

## Evaluating the Relevancy of the Directors' Duty to Exercise Powers for a Proper Purpose: Should Sri Lanka Recognise it in Statutory Form?

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### Abstract

A comparison of the directors' duties in the Companies Act No 07 of 2007 of Sri Lanka (SLCA 2007) with the Companies Acts of the selected comparative jurisdictions, the United Kingdom and New Zealand demonstrates that Sri Lankan statute has recognised the key fiduciary duties of directors in statutory form, similar to these comparative jurisdictions, except for the proper purpose rule that dictates directors must exercise their powers for a proper purpose. In this context, an inevitable question arises, whether the proper purpose rule needs to be statutorily recognised in Sri Lanka as part of a directors' duty, one that is found in similar corporate legislations in other jurisdictions. It is this concern that the article addresses. It critically analyses the scholarly and judicial debate surrounding the duty of directors to exercise powers for a proper purpose. Firstly, this article points out that in many cases, the standard of good faith is applied to ascertain the propriety of purpose. It is argued that in such cases, the duty of proper purpose is adding nothing more to the duty of good faith. Secondly, the article examines the alternative judicial approach of considering the two as separate duties and analyses its weaknesses focusing on the tests employed in such context. Further, the article considers the opinion that strict scrutiny of directors' decision-making through the proper purpose rule reflects the necessity to protect shareholders from abuse of power that existed prior to the introduction of statutory remedies for shareholders' protection. It is demonstrated that the proper purpose rule appears to be redundant in the presence of the cumulative effect of the duty of good faith to act in the best interest of the company, duty to follow legislation and the corporate constitutions and also the discretionary remedies of the court to protect shareholders. This article concludes that recognising the proper purpose rule in statutory form in Sri Lanka is unnecessary and suggests that the suitable standard to apply for keeping the discretionary powers of corporate directors in check is the standard of good faith.

**Keywords:** Directors Duties, Proper Purpose Rule, Good Faith, Shareholders.

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## I. INTRODUCTION

The duty to exercise powers for a proper purpose is a principal standard of loyalty and a duty related to fiduciaries. Its roots can be traced to the old equitable concept known as the “fraud on a power” which denotes that a donee should exercise a power within the scope of, or justified by, the instrument creating the power.<sup>1</sup> This principle was originally applied in the context of trustees’ powers of appointment.<sup>2</sup> However, it was later broadened to be applicable to others holding power such as insurers, mortgagees liquidators and also directors.<sup>3</sup> An improper purpose can be recognised as an extraneous or a collateral purpose other than the purpose for which the power has been given. Where it is alleged that powers have been exercised by directors for an improper purpose, the burden of proving the impropriety is borne by the party alleging the breach of the duty.<sup>4</sup>

The proper purpose rule has been awarded statutory recognition in many jurisdictions like the United Kingdom (the UK) (see Section 171 (1) (b) of the Companies Act 2006 of the United Kingdom (UKCA 2006)) and New Zealand (see Section 133 of the Companies Act of 1993 of New Zealand (NZCA 1993)). Unfortunately, in Sri Lanka this rule has not been statutorily recognised. While the proper purpose rule as established in English common law remains applicable in Sri Lanka,<sup>5</sup> it has been observed that in the absence of an express statutory requirement, judges have been generally reluctant to apply the proper purpose rule when reviewing director’s business decisions.<sup>6</sup>

In Sri Lanka, the directors’ duties were statutorily enacted for the first time in 2007 by the SLCA 2007. However, it is notable that even after more than a decade since its enactment, directors’ duties, in the context of the SLCA 2007, have not been subjected to in-depth scrutiny by scholars or the judiciary of Sri Lanka.<sup>7</sup> Hence, critical research to evaluate the characteristics of the statutory statement of directors’ duties can advance the academic scholarship and lead to a better understanding of this area of Sri Lankan company law. It is further observed that the duty to exercise powers for a proper purpose seems to be the least analysed and the least well understood among the fiduciary duties

<sup>1</sup> *Vatcher v Paull* [1915] AC 372, 378.

<sup>2</sup> *Ibid.*; *Topham v Duke of Portland* (1869) LR 5 Ch App 40, 11 WR 507; *Aleyn v Belchier* (1758) 1 Eden 132, 28 ER 634.

<sup>3</sup> Remus Valsan, “Directors’ powers and the Proper Purpose Rule”, *King’s Law Journal*, 2016, Vol. 27 (2), pp.157-164, p.157.

<sup>4</sup> Shanthy Rachgan, Janine Pascoe and Anil Joshi, *Company Law in Malaysia*, 2nd ed., (LexisNexis, Selangor, 2010), p.362.

<sup>5</sup> As a result of the s.3 of the Civil Law Ordinance No 05 of 1852 of Sri Lanka, English common law is applicable in all commercial matters in the absence of a relevant local enactment.

<sup>6</sup> K. Kanag-Isvaran and Dilshani Wijayawardana, *Company Law*, Unie Arts Pvt Ltd, Colombo 2014, p. 432.

<sup>7</sup> Interview with the President’s Counsel/ Chairman of the Advisory Commission on Company Law responsible for drafting the Companies Act No 07 of 2007 of Sri Lanka and the co-author of the book *Company Law* (Unie Arts Pvt Ltd, Colombo, 2014), Mr. K. Kanag-Isvaran (Personal Interview) on 9 May 2018. Authors’ submission was affirmed by Mr. K-Kanag-Isvaran; Yasoda Wijerathna, *Provisions Relating to Director’s Duties of Good Faith, Care and Skill under the Company Law of Sri Lanka* (LLM Dissertation, University of West London, 2015), 11-12.

of directors in company law in general as well and this topic has been left untouched in corporate law reforms in many countries.<sup>8</sup>

In this context, the article seeks to analyse whether the proper purpose rule should be given statutory recognition as a separate duty of directors in Sri Lanka following jurisdictions like the UK and New Zealand. Further, the critical discussion in this paper is intended to promote the understanding of this much neglected area in company law.

## II. USAGE OF THE PROPER PURPOSE RULE AND THE SURROUNDING UNCERTAINTY

The struggle to obtain control of a company is a sphere where the proper purpose rule has its 'most valuable part to play'.<sup>9</sup> Although this duty is invoked under a large variety of circumstances it has mostly arisen with regard to the exercise of power to issue shares which is vested in the Board of Directors.<sup>10</sup> In most cases issuing shares for purposes such as to raise capital when required,<sup>11</sup> to establish the company's financial stability,<sup>12</sup> to make use of a genuine commercial opportunity<sup>13</sup> or distribute reserves of profit by means of bonus shares<sup>14</sup> are considered issues made for a proper purpose whereas share issues made for diluting the shareholding of a shareholder<sup>15</sup> or to secure the company's control in the hands of certain shareholders<sup>16</sup> are considered as an exercise of power for an improper purpose. However, the basis for determining the propriety of a purpose has not remained the same over the years.

It is observed that the proper purpose rule causes uncertainty and difficulty in its analysis<sup>17</sup> and application. The duty created by this rule is viewed as "the least discussed and least well understood of the fiduciary obligations affecting a director".<sup>18</sup> Statutes that have recognised this rule have not defined 'proper purpose' and it can be assumed that drafters must have intended for the judiciary to seek guidance from case law.<sup>19</sup> Yet, case law has been unclear and has arguably failed to clarify doubts surrounding the duty. In

<sup>8</sup> RC Nolan, "The Proper Purpose Doctrine and Company Directors", *The Realm of Company Law*, Ed., Barry AK Rider, Kluwer Law International, London, 1997, p.1.

<sup>9</sup> *Eclairs Group Limited v JKK Oil & Gas Plc* [2015] UKSC 71, 37.

<sup>10</sup> See section 51 – Companies Act 2007 (Sri Lanka) No 07, section 549 – Companies Act 2006 (UK), Act 777, section 42 – Companies Act 1993 (New Zealand).

<sup>11</sup> *Howard Smith Ltd v Ampol Petroleum Ltd and others* (1974) AC 821.

<sup>12</sup> *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483.

<sup>13</sup> *Pine Vale Investments Ltd v McDonnell and East Ltd* (1983) 1 ACLC 1294; *Winthrop Investments Ltd. v. Winns Ltd* [1975] 2 NSWLR 666.

<sup>14</sup> *Mills v Mills* (1938) 60 CLR 150.

<sup>15</sup> *Kokotovich Constructions Pty Ltd v Wallington* (1995) 17 ACSR 478.

<sup>16</sup> *Supra* n 11, *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285.

<sup>17</sup> Saul Fridman, An analysis of the Proper Purpose Rule, *Bond Law Review*, 1998, Vol. 10(2), pp.163-183, p.164.

<sup>18</sup> RC Nolan, *supra* n8, p1.

<sup>19</sup> For example, the Company Law Review Steering Group (UK) stated that it had not defined the duty under section 171(b), Companies Act 2006 (UK) and had left it for case law development; The United Kingdom, Department of Trade and Industry, March 2000, *Modern Company Law for a Competitive Economy: Developing the Framework (URN 00/656)*, <<http://webarchive.nationalarchives.gov.uk/+http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/clr-review/page25086.html>>, Site accessed on 8 August 2018.

fact, case law creates confusion regarding the basis for the duty<sup>20</sup> and the criteria for holding directors liable for its breach.

In New Zealand's context, referring to Section 133 of the NZCA 1993, Tompkins J commented that:

Of all the enacted directors' duties, this is likely to be the most troublesome. The problem with the provision is its great uncertainty. It appears to be directly contrary to the purpose of the enacted directors' duties, that is, to make it easier for directors to know just what their responsibilities are. A director looking at this provision will be left completely in the dark. Even if he or she consults a lawyer to find out what it means, I doubt that much light will be cast.<sup>21</sup>

### III. GOOD FAITH AND THE PROPER PURPOSE RULE

#### A. *Convergence of the Duty of Good Faith and Proper Purpose*

Analysis of the evolution of common law on directors' duty to exercise power for a proper purpose indicates that judicial opinion on the basis of its application is unsettled. It is the common belief that the objective of the proper purpose rule is to capture cases, notwithstanding the good faith of the directors, where the purpose for exercising power cannot be justified. However, it is observed that, to deal with the difficulties associated with the proper purpose rule, generally the courts, in many instances, have applied the general limitations applicable to fiduciaries; their obligation to exercise power bona fide in the best interest of the company.<sup>22</sup> Many cases like *Punt v Symons & Co Ltd*,<sup>23</sup> *Teck Corp Ltd v Millar*,<sup>24</sup> *Re Olympia and York Enterprises Ltd v Hiram Walker Resources Ltd*,<sup>25</sup> *Residues Treatment & Trading Co. Ltd v Southern Resources Ltd*<sup>26</sup> and *Darvall v North Sydney Brick & Tile Co Ltd*<sup>27</sup> have suggested that directors are considered to have acted for a proper purpose if they have exercised the powers in good faith in what they believed was in the interest of the company. In such cases, where the propriety of purpose is decided applying the standard of good faith, it can plausibly be argued that the duty of proper purpose adds nothing more to the duty of good faith.

King CJ in *Residues Treatment & Trading Co. Ltd v Southern Resources Ltd*,<sup>28</sup> held the view that pursuing the company's interests was the proper purpose of corporate powers:

<sup>20</sup> *Supra* n19.

<sup>21</sup> Justice Tompkins, "The Stace Hammond Grace Lecture in Commercial Law Directing the Directors: The Duties of Directors under the Companies Act 1993", *Waikato Law Review*, 1994, 2 < [https://www.waikato.ac.nz/law/research/waikato\\_law\\_review/pubs/volume\\_2\\_1994/3](https://www.waikato.ac.nz/law/research/waikato_law_review/pubs/volume_2_1994/3) > Site accessed on 4 July 2018.

<sup>22</sup> PD Finn, *Fiduciary Obligations*, Law Book Company, Sydney, 1977, p.39

<sup>23</sup> [1903] 2 Ch 506, 515.

<sup>24</sup> (1972) 33 DLR (3d) 288, 312.

<sup>25</sup> (1986) 59 OR (2d) 257.

<sup>26</sup> (1988) 51 S.A.S.R. 196.

<sup>27</sup> (1989) 16 NSWLR 260.

<sup>28</sup> *Supra* n26.

Directors are in a fiduciary relationship to the company and are therefore under a duty to exercise the powers...conferred upon them...for the purposes for which they are conferred, namely the benefit of the company as a whole.<sup>29</sup>

If purpose of a power is well defined, using that power for another purpose is not proper. However, usually the directors' powers are not clearly and expressly defined in corporate constitutions. Purpose will not necessarily be proper if it solely relates to directors' own interest rather than the company's interest. Such an act will be invalid since it breaches the duty of good faith. In *Punt v Simons*, with regard to issuing shares, Byrne J held that:

A power of the kind exercised by the directors in this case, is one which must be exercised for the benefit of the company: primarily it is given [to] them for the purpose of enabling them to raise capital when required for the purposes of the company...but when I find a limited issue of shares to persons who are obviously meant and intended to secure the necessary statutory majority in a particular interest, I do not think that is a fair and bona fide exercise of the power.<sup>30</sup>

However, the legal position, where the directors have exercised a power motivated by a different purpose than the usual but in good faith for the benefit of the company<sup>31</sup> is unclear and has been subjected to judicial and scholarly controversy. As suggested in *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co N L*<sup>32</sup> as long as the directors have exercised the power with the purpose of benefiting the company, having other practical considerations behind their decisions will not matter. In such instances, the duty to act bona fide in the interest of the company and the duty to exercise powers for a proper purpose become indistinguishable as separate duties.

## **B. *Demerits of Separating the Duties of Good Faith and Proper Purpose***

Despite concerns raised regarding the convergence of the duty to act for a proper purpose and the duty of good faith, some scholars and judges differentiate between the two duties. They opine that even where the directors have acted bona fide in the best interest of the company, they can still be held liable for breaching the proper purpose rule if they have exercised powers motivated by a collateral purpose.<sup>33</sup> However, the authors submit that not applying the standard of good faith when deciding whether directors have complied with the proper purpose rule leads to confusion. The following analysis of key cases, scholarly and judicial opinions seeks to support the authors' submission.

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<sup>29</sup> *Ibid*, p. 198.

<sup>30</sup> *Supra* n23.

<sup>31</sup> For instance, refusing to approve a share transfer believing it to be in good faith and for good reasons that the transferee will harm the company.

<sup>32</sup> *Supra* n12, pp. 492-493.

<sup>33</sup> Shanthi Rachgan.et.al., *supra* n4, p.362.

**(i) *Hogg v Cramphorn Ltd***

Decisions like *Hogg v Cramphorn Ltd*<sup>34</sup> (*Hogg*) differ from the rest of the cases that assume directors to have acted for a proper purpose when they have exercised power in good faith in the best interest of the company. This strand of cases demonstrates that the good faith of directors is irrelevant to the court's decision regarding the propriety of the purpose.<sup>35</sup> *Hogg* took the view that directors may not allot shares for the purpose of defeating an attempt to obtain the company's control even if such act has been done in good faith believing it to be in the best interest of the company. Prior to this case, the duty to act for proper purpose and duty to act bona fide were considered two elements of a single duty and *Hogg* led to the proper purpose rule acquiring the status of a separate duty.<sup>36</sup>

**(ii) *Teck Corporation Ltd v Millar***

Yet, the approach in *Hogg* was rejected in the later Canadian case, *Teck Corporation Ltd v Millar*<sup>37</sup> (*Teck Corporation*) where Berger J stated as follows:

How can it be said that directors have the right to consider the interests of the company, and to exercise their powers accordingly, but that there is an exception when it comes to the power to issue shares, and that in the exercise of such power the directors cannot in any circumstances issue shares to defeat an attempt to gain control of the company? It seems to me that this is what *Hogg v Cramphorn* says. If the general rule is to be infringed here, will it not be infringed elsewhere? If the directors, even when they believe they are serving the best interests of the company, cannot issue shares to defeat an attempt to obtain control, then presumably they cannot exercise any other of their powers to defeat the claims of the majority or, for that matter, to deprive the majority of the advantages of control. I do not think that the power to issue shares can be segregated.

Neither can it be distinguished on the footing that the power to issue shares affects the rights of the shareholders in some way that the exercise of other powers does not. The court's jurisdiction to intervene is founded on the theory that if the directors' purpose is not to serve the interest of the company, but to serve their own interest or that of their friends or of a particular group of shareholders, they can be said to have abused their power. The impropriety lies in the directors' purpose. If their purpose is not to serve the company's interest, then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a collateral purpose; it does not depend upon the nature of any shareholders' rights that may be affected by the exercise of the directors' powers.<sup>38</sup>

<sup>34</sup> [1967] 1 Ch 254.

<sup>35</sup> LSL Joyce, "Making a Case for the Duty to Act for Proper Purpose", *Singapore Journal of Legal Studies* 2014, pp.79-97, p.80.

<sup>36</sup> Ross Grantham, "The Powers of Company Directors and the Proper Purpose Doctrine", *King's College Law Journal*, 1995, Vol.5, pp.16-44, p.20.

<sup>37</sup> *Supra* n24.

<sup>38</sup> *Ibid.*, p. 312.

It appears that Berger J considered the approach in *Hogg* to have been wrongly decided since it contradicted the long established rule in corporate law that the director's discretionary power as properly conferred by a corporate Constitution, in the absence of mala fide, shall not be disturbed.<sup>39</sup> In *Hogg*, the court assumed the existence of a range of purposes for which the power may be exercised. In *Teck Corporation*, Berger J rejected this and held that where there are no limitations in the terms of the power itself, the court is prevented from implying limitations to such powers and the power of management is vested in the Board without any other restrictions except the duty of loyalty and good faith to stop them from using the power for any purpose they saw fit.<sup>40</sup>

In this context, it is noteworthy that Berger J distinguished *Hogg* on the basis that in *Hogg* the purpose was to keep the directors in control whereas in *Teck Corporation* the purpose was rather to prevent the "ultimate deal".<sup>41</sup>

### (iii) *Howard Smith Ltd v Ampol Petroleum Ltd and others*

According to Tompkins J, the leading authority in New Zealand relating to proper purpose rule is the case of *Howard Smith Ltd v Ampol Petroleum Ltd and others*<sup>42</sup> (*Howard Smith*). In this decision two arguments made in previous cases were analysed. One argument was that the power is exercised for a proper purpose if it has been exercised by directors not in their self-interest but in good faith in the interest of the company. If such is established, the court will not interfere to ascertain the validity of the reasons for exercising power. The Judicial Committee of the Privy Council responded to this argument as follows:

It does not follow...that the absence of any element of self-interest is enough to make an issue valid. Self-interest is only one, though no doubt the commonest, instance of improper motive: and before one can say that a fiduciary power has been exercised for the purpose for which it was conferred a wider investigation may have to be made.<sup>43</sup>

It is submitted that the above opinion is merely a comment on the correct approach to ascertain good faith. However, it is not a rejection of the standard that if the directors have acted bona fide in the interest of the company then they have acted for a proper purpose. The merits of approaches to ascertain good faith are beyond the scope this article.

The other main argument was that since the power to issue shares is conferred for raising capital, an issue made for any other purpose would be invalid. The Judicial Committee rejected this stating that it is "too narrow an approach to say that the only valid

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<sup>39</sup> *Re Smith & Fawcett* [1942] Ch 304; Chong Ke, "An attempt to rationalize *Teck Corp's* departure from *Hogg*", The University of British Columbia, <<http://bizorg.allard.ubc.ca/page/5/>> Site accessed on 21 July 2018.

<sup>40</sup> Ross Grantham, n36, p.21.

<sup>41</sup> *Supra* n24, p. 328. *Teck Corporation* involved a dispute between *Teck Ltd* and *Afton Ltd*. A contract had been had prepared between the two companies enabling *Teck Ltd* to exploit certain mining rights owned by *Afton*. This was referred to as an 'ultimate deal'.

<sup>42</sup> *Supra* n11.

<sup>43</sup> *Ibid.*, p. 834.

purpose for which shares may be issued is to raise capital for the company”.<sup>44</sup> However, in this case, the Judicial Committee decided that the directors have exercised the power for an improper purpose because their substantial purpose was “simply and solely to dilute the majority voting power...so as to enable a then minority of shareholders to sell their shares more advantageously”.<sup>45</sup> It was considered impermissible.

It is observed that in *Howard Smith*, the trial judge had taken a more justifiable approach. The decision was reached following an extensive investigation of the directors’ motives. The judge examined directors’ actions, timing, the company’s history and prior practices. This was necessary since the directors claimed that they issued shares motivated by the need to secure finance. It was evident that the company was in need of funds. The trial judge decided against the directors after examining the past records that issuing shares was not the preferred method of that company to secure funds.<sup>46</sup> The investigation demonstrates that the judge sought to find whether the directors had veritably acted in the interest of the company.

#### **(iv) Analysis of the Weightiest Purpose Test Suggested in *Howard Smith***

Lord Wilberforce, in *Howard Smith*, suggested an approach to evaluate the propriety of the purpose. This test has two steps:<sup>47</sup>

1. the court should ascertain, as a question of law, purposes for which the power was conferred; and
2. the court should ascertain, as a matter of fact, the substantial purpose for which the power was exercised in the particular case and decide whether that purpose is within the category of ‘permissible purposes’.

The first step requires the court to ascertain the purposes for which a power has been conferred that led to the identification of the limitations within which that particular power can be exercised. This involves interpretation of the provision/article which confers the power.<sup>48</sup> It should be noted that the Judicial Committee at one point stated that it is a too narrow approach to consider that the only valid purpose for issuing shares is to raise capital.<sup>49</sup> However, the test suggested by Lord Wilberforce and accepted by the Judicial Committee once again makes the assumption of an “imaginary list of purposes” for a power specified in general terms. Hence, the authors submit that their approach is paradoxical. Corporate constitutions generally grant wide authority to directors. In most cases it is impossible to clearly understand the permissible purpose of a power.<sup>50</sup>

Professor Bruce Welling comments on the Judicial Committee’s approach as follows:

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*, p. 837.

<sup>46</sup> *Howard Smith Ltd v Ampol Petroleum* [1972] 2 NSWLR 850, 856 per Street CJ.

<sup>47</sup> *Supra* n11, p. 835.

<sup>48</sup> LSL Joyce, n35, p.81.

<sup>49</sup> *Supra* n11, p.835.

<sup>50</sup> *Howard Smith Ltd v Ampol Petroleum* [1974] UKPC 3, [1974] 1 All ER 1126, p.1134.



The test used by the Judicial Committee was not the same as that of Berger J ... their approach to the problem was backwards. They said that the directors' motives could not be related to any purpose for which the power over the share capital was conferred upon them. This indicates that they were falling into the old trap of assuming that there was a specified list of purposes, unmentioned in the corporate constitution, for which the share-issue power was given. The *Teck* case was decided on a simpler proposition: where the statute and the corporate constitution are silent as to purpose, no purpose (other than the general overriding equitable requirement of pursuing the corporation's best interests) is imposed on the directors.

In effect, the Judicial Committee found that none of the directors' purposes could be found on their imaginary list of proper purposes. This is understandable, as there was no such list in existence. Had they approached the question from a more basic point of view – had they simply asked whether it was proved that the directors had done anything improper – the decision may or may not have been the same, but the reasoning would have been impeccable.<sup>51</sup>

In the second step of this test, the substantial purpose was equated with the weightiest purpose, in this instance, the purpose which the directors felt most strongly about. Further, Lord Wilberforce in *Howard Smith*, regarding the analysis of the substantial purpose, continued that:

...In doing so it will necessarily give credit to the bona fide opinion of the directors, if such is found to exist, and will respect their judgment as to matters of management; having done this, the ultimate conclusion has to be as to the side of a fairly broad line on which the case falls.<sup>52</sup>

This approach was considered correct by the Judicial Committee. Justice Tompkins points out that Lord Wilberforce's approach is somewhat self-contradictory<sup>53</sup> as earlier in the judgment, Lord Wilberforce had rejected the test that an exercise of the power is proper if it is done bona fide in the interests of the company.<sup>54</sup> With reference to ascertaining whether the purpose was proper, Lord Wilberforce further stated:

It must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. To do so is to interfere with that element of the company's constitution which is separate from and set against their powers.<sup>55</sup>

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<sup>51</sup> Bruce Welling, *Corporate Law in Canada: The Governing Principles*, Butterworth, Toronto, 1992, pp.352-353.

<sup>52</sup> *Supra* n11, p. 835.

<sup>53</sup> *Supra* n21.

<sup>54</sup> *Ibid.*

<sup>55</sup> *Supra* n11, p. 837.

Suggesting a new test in *Howard Smith* reflects Lord Wilberforce's intention to adopt a different approach from the cases where the standard of good faith is applied to determine the propriety of the purpose. However, it is noteworthy that his Lordship's position as demonstrated by the above statement does not essentially contradict the approach that the directors must exercise the powers in good faith in the interest of the company.<sup>56</sup> What his Lordship presents as an improper purpose is not a power exercised in the interest of the company but for some other purpose. Further, his Lordship referred to the judgment of Berger J in *Teck Corporation* (which confirms that a power if exercised bona fide in the interest of the company is exercised for a proper purpose) and observed that it was in line with the English and Australian authorities.<sup>57</sup> At this point, it is important to refer to Justice Berger's comment in *Teck Corporation* that:

[T]heir [sc. the directors'] purpose was to obtain the best agreement they could while...still in control. Their purpose was in that sense to defeat Teck. But, not to defeat Teck's attempt to obtain control, rather it was to foreclose Teck's opportunity of obtaining of itself the ultimate deal. That was...no improper purpose.<sup>58</sup>

In the context of the above discussion, the authors submit that the two steps test, which is the test currently in use, cannot be considered appropriate due to the reasons summarised below:

1. the first step of the test requires the production of an imaginary list of purposes of directorial power granted in general terms without express limitations;
2. determining the weightiest purpose, as required by the second step of the test, involves a subjective evaluation and a forensic inquiry into the relative intensity of directors' feelings on different considerations that had influenced them. In the presence of multiple purposes even the decision maker might not be able to understand what had been more influential in his mind.<sup>59</sup> Hence, the uncertainty and the confusion this test creates for directors outbalances the flexibility it affords to courts;<sup>60</sup>
3. weighing the heaviest in directors' minds permits the court to make a value judgment. It encourages second guessing the directors' decisions<sup>61</sup> and hence undermines the business judgment rule.<sup>62</sup> Second guessing what is in the best interest of the company, is something that the courts have admitted that they are unprepared to do;<sup>63</sup> and

<sup>56</sup> *Supra* n21.

<sup>57</sup> *Ibid.*

<sup>58</sup> *Supra* n24, p. 328.

<sup>59</sup> Remus Valsan, *supra* n3, p.163.

<sup>60</sup> JH Farrar, "Abuse of Power by Directors", *The Cambridge Law Journal*, 1974, Vol.33, pp. 221-225, p.223.

<sup>61</sup> JU Plessis, "Directors' Duty to Use Their Powers for Proper or Permissible Purposes", *South African Mercantile Law Journal*, 2004, Vol.16(3), pp.308-328, p.308; LS Sealy, "Bona Fides" and "Proper Purposes" in Corporate Decisions", *Monash University Law Review*, 1989, Vol.15, pp. 265-278, pp.276-77; Remus Valsan *supra* n3, p.158.

<sup>62</sup> JU Plessis, *supra* n61, p.308; LS Sealy, *supra* n61, p.274; Remus Valsan, *supra* n3, p.158.

<sup>63</sup> Saul Fridman, *supra* n17, p.178.

4. as depicted by Lord Wilberforce's statements,<sup>64</sup> this test ultimately attempts to find nothing but whether the directors' have acted in good faith in the best interest of the company.<sup>65</sup>

**(v) *Eclairs Group Ltd and Glengary Overseas Ltd v JKX Oil and Gas plc***

The most recent authority regarding the proper purpose rule is *Eclairs Group Ltd and Glengary Overseas Ltd v JKX Oil and Gas plc (Eclairs)*.<sup>66</sup> There, the court adopted the debatable approach that acting in good faith in the interest of the company is not the only criterion to ascertain the propriety of purpose, but an additional test.<sup>67</sup>

In *Eclairs*, two minority shareholders, of JKX Oil and Gas Plc (JKX) were issued restriction notices suspending them from voting. This was done in accordance with Article 42 of the JKX's articles of association. It is modeled on Section 793 of the UKCA 2006 and authorises the board to request information from shareholders of any voting arrangements affecting company shares and to issue restriction notices suspending shareholders from voting if the board have reasonable grounds for believing the replies are inaccurate. The two minority shareholders applied to the court claiming that the board acted for an improper purpose when issuing the restriction notices.

The case was decided in favour of the shareholders in the trial court by Mann J. The learned judge commented that the purpose of the Article 42 was to ensure that proper information would be provided in response to notices. Further, the judge observed that the predominant purpose for issuing restriction notices by JKX was to prevent the shareholders from voting at the AGM to ensure that the resolution would be passed.

However, the Court of Appeal reverted to Mann J's judgment and the shareholders made an appeal to the Supreme Court. The Supreme Court upheld the trial judgment and allowed the appeal. Lord Sumption listed down three purposes of Article 42 according to the Lordship's own view.<sup>68</sup> Further, the Supreme Court stated that the duty to exercise powers for a proper purpose imposes different responsibilities from the duty to act in good faith in the interest of the company.<sup>69</sup>

**(vi) The Causative Test**

In *Eclairs*, it was suggested in *obiter* that a test of causation (but-for test) may be the better limiting factor for the proper purpose rule. Accordingly, the question asked was whether the same decision would have been made without the influence of any improper purpose,

<sup>64</sup> *Supra* n11, p. 835.

<sup>65</sup> Lord Wilberforce cited Lord Finlay in *Hindle v John Cotton Ltd* (1919) 56 ScLR 626, p. 630-631, where the latter recognised that exercise of power would be valid if the directors have acted bona fide in the interests of the company; Tompkins J, *supra* n21

<sup>66</sup> *Supra* n9.

<sup>67</sup> *Ibid.*, p.16; Hans Tijo, "The Proper Purpose Rule", *Lloyd's Maritime and Commercial Law Quarterly*, 2016, pp.176-185, p.179.

<sup>68</sup> *Supra* n9, p.32.

<sup>69</sup> RT Langford and IM Ramsay, "The Proper Purpose Rule as a Constraint on Directors' Autonomy – *Eclairs Group Limited v JKX Oil & Gas Plc*", *Modern Law Review*, 2017, Vol.80(1), pp. 110-120, p.110.

be it predominant or ancillary.<sup>70</sup> Hence, under this test, the court would allow a decision to remain valid if it decides that directors would have adopted the same decision if they had focused appropriately on the permissible purpose. However, it is humbly submitted that this test has a number of problems.

Firstly, the causative test, similar to the first step of the test established in *Howard Smith*, also requires deciding permissible purposes of a power. In *Eclairs*, the shareholders did not argue that the directors have exceeded their powers or have breached the duty of good faith. Instead the issue was that the powers were exercised for an improper reason.<sup>71</sup> However, Article 42 JKK's articles of association or Section 793 of the UKCA 2006 have no express limitations. It is submitted that where directors have exercised a power within the scope (complying with the Act and the Articles) in good faith in the interest of the company, it is unreasonable to hold them liable claiming that they have been motivated by a purpose that the court guesses to be impermissible. Simply put, the only limitation on the power should be exercising powers in good faith in the interest of the company.

In this context, it is useful to consider the approach in *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL*,<sup>72</sup> where the Supreme Court of Australia dealt with a share issue to prevent an attempt to secure the control of a company. In that case, the court commented:

To lay down narrow lines within which the concept of a company's interests must necessarily fall would be a serious mistake... The principle is that although primarily the power is given to enable capital to be raised... there may be occasions when the directors may fairly and properly issue shares for other reasons, so long as those reasons relate to a purpose of benefiting the company as a whole, as distinguished from a purpose, for example, of maintaining control of the company in the hands of the directors themselves or their friends.

Directors in whom are vested the right and the 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.<sup>73</sup>

As commented by the scholar Saul Fridman, the above opinion demonstrates that the courts deciding what amounts to 'proper purpose' is inappropriate.<sup>74</sup> Instead in this case, the court suggested a negative test through which the exercise of power outside the company's best interest can be invalidated.

Further, it is submitted that the approach of imagining and second guessing purposes that are not expressed in a statute or a corporate Constitution makes the law uncertain.

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<sup>70</sup> *Supra* n67, p. 173.

<sup>71</sup> *Supra* n9, p.15.

<sup>72</sup> See n32

<sup>73</sup> *Supra* n12, pp. 492-493.

<sup>74</sup> Fridman, n17, p.171.

Hence, it has been criticised by scholars and legal practitioners.<sup>75</sup> Inferring the purpose of a power with no express limitations is inherently and conceptually difficult.<sup>76</sup> If the court applies the proper purpose rule and invalidate a decision made by directors where they have exercised powers within the scope, in good faith in the best interest of the company, it would add uncertainty to commercial affairs.<sup>77</sup>

Secondly, under the causative test, the question: what is the standard that directors have to reach to show that they would have arrived at the same decision even if they had no improper purpose in mind, is difficult to determine. It is uncertain whether a probability is adequate or would the test be whether their decision would inevitably have been the same.<sup>78</sup>

Thirdly, under the causative test, where there are multiple purposes (both proper and improper), the decision will not be invalidated if there were proper reasons for exercising the power and it would still have been exercised for those reasons even in the absence of improper ones. As pointed out by Lord Mance (with whom Lord Neuburger also agreed), this position is in conflict with Section 171(b) of the UKCA 2006 which provides that directors should exercise power “only” for the purpose for which they were conferred.<sup>79</sup> His Lordship stated that on the face of Section 171(b), it is clear that all purposes in mind must be legitimate.<sup>80</sup> While referring to contrary opinion on this point, Lord Mance raised concerns regarding the scope of the duty under Section 171(b).<sup>81</sup>

Finally it is noteworthy that Lord Mance in *Eclairs* disagreed that the causative test has practical advantages over the current test in force, that is: the weightiest purpose approach.<sup>82</sup> At this juncture, the authors emphasise that the two tests have no drastic difference. As commented by Dr. Langford and Prof. Ramsay:

[T]he difference between the ‘but for’ test and the substantial purpose test is more pronounced than real, given that even under the ‘but for’ test the improper purpose must be a significantly contributing cause.<sup>83</sup>

Further, Dr. Valsan, while stating that these two tests can lead to different results, admits that:

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<sup>75</sup> *Ibid*; Farrar, n60; G. Milner-Moore and A. Cooke, “*Supreme Court Confirms that Company Directors’ Powers must be Exercised for a Proper Purpose*”, Herbert Smith Freehills Litigation Notes, <<https://hsfnotes.com/litigation/2015/12/08/supreme-court-confirms-that-company-directors-powers-must-be-exercised-for-a-proper-purpose/>> Site accessed on 27 July 2018.

<sup>76</sup> G. Milner-Moore and A. Cooke, n75.

<sup>77</sup> *Ibid*.

<sup>78</sup> See, n9, 55 Per Lord Mance.

<sup>79</sup> Michael Howlin, “Directors’ Duties”, *Terra Firma Chambers*, <<http://www.terrafirmachambers.com/articles/DirectorsDuties.pdf>> Site accessed on 01 July 2018.

<sup>80</sup> *Supra* n9, p.52.

<sup>81</sup> *Ibid*.

<sup>82</sup> *Ibid*. at p.53.

<sup>83</sup> RT Langford and IM Ramsay, n69, p.119.

For the most part, the distinction between the weightiest and the causative tests for determining the principal purpose of the exercise of a power may be irrelevant. The weightiest purpose will usually be causative as well.<sup>84</sup>

It is noteworthy that Lord Sumption himself has accepted that in ordinary inference the ‘weightiest purpose’ will also have been causative:

The ordinary inference is that the ‘weightiest’ purpose (in this sense) will also have been causative, and that minor purposes will not have been. In most cases the two tests will in practice lead to the same result.<sup>85</sup>

It is submitted that, as reflected by the dissenting opinion of the Supreme Court itself, the approach to causation is unsettled.<sup>86</sup>

### (vii) The Decision of Court Appeal in *Eclairs*

The Court of Appeal decision in *Eclairs* has an intellectual value.<sup>87</sup> Overturning the High Court’s judgment, the Court of Appeal pointed out that the proper purpose rule served no significant purpose in the context of *Eclairs*, based on three reasons. One of the three reasons will be discussed in this article.

One reason submitted by the majority was that Article 42 or Section 793 of the UKCA 2006 have no express or implied limitations on how the power under those provisions should be exercised and hence the directors can exercise power for any purpose including the purpose recognised by Mann J. as the predominant purpose (prevent voting at the AGM). It was emphasised that there was no room to imply such a purpose, since in the nature of things the statutory disclosure procedure tends to operate mostly at a time of controversy in a company’s affairs.<sup>88</sup>

Some commentators consider the Court of Appeal’s approach to reflect the view that directors are both the decision makers and the protectors of a company and in playing that role they ought not to be fettered by an inquiry into their motives when they issue a restriction notice.<sup>89</sup> The authors submit that this approach makes more sense in the context of corporate management and the business judgment rule.

<sup>84</sup> *Ibid.*, p.163.

<sup>85</sup> *Supra* n9, 19. *Eclairs Group Limited v JKX Oil & Gas Plc* [2015] UKSC 71

<sup>86</sup> RT Langford and IM Ramsay, *supra* n69, p.120.

<sup>87</sup> Valsan, *supra* n3, p.161.

<sup>88</sup> *JKX Oil & Gas plc v Eclairs Group Ltd* [2014] EWCA Civ 640 (JKX Oil), 143; “*JKX Oil and Gas Plc and Others v Eclairs Group Ltd: CA 13 MAY 2014*”, *Swarb.Co.Uk*, <<http://swarb.co.uk/jkx-oil-and-gas-plc-and-others-v-eclairs-group-ltd-ca-13-may-2014/>>, Site accessed on 27 June 2018.

<sup>89</sup> RT Langford and IM Ramsay, *supra* n69, p.116.

### (viii) The Business Judgment Rule and the Judicial Approach in *Eclairs*

In *Eclairs*, the directors issued the restriction notices on the basis that the shareholders' responses were incomplete and inadequate.<sup>90</sup> However, the Supreme Court invalidated that decision by ruling that directors were primarily motivated by an improper purpose. This approach in *Eclairs* appears to have restricted the freedom of directors to make business judgment by substituting it with the court's own judgment.

The business judgment rule intends to prevent the courts from questioning the merits of a business decision taken by directors following a reasonable inquiry with bona fide intent, without personal interest and with reasonable belief that they are acting for the benefit of the company.<sup>91</sup> However, under the proper purpose rule, the court proceeds to decide a list of permissible purposes of powers conferred on directors. In cases where the duty of good faith and the proper purpose have been distinguished, the reasonable belief of directors that they acted in good faith in the company's best interest is inadequate to satisfy the court as long as the powers have not been exercised for one of the purposes in the list of purposes decided by courts.

Differentiating the judicial approach of the duty to act for a proper purpose with the duty of good faith, Professor Sealy states that:

...[T]he modern emphasis on "proper purposes" has let in criteria which give judges of an interventionist inclination far greater scope to go into the evidence, to assess matters objectively, and in effect to impose their own views. ... When the emphasis was on bona fides, and the onus of proof of want of it was on the plaintiff, and a judicial attitude of laissez-faire prevailed....<sup>92</sup>

Further, at this point, it is important to consider Berger J's opinion in *Teck Corporation* (made in the context of a takeover bid) which emphasised the significance of leaving room to make business judgment without heavily restricting directors' autonomy in decision making:

I think that directors are entitled to consider the reputation, experience and policies of anyone seeking to take over the company. If they decide, on reasonable grounds, that a takeover will cause substantial damage to the company's interests, they are entitled to use their powers to protect the company. That is the test that ought to be applied in this case.<sup>93</sup>

In issuing shares, which is the most common scenario leading to the application of the proper purpose rule, the general purpose is to raise capital. However, if directors use their power to issue shares to protect the company from a hostile takeover, motivated by their *bona fide* intention to serve the best interest of the company, their decision should

<sup>90</sup> "JKX OIL & GAS PLC ('JKX' or the 'Company')", *JKX*, <<http://www.jkx.co.uk/~media/Files/J/JKX/press-release/2013/AGM-Update-31-05.pdf>> Site accessed on 21 July 2018.

<sup>91</sup> Shanthi Rachgan, et.al., n4, p.400.

<sup>92</sup> LS Sealy, *supra* n61, p.278.

<sup>93</sup> *Supra* n24, 317.

not be invalidated. It should be borne in mind that directors, in their fiduciary capacity, are required to apply business judgment in complicated and rapidly changing business contexts. Their decisions are usually motivated by many different objectives with complex effects, proximate and remote.<sup>94</sup>

In this context, the authors submit that the proper purpose rule, when considered separate from the duty of good faith, undermines the business judgment rule.<sup>95</sup> Reflecting on the discussion on the decision in *Eclairs*, it can be stated that the Supreme Court's approach and the proposed causative test in *Eclairs* is unsuitable since it leads to uncertainty and ambiguity of law while inappropriately and heavily restricting the directors' discretion to make business decisions.

### C. *Determining the Purpose of Directors' Powers*

One of the main causes for the uncertainty surrounding the proper purpose rule is the difficulty the related tests create by requiring the determination of the permissible purpose of a power. This difficulty arises mainly due to the nature of the sources that grant powers to corporate directors (relevant legislation and company's constitution).

The duty to act for a proper purpose has its origin in equity and was originally applied to trustees.<sup>96</sup> However, it is noteworthy that corporate constitutions, the main source of the power of directors, is different from a trust deed. A trustee is granted powers by an instrument of trust and its drafters are free to specify any limitations to the powers. Even in the case of a trust deed, where there are no express limitations, determining the proper purpose of powers is difficult.<sup>97</sup> However, Fridman emphasises that inferring the purpose of a power in a trust deed is relatively easier when compared to a corporate constitution.<sup>98</sup> In *Mills v Mills*,<sup>99</sup> Dixon J. commented that "the application of the general equitable principles to the acts of directors managing the affairs of a company cannot be as nice as it is in the case of a trustee exercising a special power of appointment"<sup>100</sup> and as emphasised by Professor Farrar this difficulty arises because 'it is necessarily different'.<sup>101</sup>

Usually, in corporate constitutions and in legislation, the managerial powers are laid down in general, and without express limitations in broader terms. For instance, Section 51 (1) of the SLCA 2007 provides that subject to the company's articles and Sections 52 and 53 (which specify, respectively, the requirements regarding the consideration for issuing shares and pre-emptive rights to new issues), "the board of a company may issue such shares to such persons as it considers appropriate".

<sup>94</sup> Remus Valsan, *supra* n4, p.157.

<sup>95</sup> Interview with Mr. K.Kanag-Isvaran, *supra* n7. Authors' submission was affirmed by Mr. K-Kanag-Isvaran.

<sup>96</sup> Saleem Sheik, "Directors' Duties: Scope of the Proper Purpose Doctrine", Bloomsbury LawOnline, <http://www.bloomsburylawonline.com/2015/12/10/directors-duties-scope-of-the-proper-purpose-doctrine/> Site accessed on 21 July 2018.

<sup>97</sup> Finn P, *Fiduciary Obligations*, (Sydney: Law Book Company, 1977), p.39.

<sup>98</sup> Saul Fridman, n17, p.168. Also see *Cowan v Scargill* [1985] Ch 270, 279.

<sup>99</sup> *Supra* n14.

<sup>100</sup> *Ibid.* at pp. 185-6.

<sup>101</sup> Farrar, *supra* n60, p.222.



Against this backdrop, determining whether directors have breached the proper purpose rule becomes problematic. Further, the trend of abolishing the mandatory requirement for companies to specify objects in constitutions makes this more difficult.<sup>102</sup> When deciding the purpose of a power, the judiciary could take some guidance by referring to the objects of a company. However, in the absence of a mandatory requirement to state objects, the judiciary's search for corporate constitutions (as an interpretative aid) to find a company's objects is not likely to be helpful.<sup>103</sup>

As mentioned earlier, in corporate law the instances where the permissible or impermissible purpose or purposes of a power conferred are clearly spelt out tend to be the exception rather than the rule.<sup>104</sup> Where there are no express limitations, it is a too narrow approach to infer that power conferred by articles can be exercised for one or several particular purposes.<sup>105</sup> Further, it is submitted that courts are ill-equipped, in corporate context, to decide the purposes for which a power is given in the absence of express limitations to such power.<sup>106</sup> It encourages looking behind a purpose other than what is recorded in board minutes. Therefore, in the authors' opinion, the only restriction appropriate is that a power should not be exercised solely to promote one's self-interest and not for the benefit of the company.

Further, even if a court's ability to determine the purpose of a power is accepted, another difficulty arises when deciding whether directors have acted for a purpose contemplated to be 'proper' by the court. Usually directorial decisions are driven by multiple purposes with different degree of effects at different stages, some improper and some proper. According to the two steps test that is currently in force, where there are mixed purposes, an evaluation of the weightiest purpose is required. The other test, the causative test suggested in *Eclairs*, considers the primary purpose to be the purpose with the greatest causative effect.<sup>107</sup> Whether the directors' decisions will be valid will depend on the test employed by the court. However, the danger is that these tests are not yet clearly established and are subjected to longstanding heavy controversy.<sup>108</sup>

Directors' duties are set out in statutes to make the law clear and unambiguous to the directors and the public alike. The authors submit that the above-discussed uncertainties linked to the proper purpose rule undermine these objectives.

## VII. REDUNDANCY OF THE PROPER PURPOSE RULE

### A. *Protection of Shareholders*

The strict scrutiny of directors decision-making through the proper purpose rule reflects the necessity inspired by equity to protect shareholders from abuse of power that existed

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<sup>102</sup> For instance, see section 13 of the Companies Act 2007 (Sri Lanka) No 07.

<sup>103</sup> Saul Fridman, *supra* n17, pp.169-170; LS Sealy, n61, p.274.

<sup>104</sup> LSL Joyce, *supra* n35, p.81.

<sup>105</sup> *Supra* n11, p.835.

<sup>106</sup> Saul Fridman, *supra* n17, p.182.

<sup>107</sup> Hans Tijo, *supra* n67, p.7.

<sup>108</sup> Remus Valsan, n3, p.157; RT Langford and IM Ramsay, n69, p.120.

prior to the introduction of statutory remedies for shareholder's protection. This necessity was clearly reflected in *Piercy v S Mills & Co Ltd*<sup>109</sup> that was decided at a time prior to the introduction of the more direct statutory remedy for shareholder's protection, the remedy of oppression, into English company law.<sup>110</sup>

[D]irectors are not entitled to use their powers of issuing shares merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders.....<sup>111</sup>

It is recognised that the proper purpose rule had been useful when there were no discretionary remedies in statutory form that permit courts to intervene when internal problems occur in companies, particularly to protect shareholders.<sup>112</sup> However, now the judiciary has much more direct and broader ways of intervention. Hence, resorting to the proper purpose rule, regardless of the problems surrounding it, cannot be justified in the same way as before. Currently, all modern corporate legislation encapsulates direct and clear remedies for shareholder's protection. For instance, the SLCA 2007 clearly specifies shareholders' rights<sup>113</sup> and includes many measures to protect their interests<sup>114</sup> such as the statutory derivative action<sup>115</sup>, remedies to prevent oppression and mismanagement<sup>116</sup>, minority buy-out rights,<sup>117</sup> restraining orders,<sup>118</sup> and others.<sup>119</sup>

In New Zealand's context when drafting the NZCA of 1993, the Law Commission acknowledged that in the presence of unrecognised limitations to the powers of companies and directors, the proper purpose rule involves serious incertitude.<sup>120</sup> It suggested that if chief problematic aspects of company law such as minority shareholder remedies and restrictions of share issues could be directly addressed by the NZCA 1993, then common law rules such as the proper purpose concept that had been established to ward off clear injustices can be safely set aside. Further, it was recognised that "[t]he use of the concept to prevent disruption of existing constitutional balances...would be overtaken by the

<sup>109</sup> [1920] 1 Ch 77.

<sup>110</sup> Saul Fridman, *supra* n17, p.172.

<sup>111</sup> *Supra* n108, 84-5.

<sup>112</sup> Saul Fridman, *supra* n17, p.166.

<sup>113</sup> Part V (Shareholders and their Rights and Obligations) of the Companies Act 2007 (Sri Lanka) No 07.

<sup>114</sup> "New Sri Lanka Company Law Seen Safeguarding Shareholders, Boosting Market", Lanka Business Online, <<http://ftp.lankabusinessonline.com/news/new-sri-lanka-company-law-seen-safeguarding-shareholders-boosting-market/282396397>>, Site accessed on 22 July 2018.

<sup>115</sup> Sections 234-237 of the Companies Act 2007 (Sri Lanka) No 07.

<sup>116</sup> Sections 224 and 225 of the Companies Act 2007 (Sri Lanka) No 07.

<sup>117</sup> Sections 93-98 of the Companies Act 2007 (Sri Lanka) No 07.

<sup>118</sup> Section 233 of the Companies Act 2007 (Sri Lanka) No 07.

<sup>119</sup> Also see section 425 (Protection of interests of creditors and shareholders) of the Companies Act 2007 (Sri Lanka) No 07.

<sup>120</sup> Law Commission of New Zealand, September 1990, *Report No 16 : Company Law Reform: Transition and Revision*, <<http://www.lawcom.govt.nz/sites/default/files/projectAvailableFormats/NZLC%20R16.pdf>>, Site accessed on 22 July 2018, p.14-15.

Commission's draft dealing with class rights and minority remedies".<sup>121</sup> However, it is noteworthy that even though due to this reasoning the rule was excluded from the Draft Bill prepared by the Law Commission, it was included in the Bill introduced to the parliament by the Law Reform Division. Hence, the rule was codified without any explanation as to what it was intended to achieve.<sup>122</sup>

Ultimately, the debate about the proper purpose rule seems like a debate on directors' role in managing companies. Some legal scholars comment that in the presence of strong measures for shareholder's protection, it is not justifiable to expect directors to satisfy shareholders as groups or individuals when making business judgments, besides expecting them to act for the benefit of the company while protecting the interests of the shareholders as a whole.<sup>123</sup> In fact, what shareholders consider as the intended purpose of a particular power is irrelevant to the test of whether directors have acted for a proper purpose.<sup>124</sup>

Against this backdrop, the authors support the view that it is unnecessary to overburden directors through reviewing and overturning decisions taken in good faith within the scope by applying the proper purpose rule, particularly when more direct methods of judicial intervention to protect shareholders' interests are available.<sup>125</sup>

## **B. The Duty of Good Faith**

In analysing the redundancy of the proper purpose rule, the main concern relates to its potential overlap with the duty of good faith. Jurisprudence demonstrates that in applying the rule, the courts have ultimately asked whether directors have acted in good faith and hence it had added nothing more to the duty of good faith.<sup>126</sup> Weaknesses of the approach to consider the two duties as separate have been discussed earlier in this article. Commentators have emphasised that when the propriety of a director's purpose is challenged, if he can overcome it by establishing that he acted in good faith in what he believed to be the best interests of the company (as in Canada), then the statutory duty to act for a proper purpose will appear to be redundant.<sup>127</sup>

In this context, it is noteworthy that the duty of good faith, although expressed with a subjective standard, does not offer unnecessary flexibility. Firstly, in exercising good faith, statutes like the UKCA 2006 require directors to take several considerations into account.<sup>128</sup> Secondly, as established by case law, the statutory duty of subjective good faith is not considered to be complied with, if no reasonable director would have reached a similar decision. This is known as the 'amiable lunatic' test.<sup>129</sup> Courts usually hesitate

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<sup>121</sup> Justice Tompkins, n21.

<sup>122</sup> *Ibid.*

<sup>123</sup> Interview with Ms. Dilshani Wijayawardana, an attorney at law in Sri Lanka and the co-author of the book *Company Law* (Unie Arts Pvt Ltd, Colombo, 2014).

<sup>124</sup> G. Milner-Moore G. and A. Cooke, n75.

<sup>125</sup> *Ibid.*

<sup>126</sup> Saul Fridman, *supra* n17, p.182.

<sup>127</sup> Justice Tompkins, n21.

<sup>128</sup> See section 172 (1) of the Companies Act 2006 (UK).

<sup>129</sup> *Hutton v West Cork Railway Co* (1883) LR 23 Ch D 654.

to reject a director's evidence concerning motive.<sup>130</sup> However, directors' assertions are not impregnable.<sup>131</sup> A judge may choose not to believe a director's evidence regarding the state of his/her mind without first investigating the surrounding circumstances<sup>132</sup> and surrounding circumstances could discount, cast doubt, or result in directors' claims that they acted in good faith being disregarded.<sup>133</sup> Where directors have led to the detriment of a company, they have to convince the court that they believed in good faith that their actions were in the best interest of the company.<sup>134</sup>

What is noteworthy is that, while the duty to act for a proper purpose is considered separate from the duty of good faith, where the standard of good faith is applied to determine the propriety of purpose, the court's intervention can be minimal. In the latter kind of cases, no need arises to imagine particular purposes of corporate powers. A business decision will be struck down only in exceptional situations where "a result may be so unreasonable that the court is entitled to infer that it has not been reached by a proper process".<sup>135</sup>

The discussion developed in this article can be further illustrated with an example in the context of a takeover bid. If directors exercise their powers to defend a company from a hostile takeover bid, to determine whether the directors' have exercised powers for a proper purpose, the judiciary will evaluate whether directors have acted in good faith in the best interest of the company. For instance, in *North Sydney Brick & Tile Co. Ltd. & Ors*,<sup>136</sup> directors entered into an agreement to resist a takeover bid which they considered to be grossly inadequate. This was challenged on several grounds including the contention that directors acted for an improper purpose. However, the court recognised that the director's had acted believing that the existing offer of the takeover bid was disadvantageous to the company and therefore sought to provide an alternative which was more advantageous to the shareholders.<sup>137</sup> Hence, it is clear that the standard used in this case to determine whether directors have acted for a proper purpose is the standard of good faith. It is the authors' perspective that where the *bona fides* of directors are established, respecting directors business decision without substituting the court's own judgment of what it is in the best interest of a company, is the correct approach.

In this kind of a case, if the directors have exercised power merely to prevent shareholders from accepting the takeover offer or merely to maintain their power, directors will be and should be considered to have acted for an improper purpose. Such

<sup>130</sup> Andrew Keay, "The Duty to Promote the Success of the Company: Is it Fit for Purpose?", Academia.edu <[http://www.academia.edu/35425617/THE\\_DUTY\\_TO\\_PROMOTE\\_THE\\_SUCCESS\\_OF\\_THE\\_COMPANY\\_IS\\_IT\\_FIT\\_FOR\\_PURPOSE](http://www.academia.edu/35425617/THE_DUTY_TO_PROMOTE_THE_SUCCESS_OF_THE_COMPANY_IS_IT_FIT_FOR_PURPOSE)>, Site accessed on 23 July 2018.

<sup>131</sup> Andrew Keay, *supra* n129. Also see *ASIC v Adler* (2002) 168 FLR 253, 738.

<sup>132</sup> See *Re a Company* [1988] BCLC 570, 577; *Extrasure Travel Insurance Ltd v Scattergood* [2003] 1 BCLC 598, 106.

<sup>133</sup> *Bell Group Ltd (in liq) v Westpac Banking Corporation* (No 9) (2008) 70 ACSR 1.

<sup>134</sup> See Parker J in *Regentcrest plc v Cohen* [2002] 2 BCLC 80, 90; Arden LJ in *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244; [2005] 2 BCLC 91, 52.

<sup>135</sup> LS Sealy, *supra* n61, p.277.

<sup>136</sup> (1988) 6 A.C.L.C. 154.

<sup>137</sup> *Supra* n135, 178.

acts can negatively affect a company. It is observed that in such a context, directors will be held liable anyway for breaching the duty of good faith to act in the best interest of the company. Hence, it is apparent that the limitation of proper purpose adds nothing additional to the limitation to act in good faith in the interest of the company.

However, even where it is established that directors have acted within the scope of their powers and in good faith in what they believed to be in the interest of the company, the shareholders can still resort to shareholders' remedies provided by the statutes if they are of the opinion that directors have misused their powers.

Consequently, the authors submit that in the presence of the duty of good faith along with the duty to comply with corporate legislation and company constitutions and statutory mechanisms for shareholders protection, the proper purpose rule can be safely set aside. This is a prudent step which can make the business judgment rule more meaningful.<sup>138</sup>

## V. Conclusion

As elaborated earlier, the courts have considered the duty to exercise powers for a proper purpose fulfilled where the directors have complied with their duty to act in good faith. In such cases, the duty of proper purpose cannot be recognised as serving a different purpose from the duty of good faith and hence appears to be redundant. However, in some cases these two duties have been distinguished. Weaknesses of that approach can be analysed in two layers.

First, in this type of cases the judiciary proceeds to determine the purpose of the power granted by a company's constitution or by legislation. Corporate constitutions usually set out powers in general terms.<sup>139</sup> In this context, judges actually proceed to create an imaginary list of permissible purposes and based on it seek to limit or even invalidate directorial decisions. It is submitted that this is not appropriate for the following reasons:

1. the courts are ill-equipped to decide the purpose of a power set out in a corporate constitution, particularly if it is stated in general terms with no express limitations; and
2. this stringent approach to restrict the use of power disturbs the independence of directors and encourages courts to heavily interfere in the process of making business judgments.

Secondly, it is required, in this context to find the principal purpose. Generally the allegation of improper purpose arises when directors exercise powers driven by mixed purposes. Hence, it demands an inquiry to discover the principal purpose. The test to be employed in this quest is not yet established with certainty.<sup>140</sup> Currently, the test which is applied requires weighing the heaviest purpose in directors' minds. This involves a value judgment that plausibly leads to uncertainty of law.<sup>141</sup> The test of causation in *Eclairs* was

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<sup>138</sup> Saul Fridman, n17, p.183.

<sup>139</sup> *Ibid.*, p.173.

<sup>140</sup> *Supra* Saul Fridman, n17; Remus Valsan, n3, p.157.

<sup>141</sup> *Supra* Remus Valsan, n3, p.158.

merely suggested *obiter* and not established as a central part of English law. Further, there is no significant difference between the causative test and the weightiest purpose test.

In addition to the aforementioned weaknesses, there are further reasons that demonstrate that the duty to act for a proper purpose serves no significant purpose in the current context.

The first reason is that the duty of proper purpose adds nothing additional to the duty of good faith. The demerits of considering the two duties as separate have been analysed earlier. In many significant cases, directors were considered to have acted for a proper purpose if the courts were satisfied that directors had exercised powers in good faith in the best interest of the company. Scholars suggest that where there is no bad faith or an intention to deceive, the directors are presumably acting in good faith and hence acting with a proper purpose.<sup>142</sup> In this context, the difference between the two duties becomes indistinct.

The second reason is that the necessity to apply the proper purpose rule to prevent abuse of power is no longer crucial in the current corporate law. Heavily restricting how directors exercise powers would have been significant in the absence of clear and direct means to deal with inappropriate use of directorial powers.<sup>143</sup> However, modern corporate legislation provides ample mechanisms to protect shareholders from abuse of power by directors. When consideration is given to the confusion created by the proper purpose rule, one may now choose to have recourse to the statutory remedies when oppression or mismanagement takes place.<sup>144</sup>

After examining scholarly opinions and case laws on the subject, it can be safely stated that thus far there is no clear and consistent criteria or guideline to ascertain the propriety of purpose.<sup>145</sup> Some scholars reckon that due to the ambiguities surrounding the proper purpose rule, it is not mature enough to bring into statutory law.<sup>146</sup>

Most importantly, the analysis in this article leads to the conclusion that this rule does not serve a separate purpose in the presence of the cumulative effect of the duty of good faith to act in the best interest of the company, duty to follow the Companies Act and the articles and also the discretionary remedies of the court for the protection of shareholders.<sup>147</sup> Consequently, the application of the rule appears to be redundant.

In the context of these arguments, it is submitted that not recognising the proper purpose rule in statutory form in Sri Lanka is not a weakness. Even though the non-inclusion of the rule in the SLCA 2007 does not exclude its application,<sup>148</sup> in the absence of a direct statutory requirement, judges are not encouraged to apply it.<sup>149</sup> It is submitted

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<sup>142</sup> *Supra* Chong, n39.

<sup>143</sup> See for instance *supra* n108; Saul Fridman, n17, p.172.

<sup>144</sup> See for instance, sections 224 – 225 of the Companies Act 2007 (Sri Lanka) No 07.

<sup>145</sup> Earnest Lim, “Directors’ Duties: Improper Purposes or Implied Terms?” *Legal Studies*, 2014, Vol.34(3), pp.395-418, p.409; PL Davies, Gower and Davies Principles of Company Law, 8<sup>th</sup> ed., Sweet & Maxwell, 2008, para 16-22.

<sup>146</sup> Interview with Ms. Dilshani Wijayawardana, n122.

<sup>147</sup> *Ibid.*

<sup>148</sup> Section 3 of the Civil Law Ordinance 1852 (Sri Lanka).

<sup>149</sup> *Supra* K. Kanag-Isvaran and Dilshani Wijayawardana, n6, p.434.

that the resulting reluctance to substitute the judiciary's judgment in place of directors' business judgment is a positive consequence of not enacting the proper purpose rule in statutory form. It is recommended that jurisdictions like the UK and New Zealand should rethink their approach of recognising the duty to act for a proper purpose as a separate statutory duty. This article finally submits that the suitable standard to apply to keep the discretionary power of corporate directors in check is the standard of good faith.

