Directors' Duty to Use their Powers for Proper or Permissible Purposes

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This article focuses generally on the interaction among several internal company law doctrines such as the supremacy of the articles of association; that other organs cannot interfere with powers exclusively conferred upon a particular organ; that courts will not readily interfere with internal company matters; that directors are under a duty to act in good faith and in the best interest of the company as a whole and under a duty to use their powers for proper or permissible purposes; and that there are some remedies available to shareholders if directors did not perform their powers for a proper or permissible purpose. The specific aim with the article is to establish when and why the courts will be prepared to set aside decisions by directors if they have taken them for an improper or impermissible purpose. The article concludes that the courts will be prepared to set the decisions of directors aside when they have used a particular power substantially or primarily for an improper or impermissible purpose. When the exercise of directors' powers is challenged under circumstances where there were both permissible and impermissible purposes for exercising a particular power, there is no alternative for the court but to inquire into the complex area of the state of mind of those who acted and the motive on which they acted. This is, in fact, second-guessing the decisions of directors.

1 Introduction

There are quite a few prominent academic writings dealing with general internal company law principles in South African academic literature. These articles cover aspects such as the division of powers between company organs, and the role, functions and duties of company directors. However, it is remarkable that not a single article in South African legal periodicals deal pertinently with directors' duty to use powers for their proper or permissible purpose. This is a prominent principle and forms the primary focus of this article.

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2 Some Phraseology and the Scope of Investigation

All current publications on South African company law and company directors discuss directors’ duty to use powers for their proper or permissible purpose. Most of them specifically classify this as a fiduciary duty, but they describe this duty in a slightly different way. Beuthin does not deal with this duty under a separate heading, but refers to directors’ duty to ‘exercise their powers for a proper purpose for which they were conferred’;1 Blackman refers to the ‘[d]uty to exercise powers for proper purpose’;2 Cilliers and Benade use ‘[f]ailure to exercise ... powers for the purpose for which they were conferred’;3 Hahlo talks about directors’ ‘[d]uty to act within their powers’;4 Henochsberg still has no separate part allocated to this duty, but discusses it under two separate headings, namely the ‘[d]uty to act only under available powers’ and the ‘[d]uty to act bona fide in the interest of the company’;5 Naudé refers to the fact that ‘[e]lke bevoegdheid moet vir die doel uitgeoefen word waarvoor dit aan die direksie of bepaalde direkteur verleen is’,6 while Van Dorsten describes this duty under the heading ‘[p]owers must be exercised for the purpose for which they were conferred’.7

The same trend of subtle different ways of describing this duty may be detected from the decided cases. It has been held that ‘a person having a power, must execute it bona fide for the end designed, otherwise it is corrupt and void’;8 or that directors may only used their powers within ‘a literal execution of the power, with a purpose which it does ... sanction’;9 or that ‘powers conferred upon [directors] cannot be exercised ... for any purpose foreign to the power’;10 or that directors must prevent ‘an abuse ... of the powers conferred on them by the articles’;11 or that a director’s ‘powers must be used bona fide for the purpose for which it was conferred’;12 or that directors must exercise their powers ‘bona fide and not for irrelevant purposes’;13 or that directors’ powers must be

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6 S J Naudé Die Regeposisie van die Maatskappydirekteur met Besondere Verwysing na die Internne Maatskappyverband (1970) at 111.
7 L van Dorsten Rights, Powers and Duties of Directors (1992) at 188.
8 Alyn v Belchier (1758) 1 Edn 132, 28 ER 634 at 138, 637 as quoted in Ngurli Ltd v McCann (1953) 90 CLR 425 (HC of A) at 440.
9 Vatcher v Paull [1915] AC 372 (CA) at 378; Ngurli Ltd v McCann supra note 8 at 438.
10 Mills v Mills (1938) 60 CLR 150 (HC of A) at 185, per Dixon J.
11 Ngurli Ltd v McCann supra note 8 at 439.
12 Idem at 439-40, articulating what was decided in Mills v Mills supra note 10.
13 Harlow’s Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL (1968) 121 CLR 483 (HC of A) at 493.
'exercised for the purpose for which it was granted (or conferred)';\textsuperscript{14} or that directors may not exercise their powers for 'an improper purpose or alternatively [abuse] their directors' powers';\textsuperscript{15} or that directors may not exercise their powers for 'an impermissible and vitiating purpose';\textsuperscript{16} or that directors may not exercise their powers 'for a purpose foreign to the object and purpose of the power'.\textsuperscript{17}

It is clear from this short analysis of some South African sources and the decided cases that one and the same duty could be described under different banners. The way in which the duty is tagged also depends on whether it is stated positively or whether the focus is rather on the breach of the duty. At least the following possibilities exist if the focus is on the breach of the duty: directors may not misuse or abuse their powers; or directors may not use their powers for an improper or an impermissible purpose. It is interesting to note that not all these negative statements lend them to be converted into positive statements. For instance, it is more difficult to convert the statement that directors 'may not misuse or abuse their powers' into a positive statement without using different words. On the other hand, the second statement could easily be converted into a positive description of the duty, namely that 'directors may only use their powers for a proper or a permissible purpose'.

Whether there is any real significance in the way in which the courts have described this duty or its breach will require a careful analysis of exactly how the courts employed the terminology and a comparison of that with the facts of each case. That falls outside the scope of this article. In this article the terms 'proper (improper) purpose' and 'permissible (impermissible) purpose'\textsuperscript{18} will be used as synonyms and as indications of whether or not the powers directors exercised were misused or abused.

This article only deals with powers conferred upon directors, normally by the articles of association, to fulfil internal actions, for instance the power to manage the business of the company; the power to issue shares; the power to recommend dividends; and the power not to register somebody as a shareholder. It does not deal with the question whether the directors exceed the powers of the company as described in the

\textsuperscript{14} Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821 (CA) at 834B-C and 834H.
\textsuperscript{15} Darvall v North Sydney Brick & Tiles Co Ltd (1989) 15 ACLR 230 (CA, NSW) at 247.
\textsuperscript{16} Whitehouse v Carlton Hotel Pty Ltd (1987) 5 ACLR 715 (HC of A) at 720.
\textsuperscript{17} Permanent Building Society v McGee (1993) 11 ACLC 761 (SC, SA) at 762. LS Sealy "'Bona Fides' and "Proper Purposes" in Corporate Decisions' (1989) 15 Monash University LR 76 at 268 explains the use of various interchangeable terms as follows: 'In company law, the court may say that the relevant power has been abused, or exceeded, or not genuinely exercised, or that those who exercised it acted upon irrelevant considerations, or from an improper motive.' In a stimulating article, Franz J Ranero 'Measured Investment Schemes: The Responsible Entity's Duty to Act for Proper Purposes' (1999) 17 Company & Securities LJ 422, discusses the 'duty to act for a proper purpose' under the catchy phrase '[f]raud on the power' (see at 423-7), but later he distinguishes the two concepts (see at 427ff).
\textsuperscript{18} As far as I could determine, the phrase 'permissible or impermissible purpose', rather than the more traditional phrase 'proper or improper purpose', was first used in Whitehouse v Carlton Hotel supra note 16 at 718D. In this case there was a seamless transition from the more traditional phraseology ('proper or improper purpose') to the 'permissible or impermissible' phraseology even though the Court relied on cases where the traditional phrases were employed.
memorandum of association, the area where the *ultra vires* doctrine becomes prominent. It also does not deal with the interaction among the *ultra vires* doctrine, the *Turquand* rule, and s 36 of the Companies Act 61 of 1973. Those areas have been covered quite extensively by others. 

This article only deals with how the courts determine the purpose or purposes for which powers are conferred upon directors by the articles and whether the directors have exercised these powers for a proper or permissible purpose. In this sense the article deals with what could commonly be described as the intra vires exercise of powers conferred upon directors by the articles.

### 3 The Doctrine of the Supremacy of the Articles of Association

Provisions in a company's articles may have considerable consequences because of the doctrine, now recognised in the South African law, of the supremacy of the articles of association. In *LSA (UK) Ltd v Impala Platinum Holdings (Ltd)*,21 Schutz JA explained the principle of supremacy of the articles of association 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.'

A very specific consequence of this doctrine is that powers conferred upon a certain organ by the articles, are within the exclusive power of that organ and that such powers cannot be usurped by any of the company's other organs,23 unless exceptional circumstances apply. Under such exceptional circumstances, certain powers of the board may revert to the general meeting,24 but the specific organ that will have

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20 See Colin Baxter 'Ultra Vires and Agency Untwined' (1970) 28 Cambridge LJ 280ff for a comprehensive analysis of the various ways in which powers can be exercised in company law context with particular reference to older cases decided in this area.


23 See Cilliers & Benade op cit note 3 in para 7.08 at 87 and cases referred to there. See also *The Duke Group Ltd (In Liq) v Plimer* (1998) 16 ACLC 567 (SC, SA) at 691, and generally Sealy op cit note 17 at 272.

24 Cilliers & Benade op cit note 3 in para 7.11 at 88.
the default power to exercise a power if a particular organ cannot or will not exercise its powers, will depend on the facts of the case. The particular power at stake and the specific organ that cannot or will not exercise the power, are factors to be taken into consideration.

4 The Doctrine of Non-interference with Internal Matters of a Company

Closely linked with the doctrine of supremacy of the articles of association is the principle that courts are reluctant to interfere with the internal affairs of companies. It has been held on several occasions that courts will not second-guess the decisions properly taken by directors as part of powers conferred upon them by the articles. 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*:

> "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."

The reason why a court will not interfere with duly exercised internal decisions of directors was summarised neatly by Kirby P in *Darvall v North Sydney Brick*:

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25 This principle is explained neatly by Blackman op cit note 2 in par 42 at 73: 'Where the articles confer powers (expressly or impliedly) on the directors, the general rule is that the members in general meeting cannot, unless empowered to do so by the articles, also exercise those powers (that is to say they have no 'collateral powers').


27 *Lord v The Governor and Company of Copper Miners* (1848) 2 PH 739, 41 ER 1129 at 1134; *MacDougall v Gardner* (1875) 1 ChD 13 (CA) at 23; *Isle of Wight Railway Company v Takoordin* (1883) 25 ChD 320 (CA) at 333; *Bainbridge v Smith* (1889) 41 ChD 462 (CA) at 474. This principle is firmly imbedded in the South African law: see Adams v North 1933 CPD 100 at 108; *Cooper v Garratt* 1945 WLD 137 at 148 and 152; and cases cited in Makhuva v Lukos Bus Service (Pty) Ltd 1987 (3) SA 376 (V) at 3931-3953. See generally RB (1974) 48 Australian LJ 319.

28 See in particular *Hoole v Great Western Railroad Co* (1867) 3 Ch App 262 at 268 and 275; *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353 at 368; the cases cited in *The Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199 (HC of A) at 217; *Shuttleworth v Cox Brothers & Company (Maidenhead) Limited* [1927] 2 KB 9 at 23-4; *Re Smith & Fawcett Ltd* [1942] Ch 304 (CA) at 306; *Hogg v Cramphorn Ltd* [1967] Ch 254 at 268B-E; *Wayde v NSW Rugby League Ltd* [1985] 10 ACLR 87 (HC of A) at 93-4 and 95-6. See also Sealy op cit note 17 at 277; Robert Bax 'Second Guessing Directors' Decisions on Takeovers – A Mixed Message from the New South Wales Court of Appeal' (1990) 8 Company & Securities LJ 26 at 27.

29 Supra note 14 at 832E-F. See also *Wayde v NSW Rugby League* supra note 28 at 93-4; *Harlow's Nominees v Woodside Oil* supra note 13 at 493.

30 Supra note 15 at 247. See also *Harlow's Nominees v Woodside Oil* supra note 13 at 493:

> "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."
DIRECTORS' DUTY TO USE THEIR POWERS

‘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.’

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 articles. Firstly, the Courts will consider the provisions in the articles 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 articles of association. Secondly, if the powers were prima facie exercised within the limits of the powers conferred upon the organs and bona fide and honestly, the courts will not, and in fact cannot, second-guess the wisdom of decisions relating to these powers.

The discussion so far naturally leads to the question whether shareholders, not satisfied with the way in which directors exercised their powers under provisions in the articles, would have any remedies available to them. It is submitted that such remedies are indeed available.31 In this article the focus is primarily on the remedy of challenging the validity of directors’ actions because they have misused their powers, but the possibility of challenging directors’ actions based on non-compliance with statutory provisions or with the provisions of the articles of association is briefly mentioned in the next part.32

5 Remedies for Shareholders

5.1 Non-compliance with Statutory Provisions or the Provisions of the Articles of Association

Under circumstances where there was non-compliance with statutory provisions or non-compliance with provisions of the articles, any member can enforce compliance and restrain the irregular exercise of such powers.33 It should be remembered that the principle that courts cannot interfere with duly exercised internal discretions does not mean that they will not intervene if the procedures laid down in the articles are not followed strictly. It is indeed a general principle of company law that the courts will insist on strict adherence to the requirements laid down in the

31 A detailed analysis of all shareholder remedies falls outside the scope of this article, but see See CG Kilian & J de Plessis 'Possible Remedies for Shareholders When a Company Refuses to Declare Dividends or Declares Inadequate Dividends' 2005 Tydskrif vir die Suid-Afrikaanse Reg (forthcoming) for some of the other remedies available to shareholders.

32 Another important remedy will be the statutory remedy of oppressive or unfairly prejudicial conduct under s 252 of the Companies Act 61 of 1973. The oppressive nature of directors’ decisions have specifically been raised when the directors used their powers for an improper purpose; see in particular Wayde v NSW Rugby League supra note 28 at; and Thomas v HW Thomas Ltd [1984] 2 ACLC 610. See generally Nicolette Rogers 'When Can Target Directors Legitimately Frustrate a Takeover Bid?' (1994) 12 Company & Securities LJ 207 at 214-5.

33 Hoole v Great Western Railroad supra note 28 at 266-9.
articles for the exercise of a particular power.\(^{34}\) This principle will apply to all internal matters such as provisions in the articles dealing with the removal of directors; issuing of shares; and declaring dividends, that are considered to be more than mere procedural issues that could easily be rectified by convening subsequent meetings.\(^{35}\)

The principles involved here could be illustrated by a simple example. Suppose a company's articles contain provisions regarding dividends similar to arts 84-87 of Table A. Under these articles, the board has the power to recommend the amount of dividends (arts 84 and 86 read together). The board also has the exclusive power to set aside, out of profits, such sums as it thinks fit before making the recommendation regarding the amount that will be paid as dividends to the shareholders (art 87). Furthermore, the board has wide powers under art 85 to 'pay' interim dividends. It is, however, the exclusive power of the general meeting under art 84 to declare the dividends, but apparently not interim dividends.

Because of the principles explained above, it is safe to conclude that under normal circumstances the general meeting will have no power to interfere with the board's discretion to set aside certain sums for a reserve or reserves; to recommend or not to recommend an amount to be paid as dividends to the shareholders; or to pay interim dividends. On the other hand, the directors will not be able to force the general meeting to declare the dividends they have recommended as this is an exclusive power of the general meeting.

Conversely, the exercise of these powers would be open for challenge if dividends were, for instance, declared without a recommendation by the directors; if the amount payable as dividends declared by the general meeting exceeds the recommendation by the directors; or if dividends were not paid out of divisible profits. Furthermore, if the articles are clear that the right to dividends will accrue merely upon the establishment of the fact that there are divisible profits, courts will enforce such a right against the company irrespective of the fact that dividends were not declared by the general meeting.\(^{36}\) And, if the articles provide that a dividend must be paid if there is a divisible profit, courts will insist on such payment if there is a divisible profit.\(^{37}\) Both the last two examples clearly illustrate the principle of the supremacy of the articles of association.


\(^{35}\) Regarding the rule of non-interference by the courts on easily ratifiable procedural or technical matters, see MacDougall v Gardiner (1875) 1 ChD 13 (CA) at 24 and 25; and Blackman op cit note 2 in par 38 at 63-4. See, however, HAJ Ford, RP Austin & IM Ramsay Ford's Principles of Corporations Law 11 ed (2003) ('Ford') in par 11.235 at 575 for several exceptions to this rule.

\(^{36}\) Henochsberg op cit note 5 at 1054.

\(^{37}\) Idem at 1056.
5.2 Failure to Exercise Power for Their Proper Purpose

5.2.1 The bona fide and Proper Purpose Doctrines Differentiated

As mentioned above, courts will not second-guess the decisions taken by directors as part of powers conferred upon them by the articles, as long as the powers have prima facie been exercised within the limits of the powers conferred upon the organs, and have been exercised bona fide as well as honestly. When one looks at this statement, it seems as if the only way in which shareholders can challenge the decisions of directors taken under powers conferred upon them by the articles is on the basis that the power was exercised outside the limits of the power conferred upon them, mala fide or dishonestly. However, it is submitted that there is in fact just one consideration, namely whether the power was exercised for a proper or permissible purpose. Mala fides and dishonesty serve only to indicate that the power was not exercised for a proper or permissible purpose. Perhaps the clearest expression of this principle occurs in the case of *The Australian Metropolitan Life Assurance Co Ltd v Ure*:

'[A]lthough it is a power [power to issue shares] which necessarily involves some discretion, it must be exercised, as all such powers must be, bona fide—that is, for the purpose for which it was conferred, not arbitrarily or at the absolute will of the directors, but honestly in the interest of the shareholders as a whole.'

In this sense bona fides is defined in terms of the purpose for which the power was conferred, but the term bona fides could of course be defined in many other ways. However, none of these closer descriptions brings us any nearer to a workable way of determining when the acts of directors should be set aside because they have not acted bona fide. Developments in this area of company law have led to the recognition that there was a shift from a requirement that directors must exercise their powers bona

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38 Naude *op cit* note 6 at 111, under the main heading that directors must exercise their powers bona fide, observes as follows on the concept of 'honesty': 'Sy vertrouensposisie bring mee dat elke direkteur eerlik moet wees in sy optrede as direkteur. Dit is 'n subjektiewe verpligting wat in 'n dikkers ingewikkelde praktiese regswerker nagekom moet word. Hoewel die basiese vraag is of die direkteur inderdaad eerlik was, word eerlikheid gewoonlik aanvaar indien hul optrede die was van eere-like akseptasie' (emphasis in the original). See generally R C Nolan ‘The Proper Purpose Doctrine and Company Directors’ in: Barry AK 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* (1996) at 8. See also Ross W Parsons ‘The Director’s Duty of Good Faith’ (1967) 5 *Melbourne University LR* 395 at 417; and Sealy *op cit* note 17 at 269 regarding the fact that directors must act ‘honestly’.

39 Supra note 28 at 217 (emphasis in the original). Several of the leading English cases were cited as authority for this proposition, including *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656 at 671; *Automatic Self-cleansing Filter Syndicate Co v Cunninghame* [1906] 2 Ch 34 at 45; *British Equitable Co v Bailey* [1906] AC 35 (ChD) at 42. Cf Rogers *op cit* note 32 at 210-1; see also *In re a Company (no 90376 of 1987), Ex parte Glossop* [1988] 1 WLR 1068 (Ch) at 1076B-E; *Rogers op cit* note 32 at 209 and 210. Rogers is faced with the classic dilemma: just when it is thought that the meaning of bona fides is captured (see at 210), its illusory nature becomes apparent and then further qualifications become inevitable (see 210 where she must qualify that the 'acting bona fide also require that ...'). In actual fact any type of consideration that could reflect negatively on directors' intentions, the way in which they have exercised their powers, or the result that was achieved by their actions, could possibly indicate that they have not acted bona
fide to a requirement that they must exercise their powers for proper or permissible purposes. 41

5.2.2 Types of Action Challenged Based on Improper or Impermissible Use of Powers

The classic cases where the courts were prepared to intervene and set aside decisions taken by directors when they exercised a power conferred upon them by the articles for an improper or impermissible purpose, deal with the power of directors to issue shares. 42 Several other decisions of directors were also challenged on this basis. For instance, the decision of directors to pay sums of money to the chairman as presents, relying on the power conferred upon them to manage the company's business and allowing them to borrow money in the name of the company for the purpose of its business (the sums were paid to the chairman from money borrowed in the name of the company). 43 Also, where the directors used company funds to defend their position and to justify why shareholders should not vote for a proposed take-over. 44 Other examples include cases where directors transferred a major asset of a company just after a take-over offer was announced, alleging that they did this as an exercise of their power to manage the business of the corporation; 45 directors incurring substantial debts (purchasing of trading outlets of competing companies) and making a huge rights issue to fund the purchase shortly after a take-over offer of the company was announced, alleging that it was a commercial transaction and a natural expansion of the business of the company; 46 and directors refusing to register a person as a
shareholder, relying on a provision in the articles that they had the power to refuse such registration without giving any reasons for their decision.\(^{47}\)

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 or impermissible purpose.

### 5.2.3 When Will a Court be Prepared to Intervene Based on a Power Exercised for an Improper or Impermissible Purpose?

It will be clear from the discussion above that there is scope for shareholders to challenge the validity of a decision taken by the board under a power conferred upon them by the articles on the basis that the power was exercised for an improper or impermissible purpose. The burden of showing that a power has not been properly exercised, is on the party complaining.\(^{48}\) The reason why courts are prepared to set aside decisions taken by directors if they exercised their powers for an improper or impermissible purpose, is that powers conferred upon directors in the articles of association is considered to be fiduciary powers and if they are exercised for an improper or impermissible purpose, it will constitute a breach of the directors' fiduciary duties.\(^{49}\) However, it is 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 directors if they acted for improper or impermissible purposes. Another interesting question is to what extent the general meeting can ratify the breach of directors' fiduciary duty where they have misused their powers.\(^{50}\) This falls outside the scope of this article.

### 5.2.4 Defences by Directors to Justify their Actions

In a case where the court must consider whether a particular power 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

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\(^{47}\) *Australian Metropolitan Life Assurance v Ure* supra note 28 at 215-6 and 220. See generally Nolan op cit note 38 at 23ff.

\(^{48}\) Idem at 219; *Ngurli Ltd v McCann* supra note 8 at 445. See further cases referred to by Blackman op cit note 2 in par 122 at 187; see also Parsons op cit note 38 at 425.

\(^{49}\) *Ngurli Ltd v McCann* supra note 8 at 439 and 440; *Hogg v Cramphorn* supra note 28 at 268C and 269A; *Howard Smith v Ampol Petroleum* supra note 14 at 834H-C; *Lee Panvision v Lee Lighting* supra note 45 at 29c; *Ex parte Gossop* case supra note 39 at 1076H-1077A; *Kirwan v Cresvale Far East Ltd (In Liq)* (2002) 44 ACSR 21 (CA, NSW) in par 127 at 56 (per Gilies JA). See also Cilliers & Benade op cit note 3 in pars 10.27-10.29 at 146-7; Nolan op cit note 38 at 12-7.

\(^{50}\) See in this regard *Bamford v Bamford* [1970] Ch 212 (CA) and *Hogg v Cramphorn* supra note 28. These cases are considered by KW Wedderburn 'Going the Whole Hogg v Cramphorn?' (1968) 31 Modern LR 688 and by RB (1974) 48 Australian LJ 519. See generally *Hannes v MJH Pty Ltd* (1992) 10 ACLC 400 (CA, NSW) at 406-10; see also Michele Kyra Havenga Fiduciary Duties of Company Directors with Specific Regard to Corporate Opportunities (LLD thesis, University of South Africa (1995)) at 67-8.
the best interest of the company as a whole.51 The courts have invariably rejected such defences in cases where the self-interest of directors was involved.52 In these types of cases, the fact that directors have acted ‘in the best interest of the company as a whole’ has been held to serve no other purpose than restating the general law.53 Another reason why the courts have not simply been prepared to accept directors’ defences that they have acted ‘in the best interest of the company as a whole’, was that in cases where a misuse of powers 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.54 For all these reasons it has been argued with some force that directors’ 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’.55 This distinction is now also clearly recognised in s 181(1) of the Australian Corporations Act, 2001 requiring that ‘[a] director or other officer of a corporation must exercise their powers and discharge their duties: (a) in good faith in the best interest of the corporation; and (b) for a proper purpose.’

5.2.5 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. Thus, it has been

53 As to the meaning of the phrase ‘best interest of the company as a whole’, see Hahlo op cit note 4 at 293. But as Parsons op cit note 38 at 396 points out, ‘the concept remains miserably indeterminate’. It is submitted that it is still the case: see Kirwan v Cresvale Far East supra note 48 in par 127 at 56 (per Giles JA). I would respectfully agree with Young CJ’s observation in Kirwan v Cresvale Far East (in par 292 at 90) that ‘it is of no real use to regurgitate the numerous utterances of past courts on this topic’. See also Ex parte Glossop supra note 39 at 1076G; Sealy op cit note 17 at 269-71.

52 Howard Smith v Ampol Petroleum supra note 14 at 834G; Hogg v Cramphorn supra note 28 at 267A ff; Whitehouse v Carlton Hotel supra note 16 at 718; Southern Resources Ltd v Residues Treatment & Training C Ltd (1990) 8 ACLC 1151 ((SC (SA)) at 1164; Lee Panavision v Lee Lighting supra note 45 at 29d-30h. See also Henschchberg op cit note 5 at 467-8; Steel op cit note 46 at 51. It is submitted that Blackman op cit note 19 at 7 states the principle too wide 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 the discussion below.

51 As the meaning of the phrase ‘best interest of the company as a whole’, see Hahlo op cit note 4 at 293. But as Parsons op cit note 38 at 396 points out, ‘the concept remains miserably indeterminate’. It is submitted that it is still the case: see Kirwan v Cresvale Far East supra note 48 in par 127 at 56 (per Giles JA). I would respectfully agree with Young CJ’s observation in Kirwan v Cresvale Far East (in par 292 at 90) that ‘it is of no real use to regurgitate the numerous utterances of past courts on this topic’. See also Ex parte Glossop supra note 39 at 1076G; Sealy op cit note 17 at 269-71.

54 Howard Smith v Ampol Petroleum supra note 14 at 835D. In Re Halt Garage (1964) Ltd supra note 432 at 1039F (read with 1038b-c), 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’.

55 Mills v Mills supra note 10 at 164 as quoted with approval in Howard Smith v Ampol Petroleum supra note 14 at 835F; and McGuire v Ralph McKay Ltd (1987) 5 ACLC 891 at 894. See also Whitehouse v Carlton Hotel supra note 16 at 718. See generally Henschchberg op cit note 5 at 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) 13 ACLC 242 (HC of A) at 348 as inappropriate ‘[i]n 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’.

56 Sarah Worthington ‘Directors’ Duties, Creditors’s Rights and Shareholder Interventions’ (1991) 18 Melbourne University LJ 121 at 122-3 and 123-4; Nolan op cit note 38 at 3 and 7-13; see also JH Farrar ‘Abuse of Power by Directors’ (1974) 32 Cambridge LJ 221 at 221 and 224; Havenga op cit note 50 at 65; Ranero op cit note 17 at 425 and 427.
necessary for courts to develop rules to enable them to determine, especially in cases where there were permissible and impermissible purposes, whether the actions of the 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 Ltd v Ampol Petroleum Ltd* is a realistic one that should be followed by South African courts. Not only is the case based on sound principle, but it relies on several old English and Australian cases that are consistent with the South African common law in this area. The relevance of the Australian authorities becomes particularly apparent if one looks at the numerous references to Australian cases in this area in some South African texts.

In *Howard Smith Ltd v Ampol Petroleum Ltd* it was pointed out that when the exercise of a power by the directors is challenged on the basis that the power was exercised for an improper or impermissible purpose, the first step is to determine what the purpose was for which the particular power had been conferred upon the directors. This should be determined objectively and by taking into consideration modern conditions regarding the purpose of the particular power. The Court was, however, realistic to appreciate that there may be more than one purpose for which a particular power was conferred upon directors. For instance, the main purpose for a power to issue shares is to raise share capital, but there may also be other purposes. Several other issues could also be taken into consideration in analysing the purpose of a particular power conferred upon the directors, including its functions for the particular company; the size and nature of the company; and its constitution (memorandum and articles) as a whole.

Once the purpose of the power has been determined, the second step will be to determine whether, in the light of the particular facts of the case, the directors misused that power. In this regards the courts have employed the so-called 'substantial or primary purpose' test. The first traces of this test in Australia is to be found in the 1923 decision in *Australian Metropolitan Life Assurance v Ure* where the Court looked at 'the impelling motive' or 'moving cause' when the conduct of directors was challenged based on the fact that they had not acted bona fide.

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56 See *McGuire v Ralph McKay* supra note 54 at 894.
57 See in particular Blackman (in *LAWSA*) op cit note 2 in pars 121-2, 124 and 125.
58 See generally Ford op cit note 35 at 336 para 8.200.
59 *Howard Smith v Ampol Petroleum* supra note 14 at 835G. See also Blackman op cit note 19 at 7.
60 *Howard Smith v Ampol Petroleum* supra note 14 at 835C and 836Aff. See also *Punt v Symons & Co Ltd* [1903] 2 Ch 506 at 515, referred to in *Hogg v Crump horn* supra note 28 at 267D-E; *Kirwan v Cresvale Far East* supra note 48 in pars 123-6 at 51-6 (per Giles JA). See further Ford op cit note 35 in par 8.210 at 337; Steel op cit note 46 at 32; Birds op cit note 41 at 583-4; and Sealy op cit note 17 at 275-6.
61 *See Australian Metropolitan Life Assurance v Ure* supra note 28 at 217. See also Ford op cit note 35 in par 8.210 at 336-7; Worthington op cit note 54 at 124-5.
62 Supra note 28 at 216-7 and 218-9.
few years later, in 1938, the test was refined further in the leading case of *Mills v Mills*:

'The application of the general equitable principle to the acts of directors managing the affairs of a company cannot be as nice as it is in the case of trustees exercising a special power of appointment. It must, as it seems to me, take the substantial object the accomplishment of which formed the real ground of the board's action. If this is within the scope of the power, then the power has been validly exercised. But if, except for some ulterior and illegitimate object, the power would not have been exercised, that which has been attempted as an ostensible exercise of the power will be void, notwithstanding that the directors may incidentally bring about a result which is within the purpose of the power and which they consider desirable.'

In *Howard Smith Ltd v Ampol Petroleum Ltd*, after explaining the fact that a court cannot interfere on the merits of a management decision or act as a kind of supervisory board to judge managerial decisions, Lord Wilberforce explained the test as follows:

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

What this test amounts to is that if the decision was primarily or substantially taken within the purpose for which the power was conferred upon the directors (as determined as part of the first step mentioned above), the court will not set such a decision aside irrespective of the fact that partially or incidentally the power might have been exercised for an improper or impermissible purpose. Conversely, if the decision was primarily or substantially taken for an improper or impermissible purpose, the 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 had 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 the misuse of powers.

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63 Supra note 10 at 185-6.
64 Supra note 14 at 832F-G.
65 In *McGuire v Ralph McKay* supra note 54 at 895, 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]'.
66 See also *McGuire v Ralph McKay* supra note 54 at 893-6 for a comprehensive discussion of the various tests applied by the Australian and English courts in this regard, and *Munie (London) Ltd v Cook & Watts Ltd* (1967) CL Y 481, as referred to in Havenga op cit note 50 at 67n89.
67 See *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (HL) at 391G-H.
5.2.6 Later Developments

The primary or substantial purpose test has been subjected to some further scrutiny in Australia. The question was whether the improper or impermissible purpose should not only be primary or substantial, but whether it should also be the dominant purpose. In Whitehouse v Carlton Hotel, the High Court of Australia explained (obiter) as follows:

'In this court, the predominant view has tended to be that the allotment will be invalidated only if the impermissible purpose or combination of impermissible purposes can be seen to have been dominant – "substantial"...; "the moving cause".... The cases in which that view has been indicated have not, however, required determination of the question whether the impermissible purpose must be the substantial object or moving cause or whether it may suffice to invalidate the allotment that it be one of a number of such objects or causes. As a matter of logic and principle, the preferable view would seem to be that, regardless of whether the impermissible purpose was the dominant one or but one of a number of significantly contributing causes, the allotment will be invalidated if the impermissible purpose was causative in the sense that, but for its presence, "the power would not have been exercised"...'.

In Darvall v North Sydney Brick, Kirby P, in a minority judgment, explained this approach further by mentioning that the primary or substantial purpose test is assisted by 'a rule of thumb', namely that 'it is necessary for the court to determine whether but for the allegedly improper or collateral purpose, the directors would have performed the act which is impugned'.

Two important questions arise from this apparent refinement or narrowing down of the original primary or substantial purpose test. The first is whether the approach adopted in the High Court case of Whitehouse v Carlton Hotel is now law in Australia, and, secondly, how the 'but for' test will contribute in assisting courts to determine whether or not to set the actions of directors aside when there were both permissible and impermissible purposes.

It is submitted that that the primary or substantial purpose test, as developed in the two High Court decisions in Australian Metropolitan Life Assurance v Ure and Mills v Mills, and then articulated in the decision of the Judicial Commission of the Privy Council in Howard Smith v Ampol Petroleum, should still be regarded as the current test in cases where a court must decide whether the actions of the directors should be set aside because they have exercised a particular power for competing permissible and impermissible purposes. There are several reasons for this view.

Firstly, the majority in Whitehouse v Carlton Hotel commented on the test obiter and pertinently recognised this by stating that the case did 'not

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68 Supra note 16 at 721.
69 But indeed a significant minority judgment: see Baxt op cit note 28 at 26.
70 Supra note 15 at 248 (emphasis in the original).
71 See Hahlo op cit note 4 at 292, but note that the part reading 'will be invalidated if the permissible purpose was causative' should read 'will be invalidated if the impermissible purpose was causative'. 
raise any problem of competing permissible and impermissible purposes'. 72 It was for that reason that the majority also conceded that it was 'unnecessary to express a concluded view on the question of precise formulation of the relevant test [in cases] of competing permissible and impermissible purposes'. There can hardly be a clearer indication that the majority did not consider the suggested test as a concluded view or a precise formulation. The case of McGuire v Ralph McKay, where the test in Whitehouse v Carlton Hotel was accepted as a correct statement of law, was not a High Court decision, but one of the Supreme Court of Victoria. 73 Furthermore, it was specifically recognized in McGuire v Ralph McKay that the statement in Whitehouse v Carlton Hotel was only obiter. It is also significant to note that neither Wilson J nor Brennan J who delivered the minority judgments in Whitehouse v Carlton Hotel, made any reference to the ‘but for’ test mentioned obiter by the majority in that case. 74

Secondly, what is really the difference between determining ‘the moving cause’ (a test already adopted in 1938 in Mills v Mills and quoted by the majority in Whitehouse v Carlton Hotel) and determining ‘the substantial object or moving cause’ (emphasis in original case), the test suggested by the majority judgment in Whitehouse v Carlton? It seems as if the majority only adopted the ‘but for’ test when it is required to determine whether the impermissible purpose was ‘the substantial object or moving cause’, but it is difficult to see any difference in determining ‘the moving cause’ or determining ‘the substantial object or moving cause’, apart from the emphasis on ‘the’ that the majority added. It is also noteworthy that the majority in fact imported the condictio sine qua non test (‘but for’ test) to determine causation into this area of the law. Not only is that test renowned for its complexities, but it has been rejected in several other areas of the Australian law as all but the ultimate test to determine causation. 75

Finally, not only did Kirby P 76 assign no greater importance to the

72 Whitehouse v Carlton Hotel supra note 16 at 721.
73 It seems as if the only other case where the so-called ‘but for’ test was applied in this area, is the the single judgment of Wheeler J in the Supreme Court of Western Australia in Emlen Pty Ltd v St Barbara Mines Ltd (1997) 15 ACLC 1107 (SC, WA) at 1112, but without any discussion of the substantial or primary purpose test adopted in other superior courts. In Southern Resources v Residues Treatment supra note 51 at 1165, there was a brief mention of Whitehouse v Carlton Hotel, but the Court found that ‘it was unnecessary to formulate or apply that test [apparently the test in Whitehouse v Carlton Hotel]’.
74 It is no wonder that Sealy op cit note 17 at 276 refers to ‘the High Court’s somewhat surprising obiter dictum in Whitehouse v Carlton that a “single causative” test should replace a “substantial purpose test” . . .’.
76 Kirby P delivered the minority judgment in the case, but as he reached the same conclusion as the majority on this point, namely that the directors did not act for improper purposes, it was thought better not to use the fact that it was a minority judgment as another reason why his comments on the ‘but for’ test should not be given too much weight.
approach in *Whitehouse v Carlton Hotel* than calling it a ‘rule of thumb’, but his reliance on the High Court Decision of *Ngurli Ltd v McCann* for this statement provides no authority for the introduction of the ‘but for’ test in this area of law. In *Ngurli Ltd v McCann*, at the relevant page referred to by Kirby P, there is simply a reference to *Mills v Mills* and the statement in the latter decision that ‘[t]he substantial object the accomplishment of which formed the real ground of the board’s ... action’.  

For all these reasons it would be safe to conclude that the introduction of the ‘but for’ test in this area of law was no more than putting ‘an unnecessary gloss’ on the primary or substantial purpose test developed over many years.

5.2.7 Fundamentally a Value Judgment over an Internal Matter is Required by the Court

In order to make a determination of the 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’. This could be a daunting task as it ‘involves an inquiry into motivations of an almost infinite range of variety’. This is not surprising.

Firstly, it can be immensely difficult to determine the collective purpose of a group such as the directors, especially if individual directors were motivated by diverging considerations in reaching a particular decision. Secondly, how would one expect directors to respond to the fundamental question the court must decide in cases where actions they have already taken, are challenged on the basis that they have used their powers for an improper or impermissible purpose and that they are therefore in breach of their fiduciary duties towards the company? One can hardly expect of them to say, ‘Yes, of course, we are in breach of our fiduciary duties because we have used a particular fiduciary power for an improper or impermissible purpose and for that reason the court should set aside the action(s) we have taken under these powers’.

It is to be expected that directors will do what they did in all the decided cases where their actions have thus far been challenged. They will argue that the court should not interfere with internal management decisions and they will then explain why they thought that the actions they had taken, should not be set aside. In this regard they will use the

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77 *Darvall v North Sydney Brick* supra note 15 at 248.
78 *Ngurli Ltd v McCann* supra note 8 at 445.
79 The phrase is derived from the article by LS Sealy ‘Directors’ Duties – An Unnecessary Gloss’ (1986) 46 Cambridge LJ 175, commenting on a different area of the law.
80 *Hindle v John Cotton Ltd* (1919) 56 SLR 626 at 630-1, as quoted with approval in *Australian Metropolitan Life Assurance v Ure* supra note 28 at 220; and *Howard Smith v Ampol Petroleum* supra note 14 at 835A-B.
81 *Pine Vale Investments v McDonnell & East* supra note 45 at 1303.
82 Ford op cit note 35 in paras 8.230 at 341. See also the decision by the Full Industrial Relations Court of Australia in *Re McIntyre* (1995) 131 ALR 689 at 696-7.
smorgasbord of defences used on so many occasions over many years:
‘the power was conferred upon us by the articles of association and the
court should respect the supremacy of the articles of association’;
‘the power was an exclusive power of the board’; ‘a court should not interfere
with the internal matters of a company’; ‘a court should not second-guess
the decisions of the directors’; ‘the directors are in a better position than
judges to evaluate the best interests of the corporation’; ‘there is no
appeal on merits from management decisions to courts of law’; ‘a court of
law should not assume to act as a kind of supervisory board over
decisions within the powers of management’; ‘the powers were exercised
bona fide in the interest of the company as a whole’; ‘the directors acted
honestly and had no self-interest in the actions they have taken’; ‘there
were more than one purpose why the power was conferred upon the
directors and the directors’ actions could be justified under any one of
these purposes’; ‘the substantial or primary purpose of the actions of the
directors have been proper and within the purpose for which the power
was conferred upon the directors’; or ‘a court can only invalidate actions
of directors if the impermissible purpose was causative in the sense that,
but for its presence, the power would not have been exercised’.

The only cases where courts are able to make decisions reasonably
easily are where directors’ self-interests are blatant or where they
blatantly acted dishonestly. In all the other instances, directors will
exhaust their available defences one by one, probably starting with the
straightforward ones at the beginning of the list (in the previous
paragraph), and moving down that list to the more ingenious ones
articulated over many years. When the more involved defences are raised,
courts are indeed faced with complicated legal principles, obscured by
several cases, and not always easy to reconcile with each other. 83

But, in essence, courts are expected 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 already discovered more than 80 years ago in
Hindle v John Cotton. 84 It is exactly the difficulties involved in making
such value judgments or second-guessing the decisions of directors that
have made courts cautious to enter the arena of internal processes by
directors in the first place. There is probably no better illustration of this
hesitation than the case of Regal (Hastings) Ltd v Gulliver, 85 where Lord
Wright explained as follows:

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83 Saul Fridman ‘An Analysis of the Proper Purpose Rule’ (1998) 10 Bond LR 164 at 165-6 and
172.
84 Supra note 78 at 630-631. See generally Sealy op cit note 17 at 276. Sealy (at 278) 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 op cit note 84 at 166.
85 Supra note 67. It was not a case dealing with the proper or improper exercise of a power, but
probably the most quoted case dealing with directors’ breaches of their fiduciary duty to prevent a
conflict of interest and duty: see generally Parsons op cit note 38 at 397ff.
The court will not inquire whether the other person is damned or has lost a profit which otherwise he would have got. The fact is in itself a fundamental breach of the fiduciary relationship. Nor can the court adequately investigate the matter in most cases. The facts are generally difficult to ascertain or are solely in the knowledge of the person who is charged. They are matters of surmise; they are hypothetical because the inquiry is as to what would have been the position if that party had not acted as he did, or what he might have done if there had not been the temptation to seek his own advantage, if, in short, interest had not conflicted with duty. 86

The complex nature of such value judgments is the reason why courts have been unsuccessful in developing exact guidelines or tests to solve these matters. That is also the reason why they will probably continue grappling to find appropriate measures to form their value judgments. 87 One thing is sure: there is no simple way in which courts will ever be able to decide whether or not directors used their powers for a proper or improper purpose if both permissible and impermissible purposes are present. 88 As Ford puts it,

'[t]here seems to be no escape for the tribunal of fact from the difficult task of deciding whether one of a number of purposes can be taken to have been more important than others in the mind of directors.' 89

6 Conclusion

There is a very unique interaction among internal company law principles such as the supremacy of the articles of association; non-interference by other organs with powers conferred exclusively on a particular organ; non-interference by the courts with internal company decisions; directors' duty to act bona fide and in the best interest of the company as a whole; directors' duty to use powers for their proper or permissible purpose; and the remedies available if directors did not perform their powers for a proper or permissible purpose. They are all recognised in company law, but the friction created by them is not always properly explained or appreciated.

One of the aims of this article was to establish when and why courts will be prepared to set aside decisions by directors if they were taken for an improper or impermissible purpose. It was discovered that the courts will be prepared to set the decisions of directors aside when they have used a particular power substantially or primarily for an improper or

86 Supra note 67 at 392H.
87 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 op cit note 84 at 182.
88 In Pine Vale Investments v McDonnell & East supra note 46, the focus was whether the directors' actions were 'commercially justifiable'. This could be interpreted as another test to determine whether directors acted for a proper or improper purpose. See also Steel op cit note 46 at 36-8; and Ford op cit note 35 in par 8.210 at 339 with reference to the Canadian case of Teck Corp Limited v Millar (1973) 33 DLR (3d) 288 (SC, BC). In the latter case, at 309-17, the existence of directors' duty to exercise their powers for a 'proper purpose' was apparently denied: see Blackman op cit note 19 at 7n38.
89 Ford op cit note 35 in par 8.240 at 344. See also Sealy op cit note 17 at 276.
impermissible purpose. When the exercise of directors' powers is challenged under circumstances where there were both permissible and impermissible purposes for exercising a particular power, there is no escape for the court but to inquire into the complex area of the state of mind of those who acted and the motive on which they acted. This is in actual fact second-guessing the decisions of directors.