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Question 2

83/100

XY Bank (XY) and Buck (B) Insurance own 55% of shares in Gunawan Ltd (G). Private Pty Ltd (P) wants to takeover G. XY and B oppose the proposed takeover bid and the G issues shares.

The issue at hand is whether the exercise of power by G’s directors to issue shares was a proper purpose.

Proper Purpose

Director’s of a company are bound by a fiduciary duty to shareholders to exercise their powers for a proper purpose: s181(1)(6); Whitehouse v Carlton

Generally, the Director’s must exercise powers for the purpose for which it was conferred: Harlowe Nominees. To determine if this was done it is necessary to apply the 2 stage test from Howards Smith: what is the purpose for which the power was conferred?; for what purpose was it actually exercised?

Implicit in replaceable rule s198A is the power of directors to issue shares.

Proper purpose of share issues have been: to raise capital (Howard Smith); to take advantage of a genuine commercial opportunity (Pine Vale Investments); and to ensure the financial stability of the company (Harlowe’s Nominees). Improper purposes have included altering the shareholder makeup (Howard Smith), or avoiding a takeover (Whitehouse).

In this case, the issue of shares by G appears to have mixed purposes. First it would like to allow takeover by P that B and ZY have publicly opposed, so they may wish to dilute the shareholdings of B and XY (currently 55%) in order to ensure the resolution is passed at General Meeting. Secondly, public documents suggest that the purpose of share issue is to finance a major expansion into stage 3 of the G’s strategic business plan. There is, then, two potential purposes: one valid (secure business opportunity), and one invalid (alter shareholder makeup).

Current caselaw suggests that an exercise of power is invalid if that exercise of power would not have taken place but for the improper purpose: Whitehouse. The facts state that the share issue was proposed as an already existing business strategy plan and thus the exercise of proper to issues shares would have occurred without the takeover bid. The questions that is contentious is that of timing.
The facts here are analogous to those of *Howard Smith*. In that case the Board of Directors claimed they wanted to buy a tanker, but the actual purpose was to avoid a takeover bid. It was considered by judges that the opportunity to buy a tanker was not part of regular business, there had been no evidence of planning for the purchase and that there had been no evidence of a plan to issue shares prior to the takeover bid. The decisive factor, though, was that the share issue was restricted to one person, Howard Smith, there was not a public offer of shares.

**How does Howard Smith Apply here?**

In this case the share issue was to alter votes and secure a takeover and the share issue in *Howard Smith* was to avoid a takeover bid. Arguably, however, the criteria still applies. If this is so, then the facts of the instant case may be distinguished from *Howard Smith* on two grounds. First, there is evidence that the share issue was planned before the public announcement of the takeover by XY and B. Secondly, it appears that there is a real business opportunity that is presented by this “strategic plan”. Arguably, the decision to move the issue forward was a valid exercise of the power in these circumstances: *Whitehouse, Howard Smith*.

**Proper or Improper Purpose**

The issue of shares here was motivated by both the desire to alter voting structures and secure a takeover, and also secure a genuine commercial opportunity. There was evidence of a business plan in place and the fact that it was bought forward does not seem to contravene a proper exercise of the power. The decisions of the directors of G to issue shares was not a breach of their fiduciary duty to shareholders to exercise powers for a proper purpose.

**Other Possible Actions**

Depending on the constitution, XY and B may bring an action against the directors of the company for breach of a clause that specified, for example, they has special rights.

Provided that XY and B could establish that the issue would cancel or vary or cancel rights which attach to their shares then they may have an action under this head. Also must be established that shares can be meaningfully differentiated by class rights (*Crimption*) so unlikely action because G has only one class of shares.

Another option would be to pursue action on the grounds of oppression or unfairly prejudicial or discriminatory conduct: s232. The decision to issue shares, however, is unlikely to satisfy the special criteria of unfairness required by case law on this section: see *Wayde v NSW Rugby*.

**Conclusion**
It is unlikely that XY or B could institute successful proceedings challenging the issue of shares under a breach of director’s duty. It may be possible to establish alternative action under heads such as oppression and variation of class rights. This too, however, is unlikely. If it were successful, XY and B could apply to court for orders in s233, or for an injunction under s1324. Thus the best advice would be to purchase more shares to sustain voting rights but they have already discharged the option. Not many ways for XY and B to go – may just have to suffer.