*⁷, and arguably misinterprets the House of Lords decision in *Reckitt v Barnett, Pembroke and Slater Ltd*⁸. In the New Zealand context, the New Zealand Supreme Court has criticised the relevant passage from *Bowstead*.⁹ Further, even if the proposition set out in *Bowstead* is correct as a matter of general agency law, there must be doubt as to whether it should be applied to the particular context involving a principal which is a New Zealand registered company, and an agent who is a director of such a company.

⁵ At [73].

⁶ At [74] citing *Lysaght Bros & Co Ltd v Falk* (1905) 2 CLR 421 (HCA) at 439.

⁷ *Lloyd v Grace, Smith & Co* [1912] AC 716 (HL).

⁸ *Reckitt v Barnett, Pembroke and Slater Ltd* [1929] AC 176 (HL).

⁹ *Nathan v Dollars & Sense Ltd* [2008] NZSC 20, [2008] 2 NZLR 557 at [42].

An Objective Approach to Actual Authority

The leading authority on the approach to company contracting as a matter of agency law is the decision of the English Court of Appeal in *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd*.¹⁰ In that case, Lord Diplock explained how the principles of actual and apparent authority in agency law apply to companies. Also persuasive in the New Zealand context is the Court of Appeal decision in *Giltrap City Ltd v Commerce Commission*.¹¹ There, in relation to the actual authority of corporate agents, the Court of Appeal explained how actual authority can either be express or implied, with implied authority resulting from the nature of the agent's position. The principles in both *Freeman & Lockyer* and *Giltrap City* are well established in New Zealand, and were more recently followed by the Court of Appeal in *Bishop Warden Property Holdings Ltd v Autumn Tree Ltd*.¹²

In *Freeman & Lockyer*, Lord Diplock said:¹³

An 'actual' authority is a legal relationship between principal and agent created by a consensual agreement to which they alone are parties. Its scope is to be ascertained by applying ordinary principles of construction of contracts, including any proper implications from the express words used, the usages of trade, or the course of business between the parties.

What then are the "ordinary principles of construction of contracts" referred to by Lord Diplock? Those will provide a starting point for when we should find that an agent has actual authority, at least in cases involving express delegation of authority. As Lord Diplock suggests, there is no reason why the agency contract between principal and agent (which will govern the actual authority of the agent) should not be interpreted consistently with ordinary principles of contract interpretation.

Former New Zealand Supreme Court judge Andrew Tipping has commented that principles of contract law interpretation should apply to all forms of contract, saying:¹⁴

The approach chosen should be principled and coherent but also pragmatic. It will apply to all types of contract, not just commercial contracts, and should be designed to give lawyers the

¹⁰ *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (CA)

¹¹ *Giltrap City Ltd v Commerce Commission* [2004] 1 NZLR 608 (CA) at [40].

¹² *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809 at [28] and [30].

¹³ *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd*, above n 10, at 502.

¹⁴ Andrew Tipping "The subjective and objective dimensions of contract interpretation" [2020] NZLJ 388 at 388.

best chance of resolving interpretation disputes out of court, as well as giving the courts clear guidance.

It is well-established law that the interpretation of contracts is assessed on an objective basis.¹⁵ Tipping J in the Supreme Court in *Vector Gas Ltd v Bay of Plenty Energy Ltd* noted that as “a matter of policy, our law has always required interpretation issues to be addressed on an objective basis”.¹⁶ The meaning of a document will be that which the contractual document conveys to a reasonable person having regard to all the background knowledge reasonably available to the parties at the time.¹⁷

The New Zealand courts have taken a wide approach to the permissible context that can be considered, including for example evidence of prior negotiations.¹⁸ However, the fact that parties are aware their contract might be relied upon by a third party may justify a more restrictive approach to the use of extrinsic evidence in some cases.¹⁹

When interpreting a contract, evidence of the subjective intent of the parties is not admissible.²⁰ As Tipping J noted in *Vector*, “evidence of a party’s subjective intention is not relevant to an objective resolution of interpretation issues”.²¹

¹⁵ Questions relating to the effective formation of a contract (i.e. whether parties intended to enter into a contract and whether they have succeeded in doing so) are also determined objectively from the words of the “agreement” and the background matrix of facts: *Fletcher Challenge Energy Ltd v Electricity Corp of New Zealand Ltd* [2002] 2 NZLR 433 (CA) at [53]–[54]; *Air Great Lakes Pty Ltd v K S Easter (Holdings) Pty Ltd* (1985) 2 NSWLR 309 (NSWCA) at 337 per McHugh JA. There is an exception to this where a party is aware that the other party was not agreeing: *Giltrap City Ltd v Commerce Commission*, above n 11, at [20]; *Air Great Lakes Pty Ltd v K S Easter (Holdings) Pty Ltd* (1985) 2 NSWLR 309 (NSWCA) at 331 per Mahoney JA; *Paal Wilson & Co v Partenreederai Hannah Blumenthal* [1983] 1 AC 854 (HL) at 924–925 per Lord Brightman.

¹⁶ *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, [2010] 2 NZLR 444 at [19].

¹⁷ *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 (HL) at 912 per Lord Hoffmann; *Vector Gas Ltd v Bay of Plenty Energy Ltd*, above n 16, at [19] per Tipping J and [61] and [65] per McGrath J; *Firm PI 1 Ltd v Zurich Australian Insurance Ltd* [2014] NZSC 147, [2015] 1 NZLR 432 at [60] per McGrath, Glazebrook and Arnold JJ.

¹⁸ *Bathurst Resources Ltd v L & M Coal Holdings Ltd* [2021] NZSC 85, [2021] 1 NZLR 696 at [75]–[79].

¹⁹ *Firm PI 1 Ltd v Zurich Australian Insurance Ltd*, above n 17, at [62]; *Green Growth No 2 Ltd v Queen Elizabeth the Second National Trust* [2018] NZSC 75, [2019] 1 NZLR 161 at [60] and [73]–[74] (in a case involving a document registered in a land registry); *Bathurst Resources Ltd v L & M Coal Holdings Ltd*, above n 18 at [47]; J J Spigelman “From text to context: Contemporary contractual interpretation” (2007) 81 ALJ 322 at 334–335.

²⁰ *Vector Gas Ltd v Bay of Plenty Energy Ltd*, above n 16, at [19] and [27]–[28] per Tipping J.

²¹ At [28]. See also *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38, [2009] 1 AC 1101 at [39] per Lord Hoffmann.

The New Zealand Supreme Court recently followed this objective approach in *Bathurst Resources Ltd v L & M Coal Holdings Ltd*, where Winkelmann CJ and Ellen France J confirmed that:²²

evidence of what a party subjectively understood or intended as to the meaning of the contract will not be admissible if that was not communicated to the other party prior to contract formation. Such undeclared intentions are not evidence that would have been available to “the notional reasonable person”.

Tipping J in *Vector* noted the two main advantages of the objective approach as being greater certainty (as a subjective approach may undermine the security of written words recording an agreement) and saving of time and cost (as a subjective approach may require a further search for and examination of extrinsic evidence).²³

The Supreme Court decision in *Bathurst Resources* confirms that New Zealand law as to the implication of terms in contracts is also objective. The inquiry of a court in considering whether to imply a term is based on “the understanding of the notional reasonable person with all of the background knowledge reasonably available to the parties at the time of contract”.²⁴ Evidence of subjective intent is irrelevant.²⁵ The legal test for implication of a term is said to be “a standard of strict necessity, a high hurdle to overcome”.²⁶

How then do these general principles of interpretation apply to the assessment of *an agent's* actual authority to bind a principal? Do they support the contention in *Bowstead* and *Philipp* that there is an implied limitation on the actual authority of agents, limiting actual authority to situations where the agent is acting honestly in pursuit of the principal's interests? In particular,

²² *Bathurst Resources Ltd v L & M Coal Holdings Ltd*, above n 18, at [68]. See also at [48]. The Court did note that oral contracts may raise different considerations. See at n 27 referring also to *Thorner v Major* [2009] UKHL 18, [2009] 1 WLR 776 at [82]-[83].

²³ *Vector Gas Ltd v Bay of Plenty Energy Ltd*, above n 16, at [21] per Tipping J. See also McGrath J at [71] and [77] and *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337 (HCA) at 352 per Mason J. However, the consideration based on saving of time and cost is made somewhat less effective by the approach confirmed in *Bathurst Resources Ltd v L & M Coal Holdings Ltd*, above n 18, that does permit consideration of evidence of prior communications between the parties.

²⁴ *Bathurst Resources Ltd v L & M Coal Holdings Ltd*, above n 18, at [116(e)]. See also *Marks & Spencer plc v BNP Paribas Securities Services Trust Co (Jersey) Ltd* [2015] UKSC 72, [2016] AC 742 at [21], [23] and [27] per Lord Neuberger PSC and [72] per Lord Carnwath JSC.

²⁵ At [117].

²⁶ At [116(a)]. In this respect, the conditions previously set out by the Privy Council in *BP Refinery (Westernport) Pty Ltd v President, Councillors and Ratepayers of the Shire of Hastings* (1977) 180 CLR 266 (PC) at 283 will be considered a useful tool to test whether the proposed implied term is strictly necessary to spell out what the contract must be understood to mean: see at [116(f)].

should such an implied limitation apply in the context of New Zealand companies, limiting the actual authority of directors to contract on behalf of companies?

The Relevance of an Agent's Motivations- The Early English Case Law

In early English cases, the courts regarded the fact that an agent might have dishonest motivations, and be intending to act in his or her own interests rather than the interests of his or her principal, as irrelevant to the question of whether the agent had actual authority.

I will discuss two early case examples, one in which the agent had been given an express written authority (*Hambro v Burnand*²⁷) and the second in which an agent was operating under the usual (implied) authority associated with his position as an employee of the principal (*Lloyd v Grace, Smith & Co*²⁸).

In *Hambro v Burnand*, Burnand had been authorised in writing by four persons (together with Burnand himself, the defendants in the case) to act as their agent for the purpose of underwriting policies of insurance. Under this authority, Burnand wrote a guarantee policy on behalf of the defendants. The policyholder was CJ Hambro and Son. The guarantee policy provided for the defendants to indemnify the policyholder should Henry Gaze & Sons Ltd not make payment on drafts written by them.

The guarantee policy was within the kinds of policy authorised by the written authority. However, Burnand had a dishonest motive for causing the defendants to enter into the policy. Burnand had become a director of Henry Gaze & Sons Ltd and was personally engaged in financial dealings with that company. The trial judge also held that Henry Gaze & Sons Ltd was not solvent when the guarantee policies were given and that Burnand, knowing the position, was “acting for himself and in furtherance of his own interests, and not for or in the interest of the other defendants.”²⁹

Collins MR followed American authority in holding that where the very act of the agent is authorised by the terms of the power, then that will be binding on the principal and no inquiry was admissible into the motives on which the agent acted.³⁰ Collins MR said it was unnecessary for him to consider whether Burnand was acting for his own benefit, and in his own interests,

²⁷ *Hambro v Burnand* [1904] 2 KB 10 (CA).

²⁸ *Lloyd v Grace, Smith & Co*, above n 7.

²⁹ *Hambro v Burnand*, above n 27, at 12.

³⁰ At 20-22.

and not in those of his principals.³¹ Furthermore, Collins MR said it would be impossible for mercantile business to be conducted if those dealing with agents had to look behind the authority of agents and inquire as to their private motives.³²

The other two Appeal Court judges agreed. Romer LJ also held that a principal could not escape liability where the agent has acted within the scope of a written authority just because the agent had abused the authority.³³ Mathew LJ said that it was “well settled” that the liability of a principal on a contract entered into by his agent within the terms of his authority “cannot be affected by the unknown motives by which the agent was actuated in making the contract.”³⁴

There are passages in the judgment of Romer LJ that suggest that the policy would not have been binding if the policyholders had had notice of the agent’s (Burnard’s) fraud.³⁵ That does not, in my view, detract from a finding that there still would have been actual authority in such a case. It is just that if the third party had knowledge of the agent’s dishonesty, the transaction would have been voidable in equity. Romer LJ does not expressly confirm that that is the analytical basis for his comments. However, such an approach would not be surprising given Romer LJ’s background as a leading Chancery barrister at Lincoln’s Inn and as a Chancery judge before his elevation to the Court of Appeal.

In *Philipp*, Lord Leggatt suggested that the decision in *Hambro* could only be justified on the grounds of apparent authority.³⁶ I disagree. *Hambro* can be justified on the basis that if the contracting third party was aware of the agent’s mismotivation, the transaction would have been voidable in equity.

The judgments in *Hambro* did not rely on apparent authority, and the report of argument in the case confirms there was no suggestion of a holding out so as to give rise to apparent authority.³⁷ *Bowstead* also notes that the report of the case at first instance confirms that the claimants had had no direct dealings with the principals and their counsel expressly disowned reliance on

³¹ At 22.

³² At 20. See also Mathew LJ at 25-26.

³³ At 23.

³⁴ At 26.

³⁵ At 25. See also at 23, where Romer LJ refers to the third party as “taking in good faith and for valuable consideration”.

³⁶ *Philipp v Barclays Bank*, above n 4, at [80].

³⁷ *Hambro v Burnand*, above n 27, at 15.

apparent authority.³⁸ An earlier edition of *Bowstead* had cited *Hambro* for the proposition that actual authority was not removed by an agent acting fraudulently in his own interests.³⁹

An approach under which a transaction entered into by a mismotivated agent would make the transaction voidable where the third party was aware of the breach of fiduciary duty was in fact the one later taken by Dixon J in *Richard Brady Franks Ltd v Price*, where His Honour followed *Hambro*.⁴⁰

The second example of the early English approach is the House of Lords decision in *Lloyd v Grace, Smith & Co*.⁴¹ Unlike *Hambro*, this case did not consider an *express* written authority. Instead, it involved actions taken by the clerk of a law firm held to be within the clerk's usual (*implied*) authority.

Mrs Lloyd consulted a firm of Liverpool solicitors. The managing clerk (Mr Sandles) induced Mrs Lloyd to give him the deeds to two cottages and to sign certain documents (which were, in fact, a transfer of the cottages to Sandles and a transfer to him of a mortgage that Mrs Lloyd held). Sandles then dishonestly disposed of the property for his own benefit.

The House of Lords held that the law firm was responsible for the fraud committed by Sandles in the course of his employment. The dishonesty of Sandles as agent, and his acting in his own interests rather than those of the law firm principal, did not prevent the law firm from being liable as principal both in contract and tort.

Lord Macnaghten was clear that a principal could be held liable for a fraud committed by an agent within "the scope of his agency" even though the fraud was committed for the benefit of the agent himself and not for the benefit of the principal.⁴² The fact that the agent was acting for his own benefit rather than that of the principal did not mean that the agent was acting without authority.

³⁸ Watts and Reynolds, above n 1, at 3-012, 143; See also Peter Watts "Actual Authority: The Requirement for an Agent Honestly to Believe that an Exercise of Power is in the Principal's Interests" [2017] JBL 269 at 277.

³⁹ FMB Reynolds *Bowstead on Agency* (15th ed, Sweet & Maxwell, London, 1985) at article 74, 279. This principle from this edition of *Bowstead* was followed by Millett J in *Macmillan Inc v Bishopsgate Investment Trust Plc* [1995] 1 WLR 978 (Ch) at 984. The Court considered the case under Delaware law, but Millett J was satisfied that the principle reflected both Delaware law and English law. The current edition of *Bowstead* (Watts and Reynolds, above n 1, at 3-012, 142-144), and the judgment of Lightman J in *Hopkins v TL Dallas Group Ltd*, above n 3, at [89], resile from the principle of law set out in the 15th edition of *Bowstead* and suggest this principle should be limited to apparent authority only.

⁴⁰ *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112 (HCA) at 142. See discussion in Chapter 5.

⁴¹ *Lloyd v Grace, Smith & Co*, above n 7.

⁴² At 730- 738.

In particular, Lord Macnaghten referred to *Barwick v English Joint Stock Bank*⁴³ and concluded:⁴⁴

And I think it follows from the decision, and the ground on which it is based, that in the opinion of the Court a principal must be liable for the fraud of his agent committed in the course of his agent's employment and not beyond the scope of his agency, whether the fraud be committed for the principal's benefit or not.

Lord Shaw's analysis was similar, though his language is more capable of being interpreted as referring just to apparent authority. Nevertheless, Lord Shaw did consider it unsound to investigate the private motives of the agent.⁴⁵ He concluded that as long as a third party dealt with an agent in good faith "and that the conduct of the agent is fully within the scope of his authority" then the principal was responsible for the agent's fraud even though the agent did not mean to benefit his principal by the fraud, but to benefit himself.⁴⁶ He found that on the facts the particular fraud was committed in the course of, and within the scope of, the duties with which the law firm had entrusted Sandles as their managing clerk. The law firm was therefore responsible.⁴⁷

Lloyd is sometimes referred to as a tort case.⁴⁸ However, the action of the clerk in *Lloyd* was considered by the House of Lords in that case to give rise to both contractual and tortious liability for the firm.⁴⁹ Further, Lord Macnaghten was clear when citing Lord Selborne from *Holdsworth* that the principle he was discussing was a principle "not of the law of torts, ... but of the law of agency".⁵⁰

The fact that the House of Lords in *Lloyd* considered it was discussing a principle that applied to both contract and tort cases is also apparent from their Lordships' approval of *Hambro*,⁵¹ and their discussion of *Ruben v Great Fingall Consolidated*, also a contract case.⁵² As discussed

⁴³ *Barwick v English Joint Stock Bank* (1867) LR 2 Ex 259.

⁴⁴ *Lloyd v Grace, Smith & Co*, above n 7, at 731.

⁴⁵ At 740.

⁴⁶ At 741.

⁴⁷ At 742.

⁴⁸ Watts, above n 38, at 276.

⁴⁹ *Lloyd v Grace, Smith & Co*, above n 7, at 724-725 per Earl Loreburn.

⁵⁰ At 734.

⁵¹ At 741-742.

⁵² At 738 and 741 discussing *Ruben v Great Fingall Consolidated* [1906] AC 439 (HL).

further below, the New Zealand Supreme Court has also regarded *Lloyd* as being authoritative in the context of a principal's liability in contexts other than tort liability.⁵³

Both the *Hambro* and *Lloyd* decisions, then, support the proposition that a subjective intention by an agent to act in their own interests rather than those of the principal will not remove actual authority if the agent's actions are otherwise within the scope of the agent's express or usual authority.

The line of older English cases does not stop with the *Hambro* and *Lloyd* decisions, but continues with the important decision in *Reckitt v Barnett, Pembroke and Slater Ltd.*⁵⁴

In that case, Sir Harold Reckitt gave a power of attorney in favour of Lord Terrington to manage his affairs while Sir Harold was abroad. Following a question raised by Sir Harold's bankers, Sir Harold wrote to them confirming he wished the power of attorney to cover the drawing of cheques upon the bank by Lord Terrington "without restriction".

Lord Terrington drew a cheque upon Sir Harold's bank payable to Barnett, Pembroke and Slater ("BPS") in payment of Lord Terrington's own personal debts (hire purchase payments in relation to the purchase of a Rolls Royce motor vehicle and servicing costs in relation to a Daimler motor vehicle). BPS accepted the cheque without inquiry and received the proceeds. Sir Harold sued BPS to recover the amount of the cheque.

Sir Harold could recover unless BPS could establish that Lord Terrington had either actual or apparent authority to make the payments from Sir Harold's bank account. There could, however, be no question of apparent authority as BPS did not claim to have acted on any holding out of authority by Sir Harold.⁵⁵ The key question then was whether there was *actual* authority for Lord Terrington to use Sir Harold's money for Lord Terrington's private debts. Lord Hailsham in the House of Lords regarded this question as "purely a question of construction".⁵⁶

In Lord Hailsham's view, the whole authority of Lord Terrington under the power of attorney was limited to acting for Sir Harold in the management of his affairs. The addition of the words "without restriction" in Sir Harold's letter to his bankers did not entitle Lord Terrington to draw

⁵³ *Nathan v Dollars & Sense Ltd*, above n 9, at [42].

⁵⁴ *Reckitt v Barnett, Pembroke and Slater Ltd*, above n 8.

⁵⁵ At 182.

⁵⁶ At 182.

cheques for any other purpose than for the discharge of Sir Harold's debts or in the conduct of his business.⁵⁷

The finding on the facts then was that the authority in the power of attorney did not permit Lord Terrington to use Sir Harold's funds to pay Lord Terrington's own private debts. However, Lord Hailsham's statement that the question of whether there was actual authority was purely a question of construction does not suggest that the House of Lords considered that an agent's dishonesty, or acting contrary to the interests of the principal, *necessarily* negated actual authority.

That their Lordships took the view that mismotivation of an agent did not necessarily remove actual authority is also evident from the way that the Lords *distinguished*, but did not overrule, *Hambro*. The Lords in *Reckitt* recognized that what the agent did in *Hambro* was dishonest. Lord Hailsham commented that the risks underwritten by Mr Burnand in *Hambro* had been held to be "within the actual authority conferred upon him, although his motive in doing the act was to benefit himself and not his principals".⁵⁸

The Lords did not overrule *Hambro*. Instead, they simply distinguished it on the basis that in *Hambro*, Mr Burnand "was doing the very business he was authorised to do".⁵⁹ By contrast, the power of attorney in the *Reckitt* case, properly construed, only authorised Lord Terrington to conduct Reckitt's business, not pay accounts of his own.⁶⁰

The House of Lords in *Reckitt* did not specifically discuss *Lloyd*. However, the Lords did expressly approve the reasoning of Russell LJ from the Court of Appeal in *Reckitt*. Russell LJ placed significant weight on *Lloyd* as having clearly established that the fact that an agent had acted in their own interests rather than those of the principal did not of itself remove actual authority. Nothing in the House of Lords judgments in *Reckitt* indicates any intention by their Lordships not to follow their previous decision in *Lloyd*.

Lord Hailsham, in giving the leading judgment in the House of Lords, commented that the judgment of Russell LJ in the Court of Appeal was "quite accurate in its reasoning and in its conclusions" and but for the fact that Lord Hailsham was differing from the majority in the

⁵⁷ At 182. See also 184-185 per Viscount Dunedin and 193 per Lord Warrington.

⁵⁸ At 183.

⁵⁹ At 185.

⁶⁰ At 184.

Court of Appeal, he would have been content to adopt the judgment of Russell LJ as his own.⁶¹ Lord Warrington also endorsed the “very clear judgment” of Russell LJ.⁶² Russell LJ’s judgment has also been cited with approval by the High Court of Australia and more recently by the Australian Full Federal Court.⁶³

A review of the Court of Appeal judgments in *Reckitt* in fact shows little difference between the judges on questions of principle. All judges considered that the question of whether there was authority was a question of construction⁶⁴, and that the agent’s motive was irrelevant to the question of authority⁶⁵. All three judges cited with approval the previous English decisions in *Hambro* and *Lloyd*.

Where the Court of Appeal judges differed with each other was solely on what particular construction they should give to the power of attorney. Scrutton LJ and Sankey LJ took the view that Sir Harold’s letter saying that Lord Terrington could draw cheques “without restriction” gave Lord Terrington unlimited power to draw cheques. Russell LJ, however, took the view that the letter had to be read in the context of the power of attorney the letter related to, and that power of attorney properly construed just authorised Lord Terrington to act in the management of Mr Reckitt’s affairs. The words in the letter that cheques could be drawn “without restriction” could be “sufficiently satisfied by interpreting them to mean without restriction as to amount”.⁶⁶

The Court of Appeal judgment sets out in full the text of the power of attorney.⁶⁷ The power of attorney set out 12 specific powers, which as Russell LJ noted, were “carefully and in terms limited to acting in the management of the plaintiff’s affairs”.⁶⁸ Clause 10 of the power of attorney was a general provision which gave the power “Generally to act in all respects in relation to my estate or affairs...”.

⁶¹ At 183.

⁶² At 195.

⁶³ *Tobin v Broadbent* (1947) 75 CLR 378 (HCA) at 401 per Dixon J; *Great Investments Ltd v Warner* [2016] FCAFC 85, (2016) 335 ALR 542 at [85].

⁶⁴ *Reckitt v Barnett, Pembroke and Slater, Ltd* [1928] 2 KB 244 (CA) at 265 per Sankey LJ and 268 per Russell LJ.

⁶⁵ At 258 per Scrutton LJ, 262 per Sankey LJ and 273- 275 per Russell LJ (in discussing with approval but distinguishing *Bryant, Powis & Bryant v Quebec Bank* [1893] AC 170 (PC, Canada), *Hambro v Burnand*, above n 27 and *Lloyd v Grace, Smith & Co*, above n 7).

⁶⁶ At 269.

⁶⁷ At 245-246.

⁶⁸ At 268.

With respect to Watts (who has suggested that Lord Terrington did possess “powers of the relevant description”⁶⁹), it is not at all surprising that Russell LJ and the House of Lords construed the power of attorney (even if read together with the subsequent letter by Sir Harold Reckitt to his bankers⁷⁰) as limited to the management of Mr Reckitt’s affairs.

While Russell LJ was less ready than his fellow judges to interpret the power of attorney as covering Lord Terrington’s actions, nevertheless it is clear that he too clearly regarded the question of authority as one based on construction.

Watts has suggested that Scrutton LJ (one of the three judges in the Court of Appeal in *Reckitt*) was the main English advocate for an approach under which abuse of authority is not relevant to actual authority.⁷¹ However, the view that abuse of authority is not relevant to actual authority was a view held by *all* three Court of Appeal judges in *Reckitt*. Russell LJ, consistently with the other judges, agreed that the motive of the agent was not relevant to authority, and cited for that proposition *Bryant, Powis and Bryant Ltd v Quebec Bank*⁷², *Hambro* and *Lloyd*. On appeal, the House of Lords did not take a different view.

In relation to *Lloyd*, Russell LJ said:⁷³

As to the case of *Lloyd v. Grace, Smith & Co.* no one can now dispute that a principal is liable for the fraud of his agent acting within the scope of his authority, whether the fraud is committed for the benefit of the principal or for the benefit of the agent. The agent must, however, be acting within the scope of his authority.

In conclusion, a correct analysis of the judgments of Russell LJ and the House of Lords in *Reckitt* does not support the suggestion in *Bowstead*, or by the United Kingdom Supreme Court in *Philipp*, that there will not be actual authority for actions taken by an agent contrary to the interests of the principal.

To the contrary, the judgments in *Reckitt* suggest that the motive of the agent is irrelevant, and that the question of actual authority should be regarded purely as a question of construction. *Reckitt* does suggest, however, that there will be a *presumption* of construction (at least in the

⁶⁹ Watts, above n 38, at 276.

⁷⁰ Russell LJ would have regarded the subsequent letter as irrelevant as it was only provided to Mr Reckitt’s bankers (and was not formally part of the power of attorney giving authority to Lord Terrington): *Reckitt v Barnett, Pembroke and Slater, Ltd*, above n 64, at 269.

⁷¹ Watts, above n 38, at 275.

⁷² *Bryant, Powis and Bryant Ltd v Quebec Bank*, above n 65.

⁷³ *Reckitt v Barnett, Pembroke and Slater, Ltd*, above n 64, at 275.

case of an agency relationship under a power of attorney) that an agent is not authorised to appropriate a principal's funds for the agent's own purposes.⁷⁴

Based on the House of Lords decision in *Reckitt*, it is arguable that an agent acting deliberately contrary to the interests of a principal does not necessarily result in actual authority being removed. Instead, one must compare the agent's actions with the express power given to the agent and assess whether as a matter of fact the actions fall within the power. In doing so, the agent's subjective motivations are irrelevant.

The approach in *Reckitt* based on construction has been frequently, and consistently, followed in Australia. In particular, *Reckitt* has been followed by the High Court of Australia in *Tobin v Broadbent* and recently by the Full Federal Court in *Great Investments v Warner*.⁷⁵

In *Philipp*, Lord Leggatt did not discuss *Lloyd*. Nor did he discuss the Australian cases just referred to. Instead, the main authority relied on in *Philipp* is the much earlier Australian decision in *Lysaght Bros & Co v Falk (No 1)*, decided in 1905.⁷⁶ This may well be because *Bowstead* also cited *Lysaght*.⁷⁷

In *Lysaght*, Mr Falk brought an action against Lysaght Bros upon an alleged contract for the sale of a quantity of spelter dross (a form of zinc waste product of Lysaght Bros' business). The contract was entered into on behalf of Lysaght Bros by Mr Wilkinson, the company's general manager. Lysaght Bros alleged that the contract was entered into by Mr Wilkinson for the benefit of Mr Falk and of Mr Wilkinson personally, at the company's expense.

Lysaght is not, with respect, a strong authority for the proposition set out in *Philipp* and *Bowstead*.

First, the case dealt only with a pleading point. Was Lysaght Bros able to raise the argument that the contract was entered into for the benefit of Falk and Wilkinson at the expense of the company given how Lysaght Bros' defence had been pleaded? This pleading point was relevant to whether the trial judge was right to have excluded evidence addressed to that defence.

⁷⁴ *Reckitt v Barnett, Pembroke and Slater, Ltd*, above n 8, at 268.

⁷⁵ *Tobin v Broadbent*, above n 63; *Great Investments v Warner*, above n 63. See also *Sweeney v Howard* (2007) 13 BPR 24,381; [2007] NSWSC 852 and *St George Bank Ltd v Trimarchi* [2003] NSWSC 151 at [38].

⁷⁶ *Lysaght Bros & Co Ltd v Falk*, above n 6.

⁷⁷ *Watts and Reynolds*, above n 1, at 3-012.

Secondly, the case suggests dishonesty only removes authority at law where there is knowledge of the dishonesty on the part of the other party to the contract. O'Connor J suggests that if the agent does not act honestly and on behalf of the principal, then the agent's act will be void "unless in a dealing with innocent parties" and further says that if a third party dealing with the agent has knowledge of the agent's fraud then the third party "is not allowed to say that the authority exists".⁷⁸

However, as Lord Diplock said in *Freeman & Lockyer*, actual authority is based on the "legal relationship between principal and agent created by a consensual agreement to which they alone are parties" and to which "the contractor is a stranger".⁷⁹ Accordingly, knowledge by the third party should not go to the question of whether there is actual authority.

Such knowledge could, however, be relevant to whether a third party could rely on a holding out for the purpose of apparent authority, or to whether a transaction was voidable in equity. There is a passage in the judgment of Griffiths CJ that suggests he had in mind that an innocent third party could rely on apparent authority.⁸⁰ However, in support, Griffith CJ cites the decision in *Hambro*, which as discussed above, was not in fact an apparent authority case.

Watts asserts that there is nothing in the subsequent case law to suggest *Lysaght* has been overtaken⁸¹, but with respect that is not correct. As discussed in Chapter 5, the High Court of Australia in *Richard Brady Franks Ltd v Price* was clear that a breach by a director of the best interests duty did not make a transaction void for lack of authority but only voidable in equity.⁸² In *Tobin v Broadbent*, Dixon J in the High Court of Australia distinguished between transactions which objectively had nothing to do with a principal's affairs (which would not be authorised) and transactions where the agent entered into a transaction that fell within the terms of an authority, but for an improper motive, saying:⁸³

If a transaction is ostensibly on the principal's behalf and is of a description that falls within the authority, it is nothing to the point that the agent's purpose was to act for his own benefit and to defraud the principal, that is, unless the opposite party to the transaction had notice.

⁷⁸ At 439. See also at 441 and Griffiths CJ at 432.

⁷⁹ *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd*, above n 10, at 502.

⁸⁰ *Lysaght Bros & Co Ltd v Falk*, above n 6, at 431. Griffiths CJ refers to estoppel, and apparent authority is a form of estoppel: *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd*, above n 10, at 503; *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies Ltd ("the Raffaella")* [1985] 2 Lloyd's Law Reports 36 at 41.

⁸¹ Watts, above n 38, at 280.

⁸² *Richard Brady Franks Ltd v Price*, above n 40, at 142.

⁸³ *Tobin v Broadbent*, above 63, at 401.

One clear difference between the approach taken in *Lysaght* and that taken in the English decisions of about the same time concerns the treatment of the old English case of *The British Mutual Banking Company, Ltd v Charnwood Forest Railway Company*. *Charnwood* was a tort of deceit case. In that case, Lord Esher and Bowen LJ both assert that for a principal to be liable for an agent, the agent must be acting for the benefit of the principal.⁸⁴

Although a tort case, *Charnwood* was treated as influential in *Lysaght* and specifically followed.⁸⁵ In *Lloyd*, however, *Charnwood* was regarded as *wrongly decided* on this point.⁸⁶

In conclusion, *Lysaght* is not a strong foundation on which to support the proposition, as a matter of general agency law, that the actual authority of an agent is necessarily removed in the case of actions not taken in pursuit of the principal's interests. Instead, consistent with the approach taken in *Hambro* and *Lloyd*, the subjective motivation of an agent should not be relevant to an agent's actual authority to bind their principal. Actual authority should instead be determined as a matter of construction of the relevant agency agreement.

New Zealand Authority- the Nathan Decision

There is little New Zealand authority. However, both the Court of Appeal and Supreme Court in *Nathan v Dollars & Sense Ltd* support the approach taken in *Lloyd* and specifically reject that taken in *Bowstead*.⁸⁷

In *Nathan*, Rodney Nathan arranged a loan from a finance company, Dollars & Sense Ltd, to fund the acquisition of shares in a business. The finance company sought mortgage security for the loan over Rodney's parents' property in Kerikeri. The finance company sent Rodney the relevant mortgage documentation and requested that he arrange execution of the mortgage by his parents.

The High Court, Court of Appeal and Supreme Court all took the view that Rodney was acting as the finance company's agent for the purpose of arranging execution of the mortgage documentation. Rodney arranged for his father to sign the documentation but forged his mother's signature. The finance company subsequently sought to enforce its mortgage over the

⁸⁴ *The British Mutual Banking Company, Ltd v Charnwood Forest Railway Company* (1887) 28 QBD 714 at 717 per Lord Esher and 718 per Bowen LJ.

⁸⁵ *Lysaght Bros & Co v Falk (No 1)*, above n 6, at 430-431.

⁸⁶ *Lloyd v Grace, Smith & Co*, above n 7, at 737-738 per Lord Macnaghten and 741 per Lord Shaw.

⁸⁷ *Nathan v Dollars & Sense Ltd*, above n 9; *Nathan v Dollars & Sense Finance Ltd* [2007] NZCA 177, [2007] 2 NZLR 747.

property. It argued that following registration the mortgage conferred indefeasible rights on the finance company. Rodney's mother, however, sought to contest indefeasibility based on the fraud exception to indefeasibility of title.

The main issue in the case was whether Rodney's fraud should be imputed to the finance company (on the basis that Rodney was acting as the finance company's agent) so that the finance company lost the benefit of indefeasibility of title. The High Court, Court of Appeal (by majority) and Supreme Court all held that Rodney's fraud should be imputed or attributed to the finance company. Accordingly, all Courts agreed that an order should be made to remove the finance company mortgage from the land transfer register.

The Court of Appeal and Supreme Court judgments also contain some general comments about the extent to which Rodney's actions could be said to be within the scope of his authority as an agent notwithstanding their fraudulent character.

In the Court of Appeal, Glazebrook J said that the suggestion that fraud takes the agent outside the scope of their agency takes "too narrow a view of an agent's task".⁸⁸ Here, Rodney's task was to obtain the execution of registrable documents. Obtaining execution, even by forgery, was within the scope of that task.

Glazebrook J discussed *Lloyd* in detail and expressly followed it.⁸⁹ She noted that the issue in *Lloyd* was whether a principal can be liable for the fraud of an agent where the agent acts within the scope of their authority but the fraud was committed for the benefit of the agent *and against the interests of the principal*. She confirmed that the answer to this question was yes.⁹⁰

Glazebrook J then held that the *Nathan* case fell within the principles set out by Lord Macnaghten in *Lloyd*:⁹¹

We consider that the present case falls squarely within the principles set out by Lord Macnaghten. The critical fact is that the fraud took place to achieve the very thing that Rodney was asked to do as agent by Dollars & Sense; that is, obtain a registrable mortgage. We thus consider that he was acting within his actual authority ...

⁸⁸ *Nathan v Dollars & Sense Finance Ltd* [2007] NZCA 177, [2007] 2 NZLR 747 at [103].

⁸⁹ At [104]-[114].

⁹⁰ At [104] and [106].

⁹¹ At [107].

Glazebrook J said that *Lloyd* proceeded on the basis that the wrongful action of the agent did not negative actual authority.⁹² She acknowledged the suggestion in *Bowstead* that fraud not for the benefit of the principal may negative actual authority, but on behalf of the majority preferred the reasoning in *Lloyd* and did not favour the view in *Bowstead*.⁹³

Accordingly, the majority judgment of the Court of Appeal in *Nathan* is an explicit endorsement of the approach taken in *Lloyd*, and a confirmation of the proposition that an agent can still be acting within their actual authority when they act contrary to the interests of their principal.

On further appeal, the analytical approach taken by the Supreme Court was different. The Supreme Court, in deciding whether the fraud exception to indefeasibility applied, took an approach based on whether the finance company was vicariously liable for Rodney Nathan's actions.⁹⁴ On that analytical approach, it was not strictly necessary to decide whether Rodney's actions were within his actual or apparent authority. Instead, the relevant question became whether Rodney's actions were closely connected with what was authorised (applying the commonly used test for vicarious liability).

Nevertheless, there is still a strong indication in the judgment of Blanchard J that the Supreme Court accepted the view of Glazebrook J that a fraudulent act by an agent could still come within the scope of an agent's actual authority.

The Supreme Court said that no one suggested that the finance company actually authorised the particular forgery but that it did not follow from that that the forgery was beyond the scope of the agency.⁹⁵

The key passage in the Court's judgment was as follows:⁹⁶

We come now to our second proposition, that a fraudulent act may be done within the scope of an agency, even if done exclusively for the benefit of the agent (and even more so when it is done for the benefit of the principal as well as for the benefit of the agent). The leading authority is *Lloyd v Grace, Smith & Co* in which a firm of solicitors was held liable for frauds covertly committed against a client by their managing clerk for his own benefit entirely. The firm had

⁹² At [110].

⁹³ At [111]-[112].

⁹⁴ *Nathan v Dollars & Sense Ltd*, above n 9, at [44].

⁹⁵ At [31].

⁹⁶ At [41].

gained nothing from the frauds. The House of Lords rejected the argument that a principal was not liable for the fraud of his agent unless committed for the benefit of the principal. The case has often been understood to be an authority on apparent or ostensible agency,... But the better view, we think, is that their Lordships were in this respect not drawing any distinction between actual and apparent authority. The managing clerk plainly had actual authority to conduct business of the kind he conducted for the plaintiff and in the course of which he defrauded her.

Blanchard J then went on to suggest that both Lords Macnaghten and Shaw proceeded on the basis that Sandals committed the fraud within the scope of his authority. The Supreme Court therefore expressly rejected the argument that *Lloyd* should be seen as just precedent on the question of apparent authority and confirmed that it was a precedent that went to actual authority as well.

The Court then importantly referred to the passage in *Bowstead* that suggested authority to act as agent includes only authority to act for the benefit of the principal. The Court noted the change in that respect from the approach taken in previous editions of *Bowstead*. The Supreme Court, like Glazebrook J, was not enamoured of the current approach in *Bowstead*. The Court went as far as to suggest that the previous formulation in *Bowstead* was “preferable”, at least in the context of land transactions.⁹⁷

In conclusion, both the Court of Appeal and Supreme Court in *Nathan* preferred the approach taken in *Lloyd* to that currently taken in *Bowstead*. As a matter of New Zealand agency law, an agent acting contrary to the interests of the principal will not necessarily negative actual authority.

The Corporate Context

The *Bowstead* approach is particularly problematic in the corporate context. Consider the accepted New Zealand approach to contract interpretation and implication of contractual terms discussed earlier in this Chapter. That approach is based on the meaning that a reasonable person would take having regard to the background knowledge available to the parties to the contract at the time. How does that approach apply in the case of the interpretation of an agency arrangement between a company and a director?

⁹⁷ At [42]. The only puzzling part of the Supreme Court judgment is at [35] where Blanchard J suggests that as between the principal and agent “the principal will be entitled to impeach the agent’s conduct and say that what the agent did was unauthorized”. However, this passage seems out of place and inconsistent with the Court’s subsequent comments at [41]-[42].

Part of the relevant background to the agency arrangement between a company and a director is that the director owes the company a duty to act in the company's best interests. Is it implicit that a breach of that duty necessarily removes the actual authority of the director? As discussed in Chapter 5, the Law Commission assumed that was the case.⁹⁸

However, part of the relevant background must also be the provisions of the Companies Act which (at least as a default provision, subject to the company's constitution) confer authority on the board to manage the business of the company, including the ability to enter into contracts with third parties. Further, part of the relevant background must be the knowledge that third parties contracting with the company will rely on directors having authority (at least collectively), and that third parties will not usually be aware of any subjective mismotivation of directors. In that context, it is not self-evident that a reasonable person would regard it as implicit in an agency arrangement between a company and a director that the director's actual authority was removed by the director's mismotivation. The intuition of the judges in *Hambro* and *Lloyd* was that contracting third parties could not be expected to inquire into the subjective motivations of agents.⁹⁹

In cases where Courts have followed the view of *Bowstead* in the corporate context, the Courts have not been consistent in how they have applied that view. In *Hopkins v Dallas*, the Court took an objective approach suggesting that authority was removed where an agent acted contrary to what was in the interests of the principal.¹⁰⁰ However, in *LNOC Ltd v Watford Association Football Club Ltd*, the Court took a subjective approach suggesting authority was removed where a director acted deliberately contrary to the company's interests.¹⁰¹

Basing actual authority on an objective approach to the assessment of whether directors' actions are in the company's interests puts a difficult onus on third parties. As Sarah Worthington suggests, such a test requires third parties "to be unduly wary of attractive bargains".¹⁰² Third parties would be concerned that companies with whom they enter into contracts might subsequently change their minds. Such companies might resile from contracts freely entered

⁹⁸ Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [348]. So also have some English cases: *Re Capitol Films Ltd (in admin) Rubin v Cobalt Pictures Ltd*, above n 3 at [53] and *LNOC Ltd v Watford Association Football Club Ltd*, above n 3 at [63]-[67].

⁹⁹ *Hambro v Burnand*, above n 27, at 20 per Collins MR and 25-26 per Mathew LJ; *Lloyd v Grace, Smith & Co*, above n 7, at 740 per Lord Shaw.

¹⁰⁰ *Hopkins v TL Dallas Group Ltd*, above n 3, at [88].

¹⁰¹ *LNOC Ltd v Watford Association Football Club Ltd*, above n 3 at [64]-[67] where the Court suggested that it was "irrelevant whether, with the benefit of hindsight, the transactions were ill-advised".

¹⁰² Sarah Worthington "Corporate Attribution and Agency: Back to Basics" (2017) 133 LQR 118 at 137.

into on the basis that there was no authority for a contract because it was not in the company's best interests.

Watts would contend that the test for removal of authority is entirely subjective. In his view, the test for whether a director has actual authority is based on whether the agent is or is not acting *for the purpose* of benefiting the principal. On that view, the removal of authority will require a lack of belief by the agent that the transaction is in the principal's interests.¹⁰³

However, a test for actual authority that depends on the agent's subjective motivations is inconsistent with the approach taken in the early case law, such as *Lloyd* and *Reckitt*.

Implied Authority of Corporate Agents

There is also case law support for the proposition that the delegated authority of corporate agents is not removed by the mere fact that such agents are subjectively acting for purposes contrary to the company's interests. The Courts have been prepared to hold that actions are within a corporate agent's implied actual authority even where the actions involved are illegal, corrupt, or in the agent's own interests and contrary to the interests of the principal.¹⁰⁴

As to illegality, the New Zealand Court of Appeal made it clear in *Giltrap City* that "the fact that conduct is unlawful does not of itself prevent it from falling within the scope of the implied actual authority".¹⁰⁵ In relation to corrupt conduct, in *Morgan v Babcock and Wilcox Ltd*, a majority of the High Court of Australia held that the corrupt nature of a Managing Director's actions (in causing the company to bribe a Council officer) did not remove his authority.¹⁰⁶ The majority held that the Managing Director had very wide powers and accepted that he was acting

¹⁰³ Watts, above n 38, at 269 and 274.

¹⁰⁴ That a company can be responsible for mismotivated conduct of a corporate agent is even more clearly apparent in a case of tort liability, where a company can be held vicariously liable for actions of an employee that are contrary to the company's interests. See, for example, *Mohamud v WM Morrison Supermarkets plc* [2016] UKSC 11, where Mr Khan, an employee of a service station owned by Morrisons, followed a customer out onto the courtyard and seriously assaulted the customer. The Court held Morrisons vicariously liable because the assault was "in connection with the business" in which Mr Khan was employed to serve customers. Lord Toulson said at [48], "Mr Khan's motive is irrelevant. It looks obvious that he was motivated by personal racism rather than a desire to benefit his employer's business, but that is neither here nor there."

¹⁰⁵ *Giltrap City Ltd v Commerce Commission*, above n 11, at [42] per Gault P and Tipping J. To similar effect, see *Australian Agricultural Co v Oatmont Pty Ltd* (1992) 8 ACSR 255 (Northern Territory Court of Appeal) at 265. Contrast *Equiticorp Industries Group Ltd v The Crown (No 47)* [1998] 2 NZLR 481 (HC) where Smellie J considered that illegality removed actual authority for the relevant transactions (see Chapter 5).

¹⁰⁶ *Morgan v Babcock and Wilcox Ltd* (1929) 43 CLR 163 (HCA) at 173-174. See also Isaacs J at 177. Starke J dissented. He seems to have assumed that the payment of the bribe would have been without authority and that the company could only be liable if there was apparent authority: at 182.

in the course of his authority.¹⁰⁷ In relation to self-interested conduct, in *Moore v I Bresler, Ltd*, a Full Court of the Kings Bench Division was clear that the fact that company officers were acting in their own interests in making sales of company property did not remove their authority to do so.¹⁰⁸

The board can delegate its powers expressly to directors or other corporate agents who can enter into contracts on the company's behalf as agents of the company. Often, however, delegation to a corporate agent will not be express but will be implied through appointment to a position¹⁰⁹ or sometimes through acquiescence by the board¹¹⁰.

Regardless of whether the board has delegated contracting power expressly or impliedly, the relevant corporate agent to whom that power is delegated does not lose authority just because they have an improper motive.

Take, for example, the situation of a managing director who only causes her company to enter into a contract because the third party has given her a large bribe. The managing director here has breached her duty to act in the company's best interests. There is also abundant authority for the proposition that such a transaction may be voidable in equity for breach of fiduciary duty.¹¹¹ However, the cases would not suggest that the transaction procured by the bribe is void for lack of authority if the kind of transaction was otherwise within the normal wide scope of transactions that can be entered into by a managing director.¹¹²

The failure to act in the company's best interests should not, therefore, normally remove actual authority.

There is scope to argue a different approach in a situation involving simple misappropriation of property, consistent with the rationale of Atkin LJ in *AL Underwood Ltd v Bank of*

¹⁰⁷ At 174. See also Isaacs J at 177.

¹⁰⁸ *Moore v I Bresler, Ltd* [1944] 2 All ER 515 (KB, Full Court) at 517. See also *Australian Agricultural Co v Oatmont Pty Ltd*, above n 105, at 265-266.

¹⁰⁹ *Giltrap City Ltd v Commerce Commission*, above n 11.

¹¹⁰ *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549 (CA); *Brick and Pipe Industries Ltd v Occidental Life Nominees Pty Ltd* [1992] 2 VR 279 (Supreme Court of Victoria Appeal Division).

¹¹¹ *Logicrose Ltd v Southend United Football Club Ltd (No. 2)* [1988] 1 WLR 1256 (Ch); *Armagas Ltd v Mundogas SA (The Ocean Frost)* [1986] AC 717 at 742-743 per Robert Goff LJ in the Court of Appeal. The House of Lords did not discuss the point.

¹¹² As in *Morgan v Babcock and Wilcox Ltd*, above n 106. In *Logicrose*, there was no suggestion that the fact of the bribe removed actual authority. In *Armagas*, the particular agent (Mr Magelssen, the chartering manager) was held not to have authority, but that was only because the particular kind of transaction was not within the usual authority of someone holding that role.

Liverpool.¹¹³ The argument would be that any implied actual authority must be restricted to management of the company's affairs as s 128(2) limits the board's authority to such management. Any delegated authority from the board (including implied delegated authority) cannot be wider than the authority that the board itself holds and, therefore, also cannot go beyond the management of the company's affairs. If the particular transaction amounts to a simple misappropriation of assets, it is not part of the management of the company's business at all. In that case, a finding that there is no implied actual authority could be justified.

The decision in *Underwood* can be contrasted with the decision of the New South Wales Court of Appeal in *Greater Pacific Investments Pty Ltd v Australian National Industries Ltd*.¹¹⁴ In that case, Mr Yuill entered into certain transactions on behalf of GPI. The transactions involved the sale by GPI of securities to ANI on the basis of put options, allowing ANI to sell the securities back to GPI, and with GPI loaning the proceeds of the original sale of securities on an unsecured basis to a company called SSL.

The Appeal Court considered that Mr Yuill had implied actual authority from the board to conduct the business of GPI as he saw fit.¹¹⁵ This was even though at first instance Cole J had held that Mr Yuill had "completely disregarded the interest of GPI" in entering into the particular transactions.¹¹⁶

The Appeal Court did not regard this breach of fiduciary duty as being sufficient to remove authority at law, holding that such a breach would only give rise to equitable remedies.¹¹⁷ (The breach of fiduciary duty did make the transactions voidable, but rescission was not available as it was not possible to restore the parties substantially to their previous positions.¹¹⁸)

Consistent with *Greater Pacific*, a breach of s 131 should not remove a corporate agent's implied authority unless the situation can be regarded as one of simple misappropriation.

The potential dangers of taking a wider approach to when a breach of the best interests duty removes implied authority are illustrated by the judgment of Kirby P in *Equiticorp Finance Ltd*

¹¹³ *AL Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775 (CA).

¹¹⁴ *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd* (1996) 39 NSWLR 143 (NSWCA).

¹¹⁵ At 148.

¹¹⁶ *Australian National Industries Ltd v Greater Pacific Investments Pty Ltd (in liq)* Supreme Court of New South Wales Cole J 14 December 1990 BC9003271 at 78.

¹¹⁷ *Greater Pacific Investments Pty Ltd v Australian National Industries Ltd*, above n 114, at 149 per McLelland AJA.

¹¹⁸ At 152-153.

v Bank of New Zealand.¹¹⁹ The question arose whether Mr Hawkins had authority to apply the liquidity reserves of Equiticorp Finance Ltd and Equiticorp Financial Services Ltd in transactions for the discharge of the debts of a related company. The majority of the New South Wales Court of Appeal (Clarke JA and Cripps JA) held that Mr Hawkins had implied actual authority to make the transactions arising out of the way the business of Equiticorp Finance Ltd and Equiticorp Financial Services Ltd were conducted.

Kirby P dissented. He said that where actual authority is held to be implied, this only extends to doing something apparently in the best interests of the company (with the best interests of the company extending to considering the interests of creditors in times of “economic danger”).¹²⁰ If Kirby P’s judgment had prevailed, the relevant transactions would have been held void. That seems an extreme result, particularly given the disagreement among the bench as to whether Mr Hawkins did breach the duty to act in the company’s best interests.

The majority held there was no breach of duty by Mr Hawkins as steps taken to protect the group of companies as a whole were of benefit to the individual companies in question.¹²¹ By contrast, Kirby P thought “no intelligent and honest person” could have considered the actions were in the best interests of the two companies!¹²²

It is undesirable for the extreme consequences of holding a contract void to depend on fine assessments as to whether a transaction breaches the best interests duty.

From that perspective, the approach taken by the Court in *Greater Pacific* is preferred. A breach of fiduciary duty should not remove the implied authority of a corporate agent at law where there is some apparent connection between the transaction in question and the management of the company. If the background facts suggest some possible business justification for a transaction, then the transaction should not be treated as void for lack of authority just because there is an argument that the transaction is not in the best interests of the company. The transaction should be challenged (if at all) on the grounds that it is voidable in equity (in which case the transaction will only be set aside if the third party is aware of the breach of duty and so cannot be considered innocent).

¹¹⁹ *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50 (NSWCA).

¹²⁰ At 90.

¹²¹ At 149.

¹²² At 100-101.

Where it is objectively clear that a transaction is a pure misappropriation of company assets (as in *Underwood*), then a finding that this is not within the implied authority of a corporate agent is justified. However, a subjective intention to misappropriate company money or assets should not be enough if objectively it would appear that the agent is engaged in company business, such as on the facts in *Lloyd*.¹²³

Recklessness

The *Bowstead* approach creates uncertainty as to the validity of commercial contracts. This uncertainty increases further if reckless actions by directors are enough to remove actual authority.

Bowstead suggests:¹²⁴

It is implicit in a conferral of authority that the principal intends the agent to exercise the relevant powers in the interests of the principal. An agent who deliberately *or recklessly* exercises powers against the interests of the principal must know that that the agent acts without the principal's consent, and therefore acts without authority. (emphasis added)

The case law does not support the suggestion that an agent's authority is removed just because they act recklessly. The removal of authority in such circumstances would also significantly prejudice the interests of innocent third parties.

An example in the corporate context is *Cowan de Groot Properties Ltd v Eagle Trust plc*, where two directors of Eagle Trust (Mr Ferriday and Mr Smith) brought about the sale of five properties at a substantial undervalue.¹²⁵ Knox J noted that Mr Ferriday was more concerned with obtaining a very large (£500,000) deposit on the transaction so as to pursue another project for which a payment was due, than he was in obtaining a proper price for the sale of the five properties.

Knox J described this attitude as "reckless", said that the terms of sale chosen (including the large deposit) were grossly depreciatory of the expected sale price, and that Mr Ferriday and

¹²³ See also *Royal-Globe Life Assurance Company Ltd v Kovacevic* (1979) 22 SASR 78 (SASC). The facts of *Moneyworld NZ 2000 Ltd v Lee* (2005) NZBLC 101,638 (HC) might also have fallen into this category, but for the fact that the actual authority of Mr Kim was expressly limited (to over-the-counter foreign currency transactions and not to major foreign exchange transactions). There was no suggestion in the judgment that Mr Kim's dishonesty in itself removed actual authority.

¹²⁴ Watts and Reynolds, above n 1, at 3-012. See also Watts, above n 38, at 269-270.

¹²⁵ *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700 (Ch).

Mr Smith were “recklessly negligent” and in breach of duty in selling on those terms and that Mr Ferriday in particular had shown a “reckless disregard” for his duties.¹²⁶

Knox J accepted the argument by Eagle Trust that Mr Ferriday and Mr Smith were in breach of fiduciary duty in that they either deliberately or recklessly brought about the sale of the five properties at a gross undervalue.

However, Knox J did not accept that the purchaser had knowledge of that breach of fiduciary duty.¹²⁷ He said that the actual purchase price was not so far below what a purchaser on those terms could be expected to pay to indicate to a purchaser that dishonesty or even negligence was involved.¹²⁸ Mr Samuelson, the representative for the purchaser, considered Eagle Trust could not afford the time to market the properties properly and was looking for a very quick sale with an exceptionally large deposit which necessarily meant a drop in price.¹²⁹

Yet if *Bowstead* was correct, and recklessly acting contrary to the interests of the company meant that there was no authority for a transaction, then the sale contracts would have been void even though the purchaser did not know about the breach of duty. I suggest that would provide an unfair result. It would undermine commercial certainty and the reasonable expectations of contracting parties.

The preferable approach is that there is no actual authority if a director’s actions fall outside the scope of the director’s express authority as a matter of construction, or outside their implied authority because it is clear the actions bear no relationship to the management of the company. If, however, the actions are within that scope then there will be actual authority, and no subjective mis-motivation of the corporate agent will change that.

The Relevance of Section 18(1)(a)

If, however, a director acting contrary to the interests of the company does remove actual authority, then there is a question whether s 18(1)(a) of the Companies Act 1993 would protect the interests of third parties.

Section 18(1) relevantly provides:

¹²⁶ At 731, 752 and 760.

¹²⁷ At 760.

¹²⁸ At 752 and 760-761.

¹²⁹ At 760-761.

A company ... may not assert against a person dealing with the company or with a person who has acquired property, rights, or interests from the company that:

(a) This Act or the constitution of the company has not been complied with...

unless the person has, or ought to have, by virtue of his or her position with or relationship to the company, knowledge of the matters referred to in any of paragraphs (a), (b), (c), (d), or (e), as the case may be, of this subsection.

Section 18(1)(a) might be taken to allow a third party to assume that directors have complied with their statutory duty under s 131. The closest Australian provision is s 129(4) of the Corporations Act 2001, which entitles a person dealing with the company to assume that officers of the company “properly perform their duties to the company”. The High Court of Australia has held this provision prevented an argument that a director did not have authority on behalf of a company because a transaction conferred no benefit on the company.¹³⁰ However, in *Great Investments v Warner* the Full Federal Court held that s 129(4) did not protect the third parties in that case where they had received company assets which the director had transferred due to lack of authority (the Court having construed the power of attorney given to the director not to permit a transfer of company assets for the director’s own personal benefit).¹³¹

There is also a potential argument that s 18(1)(a) is only intended to allow third parties to assume that company officers have complied with internal procedures, rather than with fiduciary duties.¹³²

Arguably, s 18(1)(a) would not protect an innocent third party as the claimed lack of actual authority does not result from there being a breach of s 131 of the Act as such, but from the case law principle suggested by *Bowstead* (if it exists) that a company is deemed not to have consented to a director acting deliberately contrary to the company’s interests. Accordingly, if *Bowstead* was correct that acting contrary to the company’s interests removes actual authority, s 18(1)(a) may not be effective to protect contracting third parties.

¹³⁰ *Pico Holdings Inc v Wave Vistas Pty Ltd* [2005] HCA 13, (2005) 214 ALR 392 at [57]-[58].

¹³¹ *Great Investments Ltd v Warner*, above n 63, at [97]-[101].

¹³² Robyn Carroll “Proper performance of duties by company officers: the Statutory Assumption in s 164(3)(f) of the Corporations Law” (1995) 69 ALJ 200 commenting on the then closest Australian provision to s 18(1)(a). That section, like s 129(4) of the Corporations Act 2001, allowed a person to assume that company officers “properly perform their duties to the company”.

Validity of Board Resolutions where Directors have Breached Section 131

A final question worth considering under the heading of actual authority is the impact on the validity of board resolutions, and therefore on the actual authority of transactions authorised by such resolutions, where directors have acted in breach of s 131.

In my view, a board member's vote should not be regarded as invalidly cast, and a board resolution should not be impugned, just because a director in voting for a resolution was not acting in the best interests of the company.

However, at least two cases (from Australia and England respectively) support an argument that a board resolution in breach of the best interests duty is invalid, and that accordingly there is no authority to enter into the contract. In those cases, the Courts held invalid board resolutions where the Courts found that directors involved had breached the best interests duty in passing the resolutions. The invalidity of the board resolutions, in turn, removed authority for the contracts approved by the resolutions.

In *Blackwell v Moray*, the liquidator of Unicapital Ltd sought to challenge a deed entered into by the company which, among other things, released Mr Moray (a director of the company) from a debt owed to the company. The directors' resolution approving the entry into the deed was passed by the sole vote of another director, Mr Bullivant. However, Mr Bullivant gave no independent consideration to the resolution. Cohen J in the New South Wales Supreme Court held that this was a breach of the best interests duty and that, as a result, the resolution passed was not a valid resolution of directors.¹³³

In *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd*, the contract at issue was a settlement agreement between London Wharf and Colin Gwyer. Leslie Kosmin QC, sitting as a deputy judge of the English High Court, held the directors' resolution of London Wharf was not valid because neither director attending the board meeting properly considered the interests of the company's creditors when passing the resolution at a time the directors knew the company was insolvent.¹³⁴ While the judge held that both directors had breached the best interests duty, the judge also suggested that if just a single director had been in breach of their

¹³³ *Blackwell v Moray* (1991) 5 ACSR 255 (NSWSC).

¹³⁴ *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153 (Ch) at [80]-[81]

fiduciary duty their vote should be disregarded and they should not be taken into account for the purpose of ascertaining whether a quorum was present.¹³⁵

The reasoning in those cases would undermine the approach discussed above, under which directors' actions in breach of fiduciary duty will only result in the transaction being voidable for breach of fiduciary duty, rather than void for lack of authority. That directors' actions in breach of fiduciary duty only make a transaction voidable is the view taken in a significant line of authority, including *Richard Brady Franks Ltd v Price*.¹³⁶ Consistent with that approach, the fact that a director in voting for a resolution has breached s 131 should not make the resolution invalid. Nor should it mean that the director's presence should not be counted in assessing whether there was a quorum for the meeting.

The *Richard Brady* case itself (which held that a contract is only voidable when entered into in breach of fiduciary duty) would have been decided differently if the directors' resolution passed in that case was considered invalid due to the breach of fiduciary duty.¹³⁷

Nor would it make sense for the validity of a transaction entered into in breach of the best interests duty to depend on whether or not the transaction was preceded by a formal directors' resolution. The approach taken in *Blackwell* and *Colin Gwyer & Associates* would only seem to create an argument that a transaction is void for lack of authority where a formal board meeting and resolution approve the transaction. In many cases directors proceed with transactions without the formal sanction of a board resolution. In such cases, it would seem clear that a failure by the directors to comply with their s 131 duty would only make the transaction voidable.

There is no principled justification for saying that a transaction involving an identical breach of s 131 is voidable if the directors have entered into the transaction without the benefit of a board resolution, but void where they have done so following a board resolution. If anything, the third party might expect to have *greater* protection if they were aware that the company with which they were dealing had approved the transaction by way of formal board resolution.

¹³⁵ At [92]-[93].

¹³⁶ *Richard Brady Franks Ltd v Price*, above n 40, at 142.

¹³⁷ *Richard Brady Franks Ltd v Price*, above n 40. See also *Re Cummings Engineering Holdings Pty Ltd* [2014] NSWSC 250, where the contract in question was also approved by board resolution.

It would enhance commercial certainty if the transaction approved in breach of the best interests duty is voidable rather than void. An innocent third party is then protected. There is no good reason to remove that protection just because the directors' breach of duty was formalised in a board resolution. The approach taken in *Blackwell* and *Colin Gwyer & Associates* should be regarded as anomalous.

Having discussed in Chapters 5-6 the actual authority of directors, I turn in the next chapter to *apparent authority*. Assuming that in the particular case the director did not possess actual authority to bind the company, a third party may still be able to rely on apparent authority to enforce a contract. That will be the case in circumstances where the company has held out the director as having authority. However, to what extent does knowledge by a third party that a director is acting contrary to the interests of their company prevent the third party from relying on such apparent authority?

Chapter 7- Apparent Authority

In all cases where actual authority is removed (whether as a matter of construction, or under a principle of law as suggested in *Bowstead* and discussed in Chapter 6), it will still be relevant to consider if apparent authority exists.

I will consider:

- (a) where actual authority is removed by actions contrary to the best interests of a company, to what extent can a third party nevertheless later rely on apparent authority?;
- (b) What form of knowledge held by a third party of a director's breach of duty will prevent the third party from being able to rely on apparent authority? Here, I will discuss first the common law approach to this question in cases such as *Northside*, the legislative intent to change that test through the proviso to s 18(1) of the Companies Act 1993, the clarification of the knowledge test under the proviso by the Court of Appeal in *Autumn Tree*, and the amendment of the knowledge test in relation to fraud in s 18(2).¹

If a corporate agent does not have actual authority to act for a principal, the agent may still have apparent authority in accordance with general rules of agency. Apparent authority of an agent results from a holding out or representation by the principal to the third party that the agent has authority.²

The security of commercial transactions demands that a principal be held bound to a contract when the principal has so conducted themselves that the third party is reasonably led to believe that the agent did have authority. Lord Ellenborough noted the policy concern behind the law of apparent authority back in 1812, saying that “there would be no safety in mercantile transactions” if a principal was not bound by transactions where the principal has held out an agent as having authority.³

¹ *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146 (HCA); *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809.

² Andrew Griffiths *Contracting with Companies* (Hart Publishing, Oxford, 2005) at 224; *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480 (CA) at 503.

³ *Pickering v Busk* (1813) 15 East 38, 104 ER 758 (KB).

In his analysis of the development of the law of apparent (ostensible) authority, Televantos notes how the doctrine of apparent authority encouraged third parties to deal with agents knowing that they could take good title to assets in circumstances that were not suspicious.⁴

As discussed in Chapters 2 and 5, the courts developed agency law, including the law of apparent authority, before the corporate form became common. However, the courts then applied the law to corporate transactions.

The leading discussion of the principles of apparent authority in the context of a corporate principal is that of Diplock LJ in *Freeman & Lockyer v Buckhurst Park Properties (Magna) Ltd*.⁵ Lord Diplock's statement of the common law relating to apparent authority was restated and summarised by the New Zealand Court of Appeal in *Bishop Warden Property Holdings Ltd v Autumn Tree*.⁶

Apparent authority requires that the agent be held out as having authority to enter into a transaction of the kind made, the holding out must be done by a principal or someone with actual authority, the third party must know of the principal's holding out and rely on it, and the third party's reliance must be reasonable. The onus of proof is on the third party. If there is no actual benefit to a company, it may not be reasonable to rely on any holding out or apparent authority.

The requirement that the third party's reliance on the holding out of authority must be reasonable is part of the test set out by the Court of Appeal in *Autumn Tree*, but was not specifically discussed by Diplock LJ in *Freeman v Lockyer*. However, the requirement that there must be reasonable reliance on a holding out is consistent with the general acceptance that apparent authority is a form of estoppel.⁷

No Benefit to the Company

The passage from *Autumn Tree* above suggests that it may not be reasonable for a third party to rely on a holding out by a company of an agent as having authority when there is no benefit to the company from a particular transaction.

⁴ Andreas Televantos *Capitalism Before Corporations* (Oxford University Press, 2020) at 171. See also chapter 3 of that book.

⁵ *Freeman & Lockyer v Buckhurst Park Properties (Magna) Ltd*, above n 2, at 503-509, and see particularly the four-limb test at 506.

⁶ *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 1, at [30].

⁷ *Egyptian International Foreign Trade Co v Soplex Wholesale Supplies Ltd* ("*the Raffaella*") [1985] 2 Lloyd's Law Reports 36 at 41.

Accordingly, if a corporate agent does not have actual authority due to the fact that they have acted contrary to the interests of the company (either applying the principle in *Bowstead*, or because the agent has stepped outside their authority as a matter of construction), there may also be a question as to whether the agent can even have apparent authority despite a holding out of authority by the company.

However, there have been many cases in which the courts have held that a corporate agent has apparent authority despite a lack of benefit to the company.⁸ This has also been the case where the particular corporate agent is a director who has acted in breach of the best interests duty. In *Lovett v Carson Country Homes*, the Court held that a company was bound to a banking transaction entered into by a director as a result of the director having apparent authority. The apparent authority arose from a previous course of conduct in which the company's board allowed a single director to deal with the bank alone. The Court found apparent authority to exist even though the director entering into the transaction was not acting for the company's benefit but for the benefit of his own family company. Further, the director had acted dishonestly forging the signature of the other director.⁹

One case that appears anomalous is the New Zealand *Equiticorp* case, where Smellie J refused to hold that directors had customary apparent authority in a situation where the directors had engaged in a grossly improvident (and illegal) transaction.

Smellie J accepted that directors of investment companies (like Ararimu Investments Four Ltd in that case) would customarily have the power to purchase shares in another company. However, he considered that the transaction should be defined with more particularity, "namely the purchase of shares, at approximately four times their market value (improvidence), by a subsidiary in its holding company (thereby breaching s 40) with the financial assistance of the holding company and other subsidiaries of the holding company (thereby breaching s 62)."¹⁰ Smellie J considered that the directors by entering into illegal contracts (in breach of ss 40 and 62 of the Companies Act 1955), and acting improvidently, "were not exercising powers customarily held by directors".¹¹

⁸ *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd* [1971] 2 QB 711 (CA) (company secretary hiring cars for own purposes); *Moneyworld NZ 2000 Ltd v Lee* (2005) NZBLC 101,638 (HC) (employee absconding with client funds).

⁹ *Lovett v Carson Country Homes Ltd* [2009] EWHC 1143 (Ch).

¹⁰ *Equiticorp Industries Group Ltd v The Crown (No 47)* [1998] 2 NZLR 481 (HC) at 719-720.

¹¹ At 720.

This finding is inconsistent with the normal approach to customary apparent authority, which does not require such a granular approach to the assessment of whether the agent has been held out by the company as authorised to enter into a particular transaction.¹²

The usual approach of Commonwealth courts to questions of customary apparent authority is simply to consider whether agents appointed to the particular position would normally have the authority to enter into the particular kind of transaction. For example, in *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd*, the Court held a company secretary to have customary apparent authority to hire cars even though on the particular occasion he hired cars for his own purposes.¹³ The fact that the transaction was dishonest or improperly motivated was not a reason to more specifically define the transaction, or to refuse to hold the agent to have customary apparent authority.

Where a person is held out by a company as having the normal authority associated with a particular position, a third party can reasonably rely on that holding out so as to make it just for the company to be estopped from denying the authority of the agent. That is so even where the agent has in fact dishonestly entered into the transaction.

The passage from *Autumn Tree* states that it may not be reasonable to rely on a holding out “if there is no actual benefit” to the company. It is necessary to discuss whether this is a correct statement of the law, first as a matter of common law, and then following the enactment of s 18(1) of the Companies Act 1993 (and its predecessor s 18C of the Companies Act 1955).

It was certainly true that at common law, a third party could not rely on a holding out unless it was reasonable to do so. Also at common law, if a third party was “put on inquiry” about the possibility of a defect in an agent’s authority, that was enough to prevent the third party from being able to rely on apparent authority.¹⁴ Further, the case law did suggest that a third party was sufficiently put on inquiry as to a defect in an agent’s authority to bind a company in circumstances where it was apparent that a transaction had no benefit to the company. This

¹² I put to one side, however, the question of whether a transaction’s illegality would prevent the contracting party from relying on apparent authority. In my view, they could not rely on apparent authority because if a contract amounted to an illegal contract then it would have no effect (s 73 Contract and Commercial Law Act) and cannot be enforced unless validated by the Court under s 76 Contract and Commercial Law Act.

¹³ *Panorama Developments (Guildford) Ltd v Fidelis Furnishing Fabrics Ltd*, above n 8.

¹⁴ Griffiths, above n 2, at 196; *AL Underwood Ltd v Bank of Liverpool* [1924] 1 KB 775 (CA) at 788-789. The courts also applied the putting on inquiry test to the question of whether the third party could rely on the indoor management rule, under which third parties were entitled to presume that a company had followed correct procedures.

position is illustrated by the High Court of Australia decision in *Northside Developments Pty Ltd v Registrar-General*, which was cited by the Court of Appeal in *Autumn Tree* to support the proposition that it may not be reasonable to rely on a holding out if there is no benefit to a company.¹⁵

Northside concerned a mortgage of company property by Northside to Barclays Bank. The mortgage secured a loan to Farola Pty Ltd, a company owned and controlled by one of Northside's directors (Mr Robert Sturgess). Northside did not receive any of the money (some \$1,400,000) lent by Barclays. The High Court accepted that there was no actual authority for the mortgage as the directors of Northside had not authorised the affixing of the company seal in accordance with the company's articles.¹⁶ That made relevant the question of whether Northside was nevertheless bound to the mortgage as a result of those persons executing the mortgage (Mr Sturgess and his son Gerard) having apparent authority.

The High Court unanimously held that (but for registration, which conferred indefeasibility of title) the mortgage was not binding on Northside. However, the reasoning of the five judges differed in some respects on whether Barclays could have relied on apparent authority. The key points on which the majority of the High Court found in favour of Northside were:

- (a) Mr Sturgess and his son had not been held out by the company as having authority to bind Northside, and
- (b) in the alternative, Barclays was put on inquiry by the lack of apparent benefit to Northside so that even if there was a holding out of authority, Barclays could not rely on apparent authority.¹⁷

The House of Lords decision in *Criterion Properties v Stratford UK Properties* includes similar comments to those made in *Northside*. In *Criterion*, Lord Scott suggested that lack of belief by a contracting third party that a transaction was in the commercial interests of an agent's principal would be fatal to a claim that the agent had apparent authority.¹⁸

¹⁵ *Northside Developments Pty Ltd v Registrar-General*, above n 1.

¹⁶ At 170 and Dawson J at 204. There was no suggestion that the lack of benefit to the company also removed actual authority.

¹⁷ At 188-189 per Brennan J. See also Mason CJ at 164-165 and 165-166, Brennan J at 182-183, Dawson J (with whom Toohey J agreed) at 204-206, and Gaudron J at 216.

¹⁸ *Criterion Properties v Stratford UK Properties*, *Criterion Properties v Stratford UK Properties* [2004] 1 WLR 1846 (HL) at [31].

Accordingly, cases such as *Northside* and *Criterion* suggested that a third party may lose the ability to rely on apparent authority at common law when the third party knew or had reason to believe that a corporate agent (including a director) was acting contrary to the company's commercial interests.

The common law test of being put on inquiry effectively meant that a third party who had only constructive knowledge of a defect in actual authority would not be able to rely on apparent authority.¹⁹

The common law test of being put on inquiry was challenged by Lord Neuberger in the Hong Kong Court of Final Appeal in *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)*. His Lordship suggested instead a test under which a party would only not be able to rely on apparent authority in circumstances where it was “imperative to seek an explanation” or it would be “dishonest or irrational” to rely on a holding out of authority.²⁰ However, this alternative approach came in for academic criticism.²¹ In *East Asia Company Ltd v PT Satria Tirtatama Energindo*, the Privy Council rejected Lord Neuberger's test and confirmed that the putting on inquiry test remained part of the common law.²²

In New Zealand, however, the common law approach based on whether the third party was put on inquiry has been modified for corporate transactions by the proviso to s 18(1) of the Companies Act 1993 (and s 18(2) in cases of fraud).

Section 18(1) and Constructive Knowledge of Defects in Authority

The law relating to the apparent authority of corporate agents is partially summarised and partially reformed by s 18 of the Act.

Section 18(1)(c) and (d) summarise the law relating to apparent authority in a way that is consistent with the common law. They are, however, subject to a new knowledge qualification

¹⁹ See also *Hopkins v TL Dallas Group Ltd* [2005] 1 BCLC 543 (Ch) at [94] where Lightman J said if there were “suspicious circumstances or abnormalities, then the third party should ‘make such inquiries as ought reasonably to be made’ to ensure that the authority is sufficient to bind the principal”.

²⁰ *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)* [2010] HKCFA 64, (2010) 13 HKCFAR 479 at [55], quoting *Macmillan Inc v Bishopsgate Investment Trust Plc* [1995] 1 WLR 978 (Ch) at 1014 G-H, and [62].

²¹ Peter Watts “Some Wear and Tear on *Armagas v Mundogas* – The Tension between Having and Wanting in the Law of Agency” (2015) 1 LMCLQ 36 at 48-56.

²² *East Asia Company Ltd v PT Satria Tirtatama Energindo* [2019] UKPC 30 (PC, Bermuda) at [83]-[93]. *East Asia* has since been endorsed in *Philipp v Barclays Bank* [2023] UKSC 25 at [89].

in the proviso to s 18(1). This new knowledge test at least partially replaces the common law test discussed above.

The effect of ss 18(1)(c) and (d), combined with the proviso, is that a company cannot deny a holding out that would give rise to apparent authority unless the third party has knowledge of the kind referred to in the proviso.

The proviso states:

unless the person has, or ought to have, by virtue of his or her position with or relationship to the company, knowledge of the matters referred to in any of paragraphs (a), (b), (c), (d), or (e), as the case may be, of this subsection.

The proviso to s 18(1) sets out a test that is more favourable to third parties who are seeking to rely on a contract, than the common law test. In particular, while the common law test meant that all third parties could lose the ability to rely on apparent authority if they ought to know of a defect in actual authority, under the proviso only third parties with a “position with or relationship to the company” would be adversely affected by such constructive knowledge.

The predecessor to s 18(1) of the 1993 Act was originally enacted in 1985.²³ There was a general view at the time that it was too harsh for third parties’ positions to be prejudiced by mere constructive knowledge of a defect in authority. The intention was that the proviso would only stop a contracting party from being able to rely on the relevant assumption in s 18(1) if the contracting party had actual knowledge of the defect, or the contracting party should have known about the defect because of their close relationship with the company.²⁴

The Court of Appeal stated in *Autumn Tree*:²⁵

The intention of the proviso, enacted by a 1985 amendment to the Companies Act 1955, was to change the common law so that constructive knowledge of a defect would not be fatal to a third party’s attempt to enforce a contract. It was considered that the interests of commerce required third parties who were not insiders to be able to rely on a company having complied with its internal requirements unless the third party had actual knowledge of the defect in question.

²³ Section 18C Companies Act 1955, enacted by the Companies Amendment Act 1985.

²⁴ Peter Watts, Neil Campbell and Christopher Hare *Company Law in New Zealand* (2nd ed, LexisNexis, Wellington, 2016) at [11.13.3] particularly at 349-350.

²⁵ *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 1, at [73].

This legislative background was important to the Court of Appeal interpreting the proviso to s 18(1) in such a way that a contracting party would only be affected by constructive knowledge of a defect in authority where the party had an “ongoing relationship” with the company.²⁶ In the absence of an ongoing relationship with the company, a contracting party’s ability to rely on the apparent authority of a corporate agent would only be defeated by actual knowledge of a defect in authority.

Previously, some Australian cases had read down the expression “relationship to the company” in the proviso to the equivalent Australian statutory provision so that such a “relationship” was interpreted as including a mere single contractual dealing with the company, rather than a true inside or close relationship.²⁷ However, reading down the expression “relationship to the company” so that it includes a mere contractual dealing with the company would undermine the purpose for the legislative amendment. Essentially, every contracting party, regardless of whether they had a previous or close relationship with a company, would be held to be affected by the irregularity as long as they had constructive knowledge of a defect in authority.

The discussion by the Court of Appeal of the legislative history, and the Court’s endorsement of a more favourable approach to third parties than that taken under the common law, appears significant for the application of apparent authority to corporate transactions. The Court approved an approach that requires the third party to have dealt with the company on previous occasions before any constructive knowledge of a defect in actual authority will prevent reliance on apparent authority.

However, within the reasoning of *Autumn Tree*, there is an internal inconsistency that potentially undermines the Court’s approach to the proviso. As discussed above, the Court cites *Northside* as authority for the proposition that it may not be reasonable to rely on apparent authority if there is no actual benefit to a company from a transaction.²⁸ Under the approach in *Northside*, being aware that there was no benefit to a company from a transaction would be enough to put you on inquiry as to a lack of authority and amount to a form of constructive knowledge that would defeat the ability to rely on apparent authority. However, it was that very aspect of the common law that the proviso to s 18(1) was intended to reform. As the Court of Appeal itself noted in the passage quoted above, the reform was intended to do away with the

²⁶ At [33] and [73]-[74] following *Equiticorp Industries Group Ltd v The Crown (No 47)*, above n 10, at 722-723.

²⁷ *Bank of New Zealand v Fibern Pty Ltd* (1994) 14 ACSR 736 (NSWCA) at 743.

²⁸ *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 1, at [30].

common law approach under which constructive knowledge of a defect (including knowledge due to being “put on inquiry”) was enough to prevent a third party relying on apparent authority.

It is clear, then, that the proviso to s 18(1) was intended to modify that part of the common law test for apparent authority that imposes a requirement that it be reasonable to rely on a holding out of authority. Parliament replaced the common law requirement that a third party could not rely on apparent authority where the third party was put on inquiry as to a possible defect in authority (and therefore, it was not reasonable to rely on apparent authority) with the more limited knowledge test in the proviso to s 18(1).

The explanatory note to the Bill which first introduced the proviso referred to this intended reform by noting the “putting on inquiry” test from the common law, and then setting out the proposed replacement knowledge test contained in the proviso.²⁹

As a result of the proviso, it should no longer be enough to prevent reliance on apparent authority that a third party has been put on inquiry by an apparent lack of benefit to a company from a transaction (at least where the third party does not have an “ongoing relationship” with the company, and unless the circumstances are such that the third party can be said to have *actual* knowledge of the relevant defect in actual authority).

If the proviso had been relevant to the facts in *Northside* this would have led to a different outcome in the case on the question of apparent authority (assuming that a holding out of authority was held to exist). Barclays Bank had not dealt with Northside before. Accordingly, it had no ongoing relationship with Northside from which it could derive relevant constructive knowledge of a defect in actual authority. To the extent that Barclays was put on inquiry, and thus might have been argued to have constructive knowledge, that potential constructive knowledge arose only from the fact that the *particular transaction* did not have any benefit to Northside. That form of constructive knowledge would not be sufficient under the proviso to remove a third party’s ability to rely on apparent authority.

Similarly, on the facts of *Autumn Tree*, Bishop Warden as the other contracting party had not dealt with Autumn Tree before. Any constructive knowledge Bishop Warden had of a defect in

²⁹ Explanatory note to the Law Reform (Miscellaneous Amendments) Bill 1984, the relevant part of which Bill later became the Companies Amendment Act 1985. The discussion in the explanatory note refers specifically to the application of the indoor management rule, which, together with the common law relating to apparent authority, was summarised in s 18C of the Companies Act 1955 (now s 18(1) of the Companies Act 1993). The proviso must, however, apply to all aspects of s 18(1) in the same way.

Tina's authority must have related just to the circumstances of the particular transaction and the fact the sale price was substantially undervalue. The sale price was \$1.1 million when the property's value at the time was \$3.35 million.³⁰

The Court of Appeal at one stage suggested that this "obviously undervalue" sale price "was arguably inconsistent with any apparent authority to enter into the Agreement" on the basis that it was not reasonable for Bishop Warden to rely on Tina being held out as a director.³¹ However, that cannot be right if constructive knowledge of a defect only removes apparent authority when the third party has an ongoing relationship with the company. Bishop Warden had no such relationship with Autumn Tree.

The Court, therefore, appeared to be applying the old fourth limb of the old common law test for apparent authority (of reasonable reliance on a holding out of authority) independently and before considering the proviso. I consider that this aspect of the Court's judgment was in error. The Court should just have considered the issue of knowledge once and consistently with the test under the proviso.³²

Consistent with the Court's explanation of the purpose behind the introduction of the proviso to s 18(1), the proviso should be taken to modify the requirement that it must be reasonable to rely on the relevant holding out, and to define or colour how that requirement of reasonableness should now be applied.

Accordingly, being put on inquiry as to a potential defect in actual authority (including through becoming aware that the particular transaction is not in the company's best interests) should no longer remove the ability to rely on a holding out. A simple reliance on the holding out will be enough for apparent authority to exist unless the third party:

- (a) has *actual* knowledge of a defect in authority, or
- (b) has an ongoing relationship with the company, and constructive knowledge of the defect in authority arising out of that ongoing relationship.

In any event, just being aware that a transaction is not in the interests of a company is not enough for *constructive knowledge* of a defect in actual authority. While under the common

³⁰ *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 1, at [15].

³¹ At [71].

³² See further John Land "Company Contracting in New Zealand after *Autumn Tree*" (2018) 24 NZBLQ 311 at 318-320.

law it might have been considered that this would put a third party on inquiry, a company may have valid reasons to enter into a transaction that appears contrary to its interests.³³ The fact that a transaction seems contrary to the interests of a company is not enough to establish that a third party should have known that the corporate agent lacked actual authority. Most contracting parties will not even consider whether the contract is in the interests of the company with which they are contracting. It is not their job to do so.³⁴

A further issue is that for constructive knowledge of a defect to ruin the ability to rely on apparent authority under the proviso to s 18(1), that constructive knowledge must arise from the third party's relationship with the company. In *Equiticorp*, Smellie J said:³⁵

Thus facts which would put a person on inquiry at common law are irrelevant unless they can be said to form part of the relationship between the person and company.

So constructive knowledge about a defect will be relevant under the proviso if the third party should know about the defect because they were an insider to the company and could reasonably be expected from that inside position to be aware of the particular matter. Constructive knowledge will also be relevant if the third party had undertaken a number of previous transactions with the company and should have realised from the way those previous transactions were conducted that there was a problem with authority for the current transaction.

However, just being aware that the current transaction is not in the best interests of the company is unlikely to amount to constructive knowledge of a defect in authority for the purpose of the proviso to s 18(1). The third party dealing with a company will be entitled to rely on a holding out for the purpose of apparent authority even though they may be aware that the transaction is not in the company's best interests. That is, unless the third party is found to have *actual knowledge* of the defect in actual authority.

Actual Knowledge of Defect in Authority

That raises the question as to whether there can be situations where being aware that a transaction is not in the company's best interests can potentially amount to actual knowledge of a defect in authority. This might be the case if the circumstances were such as to amount to

³³ As in *TVBI Company Ltd v World TV Ltd* [2019] NZHC 246 at [196], discussed below.

³⁴ Griffiths, above n 2, at 207.

³⁵ *Equiticorp Industries Group Ltd v The Crown (No 47)*, above n 10, at 725.

“wilful blindness” by the third party. In *Autumn Tree*, the Court of Appeal noted that “wilful blindness” would amount to a form of actual knowledge:³⁶

Actual knowledge includes wilful blindness, being a state of affairs where someone is sufficiently aware something is wrong but deliberately avoids further investigation.

In this respect, the Court goes further than the Law Commission anticipated as the Law Commission did not consider wilful blindness to amount to actual knowledge.³⁷ I would, however, respectfully agree with the Court’s approach here. The courts have frequently regarded wilful blindness as equivalent to actual knowledge.³⁸

An example might be a director of a company with a business that owns and leases office space, agreeing to lease office premises to a friend’s business for two years at a mere peppercorn rental. The provision of valuable leasehold space for essentially no consideration would be sufficiently suspicious that the tenant could be said to be wilfully blind if the tenant did not make inquiries as to the authority of the director to provide lease terms on that basis.

There is still scope for argument about whether particular cases would fall within a wilful blindness test. Take, for example, a situation like *Autumn Tree* where a corporate agent causes a company to sell an asset at a price substantially lower than market value. Depending on how extreme the discount to market value was, a third party might or might not be considered wilfully blind in such circumstances.

Just being aware that a transaction is not in a company’s interests would not be enough to amount to wilful blindness as to whether the particular corporate agent had actual authority.

An example is the New Zealand High Court decision in *TVBI Company Ltd v World TV Ltd*. The agreements at issue involved World TV’s continued licensing of broadcasting content from TVBI and utilizing over-the-top streaming boxes provided by TVBI. Smith AJ held that even if TVBI thought the agreements were uneconomic for World TV, that did not provide a basis for inferring that Mr Ho (the corporate agent purportedly acting for World TV) might not have his board’s authority when he negotiated the agreements.³⁹ Instead TVBI would likely have

³⁶ *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 1, at [72].

³⁷ Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [347].

³⁸ *White v White* [2001] UKHL 9; [2001] 1 WLR 481 at [16] per Lord Nicholls and [34] per Lord Cooke; *Macmillan Inc v Bishopsgate Investment Trust Plc*, above n 20, at 1000 per Millett J.

³⁹ *TVBI Company Ltd v World TV Ltd*, above n 33, at [196].

assumed that Mr Ho did have the necessary authority and that World TV was attempting to deal with its then business difficulties by moving to a new, arguably more attractive product using the new platform.

I discuss further in Chapter 9, the policy considerations relevant to what form of knowledge by a contracting third party should be sufficient to remove a third party's ability to rely on apparent authority. Lord Neuberger, in the *Akai* case, suggested that in a commercial context, in the absence of dishonesty or irrationality, a person should be entitled to rely on what they are told as this "enables people engaged in business to know where they stand".⁴⁰

Similarly, Griffiths suggests that a duty of inquiry should not be required of a third party unless the circumstances suggest "the likelihood of fraud rather than poor or incompetent management".⁴¹ Proceeding with a contract despite knowledge of the likelihood of fraud would, however, likely amount to "wilful blindness" that would meet the test of actual knowledge in the proviso to s 18(1) under the Court of Appeal's approach in *Autumn Tree*.

As interpreted by the Court of Appeal in *Autumn Tree*, the approach taken in the proviso to s 18(1), adjusts the common law to close to where Lord Neuberger in *Akai* would have taken it. A third party's ability to rely on apparent authority is not removed by the third party being aware that a transaction is not in the company's best interests except in three situations. The first is where the third party has actual knowledge of the lack of authority of the directors entering into the transaction. The second is where the third party is wilfully blind in the sense discussed in *Autumn Tree* (which could be said to be the case where there is real doubt over the honesty of the directors in question). The third is where the third party is a company insider or otherwise has an ongoing relationship with the company, and so could more reasonably be expected to know that there is a problem with authority.

It is only the third situation that gives rise to a potential concern. Should the fact that the third party has entered into a number of contracts with the company be enough that mere constructive knowledge of a lack of authority removes apparent authority?

I suggest that it may be preferable to align the knowledge test in the proviso more closely with the same degree of knowledge that would cause a third party to lose their ability to resist rescission of a contract in equity for breach of fiduciary duty (discussed in Chapter 4). The case

⁴⁰ *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)*, above n 20, at [52].

⁴¹ Griffiths, above n 2, at 208.

law suggests a third party will only lose the right to resist rescission of a contract on the grounds of breach of fiduciary duty where the third party is aware of the breach or was wilfully blind to it.

Essentially the same policy considerations apply to the question of whether a contracting party should be able to rely on apparent authority. If a contracting party with an ongoing relationship with the company is wilfully blind to an agent's lack of authority, then the contracting party should lose the ability to rely on apparent authority. However, mere constructive knowledge should not be enough. Of course, the fact that a contracting party has an ongoing relationship with the company might make it somewhat easier to infer wilful blindness on the facts.

Section 18(2) and Knowledge of Fraud

Section 18(2) provides for a different knowledge test in cases of fraud or forgery by a corporate agent. In the case of fraud, s 18(2) suggests that no third party would be affected by constructive knowledge of the fraud, regardless of whether they had a relationship with the company.

Section 18(2) provides:

Subsection (1) of this section applies even though a person of the kind referred to in paragraphs (b) to (e) of that subsection acts fraudulently or forges a document that appears to have been signed on behalf of the company, unless the person dealing with the company or with a person who has acquired property, rights, or interests from the company has actual knowledge of the fraud or forgery.

In my view, the knowledge test in s 18(2) is preferable to that in the proviso to s 18(1) in that it provides a test of actual knowledge. As discussed above, that would align the knowledge test required to defeat reliance on apparent authority with the knowledge test that permits voidability of transactions for breach of fiduciary duty. The proviso in s 18(1) should be amended accordingly.

It may also be desirable to expressly clarify in s 18 that it will be considered reasonable for a third party to rely on a holding out of authority unless they have actual knowledge of a defect in actual authority. The point of this clarification would be to avoid the implications of the potential ambiguity in the *Autumn Tree* decision, where the Court of Appeal at one stage

suggested that knowledge by the contracting third party of an undervalue sale price was arguably inconsistent with the corporate agent having apparent authority.⁴²

Having discussed in Chapters 3-4 the impact in equity of a breach of the duty to act in the best interests of the company, and in Chapters 5-7 the impact as a matter of agency law of such a breach, I turn now in Chapter 8 to a discussion of the situations in which a company can effectively affirm or adopt a transaction entered into in breach of the duty.

⁴² *Bishop Warden Property Holdings Ltd v Autumn Tree*, above n 1, at [71].

Chapter 8- Affirmation, Adoption and Ratification

On the basis suggested in Chapters 3-7, a transaction entered into by a director contrary to their duty to act in the best interests of the company, will:

- (a) Still be binding as a matter of agency law unless the transaction is outside the permitted authority of the board (for example, if the transaction does not relate to “the business and affairs” of the company¹) or is outside the delegated authority of individual directors or corporate agents (see Chapters 5-6). However, if the transaction was outside the authority of the board, or of relevant corporate agents, the transaction may still be binding under principles of apparent authority unless the contracting third party was aware of the defect in actual authority or was wilfully blind to the existence of that defect (with mere constructive knowledge of the defect not being sufficient to remove a third party’s ability to rely on a holding out of authority unless the third party had an ongoing relationship with the company) (see Chapter 7);
- (b) Be voidable in equity for breach of fiduciary duty unless the contracting third party is innocent (see Chapters 3-4).

To the extent that the transaction’s validity is impugned (either as void for lack of authority, or voidable for breach of fiduciary duty) a question remains as to whether the transaction can become binding by some action on behalf of the company that might be said to “ratify” or confirm the transaction.

I have used inverted commas for “ratify”, as judges and commentators have used the term to describe quite different concepts.

Gower’s Principles of Modern Company Law usefully distinguishes between four types of shareholder approval (all of which have sometimes been described as “ratification”) as follows;

- (a) “authorisation”, where shareholders provide approval to directors of conduct in breach of duty in advance of the conduct occurring;
- (b) “ratification”, where shareholders provide forgiveness to directors of conduct in breach of duty after the conduct has taken place (although for this type of approval, I prefer the term “release”);

¹ Sections 128(1) and (2) Companies Act 1993.

- (c) “affirmation”, where a shareholder resolution has the effect of binding the company to a transaction that would otherwise be voidable due to the breach of duty; and
- (d) “adoption”, where shareholders approve a transaction purportedly entered into by directors but which the directors did not in fact have the power to enter into.²

When we are looking at the validity of a corporate transaction that one or more directors has entered into in breach of the best interests duty, I consider that it is the third of these kinds of approval (i.e. *affirmation* of a voidable transaction) that is most relevant. The first kind of approval (*authorisation*) is also potentially relevant in a situation where shareholder approval is given *in advance* of directors entering into a transaction. I will also discuss the fourth kind of approval (*adoption* of a void transaction) in relation to transactions where directors did not have *authority* to enter into a transaction. The second kind of approval (*release* of a director from personal liability) is not strictly relevant here unless also accompanied by authorisation or affirmation of a voidable transaction, or adoption of an unauthorised transaction.

Contracting third parties have a valid interest in knowing what form of “ratification” would be sufficient to protect their transaction. Consider, for example, the hypothetical scenario of a bank taking security for the debts of Company A by way of guarantee from Company B when Company B receives no apparent benefit from the transaction.³ It is reasonable for the bank to know whether approval of the transaction by the shareholders of Company B would be sufficient to prevent later challenge to the transaction.

Where a director acts contrary to the interests of the company in entering into a transaction, and the question of approval of the transaction arises, different considerations are relevant depending on whether the transaction was entered into without authority at law and/ or whether the contract is voidable at equity.

If the transaction is both void at law and voidable in equity, then the transaction may conceivably require approval in two forms to ensure the transaction’s validity is beyond doubt. These are, first, *adoption* of a contract made without authority which would otherwise be void at law, and, secondly, *affirmation* of a contract made in breach of fiduciary duty which would

² Paul L Davies, Sarah Worthington and Christopher Hare *Gower Principles of Modern Company Law* (11th ed, Thomson Reuters, London, 2021) at 10-112, 356-358.

³ Holborow “Shareholder Ratification of Directors’ Breaches of Duty in Financial Transactions: A New Zealand Perspective” (2006) 12 NZBLQ 384 at 390.

otherwise be voidable in equity. These two forms of ratification are distinct in law.⁴ Watts comments that in New Zealand the wording of s 177(4) of the Act is wide enough to preserve the common law relating to both forms of ratification.⁵

Affirmation of Voidable Transactions

I will start with a discussion of the affirmation of transactions voidable for breach of fiduciary duty. As discussed in Chapter 3, a breach of the best interests duty is likely to make a transaction voidable in equity, giving the company a right to either affirm or avoid the transaction.

Judges and commentators have often conflated discussions of affirmation with discussions of other forms of “ratification” (and particularly with the release of directors from personal liability). Often, the language of “ratification” is used in situations where what is really being discussed is the potential *affirmation* of a transaction voidable for breach of fiduciary duty.⁶

As such, case law involving the “ratification” of a breach of fiduciary duty has not usually distinguished between the different considerations that may apply to affirmation of voidable transactions and the release of claims against directors.

Where directors have breached their duties, it is well-established that shareholders can usually “ratify” the breach of duty. “Ratification” will normally relieve directors from the possible consequence of the company suing them for damages or other relief (such as an account of profits). However, where a breach of fiduciary duty would make a transaction voidable in equity, then ratification of the actions that amount to a breach of duty may both relieve the director from liability *and* also prevent the transaction entered into by the director from being voidable (on the basis that there is also an effective affirmation or authorisation of the

⁴ Andrew Griffiths *Contracting with Companies* (Hart Publishing, Oxford, 2005) at 91; Peter Watts, Neil Campbell and Christopher Hare *Company Law in New Zealand* (2nd ed, LexisNexis, Wellington, 2016) at [19.1], 579-580; Dal Pont *Law of Agency* (4th ed, LexisNexis, Australia, 2020) at [5.4].

⁵ Watts, Campbell and Hare, above n 4, at 313, n 40. See also *MacFarlane v Barlow* (1997) 8 NZCLC 261,470 (HC).

⁶ See, for example, *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 (NSWCA) at 730 and 732; *Hogg v Cramphorn* [1967] Ch 254 at 269-272; *Bamford v Bamford* [1970] Ch 212 (CA) at 238-241 per Harman LJ and 242-242 per Russell LJ; *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666 (NSWCA) at 683 per Samuels JA (though contrast Mahoney JA at 699 who correctly refers to the question being one of affirmation of a voidable transaction); *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 (HCA) at 295 per Mason, Deane and Dawson JJ. See also R Partridge “Ratification and the release of directors from personal liability” (1987) 46 CLJ 122 at 138.

transaction). A single resolution of shareholders may be intended to have the effect of both release and affirmation.⁷

However, this is not always true. It is possible for the shareholders of a company to affirm or authorise just the underlying transaction without also releasing the directors from potential claims against them for compensation or other relief arising from the breach of duty.⁸

Commonwealth courts have not usually distinguished between the requirements for release and affirmation. In *Smith v Croft (No 2)*, Knox J rejected a submission that a distinction should be drawn between cases where minority shareholders sought to set aside a transaction, and cases where only compensation was claimed.⁹

However, the affirmation of voidable transactions and the release of directors from liability are conceptually different. The rules may be different. For example, the effective release by the company of claims against directors requires the provision of consideration by a director in return for the release, while affirmation of a voidable contract does not.¹⁰ Releasing a director from personal liability is a gratuitous act and so to be binding the director should have provided the company with consideration. By contrast, a contract voidable for breach of fiduciary duty but otherwise meeting the normal requirements for a binding agreement (such as offer, acceptance and consideration) does not need fresh consideration to be affirmed. It simply needs the party who has suffered from the breach of fiduciary duty to make an informed decision to be bound by the contract.

Affirmation is the form of approval required to ensure that a transaction is binding when it otherwise would have been voidable in equity for breach of fiduciary duty.¹¹ It is important, therefore, to look at the established principles relating to the affirmation of voidable contracts. Those principles apply to contracts that are voidable for a number of different reasons (such as due to undue influence or economic duress, as well as breach of fiduciary duty). However, the case law suggests some variations to the generally established principles for affirmation, which

⁷ Davies, Worthington and Hare, above n 2, at 10-112, 357.

⁸ Watts, Campbell and Hare, above n 4, at [19.1], 579.

⁹ *Smith v Croft (No 2)* [1988] 1 Ch 114 at 173. *Miller v Miller* (1995) 16 ACSR 73 (NSWSC) at 87 is an exception. Santow J appears to suggest that ratification which amounts to affirmation of a voidable transaction may have different requirements from ratification in the form of release from liability.

¹⁰ Partridge, above n 6, at 136; *Miller v Miller*, above n 9, at 87; Sarah Worthington “Corporate governance: remedying and ratifying directors’ breaches” (2000) 116 LQR 638 at 651-652; *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237 at 254.

¹¹ For the general principles relating to the rescission of voidable transactions, see Chapter 3.

apply in the specific context of affirmation by *a company* of a contract that is voidable *for breach of fiduciary duty by a director*.

Where a contract is voidable due to some defect the innocent party (e.g. the company to whom a fiduciary duty is owed) has an election. They can elect to rescind (avoid) the contract or to affirm it.¹² An election to affirm once made is binding. The party with the right to rescind cannot avoid the contract if they have already elected to affirm it.¹³ Equally, once rescinded, a contract cannot be resurrected by affirmation.¹⁴

Affirmation requires an unequivocal statement or unequivocal act by the party with the right to rescind, which demonstrates to the other party to the contract that the first party still intends to proceed with the contract, notwithstanding the relevant defect which gives the right to rescind.¹⁵ An election to affirm should be clearly communicated to the other contracting party.¹⁶

Alternatively, affirmation can be constituted by an unequivocal act which manifests an intention to affirm the contract if the fact of such act is known to the other contracting party.¹⁷ For conduct to amount to affirmation, it must be conduct that is only consistent with the continued existence of the contract.¹⁸

The onus of proving affirmation is on the party seeking to avoid rescission.¹⁹

¹² Dominic O’Sullivan, Steven Elliott and Rafal Zakrzewski *The Law of Rescission* (3rd ed., 2023, Oxford University Press) at [11.01].

¹³ *Clough v London and North Western Railway Co* (1871) LR 7 Ex 26 at 34 and 36; *Scarfe v Jardine* (1882) 7 App Cas 345 (HL) at 360; *Law v Law* [1905] 1 Ch 140 (CA) at 158 (CA); *Halifax Building Society v Thomas* [1996] Ch 217; *Jyske Bank (Gibraltar) Ltd v Spjeldnaes* [1999] EWCA Civ 2018 at 12-13; *Re Cape Breton Company* (1885) 29 ChD 795 (CA) at 801-803.

¹⁴ *De Molestina v Ponton* [2002] 1 Lloyd’s Rep 271 (QB) at [8.4].

¹⁵ *Peyman v Lanjani* [1985] Ch 457 (CA) at 501 per Slade LJ; See also *Clough v London and North Western Railway Co*, above n 13, at 34.

¹⁶ *Dyer v Potter* [2011] EWCA Civ 1417 at [56]. Note that the position differs if the question is *adoption* of an unauthorised contract. Adoption does not need to be communicated to the other contracting party: O’Sullivan, Elliott and Zakrzewski, above n 12, at [23.57]; Peter Watts and FMB Reynolds (ed) *Bowstead and Reynolds on Agency* (23rd ed, Thomson Reuters, London, 2024) at [2-047], [2-050], [2-074] (Article 17(2)), and [2-078].

¹⁷ *Scarfe v Jardine*, above n 13, at 361.

¹⁸ *The Bell Group v Westpac Banking Corp (No.9)* [2008] WASC 239 at [9359]; *Car and Universal Finance Co Ltd v Caldwell* [1965] 1 QB 525 at 550. In *Erlanger v New Sombrero Phosphate Co* (1878) 3 App Cas 1218; [1874-80] All ER Rep 271 (HL) at 1282, a resolution that adopted a report which recommended the recovery of damages in relation to a contract for the purchase of an island was held insufficient to amount to affirmation of the purchase.

¹⁹ *Kenny v Fenton* [1971] NZLR 1 (CA) at 17; O’Sullivan, Elliott and Zakrzewski, above n 12, at [23.110].

Who Affirms a Voidable Contract for a Company?

The next question to consider is who can exercise the right to affirm or avoid a voidable transaction on behalf of a company. Normally, this should be the board (or persons with delegated authority from the board), as the decision whether to continue with a contract that the company is party to is inherently a management decision. For example, this would have been the case where a company had a right of rescission of a contract due to fraud of the other contracting party.²⁰

But what if the company's right to avoid a contract has arisen from a breach of duty by the company's own directors i.e. the very same people who (as the board) have the responsibility for management of the company? The cases have commonly required ratification of breaches of directors' duties to be effected by *shareholders* either by resolution in general meeting or otherwise by unanimous shareholder assent.²¹

Susan Watson explains one reason why the decision to ratify breaches of directors is that of shareholders rather than directors:²²

It is not difficult to see why this limitation on the power of the board developed: it avoids the spectre of members of the board of directors, acting as such, being able to unilaterally excuse their own misconduct.

It could also be said that it is appropriate for shareholders to be the party that excuses a breach of duty, given that the duty is owed for their collective benefit (at least while the company is solvent), as discussed in Chapter 2.

The courts have most commonly applied the requirement for shareholder ratification in cases involving the release of directors from liability. However, the policy justification for shareholders exercising the power is the same in the context of affirmation of contracts that are voidable due to a breach of directors' fiduciary duty.

²⁰ For example, *Clough v London and North West Railway*, above n 13. Now, in New Zealand, the cancellation of a contract for misrepresentation (whether innocent or fraudulent) is governed by ss 37-48 of the Contract and Commercial Law Act 2017.

²¹ Worthington, above n 10, at 645; Watson and Taylor, *Corporate Law in New Zealand* (Thomson Reuters, Wellington, 2018) at 25.3.

²² John Farrar and Susan Watson, *Company and Securities Law in New Zealand* (2nd edition, Brookers, Wellington, 2013) at [21.3], 551.

In that context, Mahoney JA in the New South Wales Court of Appeal in *Winthrop Investments Ltd v Winns Ltd*, said:²³

...the ordinary power to affirm or avoid a voidable transaction arising, for example, in the ordinary trading activities of the company would, under the present articles, be vested in the directors. However, the voidability of the transaction here proposed is of a special nature: it arises because of the collateral purpose of the directors. In these circumstances, it cannot remain with the directors whether to affirm or avoid the transaction. The better view is, in my opinion, that, notwithstanding the generality of the grant of power to the directors by art. 120, that grant is limited by implication so as to exclude, and to allow to remain with the shareholders in general meeting, powers such as those in question in *Regal (Hastings) Ltd. v. Gulliver* and in the present case.

There is a long history behind that position. Early English cases such as *Foss v Harbottle* suggested that the appropriate decision-making body for the approval of contracts in breach of directors' fiduciary duties was the shareholder general meeting.²⁴ *Salomon v Salomon* was also a case in which the House of Lords confirmed that if there was a breach of duty to the company through a promoter's sale of assets to the company at overvalue, the contract was affirmed by approval of the shareholders.²⁵ Since then, numerous cases have confirmed that it should be the shareholders in general meeting that decide whether to approve contracts of the company entered into in breach of fiduciary duty, including breach of the duty to act for proper purposes²⁶, and breach of the best interests duty²⁷.

Worthington has suggested that the company's decision whether to ratify directors' breaches of duties should be a board decision. She argues that the requirement for shareholder ratification stems from the law's failure to keep pace with developments in the accepted principles underpinning company law, and in particular, the separate legal identity of the company.²⁸

While Worthington's argument relates to ratification in the form of release of directors from liability, her reasoning would seem to apply equally to ratification in the form of affirmation of

²³ *Winthrop Investments Ltd v Winns Ltd*, above n 6, at 699.

²⁴ *Foss v Harbottle* (1843) 67 ER 189 at 203-204, 2 Hare 460 at 493-494.

²⁵ *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL) at 37 and 54.

²⁶ *Hogg v Cramphorn*, above n 6, at 269; *Bamford v Bamford*, above n 6, at 237-239 per Harman LJ and 242 per Russell LJ; *Winthrop Investments Ltd v Winns Ltd*, above n 6, at 697, 699-700 per Mahoney JA and 681 per Samuels JA.

²⁷ *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd* (1972) 5 SASR 386 (SASC) at 404 (no meeting held); *Pascoe Ltd v Lucas* (1999) 33 ACSR 357 (SASC) at [264].

²⁸ Worthington, above n 10, at 653-654.

voidable contracts. Affirmation or avoidance of contracts is just as much a management decision as a decision whether to pursue directors for liability for their breach of duty.²⁹

However, I do not agree that a board should be able to decide whether to excuse its own default or the default of some board members. Where a transaction is voidable because of the breach of fiduciary duty of directors, then there is sense in someone independent of the board being responsible for deciding whether the transaction should or should not be affirmed by the company. Otherwise, there is the danger that the board may not act in the company's best interests when a director has a conflicting personal interest.³⁰

Further, if the best interests duty is owed for the collective benefit of shareholders (as discussed in Chapter 2), then it makes sense that it is the shareholders who can excuse the consequences of a breach of that duty. However, even if a more entity-focused approach is taken to the best interests duty, it is still appropriate to recognise the important role of governance/accountability that a shareholders' general meeting has. Recognising that role does not undermine the legal separation of shareholders from the company.

Accordingly, it should normally be shareholders who have the right to avoid or affirm a contract that is voidable due to a breach of director's duty. In the case of a company that is in liquidation, however, affirmation or avoidance of a voidable contract can be exercised by a liquidator.³¹

As to the nature of the required shareholder resolution, subject to the limitations at common law (such as the principle relating to fraud on a minority discussed below, and the principle that shareholders cannot ratify a breach of the best interests duty where the company is insolvent or is bordering on insolvency), the case law suggests that a simple majority of shareholders can ratify a breach of directors' fiduciary duties.³²

²⁹ Cranston argues that ratification in the form of affirmation of a voidable contract is more clearly a matter of management of the company than the release of personal liability of directors: Ross Cranston "Limiting directors' liability: ratification, exemption and indemnification" (1992) JBL 197 at 202.

³⁰ Griffiths, above n 4, at 120.

³¹ *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) at [1441] and [1740]; *Westpac Banking Corporation v The Bell Group* (No 3) [2012] WASCA 157, (2012) 89 ACSR 1, though in that case, the Court held the liquidators had not elected to affirm the transactions: at [1137], [1190]-[1191], [2668] and [2674].

³² *Hogg v Cramphorn Ltd*, above n 6, at 269-272; *Bamford v Bamford*, above n 6, at 237-241 per Harman LJ and 242 per Russell LJ; *Winthrop Investments Ltd v Winns Ltd*, above n 6, at 681 per Samuels JA; *Pavlides v Jensen* [1956] 2 Ch 565 at 576; *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 (HL) at 150; *Provida Foods Ltd v Foodfirst Ltd* (2012) 21 PRNZ 546 (HC) at [53(e)]; Farrar and Watson, above n 22, at [21.3], 552.

Requirements for Shareholder Affirmation

Affirmation of a contract voidable for breach of fiduciary duty cannot occur until after the person to whom the duty is owed is effectively freed from the effects of the breach of duty. In turn, this requires awareness of the material facts.³³ Consistent with that, the case law suggests that for a shareholder resolution affirming a transaction in breach of fiduciary duty to be valid, there should first be a disclosure to the shareholders of all material facts³⁴, including specific notice to the shareholders of the fact that there was a breach of duty³⁵. The requirement is for “full and frank disclosure”.³⁶

The need for disclosure of material facts to shareholders is consistent with the general principle relating to the affirmation of voidable contracts that for affirmation to be effective, the affirming party must have sufficient knowledge of the facts constituting the right to rescind.³⁷ For that purpose, there must be actual knowledge of the relevant facts. Mere suspicion is not enough.³⁸

There are, however, limitations in the case law to the general proposition that a shareholder resolution can affirm a contract that is voidable due to a breach of fiduciary duty by a director.

³³ O’Sullivan, Elliott and Zakrzewski, above n 12, at [23.16], [24.39] and [24.45]-[24.47]. See also Cranston, above n 29, at 204, noting that the need for full information before shareholder ratification “is based on the notion that beneficiaries may consent to a lessening of fiduciary duties, if fully informed”.

³⁴ *Lagunas Nitrate Company v Lagunas Syndicate* [1899] 2 Ch 392 (CA) at 452 and 454; *Bamford v Bamford*, above n 6, at 237-238 per Harman LJ and 239 (referring to *North-West Transportation Company v Beatty* (1887) 12 App Case 589 (PC, Ontario), suggesting that the matter needed to have been properly explained to the shareholders); *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9389]. The requirement that the directors must have made full disclosure to the shareholders applies even where shareholder approval is unanimous: *Pascoe Ltd v Lucas*, above n 27, at [266]-[267], [269] and [279].

³⁵ *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9389] and [9393]; *Westpac Banking Corporation v The Bell Group* (No 3), above n 31, at [1168] noting that where directors had the belief that there was no breach of duty involved in certain transactions, it wasn’t possible to argue that directors had made full disclosure of an intended breach of duty and sought absolution in respect of it; *Winthrop Investments Ltd v Winns Ltd*, above n 6, at 684-685 per Samuels JA and 709 per Mahoney JA. Contrast Glass JA at 674. For cases to the same effect involving purported ratification in the form of release from personal liability, see *Miller v Miller*, above n 9, at 89; *Forge v Australian Securities and Investments Commission* (2004) 213 ALR 574 (NSWCA) at [394]; *Heatherington v Carpenter* [1997] 1 NZLR 699 (CA) at 708.

³⁶ *Bamford v Bamford*, above n 6, at 237-238 per Harman LJ; *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9389]. See also more recently (although not in a case involving affirmation of a voidable transaction), *BTI 2014 LLC v Sequana SA* [2022] UKSC 25, [2024] AC 211 at [23] per Lord Reed P stating that ratification in a shareholder general meeting after full disclosure results in the treatment of directors’ acts as the acts of the company. A New Zealand example where insufficient disclosure rendered ineffective a purported shareholder ratification (albeit in the context of potential release of director liability) is *Heatherington v Carpenter*, above n 35, at 708.

³⁷ *Lindsay Petroleum Company v Hurd* (1874) LR 5 PC 221 (PC, Ontario) at 241; *Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd* [2005] QSC 233 at [632]; *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9360]; *Car and Universal Finance Co Ltd v Caldwell*, above n 18, at 554.

³⁸ *Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd*, above n 37, at [662].

A shareholder resolution affirming such a voidable contract may not be effective where the transaction would be oppressive or unfair to minority shareholders, or in circumstances where the company is insolvent. There is also some case law suggesting that action by directors which amounts to bad faith is not capable of ratification.³⁹

Unfairness to Minority Shareholders

The courts have attempted to address circumstances of apparent unfairness to minority shareholders of the majority purporting to ratify breaches of duty by directors (particularly where the shareholding majority is associated with the defaulting directors). The relevant case law largely relates to the release of directors from liability for breach of duty. However, the case law assumes that the same limitations are equally applicable to the affirmation or authorisation of voidable transactions.⁴⁰

The courts have endeavoured to protect minority shareholders in different ways, thus creating some complexity in considering the correct analytical approach. The complexity surrounding the different approaches adopted by the courts is eloquently described by Worthington as “akin to having several teams tunneling through a mountain from different directions”.⁴¹

There are three main ways in which the courts have limited the ability of shareholders to pass a majority resolution “ratifying” a breach of directors’ duty so as to address unfairness to minority shareholders:

- (a) The fraud on the minority principle, in which majority shareholders associated with directors have been held unable in some circumstances to pass a shareholder resolution to ratify a breach of directors’ duty, particularly where the directors would have obtained a personal benefit from the breach;
- (b) A suggestion that the shareholders themselves are required to exercise their voting powers to ratify in the best interests of the company as a whole (i.e., in the best interests of all shareholders);
- (c) An approach under which the votes of interested shareholders are disallowed.⁴²

³⁹ *Pascoe Ltd v Lucas*, above n 27, at [266]-[267].

⁴⁰ See, for example, *Ngurli Ltd v McCann* (1953) 90 CLR 425 (HCA) at 439 and 447-448.

⁴¹ Worthington, above n 10, at 643-644.

⁴² Sometimes, the cases relate just to release of directors from liability, sometimes specifically to affirmation of voidable transactions, and sometimes both.

Fraud on the Minority

The first (and most common) approach is the “fraud on a minority” principle. Under this principle, shareholder ratification was regarded as ineffective where the wrongdoing directors (or their associates) controlled the outcome of the shareholder vote, and the directors/ majority shareholders exercised their power of ratification to obtain an advantage to the disadvantage of the company or the minority shareholders⁴³, where a majority shareholder vote purported to ratify something that amounted effectively to misappropriation of assets by the directors⁴⁴ or where the shareholder resolution could otherwise be regarded as an abuse or misuse of power⁴⁵. As Watts comments, the fraud on a minority exception to shareholder rights of ratification is of particular relevance to breaches of the best interests duty.⁴⁶

The fraud on the minority principle was regarded as relevant to shareholder resolutions affirming voidable transactions by the High Court of Australia in *Ngurli Ltd v McCann*.⁴⁷

The principle of “fraud on the minority” is, however, not a straightforward one to apply. The precise boundaries of the principle are uncertain.⁴⁸ The name of the principle is potentially misleading as the cases make it clear that it may not be strictly necessary to show fraud. The principle will apply even without fraud where the action of the directors and majority shareholders confers some benefit on those directors and major shareholders themselves.⁴⁹ In a number of cases, the Courts have held ratification ineffective when the relevant conduct would amount to misappropriation of company property or resources.⁵⁰ However, the relevant case law in cases involving claimed misappropriation of property is not entirely consistent.⁵¹

⁴³ Worthington, above n 10, at 650; *Burland v Earle* [1902] AC 83 (PC, Ontario) at 93. See also *Cook v Deeks* [1916] 1 AC 554 (PC, Ontario) and *Ngurli Ltd v McCann*, above n 40, at 447-448.

⁴⁴ *Daniels v Daniels* [1978] 1 Ch 406 at 414. In *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9396] Owen J held that the creation and disposal of security interests over the assets of the company brought about in breach of duty should be characterised as misappropriation of company resources and that accordingly shareholder ratification was not available.

⁴⁵ *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 All ER 437 (Ch) at 447-448.

⁴⁶ Watts, Campbell and Hare, above n 4, at [19.3.1], 583.

⁴⁷ *Ngurli Ltd v McCann*, above n 40, at 439 and 447-448. See more recently *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9392].

⁴⁸ Blair Leahy and Andrew Feld “Directors’ Liabilities: Exemption, Indemnification, and Ratification” at [20.31] in Simon Mortimore (ed) *Company Directors* (3rd ed, Oxford University Press, 2017).

⁴⁹ *Daniels v Daniels*, above n 44, at 414.

⁵⁰ *Cook v Deeks*, above n 42.

⁵¹ Rosemary Langford “Solving the riddle of ratification of misappropriation of company property: A new analogy” (2021) 15 JEQ 233.

Vinelott J has commented that “fraud”, when used in the phrase “fraud on the minority”, lies in the majority’s use of their voting power, rather than in the character of the act or transaction giving rise to the cause of action.⁵²

Wrongdoer control of the shareholder meeting (i.e., control of the meeting by the wrongdoing directors or parties associated with them) will be required for the fraud on the minority principle to apply, but de facto control may be enough for this purpose.⁵³

At common law, the courts also used the “fraud on the minority” principle in deciding whether a shareholder should be entitled to bring a derivative action on behalf of a company to enforce a breach of duty.⁵⁴ The fraud on the minority principle is no longer relevant in that context in New Zealand given statutory reform.⁵⁵ The principle is still relevant, however, to the question of ratification of breaches of directors’ duties, including ratification in the form of affirmation of voidable transactions.⁵⁶

The old case law relating to what amounts to fraud on the minority has continued to be referred to and applied on the question of ratification under the Companies Act 1993. For example, in *MacFarlane v Barlow*, the Court confirmed that the common law relating to ratification was preserved by s177(4) of the Act, and cited leading cases on the fraud on the minority principle.⁵⁷

Requirement for Shareholders to act in Best Interests of Company?

A possible second way of dealing with unfairness to minority shareholders arising from a shareholder ratification resolution is to apply a requirement that shareholders in voting to approve such a resolution should act in the best interests of the company as a whole.

⁵² *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] 1 Ch 257 at 307.

⁵³ *Heatherington Ltd v Carpenter*, above n 35, at 707.

⁵⁴ *Worthington*, above n 10, at 649.

⁵⁵ Section 165 Companies Act 1993.

⁵⁶ *MacFarlane v Barlow*, above n 5, at 261,475-261,476; *Massey v Wales* (2003) 57 NSWLR 718 (NSWCA) at 730. In *Winthrop Investments Ltd v Winns Ltd*, above n 6, at 702G-703A, a case of prior authorisation of a transaction by shareholders, it was not necessary to decide whether fraud on the minority principles would also apply to the validity of shareholder resolutions passed to approve a transaction in advance.

⁵⁷ *MacFarlane v Barlow*, above n 5, at 261,475-261,476. The Court cited *Estmanco (Kilner House) Ltd v Greater London Council*, above n 45, and *Daniels v Daniels*, above n 44, both leading cases on the fraud on the minority principle (albeit used in those cases in the different context of granting leave for the bringing of derivative actions), and applied the principle in the context of whether a ratifying resolution would be effective to release defaulting directors from liability, and to affirm transactions entered into in breach of duty.

For example, in *Ngurli Ltd v McCann* (a case involving potential affirmation by shareholders of a share issue issued in breach of director's fiduciary duty), the High Court of Australia suggested that voting powers conferred on shareholders "must be used bona fide for the benefit of the company as a whole".⁵⁸ However, the actual decision on the facts in *Ngurli* suggests that the Court did not intend to go any further than apply the fraud on a minority principle.⁵⁹ The Court said that an attempted confirmation by a shareholder general meeting of the share issue in that case would have been ineffective on the basis that:⁶⁰

[E]ven in general meeting a majority of shareholders cannot exercise their votes for the purpose of appropriating to themselves property or advantages which belong to the company for that would be for the majority to oppress the minority.

There is a risk that an overriding general test based on the interests of shareholders as a whole would add uncertainty if applied as an additional requirement to the fraud on the minority principle. In *re Halt Garage (1964) Ltd*, Oliver J accepted a shareholder resolution approving the remuneration of directors would not be effective in the case of oppression or fraud on the minority, or where there was fraud or bad faith, but doubted the appropriateness of a test based on "some abstract standard of benefit".⁶¹ Baxt similarly argues against a requirement for shareholders to assess whether a matter was in the interests of the company, and suggests such a test would require courts to "engage in a gymnastic analysis".⁶²

The better view is that there is no separate requirement for a shareholder ratification resolution to be in the "interests of shareholders as a whole" that adds anything to the fraud on the minority principle.⁶³

⁵⁸ *Ngurli Ltd v McCann*, above n 40, at 438.

⁵⁹ At 439 and 447-448.

⁶⁰ At 447.

⁶¹ *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016 (Ch) at 1036, 1037 and 1043.

⁶² R Baxt "Judges in Their Own Cause: The Ratification of Directors' Breaches of Duty" (1978) Monash ULR 16 at 48.

⁶³ See, however, Ernest Lim and John Lowry "Reconsidering the rule on shareholders' exercise of voting powers" (2020) JBL 645 who suggest shareholders acting in the general meeting are agents of the company and owe a fiduciary duty to exercise votes in the interests of the company. New Zealand case law would not support such an approach as a general proposition: *Baker v Hodder* [2018] NZSC 78, [2019] 1 NZLR 94 at [58]-[60].

Exclusion of Interested Shareholder Votes

A third potential way of dealing with unfairness to minority shareholders arising from a ratifying shareholder resolution is to exclude the votes of shareholders who are interested in the resolution. That would also be consistent with the suggestion of Vinelott J in *Prudential Assurance* that the “fraud” on the minority really arises from the majority’s use of voting power.

The cases are not easy to reconcile on the question of whether the votes of interested shareholders should be excluded when deciding on the effectiveness of a resolution to affirm a transaction voidable for breach of director’s fiduciary duty.

An early case suggesting that interested shareholder votes should be excluded is *Atwool v Merryweather*.⁶⁴ In that case, a shareholder resolution for affirmation of a transaction entered into in breach of fiduciary duty was held ineffective when passed by votes of those involved in the director’s breach of fiduciary duty. The case concerned a claim by a minority shareholder of East Pant Du United Lead Mining Company to set aside a contract for purchase of mines by the company from Mr Merryweather, a director of the company. The company’s shareholders had voted 344-324 that the company *not* proceed with the claim, effectively a resolution to affirm the contract. However, if you were to exclude the votes of Mr Merryweather and a person associated with him from the calculation of the shareholder vote, there would have been a majority of 86 votes in favour of proceeding with the claim.

Sir W Page Wood VC suggested that “the whole contract is a complete fraud” and commented “plainly before me that I have a majority of shareholders, independent of those implicated in the fraud, supporting the bill...”⁶⁵

The case could just be seen as an example of the fraud on the minority principle. However, it could also be seen as a case that suggests that a shareholder ratifying resolution will be considered ineffective when the outcome of the vote is dependent on the votes of parties implicated in the breach of fiduciary duty.

⁶⁴ *Atwool v Merryweather* (1867) LR 5 Eq 464.

⁶⁵ At 468.

The approach taken in *Atwool* can be contrasted with that in *North-West Transportation Company Ltd v Beatty* some 20 years later. In *North-West Transportation*, the Privy Council held that the majority of shareholders could sanction an interested transaction even though this was dependent on the votes of an interested director/ shareholder as long as the transaction was not brought about by unfair means and was not oppressive to the shareholders who opposed it.⁶⁶

The case concerned a transaction in the form of the purchase by the company of a steamer vessel. There was a shareholder resolution to affirm the transaction passed by a shareholder vote of 306 votes in favour and 289 votes against. However, as in *Atwool*, the shareholder vote in the *North-West Transportation* case was only carried through the positive votes of interested parties. The 306 votes in favour included 291 votes by James Beatty, the director from whom the steamer was purchased, and 10 votes by persons associated with Mr Beatty.

The Privy Council nevertheless held that the shareholder affirming resolution was effective. The Privy Council said that the acquisition by the company of the steamer “was a pure question of policy ... upon which the voice of the majority ought to prevail”.⁶⁷ The Privy Council expressly rejected the argument that the acts or transactions of a director could only be confirmed by shareholders if this was through the exercise of votes of disinterested shareholders.

It is significant, however, that the Court accepted that the price for the purchase of the steamer “was not excessive or unreasonable”.⁶⁸ Had the purchase of the steamer been at an excessive price, then it is hard to imagine the result in the case being the same. If the purchase price was excessive, then the shareholder ratification passed with the votes of parties associated with the interested director could be viewed as a fraud on the minority, and the votes of interested parties appropriately excluded on the same basis as in *Atwool*.

The approach taken in *North-West Transportation* was specifically approved by the House of Lords in *Salomon v Salomon*, even though in *Salomon* it was alleged that the company had

⁶⁶ *North-West Transportation Company Ltd v Beatty*, above n 34, at 593-594 and 600.

⁶⁷ At 601.

⁶⁸ At 596.

purchased assets at a gross overvalue.⁶⁹ However, in *Salomon* there was unanimous shareholder acquiescence to the transaction so there was no question of unfair prejudice to minority shareholders.

Some more modern authorities have supported the concept of excluding interested votes from being counted in support of a shareholder ratifying resolution.

First, it is an accepted principle that where shares have been issued in breach of the directors' duty to act for proper purposes, the new shares issued may not be voted in a shareholder resolution to ratify the share issue.⁷⁰ Secondly, there is the suggestion by the English Court of Appeal in *Prudential Assurance* that a company could not condone a fraud if this was only confirmed by a majority created by the use of the fraudsters' own voting power.⁷¹

An approach that excludes the votes of directors, or parties associated with them, has some difficulties, particularly for companies with many shareholders. There may sometimes be real practical issues in determining whether shareholders are or are not interested.⁷² Vinelott J has suggested that the court will look behind the shareholding register to the beneficial owners of shares to see if they are the persons against whom relief is sought.⁷³ However, there is no requirement to show beneficial interests on share register which will make it harder to assess whether a shareholder is associated with a director.⁷⁴

Nevertheless, such potential problems of proof are not a sufficient reason to shy away from considering whether a shareholder resolution is tainted by the votes of shareholders associated with the director. The law would not normally preclude a legal remedy just because of difficulties of proof.

⁶⁹ *Salomon v Salomon & Co Ltd*, above n 25 at 58.

⁷⁰ *Hogg v Cramphorn*, above n 6, at 269. *Hogg v Cramphorn* was cited with approval in *Bamford v Bamford*, above n 6, at 240-241.

⁷¹ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA) at 219. See also the comments of Vinelott J at first instance (albeit in the different context of whether a shareholder should be permitted to bring a derivative action on behalf of the company despite a shareholder resolution suggesting action not be brought) suggesting the Court could "disregard votes cast or capable of being cast by shareholders who have an interest which conflicts with the interests of the company": *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*, above n 52, at 323.

⁷² Jennifer Payne "A re-examination of ratification" [1999] 58 CLJ 604 at 621.

⁷³ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*, above n 52, at 324.

⁷⁴ Section 92 Companies Act 1993.

However, there may be a line to be drawn in terms of the extent of inquiry that is required. In *Smith v Croft*, Knox J suggested a test that would have required consideration of the *motivations* of particular shareholders voting on a ratification resolution.⁷⁵ I suggest that is problematic. As the High Court of Australia has commented:⁷⁶

An investigation of the thoughts and motives of each shareholder voting with the majority would be an impossible proceeding.

A broader consideration of shareholder motivations might be considered relevant to a discretionary decision whether to permit a shareholder to bring a derivative claim on behalf of the company (as was the issue in *Smith v Croft*). However, where the issue is one of whether a contract is or is not binding, commercial certainty requires a simpler (and more practical) approach to assessing whether a ratifying (affirming) resolution is effective. It may be practical to exclude the votes of shareholders where those shareholders are associated with directors whose decision is challenged, but not to scrutinise the individual motivations of each and every shareholder.

Concluding Thoughts for Addressing Unfairness to Minority Shareholders

Given that one purpose of shareholder ratification is to avoid the spectre of those in breach endorsing their own conduct, it makes sense that there be some limitations on shareholders' ability to release directors from liability for breach should the directors in breach also be shareholders or be associated with shareholders. That policy rationale is also relevant in a case involving the affirmation of a transaction voidable for breach of fiduciary duty.

An approach that involves excluding the votes of shareholders who are associated with the directors whose decision is challenged appears preferable to a broader assessment of whether there is a "fraud on the minority" given the imprecision of the fraud on the minority test, and difficulty in applying it.⁷⁷

⁷⁵ *Smith v Croft (No 2)*, above n 9, at 186.

⁷⁶ *Peters' American Delicacy Company Ltd v Heath* (1939) 61 CLR 457 (HCA) at 512.

⁷⁷ Baxt, above n 62, at 35-40, and in relation to the affirmation of voidable contracts, at 42-43.

It would be useful to reform the law to expressly provide for a test of shareholder ratification of breaches of directors' duties based on excluding the votes of interested shareholders (except where there is unanimous shareholder assent). I will discuss this further in Chapter 9.

Insolvency as a Bar to Shareholder Affirmation

It now appears well-established that a transaction that is voidable due to a breach of directors' fiduciary duty cannot be affirmed by the shareholders (even unanimously) if the company was insolvent when the transaction was entered into.

The leading authority is the Australian decision, *Kinsela v Russell Kinsela Pty Ltd*. While the company was insolvent, its directors caused it to enter into a lease agreement to related parties at undervalue. The Court held that the directors' conduct breached the best interests duty, and that the lease contract was voidable. Further, the purported affirmation of the lease contract by the shareholders was ineffective. Street CJ said:⁷⁸

It is, to my mind, legally and logically acceptable to recognise that, where directors are involved in a breach of their duty to the company affecting the interests of shareholders, then shareholders can either authorise that breach in prospect or ratify it in retrospect. Where, however, the interests at risk are those of creditors I see no reason in law or in logic to recognise that the shareholders can authorise the breach. Once it is accepted, as in my view it must be, that the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors (*Nicholson v Permakraft (NZ) Ltd* and *Walker v Wimborne*) the shareholders do not have the power or authority to absolve the directors from that breach.

The language used by Street CJ of *ratification* of breach of duty, and of *absolving* the directors from the breach, creates the connotation of release of directors from liability. However, the specific context of the case was whether the lease transaction could be set aside. Therefore, the case is properly seen as one relating to the ability of shareholders to affirm a voidable transaction.

⁷⁸ *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 6, at 732.

More recent case law also applies the same restriction on shareholder ability to “ratify” in the case of an insolvent company to both cases involving the potential release of directors from liability⁷⁹ and cases involving affirmation of voidable transactions⁸⁰.

Recently, in *Sequana*, the United Kingdom Supreme Court referred to *Kinsela* with approval and applied it generally to ratification of breaches of the best interests duty. The context of *Sequana* was one of potential liability of directors for damages.⁸¹ However, there is nothing in *Sequana* to suggest that the principle should be applied any differently in cases, like *Kinsela* itself, where the real issue is one of *affirmation* of a voidable transaction.

The Court in *Sequana* considered that the ability of shareholders to ratify a breach of the best interests duty should be aligned with the circumstances in which the requirement to consider creditors’ interests arose. Lord Reed P said that the law would not be coherent if directors were required to take the interests of creditors into account as part of the best interests duty, but shareholders could then ratify a breach of the duty.⁸² Similarly, Lord Briggs JSC said that the trigger for the engagement of the requirement to consider the interests of creditors must sensibly coincide with the moment when the shareholder ratification principle ceases to apply.⁸³

As discussed in Chapter 4, the Court in *Sequana* held that the trigger for when directors must consider the interests of creditors is when the company is insolvent, or its insolvency is imminent, or where it is probable that the company will enter insolvent liquidation. Accordingly, where those situations apply, shareholders will not be able to ratify breaches of the best interests duty, with “ratification” in this context including both release of directors from personal liability and affirmation of voidable transactions. *Sequana* also suggests that

⁷⁹ *Re New World Alliance Pty Ltd* (1994) 122 ALR 531 (FCA) at 550; *Sojourner v Robb* [2007] NZCA 443, [2008] 1 NZLR 751 at [25]; *Singularis v Daiwa* [2019] UKSC 50 at [10]; *BTI 2014 LLC v Sequana SA*, above n 36, at [37]-[42] and [91] per Lord Reed P, at [149] per Lord Briggs JSC.

⁸⁰ *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9390]; *Westpac Banking Corporation v The Bell Group* (No 3), above n 31, at [1161] and [2672]; *Bowthorpe v Hills* [2003] 1 BCLC 226 (Ch) at [51]-[55].

⁸¹ *BTI 2014 LLC v Sequana SA*, above n 36. The same was also true of the earlier leading English decision, *West Mercia Safetywear v Dodd* [1988] BCLC 250 (CA) at 252-253, where *Kinsela* was also cited with approval.

⁸² At [5].

⁸³ At [196].

shareholders should not be able to ratify a transaction in breach of fiduciary duty where the implementation of the transaction would render the company insolvent.⁸⁴

In the case of insolvency, even unanimous shareholder consent will not be effective for ratification.⁸⁵

For completeness, it is worth noting that another possible restriction on the ability of shareholders to ratify is where the shareholders themselves are acting in bad faith or dishonestly.⁸⁶

Affirmation by Conduct

I have indicated above that:

- (a) Affirmation by a company of a transaction that is voidable due to a breach of the fiduciary duty to act in the best interests of the company can only be exercised by the shareholders of the company, rather than by the board;
- (b) A shareholder resolution to affirm such a voidable contract will not, however, be effective where that amounts to a “fraud on the minority” and possibly (if this does not amount to the same thing) where the resolution is only passed due to votes of shareholders who are also the directors in breach, or parties associated with those directors;
- (c) A shareholder resolution to affirm a contract will not be effective to affirm a contract voidable for breach of a director’s fiduciary duty if the breach of duty occurred when the company was insolvent, the company’s insolvency was imminent, or it was probable that the company would go into insolvent liquidation, or if the transaction would cause the company to become insolvent.

⁸⁴ At [149] per Lord Briggs JSC citing *Bowthorpe v Hills*, above n 80, at [51]-[54]. Lord Reed P at [91] refers to a possible lesser test of shareholders not being able to ratify a transaction which would *jeopardise* the company’s solvency or cause loss to its creditors, citing *Ciban Management v Citco* [2021] AC 122 (PC, British Virgin Islands) at [40]. However, such a test is difficult to reconcile with the UKSC’s rejection in *Sequana* of a trigger for the creditor duty based on there being a real risk of insolvency (unless “jeopardise” is taken to mean “would result in the company’s insolvency” rather than just “would result in a real risk of the company’s insolvency”).

⁸⁵ *Kinsela v Russell Kinsela Pty Ltd (in liq)*, above n 6; *Bowthorpe v Hills*, above n 80, at [51]-[55]; *Madoff Securities International Ltd (in liq) v Raven* [2013] EWHC 3147 (Comm) at [272]-[273]; Leahy and Feld, above n 48 at [20.65]-[20.68].

⁸⁶ *Madoff Securities International Ltd v Raven* [2012] 2 All ER (Comm) 634 at [105]-[124]; *Bowthorpe v Hills*, above n 80, at [55]-[56]; Leahy and Feld, above n 48 at [20.61].

One potential qualification should be made in relation to these restrictions on a company's ability to affirm a contract voidable due to a director's breach of fiduciary duty. That qualification is that a company's *conduct* might itself amount to affirmation of a contract, or at least give rise to an estoppel, regardless of the rules summarised above.

Under normal principles of affirmation of voidable contracts, affirmation can occur through conduct, including exercising rights under the contract⁸⁷ and sometimes delay⁸⁸. Conduct by shareholders in the form of acquiescence has been held effective to release directors from liability.⁸⁹ In an appropriate case, it could also amount to affirmation of a voidable contract.

If the company is in liquidation, then conduct by the liquidator could amount to affirmation.⁹⁰ There does not seem any reason why conduct by a liquidator would not be effective to amount to affirmation of a contract voidable for breach of directors' fiduciary duty, where the liquidator's conduct satisfies the normal tests for affirmation of voidable contracts.

However, often conduct that might be argued to affirm a contract is entered into by the directors, or by management under delegated authority from the directors. Can such conduct be enough to amount to affirmation, given the established principle that affirmation should be by shareholders in the case of a contract voidable due to breach of fiduciary duty by the directors? Similarly, can conduct by directors or management of the company amount to

⁸⁷ *The Bell Group v Westpac Banking Corporation (No.9)*, above n 18, at [9365]; *Ultraframe (UK) Ltd v Fielding*, above n 31, at [1449] and [1740] where the Court held that an unqualified demand for payment of sums due under a voidable contract amounts to an election to affirm the contract, and that the liquidator of Sequest did affirm an intellectual property rights licence (which was otherwise voidable as an interested transaction) by unequivocally demanding payment under it; *United Shoe Machinery Company of Canada v Brunet* [1909] AC 330 (PC, Canada) at 339-340 where continuing to work machines and pay royalties was held to amount to affirmation; *Lindgren v L & P Estates Ltd* [1968] 1 Ch 572 (CA) at 597 and 604-605 where the Court held it was arguable that the company had affirmed a contract (which was alleged to have been voidable for breach of fiduciary duty) by acting upon it and treating it as effective for some years.

⁸⁸ *Clough v London and North Western Railway Co*, above n 13, at 35; *Lindsay Petroleum Company v Hurd*, above n 37, at 239-240; *Peninsular & Oriental Steam Navigation Co v Johnson* (1938) 60 CLR 189 (HCA) at 205; *Law v Law*, above n 13, at 159. Conduct will not, however, amount to affirmation if the party with the right to rescind did not have sufficient knowledge of the relevant facts giving the right to rescind. For example, in *Southern Cross Mine Management Pty Ltd v Ensham Resources Pty Ltd*, above n 37, at [630], conduct by the company in engaging in stripping operations using a dragline (acquired under contract for hire) and accepting the performance of a contract for almost three years was argued to be affirmation. However, this argument was unsuccessful as the company did not have knowledge of the relevant misrepresentations before rescission: at [641] and [644].

⁸⁹ *Sharma v Sharma* [2013] EWCA Civ 1287 at [52], [66] and [72]. This case was, however, a case involving advance authorisation of transactions, rather than affirmation after the event.

⁹⁰ *Ultraframe (UK) Ltd v Fielding*, above n 31, at [1740] where the Court held that the liquidator of Sequest had affirmed an intellectual property rights licence (which was otherwise voidable as an interested transaction) by unequivocally demanding payment under it.

affirmation in circumstances where even shareholder ratification would not have been sufficient (due to the fraud on a minority principle, or the fact that the directors had failed to take into account the interests of creditors at a time that the company was insolvent)?

In my view, conduct by directors or management is not enough to amount to affirmation in cases involving contracts that are voidable for breach of directors' fiduciary duty. That would be inconsistent with the principle that directors should not be able to excuse their own misconduct.

However, in some cases, equity will demand that a company be held bound to a contract where a third party has relied on conduct of the company. In appropriate cases, therefore, conduct by the directors or management while not strictly amounting to affirmation may give rise to an estoppel.⁹¹

Partial Affirmation

The traditional approach is that voidable contracts must be either totally affirmed or totally avoided.⁹² The remedy of rescission allows the party with the right of rescission an election to either avoid or affirm the contract as a whole. It is not possible to rescind part and affirm part of a contract.⁹³ This approach finds its roots in the 1800s decision of *Hunt v Silk*, where Lord Ellenborough said, "where a contract is to be rescinded at all, it must be rescinded in toto...".⁹⁴

⁹¹ *Peyman v Lanjani*, above n 15, at 488 (per Stephenson LJ), 495-496 (May LJ) and 501 (Slade LJ). However, there was no proof of detrimental reliance in that case: at 491 (Stephenson LJ) and 496 (May LJ). Estoppel was also unsuccessfully argued as a defence to a claim for rescission in *Goldsworthy v Brickell* [1987] 1 Ch 378 (CA) at 411. There, estoppel was argued because the parties assumed the defendant could not rely on a defence of acquiescence unless the plaintiff had knowledge of his right to rescind: at 410.

⁹² *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549 (CA) at 594, approved in *Guinness Plc v Saunders* [1990] 2 AC 663 (HL) at 697.

⁹³ O'Sullivan, Elliott and Zakrzewski, above n 12, at [11.18]; *United Shoe Machinery Co v Brunet*, above n 87, 340; *Dyer v Potter*, above n 16, at [58]. See also Peter Watts "Partial rescission: disentangling the seedlings, but not transplanting them" in Elise Bant and Matthew Harding (eds) *Exploring Private Law* (Cambridge University Press, 2010) 427 who does note, however, that counter-restitution that is a condition of rescission of the whole contract will sometimes provide an outcome that can look like partial rescission: at 445. See also O'Sullivan, Elliott and Zakrzewski, above n 12, at [19.39]-[19.45].

⁹⁴ *Hunt v Silk* (1804) 5 East 449, (1804) 102 ER 1142. See also *Sheffield Nickel and Silver Plating Co Ltd v Unwin* (1877) 2 QBD 214 (CA) at 223: "...a contract cannot be rescinded in part and stand good for the residue. If it cannot be rescinded in toto, it cannot be rescinded at all; but the party complaining of the non-performance, or the fraud, must resort to an action in damages."

It would only be possible to avoid one part of a contract and affirm another part if they are in truth so severable as to form two independent contracts.⁹⁵ If there is more than one contract but there is in substance one transaction then there needs to be rescission of the entire transaction.⁹⁶ For example, it would not be possible to rescind a mortgage while leaving the underlying loan documents intact. That would leave the borrower with the loan money while depriving the lender of its security.⁹⁷

An anomalous decision is *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd*. Mitchell J in the South Australia Supreme Court held that the directors could not have had a belief that a guarantee by David Murray Holdings that extended to future indebtedness of other group companies was for the benefit of David Murray Holdings. The Court therefore held that the guarantee was voidable. However, the judge said to the extent the guarantee had been limited to amounts *already advanced* to the other group companies, the directors had properly formed the view that it was to the benefit of David Murray Holdings to execute the guarantee. To that extent, the guarantee was enforceable on the basis that the improper covenants in the guarantee could be severed.⁹⁸

That is a novel approach that is hard to square with how the remedy of rescission applies in equity. Principles of severance can apply in certain circumstances to contracts where a provision of a contract is illegal or void, and the invalid provision can be severed from the

⁹⁵ *United Shoe Machinery Company of Canada v Brunet*, above n 87, at 340. This may have been the approach taken in *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700 (Ch) at 762-763, where Eagle was potentially able to avoid options over two properties but not to set aside sales of three other properties as they had been sold on and so restitution was not possible. It is unclear from the case report whether the sales and options were all part of the same agreement.

⁹⁶ *Greater Pacific Investments Pty Ltd (in liq) v Australian National Industries Ltd* (1996) 39 NSWLR 143 (NSWCA) at 151; *UBS AG v Kommunale Wasserwerke Leipzig GMBH* [2017] EWCA Civ 1567 at [304]-[319] and [332] where the Court of Appeal upheld the first instance judge's decision that if certain derivative contracts were rescinded then certain related transactions must also be rescinded, on the basis that in reality the transactions together represented part of the same overall deal and would not have proceeded without each other; *A H McDonald & Co Pty Ltd v Wells* (1931) 45 CLR 506 (HCA) at 512; *De Molestina v Ponton*, above n 14, at 288-289 where Colman J suggested that it would not be possible to rescind one contract without also rescinding another contract if the parties would never have entered into second contract without also entering into the first: at [6.9] and [7.4]. On the facts in *De Molestina*, three share distribution agreements were held interdependent, but it was unclear whether those three agreements and another agreement (the "Brunswick agreement") were inseparable parts of one transaction such that the share distribution agreements could be rescinded without also rescinding the Brunswick agreement: see at [7.1]-[7.12], 289-291 and [10], 293.

⁹⁷ *Maguire v Makaronis* (1997) 188 CLR 449 (HCA) at 474-475.

⁹⁸ *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd*, above n 27, at 402-406 and 410 at (10).

contract without altering the nature of the contract.⁹⁹ However, such principles are not readily applicable to the equitable remedy of rescission. As mentioned in Chapter 3, rescission is not permitted unless the parties can be restored to their original position. That cannot occur if the contract is enforced in part.¹⁰⁰

Further, it detracts significantly from commercial certainty if a Court can pick and choose which provisions in a commercial contract can be said to be invalid due to breach of fiduciary duty.

As the English Court of Appeal said in *Dyer v Potter*, an approach involving “partial affirmation” is unsupported by authority and contrary to basic principle.¹⁰¹ The approach taken in *Reid Murray* should not be followed.

Authorisation of Future Transactions

I have discussed above the situation where the approval by shareholders of a company is of a transaction already entered into by the directors of the company (and so approval amounts to affirmation of an existing voidable transaction). But what is the position if the shareholders instead purport to give *prior approval* to a transaction being entered into by the directors?

As previously discussed, this form of approval (if valid) amounts to “authorisation” within the *Gower* categories.

⁹⁹ *Carr v Gallaway Cook Allan* [2014] NZSC 75, [2014] 1 NZLR 792 (SC) at [48] and [62].

¹⁰⁰ *De Molestina v Ponton*, above n 14, at [6.2]. There is some Australian authority for partial rescission in the case of rescission for misrepresentation (*Vadasz v Pioneer Concrete (SA) Pty Ltd* (1995) 184 CLR 102 (HCA) followed in New Zealand in *Scales Trading Ltd v Far Eastern Shipping Co Public Ltd* [1999] 3 NZLR 26 (CA) at 41 and 49). However, that authority has been held not applicable in a case involving rescission for breach of fiduciary duty: *Maguire v Makaronis*, above n 97, at 472. The Privy Council in *Scales Trading Ltd v Far Eastern Shipping Co Public Ltd* [2001] 1 NZLR 513 at [34] declined to decide whether *Vadasz* should be preferred to *TSB Bank plc v Camfield* [1995] 1 WLR 430 (CA), which took a different approach to *Vadasz* in misrepresentation cases. See also *Bridgewater v Leahy* (1998) 194 CLR 457 (HCA), where the majority considered that partial rescission might be appropriate in a case of unconscionable dealing (at 493), but the minority did not (at 473). Colman J in *De Molestina v Ponton*, above n 14, at [6.7], said that under English law, *Vadasz* was wrongly decided. For academic criticism of the approach in *Vadasz*, see O’Sullivan, Elliott and Zakrzewski, above n 12, at [19.34]–[19.46].

¹⁰¹ *Dyer v Potter*, above n 16, at [58]. The case concerned whether Ms Goscomb, who was a joint tenant with Mr Potter, had affirmed a notice to quit she had given of the joint tenancy. Ms Goscomb’s affirmation was given after she became aware of a misrepresentation by the landlord. Mr Potter suggested that that Ms Goscomb only intended to bring her own personal tenancy to an end and not that of her joint tenant, Mr Potter. However, the Court confirmed that Ms Goscomb’s affirmation of the notice to quit the joint tenancy was effective in its entirety.

There is significant authority for the proposition that prior shareholder approval of a transaction said to be in breach of fiduciary duty can absolve or release directors from personal liability arising from the transaction. For example, in *Regal (Hastings) Ltd v Gulliver*, the House of Lords said that the directors of the company could have protected themselves by a shareholder resolution “either antecedent or subsequent” to the transaction in question.¹⁰²

What, then, about the status of the transaction itself when there is prior shareholder approval of it? If entering into a transaction would amount to a breach of directors’ fiduciary duties, there is case law suggesting that prior shareholder approval will prevent the transaction from being voidable. In relation to interested transactions which were otherwise voidable at equity, Vinelott J referred to the principle that these could be authorised by shareholders in advance as “well-settled”.¹⁰³ Further, in *Pascoe Ltd v Lucas*, a Full Court of the Supreme Court of South Australia held that a transaction otherwise voidable for breach of fiduciary duty would be binding where the only shareholder of the company had approved the transaction in advance.¹⁰⁴

In *Pascoe*, Lander J did note that this proposition was subject to some qualifications that appear consistent with the qualifications to shareholder affirmation of transactions already entered into. The company must be solvent, the directors must make full disclosure to the shareholders and the directors must be acting in good faith.¹⁰⁵ Similarly, in the English decision *Bowthorpe Holdings v Hills*, the Court suggested that a transaction must be bona fide or honest, and not jeopardise the company’s solvency.¹⁰⁶

However, in the specific context of the prior authorisation of a transaction that would otherwise amount to a breach of fiduciary duty, the courts have not been entirely clear or consistent on the form of shareholder resolution required, and in turn on what form of disclosure must be made to shareholders before the resolution is passed.

¹⁰² *Regal (Hastings) Ltd v Gulliver*, above n 32, at 150. See also *Pascoe Ltd v DFC Overseas Ltd* [1994] 3 NZLR 627 (HC) at 638-639; *Sharma v Sharma*, above n 89.

¹⁰³ *Movitex Ltd v Bulfield* [1988] BCLC 104 (Ch) at 118.

¹⁰⁴ *Pascoe Ltd v Lucas*, above n 27, at [264]-[265].

¹⁰⁵ At [266]-[273]. Lander J did not mention the fraud on the minority principle, but that was not relevant in the case given that there was unanimous shareholder approval (by the company’s sole shareholder). Lander J did also mention as a qualification that the transaction must have been “intra vires” i.e. within the company’s capacity. That limitation is less relevant now, given s 16 of the Companies Act 1993, which means that in most cases a company will not have restrictions on its corporate capacity.

¹⁰⁶ *Bowthorpe v Hills*, above n 80, at [48]-[56], in a case involving claimed rescission of a sale of shares in breach of fiduciary duty.

In that context, there was a debate between the judges on the New South Wales Court of Appeal in *Winthrop Investments Ltd v Winns Ltd* as to whether the nature of the shareholder resolution made in advance of a transaction should be considered a resolution to approve the relevant proposed transaction, or just a resolution to forgive the directors for their breach of duty.¹⁰⁷ That, in turn, impacted the nature of the required disclosure to shareholders. The directors in that case sought advance approval from shareholders of a proposed transaction that was (for the purpose of the Court hearing) assumed to be in breach of the directors' duty to act for a proper purpose (being made for the purpose of defeating a takeover bid by Winthrop).

The majority (Mahoney JA and Samuels JA) considered that the shareholders had no power to transact the company's business or give effective directions about its management.¹⁰⁸ This led the majority to the view that the essential nature of the resolution could only be to forgive and absolve the directors from their breach of duty.¹⁰⁹ That in turn led the majority to consider that the particular notice to shareholders was insufficient as the notice did not spell out that the directors were in breach.

In dissent, Glass JA considered that the shareholders could exercise a power to approve the relevant transactions. He described this as part of a "reserve capacity" of shareholders to exercise the powers of the company when the board had solicited that.¹¹⁰ That view led Glass JA to characterise the shareholder resolution in a different way from the majority, and in turn to form the view that there was insufficient evidence to show a lack of sufficient disclosure to shareholders.¹¹¹

In my view, the view of Glass JA should be preferred. The shareholders, when asked to specifically approve a transaction that would otherwise amount to a breach of duty, can properly do so on a basis that their approval is an authorisation of the transaction itself. The suggestion by Glass JA that the shareholders have a reserve power in this context makes sense in a situation where the only reason that the transaction is impugned is because of the potential breach of duty of the directors. In that situation, the directors could be said to be unable to act effectively. The position would then be similar to that of an unresolvable deadlock of directors

¹⁰⁷ *Winthrop Investments Ltd v Winns Ltd*, above n 6.

¹⁰⁸ At 683 per Samuels JA. See also Mahoney JA at 707.

¹⁰⁹ At 683 per Samuels JA and 703-709 per Mahoney JA.

¹¹⁰ At 673-674.

¹¹¹ At 674.

where shareholders would usually be considered to have such a reserve power.¹¹² The view of Glass JA is also consistent with the approach taken in cases like *Pascoe Ltd v Lucas*.¹¹³

Nevertheless, the difference in view between the majority and minority in *Winthrop v Winns* creates further uncertainty as to what is necessary to achieve an effective authorisation in advance of a transaction otherwise voidable for breach of directors' duty. It would be useful to clarify in the Act the ability for shareholders to authorise in advance a transaction that would otherwise be voidable for breach of fiduciary duty.

Adoption of Unauthorised Transactions

Adoption (also commonly called ratification in the case law) is the form of approval required as a matter of agency law to ensure that a transaction is authorised when the corporate agents who entered into it would otherwise have been held to lack authority at law. Adoption can be by words or conduct. If adoption occurs, actual authority will have retrospective effect.¹¹⁴

The same principle of ratification/ adoption applies to unauthorised corporate transactions as long as the ratification itself conforms to general principles of agency law.¹¹⁵ This requires approval by a corporate organ (usually the board) or individual agent who has actual authority in relation to a transaction of the relevant kind.¹¹⁶ This approval must occur within a reasonable time.¹¹⁷

Most corporate transactions are within the authority of the board of directors. That would suggest that the adoption of an unauthorised transaction should be undertaken by the board. However, if a particular transaction required shareholder approval, then adoption also needs to be by shareholders. Examples of transactions requiring shareholder approval include major transactions¹¹⁸ and transactions where shareholder approval is required by the company's constitution¹¹⁹. The concept of shareholders adopting transactions that required their approval in the first place is expressly preserved in s 177(1) of the Act.

¹¹² *Massey v Wales*, above n 56, at 730.

¹¹³ *Pascoe Ltd v Lucas*, above n 27.

¹¹⁴ *Bolton v Lambert* (1889) 41 Ch D 295.

¹¹⁵ *Watts, Campbell and Hare*, above n 4, at [11.5.2], 313.

¹¹⁶ *Watts, Campbell and Hare*, above n 4, at [11.5.2], 313 and [19.1], 579-580.

¹¹⁷ *Smith v Henniker-Major* [2002] EWCA Civ 762, [2002] 2 BCLC 655; *Forge v Australian Securities and Investments Commission*, above n 35, at [386].

¹¹⁸ Section 129 Companies Act 1993.

¹¹⁹ *Irvine v Union Bank of Australia* (1877) 2 App Cas 366 (PC, Rangoon).

There is also case law suggesting that unauthorised actions of directors can be ratified by shareholders where the board composition is such that the board is not capable of providing authority for a particular transaction¹²⁰ or in situations where there is a deadlock on the board which cannot be resolved by shareholders appointing further directors¹²¹.

However, with those exceptions, shareholders cannot purport to ratify unauthorised actions which are part of the management responsibility of the board, or which have been entrusted to the board or particular persons by the company's constitution.¹²² The well-known decision of *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunningham* provides that shareholders are not entitled to usurp management decision-making powers which have been allocated to the board.¹²³ Consistent with the approach taken in that case, there is also authority for the proposition that the majority of shareholders does not have the power to ratify (adopt) management action taken without board authority. Such shareholder ratification would undermine the allocation of management power to the board. An example is *Massey v Wales*, where the Court held shareholders were unable to ratify a decision by a single director (on a board of two directors) to bring certain legal proceedings.¹²⁴

In *Massey v Wales*, the Court drew a distinction between a situation where directors did not have authority, and a situation where directors had authority but a transaction was voidable due to the exercise of power for an improper motive. Shareholders by ordinary resolution could approve (affirm) a transaction that might otherwise be said to be voidable for breach of fiduciary duty¹²⁵, but would not have the ability to ratify (adopt) unauthorised actions (such as matters of management on which a two-person board was deadlocked)¹²⁶.

However, if the reason for a corporate agent lacking authority was the fact that directors are acting in a way that cannot be said to amount to the management of the company's affairs, and therefore also a clear breach of the best interests duty, then it may not be appropriate for adoption of the transaction to be by the board.

¹²⁰ *Grant v United Kingdom Switchback* (1888) 40 Ch D 135 (CA), which involved ratification by shareholders of an interested transaction where 4 of 5 directors were interested and prevented from voting by the company's articles, and the required quorum of disinterested directors was 2 directors.

¹²¹ *Massey v Wales*, above n 56, at 730.

¹²² *Quin & Axtens Ltd v Salmon* [1909] AC 442 (HL).

¹²³ *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cunningham* [1906] 2 Ch 34 (CA).

¹²⁴ *Massey v Wales*, above n 56.

¹²⁵ At 730 per Hodgson JA; See also *Bamford v Bamford*, above n 6, at 242 per Russell LJ.

¹²⁶ At 730-738.

Consider the situation where a transaction is held to be unauthorised because the conduct of the directors is fraudulent or grossly improvident. Is a decision whether to ratify (adopt) such a transaction still left with the directors rather than shareholders? Smellie J's judgment in *Equiticorp* would say no, and that it should be up to shareholders to ratify the transaction.¹²⁷

Equiticorp concerned the purchase by Ararimu Investments Four Ltd ("AI4") of a share parcel in Equiticorp from the Crown. The purchase price was \$327 million in respect of a share parcel whose value was at most \$90 million. Smellie J held the transaction was unauthorised even though it was entered into by both directors of the company (i.e. the board).

Smellie J held that the transaction was unauthorised partly because it was illegal in breach of provisions of the Companies Act 1955. However, he also held that the transaction was unauthorised because it was a grossly improvident transaction as it involved the purchase of shares worth \$90 million for \$327 million, and AI4 made the purchase using borrowed funds which the company had no prospect of repaying and which rendered the company insolvent.

As to the suggestion in *Equiticorp* that "grossly improvident" contracts are unauthorised, I consider the better view is that they are not unauthorised (and therefore void) but only voidable for breach of fiduciary duty (see Chapter 6).

But let us assume Smellie J is correct, and the transaction is unauthorised because it is grossly improvident. Can the transaction be ratified (adopted), and if so, how? Smellie J considered that any ratification needed to be by shareholders rather than by the same directors who were guilty of procuring the improvident transaction:¹²⁸

It cannot be that directors can unilaterally excuse their own failure to perform. That would frustrate the policy behind the concept of the imposition of *fiduciary duties*. In order to maintain that policy I consider the shareholders in general meeting alone must be vested with the power to ratify the directors' *unauthorised* actions. It cannot reside in the directors themselves. (emphasis added)

In this passage, Smellie J conflates breach of fiduciary duty (which may make a transaction voidable) with lack of authority (which makes a transaction void).

¹²⁷ *Equiticorp Industries Group Ltd v The Crown (No 47)* [1998] 2 NZLR 481 (HC).

¹²⁸ At 729.

As discussed above, abundant case law supports the proposition that shareholders are the appropriate party to decide whether to affirm a transaction that is voidable for breach of fiduciary duty.

However, if the question is *adoption* of an unauthorised transaction, then the case law does not suggest that shareholders can normally ratify (adopt) a transaction just because the particular corporate agents have exceeded their authority. Unless the transaction is a major transaction that requires shareholder approval, or a transaction where the constitution requires shareholder approval, the transaction is a matter within the province of the board. The case law holds that shareholders may not usurp the role of the board by purporting to ratify an unauthorised management decision.¹²⁹

However, if the reason for lack of authority is the gross misconduct of directors, Smellie J's approach may make sense at least in a case where the whole board is culpable. The approach would be consistent with that taken for a company's affirmation of transactions that are voidable for breach of fiduciary duty.

There might be limited situations where it could be appropriate for the board to itself be able to ratify (adopt) a transaction that is unauthorised because it is grossly improvident. This might be the case if there was an entirely new board, or perhaps if the majority of the board had not been involved in the particular transaction. However, it would be an unusual circumstance where a "grossly improvident" transaction subsequently became one that a new board could properly approve.

In any event, if the honesty of all or the majority of the board is impugned, then I suggest any adoption of the transaction at law should be by shareholders (by analogy with the approach taken to affirmation of transactions voidable for breach of fiduciary duty).

Such an approach is also consistent with the approach taken by the courts in situations where the board cannot exercise management power due to deadlock on the board, usually combined with the lack of ability of shareholders to appoint or remove directors so as to break the

¹²⁹ *Quin & Axtens Ltd v Salmon*, above n 122; *Massey v Wales*, above n 56, at 730.

deadlock. The Courts have held that in such situations, the shareholders can exercise a reserve power to bind the company.¹³⁰

Assuming the shareholders must ratify (adopt) a transaction that is unauthorised because it is grossly improvident, would that be appropriate on facts like those in *Equiticorp*?

Smellie J noted why he considered the transaction unauthorised as follows:¹³¹

...the borrowing of the whole purchase price by AI4 to pay \$327 million-odd for shares known at the time to be worth significantly less than \$90m was so grossly improvident that the directors could not possibly have regarded themselves as authorised to so transact. *AI4 became instantly and irretrievably insolvent as a result.* (emphasis added)

If the company's insolvency was an issue that impacted on the transaction being unauthorised, should the shareholders be able to ratify the transaction? In *Sequana*, the Court suggested that shareholders should not be able to ratify a transaction in breach of directors' duty which caused the company to become insolvent.¹³²

On the facts of *Equiticorp*, it is also notable that the directors of AI4 would have had control of any shareholder resolution, making the requirement for shareholder approval pointless. The directors of AI4 were Mr Hawkins and Mr Darvell. But Hawkins and Darvell, as trustees in Ararimu Trust, had effective control over the shareholders in the company (which shareholders were two companies called Setar 72 and Shoeshine 59).¹³³ Accordingly, had it been required, Hawkins and Darvell could readily have arranged for unanimous assent of the shareholders of AI4. Further, arguably their informal agreement to the transaction was sufficient in itself to amount to unanimous shareholder approval.¹³⁴

Is unanimous shareholder approval good enough when the reason the transaction has been held unauthorised is due to the company's insolvency and prejudice to creditors?

¹³⁰ *Massey v Wales*, above n 56, at 730-738 per Hodgson JA (with the Court holding, however, that the shareholders did not have a reserve power to ratify the issue of court proceedings in that case because the shareholders could have resolved the deadlock on the board by appointing additional directors); *Foster v Foster* [1916] 1 Ch 532 at 551-552 (where Peterson J held that the shareholders were capable of exercising a power to appoint a Managing Director which normally would have fallen to the board under the articles in a circumstance where there were only two potential candidates for the position and the circumstances were such that the board could not effectively appoint either candidate).

¹³¹ *Equiticorp Industries Group Ltd (in stat man) v Attorney-General (No 47)*, above n 127, at 700-701.

¹³² *BTI 2014 LLC v Sequana SA*, above n 36, at [149] per Lord Briggs JSC.

¹³³ See company group structure chart in the judgment: *Equiticorp Industries Group Ltd (in stat man) v Attorney-General (No 47)*, above n 127, at 530.

¹³⁴ *Sharma v Sharma*, above n 89.

In my view, the better approach would simply have been to describe the transaction not as unauthorised because it was grossly improvident, but just as voidable for breach of fiduciary duty. The transaction was in breach of fiduciary duty because the directors failed to take into account the interests of creditors in relation to a transaction that caused the company to become insolvent.

Applying the approach taken in *Kinsela* and *Sequana*, ratification (affirmation) by shareholders would not have been effective in the context of the fact pattern in *Equiticorp*. Where a company would be made insolvent by a transaction then the directors are in breach of fiduciary duty where they enter into a transaction without considering the interests of creditors. Further, the shareholders do not have the right to ratify that breach of duty, or affirm a transaction that is voidable due to such breach.

An improvident transaction entered into by directors would only be regarded as unauthorised and void in an extreme case where the directors' action could be said to fall outside the "business and affairs" of the company (such as purchase of assets for the personal benefit of a director). In such a case, the board could not adopt the transaction as approval of a transaction unrelated to the company's business would remain outside the board's power under s 128. Adoption of the transaction by shareholders might be possible as long as the shareholder approval was unanimous (as such a transaction would seem unfairly prejudicial to minority shareholders if they did not consent), and the company was solvent.

Impact of Statutory Provisions on Ratification

In New Zealand, the complexity and uncertainty of the common law rules of ratification are exacerbated by the passing of the Act, and by particular provisions in the Act.

First, there is the impact of ss 162 and 177(4), two provisions which arguably conflict with each other on the extent to which the common law rules of ratification survive the passing of the Act. Secondly, there is the question whether the common law principles of ratification apply to the statutory reformulation of directors' duties (including s 131). Thirdly, there is the potential impact of s 18(1)(a) on the ability of a company to avoid a voidable transaction. Fourthly, there is the potential impact of s 141 on the ability of shareholders to affirm a transaction where the transaction is one where directors are interested.

Impact of Section 162 on Shareholder Ratification

As discussed in Chapter 2, the Law Commission originally recommended the abolition of the ability of shareholders to ratify breaches of directors' duties.¹³⁵ However, the Law Commission's recommendation was not adopted. Following submissions to the Select Committee, s 177(4) was added to the Act providing:

Nothing in this section limits or affects any rule of law relating to the ratification or approval by the shareholders or any other person of any act or omission of a director or the board of a company.

Section 177(4) was intended to preserve the general law relating to shareholder ratification of breaches of directors' duties.¹³⁶ Certainly, that was the assumption taken by the High Court in *Macfarlane v Barlow* and the Court of Appeal in *Provida Foods v Foodfirst*.¹³⁷

What the Select Committee overlooked when inserting s 177(4) was s 162, which contains a restriction on companies indemnifying directors for liability as a director. Importantly, s 162(9) provides: “‘indemnify’ includes relieve or excuse from liability, whether before or after the liability arises.”

The prohibition on indemnification in s 162 has some exceptions as provided for in subsections 162(3) and (4), where indemnification is expressly authorised by the company's constitution. However, s 162(4) makes it clear that the scope of permitted indemnification does not extend to indemnification of a director's liability to the company itself (such as liability for breach of s 131). Further, s 162(4) specifically excludes from the permitted scope of any indemnity, indemnity for “liability in respect of a breach, in the case of a director, of the duty specified in section 131 of this Act”.

On a strict reading of s 162, the section prevents shareholder ratification of a breach of the best interests duty, at least to the extent that such ratification would have the effect of excusing a director from personal liability for such breach.

¹³⁵ Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [86], [564] and [569].

¹³⁶ Watts, Campbell and Hare, above n 4, at [19.2], 580-581; Peter Watts “Directors’ Duties and Shareholders’ Rights”, NZLS Seminar, August- September 1996 at 71.

¹³⁷ *Macfarlane v Barlow*, above n 5, at 261,476; *Provida Foods Ltd v Foodfirst Ltd*, above n 32, at [53(e)] and n 33.

However, the better argument is that s 177(4) indicates that common law ratification principles still apply generally, and are not overridden by s 162. As Taylor notes, s 177(4) would otherwise be “largely redundant”.¹³⁸

In Australia, the courts have treated rules relating to shareholder ratification as an exception to statutory rules restricting the indemnification of directors.¹³⁹ A similar approach may well be taken in New Zealand. Overall, it seems likely that s 177(4) has preserved the common law rules of ratification of breaches of directors’ duties.

Further, as Watts suggests, even if s 162 did prevent the company from relieving a director of liability, it is likely that common law principles of ratification would still be effective to ensure the validity of transactions otherwise impugned by a breach of director’s duty.¹⁴⁰ Ensuring such validity does not by itself amount to relieving or excusing a director from liability so as to bring into operation the prohibition on indemnification in s 162.

Accordingly, a company’s ability to *affirm* voidable transactions by shareholder resolution should not be affected by s 162. Equally, a company’s ability to *adopt* a transaction that is considered unauthorised due to the dishonesty of a director should also not be affected by s 162.

Potentially problematic is the question of authorisation in advance by shareholders of a transaction that would otherwise be voidable for breach of fiduciary duty. On the analytical approach of the majority in *Winthrop*, a ratifying resolution made in advance of a transaction is only effective to the extent that it absolves directors of the breach of directors’ duty.¹⁴¹

However, as discussed above, I prefer the approach of Glass JA in *Winthrop*, who considered that the shareholders did have a reserve power to authorise in advance a transaction that would otherwise amount to a breach of fiduciary duty.¹⁴² The affirmation or authorisation of the underlying transaction can appropriately be considered separately from any release of the director from personal liability.

¹³⁸ Lynne Taylor “Controlling Shareholders” in Watson and Taylor, above n 21, at [25.3], 698. See also Watts, Campbell and Hare, above n 4, at [19.2], 581.

¹³⁹ *Eastland Technology Australia Pty Ltd v Whisson* (2005) 223 ALR 123 (WASCA) at [26]; Watson and Taylor, above n 21, at 698-699; *Miller v Miller*, above n 9, at 86-88.

¹⁴⁰ Watts, Campbell and Hare, above n 4, at [19.2], 582 where Watts says, “it seems likely that s 162 would not preclude a ratification from being effective to prevent a voidable contract from remaining voidable”.

¹⁴¹ *Winthrop Investments Ltd v Winns Ltd*, above n 6, at 684.

¹⁴² At 674.

Nevertheless, it is undoubtedly the case that the potential conflict between ss 162 and 177(4) should be addressed, and the ability for shareholders to ratify transactions entered into in breach of directors' duties confirmed beyond doubt. Fortunately, the Government has recently announced it intends to amend the Act to ensure that the ability for shareholders to ratify breaches of directors' duties is not affected by s 162.¹⁴³

However, even on the basis that s 177(4) preserves common law rules of ratification, it does so without settling those rules out. The lack of guidance in the Act as to the rules for ratification is not satisfactory, particularly when commentators have suggested such rules are "riddled with inconsistencies and uncertainties".¹⁴⁴

Ratification of Breach of Statutory Duties

Another question is whether the common law principles of ratification of breaches of common law duties also apply to permit ratification of a breach of a statutory duty such as s 131. In my view, the answer to this should be yes given that the duty in s 131 is simply the statutory formulation of a common law duty that was subject to the common law ability to ratify.¹⁴⁵

I agree with Holborow that it is:¹⁴⁶

...difficult, in the face of the express preservation of common law principles of ratification in s177(4), to maintain the view that Parliament could be taken to have removed any possibility of ratification by virtue of a statutory statement of directors' duties.

Taylor argues that shareholders should not be able to ratify a breach of a director's duty that gives rise to a criminal offence, including for example a breach of s 131 that gives rise to an offence under s 138A.¹⁴⁷ There is Australian authority that ratification of a breach of statutory duty is not possible where the breach gives rise to a criminal offence¹⁴⁸ or civil pecuniary

¹⁴³ Ministry of Business, Innovation & Employment Modernising the Companies Act 1993 and Making Other Improvements for Business, 31 July 2024, Appendix 1, proposal 17: "Clarify that the definition of 'indemnify' (s 162) does not invalidate shareholder ratification of director actions under s 177."

¹⁴⁴ Pearlie Koh "Director' Fiduciary Duties: Unthreading the Joints of Shareholder Ratification" (2005) 5 JCLS 363.

¹⁴⁵ Watson and Taylor, above n 21, at 25.3, 696; and see *Pascoe Ltd (in liq) v Lucas*, above n 27, at 772.

¹⁴⁶ Holborow, above n 3, at 389.

¹⁴⁷ Watson and Taylor, above n 21, at 25.3, 696-697.

¹⁴⁸ *Angas Law Services Pty Ltd (in liq) v Carabelas* (2005) 215 ALR 110 (HCA) at [32]; *Macleod v R* (2003) 214 CLR 230 (HCA) at 240, 250 and 255.

penalty¹⁴⁹ on the basis that criminal proceedings or civil penalty proceedings involve public rights.

It is undoubtedly correct that shareholders cannot excuse directors from an offence provision such as s 138A. However, the fact that actions of the directors in breach of s 131 might also breach s 138A does not mean that the shareholders cannot potentially relieve the directors from liability for compensation for breach of s 131.¹⁵⁰ Further, the fact that the director may also have breached s 138A should not prevent the company from being able to affirm or authorise any transaction that was otherwise voidable due to breach of s 131.

There is no reason in principle why a company should lose the ability to affirm or authorise a voidable contract, or lose the ability to adopt a contract entered into without authority, just because the director's actions which make the transaction voidable or void also happen to have caused the director to commit an offence. As a matter of public policy, the law may want to prevent the company from absolving the director of personal liability in a case where the director has committed an offence. However, there is no good reason to prevent the company from taking advantage of the transaction should it wish to do so (assuming that the transaction is not itself illegal).

Impact of Section 18(1)(a)

Section 18(1)(a) of the Act limits the ability of a company to allege a breach of the Act as against a third party with whom the company is contracting. Section 18(1)(a) would seem to have relevance to breaches of the best interests duty now that that duty is enshrined in s 131 of the Act.¹⁵¹

Section 18(1)(a) provides as follows:

A company ... may not assert against a person dealing with the company or with a person who has acquired property, rights, or interests from the company that –

¹⁴⁹ *Forge v Australian Securities and Investments Commission*, above n 35, at [381]-[384]. *Forge* was a case in which ASIC sought pecuniary penalties from certain directors. The Court held that shareholder ratification resolutions were ineffective to ratify contraventions of a civil penalty provision. See also to similar effect *Cassimatis v Australian Securities and Investments Commission* [2020] FCAFC 52, (2020) 376 ALR 261 at [185]-[197]; *Australian Securities and Investments Commission v Australian Investors Forum Pty Ltd (No 2)* [2005] NSWSC 267, (2005) 53 ACSR 305 at [26]-[35].

¹⁵⁰ In *Eastland Technology v Whisson*, above n 139, at [27]-[37], the Western Australian Court of Appeal held that the fact a company could not ratify a breach of duty giving rise to a penalty provision did not mean that the company could not give up a right to seek compensation under another provision.

¹⁵¹ Ross Grantham "Contracting with Companies: Rule of Law or Business Rules?" (1996) 17 NZULR 39 at 59.

(a) This Act or the constitution of the company has not been complied with

Section 18(1)(a) is subject to the same knowledge proviso to s 18 discussed in Chapter 7.

Section 18(1)(a) should prevent a company from seeking to resile from a transaction on the basis that it was entered into in breach of s 131 and would otherwise have been voidable in equity (unless the third party is aware of the breach of duty in which case the proviso to s 18(1) would apply).¹⁵²

However, s 18(1)(a) does not seem to add anything to the limitations on avoidance of voidable transactions that apply in equity.¹⁵³ Section 18(1)(a) prevents a company from being able to assert a breach of the Act (including a breach of s 131) unless (under the proviso) the third party has actual knowledge of the breach or has constructive knowledge in the case of a third party with an ongoing relationship with the company¹⁵⁴. However, as discussed in Chapter 4, a company is unlikely to be entitled to avoid a transaction at equity in any event unless the third party has actual knowledge of the breach of duty or was wilfully blind to such a breach. Millett J suggested that that was the position in *Logicrose*.¹⁵⁵ The majority of the English Court of Appeal approved of this approach in *UBS AG v Kommunale Wasserwerke Leipzig GMBH* stating that “the *Logicrose* requirement for knowledge operates as a salutary restraint against rendering contracts unduly vulnerable by the intervention of equity”.¹⁵⁶

If the approach taken by Millett J in *Logicrose* is followed in New Zealand, then s 18(1)(a) adds no further protection to contracting third parties.

Impact of Section 141

In New Zealand, s 141 of the Act provides that all corporate transactions in which a director is interested are voidable unless the company obtains fair value. If the company has not received fair value, it may avoid the transaction within three months after the disclosure of the transaction to shareholders. There is no express statutory requirement that shareholders be told of the director’s interest, but one is implied.¹⁵⁷

¹⁵² Holborow, above n 3, at 390. See also Grantham, above n 151, at 59-60.

¹⁵³ Holborow, above n 3, at 390.

¹⁵⁴ *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809 at [33] and [73]-[74]. See Chapter 7.

¹⁵⁵ *Logicrose Ltd v Southend United Football Club Ltd (No. 2)* [1988] 1 WLR 1256 (Ch) at 1261.

¹⁵⁶ *UBS AG v Kommunale Wasserwerke Leipzig GMBH*, above n 96, at [120] per Lord Briggs and Hamblen LJ.

¹⁵⁷ *Homestead Bay Trustees Ltd v Fiordland Experience Group Ltd* [2023] NZHC 3248 at [87]-[94]; see also Holborow, above n 3, at 391.

The normal test for affirmation of a voidable transaction is changed in the case of interested transactions. Under s 107(3) and (4) an interested transaction that was not at fair value is only not voidable under s 141 if an unanimous written resolution of shareholders has approved it.

Section 141(6) provides that a transaction cannot be avoided on the grounds of a director's interest other than under s 141. Section 141(6) removes the rule of equity that allowed the courts to avoid interested transactions (even where fair value was given) unless the shareholders had given consent for the transaction.

However, s 141 does not prevent a transaction from being impugned on other grounds, such as breach of the best interests duty. It is often the case that an alleged breach of the best interests duty occurs in relation to a transaction in which a director is interested.¹⁵⁸ Section 131 still applies in a situation where the provisions in ss 140-144 relating to interested directors are also relevant.¹⁵⁹

Section 142 limits the ability to avoid an interested transaction under s 141 where there has been a subsequent transfer of property to another person. That restriction on the ability to avoid a transaction under s 141 is more limited than the restrictions on rescission at equity. In particular, under s 141, a party taking directly from the company (even if unaware of the director's interest) will not be able to prevent avoidance of the transaction in a case where the company has not received fair value. At equity, however, a party taking directly from the company would not be subject to avoidance if that party did not know of the relevant vitiating factor (e.g. such as a breach of the best interests duty).

Given that there is a specific statutory regime for voidability of interested transactions under s 141, it would be helpful for the Act also to set out the circumstances under which a transaction is voidable for breach of the directors' fiduciary duty to act in the company's best interests.

Shareholder Oppression

One further potential limitation on shareholder ratification arises from the court's discretion under s 174 in a case of shareholder oppression to set aside action taken by the company or the board in breach of the Act.¹⁶⁰ That would include setting aside a transaction entered into in

¹⁵⁸ For example, *Westpac Banking Corporation v The Bell Group* (No 3), above n 31.

¹⁵⁹ *Hedley v Albany Power Centre Ltd (in liq) (No 2)* (2006) 2 NZCCLR 1148 (HC) at [16]; See also *Rusher v Owen*, Auckland Registry, Potter J, 9 June 1999 at 9.

¹⁶⁰ Section 174(2)(h).

breach of s 131. Holborow has suggested that the court's power to set aside transactions would override any ratification by shareholders.¹⁶¹ In some cases, shareholder ratification can in itself amount to oppression.¹⁶² There does not appear to be any need to reform s 174.

There are, however, some aspects of the law of shareholder ratification that do require reform. In Chapter 9, I discuss potential reform of New Zealand law in so far as it relates to the impact of a breach of the best interests duty on the validity of corporate transactions. That will include potential reform in relation to the impact of agency law and equity on corporate transactions, and reform in respect of the rules of shareholder ratification. I also discuss in Chapter 9 the policy considerations that might guide the appropriate form of any potential legislative change.

¹⁶¹ Holborow, above n 3, at 393.

¹⁶² *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539 (SCWA Full Court) at 559-560 and 563.

Chapter 9- Policy Considerations and Reform

When a director of a company has caused the company to enter into a transaction with a third party in breach of the best interests duty, two competing interests arise: the interests of the company and the interests of the contracting third party. The company, which is entitled to be loyally represented by the director, has essentially been defrauded by the director entering into the transaction. On the other hand, the contracting third party may have entered into the transaction in good faith and relied on the transaction being enforceable. The question is, which of the two parties should bear the loss?

The law of equity and the law of agency both attempt to balance the competing interests of companies and contracting third parties mentioned above. As discussed in Chapters 3 and 4, equity does so by protecting the rights of contracting third parties who are unaware of the relevant breach of duty leading to a transaction and who have given value to the company. As discussed in Chapter 7, agency law attempts to balance the interests of companies and contracting third parties through the law of apparent authority. In some circumstances, the law of apparent authority will allow a contracting third party to enforce a contract that would otherwise have been void for lack of authority.

The Companies Act 1993 provides a statutory overlay to case law principles of equity and agency law and so impacts the balancing of interests of companies and contracting third parties. Section 18(1) restricts the ability of companies to assert invalidity of transactions due to breaches of the Act (including breaches of directors' duties) and/ or a lack of authority.

For the reasons set out below, the relevant policy considerations that the law should consider (and balance) in assessing the validity of corporate transactions entered into in breach of the best interests duty include:

- (a) the security of commercial transactions (which would typically favour third parties contracting with the company) and
- (b) promoting integrity in commercial dealings (which would favour the company defrauded by the mismotivated director, unless the contracting third party was unaware of the relevant breach of duty and/ or defect in authority).¹

¹ Robert Austin and Ian Ramsay *Ford, Austin and Ramsay's Principles of Corporations Law*, (17th ed., LexisNexis, 2018) at [13.015].

Security of Transactions

Commercial certainty and security of commercial transactions are important in encouraging trade. Uncertainty in the law is likely to increase risk and operate as a disincentive to engage in market transactions.² If third parties are uncertain as to the likely validity of transactions that they enter into with companies, then the relative lack of security and trust in such transactions will impact on the speed and cost of market transactions.³ Lord Browne-Wilkinson has commented that certainty and speed “are essential requirements for the orderly conduct of business affairs”.⁴

A desire to enhance the security of commercial transactions has led legislatures in several jurisdictions to enact provisions like s 18(1). Kirby P in *Bank of New Zealand v Fiberna Pty Ltd* suggested that the legislative intention behind the Australian equivalent to s 18(1) was to allocate the risk of loss from fraud and unauthorised conduct in the ordinary case upon the company itself. That was a policy of “business convenience” which recognised:⁵

the fact that the innumerable business transactions with corporations, so fundamental to our economy and form of society, cannot ordinarily require the proof of formalities concerning compliance by the company with its own internal rules and requirements.

It is commercial certainty that has driven the objective approach in our law to contract formation and interpretation discussed in Chapter 6.⁶ Commercial certainty would tend to militate against inquiring into the mis motivation of company directors leading to corporate transactions unless that mis motivation was objectively apparent.

Similar policy considerations of commercial certainty drove the Court in *Hambro* to decide that an inquiry into the subjective motivations of an agent was not admissible in considering the validity of transactions entered into by an agent:⁷

It would be impossible, ...for the business of a mercantile community to be carried on, if a person dealing with an agent was bound to go behind the authority of the agent in each case,

² Iain McNeil “Uncertainty in Commercial Law” (2009) 13 *Edinburgh Law Review* 68 at 72.

³ Stephen M R Covey *The Speed of Trust* (Simon & Schuster, London, 2006) at 13-17.

⁴ *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669 (HL) at 704.

⁵ *Bank of New Zealand v Fiberna Pty Ltd* (1994) 14 ACSR 736 (NSWCA) at 741-742.

⁶ *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5, [2010] 2 NZLR 444 at [21].

⁷ *Hambro v Burnand* [1904] 2 KB 10 (CA) at 20 per Collins MR. See also Mathew LJ at 25-26, and *Lloyd v Grace, Smith & Co* [1912] AC 716 (HL) at 740 per Lord Shaw.

and inquire whether his motives did or did not involve the application of the authority for his own private purposes.

Integrity in Commercial Dealings

However, a second very important policy consideration involves enhancing integrity in commercial dealings and discouraging fraud. Where a director deliberately acts in a way that is contrary to the interests of the company that can be seen as a form of dishonesty.

It is in the public interest to discourage dishonest conduct. That public interest is already demonstrated by the prohibitions on fraud and deceptive conduct in our criminal⁸ and civil⁹ law. Dishonest conduct can cause serious loss to innocent persons. Further, when prevalent in the marketplace, it can discourage general commercial dealing and harm the economy.

The policy consideration of discouraging fraud requires considering which party is in the best position to protect against and discourage fraud. That might be dependent on factors such as the contracting third party's relationship with the particular agent, and the extent of knowledge that the third party has about whether the agent was acting improperly.

Nolan notes that in the context of a breach of duty by a director, it is the director's mental state that is key. It is very difficult for the third party to discover that mental state. Accordingly, Nolan suggests that the third party should not be affected by a director's breach of duty unless the third party knew about it or had good reason to suspect it. Failing such knowledge, Nolan suggests:¹⁰

the risk of the agent's behaviour should fall on the principal: he entrusted his affairs to the agent in the first place and is much better placed than the counterparty to control the agent.

That also appears to have been the view of Lord Macnaghten in *Lloyd v Grace, Smith & Co*, where his Lordship suggested that it was the firm who employed the fraudulent agent in

⁸ Crimes Act 1961, ss 228 and 240-242 (offences involving dishonest use of documents and crimes involving deceit).

⁹ Fair Trading Act 1986, ss 9-14, 14A and 16 (prohibitions on misleading and deceptive conduct and false representations).

¹⁰ RC Nolan "Controlling Fiduciary Power" (2009) 68 CLJ 293 at 319.

question that should suffer from the agent's fraud, and that a firm could insure the honesty of the person employed.¹¹

By contrast, Watts has suggested a third party may often be in a better position than the company to detect dishonesty in a corporate agent as it is the third party that has had the personal interactions with the agent.¹²

The ability of a third party to recognise a likely breach of duty by a corporate agent will no doubt depend on the facts, including whether or not the third party has some association with the agent, or has had previous dealings with the agent.

Balancing of Policy Considerations

The appropriateness of the current law for determining the validity of transactions entered into by directors in breach of the best interests duty can usefully be tested against whether that law best maximises:

- (a) the certainty and security of commercial transactions and
- (b) integrity and honesty in commercial dealings.

A finding that a transaction is either valid or invalid in a particular fact situation may promote both of these objectives simultaneously. However, that will not necessarily be the case. If the two policy objectives conflict, there will be a balancing exercise. I suggest that the balancing exercise will largely depend on the relative innocence of the contracting third party and, in particular, whether the contracting third party knew about the agent's breach of duty.

Knowledge of Contracting Third Party

If a third party is completely unaware of an agent's fraud, making the transaction unenforceable will neither enhance the certainty of commercial dealings nor integrity in such dealings. However, considerations of commercial certainty should not permit a third party to enforce a contract against a company when a third party knows that the corporate agent is acting outside

¹¹ *Lloyd v Grace, Smith & Co*, above n 7 at 738. See also Earl of Halsbury at 736-737 relying on the judgment of Holt CJ in *Hern v Nichols* (1700) 1 Salk 289 that it was better "that he that employs and puts a trust and confidence in the deceiver should be a loser than a stranger".

¹² Peter Watts "Actual Authority: The Requirement for an Agent Honestly to Believe that an Exercise of Power is in the Principal's Interests" [2017] JBL 269 at 274.

their authority and/ or is acting dishonestly (with action that is deliberately contrary to the company's interests being equivalent to dishonesty).

There is no fetter on commerce caused by requiring a third party to stay their hand in a situation where they have actual knowledge of an agent's dishonesty and/ or lack of authority. A third party cannot reasonably say that they have relied on the security of a transaction if they are aware of dishonesty or a lack of authority. Nor would the integrity of commercial dealings be enhanced if a third party was able to enforce a transaction when the party had actual knowledge that a company's agent was acting dishonestly.

The position is less clear, however, when the third party did not have actual knowledge of the agent's breach of duty but it can be said that the third party *should have known* about that breach.

Some judges have suggested that policy considerations favour a third party not being able to enforce a contract where they are aware that the transaction is unrelated to the company's business and does not appear to have any benefit to the company. In such a situation, the third party may be argued to be put on inquiry as to a corporate agent's lack of authority, and to have a form of constructive knowledge of that lack of authority.

In *Northside Developments Pty Ltd v Registrar-General*, Mason CJ endorsed an approach under which a third party could not enforce a transaction where a transaction appeared unrelated to the purpose of the company's business and from which the company appeared to gain no benefit.¹³ Mason CJ considered that such an approach drew a fair balance between competing interests. He suggested it encouraged prudence for lending institutions (the third party in *Northside* being a bank), and "enhanced the integrity of commercial transactions and commercial morality".¹⁴ Brennan J took a similar approach, suggesting that a third party should not be able to enforce a contract where a transaction was other than for the company's business. He suggested that otherwise, the common law would provide "a charter for dealings between fraudulent officers of companies and supine financiers".¹⁵

However, Griffiths has criticised that view:¹⁶

¹³ *Northside Developments Pty Ltd v Registrar-General* (1990) 170 CLR 146 (HCA).

¹⁴ At 164-165. Kirby P, in dissent, cited this passage with approval in *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50 (NSWCA) at 93.

¹⁵ At 189.

¹⁶ Andrew Griffiths *Contracting with Companies* (Hart Publishing, Oxford, 2005) at 207. See also at 12 and 216.

Such an approach would, in effect, subject third parties to a general duty to ‘look out’ for the interests of the companies with which they deal, and ensure that they are being properly managed where there is evidence to suggest that they might not be. Further, third parties would have to give this duty priority over the pursuit of their own commercial interests.

It is not conducive to commercial certainty if a contract could be set aside just because it was not in the company’s best interests, and the contracting third party could be said to have been “put on inquiry” that a company director has breached their duty. If that were the law, third parties would be concerned that companies with whom they enter into contracts might be able to resile from contracts if they subsequently change their minds.

That potential for companies to go back on their word would not be conducive to commercial certainty and the security of transactions. The concern that companies might be able to resile from their bargains might cause third parties “to be unduly wary of attractive bargains”.¹⁷ A third party who sees that it is entering into a bargain that seems favourable to the third party and less favourable to the company would need to be careful. If the third party negotiates forcefully in a commercial negotiation and obtains a favourable deal (as it should be entitled to), this might be at risk of being held invalid because it appears the transaction is not in the company’s best interests.

It is not desirable in policy terms to require third parties to pause just because a transaction appears not to be in the interests of a counterpart company’s interests. As Griffiths notes, that imposes a constraint on a third party’s ability to pursue and maximise its own best interests in negotiating contracts.¹⁸ It also forces the third party to make judgments about the commercial interests of another company that they are in a poor position to make.

An assessment by a third party of whether an agent is acting contrary to the principal’s interests is particularly difficult in the case of a corporate principal. With a corporate principal, the question of whether the agent is acting in the principal’s interests is more nuanced than it is with a human principal. As discussed in Chapter 2, the interests of the company have traditionally been associated with the interests of the shareholders as a whole. But what if a transaction seems to be more in the interest of some shareholders than others? Furthermore, as

¹⁷ Sarah Worthington “Corporate Attribution and Agency: Back to Basics” (2017) 133 LQR 118 at 137.

¹⁸ Griffiths, above n 16, at 69. See also 216 and 237.

discussed in Chapter 4, the company's interests might be looked at differently (and potentially include the interests of creditors) if the company is in a difficult financial position.

The Court of Appeal in *Autumn Tree* noted how the introduction of s 18C of the Companies Act 1955 (now s 18(1) of the Companies Act 1993) was driven by a view that the interests of commerce required that independent third parties not lose the ability to rely on contracts just because of mere constructive knowledge about a potential defect in a transaction.¹⁹ That policy choice still appears sound. It should not be enough to invalidate a contract that a third party is simply put on inquiry as to a director's breach of fiduciary duty by becoming aware that the contract may not be in the interests of the contracting company.

In *Cowan de Groot Properties Ltd v Eagle Trust plc*, Knox J said:²⁰

The duty of directors of a purchasing company is to buy as cheaply as they can in the light of the mode and terms of the proposed sale and it would in my judgment be a slippery slope upon which to embark to impose upon directors of a company a positive duty to make inquiries into the reasons for an offer being made to their company at what appears to be a bargain price. The line should in my judgment be drawn at the point where the figure in question, regard being had not only to the open market value but also to the terms and mode of sale, is indicative of dishonesty on the part of the directors of a vendor company.

Lord Neuberger in *Akai* (Hong Kong) formed a similar view to Knox J on this question of policy. Lord Neuberger suggested that in a commercial context, in the absence of dishonesty or irrationality, a person should be entitled to rely on what they are told as this “enables people engaged in business to know where they stand”.²¹ Knowledge by a third party of the dishonesty of a corporate agent (with deliberate action contrary to the interests of the company amounting to dishonesty) should then remove a third party's ability to enforce a transaction.

What form of knowledge is enough to remove the third party's ability to enforce a contract? Certainly, actual knowledge of a deliberate breach of duty would be. However, so should wilful blindness or “blind-eye” knowledge, which pertains to when a person is aware that something is wrong and deliberately decides not to look further to avoid knowing for sure.²² The concept

¹⁹ *Bishop Warden Property Holdings Ltd v Autumn Tree* [2018] NZCA 285, [2018] 3 NZLR 809 at [73].

²⁰ *Cowan de Groot Properties Ltd v Eagle Trust plc* [1992] 4 All ER 700 (Ch) at 761. For a similar view, see Griffiths, above n 16, at 208. See also 212.

²¹ *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)* [2010] HKCFA 64, (2010) 13 HKCFAR 479 at [52].

²² *Bishop Warden Property Holdings Ltd v Autumn Tree Ltd*, above n 19, at [72].

of wilful blindness is well illustrated by the classic example of Lord Nelson putting his eye-patch over his one good eye so that he would not be able to see the enemy's white flag of surrender.

In *Akai*, Lord Neuberger commented that wilful blindness itself essentially amounts to dishonesty.²³ In relation to the test for liability for dishonest assistance in a breach of trust or fiduciary duty, the New Zealand Supreme Court and Privy Council have held that wilful blindness amounts to dishonesty.²⁴ When a third party has knowledge that would meet the test of wilful blindness, an honest person would not proceed with a contract. If an honest person would not proceed with a contract in the circumstances, they should not be able to enforce it.

However, just being “put on inquiry” that an agent may not be achieving the best possible deal for the company should not be enough for a third party to lose the ability to enforce a contract. There is a difference between being put on inquiry and the degree of understanding required for wilful blindness.²⁵ An example of a case where the choice of test made a difference (at least in the Court of Appeal of Bermuda) was *East Asia v PT Satria*.²⁶

Case Example- Autumn Tree

The facts of *Autumn Tree* are a useful example to test the view expressed above concerning the level of third party knowledge sufficient for a third party to lose the ability to enforce a contract.

Here, one director of Autumn Tree (Tina) purported to sell the company's main asset, a residential property, at an undervalue. The property was sold to Bishop Warden for \$1.1 million. The Court of Appeal suggested this was “obviously undervalue”.²⁷

²³ *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)*, above n 21, at [53], [62] and [96] citing Lord Blackburn in *Jones v Gordon* (1876-7) 2 App Cas 616 at 628-629.

²⁴ *Westpac New Zealand v MAP & Associates Ltd* [2011] NZSC 89, [2011] 3 NZLR 751 at [27]; *Barlow Clowes International Ltd (in liq) v Eurotrust International Ltd* [2005] UKPC 37 (Isle of Man), [2006] 1 WLR 1476 at [10].

²⁵ If you consider the five categories of knowledge in *Baden v Societe Generale pour Favoriser le Developpement du Commerce et de l'industrie en France SA* [1992] 4 All ER 161, [1983] BCLC 325 at [250], wilful blindness is category (ii) and just being put on inquiry is category (v). I would disagree with Lord Neuberger's comment in *Thanakharn Kasikorn Thai Chamkat (Mahachon) v Akai Holdings Ltd (No 2)*, above n 21, at [50] that “the distinction between turning a blind eye and being put on enquiry seems fairly slender”.

²⁶ *East Asia Company Ltd v PT Satria Tirtatama Energindo* [2019] UKPC 30 (PC, Bermuda) at [73] and [94]. The Privy Council held that the relevant test at common law was the putting on inquiry test, and did not address the Court of Appeal's finding that a more stringent test of wilful blindness was not met on the facts.

²⁷ *Bishop Warden Property Holdings Ltd v Autumn Tree Ltd*, above n 19, at [71].

A valuer had valued the property as \$2.855 million “as is”, and \$2.25 million per lot if the construction of dwellings on the two lots of the property had been completed. There was also evidence that Tina had seen this valuation.²⁸ If so, it seems clear that Tina was in breach of her duty to act in the company’s best interests.²⁹

However, could it be said that Bishop Warden, as the other contracting party, knew that Tina was in breach of her duty to Autumn Tree? There was no evidence that Bishop Warden had seen the valuation valuing the property at \$2.855 million (or more). Mr Blomfield for Bishop Warden said that he offered to buy the property for \$1.1 million, having ascertained that its rateable value was \$1.17 million. Further, there was no evidence that Bishop Warden had any prior association or relationship with Tina.

The case was decided on the basis that Tina did not have actual authority to enter into a major transaction on behalf of Autumn Tree (as this would have required a special resolution of shareholders under s 129 of the Act). Further, as a single director on a board of two directors, she did not have customary apparent authority to enter into a significant property transaction.

However, what would have been the position if the transaction had not technically been a major transaction under s 129, and if Tina had been the sole director of Autumn Tree so that she had the ordinary powers of management conferred on the board of a company? She would then have had actual authority. Alternatively, even if she did not have actual authority, what would be the position if Tina could be said to have had apparent authority on the basis that the company originally held out Tina as sole director through a notice filed to that effect at the Companies Office, and that it was that notice that Bishop Warden relied on in entering into the transaction?³⁰

If there was no actual authority, but there was held to be a holding out of authority for the purpose of apparent authority, should the lack of benefit to Autumn Tree lead to Bishop Warden not being able to rely on apparent authority? Alternatively, if Tina was held to have either actual or apparent authority, should the fact that Tina had deliberately acted contrary to the company’s interests make the transaction voidable in equity? Both questions depend on whether Bishop Warden could be said to have sufficient knowledge of Tina’s breach of duty.

²⁸ At [5]. However, Tina disputed this: see [14]. Evidence for the hearing was that the market value of the property at that time was \$3.35 million.

²⁹ As the Court of Appeal appears to have assumed at [18], n 3.

³⁰ John Land “Company Contracting in New Zealand after *Autumn Tree*” (2018) 24 NZBLQ 311 at 323.

If Bishop Warden did not have possession of the formal valuation of the property, it may not have realised that Tina was deliberately acting in a way that was contrary to Autumn Tree's interests.

The facts of relevance to an assessment of Bishop Warden's knowledge include the following:

- (a) There was no evidence Bishop Warden had seen the valuation of the property indicating a much higher value for the property than the purchase price of \$1.1 million;
- (b) Mr Blomfield said he offered to buy the property for \$1.1 million, having ascertained that the rateable value was \$1.17 million;³¹
- (c) There was no evidence that Bishop Warden knew of Tina's supposed "resignation" as a director. Mr Blomfield said he conducted a Companies Office search that showed Tina as sole director;³²
- (d) On the other hand, Bishop Warden did know that the settlement terms (very low deposit amount and deferred settlement for a year) were favourable to Bishop Warden.

Overall, it is not clear that there were sufficient signs to Bishop Warden that Tina was acting deliberately contrary to the interests of Autumn Tree. At most, Bishop Warden was "put on inquiry" as to whether Tina was acting in the best interests of Autumn Tree. It is difficult to assert that Bishop Warden had actual knowledge of a breach of fiduciary duty by Tina, or was wilfully blind to such a breach.

Bishop Warden's action in entering into the contract arguably should just be viewed as opportunistic conduct taking advantage of an apparently keen seller putting in an offer that could be described as "low-ball" but which did bear some relationship to an objective form of valuation of the property.³³

³¹ *Bishop Warden Property Holdings Ltd v Autumn Tree Ltd*, above n 19, at [9].

³² At [9].

³³ For a similar analysis in another case, see *Cowan de Groot Properties Ltd v Eagle Trust plc*, above n 20, at 752 and 760-761, where Knox J held that the directors of Eagle Trust plc were in breach of duty in offering to sell and selling at an undervalue, but that the sale price was not a figure so far below what a purchaser on the same terms could be expected to pay that the purchaser could be said to have knowledge of the breach of duty.

Bishop Warden should be entitled to make a low offer for the property in its own best interests, and then rely on Autumn Tree's acceptance of that offer, unless Bishop Warden possessed some conscious understanding that Tina was effectively defrauding Autumn Tree. Rejecting Bishop Warden's entitlement to pursue a good deal would detract from the security of commercial transactions. Further, upholding the deal would not undermine the policy consideration of promoting integrity in commercial transactions, unless Bishop Warden had sufficient knowledge of Tina's breach of duty.

The case is perhaps borderline, given that the purchase price was just under one-third of what turned out to be the market value of the property, and the contract also provided for settlement one year after the signing of the agreement. In a case where the transaction was at a transparently clear undervalue (say if Tina had agreed to sell the property for only \$200,000), Bishop Warden could properly be said to be wilfully blind to a breach of fiduciary duty by Tina. However, the position is less clear on the actual facts of the case where the contract price was close to the property's rateable value.

A contracting party should be entitled to negotiate vigorously in its own commercial interests and should not normally be required to look out for the interests of its contracting counterparty. Commercial certainty would suggest, therefore, that Bishop Warden should have been able to rely on the contract unless the purchase price was so low that Bishop Warden could be said to know that Tina was being dishonest. Then, and only then, would the policy of encouraging integrity in commercial transactions suggest that Bishop Warden should not have been entitled to enforce the deal.

Implications for Choice of Analytical Approach

Overall, it would seem that a court is best placed to appropriately balance the interests of a company and a contracting third party in a situation involving a breach of s 131 by a director of the company *if the transaction's validity is based on an analytical approach that takes into account the extent of knowledge by the third party of the director's breach of duty*. Such an approach is preferable to determining validity by reference to a legal rule that can result in the invalidity of a transaction regardless of the innocence of the third party.

If from a policy point of view, the enforceability of a transaction should depend on the level of knowledge of the contracting third party, then this has ramifications for the best analytical approach at law to deal with the transaction.

The remedies at equity (under which impugned transactions can only be rescinded where the contracting third party is not an innocent party) look more flexible than the rules of agency law (under which transactions that lack authority are void regardless of the third party's innocence).

A transaction that is merely voidable in equity cannot be avoided if an innocent third party has acquired rights under the transaction for value. Innocent third parties are, however, not protected if a transaction is void, and the company does not need to exercise a right of rescission to bring the transaction to an end. A finding that a transaction in breach of the best interests duty was automatically void would, therefore, be particularly harsh on a third party who is not well placed to assess whether the director is in fact breaching their fiduciary duty.

Accordingly, saying that an improvident contract is voidable in equity, rather than void as a matter of agency law, better balances the interests of the company and third parties because the third party only loses the ability to rely on the contract when they have notice of the breach of fiduciary duty.

Reform to Best Interests Duty and Remedies for Breach

What potential amendments are required to the Act to ensure New Zealand's statutory scheme is consistent with an approach under which a transaction entered into in breach of the best interests duty is considered voidable at equity, but not void for lack of authority in agency law?

First, it would be helpful to have clarity in the Act as to the remedial consequences of breach of fiduciary duties, including breach of the best interests duty. Many commercial actors may not realise that a breach of the best interests duty gives rise to the remedy of rescission of contracts. The Act (in s 141) only refers to that remedy in the context of transactions where directors are interested. The legislation could usefully confirm that the company has a remedy of rescission in cases of breach of fiduciary duty, set out who can exercise the remedy of rescission on behalf of the company, and explain when the right of rescission can be lost. By comparison, the Companies Act 2006 (UK) does include provisions that set out circumstances where a right of rescission is lost (including where restitution is not possible, an innocent third party has acquired rights, or the transaction has been affirmed by shareholder resolution).³⁴

Secondly, the Act should clarify that the right of rescission would be lost if the contracting third party is innocent, and set out the applicable knowledge test to determine when a third party is

³⁴ Sections 195(2), 196, 213(2), and 214 Companies Act 2006 (UK). See also s 41(4).

considered innocent. In the case law, some authority suggests that a third party needs to have actual knowledge of the breach of fiduciary duty, or be wilfully blind to such breach, for the company to preserve its right to rescind. However, there is also other authority suggesting that it is enough that the third party be “put on inquiry” as to the fact that there was a breach of duty.³⁵

Given the policy choice suggested above, the Act could usefully adopt the requirement that a contracting third party who gives value should be regarded as innocent unless they have actual knowledge of the breach of fiduciary duty or are wilfully blind to such breach. However, as discussed in Chapter 4, this position should not be undermined by imposing “knowing receipt” liability on contracting third parties in circumstances where the third party has a lesser state of knowledge of the breach of duty (for example, where the third party was merely put on inquiry as to a potential breach).

Third, it would be useful to clarify that the best interests duty is owed for the benefit of shareholders as a whole (similar to s 172 of the Companies Act 2006 (UK)). That would ensure that director actions in the context of a takeover, or distributions to shareholders, are considered lawful when the actions are in the interests of shareholders as a class, provided that the company is solvent. However, it would then be prudent to confirm (as in s 172(3) of the United Kingdom legislation) that s 131 is subject to any requirement to consider creditor interests in the case of insolvent companies.

A draft new s 169A of Act which would clarify the equitable remedies applicable for breach of directors’ fiduciary duties is set out in the attached Schedule.

Further, given that a breach of the best interests duty gives rise to the remedy of rescission, and other special equitable remedies, the courts should not be too ready to find a breach of s 131. In particular (as discussed in Chapter 4):

- (a) negligence should not be treated as a breach of the best interests duty;
- (b) a failure to consider creditor interests should not be regarded as a breach of the best interests duty unless the director had actual knowledge that the company was insolvent or bordering on insolvency, or was likely to go into insolvent liquidation, or that a transaction would put the company into one of those states;

³⁵ See Chapter 4.

- (c) a situation of “doubtful solvency” should not be regarded as sufficient to lead to a requirement for directors to consider creditor interests as part of the best interests duty;
- (d) in the case of an insolvent company, the courts should not second-guess a good faith attempt by directors to balance the interests of shareholders and creditors.

Reform to Agency Law in Corporate Context

The next question is whether any reform is required to how agency law applies to companies. Just because a transaction is improvident and in breach of the best interests duty should not of itself remove actual authority for the transaction and make the transaction void.³⁶ Actual authority should not be removed where the transaction appears on an objective basis to bear a relationship to the company’s business, and to in fact be approved by the company’s board (or by a corporate agent with appropriate delegated authority from the board).

An approach that removed authority in the case of improvident transactions would too readily permit companies to withdraw from transactions and would undermine the security of commercial transactions.

A statutory amendment could usefully clarify the point. Section 17(3) of the Act, in its current form, prevents an argument that conduct not in the best interests of the company is beyond the *capacity* of the company. However, the section does not expressly deal with the question of *authority* of the board as a matter of agency law. Parliament could usefully amend the Act to clarify that breaches of directors’ duty do not of themselves remove the authority of the board, or of any director.

As a broader matter of agency law, there is uncertainty in the case law as to whether actions by an agent contrary to the interests of a principal remove actual authority (see Chapter 6 and, in particular, the *Philipp* case). If there is a general principle of agency law to that effect, it could apply to directors or officers of a company. Section 18(1)(a) allows a contracting third party to assume there is no breach of the best interests duty in s 131 (subject to the knowledge proviso in s 18(1)). However, it is doubtful that this allows the contracting third party to overcome any common law principle that there is no actual authority when the director (as agent) acts contrary to the interests of the company (as principal). The legislative amendment referred to above could also make it clear that actions by directors or other corporate agents contrary to the

³⁶ See Chapter 5.

interests of the company do not, of themselves, remove authority of the board or any corporate agent.

There is also a lack of clarity in the case law as to whether a contracting third party can rely on the apparent authority of a director or other corporate agent in a situation where there is a lack of benefit to the company from the transaction. In such a case, the third party might be argued to have constructive knowledge of a defect in actual authority (see Chapter 7 and, in particular, the *Autumn Tree* case).

In accordance with the policy choice discussed above, s 18(1) of the Act should be amended to clarify that it is reasonable for a third party to rely on a holding out of authority for the purposes of apparent authority unless the third party has actual knowledge (including wilful blindness) of the defect in actual authority. That test should apply to all contracting third parties, regardless of whether they have previously dealt with the company. That would align the knowledge test in s 18(1) with the test that already applies to cases of fraud under s 18(2). It would also align the knowledge test necessary to ruin apparent authority with the knowledge test suggested above as being sufficient to permit companies to rescind transactions in equity for breach of fiduciary duty.

Reform to Law of Ratification/ Affirmation

The policy considerations discussed above are also relevant to the circumstances in which a company should be able to adopt, affirm or authorise a transaction impugned due to breach of directors' duty. If the very corporate agent in breach of duty is able to control whether the company approves the transaction, then that undermines integrity in commercial dealings. However, if a transaction is approved by shareholders in circumstances where the agent in breach does not control or influence that approval, then it is likely to enhance security and certainty in commercial dealings to allow a contracting third party to rely on that approval.

New Zealand could usefully enact a legislative clarification of the rules relating to ratification of breaches of directors' duties. While s 177(4) was intended to preserve the common law relating to shareholder ratification, there is a potential inconsistency between s 177(4) and s 162(9) (which appears to prohibit ratification in the form of release of directors from

liability).³⁷ Further, while s 177(4) preserves common law rules of ratification, it does not set out those rules.

The common law rules relating to shareholder ratification of breaches of directors' duties are complex, uncertain and not well known. That is contrary to the original goal of the Law Commission in making company law more accessible.³⁸ Further, the lack of clarity in the law does not enhance the security of commercial transactions.

A legislative clarification should:

- (a) confirm that it is shareholders that have the power to ratify breaches of directors duties;
- (b) set out how shareholders exercise that power; and
- (c) set out the limitations on that power.

Given the view expressed in this thesis that a breach of the best interests duty will normally just make a transaction voidable in equity (rather than remove authority for the transaction as a matter of agency law), then the appropriate potential form of "ratification" of such a transaction is in fact *affirmation* of the voidable transaction (or *authorisation* if the transaction is yet to occur). Accordingly, any legislative clarification should address ratification in the form of affirmation or authorisation of voidable transactions.

The case law suggests that such affirmation will normally be exercised by resolution of *shareholders* (even though in other contexts, affirmation of voidable transactions will be a management decision to be carried out by the board of directors). It should not be up to the board to excuse the consequences (such as voidability of a contract) caused by the board's own misconduct (or the misconduct of some of its members).

In terms of a potential model for reform, United Kingdom law provides at least in part for codification of the principle that it is shareholders who should ratify (release) breaches of

³⁷ As discussed in Chapter 8, the Government has recently signalled an intention to remove this inconsistency: Ministry of Business, Innovation & Employment Modernising the Companies Act 1993 and Making Other Improvements for Business, 31 July 2024, Appendix 1, proposal 17.

³⁸ Law Commission *Company Law Reform and Restatement* (NZLC R9, 1989) at [122].

directors' duties on behalf of the company³⁹, and who should affirm voidable transactions on behalf of the company⁴⁰.

Under s 239 of the Companies Act 2006 (UK), ratification of a breach of directors' duty must be undertaken by shareholder resolution.⁴¹ Further, where the resolution is proposed at a meeting, it is passed only if the necessary majority is obtained disregarding votes in favour by the director (if a shareholder of the company) and by any shareholder connected with the director.⁴²

Section 239 relevantly provides:

(3) Where the resolution is proposed as a written resolution neither the director (if a member of the company) nor any member connected with him is an eligible member.

(4) Where the resolution is proposed at a meeting, it is passed only if the necessary majority is obtained disregarding votes in favour of the resolution by the director (if a member of the company) and any member connected with him.

The test for "connection" between a director and another shareholder of the company is set out in ss 252-254.

Adopting similar provisions in New Zealand would be useful so that it is clear that shareholder ratification of breaches of directors' duties is permitted. An approach similar to s 239 of the United Kingdom Act would also provide certainty as to effective voting requirements for a ratifying shareholder resolution. The votes of directors, or those associated with them, would be excluded from the assessment of whether a shareholder ratifying resolution has passed.

It should be noted that the restriction on voting by interested shareholders is intended to protect against prejudice to minority shareholders. Accordingly, the voting restriction should not apply if shareholders unanimously favour ratification. Ratification by a sole shareholder would not

³⁹ Section 239 Companies Act 2006 (UK). Section 262(2) provides that leave to bring a derivative action against a director must be refused if the relevant act or omission has been ratified (or if it was authorised in advance).

⁴⁰ See ss 195(2), 196, 213(2) and 214 Companies Act 2006 (UK) (and previously ss 322, 322A and 322B of the Companies Act 1985 (UK)). In relation to a transaction where there is a constitutional limitation on the power of directors to bind the company, and where parties to the transaction include a director of the company or its holding company or a person connected with such a director, then s 41 provides that such a transaction is voidable unless affirmed by the company but without indicating who may affirm the transaction on behalf of the company. Section 175 does suggest that a director does not infringe the duty to avoid a conflict of interest if the relevant matter is authorised by the board (as long as interested directors are not included in the quorum for the directors' meeting, and the board approval is passed without the vote of any interested director).

⁴¹ See s 239(2) Companies Act 2006 (UK).

⁴² See s 239(4) Companies Act 2006 (UK).

be prevented just because the shareholder is associated with the director in question.⁴³ Section 239(6) of the United Kingdom Act expressly notes that nothing in the section affects “the validity of a decision taken by unanimous consent of the members of the company...”.

In New Zealand, if unanimous shareholder assent is to be effective for ratification, this will need explicit legislative endorsement. In *Ririnui v Landcorp Farming Ltd*, O’Regan J suggested that the doctrine of informal unanimous shareholder assent did not survive the passing of the Companies Act 1993.⁴⁴

The proposed legislative reform should also clarify any other key limitations on the effectiveness of shareholder ratification. The United Kingdom model is not comprehensive in setting out the rules for ratification. Section 239(7) of the Companies Act 2006 (UK) provides that s 239 does not affect any other rule of law imposing additional requirements for valid ratification, or any rule of law as to acts that are incapable of being ratified.⁴⁵ The Courts have confirmed that s 239 does not replace common law restrictions on ratification such as fraud on the minority and insolvency.⁴⁶ However, there is a lack of clarity and consistency in how those common law restrictions apply.

Accordingly, it is preferable for any additional rules of law relating to ratification also to be clearly set out in the Act. I would not see it as necessary to preserve the common law “fraud on the minority” exception to shareholder ratification. The limitation on voting of interested shareholders should sufficiently protect minority shareholders. The additional rules of law that would still be applicable to shareholder ratification would include:

- (a) Clarifying that for shareholder ratification of a breach of duty to be effective, full and frank disclosure of the breach of duty must first have been provided to the shareholders;

⁴³ Contrast *Goldtrail Travel Ltd (in liq) v Aydin* [2014] EWHC (Ch), [2015] 1 BCLC 89 at [116]-[118]. Rose J did not, however, consider s 239(6) which preserves the principle of unanimous shareholder assent.

⁴⁴ *Ririnui v Landcorp Farming Ltd* [2016] NZSC 62, [2016] 1 NZLR 1056 at [167].

⁴⁵ Blair Leahy and Andrew Feld “Directors’ Liabilities: Exemption, Indemnification, and Ratification” at [20.50]-[20.69] in Simon Mortimore (ed) *Company Directors* (3rd ed, Oxford University Press, 2017).

⁴⁶ *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch), [2009] 1 BCLC 1 at [43] –[47] (finding that the voting requirements in s 239 did not replace common law restrictions such as where there was “wrongdoer control” of the shareholder meeting; *Goldtrail Travel Ltd (in liq) v Aydin*, above n 36, at [113]-[118] (finding that ratification under s 239 is not possible in the case of insolvency). This point was not discussed on appeal: [2016] EWCA Civ 371, [2016] 1 BCLC 635.

- (b) Clarifying that unanimous consent of shareholders is effective for ratification even if all shareholders meet a test of connection with the directors in breach of duty (and therefore would have been excluded from voting on a shareholder resolution);
- (c) Clarifying that shareholders cannot ratify breaches of directors' duties where the breach occurred when the company was insolvent, the company's insolvency was imminent, or where the breach involved a transaction that would cause the company to become insolvent.

Any statutory reform of the law relating to ratification should also clarify whether ratification can also apply in relation to *future* actions of directors, and clarify the extent to which any "ratification" also amounts to affirmation or authorisation of any transaction entered into in breach of duty.

Section 239 of the Companies Act 2006 (UK) is included in chapter 7 of that Act, which chapter has the heading "Directors' Liabilities". The section itself appears under the subheading "Ratification of acts giving rise to liability". Accordingly, it is not clear that s 239 is intended to deal specifically with affirmation of transactions that are voidable for breach of director's fiduciary duty.⁴⁷ Further, it is notable that there are other sections of the United Kingdom legislation which do deal with shareholder affirmation of certain voidable transactions.⁴⁸

However, an approach like that taken in s 239 could readily be applied to the effectiveness of shareholder resolutions to affirm transactions that are voidable for breach of directors' duty. That point should be made clear in any New Zealand provision based on s 239.

Any New Zealand provision dealing with ratification should deal specifically with contracts that would otherwise be voidable for breach of directors' fiduciary duty (including s 131). This could be done by clarifying that in the case of such a breach of directors' fiduciary duty;

- (a) A shareholders' "ratification" of the breach of duty will automatically extend to affirmation of the underlying transaction (or to authorisation of a proposed transaction) unless the resolution provides to the contrary;

⁴⁷ Leahy and Feld, above n 45, at [20.34].

⁴⁸ Sections 195(2), 196, 213(2) and 214 Companies Act 2006 (UK).

- (b) Shareholders can alternatively elect to affirm the transaction (or authorise a proposed transaction), without otherwise absolving or releasing the directors from liability for breach of duty, if a resolution is passed by the majority of eligible shareholders. The same voting rules would apply to such a resolution i.e. the votes of shareholders connected with the director would be disregarded.

The United Kingdom legislation is also not ideal in relation to the concept of prior *authorisation* of conduct that would amount to a breach of duty. The Companies Act 2006 (UK) recognises the concept of prior authorisation in two places.

First, s 180(4)(a) provides that the general duties of directors (as set out in ss 171-177 of the Act, and including the duty in s 172 to promote the success of the company):

have effect subject to any rule of law enabling the company to give authority, specifically or generally, for anything to be done (or omitted) by the directors, or any of them, that would otherwise be a breach of duty.

Secondly, the concept of prior authorisation preventing a director from being sued by the company is recognized by s 263(2)(c)(i), which provides that leave to bring a derivative action for a claim against a director must be refused if the company authorised the relevant act or omission before it occurred.

In relation to prior authorisation of directors' actions, s 180(4)(a) is unclear. It simply preserves any existing "rule of law" relating to authority for future action that would otherwise be a breach of directors' duty. Section 180 does not attempt to align the rules relating to prior authorisation with the more specific rules in s 239 for ratification (release) of breaches of directors' duties that have already occurred. For example, only s 239 includes specific rules regarding who can vote on a resolution.

As the authors of *Gower* note, it is undesirable for the laws relating to ratification (release) and authorisation to be different as it may then matter whether the shareholders give their approval the day before or the day after the directors breach their duty.⁴⁹ This seems undesirable,

⁴⁹ Paul L Davies Sarah Worthington and Christopher Hare *Gower Principles of Modern Company Law* (11th ed, Thomson Reuters, London, 2021) at 10-112, p 358.

particularly since controlling directors will often be able to choose the timing of the necessary shareholder resolution.⁵⁰

Accordingly, any proposed reform should clarify that the rules for prior authorisation of a future breach of duty are the same as the rules for ratification (release) of a breach of duty that has already occurred (and affirmation of voidable transactions). (The only exception to that being, as discussed in Chapter 8, ratification in the form of release of directors from liability should also require the provision of consideration to the company to be effective.)

A draft new s 169B of Act which would clarify the rules for ratification of breaches of directors duties (including affirmation or authorisation of voidable transactions) is set out in the attached Schedule.

I have suggested that a breach of the best interests duty normally does not remove authority for a transaction at law (but only makes a transaction voidable in equity for breach of fiduciary duty). However, actual authority may be removed if the relevant conduct cannot be said to fall within the company's "business and affairs" (thus taking the conduct outside of the scope of permitted authority of even the board of directors under s 128). In such a circumstance, I suggest that ratification (adoption) of the unauthorised transaction should only be by shareholders (rather than the board), and to protect minority shareholders, such shareholder approval should be unanimous. Further, such ratification/ adoption should not be permitted at all if the company is insolvent.

However, it would take an extreme case where a contract could be said to fall outside the "business and affairs" of the company. Contrary to the view of Smellie J in *Equiticorp*,⁵¹ a situation in which a contract is grossly improvident should not be considered to automatically fall outside the business and affairs of the company and remove authority for the transaction, but just to make the transaction voidable for breach of fiduciary duty (unless the third party is innocent).

⁵⁰ At 10-115, p 360. See also Leahy and Feld, above n 45, at [20.38] in relation to the possible use of prior authorisation to avoid s 239.

⁵¹ *Equiticorp Industries Group Ltd v The Crown (No 47)* [1998] 2 NZLR 481 (HC) at 700-701.

Chapter 10 – Conclusion

New Zealand law relating to the impact on corporate transactions of a breach of the directors' duty to act in the best interests of the company is complex, and largely inaccessible to the business community. This makes it difficult for parties to commercial transactions to know where they stand.

Significant uncertainties arise from how agency law and the law of equity have been applied to corporate transactions.

The better view is that the fact that a contract is not in the best interests of a company should not (of itself) mean that a director or other corporate agent does not have actual authority to enter into the contract. However, there is conflicting case law on the point, and the recent United Kingdom Supreme Court decision in *Philipp* adds to the risk that contracts contrary to the interests of a company may be viewed by some courts as falling outside the authority of directors and other corporate agents.

In the corporate context, the security of commercial transactions would usefully be enhanced by clarifying that actions that appear to relate to the management of a company should not be considered to lack actual authority just because a director or other corporate agent has a subjective motivation to act contrary to the company's interests.

Such subjective mis motivation by a company director will, however, amount to a breach of fiduciary duty. That fact makes the law of equity relevant, and in particular the equitable remedy of rescission of contracts.

However, the application of the law of equity to corporate transactions is not well understood. The fact that a breach of the best interests duty makes a transaction voidable (unless the contracting third party is innocent) could usefully be spelled out in the Act. The Act should also set out the circumstances in which a company loses the right of rescission, including, but not limited to, when the contracting third party is innocent. In particular, the company should only be able to exercise a right of rescission where the contracting third party actually knew about, or was wilfully blind to, the breach of fiduciary duty.

Care should be taken in applying s 131 of the Act, which sets out the duty to act in the best interests of the company. The courts should not expand the scope of s 131 to include matters more appropriate for the directors' duty of care. Conduct can only properly be called a breach

of fiduciary duty that should give rise to a remedy of rescission where the conduct involves true disloyalty. Rescission of a transaction is not an appropriate remedy in the case of directors' actions that constitute negligence or gross negligence.

The principles relating to affirmation of transactions voidable for breach of a director's fiduciary duty are also important to the question of whether company contracts are enforceable. However, such principles are not well understood.

In particular, the principles relating to the affirmation of transactions voidable for breach of directors' fiduciary duty, are commonly confused and conflated with the principles for shareholder ratification in the form of release of directors from liability for breaches of directors' duties. It would be useful for the law relating to affirmation of transactions that are voidable for breach of fiduciary duty to be clarified and made more accessible by being set out in the Act.

Any such statutory clarification should make clear that it is the shareholders of the company, rather than the board, that should have the right, on behalf of the company, to affirm or avoid a transaction that is voidable due to a director's breach of fiduciary duty.

The statute should also clarify the circumstances in which affirmation can take place, including specifying that shareholders associated with the directors in breach should not be able to vote on a shareholder resolution to affirm a voidable transaction. The statute should also provide that shareholders do not have the right to affirm a transaction voidable for breach of directors' fiduciary duty when the nature of the breach involved a failure by directors to consider creditor interests at a time when the company was insolvent or would become so due to the particular transaction.

If the above amendments to the Act are made, that will assist in advancing the original objective of the Law Commission in making company law more accessible. Further, by doing so, the legislation will appropriately balance policy objectives of encouraging the certainty and security of commercial transactions, and encouraging integrity and honesty in commercial dealings. In particular, by making the validity of transactions depend on whether a contracting third party has actual knowledge of a breach of fiduciary duty (or is wilfully blind to such a breach), the security of commercial transactions will be enhanced without creating a significant risk of facilitating or encouraging fraudulent transactions.

Schedule- Rescission and Ratification Law Reform

Potential new ss 169A and 169B as discussed in Chapter 9.

Section 169A Consequences of Breach of Directors Duties

(1) the duties of directors set out in—

- (a) section 131 (which relates to the duty of directors to act in good faith and in the best interests of the company); and
- (b) section 135 (which relates to reckless trading); and
- (c) section 136 (which relates to the duty not to agree to a company incurring certain obligations); and
- (d) section 137 (which relates to a director's duty of care); and
- (e) section 145 (which relates to the use of company information); and
- (f) section 145A (which relates to the obtaining by a director of profit arising from their position as a director, and the usurping of corporate opportunities of the company by the director)¹

are duties owed to the company for the benefit of the shareholders as a whole.

(2) The duty of directors set out in section 133 (which relates to the duty to exercise powers for a proper purpose) is a duty owed both to shareholders and to the company for the benefit of the shareholders as a whole.

(3) The duties of directors set out in sections 131, 133, 145 and 145A are fiduciary duties of directors which give rise to remedies at equity including, where appropriate:

- (a) Equitable compensation;
- (b) An account of profits;
- (c) A finding that assets or property transferred in breach of the duty are held on constructive trust for the company or (where section 133 applies) shareholder or shareholders;
- (d) The right for the company, or (where section 133 applies) shareholder or shareholders, to elect to avoid a transaction entered into by the company as a result of the breach of duty.

¹ Section 145A is a potential new section to set out the common law duty of directors not to profit from their position.

- (4) Where the company has a right of avoidance of a transaction entered into in breach of fiduciary duty to the company the right of avoidance shall, however be lost where:
- (a) The company has affirmed the transaction under section 169B; or
 - (b) Restitution of money or other assets which was the subject matter of the transaction is no longer possible; or
 - (c) The company has delayed in exercising its right to avoid the transaction for such a period that the company can be said to have impliedly affirmed the transaction, or in such circumstances that the Court should in its discretion refuse to permit avoidance of the transaction; or
 - (d) Where the other party to the transaction provided value to the company and such other party did not have actual notice of the facts that gave rise to the breach of fiduciary duty (with wilful blindness to such facts being sufficient to amount to actual notice of such facts); or
 - (e) Where the rights of innocent third parties would be adversely affected by avoidance of the transaction; or
 - (f) Where the Court holds that avoidance of the transaction should not be granted on the grounds that such remedy is wholly disproportionate in the circumstances.

Contrast Section 169(3) Companies Act 1993 (NZ), sections 41, 195 and 213 Companies Act 2006 (UK)

Section 169B Ratification of acts of directors

- (1) This section applies to the ratification by a company of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company.
- (2) The decision of the company to ratify such conduct must be made by resolution of the shareholders of the company.
- (3) Where the resolution is proposed as a written resolution neither the director (if a shareholder of the company) nor any shareholder connected with the director is an eligible shareholder.

(4) Where the resolution is proposed at a meeting, it is passed only if the necessary majority is obtained disregarding votes in favour of the resolution by the director (if a shareholder of the company) and any shareholder connected with the director. This does not prevent the director or any such shareholder from attending, being counted towards the quorum and taking part in the proceedings at any meeting at which the decision is considered.

(5) For the purposes of this section—

(a) “conduct” includes acts and omissions and proposed acts and omissions;

(b) “director” includes a former director;

(c) a person who amounts to a director under section 126(2) or (3) is treated as a director; and

(d) a shareholder shall be considered connected with a director in the circumstances set out in ss []-[].²

(6) Notwithstanding subsections (3) and (4), but subject to subsections (7) and (8), conduct may be ratified by the unanimous written consent of the shareholders of the company.

(7) Prior to ratification by the shareholders under subsections (3), (4) or (6), full and frank disclosure of the relevant conduct must first have been provided to the shareholders.

(8) Nothing in this section permits the shareholders to ratify any conduct that occurred or will occur at a time when:

(a) the company was insolvent, or its insolvency was imminent; or

(b) the conduct resulted or will result in a transaction or proposed transaction, the likely result of which is to cause the company to become insolvent.

(9) A shareholder ratification of conduct under subsections (3) or (4), or unanimous shareholder ratification of conduct under subsection (6), will automatically extend to affirmation of a transaction entered into as a result of the conduct (or authorisation of a

² The definition of connected with a director will require provisions similar to ss 252- 256 of the Companies Act 2006 (UK).

transaction to be entered into as a result of the conduct) unless the resolution or written unanimous consent provides to the contrary. The shareholders may in the alternative elect to:

(a) release directors from liability for conduct without affirming a transaction or authorising a proposed transaction resulting from such conduct; or

(b) affirm a transaction entered into as a consequence of conduct, or authorise a proposed transaction resulting from such conduct, without releasing the directors from liability for such conduct.

(10) Any shareholder ratification under this section shall not be considered to amount to an indemnity for the purpose of s 162.

Contrast ss 41, 195 and 213 Companies Act 2006 (UK) (in respect of avoidance of transactions), s 180(4)(a) Companies Act 2006 (UK) (in respect of authorisation of future transactions) and s 239 Companies Act 2006 (UK) (in respect of ratification).

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