University of New South Wales: 2012 Directors’ Duties Seminar

Topic 6: Directors' Duties - International Regulatory Perspective

David Friedlander, Shannon Finch, Amanda Isouard and Martin Kan

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1 Overview

This paper provides an overview on recent developments in directors’ duties in the People’s Republic of China (“PRC” or “China”), Hong Kong, the United States (“US”), Canada, the United Kingdom (“UK”) and the European Union (“EU”).

Despite the differences in the cultural and economic landscape of these key jurisdictions, governments, courts and other regulatory bodies (outside of China) have generally moved towards similar developments and reforms. Overall, the changes observed are consistent with the greater awareness demonstrated by regulatory bodies to improve protection for investors following the fall out from the financial crisis. However, change has come from wide afield and a common outcome is that public company directors of significant experience are increasingly being treated like infants.

In the immediate aftermath of the financial crisis, regulatory bodies, securities exchanges, academics and bodies of varying levels of authority sought to impose or revise corporate governance standards on directors. These, often conflicting, guidelines have occupied a large part of board focus in recent years and signs of backlash are starting to appear.

In addition, there has been undue and almost obsessive focus on executive remuneration and the board’s role in setting compensation. In the US, this culminated in the “say on pay” measures, in the UK, the non-binding shareholder vote on the remuneration report and this was followed in Australia and then doubled-down with the ridiculous “2-strikes” rule.

Another area of global focus has been seeking greater diversity on boards.

This paper looks mostly at recent legislative change and case law. As a result, it does not cover many of these topical issues in detail. However, all recent developments need to be viewed against the backdrop of these issues because they explain why the world is so twitchy on directors’ duties.

Although not the focus of this paper, we compare developments in respect of directors’ duties within Australia, with the Australian Securities & Investments Commission playing a key role.

2 China

2.1 Overview

Directors’ duties in China are regulated by the PRC Company Law, the PRC Securities Law, measures issued from time to time by the Ministry of Commerce (“MOFCOM”) and overall supervision by the China Securities Regulatory Commission (“CSRC”). While established and supervised very differently to common law jurisdictions, directors’ duties are expressed in very similar terms.

Perhaps, however, because China has not experienced the same issues as other jurisdictions in the last 5 years, its directors have not been subjected to the same level of intervention as has been the case globally.
Directors in China have 2 general overarching duties – the duties of loyalty (which is similar to the Australian concept of a fiduciary duty) and diligence. In order to comply with these duties, directors must (among other things):

- comply with all PRC laws and administrative regulations, as well as the company’s articles of association;¹
- not misappropriate or divert company funds;
- not take advantage of their position to seek business opportunities;
- not personally accept any commission for any transaction that the company is party to; and
- not unlawfully disclose confidential company information.²

These are similar to the duties imposed on directors under Australian law.

Additional duties are imposed on directors of listed companies, including:

- the duty of information disclosure, which encompasses liability for any false or misleading statements or information or any major omissions in disclosure documents which lead to company investors incurring losses (similar to the position under the Australian Corporations Act 2001 (Cwlth) ("Australian Corporations Act") and common law);³
- the duty of no insider trading, which includes liability to compensate investors for any loss as a result of a breach (similar to Division 3 of Part 7.10 and section 1317H of the Australian Corporations Act);⁴ and
- the lock-up and disclosure duty, which requires directors to disclose movements in their holdings of company shares (similar to the Appendix 3Ys and 3Zs required by the Australian Securities Exchange (“ASX”)) and restricts their ability to trade shares for certain lengths of time (similar, for example, to the escrow arrangements used in initial public offerings in Australia).⁵

Furthermore, the CSRC has issued the Code of Corporate Governance for Listed Companies ("PRC Code") that applies generally to the boards of listed companies.⁶ Compliance with the PRC Code is mandatory and requires all listed companies to have at least one-third of their board consisting of independent directors.⁷

Despite these recent reform measures, a number of key corporate governance issues remain. These include:

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² Ibid art. 149.
³ Ibid arts. 68 and 69.
⁴ Ibid arts. 73 and 76.
⁵ Ibid art. 142.
• **state ownership**: the concentration of ownership of listed companies has resulted in transitional issues. The key sources of these issues include:
  - the consolidation of the split share structure whereby the non-tradeable shares held by controlling shareholders are converted into tradeable shares; and
  - the evolution of managerial accountability from the state to the corporation, and

• **supervisory board**: China has a 2-tier board structure where listed companies are required to have a supervisory board that is very similar to Europe. The supervisory board consists of at least 3 members and is in place for the purpose of monitoring the board of directors on behalf of members and employees.

In addition, and as would be expected, the nature of Chinese corporate ownership and the stage of corporate development have meant that not many cases involving directors’ duties have come before the courts.

### 2.2 Case law – non-compete obligations

One area that has seen judicial scrutiny is the non-compete obligations of company directors in the context of multinational corporations focusing on the Chinese economy post-market reforms. A practice developed through investments in a particular industry or sector – this was usually through directorships on multiple boards, some of which involved companies who directly competed with each other. This approach became the subject of various legal proceedings in the Chinese courts, with *Wahaha Group v Caquelin* being the seminal case.

This particular case involved Wahaha Food Co. Ltd. ("Guilin Co"), a Sino-foreign joint venture between Wahaha Group, Guilin Xiangsheng Co. ("Xiangsheng Co.") and Festine Pte. Ltd ("Festine"). Festine was one of Danone Asia Pte. Limited’s ("Danone Asia") Singaporean subsidiaries. Danone group was a global food and beverage manufacturer. Wahaha, a partially state-owned entity, was a Chinese beverage manufacturer.

In December 2005, Festine appointed François Caquelin ("Caquelin"), one of Danone Asia’s senior officers, to be a director of Guilin Co. At the same time, Danone Asia and other Danone subsidiaries appointed Caquelin to sit on the boards of more than a dozen other companies that were not part of the Wahaha brand, but still operated in the same industry as Guilin Co. The other companies that Caquelin served included Guangdon Robust, Shanghai Aquarius and Shenzhen Yili. All of these companies were food or beverage manufacturers that mainly produce water and dairy products similar to Guilin Co.’s products.

In July 2007, Wahaha Group and Xiangsheng Co. filed a shareholders’ derivative action against Caquelin with the Guilin Intermediate People’s Court ("Guilin

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8 Ibid at 18.
9 Ibid at 20.
Court\(^*\)). As part of this suit, Wahaha Group and Xiangsheng Co. asked the court to:

- order Caquelin to resign from Guilin Co.’s board of directors;
- prohibit Caquelin from concurrently holding the same position with more than a dozen competing companies; and
- require Caquelin to pay for any damages he caused to Guilin Co. by sitting on competing boards.

The Guilin Court held that Caquelin had violated PRC Company Law\(^{12}\) by serving as a director for multiple companies that were direct, aggressive competitors of Guilin Co. The court ordered that Caquelin resign from the boards of Guilin Co. as well as its direct competitors. He was also ordered to pay damages of RMB 500,000.

### 2.3 Amendments to PRC Company Law

In October 2005, the National People’s Congress amended the PRC Company Law to capture a number of additional duties and liabilities of directors. These amendments came into force at the beginning of 2006.

The key changes were to:

- enhance the importance of information disclosure transparency;
- increase civil liability for failing to disclose information that a director is legally required to disclose;
- highlight that any director that provides false information will be civilly liable for providing that false information;
- improve the corporate legal person management system; and
- provide more specific detail on the duties of loyalty (similar to the Australian concept of fiduciary duties) and diligence.

The updates also reiterated that corporate directors must comply with China’s laws and administrative regulations and adhere to the relevant company’s articles of association, which was unclear before that time.

There are no current plans for the Chinese government to create or amend any existing laws, rules or regulations that govern the duties of company directors.

### 3 Hong Kong

#### 3.1 Overview

With many of the listed companies in Hong Kong being controlled either by a sovereign state or members of a prominent family, significant cases brought by shareholders against the board are few and far between. However, what the case law lacks in progress on refining the laws on directors’ duties is being made up by sweeping legislative reforms that are being introduced by the Hong Kong government, which aim to codify some of the rules on directors’ duties in the next revision of the Companies Ordinance. This is in addition to the Code of

Corporate Governance Practices under Appendix 14 of the Listing Rules of the Hong Kong Stock Exchange ("HK Code"), which is of relevance to listed companies.

3.2 Case law – criminalisation of certain actions by directors

The Shanghai Land Case (Vivien Fan & Ors v HKSAR)\(^{13}\) is one of the most notorious cases in global directors’ duties of recent years.

It was an example of the risks faced by directors (and professional advisers) following the criminalisation of disclosure breaches in the Hong Kong market. The case centred around the acquisition by Mr Chau Ching-ngai ("Chau") of a controlling interest in a listed company, imGO Ltd (later renamed to Shanghai Land Holdings Ltd ("Shanghai Land")), and the events which followed this acquisition.

The defendants, who included the directors of Shanghai Land, were accused of defrauding the Hong Kong Stock Exchange by dishonestly making false statements in certain announcements in contravention of the Crimes Ordinance (Cap. 200) and the Theft Ordinance (Cap. 210). It was alleged that the defendants were party to the plan of Chau to procure the sale of certain real estate assets to Shanghai Land.

The District Court convicted each of the defendants and imposed prison terms ranging from 12 to 33 months, despite a lack of evidence of any corrupt intent on the part of the defendants. Participation by the directors in promotion of the transactions was sufficient for the court to impose criminal sanctions on those defendants. Ultimately, all convictions were quashed by the Court of Final Appeal, although not before the defendants had spent time in prison.

Despite this reversal, the case is an example of the increased willingness of courts and regulators to blame directors for the sins of those that they sit alongside.

3.3 Case law – breach of fiduciary duties and the duties of care, skill and diligence

A very recent case involving a breach of fiduciary duties and the duties of care, skill and diligence (see “New Statutory Duty of Care” in section 3.5) by directors is Securities and Futures Commission v Kenneth Cheung Chi Shing\(^{14}\).

Over a period of time, Styland Holdings Limited ("Styland") entered into a number of corporate transactions which were alleged to not be in the interests of the company but rather for the benefit of the founder and former chairman of Styland, Mr Kenneth Cheung Chi Shing ("Cheung"), and his wife.\(^{15}\) It was estimated that they received benefits of HK$79 million and HK$6.95 million respectively, without any disclosure to the market or shareholder approval.\(^{16}\)

These actions eventually came to the attention of the Hong Kong Securities and Futures Commission ("SFC"), who commenced proceedings against the directors involved (Cheung, his wife and 2 other directors).\(^{17}\) The SFC has the power to commence proceedings under section 214 of the Securities and Futures Ordinance ("SFO") in respect of certain misconduct affecting members of a listed company.

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\(^{13}\) [2011] HKCU 1344.

\(^{14}\) [2012] HKEC 341 (‘Kenneth Cheung Chi Shing case’).

\(^{15}\) Ibid at paragraphs 8 - 10.

\(^{16}\) Ibid at paragraph 106.

\(^{17}\) SFO (Cap. 571) s 214.
In the proceedings involving Cheung, his wife and one of the other directors ("third director"), the SFC alleged that:

- the directors had breached both their fiduciary duties and their duties of care, skill and diligence; and
- those breaches amounted to contraventions of section 214 of the SFO (which is similar to the oppression remedy that is available to members and former members under section 232 of the Australian Corporations Act) as the conduct:
  - was oppressive to members;
  - involved defalcation or misconduct towards members;
  - resulted in members not being given information which they would reasonably expect; or
  - was unfairly prejudicial to members.\(^{18}\)

The SFC’s claims help highlight the interrelationship between common law directors’ duties and certain statutory provisions in Hong Kong.

The Court of First Instance in March 2012 held that the financial benefits directly or indirectly received by Cheung and his wife amounted to misconduct and that the conduct was unfairly prejudicial to shareholders, and therefore was a breach of section 214 of the SFO.\(^{19}\)

Further, the court held that that the 3 directors had breached their duty to act with care, skill and diligence through their failure to:

- ensure Styland complied with the Hong Kong Stock Exchange Listing Rules;
- make proper disclosure to shareholders; and
- obtain proper independent valuations or advice in relation to certain transactions.

Their breach of the duty of care, skill and diligence was also held to amount to a breach of section 214 of the SFO.

The Court of First Instance ordered that Cheng and his wife (as directors) pay the company compensation totalling over HK$85 million. Each was disqualified for 12 years – these constituted the longest disqualification orders ever handed down in proceedings of this type. The third director was disqualified for 7 years and a fourth director (former director) was earlier disqualified for 6 years.\(^{21}\)

### 3.4 Case law – improper purpose and breach of fiduciary obligations

The 2011 case of Passport Special Opportunities Master Fund LP v eSun Holdings Ltd\(^{22}\) ("eSun case") addresses issues relating to directors acting with an improper purpose and in breach of their fiduciary obligations.

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\(^{18}\) Kenneth Cheung Chi Shing case at paragraph 9.

\(^{19}\) Ibid at paragraph 103.

\(^{20}\) Ibid at paragraphs 104 - 105.

\(^{21}\) Ibid at paragraph 148.

\(^{22}\) [2011] HKEC 754 (‘eSun case’).
eSun Holdings ("eSun") entered into a placing agreement with Chung Nam Securities Ltd ("Chung Nam") to issue 120 million new shares to placees identified by Chung Nam.

A major shareholder, Passport Special Opportunities Master Fund ("PSOMF"), challenged the placing and alleged that:

- the directors had entered into the placing agreement with the improper purpose of diluting PSOMF’s shareholding; or
- alternatively, that the directors had breached their fiduciary duties because of their failure to consider certain matters, including the dilutive effect of the placing agreement.

There are some similarities here to the recourse that shareholders can have to the Australian Takeovers Panel in respect of rights issues which have control impacts.

The High Court (Court of First Instance) held that:

- there was insufficient evidence to allow the inference of an improper purpose to be made. Based on a review of the available information, it appears that the purpose of the share issue was to raise additional capital for future projects rather than to dilute the shareholdings of existing shareholders;
- there was a fiduciary obligation imposed upon directors when deciding whether and how to embark on the issue of new shares. Their duty was to consider the interests of shareholders and to exercise their power in a manner which was fair to the different classes of shareholders. The court found that there was insufficient material placed before the eSun directors to allow the board to make any meaningful assessment of the financial impact of the placement on eSun and its shareholders. On that basis, the directors did not meet their fiduciary obligation; and
- the placing was voidable, not void. The court decided not to set the placing agreement aside on the basis that to do so would interfere with the rights of innocent third party recipients.

3.5 The Companies Ordinance rewrite

In mid-2006, the Hong Kong Government lodged a comprehensive exercise to rewrite the Companies Ordinance (Cap. 32). The key aims of the reform package were to modernise the law, enhance corporate governance and facilitate business. It was also intended to bring Hong Kong in line with other common law jurisdictions, for example the United Kingdom.

Following extensive public consultation, the Financial Services and Treasury Bureau ("FSTB") incorporated the proposals into the Companies Bill ("HK Bill"), which is currently being scrutinised by the HK Bills Committee (the originally proposed measures were perceived as too harsh on directors and were tempered prior to lodgment). Some of the measures proposed by the HK Bill include, amongst other things, the codification of certain duties owed by directors under the common law of Hong Kong.

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23 Ibid at paragraphs 11 - 12.
24 Australian Takeovers Panel, Guidance Note 17 at paragraphs 3 - 6.
25 eSun case at paragraph 138.
26 Ibid at paragraph 147.
27 Ibid at paragraph 156.
The HK Bill codifies the duty of care, skill and diligence required of directors ("New Statutory Duty of Care"). The level of care, skill and diligence is that which would be exercised by a reasonably diligent person with the general knowledge, skill and experience:

- objective test: reasonably expected of a person carrying out the functions carried out by the director; and

- subjective test: that the director has.

The New Statutory Duty of Care replaces the common law rules and equitable principles in respect of this duty. This was on the basis that retaining the common law duty would likely result in differing standards and would also hinder the development of the statutory provision.

The New Statutory Duty of Care clarifies that objective and subjective limbs exist when assessing the standard of care expected of a director. This is in contrast to the duty under common law where there is a lack of clear authority regarding the applicable test to determine the standard of care owed by a director – in some cases directors only have to meet an objective test, in others they have to meet a mixed objective and subjective test. The FSTB has noted that due to this lack of clear authority, there is some uncertainty as to how the courts will apply the new test. It remains to be seen, therefore, whether the scope of liability for directors will be changed post-codification, although it is now clear that directors will need to meet the objective standard as a minimum, and in some cases the higher subjective standard.

The civil consequences of a breach of the New Statutory Duty of Care are the same as those under the common law or in equity. These civil consequences may include an injunction, rescission of the relevant contract, damages or an account of profits.

3.6 Business judgment rule

The HK Bill does not include an equivalent to the statutory “business judgment rule” found in other jurisdictions including Australia.

During the public consultation period in the lead up to the introduction of the HK Bill it was proposed that the business judgment rule should be codified to protect directors from liability for bona fide decisions which are in the best interests of the company (this is similar to the test under section 180(2) of the Australian Corporations Act). It was decided by the FTSB, however, that this codification was unnecessary as the court’s existing approach when reviewing management decisions was sound.

An example of the court’s approach to applying the business judgment rule is the eSun case (referred to previously in section 3.4). In that case, Justice Barma PJ noted that “If it is shown that the directors have taken account of the relevant factors, and have not acted for improper purposes, the weight that they choose to assign to the various factors which they properly take into account is a matter for them, and not something with which the court should concern itself.” This

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29 Ibid cl 456(4).
30 FSTB, Consultation Conclusions on Company Names, Directors’ Duties, Corporate Directorship and Registration of Charges (2008) 10.
31 HK Bill (2011) cl 457.
32 FSTB, First Phases Consultation: Consultation Conclusions (2010) [41].
33 eSun case.
34 Ibid at paragraph 152.
confirms that when reviewing management decisions of directors, courts do take into account principles akin to the business judgement rule. On that basis, directors may still rely on the common law.

3.7 Fiduciary duties
The HK Bill does not attempt to codify the fiduciary duties owed by directors. This differs from the position in other common law jurisdictions including the UK. It appears that the highly divided responses from the public during the consultation phase led to the decision to not comprehensively codify the duties of a director.

3.8 Indemnities
The HK Bill also proposes a number of other changes relating to indemnities for directors. These include:

- prohibiting any indemnity being provided by a related company to a director of the company, ending a loophole that currently exists; and
- expressly permitting the indemnification of a director against third party liability, in order to provide greater certainty in this area of the law.

3.9 Comments from interested bodies
A number of key stakeholders have not been supportive of the codification of some of the directors’ duties. Although this has not prevented the Hong Kong government from continuing with the proposal for codification of the duty of care, skill and diligence, it did lead to a decision being made to not fully codify the directors’ duties.

The Hong Kong General Chamber of Commerce (“HKGCC”) did not support the codification of the duty of care, skill and diligence in so far as it attempted to replace common law principles. The HKGCC suggested that the common law should be retained to allow the law to develop on a case-by-case basis and to respond to the constantly evolving expectations of directors.

The HKGCC also raised the issue that the replacement of the common law principles entirely would give rise to more uncertainty as there would be no precedent from which reference could be drawn. They also suggested that the proposed codification would deter people from accepting the role of a director.

The Hong Kong Institute of Directors did not support the codification of any of the general directors’ duties, as they suggested more debate was needed on the topic. In particular, they raised the impact of codification on the supply of quality independent non-executive directors. They also raised the impact of the proposed codification on directors’ liabilities and insurance cover.

3.10 Corporate governance practices for listed companies – HK Code
The HK Code sets out corporate governance principles for Hong Kong Stock Exchange-listed companies. These principles are in addition to the duties that will be introduced under the HK Bill.

The main principles in the HK Code relate to directorship, delegation, accountability, remuneration and communication with shareholders. In the context of directors’ duties, main principle A.1 states that the board should “assume responsibility for leadership and control of the issuer and be collectively responsible for promoting the success of the issuer by directing and supervising
the issuer’s affairs. Directors should take decisions objectively in the interests of the issuer”.

While not legally required to comply with the provisions of the HK Code, companies listed on the Hong Kong Stock Exchange are required to disclose in their annual reports and interim reports which of the code provisions they have complied with and which they have not – where they have not complied, they are required to provide an explanation. This is similar to the approach in Australia, whereby under ASX Listing Rule 4.10.3 ASX-listed entities are required to disclose in their annual reports which of the Recommendations in the ASX Corporate Governance Council Principles and Recommendations they have complied with and provide reasons for any deviations.

4 United States

4.1 Overview

Recent case law in the State of Delaware has shown that the jurisdiction continues to be a business and target board-friendly environment. The majority of high profile cases have been resolved in favour of company directors and management or in favour of target boards over bidders. Despite this, the Delaware courts have been extremely critical of board actions on occasion, including in a very recent decision of the Court of Chancery.

The fact scenarios of these cases vary, but they almost always relate to the duties and powers of directors in the context of a control transaction.

As with the other market operators mentioned in this paper, the New York Stock Exchange (“NYSE”) also has corporate governance principles in place for listed companies. NYSE-listed companies are required to comply with the NYSE Corporate Governance Guidelines under Section 3 of the Listed Company Manual of the NYSE (“US Code”).

4.2 Poison puts

The 2009 case San Antonio Fire & Police Pension Fund v Amylin Pharmaceuticals provides some useful guidance for boards in approving debt instruments that contain “poison put” provisions and examines whether or not they would be triggered in the event of a board spill.

In 2007, Amylin entered into an indenture that contained a provision allowing holders of certain publicly traded convertible notes to immediately redeem in the event of a “change in control”. A “change of control” was defined to include the failure of the “Continuing Directors” to constitute a majority of Amylin’s board.

The indenture defined “Continuing Directors” as those who constituted the board on the issue date and any new directors whose election by the board or nomination for election by the stockholders “was approved by at least a majority of the directors...either who were directors on the Issue Date or whose election or nomination for election was previously so approved.”

35 See Appendix 14 of the Listing Rules of the Hong Kong Stock Exchange.
37 C.A. No. 4446-VCL (Del. Ch. May 12, 2009), 4.
38 Ibid.
In 2009, 2 stockholders of Amylin (being Eastbourne Capital Management, L.L.C. and Icahn Partners LP) separately announced their respective intentions to nominate a slate of 5 directors to serve on Amylin’s 12 member board (the 2 slates were entirely different, meaning the nominations would result in 10 new directors). To avoid triggering the “poison put” provision, the board was urged to approve the slate nominated by the contesting stockholders. The board initially resisted during the proxy contest but eventually agreed to this request subject to court approval.

The board’s eventual approval was at odds with the views of the trustee of the indenture, who ended up taking legal action. The trustee contended that because , the board had first rejected the stockholders’ nominations and had engaged in a proxy contest against them, it could not later “approve” their slates for the purposes of the terms in the indenture.

The matter was brought to the Delaware Court of Chancery, which had to decide:

- whether or not the Amylin board had both the power and right under the indenture to approve the stockholder nominees; and
- whether the board had breached its duty of care by entering into the indenture without adequately considering the “poison put” provision.

On the first point, the court held that the board was right to interpret the terms of the indenture to mean they had the power to approve the slate of nominees although they had endorsed a different slate. The court warned that if the trustee’s reading of the indenture was adopted, it would “prohibit any change in the majority of the board as a result of any number of contested elections, for the entire life of the notes.” This reading would have put into question the good faith determination by the board in accepting the “poison put” provision, and also potentially render the provision unenforceable as against public policy.

On the second point, the court held that the board had not breached its duty of care as it had retained highly qualified counsel to advise it on the terms of the indenture. Importantly, the board was told by its counsel that there was nothing “unusual or not customary” in the terms of the indenture before it approved the issuance of the notes under the indenture. It was on this basis that the court decided that the board had not substantially deviated from the standard of care expected of it.

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39 Ibid 18.
40 Ibid 19.
41 Ibid.
42 Ibid 20.
43 Ibid 21.
44 Ibid 21, 23.
Overall, the court found that the provisions in the case did not operate to entrench management as a matter of contractual construction.\textsuperscript{46} Nevertheless, the Court admonished that it was “troubling” for corporations and their counsels to routinely negotiate contract terms that may impinge on the free exercise of the stockholder franchise. It suggested that outside counsel should be mindful of the board’s continuing duties to the stockholders to protect their interests, and should advise them of any terms in an agreement that may impact on the free exercise of their franchise, even if they are considered to be customary.\textsuperscript{47}

The decision of the court can be contrasted with the approach taken by the Australian Takeovers Panel in \textit{In RCL Group Limited}\textsuperscript{48}. In that matter, the issue was whether clauses in a financing agreement between RCL and a financier that gave rise to a “review event” (or “event of default”) upon changes to RCL’s board of directors amounted to “unacceptable circumstances”. The Australian Takeovers Panel refused to hear the case on the basis that it had no reasonable prospect of making an “unacceptable circumstances” declaration. The limitation in the powers of the Australian Takeovers Panel as opposed to the Delaware Court of Chancery underlies the reason that poison put cases are subject to less regulatory oversight in Australia.

### 4.3 Poison pills

The 2011 case \textit{Air Products and Chemicals, Inc v Airgas, Inc., et al}\textsuperscript{49} provides guidance on the role that directors on a target board can play in approving a takeover offer.

Between October 2009 and December 2010, Air Products unsuccessfully engaged in a bidding process for 100% of the share capital of Airgas. During this time Air Products raised its offer from US$60 per share to the “best and final” offer of US$70 per share.\textsuperscript{50} The directors of Airgas continually rejected the offer on the basis that it (among other things) did not reflect the intrinsic value of the company, which they claimed was worth closer to US$78 per share.

The Airgas directors were able to defend the company against Air Products’ offer due to a shareholder rights plan (known as a “poison pill”) which had been adopted in 2007. The shareholder rights plan was designed so that it would explode into thousands of new discounted shares for all investors (with the exception of the bidder) in the event that the bidder (ie Air Products) acquired more than a set percentage of stock, making it prohibitively expensive for the bidder to acquire control of the company. The poison pill was triggered when Air Products made its first offer in February 2010, but the Airgas board had deferred the exercise date. Air Products challenged the legality of the ongoing poison pill in court.

In reviewing the Airgas board’s use of the poison pill, the court was bound to follow the \textit{Unocal Corp. v Mesa Petroleum Co.}\textsuperscript{51} precedent.\textsuperscript{52} This required the Airgas board to articulate a legally cognisable threat and that the defences were reasonable responses to that threat (“\textit{Unocal test}”).\textsuperscript{53} The court held that the board of Airgas had discharged its burden as the evidence showed that most Airgas shareholders would tender their shares despite the board’s view that the offer was inadequately priced.

\textsuperscript{46} Ibid 18.
\textsuperscript{47} Ibid 26 - 27.
\textsuperscript{48} [2012] ATP 2.
\textsuperscript{49} C.A. No. 5249-CC (Del. Ch. February 15, 2011) (‘Airgas case’), 12 - 77.
\textsuperscript{50} Ibid.
\textsuperscript{51} 493 A.2d 946 (Del. 1985).
\textsuperscript{52} Airgas case, 7.
\textsuperscript{53} Ibid.
The Delaware Chancery Court’s decision showed that the power to prevent an inadequate takeover bid lies with the directors of the target and that those directors can prevent shareholders from making their own decision about an inadequate offer through the use of a poison pill. It also reaffirmed the Delaware Chancery Court’s long-standing deference to the business judgment of corporate boards. It is important to note, however, that Chancellor Chandler stressed that this does not mean that boards can “just say no” to takeover offers – rather, a target board’s decision will still be subject to the Unocal test. He also added that if he had not been bound by precedent he would have decided differently.

4.4 Mixed consideration acquisitions

While the 2011 case In re Smurfit-Stone Container Corp did not completely define the threshold at which the so called “Revlon duties” apply in mixed consideration (part stock, part cash) acquisitions, it is still a useful landmark for the development of directors’ duties.

The “Revlon duties” identified in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., require the board of a target company to observe a “heightened standard of review” in the event of an all cash sale of the target company. The basis for this rule is that an all cash sale of the target company represents the final opportunity for the target shareholders to receive a control premium in connection with the sale of the business and therefore a heightened standard of review will be expected from the board.

Prior to this case, the Delaware courts had only considered whether the Revlon duties applied to transactions where the merger consideration was neither all stock nor all cash. In this case, the 2 main issues for the court were whether the Revlon duties applied in a transaction with an equal cash (50%) and stock (50%) mix, and if yes, whether the target board had discharged those duties.

The case was brought by the shareholders of Smurfit-Stone against its directors, who had accepted a merger proposal from Rock-Tenn. Rock-Tenn had offered shareholders consideration on an equal cash (50%) and stock (50%) basis which would see the Smurfit-Stone shareholders finishing up with an approximate 45% holding in the combined entity.

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54 Ibid 1.
55 Ibid 9.
58 Ibid.
The merger proposal came just a few months after Smurfit-Stone emerged from bankruptcy protection. At the time, the company had a board consisting of 2 inside directors, 1 hold-over director and 8 new outside directors. Smurfit-Stone had also just undergone a strategic review which indicated a share price (after some divesting) of between US$35 and US$40. The company was then approached by a private equity firm with a takeover offer of US$29 per share (final offer), which the board deemed to be inadequate.

After the offer was withdrawn, Rock-Tenn started bidding for Smurfit-Stone. The best and final offer from Rock-Tenn was US$35 a share split roughly as half cash, half stock. The merger agreement contained mutual no-shop provisions with fiduciary outs for superior offers, matching rights in respect of superior offers and a termination fee in the amount of approximately US$120 million.

The shareholders alleged that the:

- transaction gave rise to Revlon duties; and
- directors had breached their fiduciary obligations:
  - by preventing or hampering other offers;
  - by not doing a market check; and
  - because the 2 inside directors stood to receive a large bonus from the sale.

The court held that the transaction was one which gave rise to Revlon duties. The court also noted that although the target's shareholders would retain an approximate 45% interest in the combined entity and there was no controlling shareholder, the Revlon duties still applied because the Smurfit-Stone shareholders who accepted the offer would have to cash out half of their shareholding. On that basis, the transaction would constitute "the end game for all or a substantial portion of the stockholder's investment".

Once the court accepted that the Revlon standard of review applied, it scrutinised the directors' actions through the sale against a standard of reasonableness. Although the court acknowledged that the directors' actions were not perfect, they did not have to be and therefore the court found that the directors had discharged their duty. The court indicated that the board had sufficient market information to know that the offer was the best available and that the terms of the deal were reasonable in the circumstances.

4.5 Boards and special committees

*In re Southern Peru Copper Corp* provides useful guidance for boards and special committees in structuring and negotiating deals with controlling shareholders.

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60 Ibid 4.
61 Ibid 7.
63 Ibid 19.
64 Ibid 22 - 23.
65 Ibid 36.
66 Ibid 42.
67 Ibid 40.
Southern Peru Copper Corp. ("SPCC") was a mining company listed on the NYSE. Its major shareholders were Grupo Mexico, S.A.B. de C.V. (54.17%) ("Grupo Mexico"), Cerro Trading Company, Inc. (14.2%) ("Cerro") and Phelps Dodge Corporation (13.95%) ("Phelps Dodge"). As founders of the company, they were issued with special “Founder Shares” which gave them additional voting power to that of other shareholders.

Grupo Mexico invited SPCC to bid for its non-publicly traded subsidiary Minera Mexico, S.A. de C.V. ("Minera") in exchange for approximately US$3.1 billion of SPCC’s NYSE-listed stock. At the time, Grupo Mexico owned 99.15% of Minera.

Since Grupo Mexico was the controlling shareholder of SPCC, a special committee of the board was convened to evaluate this offer. The special committee was composed of 4 directors who were regarded as having no interest in the transaction, including 1 from Cerro.

After 8 months of deliberation, the special committee recommended the deal to the board. The board acted on the recommendation to approve the transaction subject to the approval of holders of two-thirds of the total shares of SPCC (including the shares held by Grupo Mexico). No separate vote from the disinterested shareholders was proposed to approve the transaction. In the end, the transaction was approved by over 90% of the shareholders, including Grupo Mexico, Cerro and Phelps Dodge. This prompted disinterested shareholders to bring a derivative suit against Grupo Mexico and the directors of SPCC.

In ruling in favour of the disinterested shareholders, the court applied the “entire fairness” test – which is the established standard of review in Delaware case law for transactions involving a controlling shareholder – to assess whether the transaction was fair in price and process. Chancellor Strine found that the test had not been met. He also criticised the approach taken by the special committee. He found that the initial valuation obtained by the Southern Peru special committee on Minera put its value at no more than US$1.4 billion to US$1.7 billion. This valuation fell short of the US$3.1 billion offer requested by Grupo Mexico, but instead of pursuing an aggressive negotiation strategy, the special committee and its financial adviser decided to abandon this valuation in favour of a different approach that valued SPCC and Minera based on their relative discounted cash flows. They also utilised a number of valuation techniques that were highly questionable in the circumstances to optimise the value of Minera.

Chancellor Strine concluded that the special committee had assumed a controlled mindset. Instead of negotiating and exploring alternative strategies, the special committee proceeded with the transaction as if there was no other viable alternative. This led to a process of rationalisation whereby the special committee was focused on “finding a way to get the terms of the … structure proposed by Grupo Mexico to make sense, rather than aggressively testing the assumption that the merger was a good idea in the first place”. By failing to explore alternative options, the special committee failed to “exercise real

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69 Ibid 9 - 10.
70 Ibid 1.
71 Ibid 5.
72 Ibid 46.
73 Ibid 70 - 78.
74 Ibid 1, 20.
75 Ibid 63 - 70.
"bargaining power" to extract value for the minority shareholders, which Chancellor Strine noted was the main function of a special committee.\(^{76}\)

Chancellor Strine also stated that in between the signing of the merger agreement and settlement, SPCC significantly outperformed its financial projections and the market value of its shares increased from US$46.41 to US$55.80 per share. This led to a substantial increase in the value of SPCC’s share offer from US$3.1 billion to US$3.7 billion. Although the fiduciary out provisions did not allow the special committee to terminate on that basis, it did still have the option to change its recommendation for the bid. Chancellor Strine opined that in light of the circumstances, the special committee should have reconsidered the fairness of the bid and requested a revised proposal from its financial advisers.\(^{77}\)

In addition, Chancellor Strine was also critical of the way in which the special committee managed Cerro’s conflict in negotiating the transaction. At the time when the special committee was convened to consider the bid, Cerro was seeking registration rights for its shares to be freely tradeable. The fact that Cerro’s nominee in SPCC was involved in the deliberations of the special committee at the same time when Cerro was contemplating an exit from SPCC was overlooked by the special committee until the day when it voted to approve the transaction. Although Cerro’s nominee abstained from the final vote and there was no evidence showing that he had acted in bad faith, his involvement in the deliberation process leading up to the vote was another factor contributing to the finding of a lack of fairness in the transaction.\(^{78}\)

Lastly, Chancellor Strine also observed that approval of the transaction by a majority of the disinterested shareholders would only ensue fairness if the transaction was conditional on that approval, which was not the case here.\(^{79}\)

In concluding that the transaction had failed the test of “entire fairness”, Chancellor Strine ordered Grupo Mexico to pay SPCC US$1.263 billion plus interest, which was an amount equal to the difference between the “fair value of Minera” at the signing date and the actual purchase price.\(^{80}\)

There are 3 important takeaways from this case. Firstly, and most importantly, a special committee should be empowered to negotiate and consider other strategic alternatives to prevent it from entering into a controlled mindset.\(^{81}\) Secondly, a special committee should stay grounded in the reality of real cash terms, market value and stand-alone valuations.\(^{82}\) And lastly, a special committee should be guided by fairness at all stages of the bidding process.\(^{83}\)

### 4.6 Conflict of interest

*In re El Paso Corporation*\(^{84}\) provides useful guidance for directors of listed companies on how they should conduct themselves during the negotiation process for a takeover to avoid the perception of a conflict of interest and minimise the possibility of having the bid process enjoined by disgruntled shareholders.

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76 Ibid 50.
77 Ibid 88 - 93.
78 Ibid 24 - 34.
79 Ibid 56 - 58.
80 Ibid 97 - 98.
81 Ibid 22, 63.
82 Ibid 70, 72 - 76.
83 Ibid 46, 88, 93.
El Paso Corporation ("El Paso") was a NYSE-listed company whose main activities included the exploration and production of oil and gas ("E&P business") and the transportation of natural gas throughout the United States ("pipeline business").

In 2011, the El Paso board made a decision to spin-off its E&P business. Following the announcement of this decision to the NYSE, Kinder Morgan, Inc. ("Kinder") approached El Paso on 30 August 2011 and offered to take over the whole company for US$25.50 per share (mixed cash and stock consideration). El Paso rejected this initial offer, and appointed the Chief Executive Officer and Chairman of the board ("El Paso CEO") to negotiate the terms of the offer with Kinder.\(^{85}\)

On or around 18 September 2011, the El Paso CEO reached an agreement with Kinder at US$27.55 per share (mix of cash and stock consideration). 5 days later, Kinder reneged on its offer, citing over-optimistic projections on the part of its analyst. El Paso then entered into new negotiations with Kinder and eventually accepted a reduced offer from Kinder that was valued at US$26.87 (valuation determined on 16 October 2011, being the date the merger agreement was signed).\(^{86}\)

In addition to accepting reduced terms of offer, the El Paso board also accepted the inclusion of certain restrictive deal protection measures in the merger agreement. These measures included:\(^{87}\)

- **structured “no-shop”:** that the fiduciary out for the “no-shop” clause could only be exercised in the event that El Paso received a superior proposal from a third party for more than 50% of El Paso’s equity securities or consolidated assets. This effectively stopped El Paso from abandoning the merger with Kinder to pursue a sale of the E&P assets, which constituted less than 50% of El Paso’s consolidated assets;

- **pipeline matching rights:** if El Paso chose to terminate the merger agreement to pursue a sale of the pipeline business (which made up more than 50% of the company’s consolidated assets), Kinder had matching rights; and

- **magnified break fee:** the break fee payable by El Paso for accepting a superior proposal was US$650 million (or 3.1% of the equity value and 1.69% of the enterprise value of El Paso). If the purchaser was only

\(^{85}\) Ibid 4.

\(^{86}\) Ibid.

\(^{87}\) Ibid 6 - 7.
interested in acquiring the pipeline business, the relevant break fee would be 5.1% of the equity value and 2.5% of the enterprise value of the pipeline business.\textsuperscript{88} This was out of step with US market practice and can be contrasted with the Australian Takeovers Panel’s guidance that a break fee should not exceed 1% of the equity value of the target.\textsuperscript{89}

An important overlay to the negotiations between Kinder and the El Paso CEO was the conflict of interest that developed. Prior to the signing of the merger agreement, Kinder had made it clear to him that it intended to sell the E&P business post-merger to finance the purchase. The El Paso CEO was interested in acquiring this segment of El Paso’s business from Kinder. He discussed this possibility with the other managers, but did not disclose his intention to the El Paso board during the course of the sale process. Rather, he approached the Kinder CEO twice after the merger agreement was signed to try and facilitate the bidding process for the E&P business, but Kinder was not interested.\textsuperscript{90}

After the merger proposal was announced, the shareholders of El Paso brought the matter to the Delaware Court of Chancery to seek a preliminary injunction to enjoin the merger between El Paso and Kinder. In order to be successful, the shareholders had to satisfy the court that, among other things:

- they had a reasonable probability of success on the merits;
- they would suffer irreparable harm if an injunction was not issued; and
- the balance of equities favoured an injunction being granted.\textsuperscript{91}

The court decided that the shareholders had satisfied the first limb of the test by showing that more faithful, unconflicted parties could probably have secured a better price from Kinder.\textsuperscript{92} In reaching this decision, the court took the following into consideration:

- the board made “\textit{many questionable tactical decisions}”,\textsuperscript{93} including the decision to back down after Kinder retracted its initial offer and the failure to perform soft soundings after Kinder emerged as a potential bidder. The court found that since the valuation was performed by a financial adviser which had a minority shareholding in Kinder, the El Paso board should also have sought alternative methods to evaluate the bid;\textsuperscript{94}
- the deal protection measures contained in the merger agreement precluded termination if a superior bid for the E&P business emerged, and the break fee made it prohibitively expensive for a bidder for the pipeline business to make an offer;\textsuperscript{95} and
- the failure by the El Paso CEO to disclose his interests to the El Paso board only reinforced the view that he was acting to maximise his own interests in purchasing the E&P business post-merger rather than to maximise the value of the bid for El Paso shareholders.\textsuperscript{96}

\begin{footnotesize}
\begin{enumerate}
\item Ibid 7.
\item Australian Takeovers Panel, \textit{Guidance Note 7} at paragraph 9.
\item \textit{El Paso case}, 17.
\item Ibid 3.
\item Ibid 24.
\item Ibid 19.
\item Ibid 20.
\item Ibid.
\item Ibid 21.
\end{enumerate}
\end{footnotesize}
Despite these conclusions, the court ultimately refused to grant a preliminary injunction to the shareholders since it was of the view that the merger vote would be a more appropriate forum to decide whether the merger proposal should proceed. In reaching his decision, Chancellor Strine stated that “Although a reasonable mind might debate the tactical choices made by the El Paso Board...the Revlon doctrine... does not exist as a license for courts to second-guess reasonable, but arguable, questions of business judgment in the change of control context... So long as the directors made reasonable decisions for a proper purpose, they meet their duty under Revlon and this court must defer.” The court noted that it would only enjoin a transaction if the tainted terms precluded another available, viable option that promised higher value – no rival bidder existed at the time.

4.7 Corporate governance practices for listed companies – US Code

NYSE-listed companies are required to comply with the US Code. Compared to the HK Code, the US Code is less comprehensive in terms of coverage of corporate governance issues, but is highly prescriptive. Compliance with the relevant corporate governance rules is mandatory, unlike Hong Kong and Australia (see section 3.10). The main areas of corporate governance covered by the US Code include independent / non-management directors, code of business conduct and ethics, committees and equity compensation plans.

5 Canada

5.1 Overview

Over the past few years there has been very little seminal Canadian case law on directors’ duties. However, there has been movement in the regulatory area of Canadian directors’ duties. These changes predominantly relate to common law developments on fiduciary duties and the oppression remedy, the approach of Canadian securities regulators to poison pills and class actions by secondary market purchasers.

There are corporate governance guidelines in place for companies that are listed on the Toronto Stock Exchange (“TSE”). These guidelines are the National Policy 58-201 Corporate Governance Guidelines and National Instrument 58-101 Disclosure of Corporate Governance Practices (“Canadian Code”).

5.2 Fiduciary duties and the oppression remedy

The most recent landmark Canadian directors’ duties case was in late 2008 and addressed corporate law issues, including directors’ fiduciary duties and the oppression remedy. In its decision in BCE Inc. v 1976 Debentureholders, the Supreme Court of Canada had to look at the breadth of the statutory oppression remedy available to debentureholders (unlike its Australian equivalent).

In response to the Canadian government’s reform of taxation of income trusts in 2006, BCE Inc. (“BCE”) decided to take steps to become an income trust. At the same time, BCE was approached by both Kohlberg Kravis Roberts & Co (“KKR”) and the Ontario Teachers’ Pension Plan (“OTPP”) regarding the possibility of privatising the corporation – both approaches were rejected by BCE. In response to media speculation that KKR would attempt to take control of BCE, OTPP changed its status from a “passive” to an “active” investor, which brought about concerns that it may attempt a hostile privatisation.

97 Ibid 10.
98 Ibid 28
99 2008 SCC 69.
Following this change, the BCE board undertook a strategic review to work out the best way to ensure that any change of control occurred through a competitive process. This process led to a decline in the market value of debentures as there was a possibility that a change in control transaction would lead to BCE and its subsidiary Bell Canada (in whom the debentureholders held debentures) incurring debt and a requisite decline in Bell Canada’s credit rating. Eventually the BCE board decided to recommend OTPP’s offer, which was for C$42.75 per share (40% premium) and did not impact on the rights of the debentureholders.

The proposed transaction was put to a shareholder vote (97% voted in favour) and then the final court approval was sought from the Quebec Superior Court. A number of institutional debentureholders challenged the proposed transaction, including on the grounds of oppression. The trial judge dismissed the debentureholders’ application. His decision was reversed on appeal to the Quebec Court of Appeal. This reversal was then appealed by BCE.

This was the first time the Supreme Court of Canada had examined the oppression remedy since its introduction. The court applied a 2 limbed test, being:

- that debentureholders must establish that there had been a breach of a reasonable expectation through conduct – this is an objective test; and

- if a reasonable expectation had been breached, then the court must examine if it was “oppressive”, “unfair practice” or “unfair disregard” of the relevant interest.100

The court decided that the leveraged buy-out bid did not involve oppression as the debentureholders had failed to provide that they had a “reasonable expectation” that the BCE directors would consider their economic interests in maintaining the trading value of the debentures.101 The court also noted that it was up to the debentureholders to negotiate the relevant contractual protections with Bell Canada rather than to seek those protections from the court.102

The court also provided guidance on the fiduciary duty of directors in relation to managing conflicts of interests between stakeholders. The court reaffirmed that directors’ fiduciary duties are to the corporation and not to all stakeholders, and therefore it is the corporation’s best interests that should be paramount. The court qualified this statement by noting that in reaching a decision as to how to act in the best interests of the corporation, directors should have regard to all other relevant considerations, which may include the interests of stakeholders.103

5.3 Poison pills and the “just say no” defence

Following on from the Delaware Chancery Court’s decision in Air Products and Chemicals, Inc v Airgas, Inc., et al104 and recent Canadian cases, focus has been cast on the role that Canadian regulators should play in control transactions.

In the US, courts determine whether a poison pill has overstayed its prescription. However, in Canada, provincial securities regulators have stopped the indefinite use of pills as takeover defences.

The Ontario Securities Commission (“OSC”), along with certain other Canadian securities regulators, currently has the power to “cease trade” a poison pill

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100 Ibid at paragraph 68.
101 Ibid at paragraph 113
102 Ibid at paragraph 163
103 Ibid at paragraph 82.
104 Airgas case, 12 - 77.
pursuant to its public interest jurisdiction – this power is uniquely a Canadian one which can override the acts of a corporation or shareholder. The OSC has used this power over the past 20 years to strike down poison pills.

In November 2011, the OSC floated the idea that the “cease trade” power will be replaced by a shareholder sanctioned “just say no” defence for target boards, which would facilitate the use of poison pills indefinitely although directors would then be subject to making a determination as to whether the implementation of the shareholder rights plan was an appropriate exercise of their fiduciary duty.105

A catalyst for this review is the decision by the OSC in In Neo Material Technologies Ltd106, which was handed down in 2009. In this case, Neo Material Technologies Inc (“Neo”) was the subject of an unsolicited partial takeover bid by Pala Investment Holdings Limited (held a 20.5% stake) (“Pala”). In response, the Neo board decided to implement another shareholder rights plan which did not permit partial bids. This was well received by the Neo shareholders, who voted to approve it (approximately 82% in favour, with Pala excluded from voting). Pala applied to the OSC for a “cease trade” order.

Surprisingly, Pala was unsuccessful in its application. Unlike the OSC’s previous decisions where poison pills were generally struck down after 40 to 70 days, this was the first time that it decided to let a poison pill run indefinitely. The only other previous Canadian decision allowing this was made by the Alberta Securities Commission in Re Pulse Data Inc.107 By making this decision, the OSC effectively adopted the business judgment rule and signalled that there may be a move towards giving target boards a greater say in control transactions.

In 2010, the British Columbia Securities Commission ordered a cease trade on the poison pill implemented by Lions Gate Entertainment Corporation which was subject to a hostile bid by shareholder activist and corporate raider Carl Icahn.108 Following on from that decision, the OSC also implemented a cease trade in respect of the Baffinland Iron Mines Corp. poison pill.109

It is interesting to analyse the resulting impact on directors’ duties. Instead of courts in Canada regulating the use by directors of poison pills, regulators do this.

5.4 Securities class action by secondary market purchasers

Ontario, home to the TSE, has seen a surge in the number of securities class actions following changes by the Ontario government to the local securities regime in December 2005.

The amendments to Part XXIII.1 of the Ontario Securities Act (“OSA”) allowed security purchasers in the secondary market to bring an action against issuers and related parties (including directors) for misrepresentation in secondary market disclosures (eg quarterly earnings filings and annual reports) without the need to prove individual reliance.110 This effectively lowered the requirement for security purchasers to certify their claims as a class action, which would otherwise be difficult under traditional common law misrepresentation actions due to the requirement for plaintiffs to prove individual reliance.

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106 (September 1, 2009).
107 (November 30, 2007).
109 In Baffinland Iron Mines Corporation (November 19, 2010).
110 Ontario Securities Act, s.138.3.
To prevent a rise of frivolous claims under the OSA, the statutory right of action may only be commenced with leave of the court where the plaintiff can establish that:

- the action is brought in good faith; and
- there is a reasonable possibility that the action will be resolved at trial in the plaintiff’s favour.\(^{11}\)

In 2009, the Ontario Superior Court of Justice certified Canada’s first global securities class action in *Silver v IMAX Corporation et. al*\(^ {112}\). This was also the first time a secondary market class action was brought under the OSA against an issuer and its directors.

In this case, the IMAX shareholders alleged that IMAX had misrepresented its estimated earnings per shares in various disclosure documents in 2005 and 2006 by incorrectly stating that they were prepared in accordance with the accepted accounting standards. A number of current and former officers and directors of IMAX were joined as co-defendants to the suit, as they had signed off on the various disclosure documents.\(^ {113}\)

In granting leave for the plaintiffs to proceed against all but 2 directors of the company, Justice van Rensburg held that the reasonable possibility standard required only a showing of “something more than a de minimus possibility or chance that the plaintiff will succeed at trial”.\(^ {114}\) As most of the directors and officers had been involved in the financial accounting processes of the company, the plaintiffs were able to show this. The 2 directors who were excluded were outside directors who had no role on the company’s audit committee, did not participate in meetings and relied on the audit committee’s recommendations when signing off on the company’s financial statements.

"At least somebody knows how to read a balance sheet."

The exclusion of certain directors from responsibility for the financial accounts can be contrasted with Justice Middleton’s approach in the Australian case *ASIC v Healey & Ors*,\(^ {115}\) also known as the Centro decision. In particular the court’s recognition that “outside directors” have a different position to those more active in approving the financial statements is sound but leaves director participation on the horns of an obvious dilemma.

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\(^{11}\) Ibid, s.138.8.


\(^{113}\) Ibid at paragraphs 1 - 15.

\(^{114}\) Ibid at paragraph 324.

\(^{115}\) [2011] FCA 717.
The decision handed down in the IMAX case has been viewed as highly favourable to investors as it applied a relatively low threshold for commencing a securities claim by secondary market purchasers. Since then, there has been an increase in the number of filings of class actions in Canada. As of 31 December 2011, there were 45 active securities class action in Canada, nearly half of which were filed in 2010 and 2011.\(^{116}\)

5.5 Corporate governance practices for listed companies – Canadian Code

The Canadian Code applies to TSE-listed companies. Similar to Australia (see section 3.10), the Canadian Code adopts a “comply or explain” approach. Companies that are listed on the TSE are required to provide disclosure of their compliance in their annual shareholder meeting materials, or explain why they have not provided disclosure.\(^{117}\) The main corporate governance issues covered by National Policy 58-201 include board composition, board mandate, code of business conduct and ethics, nomination, remuneration and board assessment.

6 United Kingdom and European Union

6.1 Overview

There have been a number of developments affecting UK directors in the past few years. These include the codification of directors’ duties (and their interpretation by the courts) as well as numerous government consultations ranging from directors’ remuneration to diversity in the boardroom which have resulted in changes to the corporate governance code for public companies. These movements can be contrasted with the position of the EU, where no formal attempts have been made to harmonise the difference in directors’ duties and regulations across the 27 Member States. There have, however, been attempts made to streamline approaches to certain corporate governance issues across the EU and signs are emerging that the EU may move towards aligning directors’ duties in the future.

6.2 UK – codification of directors’ duties

One of the major developments in English company law in recent times has been the codification of directors’ duties in the Companies Act 2006 (“UK Companies Act”). Although it is still necessary to consider directors’ duties under common law and equity,\(^ {118}\) the codification has given many of the duties owed by directors a statutory footing in Part 10 of the UK Companies Act.

The codified duties apply to all directors of a company (public or private) including shadow directors and some of the duties (eg the duty not to accept benefits from third parties and the duty to avoid conflict of interests) apply to former directors of a company also.\(^ {119}\)

The new codified duties are owed to the company and are enforceable by that company.\(^ {120}\) In certain circumstances shareholders are able to bring a derivative action against the directors on behalf of the company.\(^ {121}\)

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\(^{117}\) See Part 1.1 of National Policy 58-201 Corporate Governance Guidelines

\(^{118}\) UK Companies Act, ss 170(3) - (4).

\(^{119}\) Ibid ss 170(2), (5).

\(^{120}\) Ibid s 170(1).

\(^{121}\) Ibid pt 11.
In addition, public companies with a premium listing of equity securities in the UK are required to comply with the standards set out in the UK Corporate Governance Code ("UK Code").

6.3 UK – the position post codification

Post-codification, directors owe the following duties to their company pursuant to the UK Companies Act:

- to act within the powers conferred by the company’s constitution;\(^{122}\)
- to promote the success of the company;\(^{123}\)
- to exercise independent judgment;\(^{124}\)
- to exercise reasonable care, skill and diligence;\(^{125}\)
- to avoid conflicts of interest;\(^{126}\)
- not to accept benefits from third parties;\(^{127}\) and
- to declare an interest in a proposed transaction or arrangement.\(^{128}\)

A breach of any of the above duties carries civil liability. Some of these duties are discussed in further detail below.

6.4 UK – the duty to promote the success of the company

One of the most significant changes is the statutory requirement for directors to have regard to a non-exhaustive list of factors in exercising their duty of good faith. This broadly replaced the pre-existing fiduciary duty to act in the best interests of the company.

Directors must act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole (subject to any requirement to act in the best interests of creditors eg in the case of insolvency). The UK government has clarified that “success” will usually mean ensuring a “long-term increase in value” and that it is up to the directors to decide what will lead to that.\(^{129}\)

In making their decisions, directors must have regard (among other matters) to a number of listed factors, being the:

- the likely consequences of any decision in the long term;
- the interests of the company's employees;
- the need to foster the company’s business relationships with suppliers, customers and others;

\(^{122}\) Ibid s 171.
\(^{123}\) Ibid s 172(1).
\(^{124}\) Ibid s 173.
\(^{125}\) Ibid s 174.
\(^{126}\) Ibid s 175.
\(^{127}\) Ibid s 176.
\(^{128}\) Ibid s 177.
\(^{129}\) Lords Grand Committee, 6 February 2006, column 254.
• the impact of the company’s operations on the community and the environment;

• the desirability of the company maintaining a reputation for high standards of business conduct; and

• the need to act fairly as between the members of the company,

with no guidance being given as to the weight that directors should attribute to each. These factors relate to the principle of “enlightened shareholder value”, which is the concept of taking into account the considerations of other stakeholders when making decisions.

In addition to no guidance being given as to the weight directors should attribute to any particular factor, no specific guidance is given as to how directors can demonstrate that they have taken these factors into account. Current market practice is that it is considered to be adequate for the board minutes to state that the directors have taken these factors into account in carrying out their duties and the discussion of each factor need not be minuted. To the extent that a factor is particularly relevant, the minutes would generally reflect the specific points discussed. In the event that a board is required to make any significant or potentially controversial decision, then it is usual for any briefing papers prepared by management to address each relevant factor along with other factors.

Shareholders are given the opportunity to assess how directors have performed in respect of this duty during the annual business review. The test is a subjective one (i.e. did the director honestly believe that he or she had acted in a way that was most likely to promote the success of the company) and is considered to be a modern formulation of the previous acting “bona fide in the interests of the company”.

The statutory requirement for directors to have regard to a non-exhaustive list of factors has been subject to some criticism. The key criticisms have been that the inclusion of the non-exhaustive list of factors will lead to:

• greater bureaucracy in the boardroom and expose the board to greater potential liability; and

• an increase in the amount of shareholder activism / claims.

It is worth noting, however, that directors are only required to “have regard to” the non-exhaustive list of factors - their express duty is to promote the success of the company. In addition, there has been a lack of successful applications for

130 UK Companies Act, s 172(1)(a) - (f).
131 Alistair Darling, Commons Second Reading, 6 June 2006, column 125
132 ICSA International, ICSA Guidance on Directors’ General Duties (January 2008) [3.2.3]. See also GC100, GC100 Guidance on Directors’ Duties (February 2007) [6.3].
133 UK Companies Act, s 417(2).
135 Organisations, for example the Association for the General Counsel and Company Secretaries of FTSE100 companies (the GC100), the Confederation of British Industry (the CBI) and the City of London Law Society raised concerns with the Government and the Department of Trade and Industry (DTI) – the predecessor of BIS - about the possible effects of the new codified duty before and during the passing of the Companies Bill through Parliament. Although the provisions were not amended, the Government provided some assurances to directors. Lord Goldsmith said in the Lords: “There is nothing in this [UK Companies Bill] that says there is a need for a paper trail... I do not agree that the effect of passing this [UK Companies Bill] will be that directors will be subject to a breach if they cannot demonstrate that they have considered every element. It will be for the person who is asserting breach of duty to make that case.
derivative claims made by shareholders on these grounds, showing that these fears have been so far unrealised.

6.5 UK – the derivative action procedure

The introduction of the statutory derivative action procedure into the UK Companies Act led to unrealised fears that it would be deployed as a useful weapon by shareholder activists against boards or directors.

The statutory derivative action procedure was introduced in Part 11 of the UK Companies Act with the intention of providing a simplified procedure under which members of a company are able to take action on behalf of the company in relation to breaches of duty by its directors as revealed by the Explanatory Notes to the UK Companies Act.\(^{136}\) The procedure enables shareholders to bring proceedings to enforce the obligations of a director to his or her company (eg in relation to the negligence, breach of duty or breach of trust by that director) in circumstances where the company fails to take action. This is the case even if the shareholder joined after the act complained of.

The Explanatory Notes to the UK Companies Act suggest that it is not the intention to “formulate a substantive rule to replace the rule in Foss v Harbottle\(^ {137}\) and there should be a new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action” as per the Law Commission’s recommendation. The common law derivative action has not been used much due to, among other things, its complexity and expense, as well as the availability of remedies in relation to unfairly prejudicial conduct available to minority shareholders under the UK Companies Act.\(^ {138}\)

The fears that this new statutory procedure would be deployed as a useful weapon by shareholder activists have been largely unrealised as shareholders still face significant hurdles to bringing a derivative claim and to date the courts have not granted shareholders the requisite permission to commence a claim in accordance with Part 11 of the UK Companies Act. The few instances where shareholders have applied to the court for permission to commence derivative proceedings have been met with rejections.

The key hurdle is that a member seeking permission to continue a derivative action must satisfy a 2 stage procedure.\(^ {139}\) First, the member must be able to show the court that it has a prima facie case for permission to continue a derivative claim (the “first hurdle”). If successful, the member must then persuade the court to grant permission to continue the claim (the “second hurdle”). The court will consider the factors set out in section 263 of the UK Companies Act in deciding whether a claim should proceed. The court must refuse permission where:

- a person acting in accordance with the duty to promote the success of the company would not seek to continue the claim;\(^ {140}\) or
- the act or omission complained of has been authorised before it occurred or ratified by the company since its occurrence.\(^ {141}\)

In considering whether to give permission to continue the action the court must take into account (among other things):

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\(^{136}\) Explanatory Notes, UK Companies Act, at paragraph 483.

\(^{137}\) 67 ER 189; (1843) 2 Hare 461.

\(^{138}\) UK Companies Act, s 994.

\(^{139}\) Ibid s 263(2) - (3).

\(^{140}\) Ibid, s 263(2)(a).

\(^{141}\) Ibid, s 263(2)(b).
• whether the member is acting in good faith in seeking to continue the claim;

• the importance that a person acting in accordance with the duty to promote the success of the company would attach to continuing the claim;

• whether the act or omission complained of could be or is likely to be authorised by the company before it occurs or could be or is likely to be ratified by the company after it occurs;

• whether the company has decided not to pursue the claim; and

• whether the act or omission gives rise to a cause of action that a member could pursue against the director in his or her own right.142

Examples of where the 2 stage procedure has been applied include:

• Franbar Holdings Ltd v Patel and ors - where the court refused an application partly because it was not satisfied that a director acting in accordance with its duty to promote the success of the company would seek to continue the claim and partly because the shareholder had the option to seek a different remedy under the UK Companies Act for “unfair prejudice”;143 and

• Iesini v Westrip Holdings Ltd - where the court emphasised the importance for the derivative action to be based on an act or omission involving negligence, default or breach of duty by a director. Given that the directors had followed the advice of professionals, the court considered that they had not been negligent or breached their duties.144

Whilst members bringing derivative claims have so far been successful in overcoming the first hurdle (ie that they have a prima facie case), the vast majority of them to date have failed at the second hurdle. One case which appears to be the exception is Parry v Bartlett & Anor145. The court in that case determined that there was strong prima facie case that the company had been deprived of a substantial part of certain proceeds of sale and a VAT refund as a result of breach of fiduciary duty by Mr Bartlett and that he was in a position to block any resolution to institute proceedings by the company for the recovery of those sums. The court found that the case would have been a “classic case” of a derivative action under the common law.146

6.6 UK – the duty to exercise reasonable care, skill and diligence

Another duty captured by the codification is the duty of directors to exercise reasonable care, skill and diligence. This is similar to the common law duty that the directors were subject to pre-codification.

Under the UK Companies Act, a director must exercise the care, skill and diligence that would be exercised by a reasonably diligent person with both:

• objective test: the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

142 Ibid, s 263(3).
143 [2008] EWHC 1534 (Ch).
144 [2009] EWHC 2526 (Ch).
146 Ibid.
• **subjective test:** the general knowledge, skill and experience that the director has.\(^{147}\)

What this means in practice is that as a minimum directors are required to meet the objective test and the subjective test but the standard is higher where a director has “specialist” knowledge. In applying the tests, regard must be had for the functions of the particular director including his or her specific responsibilities and the circumstances of the company.

While the enactment is not a major departure from the position prior to the codification (hence the reason that there had been no reported case on section 174 until July 2010 – *Abbe v Hone*)\(^{148}\), it is worth bearing in mind that, traditionally, the courts did not require directors to have a greater degree of skill than may reasonably be expected from a person with their knowledge and experience.\(^{149}\) Accordingly, the standard which directors were expected to meet in relation to exercising their duties was a low and primarily subjective one. The position began to change in the last 20 years with the courts applying a dual objective-subjective test, beginning with *Norman v Theodore Goddard*\(^{150}\) in 1991.

Noting this, the enactment of section 174 of the UK Companies Act has cast in statute the more modern view in which the higher, dual test is applied. Section 174 confirms that the standard now expected of a director is in line with the test applied in deciding whether a director is liable for wrongful trading.\(^{151}\)

6.7 **UK – duty to avoid conflicts of interest**

Another key change is the codification of the duty of directors to avoid conflicts of interest. This change presented a shift from the previous duty under common law.

This codified duty came into effect in October 2008 and requires directors to avoid being in situations where they (or a connected person eg spouse) have or may have an interest (whether direct or indirect) that conflicts (or may possibly conflict) with the interests of the company.\(^{152}\) Although “interest” is not defined, it applies to situations involving the exploitation of any property, information or opportunity, irrespective of whether the company could have taken the advantage instead.\(^{153}\)

There are some exemptions to the duty, which include:

• where the independent directors have voted to approve the conflict (the conflicted director may not vote or be included in quorum) – the independent shareholders need to consider their other codified duties when making their decision;\(^{154}\)

• where the director discloses his or her conflict in relation to a transaction or arrangement with the company;\(^{155}\) or

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\(^{147}\) UK Companies Act, s 174.


\(^{149}\) Explanatory Notes, UK Companies Act, at paragraph 336.


\(^{152}\) UK Companies Act, s 175.

\(^{153}\) Ibid, s 175(2).

\(^{154}\) Ibid, s 175(4)(b), 175(6).

\(^{155}\) Ibid, s 175(3).
• where on the facts it would be unreasonable to consider that there was a conflict of interest.\textsuperscript{156}

The new codified duty automatically applies to all public companies and any private companies created after the implementation date. Pre-existing private companies need to adopt the new provision through a shareholder resolution (including to amend the articles of association, if required) and pre-existing public companies should be ensure the articles of association include provisions enabling directors to authorise conflicts.\textsuperscript{157}

This position can be contrasted with the one under common law pre-codification. Previously, a conflict of interest could only be overcome with shareholder approval. The new codified duty is substantially similar to the corresponding provisions under Division 2 of Part 2D.1 of the Australian Corporations Act.

\textit{Thermascan Ltd v Norman}\textsuperscript{158} was the first reported case in England in respect of the new codified duty regarding conflicts of interest. This case involved former directors of Thermascan Ltd ("Thermascan") setting up a company in direct competition with it, soon after resigning.

Thermascan’s business involved conducting specialised surveys of commercial property, typically for insurance purposes. It used infrared technology to scan factories and warehouses for problems signs including hot spots indicating an electrical fault and possible fire risk. About 70\% of its trade was repeat business with existing customers.\textsuperscript{159}

The defendant, Mr Norman ("Norman"), had been an executive director of Thermascan since 1997. His contract of employment included certain restrictive covenants to the effect that he would not (before, during and after termination of his employment) use or divulge confidential information and would not for 6 months after termination, without prior consent, canvass, solicit or approach for orders any customers he had worked with in the 12 months prior to his termination.\textsuperscript{160}

In September 2008, Norman gave 1 month’s notice to terminate his contract of employment. On expiry of the notice, he also resigned as a director. Within a month he commenced employment with Sykes & Co ("Sykes"), a building and property maintenance company. His job was to head up a new preventative maintenance division providing thermal engineering survey services.\textsuperscript{161}

It came to Thermascan’s attention that Norman had been canvassing its customers as the next survey date approached, offering to conduct scans at lower prices. Thermascan was of the view that he must have used confidential information as to the survey renewal dates.\textsuperscript{162}

Thermascan issued proceedings and sought a court order restraining Norman from canvassing or soliciting its customers or from using any confidential information and to deliver up company property in his possession or control.\textsuperscript{163}

An order was made by consent, standing the applications over to be heard on a date to be fixed upon Norman giving a number of undertakings and delivery up of

\textsuperscript{156} Ibid, s 175(4)(a).
\textsuperscript{157} Ibid, s 175(5).
\textsuperscript{158} [2011] B.C.C. 535, [2009] EWHC 3694 (Ch) ("Norman case").
\textsuperscript{159} Ibid at paragraph 1.
\textsuperscript{160} Ibid at paragraph 4.
\textsuperscript{161} Ibid at paragraph 6.
\textsuperscript{162} Ibid at paragraph 7.
\textsuperscript{163} Ibid at paragraph 8.
company property in his possession or control (which he did). The day before this order, Norman was made redundant by Sykes.\textsuperscript{164}

Subsequently, Norman started his own business through a company called Hotsport-Thermography Limited. He once again contacted customers (although on this occasion he would not have relied on confidential information) he knew were likely to require the service offered, some of whom were customers of Thermascan.\textsuperscript{165}

Thermascan once again issued proceedings, this time seeking a blanket restriction on Norman soliciting or canvassing Thermascan’s clients, even if no confidential information was being used.\textsuperscript{166}

The contractual basis for the restraint disappeared 3 months before the order was sought upon the expiry of the post-employment covenant. To deal with this apparent obstacle, counsel for Thermascan submitted that exactly the same prohibition can be derived from sections 170(2) and 175 of the UK Companies Act, which deal with the fiduciary duties of a director.\textsuperscript{167}

The court held that:

- sections 170 and 175 of the UK Companies Act did not alter the pre-existing law;\textsuperscript{168}

- in line with precedent,\textsuperscript{169} a director was precluded from taking any property or business advantage of the company, especially where he or she was a participant in the negotiations, even post-resignation if the resignation was prompted or influenced by the desire to acquire for himself or herself any maturing business opportunities sought by the company;\textsuperscript{170} and

- in line with precedent,\textsuperscript{171} a director was entitled to resign from a company and following the expiration of any applicable restriction period (subject to the terms of the contract of employment) was not prohibited from using his or her general fund of skill and knowledge acquired while a director. This included business contacts and personal connections made as a result of the directorship.\textsuperscript{172}

On that basis, the court refused to order the blanket restriction on Norman’s soliciting or canvassing of Thermascan’s clients.

6.8 UK – corporate governance code for listed companies – UK Code

Public companies with a premium listing in the UK are required to comply with the standards set out in the UK Code. These duties are in addition to the ones under the UK Companies Act.

\textsuperscript{164} Ibid at paragraph 9.
\textsuperscript{165} Ibid at paragraph 11.
\textsuperscript{166} Ibid at paragraph 12.
\textsuperscript{167} Ibid at paragraph 13.
\textsuperscript{168} Ibid at paragraph 14.
\textsuperscript{172} Norman case [2011] B.C.C. 535 at paragraph 15.
The UK Code was published on 28 May 2010 and applies to public companies with a premium listing of equity shares with accounting periods beginning on or after 29 June 2010. It is the result of the UK Financial Reporting Council’s review of the UK Code’s predecessor, the UK Combined Code (which began in March 2009) and consolidates the work of various reports and consultations. The UK Combined Code continues to apply to companies with accounting periods beginning before 29 June 2010.

The UK Code sets out certain main principles to which companies subject to the UK Code are expected to adhere to. These include that:

- companies need to disclose in their annual financial reports how they have applied the UK Code’s main principles and state whether or not they have complied with UK Code provisions. The main principles relate to leadership, effectiveness, accountability, remuneration and relations with shareholders;

- in the context of directors’ duties, main principle B.1 states that the board and its committees “should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively”; and

- while not legally required to comply with the provisions of the UK Code, not complying with the provisions could give rise to reputational embarrassment for companies as they must disclose in their annual reports whether or not they have complied with the provisions, and if not, why not. This is similar to the approach in Australia (see section 3.10).

6.9 EU – Directives on Directors Duties

There has been no formal attempt to harmonise the regulation of directors and their duties across the 27 Member States of the EU. This can be contrasted with the position in Australia, where the Council of Australian Governments (“COAG”) is currently undertaking an audit of directors’ liability in each of the States and Territories pursuant to the National Partnership to Deliver a Seamless National Economy reform package. These reforms are not expected to be implemented until 2013 at the earliest.

As there has been no attempt to harmonise, there are no directives or regulations establishing or governing directors’ duties at the EU level. Instead, each Member State is able to legislate and regulate directors’ duties itself.

There are, however, some signs that the EU may begin to move towards harmonisation. The European Commission is seeking to commission a stocktaking study in relation to directors’ duties as it is unaware of the position in the different Member States. It is not clear at this stage whether this is a possible indicator of further steps towards harmonisation of company law at the EU level or whether it is merely an information gathering exercise to enlighten the European Commission on an unknown area.

6.10 EU – corporate governance

In contrast to its current approach to directors’ duties, the EU has made various Recommendations and consulted on corporate governance issues in relation to listed companies. For example, over the last 8 years the EU has adopted certain

Recommendations in relation to executive remuneration of directors of listed companies. These include Recommendations that were adopted in relation to:

- the disclosure of executive remuneration;
- limits on the variable components of executive remuneration;
- limits on termination payments to not higher than the equivalent of 2 years of the non-variable component of the director’s remuneration. This is in contrast with the position in Australia where the limit on termination payments without shareholders’ approval is fixed at 1 year of the director’s average base salary;\(^{175}\)
- the role of shareholders and independent non-executive directors in executive remuneration; and
- the exclusion of share options as part of the remuneration package of non-executive directors.

More recently, the European Commission launched a public consultation based on a green paper entitled “The EU Corporate Governance Framework” on 5 April 2011. The consultation focused on 3 areas:

- improving the effective functioning of boards by ensuring they are composed of a mixed group of people;
- enhancing shareholders’ engagement on corporate governance issues; and
- improving monitoring and enforcement of the existing national corporate governance codes by looking at how to apply the “comply or explain” approach more effectively.

The deadline for responses was 22 July 2011. The Commission has issued a feedback statement summarising the results of the consultation but is yet to announce any policy options.


\(^{175}\) Corporations Act 2001 (Cth) pt 2D.2 div 2. These changes were introduced by the Corporations Amendment (Improving Accountability on Termination Payments) Act 2009 (Cwlth) and came into effect on 23 November 2009. Previously, the threshold for shareholder approval of termination benefits was 7 years’ total remuneration.
Biographical Details

King & Wood Mallesons is a leading law firm in Asia Pacific, with offices in all major cities of China and Australia, New York, Silicon Valley, London and Tokyo.

David Friedlander is a mergers & acquisitions and securities lawyer in the Sydney office of King & Wood Mallesons. He is consistently ranked as one of Australia’s top M&A and equity capital markets lawyers.

David regularly acts for both bidders and targets in takeovers and issuers and underwriters in securities offerings. David is integral to the firm’s growth in Asia Pacific and spends time in our Hong Kong and China practices and is a member of the Board of the firm.

David holds Bachelor of Commerce and Law degrees from the University of New South Wales and a Master of Laws degree from the University of Sydney. He is a member of the Australian Takeovers Panel, the ASX Capital Markets Panel and its Disciplinary Tribunal, the Australian Law Council’s Corporations Committee and of the Legal Committee of the Australian Institute of Company Directors.

Shannon Finch is the Partner in Charge of the Sydney office of King & Wood Mallesons, specialising in mergers & acquisitions, capital markets, restructuring and private equity, advising corporate clients, private equity funds and investment banks.

Shannon is recognised as a leading lawyer in equity capital markets and high yield products by Best Lawyers International and recognised in Chambers Global; Asia Pacific Legal; PLC Which Lawyer Handbook; PLC Cross Border Capital Markets Handbook; PLC Global Counsel 3000 and IFLR 1000.

Shannon is a member of the Australian Law Council’s Corporations Committee, the Australian Institute of Company Directors and Women on Boards. She lectures on Securities and Disclosure laws at the University of New South Wales, the University of Sydney and Monash University.

Amanda Isouard and Martin Kan are lawyers in the King & Wood Mallesons M&A team in Sydney.

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