CASE NOTE

DEFENDING AGAINST HOSTILE TAKEOVERS: DARVALL V. NORTH SYDNEY BRICK & TILE COMPANY LIMITED & OTHERS

The past few decades have witnessed the rise of the takover process as the principal mechanism for effecting change in corporate control. While a number of friendly takeovers have occurred, in many instances takeover bids have been vehemently resisted by directors of the target companies. In many such cases claims of breaches of directors' duties have been made arising out of the actions taken by the directors to insulate their companies from, or defend them against, what they perceive to be undesirable takeover offers. A heated debate has consequently sprung up touching on the proper role of directors in contests for corporate control.

Justice Hodgson of the Supreme Court of New South Wales has added his contribution to this continuing debate. His decision in *Darvall* v. *North Sydney Brick & Tile Company Limited & Others*[1] will particularly warm the hearts of the advocates of the right of directors to defend their companies against what they consider to be undesirable takeover offers. This decision is to be welcomed as it contains some pertinent and definitive dicta on the controversial subject of the proper role of directors in contested takeover situations, the interests to be considered and the proper test to be applied in determining the validity of directors' actions in such circumstances.[2]

In this case, the plaintiff made a cash takeover offer for all the issued shares in the defendant company at $10 per share. Previous to this offer, the company's shares had traded at 87¢ per share. Thus, if the bid succeeded, the shareholders stood to reap a substantial premium of $9.13 per share.

The directors however were of the opinion that this offer was grossly inadequate. This belief arose from the fact that the company's main attraction, a large parcel of land, had, since the previous dealing in the company's shares, changed in character from rural land and acquired tremendous development potential with a corresponding exponential appreciation in value. Indeed, prior to the plaintiff's bid, the directors had already started exploring means of developing the land into a business park. To this end, they had applied for the re-zoning of the land and also started negotiations with potential financiers.

[1] (1988) 6 A.C.L.C. 154.

[2] The case also contains a very interesting discussion of the prohibition against financial assistance in connection with the acquisition of the company's shares. This note will however not deal with this aspect of the case.

According to the directors, the plaintiff's bid placed the company's value at less than one half of its net worth. Further, according to the evidence available to them, a majority of the shareholders intended to accept this offer. It was therefore clear that unless the directors swiftly acted to stop this, the accepting shareholders would receive far less than their shares were intrinsically worth, and the company would be forced to part with its most valuable asset at less than half its true value.

The directors entered into a joint venture agreement with a financier to develop the land. The defendant then transferred the land to a joint venture company, formed for the purpose, consisting of that financier and a wholly owned subsidiary of the defendant.

The plaintiff filed an action challenging the validity of the directors' actions and sought an order to set aside the joint venture agreement. It was contended that the sole purpose of these contrivances was to frustrate the plaintiff's takeover offer and thus prevent him from acquiring control of the company.

His Honour found that "the substantial purposes of the directors were to provide the existing shareholders with alternatives which were more advantageous to them than the plaintiff's offer, to demonstrate to shareholders that it was not in their interest to accept the plaintiff's offer, and to advance the commercial interests of the company in relation to the development of the land".[3] He also found that the directors' purpose was not to maintain themselves in power or merely to prevent the plaintiff's bid from succeeding.[4] "If the directors had not believed that the joint venture agreement was in the commercial interests of the company, they would not have entered into it simply to persuade shareholders not to accept the plaintiff's offer."[5] His Honour accordingly declined to set aside the joint venture agreement. In so holding, he re-affirmed the principle that directors may act to advance the interests of the company and protect the interests of the shareholders, even if their actions ultimately lead to the frustration of a takeover offer, provided they are not motivated by irrelevant purposes.

It must be pointed out here that the employment of defensive strategies by directors against takeover offers which they bona fide consider not to be in the interests of the company is not prohibited by law. However, this practice has been severely criticised by a number of commentators especially where engaging in defensive conduct leads to the frustration of a takeover offer. For example, Y. Danziger argues that defending against takeovers presents directors with an inevitable conflict of interest since "directors have a substantial interest in preserving their companies' independence, thus perpetuating their managerial privileges . . .".[6]

[3] (1988) 6 A.C.L.C. 154, 178.
[4] Ibid.
[5] Ibid.
[6] Y.F. Danziger, 'Directors and Takeovers' (2) (1984) 5 *Co. L.* 217; See too S. Lofthouse, 'Competition Policies as Takeover Defences' [1984] *J.B.L.* 320, 324: Weinberg & Blank: *Takeovers And Mergers* 4th. ed. 1979, Sweet & Maxwell, London, p. 575.

By reason of the foregoing, it is argued in some quarters that on a takeover offer being made for the company, or on receiving notice thereof, the directors should not take any action during the time that the shareholders have to consider the offer which may result in the offer being frustrated. Indeed, the National Companies and Securities Commission has declared in a Policy Statement that:

> "In exercising its functions and powers, whether directly or by its Delegates, the Commission's objectives are to ensure:
> (v) that the directors of a company whose members are in receipt of a takeover offer *do not, by exercising managerial powers, do anything to frustrate the offer before members have had an adequate opportunity to consider it;*[7]" (emphasis added)

This policy of management passivity, which would require directors not to take any action to oppose any takeover bid during its currency, also accords with the policy pursued by The City Panel On Takeovers And Mergers in England as reflected in General Principle 7 of *The City Code*, which provides that:

> "At no time after a bona fide offer has been communicated to the Board of the offeree company or after the Board has reason to believe that a bona fide offer is imminent *shall any action be taken by the Board of the offeree company without the approval in general meeting of the shareholders which could effectively result in any bona fide offer being frustrated or in the shareholders of the offeree company being denied an opportunity to decide on its merits*".[8] (emphasis added)

The position taken by The Commission and The Panel with respect to the employment of defensive schemes finds support among some legal scholars. For example Y. Danziger, in the conclusion to his study on the various defensive strategies employed by directors of British companies, writes:

> "It is strongly recommended, whenever possible, that shareholders' approval, in general meeting, to the employment of the remedial defensive tactics, will be obtained in advance."[9]

Despite the intense criticism of the employment of defensive schemes, Hodgson J. has re-affirmed that directors may act to protect the company's interest, even when their actions may result in frustrating a takeover offer which they consider on reasonable grounds to be undesirable. By so deciding, His Honour has re-affirmed that "in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality".[10] This recognition of the proper role of directors in contests for corporate control is quite welcome.

[7] National Companies And Securities Commission: Policy Release No. 101, para 2(v).
[8] *The City Code On Takeovers And Mergers* as revised and published on 19th April 1985. See also General Principle 9 and Rule 21 thereof.
[9] Y.F. Danziger, 'Remedial Defensive Tactics Against Takeovers' (1983) 4 *Co. L.* 3, 13.
[10] Moore J. in *Unocal Corporation* v. *Mass Petroleum Company* 493 A. 2d. 946, 954 (1985). (emphasis added)

It is now beyond doubt that when the powers of management are vested in the directors, it is their duty to promote the best interest of their company. As such, in the event of a takeover offer being made for their company, directors ought to be allowed to take such action as they consider will most benefit the company as a whole. Any action that the directors may take in such circumstances derives from "[their] fundamental duty and obligation to protect the corporate enterprise which includes the stockholders from harm reasonably perceived irrespective of its source".[11] There appears to be no valid reason why the imminence or even existence of a takeover offer should operate to divest or release the directors from the obligation to promote the best interest of the company.[12]

On the contrary it is quite clear that to require the directors to remain passive, and let a takeover bid proceed which they consider on reasonable grounds not to be in the interests of the company, would be to deny the prerogative and duty of the directors to act in the best interests of the company.

However, whilst it is acknowledged that directors may use their powers to defend their company against what they consider to be an undesirable takeover bid, it must be emphasised that any defensive action that they take must be designed to benefit the company. Although the courts recognise that the directors have the right to resist potentially harmful takeover offers, the directors' decision to oppose the same must not be motivated solely or primarily to entrench themselves in control of the company[13] or to serve their own interests or those of their friends or other irrelevant purposes.[14] Further, the defensive measures adopted must be reasonable and informed, for there is no protection for directors who have made an unintelligent or unadvised judgment.[15] As Berger J. proclaimed:

> "The directors must act in good faith. Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose."[16]

Determining The Validity of Directors' Actions

Directors are required to exercise their powers bona fide in the interests of the company and not for any collateral purpose. Instances however do occur when an exercise of directors' powers serves more than one competing

[11] Per Moore J., *Unocal Corporation* v. *Mesa Petroleum* 498 A. 2d. 946, 954 (1985).
[12] See *Pine Vale Investments Limited* v. *McDonnell & East Limited and Another* (1983) 1 A.C.L.C. 1294, 1304.
[13] See for example *Fraser* v. *Whalley* S.C. 11 L.T. 175; 71 E.R.361; *Piercy* v. *S. Mills & Company Limited* [1920] 1 Ch. 77; *Hogg* v. *Cramphorn Limited & Others* [1967] Ch. 254; *Teck Corporation Limited* v. *Millar* (1973) 33 D.L.R. (3d) 288.
[14] By way of example again, see *Howard Smith Limited* v. *Ampol Petroleum Limited* [1974] A.C. 821.
[15] *Gluckstein* v. *Barnes* [1900] A.C. 240; *Montgomerie's Brewery Company Limited* v. *Blyth* (1901) 27 V.L.R. 175; *Smith* v. *Van Gorkom* 488 A. 2d. 858 (1985).
[16] (1973) 33 D.L.R. (3d.) 288, 315-6.

purpose. In such circumstances, the courts have hitherto applied the "primary" or "sole" or "substantial" purpose test as a standard of examining the directors' actions so as to determine the real object underlying any impugned exercise of power.[17]

Under this approach if an exercise of directors' powers serves both a permissible and impermissible purpose, the courts will not interfere with that exercise of power if it appears that the directors acted honestly and primarily or substantially in what they considered was in the best interests of the company.

In ruling upon the propriety of the directors' actions in this case, Hodgson J. preferred the test enunciated by the High Court of Australia in *Whitehouse & Another* v. *Carlton Hotel Proprietary Limited & Others*[18], wherein it was held that an exercise of power is invalid if it is caused by an impermissible purpose in the sense that, but for its presence, the power would not have been exercised, regardless of whether the impermissible purpose was the dominant one or just one of several contributing causes.

This approach has in fact been adopted and applied in several subsequent cases.[19] It would therefore now appear that if an impermissible purpose is established as having caused the directors to exercise any of their fiduciary powers, that exercise of power will be invalid notwithstanding that it was just one of several contributory purposes and notwithstanding further that the directors honestly believed that what they did was in the interest of the company.

It would however appear that in terms of the evidential burden of proof, the *Whitehouse* or 'but for' test has not made any easier the task of the party complaining that the directors have exercised their powers for an improper purpose. Under this new test, to justify a court interfering with the directors' exercise of power it must be established that but for the existence of the impermissible purpose, the directors would not have exercised the power in issue. This seems to be just a different way of saying that the complainant must prove that the primary purpose for the exercise of the directors' power was impermissible.

The Directors' Proper Constituency

At the centre of any discussion relating to the duties of directors lies the question: to whom are these duties owed? Put another way, in whose interests are directors required to act in discharging their duties and exercising their powers?

According to the famous and oft quoted dictum of Lindley M.R. in *Allen*

[17] See for example *Hogg* v. *Cramphorn Limited & Others* [1967] Ch. 254; *Teck Corporation Limited* v. *Millar* (1973) 33 D.L.R. (3d.) 288; *Howard Smith Limited* v. *Ampol Petroleum Limited & Others* [1974] A.C. 821; *Advance Bank Australia Limited & Others* v. *F.A.I. Insurances Limited & Another* (1987) 5 A.C.L.C. 725.

[18] (1987) 61 A.L.J.R. 216.

[19] See *McGuire* v. *Ralph McKay Limited & Others* (1987) 5 A.C.L.C. 891; *Abraham* v. *Tunalex Proprietary Limited* (1987) 5 A.C.L.C. 888; *T.C. Newman (Qld.) Proprietary Limited and Another* v. *D.H.A. Rural (Qld.) Proprietary Limited* (1987) 5 A.C.L.C. 922.

v. *Gold Reefs Of West Africa Limited*[20], directors must exercise their powers "bona fide in the interests of the company as a whole . . .".[21] So, in discharging their duties, the directors are required to consider only the interests of the company. But what is the company?

In *Shaw & Sons (Salford) Limited* v. *Shaw*[22], Greer L.J. reminded us that "a company is an entity distinct alike from its shareholders and its directors . . .".[23] The duties of directors on this view are owed to the company as a separate entity.

But, according to the equally famous opinion of Sir Milner Holland Q.C., the inspector appointed by the Board Of Trade to inspect the affairs of The Savoy Hotel following a takeover battle for that company, the term "the company" refers to all members of the company, present and future.[24] This view was adopted and applied by Megarry J. in *Gaiman* v. *National Association For Mental Health*[25] wherein he said:

> "I would accept the interests of both present and future members of the association, as a whole as being a helpful expression of a human equivalent."[26]

It follows from the foregoing then that directors must act in the collective interest of all the corporators.[27] But, since the company is a separate entity, the directors must also take into account the interests of the company as a distinct legal and economic entity where this is called for.[28]

It is submitted that the edict that directors must act in the interests of the company either in the sense of the company as "a legal and economic entity" or in the sense of "corporators as a whole" are not irreconcilable or mutually exclusive.

That directors must take into account the welfare of the shareholders in executing their duties and exercising their powers cannot be denied. But, it is also recognised that in doing so they must not ignore the interests of the company as a separate economic entity, such as its capital and development needs and how these are to be best served, as well as a wide range of other concerns.

Thus, it can be said that in managing the affairs of the company, the directors must endeavour to strike a fair balance between the interests of all

[20] [1900] 1 Ch. 656.
[21] Id. 671. See also, *Re Smith & Fawcett Limited* [1942] Ch. 304, 306; *Pergamon Press Limited* v. *Maxwell* [1970] 2 All E.R. 809, 813.
[22] [1935] 2 K.B. 119.
[23] Id. 134; See further, *Salomon* v. *Salomon & Salomon & Company Limited* [1897] A.C. 22; *Shuttleworth* v. *Cox Brothers & Company (Maidenhead) Limited* [1927] 2 K.B. 9; *Dafen Tinplate Company* v. *Llanelly Steel Company* [1920] 2 Ch. 124.
[24] See L.C.B. Gower 'Corporate Control – The Battle For The Berkeley (The Savoy Hotel Case)' (1955) 68 *Harv. L. Rev.* 1176.
[25] [1971] Ch. 317.
[26] Id. 330.
[27] *Peter's American Delicacy Company Limited* v. *Heath* (1939) 61 C.L.R. 457; *Ngurli Limited & Others* v. *McCann* (1954) 90 C.L.R. 425, 447; *Greenhalagh* v. *Anderne Cinemas Limited* [1951] 1 Ch. 286, 290-1.
[28] *Teck Corporation Limited* v. *Millar* (1973) 33 D.L.R. (3d.) 288; *Pine Vale Investments Limited* v. *McDonnell & East Limited & Another* (1983) 1 A.C.L.C. 1294.

corporators as a whole and those of the company as a separate legal and economic entity. For the interests of shareholders, which are basically profit maximisation on their investment, may not always coincide with those of the company as an economic or legal entity.

It is further argued that the role of the modern company is no longer akin to that of its nineteenth century counterpart which was simply and purely the promotion of the economic interests of its members. It is now argued that, having regard to the central role of the company in a capitalist society, the company must embrace wider responsibilities to the community in which it operates. The responsibilities usually cited as imperative include considering the interests of the company's employees, creditors and community relations. It is accordingly argued that in managing the affairs of the company, which includes deciding on how to respond to a takeover offer, directors should also take into account the interests of these various groups.[29]

Addressing himself to this question, Hodgson J. held:

> "In my view, ... it is proper to have regard to the interests of the members of the company, as well as having regard to the interests of the company as a commercial entity. Indeed, it is proper also to have regard to the interests of the creditors of the company. I think it is proper to have regard to the interests of present and future members of the company, on the footing that it would be continued as a going concern ...".[30]

The flexible approach taken by Hodgson J. is welcome for it recognises that as between the shareholders and the company as a legal or economic entity, there can be no hard and fast rules as to whose interests must prevail over the other at all times. This is a matter that must be determined at the time that the question falls to be decided, subject only to the condition that in arriving at their decision, the directors must exercise a reasonable degree of care and must act in good faith and not for irrelevent purposes.

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[29] See for example, F.J. Willet, 'Conflct Between Modern Managerial Practice And Company Law' (1967) 5 *M.U.L.R.* 481; E. Merrick Dodd Jr. 'For Whom Are Corporate Managers Trustees?' (1932) 45 *Harv. L. Rev.* 1145; A.A. Berle Jr. 'For Whom Are Corporate Managers Trustees – A note' 45 *Harv. L. Rev. 1365*; Lord Wedderburn Of Charlton, 'The Social Responsibility Of Companies' (1985) 15 *M.U.L.R.* 4; R. Baxt, 'The Duties Of Directors Of Public Companies – The Realities Of Commercial Life, The Contradictions Of The Law And The Need For Reform' (1976) *A.B.L.R.* 289; L.S. Sealy, 'Directors' "Wider" Responsibilities – Problems Conceptual, Practical And Procedural' (1987) 13 *Mon. L.R.* 64.

[30] (1988) 6 A.C.L.C. 154, 176.

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