

When do directors exceed their duty to exercise power for proper purpose: major new decision

May 2016

Speed Read

A new UK Supreme Court decision – in a corporate raider context - shows that, even when directors act under broadly stated powers in the company's constitution, they can still breach their statutory duties to exercise their powers for proper purpose.

The case is also an illustration of the careful governance balance as between shareholders and directors and how directors must take care before straying into impacting shareholders' rights.

The judgment also touches on the position where directors are driven by multiple purposes, some proper purposes, and some not. In this complex world, that can happen as directors make decisions. In this area, if not as to proper purpose generally in contentious situations, boards should get legal advice.



The Detail

What happened?

In an alleged corporate raider context (that is, where minority shareholders seek to exploit their shareholding to gain effective management and voting control without paying what other shareholders would regard as a proper price), two shareholders had 39% of the shares in listed UK company, JKX Oil & Gas. One of them wrote to JKX calling upon it to convene an EGM, for removal of 2 existing directors, and appointment of 3 new directors. It appears that the directors considered this was part of a corporate raid.

The company's articles (that is, part of the equivalent of the constitution under the NZ Companies Act):

- allowed the company to give notice to shareholders in such circumstances, requiring them to disclose information about the steps being taken; and

- if the information wasn't given, the board, could, among other things, withhold the relevant shareholders' voting rights.

Answers to the notices were given, including a denial that the 2 shareholders were acting in concert.

The board did not accept that they were not acting in concert and therefore did not accept that the notices had been properly answered.

But in reality, the directors "*did not have in mind the protection of the company pending the provision of the information; they had in mind protecting the company, full stop.*" Essentially this was a defensive approach by the board to a perceived corporate raid by the two shareholders. They decided, under the provision noted above, to withhold the voting rights.

Read literally, and applying contract interpretation principles,¹ the directors had unfettered power to do this, as the scope

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of the action they could take was wide, and within the scope set out in the articles. Largely for this and related reasons, the Court of Appeal decided that the directors could act in this way.

Key however, on appeal to the Supreme Court, was the duty in the UK Companies Act 2006 to "only exercise powers for the purposes for which they are conferred."

This encapsulates the law developed by the courts over many years by which directors must act for a proper purpose, as does our New Zealand equivalent in s 133 of our Companies Act under the same body of cases. That NZ section states: "A director must exercise a power for a proper purpose". This is not a rule of contract. It is a rule – now a statutory rule - reflecting the point that directors are fiduciaries

Applying that principle, the directors, while having broad powers within the rules governing them (the articles in the UK; the constitution here), still had to exercise those broad powers for a proper purpose. That is a key conclusion from the Supreme Court decision in the case.²

What is the "proper purpose" in the context of the board's ability to withhold voting rights?

The purpose of the provision allowing the directors to withhold voting rights then becomes important, in assessing whether the directors acted for a proper purpose. The Court said the 3 purposes of the provision all solely related to the non-provision of information. Those purposes were: inducing the shareholder to comply with the disclosure regime; to protect the company and shareholders from having to make decisions in ignorance of relevant information; and as a punitive measure in relation to the non-compliance.

As was said in the leading judgment:

These three purposes are all directly related to the non-provision of information

requisitioned by a disclosure notice. None of them extends to influencing the outcome of resolutions at a general meeting. That may well be a consequence of a restriction notice. But it is no part of its proper purpose. It is not itself a legitimate weapon of defence against a corporate raider, which the board is at liberty to take up independently of its interest in getting the information.

....[T]he imposition of restrictions under [the relevant] article is a serious interference with financial and constitutional rights which exist for the benefit of the shareholder not the company.....One would expect such a draconian power to be circumscribed by something more than the directors' duty to act in the company's interest as they may in good faith perceive it.

The reference to acting in good faith is the UK equivalent of another duty upon directors: the duty to act in good faith in the best interests of the company pursuant to s 131 of the Companies Act (NZ), which generally means in the interests of the shareholders, as we note in our [article](#). Essentially, the directors must comply with that good faith obligation and the proper purpose obligation too.

Constitutional and governance balance between directors and shareholders

The court particularly singled out the importance of the constitutional and governance balance between the shareholders and the directors, and between particular groups of shareholders. Shareholders, absent limited duties such as to minority shareholders, are free to act as they want, rationally or not; as stated in the leading judgment: "shareholders owe no loyalty either to the company or its board". In the governance balance, they should not have their rights to do so, curtailed by decisions by directors. As one of the judgments in the Court of Appeal noted,

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as cited by the leading judgment in the Supreme Court:

The temptation on directors, anxious to protect their company from what they regard as the adverse consequences of a course of action proposed by shareholders, to interfere in that way, whether by the issue of shares to their supporters, or by disenfranchisement of their opponents' shares, may be very hard to resist, unless the consequences of improprieties of that kind are clearly laid down and adhered to by the court.

Specifically as to directors meddling with shareholders' general meetings, the leading Supreme Court judgment noted:

One of the commonest applications of the [proper purpose duty] is to prevent the use of the directors' powers for the purpose of influencing the outcome of a general meeting. This is not only an abuse of a power for a collateral purpose. It also offends the constitutional distribution of powers between the different organs of the company, because it involves the use of the board's powers to control or influence a decision which the company's constitution assigns to the general body of shareholders.

Conclusion on the appeal

As the directors "did not have in mind the protection of the company pending the provision of the information; they had in mind protecting the company, full stop," this was not a proper purpose and therefore the directors' restriction on the 2 shareholders voting was erroneous.

What about where the directors have multiple purposes, some proper and some not?

Directors' decision-making often involves complex and multiple factors and purposes. It's unresolved as to how those situations are sorted out for the future. 2 of the 5 judges said that in most cases, if the *primary or dominant* purpose of the decision was a proper purpose, that would be enough to comply. Broadly, directors need some freedom in which to act pragmatically, where conflicts are sometimes inseparable from the directors' position. At play, among other points, as between the 5 judges were some classic causation questions familiar to litigators (such as "but for" tests etc). For procedural reasons however, this causation issue, and the position where some purposes are proper and some are not, are left to another day.

What is clear is that, where there is complexity and risk in this area of proper purpose, directors should get legal advice.

¹ For example, there was confirmation in the leading judgment in the Supreme Court, that the principles as to implying terms into contracts could apply. Articles (and constitutions in NZ) are contractual documents.

² *Eclairs v JKN Oil & Gas* [2015] UKSC 71

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