

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
Parliament House
Canberra ACT 2600
Australia

30 September 2005

Dear Sir/Madam,

Inquiry into Corporate Responsibility

Please find attached a copy of a paper we have written, entitled “Corporate Donations, the Best Interest of the Company and the Proper Purpose Doctrine”. This paper was published in the September 2005 issue of the *University of NSW Law Journal*.¹

Using donations to tsunami relief efforts as a case study, the paper discusses the law relating to corporate donations. In particular, it addresses the question of whether directors will be in breach of their duties as directors if they make donations without regard for a potential benefit to their business.

The paper addresses some of the questions in the Committee’s terms of reference, as summarized below.

c) The extent to which the current legal framework governing directors’ duties encourages or discourages them from having regard for the interests of stakeholders other than shareholders, and the broader community.

The law says that directors’ decisions must be made in the interests of the business. Does this mean that directors cannot have regard to the interests of anyone other than shareholders?

Giving money to a worthy cause is an example of having regard for stakeholders other than shareholders. Two kinds of donations can be distinguished: those made out of “enlightened self-interest”, and those made out of altruism.

Donations which are made out of “enlightened self-interest”

This type of donation is made for the mutual benefit of the business and the recipient – there are gains for both parties. A donation made by BHP to tsunami relief efforts is an example, and is discussed on page 92 of the paper. There

¹ Elizabeth Klein and Jean J Du Plessis, ‘Corporate Donations, the Best Interest of the Company and the Proper Purpose Doctrine’ (2005) 28(1) *UNSW Law Journal* 69.

were clearly potential benefits for BHP, as well as the people in Aceh and India to whom the donations were directed. The paper explains that directors will not be in breach of their directors' duties if they make this kind of donation, provided they reasonably believe that the donation would (or at least could) have a benefit for the business.

Donations made out of altruism

This kind of donation is made without regard for any gain for the business. Directors who make altruistic donations will be in breach of their duty to act in the interests of the company. The donations described in the example given on page 70 of the paper are arguably in this category. Directors who simply don't consider the interests of the company when giving company money away will also be breaching this duty.

Although truly altruistic donations are technically illegal, directors have wide discretion in forming their view as to whether a donation could benefit the business. This means that there is a lot of scope for making corporate donations without breaching directors' duties.

Summary

As far as corporate donations are concerned, the law does not explicitly encourage directors to have regard to the interests of stakeholders other than shareholders. Directors who are interested in doing so may be encouraged by the broad discretion available to them in their decision-making. Conversely, directors who are determined to focus exclusively on short-term profit may choose to use the "benefit to business" requirement as justification for their approach.

- d) Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or directors to have regard for the interests of stakeholders other than shareholders, and the broader community. In considering this matter, the Committee will also have regard to obligations that exist in laws other than the Corporations Act.**

This question is addressed on pages 93-95 of the paper. It is argued that the requirement that directors act in the interests of the company should not be relaxed. However, at the same time it could be helpful to recognize that legally, it is legitimate for directors to take account of non-shareholders' interests in their pursuit of maximum value for shareholders over the long-term. Explicitly allowing, or even *requiring* directors to take non-shareholders' interests into account may raise awareness of the importance of non-shareholders' interests not only to the broader community, but to the long-term success of the company. Failure to do so involves a multitude of risks to the business, as set out in the submission to this Inquiry by the BT Governance Advisory Service.

Companies that fail to do so are also potentially foregoing significant long-term benefits.

On the other hand it is by no means clear that changing the law would increase the extent to which directors take non-shareholders' interests into account. It could simply result in greater regulation without any significant change in behaviour. If the objective is to increase awareness of the importance for long-term business success of taking into account non-shareholders' interests, it is suggested that non-regulatory alternatives should also be considered.

We would be happy to provide further input to the Inquiry in any form the Committee feels would be helpful.

Your sincerely,

ELIZABETH KLEIN

Professor JEAN J DU PLESSIS

CORPORATE DONATIONS, THE BEST INTEREST OF THE COMPANY AND THE PROPER PURPOSE DOCTRINE

ELIZABETH KLEIN* AND JEAN J DU PLESSIS**

Corporate philanthropy is illegitimate spending by powerful corporate elite of someone else's money; an attempt to bypass democratic allocation of taxes; philanthropy by individuals is laudable, but not by corporations.¹

Just as I wouldn't want you to implement your personal judgments by writing checks on my bank account for charities of your choice, I feel it inappropriate to write checks on your corporate 'bank account' for the charities of my choice.²

I INTRODUCTION

Objections to the use of corporate resources for anything other than promoting the interests of the company have a strong historical tradition. Milton Friedman, for example, famously declared in 1970 that 'the social responsibility of business is to increase its profits'.³ More recently, Sir Gerard Brennan commented that

the choice should remain with the individual investor when he or she obtains his or her share of the distributed profits. From the moral standpoint, there is no virtue in a director's resolution to dispose of corporate assets to a charitable object.⁴

* LLB (Hons) (Deakin University); B.Agr.Sc. (Hons) (University of Melbourne). We would like to thank the referees and the board review for their constructive criticism on the first draft of this article submitted for publication in the *University of New South Wales Law Journal*.

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1 P P McGuinness, 'Corporate Philanthropy, Government and Blackmail' (2003) 47(6) *Quadrant* 2.

2 Warren Buffett, 'Berkshire Hathaway Inc – Shareholder Designated Contributions' (1981), <<http://www.berkshirehathaway.com/1997ar/shcontri.html>> at 8 August 2004.

3 Milton Friedman, 'The Social Responsibility of Business is to Increase Its Profits', *The New York Times Magazine* (New York), 13 September 1970.

4 'Law, Values and Charity' (2002) 76 *Australian Law Journal* 492, 497. A similar view was expressed by the Australian Shareholders' Association in 2004. See Australian Shareholders' Association, 'Statement of Corporate Governance Principles' (2004), [6] <<http://www.asa.asn.au/PrinciplesCorpGov.asp>> at 28 March 2004:

What is the law on this issue? Some assume that it is legal for businesses to make charitable donations,⁵ at least up to a reasonable amount, whether or not the company will gain from this commercially. For example, the Chairman of the Telstra Foundation has said:

Philanthropy is not sponsorship. *Philanthropy is giving without the expectation of reward. We will give with integrity, judging all grant applications fairly. Decisions made for the Foundation will always drive towards meeting our mission – to make a positive and lasting difference to children and young people.*⁶

This understanding is echoed in the following comments by Telstra representative Mr Bill Scales who, lamenting public scepticism regarding corporate philanthropy, said: ‘We think that over time people will come to understand that this is not for commercial gain.’⁷ Others are aware that this approach may be problematic from a legal point of view. Mr David Gonski, a prominent businessman and advocate of philanthropy, has called for the law on corporate philanthropy to be clarified.⁸

One of the most famous statements on ex gratia payments was made as early as 1883 in the case of *Hutton v West Cork Railway Co.*⁹ In that case Bowen LJ made the point, in a now famous passage, that the Court should recognise that a certain amount of largesse is conducive to good business. This comment had a very important qualification: ‘[t]he law does not say that there are to be no cakes and ale, but that there are to be no cakes and ale except such as are required for the benefit of the company.’¹⁰

Social Policy. It is not the responsibility of business to indulge in uneconomic activities in response to urging from the government of the day. If government is convinced that a service is required, it has the structure to implement an appropriate policy, and it has the taxation system to fund it. Business should not be expected to do so on a ‘voluntary’ basis. Companies have no role as unelected and unpaid implementers of social policy.

This statement is no longer available on the ASA’s website. A position statement entitled ‘Shareholders Expect’ is expressed in more moderate language, and explicitly recognises that ‘[d]irectors are elected by shareholders to oversee the management of companies in the interest of the company itself and its stakeholders’. See <<http://www.asa.asn.au/PolicyStatements/ShareholdersExpectPolicy.pdf>> at 10 July 2005.

See also Adolf Berle, ‘The Impact of the Corporation on Classical Theory’ in Thomas Clarke (ed), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (2004) 45, 49–51.

5 For purposes of this article the terms ‘gratuitous (ex gratia) payments’, ‘corporate donations’, and ‘gifts’ are used synonymously.

6 Herb Elliott, *Message from the Chairman*, Telstra Foundation <<http://202.12.135.148/dir148/tfweb.nsf/webdocs/overview~ChairpersonMessage?opendocument>> at 22 May 2005 (emphasis added).

7 Peter Munro and Ben Wyld, ‘Business Beggars for Gratitude – Not Attitude’, *The Sydney Morning Herald* (Sydney), 18 March 2003, 3. We acknowledge that this approach is more likely to be valid in a company such as Telstra, which is part-owned by the government, than in a public company. However, it is submitted that this attitude would not be uncommon in companies which are wholly publicly owned.

8 David Gonski, ‘Restoring Faith: Leadership and the Bottom Line’ (Speech delivered at the Australian Institute of Company Directors, Sydney, 26 September 2003).

9 (1883) 23 Ch D 654.

10 *Ibid* 672.

The statement made by Bowen LJ remains an accurate summary of the law on corporate donations. In this paper, it is argued that if corporate donations are made other than for the benefit of the company, directors will be in breach of their directors' duties. However, it is also submitted that in practice almost any donation could be justified as being in the interests of the company, for example, because the donation improved the company's reputation. A distinction needs to be made between donations which are justifiable in this way and are therefore not in breach of directors' duties and donations which cannot be so justified. The latter may be referred to as altruistic donations. It is argued that it is illegal in Australia for a corporation to make an altruistic donation, unless the corporation's constitution specifically allows it.

The legal position, which requires companies to be self-interested, can be contrasted with the expectations expressed by two out of three citizens in a survey of 25 000 people in 1999, who said that they 'want companies to go beyond their historical role of making a profit, paying taxes employing people and obeying all laws; they want[ed] companies to contribute to broader societal goals as well'.¹¹ The difference between what the law requires and the expectations reflected in that survey puts directors in a difficult position: they are under pressure for their companies to make altruistic donations, yet such donations are proscribed by the law. This problem is particularly acute for directors of listed companies, who are required to account to shareholders for their actions.

An illustration of the importance of ensuring legal certainty in this area was the Indian Ocean tsunami of 26 December 2004 which, by some estimates, killed approximately 288 828 people.¹² There was a real expectation that large corporations would donate to the disaster funds¹³ and many Australian companies contributed generously,¹⁴ but were these donations made legally? Were they done for 'the benefit of the company'?

The Australian Shareholders Association (the 'ASA') recently discovered the strength of feeling in the community on this issue when it was forced to retract its statement that corporate donations to tsunami relief efforts should not be made

11 Environics International Ltd, *The Millennium Poll on Corporate Social Responsibility: Executive Briefing* (1999) 2, International Business Leaders Forum <[http://www.iblf.org/iblf/csrwebassist.nsf/550d4b46b29f68a6852568660081f938/852568eb00754e1085256a02003a4d9a/\\$FILE/MillPoll_ES.pdf](http://www.iblf.org/iblf/csrwebassist.nsf/550d4b46b29f68a6852568660081f938/852568eb00754e1085256a02003a4d9a/$FILE/MillPoll_ES.pdf)> at 30 June 2005.

12 'Tsunami Dead and Missing Rises to 288,828', *The Sydney Morning Herald* (Sydney), 18 February 2005, <<http://smh.com.au/news/asia-tsunami/tsunami-dead-and-missing-rises-to-288828/2005/02/17/1108609349540.html>> at 10 June 2005.

13 See, eg, John Howard, Prime Minister of Australia, who stated: 'I obviously would like to see as many big donations as possible from Australian companies – business conditions are good, many companies can afford to make significant donations and many are': Geoff Elliott, 'Call for Companies to Give', *The Australian* (Sydney), 3 January 2005, 9.

14 Eleven days after the tsunami struck, corporate donations were estimated to have reached A\$16 000 000: Geoff Elliott, 'Corporate Donations Hit \$16m', *The Australian* (Sydney), 7 January 2005, 7.

without prior shareholder approval. The ASA had not had a bigger response to comments on any other issue over the last five years.¹⁵

This article will show that while the law on this point may be complex, it can be explained by focussing on the interplay between several well-known doctrines and tests of corporations law including the doctrine of the supremacy of the company's constitution (previously called a company's charter, memorandum and articles of association); the doctrine that a power conferred upon a particular organ is an exclusive power of that organ; the allocation of powers; the proper purpose doctrine; and the 'best interest of the company' test (or 'benefit to business') test.¹⁶

The article commences with a discussion of various core principles of internal company law before proceeding to a detailed analysis of the proper purpose duty, and the duty to act in the best interests of the company. The well-known case of *Parke v Daily News Ltd*¹⁷ and related cases are discussed in order to extract the principles that a court would apply in deciding whether or not corporate donations are valid. With regard to gratuitous payments, the application of a two-limbed test, which incorporates the principles laid down in *Parke v Daily News Ltd*, is proposed. The overlap of the duty to act in the best interests of the company and the duty to act for proper purposes is also dealt with. It is argued that where the validity of corporate donations is at stake, the 'proper purpose' requirement is conflated into the concept of the 'best interests of the company'. These principles are then applied to corporate donations, explaining how the duty to act in the best interests of the company does not necessarily prevent companies from making large donations, or from having extensive philanthropic programs. Finally, the future of the law on corporate donations is discussed, as well as some practical issues for directors to consider when making corporate donations are identified.

II CORE PRINCIPLES AND DOCTRINES OF INTERNAL COMPANY LAW¹⁸

A The Doctrine Of The Supremacy Of A Company's 'Constitution'

Although we have a system of 'replaceable rules' in the *Corporations Act 2001* (Cth), making it unnecessary for a company to adopt a constitution, many companies that were in existence on 1 July 1998 when the law changed may still

15 Malcolm Maiden, 'Tsunami: The Backlash', *The Age* (Melbourne), 12 February 2005, 1.

16 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654; *Parke v Daily News Ltd* [1962] 2 All ER 929. See also Part IV below.

17 [1962] 2 All ER 929.

18 For the application of some of these doctrines and tests in a different context, see Jean J du Plessis, 'Directors' Duty to Use Their Powers for Proper or Permissible Purposes' (2004) 16 *South African Mercantile Law Journal* 308.

have memoranda of association and articles of association. There may also be good reasons why companies would consider the 'replaceable rules' inappropriate and choose to adopt a constitution.¹⁹ It is therefore still of considerable importance to realise the important legal consequences of provisions in a company's constitution.

The legal effect of the constitution and its binding nature formed the core issue in several older company law cases. It was held, almost without exception, that the provisions of the constitution would bind the company and the shareholders as if the constitution were signed personally by each member. These sentiments are also contained in the *Corporations Act 2001* (Cth), which clearly states that a company's constitution forms a contract between the company and its members, the members inter se and the company and its directors.²⁰ This is a unique contract as it may be altered by a special resolution of the shareholders²¹ but, as long as it is not altered, the provisions of the constitution are considered to be supreme. Because of these considerations, authors started to refer to the 'supremacy of the articles of association',²² that will nowadays apply equally to the company's 'constitution'. This principle has been recognised by courts in other jurisdictions. In South Africa, the Supreme Court of Appeal in *LSA (UK) Ltd v Impala Platinum Holdings (Ltd)*²³ explained as follows:

What it amounts to is that the founding members, and also a later body of members by special resolution, may order the internal affairs of their company in the way that suits them best, subject to such prohibitions as may exist in the Act or any other law, statutory or common. This dispensation is unsurprising when one statute governs many diverse forms of company.²⁴

A very specific consequence of this doctrine is that powers conferred upon a certain organ by the constitution are within the exclusive power of that organ, until altered by special resolution, and that such powers cannot be usurped by any of the company's other organs.²⁵

19 H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (12th ed, 2004) 184, 182.

20 *Corporations Act 2001* (Cth) s 140(1).

21 In Australia, there are even limitations to the company's power to change the constitution if such a change would give rise to a conflict of interests and advantages. See *Gambotto v WCP Ltd* (1995) 182 CLR 432. See especially immediately after the heading, 'The test for determining whether an expropriation is valid' (444).

22 S C Sen, *Company Actions in the Modern Set-Up* (1969) 19, 22. Given the transition in Australia from 'articles of association' to 'constitutions', it is now more appropriate to refer to the doctrine as 'the supremacy of the constitution'.

23 (222/1998) (28 March 2000) Supreme Court of Appeal of South Africa.

24 *Ibid.*

25 See *Scott v Scott* [1943] 1 All ER 582; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113, 134 (Lord Green); H S Cilliers et al, *Cilliers & Benade: Corporate Law* (3rd ed, 2000) 87 and cases quoted there. See also *The Duke Group Ltd (in liq) v Pilmer* (1998) 144 FLR 1. See generally L S Sealy, 'Bona Fides and Proper Purposes in Corporate Decisions' (1989) 15 *Monash University Law Review* 265, 272.

B The Doctrine Of Non-Interference With Internal Matters Of A Company

Closely linked with the doctrine of supremacy of the constitution is the principle that the courts are reluctant to interfere with the internal affairs of companies.²⁶ It has been held on several occasions that the courts will not second-guess the decisions properly taken by directors as part of powers conferred upon them by the constitution.²⁷ The court can, in actual fact, not interfere with internal decisions arrived at bona fide and honestly, as explained by Lord Wilberforce in *Howard Smith Ltd v Ampol Petroleum Ltd*²⁸ ('Howard Smith'):

Their Lordships accept that such a matter as the raising of finance is one of management, within the responsibility of the directors: they accept that it would be wrong for the court to substitute its opinion for that of management, or indeed to question the correctness of management's decision, on such a question, if bona fide arrived at. There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.²⁹

The reason a court will not interfere with duly exercised internal decisions of directors is summarised neatly by Kirby P in *Darvall v North Sydney Brick & Tiles Co Ltd*:³⁰

Courts properly refrain from assuming the management of corporations and substituting their decisions and assessments for those of directors. They do so, inter alia, because directors can be expected to have much greater knowledge and more time and expertise at their disposal to evaluate the best interests of the corporation than judges.³¹

26 *Lord v The Governor & Co of Copper Miners* (1848) 41 ER 1129, 1134; *MacDougall v Gardiner* (1875) 1 Ch D 13, 23 (James LJ); *Isle of Wight Railway Co v Tahourdin* (1883) 25 Ch D 320, 333 (Lindley LJ); *Bainbridge v Smith* (1889) 41 Ch D 462, 474 (Lindley LJ). This principle is firmly embedded in South African law: see *Adams v North* 1933 CPD 100, 108; *Cooper v Garratt* 1945 WLD 137, 148, 152; and cases cited in *Makhava v Lukoto Bus Service (Pty) Ltd* 1987 (3) SA 376, 393–5. See generally 'Recent Cases: *Ampol Petroleum v R W Miller (Holdings)*' (1974) 48 *Australian Law Journal* 319.

27 See especially *Hoole v Great Western Railroad Co* (1867) LR 3 Ch App 262, 268, 275 (Lord Cairns LJ); *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353, 368 (Farewell J); cases cited in *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199, 217 (Isaacs J); *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9, 23–4 (Scrutton LJ); *Re Smith & Fawcett Ltd* [1942] Ch 304, 306 (Lord Greene MR); *Hogg v Cramphorn Ltd* [1967] Ch 254, 268 (Buckley J); *Wayde v NSW Rugby League Ltd* (1985) 180 CLR 459, 469 (Brennan J). See also Sealy, above n 25, 277; Robert Baxt, 'Second Guessing Directors' Decisions on Takeovers – A Mixed Message from the New South Wales Court of Appeal' (1990) 8 *Company and Securities Law Journal* 26, 27.

28 [1974] AC 821, 832.

29 *Ibid.* See also *Wayde v NSW Rugby League Ltd* (1985) 180 CLR 459, 469–70 (Brennan J); *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, 493 (Barwick CJ, McTiernan and Kitto JJ).

30 (1989) 16 NSWLR 260.

31 *Ibid.* 281. See also *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, 493 (Barwick CJ, McTiernan and Kitto JJ): 'Directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.'

Thus, there are formidable obstacles in the way of shareholders who want to challenge the validity of actions taken by directors under powers conferred upon them by the constitution. First, the courts will consider the provisions in the constitution as the dominant document for determining who would have the power to fulfil a particular internal function under the principle of the supremacy of the constitution. Second, if the powers were prima facie exercised within the limits of the powers conferred upon the organs and were exercised bona fide and honestly, the courts will not, and in fact cannot, second-guess the wisdom of decisions relating to these powers.

C Allocation Of Powers

Directors usually have the power to exercise all of the company's powers,³² except those powers which are explicitly required to be exercised by shareholders, either by the constitution, or by the *Corporations Act 2001* (Cth).³³ Some of the powers that are not reserved for the general meeting may also be explicit, for example, where the constitution specifically allocates the power to issue shares to the board.

In most cases, the power to make donations would not reside with shareholders. Neither would there be an explicit power granted to directors to make such donations. This means that directors who make corporate donations are acting pursuant to the same power that they would use to make other management decisions: the general power of management, as set out by the constitution (if any). Section 198A of the *Corporations Act 2001* (Cth) could be replaced by a provision in a company's constitution, as it is a replaceable rule, but is a typical example of a statutory power conferring general managerial powers upon directors: 'The business of a company is to be managed by or under the direction of the directors'.

This means that, provided directors can justify corporate donations as being made in the interests of the company, they have the power to make them without having to obtain shareholder approval.³⁴

III THE PROPER PURPOSE DOCTRINE

A Overview

The 'purpose' behind directors' decisions can be relevant in several distinct ways. First, there is the question of whether the directors were acting in what they believed to be the best interests of the company. To assess directors' intentions, the court will often need to consider the objectives that the directors

³² See Ford et al, above n 19, 214.

³³ *Corporations Act 2001* (Cth) s 198A.

³⁴ See below Part VI(D).

were trying to achieve. Second, there is the question of whether the directors have abused a power by using it for a purpose other than that for which it was conferred.³⁵

B Types Of Actions Challenged Based On Improper Use Of Powers

The classic cases involving the duty to act for a proper purpose deal with the power of directors to issue shares.³⁶ Several other decisions by directors have also been challenged on this basis: for instance, where directors used company funds to defend their position and to justify why shareholders should not vote for a proposed takeover.³⁷ Other examples include cases where directors transferred a major asset of a company just after a takeover offer was announced, alleging that they did this as an exercise of their power to manage the business of the corporation;³⁸ directors incurring substantial debts (purchasing of trading outlets of competing companies) and making a huge rights issue to fund the purchase shortly after a takeover offer of the company was announced, alleging that it was a commercial transaction and a natural expansion of the business of the company;³⁹ and directors refusing to register a person as shareholder, relying on a provision in the constitution that they had the power to refuse registration as a shareholder without giving any reasons for such a decision.⁴⁰ In the last three cases the parties alleging misuse of powers were unsuccessful, as the courts were not prepared to set aside decisions taken by directors without clear substantiation that the directors exercised their powers for an improper purpose.

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- 35 In this article 'proper purpose' is taken as being synonymous with 'permissible purpose'. Conversely, 'improper purpose' and 'impermissible purpose' are used synonymously. See further du Plessis, above n 18 and Colin Baxter 'Ultra Vires and Agency Untwined' (1970) 28 *Cambridge Law Journal* 280 for a comprehensive analysis of the various ways in which powers can be exercised in a company law context, with particular reference to older cases decided in this area.
- 36 Cilliers et al, above n 25, 146. See also J T Pretorius et al, *Hahlo's South African Company Law through the Cases – A Source Book* (6th ed, 1999) 292; M S Blackman, 'Companies' in W A Joubert and J A Faris (eds), *The Law of South Africa – Volume 4, Part 2* (1996) 8; Robert Baxt, Keith Fletcher and Saul Fridman, *Corporations and Associations: Cases and Materials* (9th ed, 2003), 365; J R Birds 'Proper Purposes as a Head of Directors' Duties' (1974) 37 *Modern Law Review* 580, 581.
- 37 *Advance Bank Australia Ltd v FAI Insurance Ltd* (1987) 9 NSWLR 464, 482–3 (Kirby P). The Court concluded that in this case the directors' primary purpose was not to act in the best interest of the company and to inform the shareholders, but to secure the re-election of the chairman and the other retiring directors (482–3, 487, 496). The reference to *Peel v London and North Western Railway Co* [1907] 1 Ch 5 is interesting (482). In that case the directors were successful in defending their decision to use company funds to solicit proxies in support of their view on what was in the best interest of the company regarding a management decision.
- 38 *Darvall v North Sydney Brick & Tiles Co Ltd* (1989) 16 NSWLR 260, 336 (Clarke JA). See also *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22, 30 (Dillon LJ).
- 39 *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 1 ACLC 1294. See Tony Steel, 'Defensive Tactics in Corporate Takeovers' (1986) 4 *Company and Securities Law Journal* 30, 43–4.
- 40 *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199, 215–16, 220 (Isaacs J). See generally R C Nolan, 'The Proper Purpose Doctrine and Company Directors' in Barry Rider (ed), *The Realm of Company Law: A Collection of Papers in Honour of Professor Leonard Sealy – SJ Berwin Professor of Corporate Law at the University of Cambridge* (1998) 23 ff.

C When Will A Court Be Prepared To Intervene Based On A Power Exercised For An Improper Purpose?

It will be clear from the discussion above that there is scope for a company to challenge the validity of a decision taken by the directors under a power conferred upon them by the constitution, on the basis that the power was exercised for an improper purpose. The onus of showing that a power has not been properly exercised is on the party complaining.⁴¹ The reason the courts are prepared to set aside decisions taken by directors if they exercised their powers for an improper purpose is that powers conferred upon directors in the constitution are considered to be fiduciary in nature and if they are exercised for an improper purpose, it will constitute a breach of the directors' fiduciary duties.⁴² It is, however, important to consider how the courts have approached this issue and how they have reconciled the principle of non-interference with internal matters with the principle that they will set aside certain acts of the directors if directors acted for improper purposes. Another interesting question is to what extent the general meeting can ratify a breach of the directors' fiduciary duty where they have misused their powers.⁴³ This falls outside the scope of this article.

D Tests Developed By The Courts Where Powers Were Misused Or Abused

It is often the case that directors exercise their powers partly for a proper purpose and partly for an improper purpose.⁴⁴ Thus, it has been necessary for the courts to develop rules to enable them to determine whether the actions of directors should or should not be set aside. It is submitted that the approach of the Judicial Committee of the Privy Council (on appeal from the Supreme Court of New South Wales) in *Howard Smith* is a realistic one. The case is based on sound principle and relies on several leading English and Australian cases.

41 *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199, 219 (Isaacs J); *Ngurli Ltd v McCann* (1953) 90 CLR 425, 445 (Williams ACJ, Fullagar and Kitto JJ). See further cases quoted in Blackman, above n 36, 187. See also Ross Parsons, 'The Director's Duty of Good Faith' (1967) 5 *Melbourne University Law Review* 395, 425.

42 *Ngurli Ltd v McCann* (1953) 90 CLR 425, 439, 440 (Williams ACJ, Fullagar and Kitto JJ); *Hogg v Cramphorn Ltd* [1967] Ch 254, 268, 269 (Buckley J); *Howard Smith* [1974] AC 821, 834 (Lord Wilberforce); *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22, 29 (Dillon LJ); *Re a Company (no 00370 of 1987)*; *Ex parte Glossop* [1988] 1 WLR 1068, 1076–77 (Harman J); *Kirwan v Cresvale Far East Ltd (in liq)* (2002) 44 ACSR 21, 56 (Giles JA). See also Cilliers et al, above n 25, 146–7; Nolan, above n 40, 12–17.

43 See *Bamford v Bamford* [1970] Ch 212 and *Hogg v Cramphorn Ltd* [1967] Ch 254. These cases are considered by K W Wedderburn 'Going the Whole Hogg v Cramphorn?' (1968) 31 *Modern Law Review* 688 and 'Recent Cases: *Ampol Petroleum v R W Miller (Holdings)*', above n 26. See generally *Hannes v MJH Pty Ltd* (1992) 10 ACLC 400, 409–10 (Sheller JA). See also Michele Havenga, *Fiduciary Duties of Company Directors with Specific Regard to Corporate Opportunities* (LLD thesis, University of South Africa, 1995) 67–8.

44 See *McGuire v Ralph McKay Ltd* (1987) 5 ACLC 891, 894 (Murray, Gobbo and Southwell JJ).

In *Howard Smith*, it was pointed out that there are two steps involved when the exercise of a power by the directors is challenged on the basis that the power was exercised for an improper purpose. The first step is to determine for what purpose the particular power had been conferred upon the directors.⁴⁵ Once the purpose of the power has been determined by the court, the second step is to determine whether, in light of the particular facts of the case, the directors misused that power.⁴⁶

The application of the two-step approach adopted in *Howard Smith* could be summarised as follows: if the decision by directors was primarily or substantially taken within the purpose for which the power was conferred upon the directors, the court will not set such a decision aside, irrespective of the fact that, partially or incidentally,⁴⁷ the power might have been exercised for an improper purpose.⁴⁸ On the other hand, if the decision were primarily or substantially taken for an improper purpose, a court will set such a decision aside, irrespective of the fact that, partially or incidentally, the power might have been exercised for a proper purpose. Once the court has determined that primarily or substantially the power was misused, it will not help the directors to allege that they had not gained personally or that they acted honestly – the conduct of the directors under attack will then be set aside because of the breach of their strict fiduciary duty to exercise their powers for the purpose for which the power was conferred upon them. In this regard, there is no difference between cases where directors made a profit by reason and in virtue of their fiduciary office as directors and cases dealing with the misuse of powers.⁴⁹

E Improper Use Of A Particular Power: Fundamentally A Value Judgment Over An Internal Matter Is Required By The Court

We have already pointed out that the courts are normally reluctant to interfere with a company's internal matters. However, we have also pointed out that courts will sometimes enquire whether a particular power was exercised for a proper or permissible purpose. In order to make a determination of proper or improper exercise of powers by directors, the court will necessarily have to investigate 'the state of mind of those who acted and the motive on which they acted'.⁵⁰ This could be a daunting task as it 'involves an inquiry into motivations of an almost

45 *Howard Smith* [1974] AC 821.

46 See further du Plessis, above n 18, 319–20.

47 *McGuire v Ralph McKay Ltd* (1987) 5 ACLC 891, 895 (Murray, Gobbo and Southwell JJ). The Court referred to things incidentally following on the decision of the directors under attack (the issuing of shares) as 'a by-product of the issue (of shares)'.

48 See also *McGuire v Ralph McKay Ltd* (1987) 5 ACLC 891, 893–6 (Murray, Gobbo and Southwell JJ) for a comprehensive discussion of the various tests applied by the Australian and English courts in this regard and *Macanie (London) Ltd v Cook & Watts* (1967) CLY 482 (Goff J), as referred to in Havenga, above n 43, 67 fn 89.

49 See *Regal (Hastings) Ltd v Gulliver* [1942] 2 AC 134, 153 (Lord Macmillan).

50 *Hindle v John Cotton Ltd* (1919) 56 Sc LR 625, 630–1 (Isaacs J), as quoted with approval in *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199, 220 and *Howard Smith* [1974] AC 821, 835 (Lord Wilberforce).

infinite range of variety'.⁵¹ This is not surprising given the difficulties associated with determining the subjective purpose of the individual directors, let alone the added difficulty of determining their collective purpose.

The only cases where the courts are able to make decisions reasonably easily are in cases where directors' self-interests are blatant or where they clearly acted dishonestly. In other cases the directors have a wide variety of defences available to them.⁵² When the more involved defences are raised, the courts are indeed faced with complicated legal principles, obscured by several cases that are not always easy to reconcile with each other.⁵³ But, in essence, it is expected of the courts to make a value judgment or second-guess 'the state of mind of those who acted, and the motive on which they acted', as was established more than 80 years ago in *Hindle v John Cotton Ltd*.⁵⁴

The complex nature of such value judgments is the reason why the courts have been unsuccessful in developing exact rules. This is also the reason that the courts will continue to have difficulty in determining appropriate measures to form their value judgments.⁵⁵

F Defences By Directors To Justify Their Actions

In a case where the court must consider whether a particular power, such as the power to issue shares, has been exercised for its proper purpose, the court will not simply hear the directors say that in exercising the particular power they have acted 'in the best interest of the company'.⁵⁶ In these types of cases, the fact that directors have acted 'in the best interest of the company' has been held to serve no other purpose than restating the general law.⁵⁷ Another reason that the courts were not simply prepared to accept directors' defences that they have acted in the

51 *Pine Vale Investments Ltd v McDonnell & East Ltd* 1 ACLC 1294, 1303 (McPherson J).

52 See du Plessis, above n 18, 323–4 and discussion below, Part III(F).

53 Saul Fridman 'An Analysis of the Proper Purpose Rule' (1998) 10 *Bond Law Review* 164, 165–6, 179.

54 *Hindle v John Cotton Ltd* (1919) 56 Sc LR 625, 630–1. See generally Sealy above n 25, 276. At 278, Sealy explains the consequence of this approach succinctly: 'It may still be true, in principle, that "business decisions are for business men", and not a matter for review by the courts, but for judges of sufficiently robust disposition that principle is not the deterrent that it may once have been.' See also Fridman, above n 53, 166.

55 The substantial or primary purpose test is a more exact measure than the best interest of the company test. Thus, it is submitted that it is a slight overstatement to argue that 'the requirement that directors act for a proper purpose adds little to the more general rule that directors must act in the best interest of the company'. See Fridman, above n 53, 182.

56 As to the meaning of the phrase 'best interest of the company as a whole', see Pretorius et al, above n 36, 293, but as Parsons points out 'the concept remains miserably indeterminate': Parsons, above n 41, 396. It is submitted that it is still the case: see *Kirwan v Cresvale Far East Ltd (in liq)* (2002) 44 ACSR 21, 56 (Giles JA). We would respectfully agree with Young CJ's observation in *Kirwan v Cresvale Far East Ltd (in liq)* (2002) 44 ACSR 21 that '[i]t is of no real use to regurgitate the numerous utterances of past courts on this topic'. See also Fridman, above n 53, 90; *Re a Company (no 00370 of 1987; Ex parte Glossop* [1988] 1 WLR 1068, 1076; Sealy, above n 25, 269–71.

57 *Howard Smith* [1974] AC 821, 835 (Lord Wilberforce). In *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016, 1039 (read with 1038) Oliver J observed that under certain circumstance 'a test of benefit to the company' (also understood as 'the benefit of the shareholders as a whole') 'would be largely meaningless'.

best interest of the company is that in cases where a misuse of a particular power (for example, the power to register a transfer of shares) is alleged, the crucial issue is often not ‘the interest of the company’, but the interest of shareholders and what is fair between different classes of shareholders.⁵⁸ The courts have also invariably rejected the defence that directors acted in the best interest of the company where the self-interests of directors were involved.⁵⁹ Developments in this area of company law led to the recognition that there was a shift from a requirement that directors must exercise their powers bona fide to a requirement that they must exercise their powers for proper or permissible purposes.⁶⁰

However, it is suggested that there is still a place for the ‘bona fide in the best interest of the company’ test. This test is still relevant where the courts must consider whether directors acted within the limits of a general power (for example, power to manage the business of the corporation) in contradistinction to a specific power (for example, the power to refuse to register a transfer of shares⁶¹). The duty ‘to act bona fide and in the interest of the company’ should be treated as conceptually independent of the duty ‘to act for proper purposes’.⁶²

58 *Mills v Mills* (1938) 60 CLR 150, 164 (Latham CJ) as quoted with approval in *Howard Smith* [1974] AC 821, 835 (Lord Wilberforce); *McGuire v Ralph McKay Ltd* (1987) 5 ACLC 891, 894 (Murray, Gobbo and Southwell JJ). See also *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, 290 (Mason, Deane and Dawson JJ). See generally Brian Galgut et al (eds), *Henechsberg on the Companies Act* (5th ed, 2004) 466: ‘Where directors act in breach of [the duty to act only under available powers] it is irrelevant whether they believe they do so in the interest of the company’. The ‘bona fide for the benefit of the company as a whole’ test was also pertinently rejected in *Gambotto v WCP Ltd* (1995) 182 CLR 432, 444 (Mason CJ, Brennan, Deane and Dawson JJ): ‘In the context of a special resolution altering the articles and giving rise to a conflict of interests and advantages, whether or not it involves an expropriation of shares’.

59 *Howard Smith* [1974] AC 821, 834 (Lord Wilberforce); *Hogg v Cramphorn Ltd* [1967] Ch 254, 267 ff (Buckley J); *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, 289–90 (Mason CJ, Deane and Dawson JJ); *Southern Resources Ltd v Residues Treatment & Training Co Ltd* (1990) 8 ACLC 1151, 1164 (Jacobs ACJ, Prior and Mullighan JJ); *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22, 29–30 (Dillon LJ). See also Galgut et al, above n 58, 467–8; Steel, above n 39, 31. It is submitted that Blackman, above n 36, 7 states the principle too widely when he argues that directors will ‘still be guilty of acting for an improper purpose’ (emphasis added). At least a ‘self-interest’ is required and where there is no such self-interest the improper or impermissible purpose must be primary or substantial – see discussion in the body of this article below.

60 See Ford et al, above n 19, 358 fn 1, but note the incorrect reference to Sealy’s article (the reference should have been to ‘Mon ULR’, not ‘MULR’). Cf Sealy above n 25, 267–8. For earlier views on this issue, see Birds, above n 36, 583. At 580–1, Birds gives an excellent summary of the different doctrines at play in this area.

61 *Corporations Act 2001* (Cth) s 1072G (replaceable rule).

62 Sarah Worthington, ‘Directors’ Duties, Creditors’ Rights and Shareholder Interventions’ (1991) 18 *Melbourne University Law Review* 121, 122–3 and 123–4; Nolan, above n 40, 3, 7–13. See also Paul Redmond, *Companies and Securities Law: Commentary and Materials* (3rd ed, 2000) 439–40; J H Farrar ‘Abuse of Power by Directors’ (1974) 33 *Cambridge Law Journal* 221, 221, 224; Havenga, above n 43, 65; Franz J Ranero, ‘Managed Investment Schemes: The Responsible Entity’s Duty to Act for Proper Purposes’ (1999) 17 *Company and Securities Law Journal* 422, 425, 427.

IV THE 'BONA FIDE IN THE INTEREST OF THE COMPANY' DUTY

A Introduction

In *Parke v Daily News Ltd*,⁶³ most of the company's business was being wound up, and the directors resolved to make ex gratia payments to former employees. Justice Plowman reviewed the cases, particularly *Hutton v West Cork Railway Co* and *Re Lee Behrens & Co Ltd*,⁶⁴ and drew the following conclusions:

First, that a company's funds cannot be applied in making ex gratia payments as such; secondly, that the court will inquire into the motives actuating any gratuitous payment, and the objectives which it is intended to achieve; thirdly, that the court will uphold the validity of gratuitous payments if, but only if, after such inquiry, it appears that the tests enumerated by Eve J are satisfied; fourthly, that the onus of upholding the validity of such payments lies on those who assert it.⁶⁵

The tests enumerated by Eve J in *Re Lee Behrens & Co Ltd*, referred to in Plowman J's third conclusion, were: '(i) [was] the transaction reasonably incidental to the carrying on of the company's business? (ii) [was] it a bona fide transaction? (iii) [was] it done for the benefit and to promote the prosperity of the company?'⁶⁶

It is submitted that all these tests are aimed at determining whether those who approved the gratuitous payment acted in the interest of the company. It is, however, necessary to focus on the specific requirements referred to in *Parke v Daily News Ltd*.

B The 'Reasonably Incidental' Requirement

1 Historical Origin

The 'reasonably incidental' test is commonly referred to in cases involving the question of whether the company was acting ultra vires.⁶⁷ However, the ultra vires rule has been abolished,⁶⁸ with the result that while the 'reasonably incidental' test is still relevant as a factor to be considered when determining whether a director has acted in the best interests of the company, it no longer needs to stand as a separate test on the same footing as the 'best interests' test.

63 Ibid.

64 [1932] All ER 889.

65 *Parke v Daily News Ltd* [1962] 2 All ER 929, 942.

66 Ibid.

67 *A-G v Great Eastern Railway Co* (1880) 5 App Cas 473.

68 *Corporations Act 2001* (Cth) ss 124, 125. Further discussion of the issue of ultra vires is beyond the scope of this article. See generally Ross Grantham, 'Ultra Vires: Gone but Not Forgotten' (1993) 10 *Australian Bar Review* 233.

2 Application Of The 'Reasonably Incidental' Test In Hutton's Case

In the judgments of Bowen LJ and Cotton LJ in *Hutton v West Cork Railway Co*, the focus of the discussion is very much on whether the payments were reasonably incidental to the carrying on of the business. Justice Plowman, by borrowing Eve J's three pertinent questions,⁶⁹ seems to have elevated the 'reasonably incidental' requirement to the same level as the 'benefit to business' requirement. It thus appears to operate as the objective constraint on Bowen LJ's now-famous 'amiable lunatic'.⁷⁰

However, a close reading of the judgments in *Hutton v West Cork Railway Co* reveals that the reasonably incidental test is subsidiary to the test of whether there is a benefit to business. For example, Bowen LJ expresses the objective test as follows:

Whether, as well as being done bona fide, it is done within the ordinary scope of the company's business, and whether it is reasonably incidental to the carrying on of the company's business *for the company's benefit*.⁷¹

Similarly, Cotton LJ found that

the sums paid ... could not be looked upon as an inducement to [the directors] to exert themselves in the future, or as an act done reasonably for the purpose of getting the greatest profit from the business, but must be looked upon simply as a gratuity, perhaps reasonable in itself, but without any prospect of ... in any way reasonably conducing to the benefit of the company.⁷²

Therefore, it is consistent with *Hutton v West Cork Railway Co*⁷³ to use 'benefit to business' as the objective test. The 'reasonably incidental' test then becomes a factor to be considered in determining whether a reasonable body of directors could have thought that the action was in the best interests of the company.

C The Bona Fide For The Benefit Of The Company Requirement

1 Overview

It is submitted that the question whether the directors acted in the 'interests of the company' is assessed subjectively as well as objectively. Provided a court is convinced that the directors really were motivated by benefiting the company, the court will be reluctant to overturn the directors' decision. However, the objective test is there to protect shareholders from the vagaries of directors who are acting in a way which could only be regarded as unreasonable.

69 See above n 66 and accompanying text.

70 *Parke v Daily News Ltd* [1962] 2 All ER 929.

71 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 672 (emphasis added).

72 *Ibid* 666 (emphasis added).

73 *Ibid* 654, 666.

2 Subjective Limb – Were The Directors Motivated By Benefiting The Business?

On the issue of bona fides of the directors, the question to be answered is: ‘What motivated the directors?’ This can be answered by reference to their purpose or objective: that is, what were they trying to achieve? If their primary goal was anything other than promoting the benefit of the company, the decision will be invalid.⁷⁴ A company may wish to present its actions as generous and/or charitable, when in fact it is motivated by its own commercial interests. This will not invalidate the action.⁷⁵

3 Objective Limb – Could No Reasonable Director Have Thought It To Be Of Benefit To The Business?

The directors may well have been acting with an honest belief that what they were doing would benefit the company, but if no reasonable director could have agreed with them, the action will be invalid.⁷⁶ The ‘no reasonable director’ standard is generous because there is no need for any sort of consensus as to reasonableness – the director only has to convince the court that there could conceivably be one reasonable hypothetical director who could think it was in the interests of the company.

In order to assess whether no reasonable director could have thought it was in the interests of the company, some or all of the factors outlined below may be relevant:

- reasonably incidental payments;
- uncertainty as to whether a benefit would materialise;
- proportionality – is the size of the payment out of proportion to the potential benefit to the company?; and
- obvious detriment to the company.

(a) Reasonably Incidental Payments

Payments that are normal industry practice are less likely to be invalidated on the ground of lack of benefit. This issue commonly arises where payments to employees, former employees, or their families, are being challenged. For example, in *Hampson v Price’s Patent Candle Co*,⁷⁷ gratuities to employees were validated on the basis that the effect on staff morale would benefit the business.

⁷⁴ *Mills v Mills* (1938) 60 CLR 150.

⁷⁵ This has been described as the ‘sheep’s clothing principle’ by Melvin Eisenberg, ‘Corporate Conduct That Does Not Maximise Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner’s Dilemma, Sheep’s Clothing, Social Conduct, and Disclosure’ (1998) 28 *Stetson Law Review* 1, 14. See, eg, *AAT Case V18* (1988) 88 ATC 197.

⁷⁶ *Charterbridge Corporations Ltd v Lloyds Bank Ltd* [1970] Ch 62, 74.

⁷⁷ (1876) 24 WR 754.

In *Henderson v Bank of Australasia*,⁷⁸ the Court was asked to invalidate a gratuity where the benefit to the company was more indirect. The case involved a pension to be paid to the widow of a bank employee. It was argued that '[giving] money to the family of a deceased well-paid officer who are otherwise well provided for can be of no benefit to the business of the company'.⁷⁹ The Court focussed on whether the payment of this kind of pension was normal practice in the industry and, finding that it was, had no difficulty in finding that it was made in order to promote the prosperity of the company. If it is normal practice within the industry, this is an indication that it is reasonable to regard the payment as being of benefit to the business. *Hutton v West Cork Railway Co* was distinguished on the basis that the railway company was not a going concern, so that the payments to the former directors could not benefit the business in the future. In *Henderson v Bank of Australasia*, on the other hand, the bank was a going concern, and its treatment of the families of employees would be relevant in terms of its reputation and its ability to attract good employees.

(b) Uncertainty As To Whether A Benefit Would Materialise

In *Evans v Brunner*,⁸⁰ the Court refused to find that a resolution made by a chemical manufacturing company that authorised directors to make grants to universities was invalid. It was argued that the potential benefits were by no means certain, and that competitors were likely to benefit to a similar degree as the company making the grants. The Court preferred to trust that the directors would exercise their discretion in such a way as to maximise the chances of a benefit accruing to the company. So in this kind of fact scenario, the question is not whether all possible decisions made within the terms of the resolution would be to the benefit of the company, but rather whether it is possible for the directors to make decisions for the benefit of the company within the terms of the resolution.

(c) Proportionality — Is The Size Of The Payment Out Of Proportion To The Potential Benefit To The Company?

In *Hutton v West Cork Railway Co*, Bowen LJ adverted to the existence of an objective limit on the amount of money that could reasonably be given away. In his view, 'the limit is what is necessary in the reasonable management of the affairs of the company'.⁸¹ Thus, in assessing whether a reasonable director could believe a payment to be in the company's interests, the amount of money involved would be a relevant consideration.

78 (1888) 40 Ch D 170, 172 (North J).

79 Ibid.

80 [1921] 1 Ch 359.

81 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 673.

(d) Obvious Detriment To The Company

In some cases, what is proposed may actually be to the detriment of the company concerned. This was the case in *ANZ Executors & Trustee Company Ltd v Qintex Ltd*⁸² ('Qintex'), where a trustee sought to force the subsidiary companies to guarantee debts that had been guaranteed by the holding company. The subsidiaries had not been party to the agreement between the trustee and the holding company and were not party to the proceedings. They were insolvent, and there was no way that the proposed action could have been to the benefit of the subsidiaries. It was clear that no reasonable director could regard the proposed action as being for the benefit of the companies which were to take on the debt. Thus, it was a clear case of failing the objective 'benefit to business' test.

4 Issues Which Apply To Both The Subjective And Objective Determination Of Whether There Is A Commercial Benefit

(a) 'Best' Interests?

The language used in the cases is inconsistent in that sometimes the requirement is expressed as 'best interests' of the company and sometimes the word 'best' is omitted.⁸³ The *Corporations Act 2001* (Cth) refers to 'best interests': 'A director or other officer of a corporation must exercise their powers and discharge their duties: (a) in good faith in the best interests of the corporation; and (b) for a proper purpose.'⁸⁴ If the test were 'best interests', this suggests that directors would have to consider all possible alternatives, and choose the best one.⁸⁵ This does not appear to be the requirement imposed by the courts.⁸⁶ In fact, the threshold may be even lower. What if the directors have failed to turn their minds to whether the benefits will be outweighed by the costs, and the net position is in fact a cost to the company? Since the primary motivation must be to promote the prosperity of the company, this implies that if the directors thought that the net position would be a cost to the company, their action could be impeached. However, it is unlikely that the courts would be as strict as this, unless the failure constituted a breach of the duty of care and diligence.⁸⁷

82 [1991] 2 Qd R 360.

83 The expressions 'interests of the company' and 'best interests of the company' appear to be used interchangeably, which is consistent with there being no significant difference between them. See, eg, *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

84 *Corporations Act 2001* (Cth) s 181.

85 This point is made by Julian Blanchard, 'Honesty in Corporations' (1996) 14 *Company and Securities Law Journal* 4, 7.

86 *Charterbridge Corp Ltd v Lloyd's Bank* [1970] Ch 62, 75 (Pennycuik J).

87 *Ibid.*

(b) Onus

Justice Plowman makes a definitive statement that ‘the onus of upholding the validity of [gratuitous] payments lies on those who assert it.’⁸⁸ This burden of proof apparently distinguishes gratuitous payments from the cases where directors’ actions were challenged on the basis that they acted for an improper purpose. In the latter group of cases, the doctrines of the supremacy of the constitution and non-interference in internal company matters convinced the courts that the onus of showing that a power has not been properly exercised is on the party complaining.⁸⁹

It is an open question whether Plowman J’s statement of the law is correct. Far from seeing gratuitous payments as ultra vires, there is nowadays a real expectation that companies fulfil their social responsibility by making such payments.⁹⁰ In fact the only question is to determine the limits of such payments. The directors will obviously be liable under the insolvent trading provision if they made gratuitous payments when the company was insolvent or if there were reasonable grounds to suspect that the company was insolvent when such payments were made.⁹¹ It will also be difficult to argue that they have acted for a proper purpose and in the interest of the company if they never declare any dividends but consistently use all the distributable profits of the company for gratuitous payments. It is, however, acknowledged that it is very hard to determine the exact boundaries where the courts should set gratuitous payments aside. There is a grey area in which courts may be required to ‘[inquire] into motivations of an almost infinite range of variety’,⁹² however reluctantly.

A comprehensive discussion of the rules of evidence is beyond the scope of this article. However, it is worth noting that in *Parke v Daily News Ltd*, the plaintiff had established a prima facie case that the directors were not motivated by a desire to advance the interests of the company. In these circumstances, it is not surprising that the directors would be expected to dispel the suggestion that their motives were improper.⁹³ It is, however, submitted that where directors make gratuitous payments and they have, prima facie, not acted dishonestly, mala fides or with self-interest, the onus of showing that the gratuitous payment should be set aside should nowadays be on those complaining. The import of the onus issue from a practical point of view is clear: once challenged, directors must demonstrate that according to both a subjective and an objective assessment, the gratuitous payments are valid. Thus it behoves directors not only to have proper motives, but also to be able to demonstrate them.

88 *Parke v Daily News Ltd* [1962] 2 All ER 929, 942 (Plowman J).

89 See above Parts II(B), II(C).

90 See above n 11, above n 13 and accompanying text.

91 *Corporations Act 2001* (Cth) pt 5.7B.

92 See *Pine Vale Investments Ltd v Mc Donnell & East Ltd* 1 ACLC 1294, 1303 (McPherson J). Some suggestions as to factors that a court may take into account are made below, Part VI(E).

93 Cf *Re Smith & Fawcett Ltd* [1942] Ch 304.

V THE BONA FIDE AND PROPER PURPOSE DOCTRINES DIFFERENTIATED

Does the court need to address two separate questions – whether the action in question was both for a proper purpose *and* in the best interests of the company? It is suggested that the answer to this question is best addressed separately for cases where there is an explicit power and cases where the power is implied.

The following discussion illustrates how in the case of gratuitous payments, and other actions which are taken under the general powers of management conferred on the board, it is easy to confuse the duty to act in the best interests of the company, and the duty to act for a proper purpose. This is essentially because (as explained below) in these circumstances, what is in the best interests of the company is both a duty in itself, and a test for whether the proper purpose duty has been breached.

As noted above, to determine whether the duty to act for a proper purpose has been breached, the first question to be answered is: for what purpose was the power conferred? Where corporate donations are concerned, the power involved would normally be the general power of management, rather than a specific power. The general power of management will be very broadly construed. It would be likely to be defined in terms of almost anything that is in the interests of the company.

The second question to determine is whether the power was used for the purpose for which it was conferred, or for some other purpose. In the case of the general power of management, this question becomes: ‘Was the action taken in order to advance the interests of the company, or for some other reason?’ Thus, the proper purpose duty, in the case of the general power of management, necessarily involves the same question as the ‘best interests’ duty: were the directors acting in the best interests of the company? It is just that this question is arrived at via a different route, depending on which duty is being examined. The conflation of the two duties is reflected in the comment of Santow J in *Re HIH Insurance*⁹⁴ that ‘whether a director has acted for a proper purpose, namely *for the benefit of the company*, is to be objectively determined.’⁹⁵ Thus, the key test, for both duties, is the same – were the directors acting for the benefit of the company?

Confusion often arises because it may not be clear whether the phrase ‘the best interests of the company’ is being used in the sense of the *duty* to act in the best interests of the company, or as a *test* for whether the proper purpose duty has been breached. Whilst acting for a ‘proper purpose’ (in the sense of not abusing the powers granted) remains an important aspect of the common law and statutory duties of directors,⁹⁶ it is not the key issue for assessing the validity of

94 (2002) 168 FLR 253.

95 Ibid 414 (emphasis added).

96 See, eg, *Howard Smith* [1974] AC 821; *Pine Vale Investments Ltd v McDonnell & East Ltd* 1 ACLC 1294; *Corporations Act 2001* (Cth) s 181.

gratuitous payments. As will be illustrated in the next part, the question of the best interests of the company is the dominant consideration when assessing the validity of gratuitous payments.

VI APPLICATION OF PRINCIPLES IN CONTEXT OF CORPORATE DONATIONS

A Reluctance Of The Courts To Interfere

As noted above,⁹⁷ once satisfied that the directors have an honest belief that they are acting in the interests of the company, the court will be reluctant to interfere, and will only do so if no reasonable director could have held that view. This gives directors very broad discretion, and in many fact scenarios a donation would have been valid if only the directors had expressed their intentions differently. For example, in *Hutton v West Cork Railway Co*, Cotton LJ expressly leaves open the possibility of the company resolving to make a payment to the directors provided it is expressed as being for services during the relevant period.⁹⁸ It is important to note that the court will not impose its own view as to whether the action was in the interests of the company. Rather, it will have regard to what a reasonable director's view would have been.

B What Is A 'Benefit To Business'?

In this article, the phrases 'benefit to business', 'in the best interests of the company', and 'in the interests of the company' are used synonymously. The benefit that must motivate the directors' actions does not necessarily have to be a direct one, nor a financial one. For example, decisions which are costly yet which lead to an enhanced reputation, or improved employee morale, would be justifiable as being in the best interests of the company.

C How Broad Is The Definition Of 'The Interests Of The Company'?

If the company interests are regarded as encompassing the interests of the recipients of corporate donations, it could be argued that a donation benefits a company even if there is no benefit to the company as an entity in itself. For example, if the company interests encompasses employees, then theoretically a board of directors could make large gratuitous payments to employees, motivated by advancing the interests of the employees rather than the interests of the corporate entity, and their doing so would not breach their duty to act in the best interests of the company. However, the position in Australian law is that the company is taken to be the legal corporate entity. The courts have admitted only

⁹⁷ See above Part II(B).

⁹⁸ *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 668.

limited variations on this definition.⁹⁹ For example, directors can legitimately consider the interests of future shareholders as well as existing shareholders,¹⁰⁰ and are required to take creditors' interests into account if the company is insolvent or nearing insolvency.¹⁰¹ This does not amount to a green light to make gratuitous payments to these or any other groups in the absence of a benefit to the corporate entity.¹⁰²

There are two other potential ways of extending the definition of the interests of the company. First, the company's constitution may define the interests of the company. For example, the constitution could permit profits to be used for charitable purposes.¹⁰³ Secondly, it may be that shareholders of a solvent company could approve actions that would otherwise be in breach of the duty to act in the interests of the company.¹⁰⁴

D Shareholder Approval

Given the lack of clarity and potential for controversy¹⁰⁵ over the law with respect to corporate donations, it may be thought that the simplest approach would be to obtain shareholder approval for corporate donations. However, this is not as straightforward as it may seem. First, there is the administrative burden associated with obtaining shareholder approval. Second, most donations could be argued to be in the interests of the company, albeit indirectly, such that shareholder approval would be unnecessary. As pointed out in Part IV(C) above, the standard is not set very high: to be dismissed as not being in the interests of the company, donations have to be such that no reasonable director would have thought them to be in the interests of the company. Third, in the case of altruistic donations, which at face value would appear to be the area where shareholder approval may be of most relevance, a resolution by shareholders approving the making of a donation would not necessarily solve the problem. The shareholders may have to resolve that making the donations would be in the best interests of the company. It may not be sufficient for the shareholders simply to approve the donations because the directors, in proceeding with the donations, may still be in breach of their duty to act in the best interests of the company. An analogous situation arose in *Qintex* where the shareholders had approved the corporation

99 Ford, above n 19, 345–6.

100 *Provident International Corporation v International Leasing Corp Ltd* [1969] 1 NSW 424, 440.

101 *Walker v Wimborne* (1976) 137 CLR 1, 7 (Mason J); *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187; *Addstead Pty Ltd (in liq) v Liddan Pty Ltd* (1997) 70 SASR 21.

102 See also William Heath, 'The Corporations Law, Section 181: A Two-Edged Sword' (2000) 18 *Company and Securities Law Journal* 377, 379; Sealy, above n 25, 269; J D Heydon, 'Directors' Duties and the Company's Interests' in P D Finn (ed), *Equity and Commercial Relationships* (1987) 120.

103 *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 (Mason CJ, Deane and Dawson JJ).

104 As discussed in the next section.

105 See, eg, the controversy over whether shareholder approval should have been obtained for corporate donations to relief efforts following the December 2004 tsunami in Asia: ABC Radio, 'Shareholders' Association Opposes Corporate Aid Donations', *AM*, 7 January 2005, <<http://www.abc.net.au/am/content/2005/s1278328.htm>> at 13 February 2005. The ASA later issued a clarifying statement: see Peter Gosnell, 'Backdown over Corporate Donors', *The Daily Telegraph* (Sydney), 8 January 2005, 5.

entering into a guarantee, but the action was disallowed by the Court because it could not have been in the interests of the company.¹⁰⁶ In summary, shareholders would either need to resolve that making the donation is in the interests of the company, or they would need to amend the constitution by inserting an express provision allowing directors to make altruistic charitable donations. The power to make altruistic donations may be limited, for example a dollar limit per annum, or a certain percentage of profits.

E Case Study – Corporate Donations To Tsunami Relief Efforts

If large corporate donations made to tsunami relief efforts are to withstand attack, either from a liquidator or from disgruntled shareholders, a court would have to find that the directors had had regard to the interests of the company in making the donations. The interests of the company are broadly defined, yet open to interpretation by the courts – as discussed, a decision can be in the interests of the company unless no reasonable director could have regarded it as such.

Some companies match contributions made by employees. This kind of corporate donation is easily justifiable as being in the interests of the company on the basis that the company's contributions help to build morale, as well as enhance their overall reputation in the community. The ASA has proposed that companies institute a dividend donation scheme, whereby shareholders can nominate a percentage of their dividend to be given to a worthy cause.¹⁰⁷ A natural extension of this would be for the company to match shareholder contributions. This is attractive in terms of promoting shareholder democracy – shareholders could no longer complain, as P P McGuinness stated, that 'corporate philanthropy is illegitimate spending by powerful corporate elite of someone else's money; an attempt to bypass democratic allocation of taxes'.¹⁰⁸

However, this approach is dangerous inasmuch as it may be taken as a signal that directors believe that shareholders need to be involved in the decision to make corporate donations. This is not a legal requirement, provided the donations can be defended as having been made for the benefit of the company. The directors have the power to manage the company,¹⁰⁹ which includes making all sorts of decisions on expenditure. The making of donations, normally a very small amount relative to the overall financial capacity of the organisation, is just another management decision to be made. If the shareholders do not agree with the decisions made by the directors regarding donations they could express their

106 See obiter in *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722,730 (Street CJ), which is cited with approval in *ANZ Executors & Trustee Co Ltd v Qintex Australia Ltd* [1991] 2 Qd R 360 (McPherson J). Cf *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285. Further discussion of this point is beyond the scope of this article. See generally M A Kerrell, 'Does Shareholder Ratification of Directors' Actions Raise More Problems Than it Solves for Those Taking a Third Party Corporate Guarantee?' (1994) 24 *Queensland Law Society Journal* 33, 42.

107 Nick Tabakoff, 'Generous to a Fault: A New Approach to Corporate Philanthropy Could Revolutionise How Donations are Made in the Event of Future Disasters', *The Bulletin* (Sydney), 25 January 2005.

108 See McGuinness, above n 1.

109 See above Part II(C).

dissatisfaction by removing the directors under s 203D of the *Corporations Act 2001* (Cth) or refusing to re-elect the directors at the annual general meeting. They may even consider relying on the oppression remedies under Part 2F.1 of the *Corporations Act 2001* (Cth), but it should be clear that this remedy will only apply if it could be established that the donations made by the directors were 'contrary to the interest of the members as a whole; or oppressive to, unfairly prejudicial to, or unfairly discriminatory against a member or members'.¹¹⁰

If large tsunami donations are to be upheld, the court would have to hold that it is reasonable for a company's directors to think the company would benefit indirectly. A court may decide that a reasonable director could think that there would be a benefit to a company (albeit an indirect and intangible benefit) for its directors to make donations according to their moral values, despite there being a tangible cost. This does not seem far-fetched, especially in the light of examples such as the pharmaceutical company Merck, the directors of which believe that the best way to make profits is not to be obsessed by them, but rather to put people first.¹¹¹ This also seems to be a sensible long-term strategy for the company that may generate large returns over time.

In what circumstances, then, might corporate donations to tsunami relief efforts be successfully challenged? The circumstances would have to be such that no reasonable director could have thought that making the donations would benefit the company. This could be the case if the company was approaching insolvency, or if the size of the donations was completely out of proportion to the company's financial resources. No doubt the courts would use a commonsense approach in order to determine what 'out of proportion' means in a particular case. The impact on the size of dividends would probably be a factor, as well as any other specific impacts of the decision to make the donations – eg, if the directors decided to forego an opportunity to make an acquisition in order to make a large donation, this may not be regarded as reasonable. Given the fact that many corporate donations represent only a very small percentage of profits,¹¹² it seems unlikely that corporate donations could be successfully challenged for want of reasonableness, unless the company is verging on insolvency. However, there may be scope in many cases for shareholders to challenge corporate donations successfully where the donations have been made without regard for the benefit of the company. Directors would be unwise to approve large donations without recording that they have done so with the interests of the company as their primary guiding principle.

Directors and the ASA could be forgiven for feeling that they are caught between a rock and a hard place. On the one hand, they are strongly criticised by

110 *Corporations Act (2001)* (Cth) sub-ss 233(d), (e).

111 See Norman Bowie, 'The Purpose of the Corporation' in Tom Beauchamp (ed) *Ethical Theory and Business* (2nd ed, 1983) 91.

112 See, eg, the National Australia Bank's donation of \$100,000, which represents 0.0003% of its annual profit of A\$3.5 billion: Don BoredWalk and Greg Bowyer, *Two Takes on Australian Corporate Donations* (2005) Crikey Daily <<http://crikey.com.au/#!/articles/2005/01/05-0003.html>> at 14 February 2005.

the public if there is any suggestion that their motives are not purely altruistic.¹¹³ On the other hand, companies are required by law to be self-interested. But it is possible to tread a fine line: for example, BHP has arguably been able to do this by presenting its corporate donations in the following way:

Soon after the tsunami, BHP gave \$US500,000 (\$600,000) to be split between UNICEF in Aceh and World Vision in India. [A BHP representative] says that while business interests were 'not a driver' in BHP's decision of where to give, the company had interests and plans for future operations in both countries. Then it announced its employee matching program, nominating World Vision, Oxfam and UNICEF as the charities of its choice. 'This ensures the company contributes in line with the interests of employees', [the BHP representative] says. 'It shows we are listening to our staff, and prepared to send out money where they think it should go, not just where we think.'¹¹⁴

By claiming that business interests were not a driver, BHP could be seen to be flaunting the legal requirement that decisions must be made in the interests of the company. However, it would surely be surprising if an Australian court were to find that directors of BHP were in breach of their fiduciary duties by making donations on the basis described above, for the following reasons. First, there are at least three ways in which the company stands to benefit from the donations: improved prospects in the countries concerned, improved employee moral, and improved reputation. Second, it is possible that the directors did in fact give at least equal weight to the interests of the company when approving the donation.¹¹⁵ Thus, while there is a conceptual discord between what the community expects and what companies can do legally, in practice this can be solved by ensuring that corporate donations are beneficial to both the donor and the recipients, and by taking care in describing the approach being taken for making donations.

F Summary

The above discussion illustrates that while courts will insist that there is a benefit to the company, directors do have wide discretion to decide what is in the interests of the company, and this gives a lot of scope for philanthropic activity. It must always be remembered, however, that 'charity has no business to sit at boards of directors qua charity'.¹¹⁶ The motivation must be, and must ultimately be seen to be, advancing the interests of the company.

113 See, eg, Zoe Taylor, 'The Debate', *The Daily Telegraph* (Sydney), 8 January 2005, 22.

114 Fiona Carruthers, 'Give and Take of Corporate Donations', *Australian Financial Review* (Sydney), 8 January 2005, 18.

115 Their actual motivation may have been slightly different (more self-interested) than they have chosen to imply in their public relations statements.

116 *Hutton v West Cork Railway Co* (1883) 23 Ch D 654, 672 (Bowen LJ).

VII THE FUTURE OF THE LAW ON CORPORATE DONATIONS

A Overview

There has not been any significant pressure in Australia for law reform specifically aimed at facilitating the making of corporate donations. However, following outrage in the community over inadequate funding by James Hardie for compensation for victims of asbestosis,¹¹⁷ two governmental inquiries were established in the first half of 2005 to look at the question of whether directors should be allowed, or indeed required, to take into account interests other than shareholders' interests.¹¹⁸

An extreme approach would be to impose new fiduciary duties on directors. For example, in addition to the existing fiduciary duty to the company, duties to employees, creditors, and potentially a multitude of other groups could be imposed on directors. Potential problems with this approach include that in owing duties to many, directors could effectively be accountable to no one, as whatever decision they make could be justified on the basis that it is in the interests of at least one stakeholder group. Another problem is the difficulty in defining the groups to which directors may owe a fiduciary duty, for example, the environment is regarded as an important 'stakeholder' by many, but what would it mean for directors to owe a duty to 'the environment'? An additional problem may be lack of guidance for directors as to how to balance competing interests.

The forthcoming governmental inquiries will no doubt consider changes which have been proposed to company law in the United Kingdom by a Department of Trade and Industry White Paper. These proposed changes are designed to:

provide greater clarity on what is expected of directors, making it easier for all to understand what those duties are. In particular the Bill will make clear that, while directors must promote the success of the company for the benefit of its members, this can only be achieved by taking due account of longer term performance and wider interests, such as the interest of its employees and the impact of the company's operations on the community and on the environment.¹¹⁹

This approach, called 'enlightened shareholder value' in the White Paper, is explained further by the Department of Trade and Industry as follows:

117 See, eg. Ean Higgins, 'Costello Takes Aim at Hardie', *The Australian* (Sydney), 25 June 2005, 11.

118 The terms of reference of the review by the Corporations and Markets Advisory Committee are set out in a letter from the Parliamentary Secretary to the Treasurer, Chris Pearce, dated 23 March 2005. See *Reference in Relation to Directors' Duties and Corporate Social Responsibility* (2005) Corporations and Markets Advisory Committee <<http://www.camac.gov.au/CAMAC/camac.nsf/byHeadline/Whats+New+Directors'+duties+and+corporate+social+responsibility?openDocument>> at 9 July 2005. The Parliamentary Joint Committee on Corporations and Financial Services is independently investigating similar issues. See *Inquiry into Corporate Responsibility: Terms of Reference* (2005) Parliamentary Joint Committee on Corporations and Financial Services <http://www.aph.gov.au/Senate/committee/corporations_ctte/corporate_responsibility/tor.htm> at 10 July 2005.

119 United Kingdom, Department of Trade and Industry, *Company Law Reform*, Cm 6456 (2005) 16.

The Government believes that the objective of directors should be to generate maximum value for shareholders, as this is most likely to maximise overall competitiveness and wealth and welfare for all. At the same time, we recognise that directors cannot do this if they focus on the short-term financial bottom line and fail to build long-term relationships. The Bill will therefore require directors to take a properly balanced view of the implications of decisions over time, and to take account of wider interests, such as the company's need for effective relationships with employees, customers and suppliers, and in the community more widely.¹²⁰

It should be noted that ultimately, the directors would still be required to act in the interests of the members of the company.¹²¹ However, in fulfilling the duty to act in the interests of the company members, directors would be required to take into account the likely long- and short-term consequences of any decision, as well as any need of the company to have regard to the interests of its employees; foster its business relationships with suppliers, customers and others; consider the impact of its operations on the community and the environment; and maintain a reputation for high standards of business conduct.¹²² This would effectively remove any doubt that spending money on corporate donations or other worthy causes is justifiable, even without any direct benefit to the company, because of the positive effect on the company's reputation. It is arguably not different from the law as it currently stands, except that it is proposed that directors be *required* to take these factors into account.

It is submitted that a requirement to take these 'broader' factors into account would be a positive step. It should be acknowledged that directors who only want to focus on short-term profit would be able to continue to do so, paying only lip service to the requirements, for example, by using standard wording in the minutes of directors' meetings to the effect that the broader factors had been considered. At the other end of the spectrum, there are no doubt many directors who already consider these broader factors in their decision-making. However, a requirement to take these broader factors into account would require greater focus on the need for their company to have the support of its community, particularly amongst directors who might not otherwise have been attuned to this need.

Care would need to be taken, as has been done in the Company Law Reform Bill 2005 (UK) which resulted from the White Paper, to specify that the duty is still owed to the members of the company,¹²³ to maintain existing protections for creditors¹²⁴ and to clarify that a company can be established for purposes other than its own benefit.¹²⁵

120 Department of Trade and Industry Company Law Reform White Paper: Frequently Asked Questions (2005) <<http://www.dti.gov.uk/cld/doc31.doc>> at 9 July 2005.

121 Except to the extent that the company is established for purposes other than the benefit of its members: see Company Law Reform Bill 2005 (UK) B3(1).

122 Company Law Reform Bill 2005 (UK) B3(3).

123 Company Law Reform Bill 2005 (UK) B1(1).

124 Company Law Reform Bill 2005 (UK) B3(4).

125 Company Law Reform Bill 2005 (UK) B3(2).

A less proscriptive approach could be taken, whereby directors are explicitly *allowed* by the legislation to take the factors in the legislation into account, but are not *required* to do so. Whilst not being as effective as a requirement that broader issues be taken into account, it would at least go some way towards meeting the need expressed by the Chairperson of James Hardie, Meredith Hellicar, for clarity on this issue:

What one needs is a safe harbour for directors to be able to integrate corporate social responsibility into their decision-making without fear that they are going to be sued both personally and as a company by their shareholders.¹²⁶

B Objective Limits

As has been argued in this article,¹²⁷ the law already restricts corporate donations to those that a reasonable director could regard as being in the interests of the company. This, combined with the increasing emphasis being placed on the more objective requirement that directors act for a proper purpose,¹²⁸ means that directors will increasingly be forced to justify their actions. Thus it is submitted that there is no need to introduce an objective requirement.

C Accountability And Transparency

The giving of some A\$20 000 000 to charitable causes by HIH,¹²⁹ chiefly under the direction of CEO Ray Williams, is a recent example of corporate philanthropy which has generated calls for greater accountability. For example, in the final report of the HIH Royal Commission, Neville Owen said:

However laudable the object of the donation, discretionary payments of this kind from the funds of shareholders should be undertaken in a transparent and justifiable way with full regard to the interests of the shareholders. Companies should develop their own guidelines for the disclosure of their arrangements for the stewardship of corporate donations. Guidelines should cover the disclosure to shareholders of donations made to charitable, philanthropic, political or other discretionary objects together with a statement of the rationale for those payments.¹³⁰

Owen does not, however, call for mandatory disclosure of corporate donations, nor for mandatory shareholder approval. According to the Business Council of Australia, '[i]t's not reasonable to expect companies to disclose and explain every spending decision. And shareholder approval would be impractical'.¹³¹

126 Stephen Bartholomuesz, 'If There's No Bar to Responsible Boards, New Plans Could Backfire', *The Age*, (Melbourne), 6 April 2005, 15.

127 See above Part IV.

128 See Ford, above n 19, regarding the trend towards greater intervention by the courts.

129 Colleen Ryan, 'The Hard Yard', *Australian Financial Review* (Sydney), 27 June 2003, 18.

130 Commonwealth of Australia, HIH Royal Commission, *The Failure of HIH Insurance* (2003) [6.2.13].

131 Fiona Buffini, 'HIH Puts Corporate Largesse in Spotlight', *Australian Financial Review* (Sydney), 30 April 2003, 3.

VIII PRACTICAL GUIDANCE FOR DIRECTORS

Given the above discussion, how are directors to avoid a potential challenge to the legality of their philanthropic programs? Directors should be acutely aware that everything they do must be motivated by commercial interests. This meets the legal requirement that there be a benefit to business. They should also be aware that decisions about corporate donations, like all other corporate decisions, need to be made in an accountable and transparent way if today's standards of corporate governance are to be met.¹³² Directors should ensure that any company officer who is likely to approve a corporate donation is aware that donations cannot be made without regard for the potential benefit to the business. Each time a donation is made, there must be a conscious assessment of whether the donation would promote the interests of the company. There must be reasonable grounds in each case for believing that the interests of the company would be promoted.

The board should consider developing a philanthropy strategy. This is likely not only to maximise the potential benefits for all parties, but may also be useful as evidence that the interests of the company have been considered. It would also help to answer a challenge regarding lack of care or diligence in supervising the giving away of corporate assets. A philanthropy strategy could include how it is envisaged that the company will benefit; policy as to disclosure; a limit above which decisions must be approved by the board; policy as to whether acknowledgement should be sought for the company; and a policy on dealing with conflicts of interest.

The following could be a useful checklist for directors making decisions regarding corporate donations:

- Benefit – if the benefit to the business is in the form of enhanced reputation over the long term, this should be stated. This will be sufficient except where no reasonable director could have believed that the company's reputation would be enhanced, or where the cost is out of all proportion to the benefit, such that no reasonable director could have thought it to be in the interests of the company to make the payment.
- Disclosure – directors should consider disclosing their philanthropy strategy and individual donations above a certain amount. This could be via the corporate website and/or annual report.
- Authorisation – the strategy should stipulate who is authorised to make corporate donations. The board may wish to stipulate a threshold above which donations must be approved by one or more directors.
- Acknowledgement – a donation will not necessarily be unlawful just because credit has not been sought for the company.¹³³ However, if

132 See generally ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003) <www.shareholder.com/visitors/dynamicdoc/document.cfm?documentid=364&companyid=ASX> at 24 May 2005.

133 See above n 80 and accompanying text.

acknowledgement is sought, this does help to demonstrate that the commercial interests have not been subverted. Failure to seek credit for the company was one of the factors mentioned in the HIH Royal Commission Final Report in criticisms of the substantial corporate donations made by HIH.¹³⁴

- Conflicts of interest – there should be a clear protocol for dealing with potential conflicts of interest, for example, where a director is involved with the recipient of the proposed donation.¹³⁵

IX CONCLUSION

The recent experience of HIH¹³⁶ and the controversy over corporate donations to relief efforts¹³⁷ illustrate that the giving away of corporate resources, where this is not done to promote the interests of the company, is as much an issue today as it was in 1883 when *Hutton v West Cork Railway Co* was decided.

While directors have considerable scope to decide what is in the interests of the company, this scope is not unlimited. The law remains basically the same as expressed in *Parke v Daily News Ltd*, however it is suggested that a simpler formulation of the law is possible and desirable. The legality of corporate donations can be addressed by asking two simple questions: did the directors believe they were acting in the interests of the company, and was this belief one which no reasonable director could have held? Provided the answers are ‘yes’ and ‘no’ respectively, the payment will not be invalidated.

From a practical point of view, directors who are sympathetic to the concept of corporate philanthropy can be encouraged that there is plenty of scope for making donations to worthy causes. There are however two important provisos. First, corporate donations must be made as part of a business strategy, the primary motivation being to advance the interests of the corporation. This may be unfashionable but it is a legal requirement. Secondly, donations must be made in a transparent, accountable way. This is not required by law but it is an expectation which directors ignore at their own peril.

134 HIH Royal Commission, above n 130.

135 A comprehensive discussion of the duty to avoid a conflict of interest is beyond the scope of this article. See generally *Darvall v North Sydney Brick & Tiles Co Ltd* (1989) 16 NSWLR 260; *North-West Transportation Co Ltd v Beatty* (1987) 12 App Cas 589.

136 *Re HIH Insurance Ltd and HIH Casualty and General Insurance Ltd* (2002) 168 FLR 253, 414 (Santow J); HIH Royal Commission, above n 130.

137 See above n 15 and accompanying text.