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# Directors' and Officers' Liability in the United Kingdom

*D Cabrelli\*/A McAlpine\*\**

## I. General Part – Overview of the corporate law framework

### *1. Nature and distinction between various types of companies*

- 1 The Companies Acts (the applicable piece of legislation is the Companies Act 2006 ('the Act' or 'CA 2006')) recognise the following forms of company:
  - A. Private company limited by guarantee;
  - B. Public company limited by guarantee;
  - C. Private company limited by shares;
  - D. Public company limited by shares;
  - E. Private unlimited company; and
  - F. Public unlimited company.
- 2 UK Law also recognises the partnership, the Limited Partnership (regulated by the Limited Partnership Act 1907) and the Limited Liability Partnership (regulated by the Limited Liability Partnership Act 2000). However, each of these aforementioned business vehicles are technically not 'companies' and as such, no more is said about them in this response to the questionnaire. UK law also recognises community interest companies, European Economic Interest- ing Groupings and the European Company (Societas Europea), but nothing further is said about these corporate forms in this response on the basis that they are not business vehicles or that they are European in their nature, rather than UK-based.
- 3 The Companies Acts prescribe a numerous clausus of companies. As such, it is not possible for legal persons to create any further companies by contract.

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- 4 The Companies Acts also draw a distinction between private and public companies. Apart from the principal point that only public companies may issue shares to the public,<sup>1</sup> some of the further implications of this division are as follows: (1) additional regulatory rules apply to public companies, eg the provisions of the UK Corporate Governance Code,<sup>2</sup> the Financial Conduct Authority's Handbook<sup>3</sup> and the Takeover Code<sup>4</sup> tend to apply only to public companies, (2) only public companies whose shares are listed may be traded on the London Stock Exchange or AIM, (3) a public company must have a minimum allotted share capital of £ 50,000, one quarter of which must be fully paid up on issue, ie £ 12,500,<sup>5</sup> and (4) the name of the public limited company ('plc') must end with the abbreviation 'plc', whereas the private company's name must end with the word 'limited' or the abbreviation 'ltd'.<sup>6</sup> However, it should be stressed that the content of the duties of directors does not vary depending on whether the director is a private company or plc.

*2. Legal personality and its consequences and the appointment, removal and accountability of the board*

- 5 Each of the companies prescribed by the Act are bodies corporate and possess separate legal personality from their members or directors: *Salomon v Salomon v Salomon & Co Ltd*.<sup>7</sup>
- 6 In the case of each of these forms of company, the law provides for the separation of the property of the company from the property of each of the members/shareholders or directors. As such, the company owns its assets, rather than its members. It has been held in court that the members do not have any rights as beneficiaries in the assets of the company in the sense of the company owning the underlying assets but holding them in trust for the members.<sup>8</sup>
- 7 Subject to certain carefully controlled and very limited exceptions, the general rule in UK law is that the shareholders of a plc or private limited company have limited liability for the debts of the company via-à-vis third parties: *Sa-*

<sup>1</sup> CA 2006, sec 755.

<sup>2</sup> See <<https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>> (last visited 9 May 2017). At the time of writing, the Financial Reporting Council were about to embark on a review of the UK Corporate Governance Code.

<sup>3</sup> See <<http://www.fca.org.uk/handbook>> (last visited 9 May 2017).

<sup>4</sup> See <<http://www.thetakeoverpanel.org.uk/the-code>> (last visited 9 May 2017).

<sup>5</sup> CA 2006, secs 763 and 586.

<sup>6</sup> CA 2006, secs 58–60.

<sup>7</sup> [1897] Appeal Cases (AC) 22.

<sup>8</sup> See *Commissioners of Inland Revenue v Crossman* [1937] AC 26 and *Short v Treasury Commissioners* [1948] 1 King's Bench (KB) 116, affirmed [1948] AC 534 House of Lords (HL).

*lomon v Salomon v Salomon & Co Ltd.*<sup>9</sup> In the case of a plc by shares or a private limited company by shares, the liability of the shareholders for the debts of that company is limited to any value which remains unpaid on their shares. Meanwhile, in the case of the plc by guarantee, or a private company limited by guarantee, the liability of the members for the debts of the company is not limited to the value of any shares in the company (since a company limited by guarantee will not usually have any shares) but to the value of the contribution which they have agreed to make towards the assets of the company on its winding up.<sup>10</sup> The company and the members agree the extent of the guarantee in the memorandum of association of the company.<sup>11</sup>

- 8 In the case of each of the companies listed at 1A, 1B, 1C, 1D, 1E and 1F, the corporate organs are (a) the shareholders in general meeting and (b) the board of directors. The board of directors is a unitary board, comprised of executive and independent non-executive directors.
- 9 Regulations 17 of Schedule 1, and Regulation 20 of Schedule 3, to the Companies (Model Articles) Regulations 2008 ('the Model Articles')<sup>12</sup> provide that an individual may be appointed to the board of directors of a plc by shares or private limited company by shares in one of two ways, namely (1) by ordinary resolution of the shareholders, ie by a simple majority of the shareholders who vote on a show of hands or by poll,<sup>13</sup> or (2) by co-option by the directors. Co-option involves a majority decision by the other directors on the board of directors to appoint an individual as a director. In practice, the appointment of directors by co-option is very common.
- 10 The CA 2006 does not prescribe who the directors on the board should be. However, regulations 12 of Schedule 1, Schedule 2, and Schedule 3, to the Model Articles direct that an individual must be appointed to chair the meetings of the board of directors of a plc by shares, private company limited by guarantee, or a private limited company by shares. The person appointed to that role is known as the 'chairman'. Beyond the chairman, the CA 2006 and the Model Articles fail to provide for the roles of the other members of the board of directors. This can be contrasted with the UK Corporate Governance Code, which recognises the roles of the chief executive, the senior independent director and a general division of responsibility between the executive and non-executive functions of the board of directors.

<sup>9</sup> [1897] AC 22.

<sup>10</sup> CA 2006, sec 3(3).

<sup>11</sup> In practice, it is common for the contribution to be limited to £ 5.

<sup>12</sup> See the model articles for private companies limited by shares and public companies in Schedules 1 and 3 to the Companies (Model Articles) Regulations 2008 (SI 2008/3229)—see <<http://www.legislation.gov.uk/uksi/2008/3229/contents/made>>.

<sup>13</sup> CA 2006, sec 282(1).

- 11 There is no impediment to a legal person (ie not a natural person) being appointed as a member of a company. However, there are restrictions in place regarding the appointment of legal persons as directors of a company. At the time of writing, it is possible for a company to be appointed as a director of a private limited company, so long as at least one of the directors is a natural person.<sup>14</sup> However, when secs 156A–156C of the CA 2006 come into force at some point in the future, it will no longer be valid for a company to act as a director, since all directors will have to be natural persons.
- 12 The rules on the removal of directors from the board of directors are set out in the Act. Directors may be removed in terms of sec 168(1) of the CA 2006 by an ordinary resolution of the members of the company, ie by a simple majority of the shareholders who vote on a show of hands or by poll in general meeting.<sup>15</sup> The power of the members to remove a director arises, ‘notwithstanding anything in any agreement between [the company] and [the director]’. Furthermore, there is no need for the members to satisfy any legally prescribed grounds or reasons for the removal of a director, ie in company law, a director may be removed for an arbitrary reason, no reason or a bad reason. A member proposing to remove a director must proceed by special notice procedure in terms of sec 312 of the CA 2006. The special notice procedure envisages the member providing notice to the company of an intention to remove a director at least 28 days before the general meeting at which the resolution is moved.<sup>16</sup> The company is then under an obligation to give notice to the members of any such ordinary resolution in the same manner and at the same time as it gives notice of the meeting.<sup>17</sup> If it is impracticable for the company to give notice within the said 28-day timescale, the company must give its members notice at least 14 days before the meeting by advertisement in a newspaper having an appropriate circulation or in any other manner permitted by the company’s articles of association.<sup>18</sup> Moreover, when the company receives notice from a member intending to remove a director, the company must forthwith send a copy of that notice to the director concerned.<sup>19</sup> At the meeting, the director has the right to protest his or her removal and has a right to be heard.<sup>20</sup> If the director provides the company with representations in writing regarding his proposed removal, if time will allow, the company must send a copy of those representations to each of the members with the notice of the resolution given to the members of the company.<sup>21</sup>

<sup>14</sup> CA 2006, sec 155.

<sup>15</sup> CA 2006, sec 282(1).

<sup>16</sup> CA 2006, sec 312(1).

<sup>17</sup> CA 2006, sec 312(2).

<sup>18</sup> CA 2006, sec 312(3).

<sup>19</sup> CA 2006, sec 169(1).

<sup>20</sup> CA 2006, sec 169(2).

<sup>21</sup> CA 2006, sec 169(3).

- 13 Turning now to the relationship between the board of directors and the shareholders in general meeting, regulations 4 of Schedule 1, Schedule 2, and Schedule 3, to the Model Articles direct that the shareholders of a plc by shares, private company limited by guarantee, or a private limited company by shares, have the power to instruct the board of directors to take certain action, or to refrain from taking certain action, by passing a special resolution in general meeting, ie by a 75% majority of the shareholders who vote on a show of hands or by poll.<sup>22</sup> In such circumstances, the board of directors are legally bound to follow the instructions of the shareholders. This is a default rule set out in the Model Articles, but is adopted by the vast majority of plcs by shares and private limited companies by shares incorporated in the UK. It is an extremely important provision, because it establishes the constitutional balance of power between the shareholders in general meeting and the board of directors that is set by UK Company law. In essence, it demonstrates that UK company law is a shareholder-centric jurisdiction, since the originating power for the direction of the company rests with the shareholders, notwithstanding that the board has the day-to-day power and decision-making authority devolved to it in terms of regulations 3 of Schedule 1, Schedule 2, and Schedule 3, to the Model Articles. Whilst shareholders retain such valuable initiation and instruction rights under regulations 4 of Schedule 1, Schedule 2, and Schedule 3, to the Model Articles, it should be recalled that the largest plcs by shares in the UK whose shares are listed on the London Stock Exchange have widely dispersed shareholders, which makes it difficult for their shareholders to be active or coalesce and co-ordinate their efforts to employ these rights to monitor or control management. There is no supervisory or controlling board in the case of each of the forms of company recognised by UK law, since the UK operates a unitary, rather than two-tier, board structure. The UK Corporate Governance Code envisages that non-executive directors appointed to the board of directors will perform a monitoring role.

### *3. The qualifications of board members*

- 14 There is no vetting process prescribed by law as to who can qualify as a director. As such, there are no basic education or professional criteria for entry to the office of director. However, directors must be over the age of 16.<sup>23</sup> Moreover, there are provisions for the automatic termination of a director's appointment and also for his/her disqualification by order of the court. For example, an individual will cease to be a director with immediate effect where (i) he/she is made subject to a bankruptcy order, (ii) he/she makes a composition with his/her creditors generally in satisfaction of his/her debts, (iii) a registered medical practitioner gives a written opinion to the company that he/she

<sup>22</sup> CA 2006, sec 283(1).

<sup>23</sup> CA 2006, sec 157

has become physically or mentally incapable of acting as a director and may remain so for more than three months.<sup>24</sup>

#### 4. Investigations into directors' misconduct

- 15 UK company law does not lay down any mandatory provision for an internal or external audit in the event of any alleged board misconduct. Instead, any investigation would be conducted internally in accordance with the company's standard disciplinary and grievance procedures which apply to all of its employees. These provisions are likely to be largely based on the Code of Practice 1 on Disciplinary and Grievance Procedures of the Advisory, Conciliation and Arbitration Service ('the ACAS Code').<sup>25</sup> Section C.3 of the UK Corporate Governance Code does instruct boards of directors to create audit committees, whose function it is to monitor the risk management function and internal financial controls of the company, but is not designed to audit directors in the case of misconduct. Where there is managerial misconduct, it is left to the company itself to seek legal recourse. The main avenue for legal redress would be via a breach of the law of directors' duties, but such a route would be blocked off if the director can convince a simple majority of the members of the company to pass an ordinary resolution ratifying or authorising such a breach, in which case, a disgruntled minority shareholder would have to attempt to raise a statutory derivative action against the director in court under secs 260 to 269 of the CA 2006, or present an unfair prejudice petition in court in terms of sec 994 of the CA 2006.

## II. Liability for Damage Caused to the Company and to the Shareholders

### A. General requirements – scope of duties and violation of duty of care of directors

#### 5. Liability of the board and its members

- 16 Upon their appointment, directors are obliged to discharge a number of 'general duties' which are imposed on them by the CA 2006. The general duties are owed by the director to the company<sup>26</sup> and the liability of directors under such general duties does not arise in the law of contract or tort, but by virtue of company law in the guise of the CA 2006. For that reason, the remedies

<sup>24</sup> See Regulation 18 of Schedule 1, Regulation 18 of Schedule 2, and Regulation 22 of Schedule 3, to the Model Articles.

<sup>25</sup> See <<http://www.acas.org.uk/?articleid=2174>>.

<sup>26</sup> CA 2006, sec 170(1). Directors do not generally owe their duties to the shareholders of the company: *Percival v Wright* [1902] Law Reports, Chancery Division (3rd Series) (Ch) 421; *Multinational Gas and Petrochemical Co Ltd v Multinational Gas and Petrochemical Services Ltd* [1983] Ch 258. The directors' duties will be owed to shareholders only where a direct fiduciary relationship exists between director and shareholder: *Peskin v Anderson* [2001] 1 Butterworths Company Law Cases (BCLC) 372.

which may be granted where a director has breached one of the general duties which is fiduciary in character – on which subject, see below – are much broader than would be the case if the liability arose in contract or tort. For example, along with the general remedies of damages or a declaratory order of the court, it is possible for a successful claimant to obtain an order for specific performance, injunctive relief and restitutionary remedies in equity, such as an account of profits, constructive trust and remedies against third parties who have dishonestly assisted the director in breach of fiduciary duty, or are in knowing receipt of funds. For further details, see below.

- 17 The general duties are set out in secs 171–177 CA 2006 and are a codification of the duties owed by a director at common law:
- The duty to act within powers and to obey the constitution (sec 171)
  - The duty to promote the success of the company (sec 172)
  - The duty to exercise independent judgment (sec 173)
  - The duty to exercise reasonable care, skill and diligence (sec 174)
  - The duty to avoid conflicts of interest (sec 175)
  - The duty not to accept benefits from third parties (sec 176); and
  - The duty to declare an interest in a proposed transaction or arrangement (sec 177)
- 18 A distinction has traditionally been drawn between fiduciary duties and other duties of a director.<sup>27</sup> A director's duties, with the exception of the duty to exercise reasonable care, skill and diligence (sec 174), are fiduciary in nature. The distinction between fiduciary duties and other duties is perpetuated in CA 2006 by virtue of sec 178. This provision states that the director's duties contained in secs 171–177 CA 2006 are, 'with the exception of sec 174 (duty to exercise reasonable care, skill and diligence) enforceable in the same way as the fiduciary duties owed by a director at common law.'<sup>28</sup> The rationale for a director's sec 174 duty not being viewed as fiduciary in nature is discussed below.<sup>29</sup>
- 19 As the director occupies a fiduciary position in relation to the company, he is required to subordinate his own interests in favour of the company's interests.

<sup>27</sup> *Bristol and West Building Society v Mothew* [1998] Ch 1.

<sup>28</sup> CA 2006, sec 178(2).

<sup>29</sup> Reference to Q13 answer.



Some of consequences of this are that the director must: act bona fide in a way he/she considers would promote the success of the company, not allow his own interests to conflict with those of the company and not make a secret profit which would affect the company's interests.<sup>30</sup> The fiduciary duties of a director are concerned with the director's *loyalty* to the company.<sup>31</sup> This is reflected in Millett LJ's judgment in *Bristol and West Building Society v Mothewe*,<sup>32</sup> a leading authority on fiduciary relationships:

- 20 'The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations. They are the defining characteristics of the fiduciary.'<sup>33</sup>
- 21 If a director breaches one or more of these duties,<sup>34</sup> then the director will be liable to the company. Reference must, however, be made back to the common law when assessing the remedies available to the company against the director who breaches one or more of his duties. This is because, whilst the duties of directors are codified, the remedies for breach of them are not.<sup>35</sup> The common law remedies for breach of a director's duties remain applicable. The remedy the company has against the director depends on the nature of the duty breached. If the duty breached is *not* fiduciary – ie the director has breached his duty to exercise reasonable care, skill and diligence which is embodied in sec 174 of the CA 2006 – then the remedies are in accordance with the common law principles applicable to negligence claims.<sup>36</sup> The director will be liable to pay damages for the breach, and the award of damages in these circum-

<sup>30</sup> CA 2006, secs 172 and 175–177.

<sup>31</sup> *Extrasure Travel Insurance Ltd v Scattergood* [2003] 1 BCLC 598.

<sup>32</sup> [1998] Ch 1.

<sup>33</sup> *Bristol and West Building Society v Mothewe* [1998] Ch 1 at 18 per Millett LJ.

<sup>34</sup> CA 2006, sec 179 states 'except as otherwise provided, more than one of the general duties may apply in any given case.' It is envisaged that two or more duties may apply to a specific situation and be breached by a director at the same time. The exceptions to this are secs 175 and 177. It is expressly provided in sec 175(3) that this provision does not apply where sec 177 is applicable.

<sup>35</sup> CA 2006, sec 178(1)-(2).

<sup>36</sup> *Simon Mortimore et al* (eds), *Company Directors: Duties, Liabilities and Remedies* (2nd edn 2013) at para 19.80.

stances is regulated by the rules relating to causation, foreseeability and quantification of damages.<sup>37</sup>

- 22 If the duty breached *is* fiduciary in nature, a range of remedies are available. It would be incorrect, however, to view payment by a director in breach of his fiduciary duties as purely compensatory of the company's losses. The fiduciary remedies available to the company do not generally depend on the loss to the company, but are concerned with the disgorgement of the director's wrongly obtained gain.<sup>38</sup> This may be contrasted with a claim for breach of a director's duty to exercise reasonable care, where emphasis is on compensating the company for the loss they suffered as a result of the director's negligence.<sup>39</sup> The remedies available to the company against a director in breach of his fiduciary duties are:

- Constructive trust – this arises where a director misapplies company property and the property can be returned, in specie, by the director to the company. The property which is misappropriated by the director is treated as if it is owned by the director but for the benefit of the company.
- Account of profits – any profit or gain enjoyed by the director can be disgorged
- Equitable compensation/damages
- Rescission – any contract to which the director committed the company may be rescinded.

#### *6. General statutory and non-statutory duties of the board and its members*

- 23 The 'general duties' of a director are contained in secs 171–177 CA 2006.<sup>40</sup> The provisions represent a codification of the common law duties of a director. The common law authorities on director's duties will, therefore, remain relevant in order to gain a proper understanding of the statutory form that director's duties now take in secs 171–177 CA 2006. Section 170 of the CA 2006 stipulates that: (1) secs 171–177 are to be interpreted and applied in the same way as the common law rules that the provisions replace; and (2) regard shall be had to the equivalent common law directors' duties when interpreting and applying the general duties contained in statute.<sup>41</sup> This has been reflected

<sup>37</sup> *South Australia Asset Management Corporation v York Montague Ltd* [1997] AC 191; *Dorchester Finance v Stebbing* [1989] BCLC 498.

<sup>38</sup> *Regal (Hastings) Ltd v Gulliver* [1942] 1 All England Law Reports (All ER) 378.

<sup>39</sup> *P Hood*, What is so special about being a fiduciary? (2000) 4 Edinburgh Law Review (ELR) 308.

<sup>40</sup> CA 2006, sec 170(1).

<sup>41</sup> CA 2006, sec 170(3)-(4).

in case law post-dating the 2006 Act, with courts commenting that secs 171–177 ‘appear[s] to do little more than set out the pre-existing law on the subject’<sup>42</sup> and that they are intended to ‘extract and express the essence of the rules and principles which they have replaced.’<sup>43</sup>

24 The general duties described in sec 170 CA 2006 are identified as:

- *The duty to act within powers (sec 171)* – this duty requires a director to (a) act in accordance with the company’s constitution;<sup>44</sup> and (b) only exercise powers for the purposes for which they are conferred.<sup>45</sup>
- *The duty to promote the success of the company (sec 172)* – this duty requires a director to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole.<sup>46</sup> In deciding what will promote the success of the company, the director must have regard to the factors listed in s172(1) and discussed in detail below.
- *The duty to exercise independent judgment (sec 173)* – this codifies the common law duty on directors not to fetter their discretion.<sup>47</sup> The duty is not breached if the director: (1) merely takes advice;<sup>48</sup> (2) acts in accordance with an agreement entered into by the company which limits the director’s exercise of discretion in the *future*;<sup>49</sup> (3) acts in a way permitted by the company’s constitution;<sup>50</sup> or (4) delegates his functions to an employee whom he can reasonably place reliance on.<sup>51</sup>
- *The duty to exercise reasonable care, skill and diligence (sec 174)* – this duty requires the director to exercise the care,

<sup>42</sup> *West Coast Capital (Lios) Ltd v DGC plc* [2008] Scotland Court of Session, Outer House (CSOH) 72 at [21] per Lord Glennie.

<sup>43</sup> *Towers v Premier Waste Management Ltd* [2011] Court of Appeal, Civil Division (EW-CA Civ) 923 at [3] per Mummery LJ.

<sup>44</sup> CA 2006, sec 171(a).

<sup>45</sup> CA 2006, sec 171(b).

<sup>46</sup> CA 2006, sec 172(1).

<sup>47</sup> *Re Englefield Colliery Co* (1878) 8 Law Reports, Chancery Division (2nd Series) (Ch D) 388; *Re London and South-Western Canal Ltd* [1911] 1 Ch 346.

<sup>48</sup> *Green v Walkling* [2008] BCLC 332; *Ridehalgh v Horsefield* [1994] Ch 205.

<sup>49</sup> CA 2006, sec 173(2)(a). See also *Fulham Football Club Ltd v Cabra Estates plc* [1994] 1 BCLC 363 at 392 per Neill LJ.

<sup>50</sup> CA 2006, sec 173(2)(b).

<sup>51</sup> *Dovey v Corey* [1901] AC 477; *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407; *Norman v Theodore Goddard* [1991] BCLC 1028.

skill and diligence expected from: (a) a person carrying out the same functions as the director in question; and (b) a person with the knowledge and expertise the director actually has.<sup>52</sup> The nature, scope and operation of this duty is discussed in detail below.

- *The duty to avoid conflicts of interest (sec 175)* – sec 175 sets out a general duty to avoid conflicts of interests. This section deals with the situation where the director acts in a way which directly/indirectly conflicts, or may conflict, with the company's interests. Examples of this include the director competing with the company through a personal business or utilizing company property for personal benefit.<sup>53</sup>
- *The duty not to accept benefits from third parties (sec 176)* – this provision deals with the situation where a third party gives a benefit to a director because he is a director or to influence his conduct as a director. Section 176 reformulates the common law duty on directors not to accept bribes or secret commissions.<sup>54</sup>
- *The duty to declare an interest in a proposed transaction or arrangement (sec 177)* – in contrast with the general duty to avoid conflicts of interest embodied in sec 175, sec 177 deals with conflicts where the director is *dealing with the company*. Section 177 is also envisaged as dealing with a specific form of conflict, namely where the director has a direct/indirect interest in a 'proposed transaction or arrangement with the company.'<sup>55</sup>

#### 7. Nature and scope of the duty to act in the best interests of the company

- 25 At common law, directors had a duty to act bona fide in the best interests of the company as a whole.<sup>56</sup> Section 172 CA 2006 codifies this duty, stipulating that 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. In deciding what course of action is most likely to promote the success of the company, sec 172(1) lays down a list of factors which the director must have regard to:

<sup>52</sup> CA 2006, sec 174(2)(a)-(b).

<sup>53</sup> Eg, see, *IDC v Cooley* [1972] 1 Weekly Law Reports (WLR) 443; *CMS Dolphin Ltd v Simonet* [2001] 2 BCLC 704; *Bhullar v Bhullar* [2003] EWCA Civ 434.

<sup>54</sup> *Attorney General of Hong Kong v Reid* [1994] 1 AC 324.

<sup>55</sup> CA 2006, sec 177(1).

<sup>56</sup> *Towers v Premier Waste Management Ltd* [2011] EWCA Civ 923; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

- a) The likely consequences of any decision in the long term;<sup>57</sup>
  - b) The interests of the company's employees;<sup>58</sup>
  - c) The need to foster the company's business relationships with suppliers, customers and others;<sup>59</sup>
  - d) The impact of the company's operations on the community and the environment;<sup>60</sup>
  - e) The desirability of the company maintaining a reputation for high standards of business conduct;<sup>61</sup> and
  - f) The need to act fairly as between members of the company.<sup>62</sup>
- 26 The list of factors contained in sec 172(1)(a)-(f) embody the so-called 'enlightened shareholder-value approach.'<sup>63</sup> This approach recognises that directors must act in the best interests of shareholders, but enables directors to focus on a wider range of factors which will maximise shareholder value in the long term.<sup>64</sup> The theory is that the objective of the company will be achieved by the board of directors successfully managing the relationships and resources which comprise the company's business.<sup>65</sup> It is thought that by having regard to the factors listed above, the proper course of action for the director looking to promote the success of the company will be illuminated.
- 27 Both at common law and in sec 172, the duty requires a subjective analysis of what the director thinks, in good faith, is in the best interests of the company: 'The [director] must exercise their discretion bona fide in what they consider – not what a court may consider – is in the best interests of the company.'<sup>66</sup> In practice, however, where an act or omission by a director results in serious

<sup>57</sup> CA 2006, sec 172(1)(a).

<sup>58</sup> CA 2006, sec 172(1)(b).

<sup>59</sup> CA 2006, sec 172(1)(c).

<sup>60</sup> CA 2006, sec 172(1)(d).

<sup>61</sup> CA 2006, sec 172(1)(e).

<sup>62</sup> CA 2006, sec 172(1)(f).

<sup>63</sup> Company Law Reform Bill White Paper (Cm 6456, 2005) para 3.3; *Company Law Review Steering Group*, Modern Company Law for a Competitive Economy: The Strategic Framework URN 99/654 (DTI, 1999) at para 5.1.1 ff.

<sup>64</sup> On enlightened shareholder value see: *AR Keay*, The Enlightened Shareholder Value Principle and Corporate Governance (2013); *A Keay*, Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach' (2007) 29 Sydney Law Review 577.

<sup>65</sup> *Company Law Review Steering Group*, Modern Company Law for a Competitive Economy: Developing the Framework (2000, URN 00/656) at para 3.51.

<sup>66</sup> *Re Smith and Fawcett Ltd* [1942] Ch 304 at 306 per Lord Greene MR.

detriment to the interests of the company, the director will have a more difficult task persuading the court that he genuinely believed his actions were promoting the success of the company.<sup>67</sup> There is some authority which suggests that even where the director acts in a way which he believes bona fide promotes the success of the company, he may still breach his sec 172 if he is deemed to have acted irrationally or perversely: 'Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational.'<sup>68</sup>

- 28 The duty embodied in sec 172 is not framed as a duty of care. The duty to promote the success of the company flows from the director's fiduciary relationship with the company.<sup>69</sup> The fiduciary (director) must act in the best interests of his principal (the company). There may be occasions when the director has to subordinate his interests to the interests of the company in order to discharge this duty. This is illustrated by the case of *Re W & M Roith Ltd*.<sup>70</sup> Here, Mr Roith had been a director of a company for 30 years, during which time he never had a written contract of employment with the company. When he became ill, he decided to put in place a service contract with the company. This service contract provided that if he died whilst in service, the company would pay a pension to Mr Roith's wife for the rest of her life. When Mr Roith died and his executors sought to obtain payment of the pension, the liquidator refused on the basis that the service agreement (and thus the pension) was not entered into for the benefit of the company or to promote its prosperity. The court agreed with the liquidator. The interests of the company were subordinated by the transaction to Mr Roith's personal interest in providing for his wife. He was found to have breached the common law equivalent of the statutory duty to promote the success of the company and the court held that the transaction was not binding on the company.
- 29 Finally, it should be stressed that there is nothing to suggest that the duty to promote the success of the company is limited to performance of work-related tasks for the company.

#### 7.1. CASE STUDY (safeguarding of interests)

- 30 The happening of (a), (b) and (c) would likely constitute a breach of secs 171, 172 and 174 of the CA 2006. It is very unlikely that D would be entitled to de-

<sup>67</sup> *Re Regentcrest plc v Cohen* [2001] 2 BCLC 80; *Re Onslow Ditchling Ltd, Roberts v Frohlich* [2011] 2 BCLC 625.

<sup>68</sup> *Hutton v West Cork Railway Co* (1883) 23 Ch D 654 at 671 per Bowen LJ; *Charterbridge Corp Ltd v Lloyd's Bank Ltd* [1970] Ch 62; *Re a Company, ex parte Glossop* [1988] BCLC 570.

<sup>69</sup> *Towers v Premier Waste Management Ltd* [2011] EWCA Civ 923 at [1] per Mummery LJ.

<sup>70</sup> [1967] 1WLR 432.

fend his/her conduct on the basis that it was a matter of his/her personal or private life, since the behaviour described in this scenario will reflect very poorly on C-Corporation. In such a case, C-Corporation would be entitled to damages in order to recover any loss suffered as a result of the breach of duty. However, C-Corporation would have to establish a clear causal link between its pecuniary losses and D's breach of duty. Furthermore, D's pecuniary losses must not be too remote from the breach. If C-Corporation decides not to take legal proceedings against D, or the shareholders of C-Corporation pass an ordinary resolution under sec 239 of the CA 2006 ratifying the breach of duty committed by D in doing (a), (b) and (c), then a shareholder could seek to recover C-Corporation's pecuniary loss by raising a statutory derivative claim under secs 260–269 of the CA 2006. If the shareholder's statutory derivative claim was successful, then C-Corporation would be entitled to a damages remedy in respect of the losses it suffered: as such, the shareholder who raised the successful derivative claim would not be entitled to the damages remedy.

### 7.2. CASE STUDY (*fiduciary duty and conflict of duties*)

- 31 In this case, D would be referred to as a 'nominee' director in UK company law, when he is acting in the capacity of director of A-Corporation for C-Corporation, ie he is a nominee director appointed by C-Corporation to the board of A-Corporation. The first point to make is that there is nothing in UK company law which prohibits directors from holding multiple directorships or even from directly or indirectly (eg through another company) engaging in business that competes with the company<sup>71</sup> of which they are a director, provided that the requisite approvals under the CA 2006 are secured beforehand from the board of directors or shareholders. Secondly, it is generally recognised that when D is acting as a director of A-Corporation, he will owe the general duties embodied in secs 171–177 of the CA 2006 to A-Corporation. As such, although nominated onto the board of A-Corporation by C-Corporation, the decision of the Court of Appeal in the case of *Hawkes v Cuddy*,<sup>72</sup> demonstrates that the fact that D has been nominated to that office by C-Corporation does not, of itself, impose any duty on D to C-Corporation.<sup>73</sup> Thus, on the facts of the hypothetical case, the law would not

<sup>71</sup> However, in Scots law, there would appear to a general duty which prohibits a director from competing with the company, see the *obiter* statement of Lord President Hamilton in *Commonwealth Oil & Gas Company Ltd. v Baxter* [2009] Scotland Court of Session, Inner House (CSIH) 75 at para [5].

<sup>72</sup> *Hawkes v Cuddy* [2009] EWCA Civ 291. See also *Central Bank of Ecuador v Conticorp SA* [2015] United Kingdom Privy Council (UKPC) 11; [2016] 1 BCLC 26.

<sup>73</sup> The director may owe duties to his nominator if he is an employee or officer of the nominator, or by reason of a formal or informal agreement with his nominator, but such duties do not arise out of his nomination, but out of a separate agreement or office. Such duties cannot, however, detract from his duty to the company of which he is a director when he is acting as such, on which, see *Hawkes v Cuddy* [2009] EWCA Civ 291, at para 32, per Stanley Burnton LJ.

treat D as having infringed his duty to avoid a conflict of interest in terms of sec 175(1) of the CA 2006.

8. *The extent of the board's control and oversight*

- 32 A director is entitled to delegate his functions to employees and others (eg other directors) within the company: see Regulations 5 of Schedules 1, 2 and 3 to the Model Articles. The courts recognise that in many companies, the board cannot manage the company's business exclusively and extensive delegation to other directors, senior managers and employees is inevitable. A director must exercise reasonable care and skill in making his decision to whom to delegate his functions. The person to whom the function has been delegated must appear trustworthy and capable of discharging it. An authoritative statement on directors' power of delegation is given by the Court of Appeal in *Re Barings plc (No 5)*, approving the following extract from Parker J's judgment in the same case:

'Whilst directors are entitled (subjects to the articles of association of the company) to delegate particular functions to those below them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.'<sup>74</sup>

- 33 Where the director delegates his functions to an employee within the company, he retains a residual duty to supervise the employee he has instructed to perform the delegated task.<sup>75</sup> This duty to supervise is a continuing duty which cannot be avoided. The directors will be responsible for ensuring there are adequate control systems in place which flag up misdemeanours in delegated areas. The director will also need to ensure that they have sufficient knowledge of the company's business to understand the warning signals which the control systems they have in place flag up.<sup>76</sup> Individual directors will also have to exercise reasonable care in supervising other members of the board.<sup>77</sup> If a director allows himself to be dominated, manipulated or bamboozled by another director, then he will have breached his duty to exercise reasonable care and skill.<sup>78</sup>

<sup>74</sup> *Re Barings plc (No 5)* [2000] 1 BCLC 523 at [36].

<sup>75</sup> *Brumder v Motornet Service and Repairs Ltd* [2013] 1 WLR 2783; *Equitable Life Assurance Society v Bowley* [2004] 1 BCLC 180; *Re Barings plc (No 5)* [1999] 1 BCLC 433 at 486–489.

<sup>76</sup> *Re Westmid Packaging Services Ltd* [1998] 2 BCLC 646.

<sup>77</sup> *Lexi Holdings (In Administration) v Luqman* [2009] 2 BCLC 1; *Weaving Capital (UK) Ltd (In Liquidation) v Dabhia* [2013] EWCA Civ 71.

<sup>78</sup> *Re Westmid Packaging Services Ltd* [1998] 2 BCLC 646.



9. *Responsibility for compliance monitoring*

- 34 Compliance with such duties is imposed on directors in an individual capacity. As such, there is no collective responsibility for decision-making and all directors who commit a company pursuant to a course of action through their decision-making are potentially personally liable for that decision. Liability does not attach to the board of directors as a collective body.

*CASE STUDY (liability of individual board members for disadvantageous transactions authorised by the majority in a board meeting)*

- 35 In such a case, although the legal position is by no means clear-cut, D3 would likely be held to be in breach of sec 174 of the CA 2006, since he would be implicated in the corporate decision, having noted no form of protest or dissent. However, if D3 notes his protest and has this minuted, then it would be unlikely that he would be treated as liable.

10. *Variation in duties and the standard of care expected of the board and its members under corporate, tort and contract law*

- 36 Unlike the rest of the duties imposed on directors under the CA 2006, the director's duty to exercise reasonable care in terms of sec 174 is not categorised as 'fiduciary' in nature.<sup>79</sup> The rationale for not treating the director's duty of reasonable care as fiduciary in nature is that a director who falls below the standard of care expected of him, whilst negligent, is not necessarily disloyal to the company he is a director of.<sup>80</sup> Fiduciary duties are concerned with the director's honesty and loyalty to the company and are based on principles of equity. The director's duty to exercise reasonable care, on the other hand, focuses on the director's competence and is derived from the law of negligence in tort.<sup>81</sup>
- 37 The standard of care which must be observed by individual directors when performing their duties finds its expression in sec 174 CA 2006. This provision replaces the common law duty to exercise reasonable care, but the statutory form of the duty is intended to be interpreted and applied in the same way

<sup>79</sup> This is expressly recognised by Companies Act 2006. Sec 178(2) identifies the duty to exercise reasonable care, skill and diligence as an exception to the rule that the duties codified in secs 171–177 are enforceable in the same way as fiduciary duties owed to a company by its directors.

<sup>80</sup> *Bristol and West Building Society v Mothew* [1998] Ch 1 at 18 per Millett LJ: 'A servant who loyally does his incompetent best for his master is not unfaithful and is not guilty of a breach of fiduciary duty.'

<sup>81</sup> *Extrasure Travel Insurance Ltd v Scattergood* [2003] 1 BCLC 598; *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407; *PL Davies/S Worthington* (eds), Gower and Davies' *Principles of Modern Company Law* (9th edn 2012) at paras 16–24.

as the corresponding common law rule which it replaces.<sup>82</sup> Section 174 CA 2006 sets out that 'a director of a company must exercise reasonable care, skill and diligence.'<sup>83</sup> The standard of care, skill and diligence applicable to a director is measured in accordance with a two part test:<sup>84</sup>

- a) the knowledge skill and experience reasonably expected from a person carrying out the functions carried out by a director in relation to the company;<sup>85</sup> and
- b) the general knowledge, skill and experience that the director has.<sup>86</sup>

38 Part (a) evaluates the director's conduct against a 'general' standard of care that is expected from all directors. This is an objective test. If the director's conduct falls short of the general standard expected from all directors under sec 174(2)(a), then the sec 174 standard of care will have been breached. But even if the director is deemed to have met the general standard, he may still be in breach of his duty if he fails to meet the 'specific' standard of care expected from the director in question. In part (b) the director's conduct is assessed against a standard of care which is based on the specific knowledge, skill and experience that the director actually possesses. This is a subjective test. If the director fails to meet the specific standard imposed on him - he will have breached his sec 174 duty, irrespective of the fact that he may have met the general standard expected of all directors described in part (a). As such, sec 174 adopts what may be described as an 'objective plus' standard. It imposes a minimum standard of care based on an objective analysis of what is expected from all company directors generally; but which can be raised by the subjective element of the test for directors who have special knowledge and experience:

39 Section 174 is in two parts. The first part, in sec 174(2)(a), is that a director must exercise the care, skill and diligence that would be exercised by a reasonably diligent person with "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". This objective test sets the floor. The second part of the definition, in sec 174(2)(b), will displace it where the

<sup>82</sup> CA 2006, sec 170(4). Authorities pre-dating CA 2006 will, therefore, remain relevant in the interpretation of sec 174.

<sup>83</sup> CA 2006, sec 174(1).

<sup>84</sup> The two part test contained in sec 174 reflects the test laid down in the context of wrongful trading, as set out in sec 214 Insolvency Act 1986. The wording of sec 174 is substantially the same as that of the wording in sec 214(4) Insolvency Act 1986.

<sup>85</sup> CA 2006, sec 174(2)(a).

<sup>86</sup> CA 2006, sec 174(2)(b).

particular director under consideration has greater knowledge, skill and experience than may reasonably be expected.’<sup>87</sup>

- 40 It has long been recognised that errors in judgment do not automatically mean that the director has breached his duty to exercise care, skill and diligence.<sup>88</sup> Courts are generally reluctant to interfere with and impose liability on directors who have made commercial decisions that they believed in good faith were in the best interests of the company.<sup>89</sup> The option of including an equivalent to the ‘business judgment rule’ – as enacted in the USA and Australia – in sec 174 was rejected by the drafters of the CA 2006. Drafters feared that imposition of a standard of business judgment on directors would have a ‘chilling effect’ on risk-taking by company directors and create a culture of excessive caution.<sup>90</sup> The absence of an equivalent to the business judgment rule reflects the drafters’ intention to encourage directors to exercise their discretion and commercial judgment.<sup>91</sup>

*10.2. CASE STUDY (concretisation of the standard of duty; Business Judgment Rule)*

- 41 As mentioned above, directors will not be liable for breaching their duty to exercise reasonable care for errors in business judgment. D is not required to be *right* about the expansion of C-Corporation, but is required to display reasonable care in making the decision about which countries C-Corporation should expand into. Reasonable care in this context is likely to be achieved if D has made an *informed decision* about C-Corporation’s expansion. Such an approach to reasonable care is consistent with authority that indicates directors have a duty to actively acquire knowledge about, and keep themselves informed on, the company’s business.<sup>92</sup> The courts have taken a dim view of directors who have tried to plead ignorance as a defence to decisions of the

<sup>87</sup> *Brumder v Motornet Service and Repairs Ltd* [2013] 1 WLR 2783 at [46] per Beatson LJ.

<sup>88</sup> *Roberts v Frohlich* [2011] 2 BCLC 625; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407; *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425 (Ch D); *Lagunas Nitrate Company v Lagunas Syndicate* [1899] 2 Ch 392; *Overend & Gurney Co v Gibb* (1872) Law Reports (LR) 5 HL 480.

<sup>89</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Mortimore* (fn 36) at para 14.33.

<sup>90</sup> *Law Commission, Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (Report No 261, 1999) paras 5.28–5.29; *Company Law Review Steering Group Modern Company Law for a Competitive Economy: Developing the Framework* (2000, URN 00/656) paras 3.69–3.70.

<sup>91</sup> *Ibid.*

<sup>92</sup> *Weaving Capital (UK) Ltd v Peterson* [2012] EWHC 1480 (Ch); *Re Barings plc (No 5)* [2000] 1 BCLC 523 CA; *Re Barings plc, Secretary of State for Trade and Industry v Baker* [1998] British Company Cases 583; *Re Westmid Packaging Services Ltd (No 2)* [1998] 2 All ER 124.

board which have proven ill-advised.<sup>93</sup> In *Re Westmid Packaging Services Ltd*, a director's absence from board meetings was not a defence to negligence but itself constituted negligence.<sup>94</sup>

- 42 The following measures may indicate that D has taken the steps necessary to make an informed decision about C's expansion and thus discharge his duty to exercise reasonable care:
- 43 *Advice of experts* – D may wish to seek the advice of experts (eg lawyers, accountants), especially from within the countries which C-Corporation may expand into. D will need to select the experts with appropriate care and ensure the expert's views do not impinge upon D's duty to exercise independent judgment when deciding which countries to expand C-Corporation into.<sup>95</sup> In addition, D will only be able to rely on the expert's advice if it is reasonable to do so.<sup>96</sup> If these steps were taken but the expansion failed and as a result C-Corporation suffered loss, it is likely that D would be able to escape liability for breach of his duty to exercise reasonable care. The taking of professional or expert advice is a factor which courts take into account as indicating the director has exercised reasonable care and skill when performing his duties.<sup>97</sup>
- 44 *Delegating functions to others within C-Corporation* – It is likely that D will wish to delegate some of his functions in order to give himself a full picture of the countries C-Corporation will expand into. He may wish employees from within C-Corporation to prepare reports on the foreign countries for potential expansion. D is entitled to delegate particular functions to those below him in the management of C-Corporation and place reasonable trust in their integrity and competence.<sup>98</sup> But delegation by D does not absolve him of his duty to supervise delegated functions.<sup>99</sup> D will also be responsible for ensuring there are adequate control systems in place which flag up misdemeanours in delegated areas.<sup>100</sup> D's duty to supervise is a continuing one. If D can demonstrate that he undertook sufficient supervision of the employees he delegated functions to in relation to the expansion of C-Corporation, he will be protected

<sup>93</sup> See *Re Westmid Packaging Services Ltd* [1998] 2 All ER 124; *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498;

<sup>94</sup> [1998] 2 All ER 124.

<sup>95</sup> CA 2006, sec 173.

<sup>96</sup> *Re Douglas Construction Services Ltd* [1988] BCLC 397.

<sup>97</sup> *Green v Walking* [2007] England & Wales High Court (EWHC) 3251 (Ch); *FB Palmer/G Morse* (eds), *Palmer's Company Law*, vol 2 (2013) para 8.2813.

<sup>98</sup> *Re City Equitable Fire Assurance Co Ltd* [1925] Ch 407; *Norman v Theodore Goddard* [1991] BCLC 1027; *Andrew Oliver & Son Ltd v Douglas* 1981 SC 192 OH.

<sup>99</sup> See above and *Re Barings plc (No 5)* [2000] 1 BCLC 433 approved [2000] 1 BCLC 523 CA; *Equitable Life Assurance Society v Bowley* [2004] 1 BCLC 180.

<sup>100</sup> *PL Davies and S Worthington*, *Principles of Modern Company Law* (2016, 10<sup>th</sup> ed) at paras 16–17.

from any argument that he breached his duty to exercise reasonable care and skill.

- 45 *Regular board meetings* – On receipt of the expert advice and reports on countries for potential expansion, D may wish to hold board meetings to discuss the expert’s views and content of the reports. Regular board meetings will show that D and other directors have exercised care and engaged in meaningful discussion about which countries are best for C-Corporation’s expansion.<sup>101</sup> D is less likely to be liable for a breach of his duty to exercise reasonable care if he has discussed the information and literature available to him about the countries C-Corporation can expand into with the rest of the board.
- 46 As mentioned above, the courts are generally reluctant to engage in analysis of the merits of commercial decisions made by a board of directors in good faith. As Lord Wilberforce said in *Howard Smith Ltd v Ampol Petroleum Ltd*:
- 47 ‘[Their Lordships] accept that it would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management’s decision, on such a question, if bona fide arrived at. There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.’<sup>102</sup>
- 48 If D makes the informed decision (using the measures discussed above) that the expansion of C-Corporation is too risky and decides not to proceed, it is unlikely that he will face liability for breach of his duty to exercise reasonable care. There is, however, some dicta indicating that the courts will impose liability on directors for breach of their duty to exercise reasonable care where the decision made was one which no reasonable director or one possessing the particular director’s expertise would have made.<sup>103</sup> The fact that D’s decision in this instance is an omission, ie a decision *not* to do something (in this case, not expand the business of C-Corporation) does not absolve D from liability for breach of his duty to exercise reasonable care. A director who fails to act

<sup>101</sup> The frequency of board meetings is a factor the court has taken into account in the context of wrongful trading cases where courts have to consider whether directors of companies on the brink of insolvency have exercised reasonable care in their decision to continue trading: see *Re Continental Assurance Co of London plc (in liq)* [2007] BCLC 287 at paras 107–108, 283.

<sup>102</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 at 832.

<sup>103</sup> *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 at 494 per Lord Hatherley LC: ‘cognisant of the circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into.’ This dicta is believed to be equally applicable to omissions by directors, see: *Mortimore* (fn 36) at para 14.34.

or avoids activities which are part of his role as a director can still be liable for breaching his duty to exercise reasonable care.<sup>104</sup>

### 11. Factors influencing duties and the standard of care

- 49 'Reasonable care, skill and diligence' is an abstract concept which can be applied universally to a variety of different factual scenarios. It is for this reason that the courts have been reluctant to lay down definitive principles as to what constitutes 'reasonable care, skill and diligence.'<sup>105</sup> The following are factors which may be taken into account by the court in determining the standard of care imposed on a director, but it should be noted that none of these factors are decisive: as such, there may be penumbral areas where the weight attached to each factor will reasonably differ:
- 50 *Business focus, size and purpose of company* – The courts have reiterated on several occasions that the scope of a director's duty to exercise reasonable care requires consideration of the facts and circumstances of the particular case. The size of the company, the nature of its business, the regulatory regime affecting the industry in which the company operates are all factors which will affect the scope of a director's duty of care.<sup>106</sup> The larger the organisation, the more a director may be entitled to delegate his functions amongst those below him in management of the company or rely on the expertise of particular departments within the company. But the extent of a director's duty to exercise reasonable care will depend on 'how the particular company's business is organised and the part which the director could reasonably have been expected to play.'<sup>107</sup> Directors are, however, responsible for ensuring that they understand the focus and nature of the business they are a director of. In *Weaving Capital (UK) Ltd v Peterson*,<sup>108</sup> the director was found to have been negligent in approving the company's swaps trading policy. It was held that if the director had acquired sufficient knowledge and understanding of the company's business, she would have known that she could not, consistently with her duties as a director, have given such approval.
- 51 *Financial scope of given project* – There is little authority on the effect a project with large financial scope has on a director's duty to exercise reasonable care. But if a financial project involves only a small portion of the company's turnover, it is foreseeable that the director may be excused for giving that project less attention. If a financial project embarked upon by a company is more

<sup>104</sup> *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498.

<sup>105</sup> See *Brumder v Motornet Service and Repairs Ltd* [2013] EWCA Civ 195 at [55] per Beatson LJ.

<sup>106</sup> *Lexi Holdings plc (In Administration) v Luqman* [2009] EWCA Civ 117; *Mortimore* (fn 36) at paras 14.08–14.09.

<sup>107</sup> *Bishopgate Management Co Ltd v Maxwell (No 2)* [1994] 1 All ER 261 at 264 CA per Hoffmann LJ; see also *Re Barings plc (No 5)* [1999] 1 BCLC 433 at 484 per Parker J.

<sup>108</sup> [2012] EWHC 1480 Ch.

significant, it is reasonable for the shareholders to expect the director to devote more attention and effort to that project. With this in mind, it is likely that a director will be subject to a higher standard of care for financial projects which are larger in scope and which could have a profound impact on the company if successful (or unsuccessful).

- 52 *Financial situation of company* – A director will be subject to a more onerous standard of care when the financial position of the company is more precarious. Acts which a director may undertake in relation to a solvent company may not be appropriate in relation to a company which is insolvent or is on the verge of insolvency. The level of risk which a director may expose the company to whilst still discharging his duty to exercise reasonable care will necessarily drop as the solvency of the company becomes more doubtful. The duties of a director of a company on the verge of insolvency are discussed more fully below.
- 53 *Remuneration received by directors* – There is authority which indicates that the level of reward a director is entitled to may be a relevant factor in establishing the scope of that director's duty to exercise reasonable care. In *Re Barings plc (No 5)* Parker J acknowledged that 'the higher the level of reward, the greater the responsibilities which may reasonably be expected (prima facie, at least) to go with it.'<sup>109</sup>
- 54 *Expertise and training of directors* – In determining the scope of a director's duty to exercise reasonable care, the knowledge and experience that a director possesses will be taken into account. Even if the director has not breached the objective standard of care expected of all directors contained in sec 174(2)(a) CA 2006, he can still be liable for breach of duty if he fails to meet the standard of care contained in sec 174(2)(b), which is based on the specialist knowledge and expertise of the particular director in question. If the director has greater knowledge and expertise than that ordinarily expected from a director of a company, a higher standard of care will be expected from him.<sup>110</sup> Here sec 174(2)(b) CA 2006 operates to raise the standard of care which must be met by a director who has specialist expertise or training.
- 55 *Executive and non-executive directors* – Section 174 CA 2006 does not distinguish between executive and non-executive directors. There is nothing in CA 2006 to indicate that a non-executive director's duty of care is any less onerous than that of an executive director. That being said, shareholder expectations of non-executive directors differ. It is unreasonable to expect a non-executive director to devote the same amount of attention to the company as

<sup>109</sup> *Re Barings plc (No 5)* [1999] 1 BCLC 433, 488 at para B6; see also *Re Barings plc, Secretary of State for Trade and Industry v Baker* [1998] British Company Cases 583 at 586 per Sir Richard Scott VC.

<sup>110</sup> See discussion on CA 2006, sec 174(2)(b) above.

an executive director. Non-executive directors are less involved in the day-to-day running of the company but perform a supervisory role – constructively challenging the executive directors and monitoring their performance.<sup>111</sup> The courts recognise that whilst the non-executive's duty of care is expressed in the same terms in sec 174 CA 2006, the duty will be applied differently in practice. Non-executive directors must exercise reasonable care in supervising the executive directors.<sup>112</sup> They cannot place unquestioning reliance on the management of the company or be a mere 'yes-man' to the board.<sup>113</sup> Conduct of this sort is likely to be a breach of a non-executive director's duty to exercise reasonable care.

### 11.2. CASE STUDY (*applicable standard of care*)

- 56 (a) For a person not involved in the banking industry, it would not have been apparent that the transaction was adverse. But as discussed above, a director is expected to acquire and maintain a sufficient knowledge and understanding of the company's business to be able to properly discharge his duties. It will not, therefore be a defence that D could not have known the transaction was adverse because banking was not an area of business he was familiar with. D will be expected to exercise the care, skill and diligence that 'may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company' – taking into account D's obligation to familiarise himself with the business of B-Bank. The baseline standard of reasonable care, skill and diligence imposed on D by the objective standard of care laid down in sec 174(2)(a) would dictate that he should recognise adverse transactions apparent to an ordinary businessman familiar with the business of B-Bank. Failure by D to recognise the transaction as adverse in these circumstances could constitute a breach of his duty to B-Bank to exercise reasonable care, skill and diligence under sec 174 CA 2006. It is therefore possible that D will be liable in damages to B-Bank in respect of the loss occasioned by negligently entering an adverse transaction.
- 57 (b) Here the transaction is not recognised as adverse by an ordinary businessman familiar with the business of B-Bank, but a more experienced professional bank manager. It is unlikely that the objective standard imposed on D by sec 174(2)(a) requires him to exhibit the care, skill and diligence of an experienced professional bank manager. The ordinary director of a UK company cannot be expected to exercise the skill of an experienced professional bank manager. It is, therefore, unlikely in these circumstances that D will be liable in damages for the loss occasioned by his failure to recognise that the transac-

<sup>111</sup> This is consistent with the guidance on the role of non-executive directors contained in the UK Corporate Governance Code 2014, A.4 Non-Executive Directors.

<sup>112</sup> *Equitable Life Assurance Society v Bowley* [2004] 1 BCLC 180 at [35]–[41]; *Lexi Holdings plc v Luqman* [2009] 2 BCLC 1, CA.

<sup>113</sup> *Ibid.*



tion was adverse to B-Bank. If, however, D had specialist knowledge or expertise (eg had worked as an experienced professional bank manager), then the standard of care, skill and diligence imposed on D will be based on the specialist knowledge or expertise he possesses about transactions of this nature. This is because sec 174 imposes on D a duty to exercise reasonable care, skill and diligence based on 'the general knowledge, skill and experience that the director has.' In these circumstances, it is more likely that D will have breached his sec 174 duty and will be liable in damages.

*12. The board and its members' duties and liability in the vicinity of insolvency*

- 58 When a company is in danger of entering insolvent liquidation, it is often said that the directors have a duty to 'take into account the interests of creditors'. The rationale for this is to ensure that, when insolvency is imminent, the company's property is not dissipated or exploited to the prejudice of the creditors.<sup>114</sup> Despite having a clear rationale, the legal source of the duty is rather opaque.
- 59 The director's duty to promote the success of the company (discussed above) is by virtue of sec 172(3) CA 2006 'subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of the creditors of the company.' The most obvious enactment which sec 172(3) alludes to is sec 214 of the Insolvency Act 1986 ('IA 1986') – the provisions on wrongful trading sec 214(1) IA 1986 allows the liquidator of an insolvent company to apply to the court for a declaration that a director is liable to make a contribution to the insolvent company's assets out of his personal estate because the director has engaged in wrongful trading. The wrongful trading provision is essentially a functional equivalent of the legal duty to file for insolvency which exists in a number of other European jurisdictions.
- 60 The director will be liable to make a contribution where he is deemed to have been responsible for the company trading 'wrongfully' – ie trading at a point in time when he 'knew or ought reasonably to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.'<sup>115</sup> The knowledge a director possesses for the purposes of determining whether he knew that there was no reasonable prospect of avoiding insolvency is set out in sec 214(4)(a)-(b). It is based on:
- a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions are carried out by that director;

<sup>114</sup> *Winkworth v Edward Baron Development Co Ltd* [1986] 1 WLR 1512 at 1516 per Lord Templeman.

<sup>115</sup> IA 1986, sec 214(2)(b).

b) the general knowledge, skill and experience that that director has.<sup>116</sup>

- 61 The test contained in sec 214(4) contains both an objective and a subjective element. Section 214(4)(a) sets an objective standard of knowledge which is imposed on all directors of UK companies. Section 214(4)(b) sets a subjective standard based on the expertise that a particular director possesses. Take the example of a company's creative director and finance director. The two will have different subjective knowledge of the company's solvency. It would be reasonable to expect the finance director to have a higher level of understanding of the company's solvency and sec 214(4)(b) will operate to set a standard which reflects the specialist knowledge that the finance director possesses. But the two directors are expected to have the same objective baseline standard of knowledge by virtue of sec 214(4)(a). The creative director will therefore be precluded from evading liability because he has minimal knowledge about the company's solvency. It will be noted that this test operates similarly to the one applied when determining the scope of a director's duty to exercise reasonable care, skill and diligence in terms of sec 174 of the CA 2006 (discussed above).<sup>117</sup>
- 62 If the court is satisfied that a director continued trading with knowledge that there was no reasonable prospect of avoiding insolvent liquidation, the director can still avoid liability for wrongful trading. Section 214 contains a defence to wrongful trading, namely that the director took every step to minimize potential losses to creditors of the company.<sup>118</sup> If a director can establish this, he/she will not be liable to make a contribution to the company's assets out of his/her personal estate.<sup>119</sup> It is in this sense that directors are often said to have a duty to 'minimize creditor's losses' or 'take into account the interests of creditors' when the company is on the brink of insolvency – because failure to do so will mean the sec 214(4) defence to wrongful trading is not available to them. Directors can discharge this duty (thus providing themselves with a defence to wrongful trading) by:

Obtaining professional advice from someone they can place reasonable reliance on – company auditor, independent accountant or, ideally, an insolvency practitioner.<sup>120</sup> In *Re Continental Assurance Co of London plc* the

<sup>116</sup> IA 1986, sec 214(4)(a)–(b).

<sup>117</sup> Reference to Q10 and Q11 answers. In *Re D'Jan of London Ltd* [1993] BCC 646, Hoffmann LJ's formulation of the director's duty to exercise reasonable care, skill and diligence was modelled on IA 1986, sec 214(4)(a)–(b). The application of sec 214(4) to the duty to exercise reasonable care is now reflected in the similarly worded sec 174 CA 2006.

<sup>118</sup> IA 1986, sec 214(3).

<sup>119</sup> *Ibid.*

<sup>120</sup> *Re Continental Assurance Co of London plc (in liq)* [2007] 2 BCLC 287; *Re Douglas Construction Services Ltd* [1988] BCLC 397

court looked favourably upon directors who repeatedly sought professional advice on whether the company should continue trading and reduced trading as the financial outlook became more bleak.<sup>121</sup>

Inform themselves of the company's financial position. The clearer it becomes that creditor's money is at risk from company dealings, the lower the risk to which the directors should expose the company financially and the more regularly the company's financial position should be reviewed.<sup>122</sup> Reducing or ceasing trading is one potential 'step' which can be taken to minimise creditor's losses.<sup>123</sup>

### 13. Impact of selection criteria on duties and the standard of care

- 63 There are no such restrictions imposed under the CA 2006 or the Model Articles. As such, there will be no effect on the standard or content of the statutory duty of care, skill and diligence in sec 174 of the CA 2006 or sec 214(4) IA 1986. However, it would be possible for such restrictions to be imposed in the company's articles of association. It is a moot point, and unresolved, whether such a provision in the articles would function to lower the standard of care. However, it is likely that such a provision would be taken into account by a court in establishing the content of the subjective element of the standard of care set out in sec 174(2)(b) CA 2006 and sec 214(4)(b) IA 1986, ie the general knowledge, skill and experience that that director has.

### 14. Compensation for damage to the corporation's property or to shareholders'/partners' property

- 64 In such a case, yes, any losses suffered by the company as a result of the director's misconduct could be recovered by the company. Where the misconduct amounts to a breach of the director's statutory duty of care, skill and diligence in terms of sec 174(2) of the CA 2006 and the breach causes damage to the company's property, the only remedies available to the company would be damages, and in certain exceptional situations, specific performance or injunc-

<sup>121</sup> *Re Continental Assurance Co of London plc (in liq)* [2007] 2 BCLC 287.

<sup>122</sup> *Re Bangla Television Ltd (in liq)* [2010] BCC 143; *Re Hawkes Hill Publishing Co Ltd* [2007] BCC 937.

<sup>123</sup> *Re Continental Assurance Co of London plc (in liq)* [2007] 2 BCLC 287 at [281] '[I]f the directors decide to close down immediately and cause the company to go into an early liquidation, although they are not at risk of being sued for wrongful trading, they are at risk of being criticised on other grounds ... Many creditors of the company from a time before the liquidation are likely to find that their debts do not get paid in full. They will complain bitterly that the directors shut down too soon; they will say that the directors ought to have had more courage and kept going. If they had done, so the complaining creditors will say, the company probably would have survived and all of its debts would have been paid. Ceasing to trade and liquidating too soon can be stigmatised as the cowards' way out.'

tive relief. However, a greater range of remedies would be available to the company where the misconduct of the director constituted a breach of secs 171, 172, 173, 175, 176 or 177 of the CA 2006. In such a case, the company would be entitled to gain-based remedies such as an account of profits made by the director, as well as the right to rescission of any contracts concluded by the company with third parties at the instance of the director as part of his breach of duty. In addition, equitable remedies such as specific performance and injunctive relief would be available to the company.

- 65 Where the director's breach of duty causes damage to the property of the shareholders of the company or other third parties, it is not clear that the shareholders or such other third parties would be able to recover any losses which they sustained via the rules of company law, eg the statutory duties of directors in terms of secs 171–177 of the CA 2006: instead, it may be that they would have a claim in the law of contract, or more likely, in the law of tort/delict, eg the duty of care owed by the company and/or its directors in the law of negligence. The principal reason for this proposition is that the statutory duties in secs 171–177 of the CA 2006 imposed on the directors are owed to the company, not to any shareholder or other third party. Even in circumstances where the shareholder raises a derivative claim under secs 260–269 of the CA 2006 and is successful in court, the shareholder would only be entitled to recover on behalf of the company in respect of the company's losses only, ie the damage to the company's property, rather than the damaged property of the shareholder him/her/itself.
- 66 Where the property damage consists of a diminution in the value of a shareholder's shares in the company, the common law rule against 'reflective loss' would preclude that shareholder from recovering any loss sustained. This is based on the rationale that the shareholder's loss in terms of the diminution in value of his shares in the company is merely reflective of the company's loss. As explained by Lord Bingham of Cornhill:
- 67 'Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company.'<sup>124</sup>

*14.1. CASE STUDY (compensation for damage to the corporation's property or to shareholders'/partners' property)*

- 68 Turning first to case 14.1, it would be likely that a court would conclude that D is in breach of his statutory duty of care, skill and diligence under sec 174 of the CA 2006. He may also be in breach of his statutory duty to obey the

<sup>124</sup> *Johnson v Gore Wood & Co* [2002] 2 AC 1, 19.

terms of the company's constitution in terms of sec 171 of the CA 2006 if the articles of association of the company impose limits on the extent to which D can commit C-Corporation to contracts with third parties. It is clear that only C-Corporation will be entitled to sue D for a breach of the secs 171 or 174 duties in order to recover its loss. If either one of S1 or S2 voted against C-Corporation raising a claim against D for breach of duty, then the other shareholder (ie either S1 or S2) would have to raise a derivative claim under secs 260–269 of the CA 2006 in order to seek recovery of C-Corporation's losses. However, the shareholder would have no right to raise a claim in a personal capacity to attempt to recover the company's losses or his own personal losses, including losses in respect of any diminution in value of his shares.

- 69 As regards the contract with X, apart from certain exceptional circumstances, C-Corporation would not be entitled to set aside the transaction, owing to the terms of secs 39 and 40 of the CA 2006. As such, X would be protected in terms of the transaction.
- 70 As for the alternative scenario in Case 14.1, for the reasons given above, S1 or S2 would have no right to recover in respect of any reduction in value of their shares as a result of the common law principle against 'reflective loss'.

*14.2. CASE STUDY (compensation for damage to the corporation's property or to shareholders'/partners' property due to delay in filing for insolvency)*

- 71 In such a case, C-Corporation would be entitled to recover any losses which it had sustained as a result of D's recalcitrance in filing for the insolvency of C-Corporation. The legal basis for this right of recovery would be sec 174 of the CA 2006, ie that D had breached his duty of care, skill and diligence, having fallen below the objective standard expected of a director in sec 174(2)(a) of the CA 2006, namely the 'knowledge skill and experience reasonably expected from a person carrying out the functions carried out by a director in relation to the company'. If C-Corporation decided not to take legal action against D on these grounds – eg because an ordinary resolution consisting of a simple majority vote of S1 and S2 was passed not to commit C-Corporation to such litigation – then S1 or S2 would have the capacity to seek recovery for C-Corporation under a statutory derivative claim in terms of secs 260–269 of the CA 2006. However, it is not clear from the facts of the Case Study 14.2 that C-Corporation has in fact suffered any losses as a result of D's breach of duty: the only losses referred to in the Case Study are the losses of the creditors.

*15. Limitation periods*

- 72 The relevant statute is the Limitation Act 1980. Since any legal proceedings raised by the company for damages in respect of a director's alleged breach of the general statutory duties prescribed in secs 171–177 of the CA 2006 relate to the recovery of a sum under statute, the relevant time limit for such a claim

to be raised would be six years under sec 9 of the Limitation Act 1980. However, this time limit would not apply where the remedy sought was specific performance, injunctive relief or some other equitable remedy.<sup>125</sup> The time period of six years is identical to the time limit in respect of actions in contract or founded on tort, ie general civil liability.<sup>126</sup> As such, there is no discrepancy.

*15.1. CASE STUDY (suspension/interruption of the limitation period)*

- 73 Section 32 of the Limitation Act 1980 would apply to extend the period available to C-Corporation to raise an action seeking damages from D in respect of his alleged breach of statutory duty. However, C-Corporation would have to show that D 'deliberately concealed' a fact relevant to the alleged breach of statutory duty. The point in time at which the limitation period of six years will begin to run will be the date that the company discovers that such a fact has been concealed, or the date that it could have discovered such concealment with the application of reasonable diligence.
- 74 In the case of the alternative scenario, D's involvement may have postponed the coming to light of his misconduct. As such, sec 32 of the Limitation Act 1980 will apply once again, so that the date from which the limitation period of six years begins to run will be pushed back to the date that C-Corporation actually became aware of D's concealment or facts relating to that concealment.

*B. Modification of the general conditions for liability*

*16. Adapting the scope and content of the board's and its members' duties*

- 75 Subject to certain limited exceptions, it is *not legally possible* for a company or its members to alter the scope and content of the duties laid down in secs 171–177 of the CA 2006 by virtue of any provision in a contract or the company's articles of association. Section 232(1) provides that any provision that purports to exempt (to any extent, eg a full exclusion, or a restriction or limitation of liability) a director of a company from any liability that would otherwise attach to him in connection with any negligence, default, breach of duty or breach of trust in relation to the company *is void*. As such, a term of any contract or the company's articles of association excluding or modifying liability for a breach of secs 171–177 would be of no legal effect: sec 232(3) of the CA 2006.
- 76 Nor is it possible for a director to be protected by the company directly or indirectly providing that director with an indemnity in respect of any losses

<sup>125</sup> Limitation Act 1980, sec 36.

<sup>126</sup> Limitation Act 1980, secs 2 & 5.

sustained by the director in respect of any liability for breach of duty: sec 232(2) of the CA 2006.

- 77 The recognised three exceptions are where the company supplies the director with (1) D&O insurance with an insurer duly furnishing the director with protection in respect of liability for breach of statutory duty, (2) a qualifying third party indemnity or (3) a qualifying pension scheme indemnity: secs 233–235 of the CA 2006. A further exception is set out in sec 232(4), which is particularly important in the context of a purported breach of sec 175 of the CA 2006, ie the director's duty to avoid a conflict of interest and duty. Section 232(4) directs that a company is not prevented from 'making such provision as has previously been lawful for dealing with conflicts of interest' in its articles. Although the breadth of this provision is unclear, it does suggest that the company could enter into a contract, or insert provisions in its articles of association, duly carving or limiting the content of the statutory duty to avoid a conflict of interest and duty laid down in sec 175 of the CA 2006. In fact, such a technique is not uncommon in practice.
- 78 However, it should be stressed that where a director commits a breach of one of the statutory duties, this does not prevent the company via a simple majority of its shareholders from passing an ordinary resolution under sec 239 of the CA 2006 in order to ratify the director's breach, and as such, relieving that director of any liability for the breach of duty. In such a case, the company will no longer be entitled to take legal proceedings against that director.

#### *16.2. CASE STUDY (distribution of competences)*

- 79 No, unless D1 is somehow liable for a breach of his sec 174 duty of care, skill and diligence in failing to supervise or monitor the conduct, decisions or activities of D2. However, since D1 is not a non-executive director, it is unlikely that he would be implicated for breach of such duty. As such, if anyone is likely to be held liable for breach of the sec 174 duty, then it is D2.

#### *16.3. CASE STUDY (authorisation of unlawful conduct)*

- 80 Although sec 39 of the CA 2006 provides that a company has unlimited capacity to contract, like all legal persons, it is subject to various controls on its capacity. For example, any provision in its articles of association which sets out unlawful objectives seeking to empower it or its directors to bribe officials, violate maximum working hours, or engaged in fraudulent activities would fall foul of the common law doctrine of illegality since it would involve a breach of the criminal or employment law.<sup>127</sup> Moreover, if a director failed to comply with such directions and his/her failure caused loss to C-Corporation, it is unlikely that the director would be held by a court to be in

<sup>127</sup> See *Bowman v Secular Society* [1917] AC 406, 452 per Lord Sumner.

breach of duty despite the fact that he has failed to obey the constitution in non-conformance with sec 171(1)(a) of the CA 2006, or he/she has failed to comply with a shareholders' resolution or the terms of his/her service agreement.

*17. Adapting the standard of care expected of the board and its members*

- 81 No. See the answer to question 16 above, which explores the role of sec 232(1) of the CA 2006 in preventing the company from excluding a director's liability for negligence in the law of tort or breach of the statutory duty of care, skill and diligence set out in sec 174 of the CA 2006. Although there theoretically may be a distinction between (1) excluding liability for a breach of duty, and (2) modifying the content and scope of a duty, it is submitted that (2) is encompassed within the ambit of (1) in this context, ie in the context of the mischief of sec 232(1) of the CA 2006. As such, the absence of the words 'or limit' after the word 'exempt' in line one of sec 232(1) of the CA 2006 should not be taken as evidence of any intention on the part of the legislature to permit companies to validly limit a director's liability for breach of the sec 174 duty.

*17.1. CASE STUDY (reduction of due diligence standard)*

- 82 No. See the answer to questions 16 & 17 above.

*18. Other limitations or exclusion of liability*

- 83 Yes, it is possible for the company to limit the liability of its directors, but not to completely exclude it. This is a reference to the three recognised exceptions set out above in the context of secs 233–235 of the CA 2006, ie where the director is provided with D&O insurance against liability for breach of duty, qualifying third party indemnity provisions or qualifying pension scheme indemnity provisions, by the company. The further exception, which enables the company to limit the director's liability for a breach of the sec 175 duty to avoid a conflict of interest and duty is set out in sec 232(4). Section 232(4) directs that a company is not prevented from 'making such provision as has previously been lawful for dealing with conflicts of interest' in its articles. Although the breadth of this provision is unclear, it does suggest that the company could enter into a contract, or insert provisions in its articles of association, duly carving or limiting the content of the statutory duty to avoid a conflict of interest and duty laid down in sec 175 of the CA 2006. In fact, in practice, it is quite common to find provisions of this kind in a company's articles of association.

*18.1. CASE STUDY (other limitation of liability)*

- 84 No, such agreements are prevented from attaining legal effect and validity by virtue of sec 232 of the CA 2006. If entered into, such contracts would be



void. The one exception is where any of these agreements at (a)-(h) relate to the director's duty to avoid a conflict of interest and duty in terms of sec 175 of the CA 2006. In such a context, agreements of the kind set out in (a), (b), (c), (e) and (f) above (but not (d), (g) and (h) – since they could operate to shape or limit the content of the sec 175 duty) may indeed be treated by a court as legally valid, although it should be stressed that the writers of this National report are not aware of any reported judicial decision to that effect.

*C. Authorisation and instructions by other organs of the company (in particular by the shareholders' meeting)*

*19. Powers and responsibilities in authorising and instructing the board*

85 Certain decisions cannot be taken by the board of directors without the prior approval or authorisation of the shareholders of the company: essentially, provisions of the CA 2006 which stipulate that the shareholders must pass an *ordinary or special resolution* before a particular decision can be taken by the company are the paradigm cases, eg an ordinary resolution is required to remove the auditors of the company,<sup>128</sup> to remove a director<sup>129</sup> or to approve a substantial property transaction entered into between the director and the company.<sup>130</sup> Meanwhile, some of the decisions which the CA 2006 specifies must be passed by special resolution in order to be valid are as follows:

1. the alteration of the articles of association of the company;<sup>131</sup>
2. a change to the company's name;<sup>132</sup> and
3. the disapplication of the statutory pre-emption rights on the allotment of shares.<sup>133</sup>

86 These statutory requirements for prior authorisation from the shareholders may be supplemented by the company providing in its articles of association for other circumstances where such an ordinary or special resolution must be passed in advance. Moreover, regulations 4 of Schedule 1, Schedule 2, and Schedule 3, to the Model Articles direct that the shareholders of a plc by shares, private company limited by guarantee, or a private limited company by shares, have a reserve power to pass a special resolution instructing the directors to (i) take a specific course of action or decision, or (ii) refrain from taking a specified course of action or decision.

<sup>128</sup> CA 2006, sec 510(2)(a).

<sup>129</sup> CA 2006, sec 168(1).

<sup>130</sup> CA 2006, sec 190(1).

<sup>131</sup> CA 2006, sec 22(1).

<sup>132</sup> CA 2006, sec 77(2)(a).

<sup>133</sup> CA 2006, secs 570 and 571.

- 87 It is only the organ of the shareholders in general meeting, or by written resolution procedure (in the case of a private limited company only) that enjoys these rights to influence corporate decision-making, which function as inherent limitations on the power of the directors. No other organ or third party has this power.
- 88 In exercising the right to vote on an ordinary resolution or special resolution, the shareholders are under no obligations of any kind, eg a duty of care. Instead, it is well-recognised by the law that the shareholders may prioritise their own personal interests at the expense of the company's interests when they are deciding how to vote on a decision which requires an ordinary or special resolution to be passed: the shareholder's share is treated as a property right.<sup>134</sup> As such, they may freely vote their shares as they please.<sup>135</sup> However, there is one important exception to the rule that members can exercise their vote in any way they think fit. This applies where the members of a company are required to pass a special resolution to alter the articles of association and the amendment introduced is likely to result in harm or loss to the company. In such circumstances, the law provides that the shareholder must exercise his vote in a way which is 'bona fide' for the benefit of the company as a whole.<sup>136</sup>

*19.1. CASE STUDY (authorisation of an apparently disadvantageous transaction)*

- 89 If we begin with question 19.1, it is likely that the prior authorisation of the decision by the shareholders would remove any liability on the part of D for a breach of his statutory duty of care, skill and diligence set out in sec 174 of the CA 2006. The reasoning behind this conclusion is that prior authorisation functions in a similar way to ex post facto ratification of the director's breach of duty by the passing of an ordinary resolution of the shareholders in terms of sec 239 of the CA 2006. In such a case, D would not be liable to C-Corporation. Furthermore, the shareholders would not be held liable to C-Corporation, since they are deemed to constitute the corporation. However, one point worth noting is that if C-Corporation subsequently entered into insolvent liquidation, it may be that post-liquidation, a liquidator appointed over the estate of C-Corporation would be able to recover some of C-Corporation's losses in an action against the shareholders who voted in favour of this decision. This would be rooted in sec 214 of the Insolvency Act 1986 which enables a liquidator to take 'wrongful trading' proceedings against any director or shadow director of C-Corporation where some time before the commence-

<sup>134</sup> CA 2006, sec 541.

<sup>135</sup> *North-West Transportation Co Ltd v Beatty* (1887) 12 Law Reports, Appeal Cases (LR App Cas) 589 (Privy Council) and *Northern Counties Securities Ltd v Jackson & Steeple Ltd* [1974] 1 WLR 1133.

<sup>136</sup> *Allen v Gold Reefs of West Africa Ltd.* [1900] 1 Ch 656.

ment of the winding up of C-Corporation, those shareholders knew or ought to have concluded that there was no reasonable prospect that C-Corporation would avoid going into insolvent liquidation. It is possible that the shareholders of C-Corporation would be treated as a shadow director if they gave instructions to the board and the board was accustomed to act in accordance with those directions.<sup>137</sup> Having said that, the potential for this post-liquidation claim is admittedly slim, since each of the shareholders would have to be micro-managing the affairs of C-Corporation on a day-to-day basis, which is not necessarily apparent based on the facts of this scenario.

- 90 Turning to the first alternative scenario, it is unlikely that the slight change in the circumstances would alter the answer to question 19.1 above, since the shareholders would be treated as having given prior authorisation of the decision.
- 91 Again, the position would be the same in the case of the second alternative scenario.

*20. Instructions to the board or individual directors to implement certain management decisions*

- 92 Regulations 4 of Schedule 1, Schedule 2, and Schedule 3, to the Model Articles direct that the shareholders of a plc by shares, private company limited by guarantee, or a private limited company by shares, have a reserve power to pass a *special resolution* instructing the directors to (i) take a specific course of action or decision, or (ii) refrain from taking a specified course of action or decision. This power of the shareholders to instruct is not subject to any conditions. It ought to be said that it is only the shareholders in general meeting, or by written resolution procedure (in the case of a private limited company) who have this power to instruct the board of directors in this way. No other third party has this power.
- 93 Turning to the consequences of such an instruction with respect to the liability of the board or director, it is likely that the prior instruction by the shareholders to the directors would remove any liability on the part of the directors for a breach of any of the statutory duties in terms of secs 171–178 of the CA 2006. The reasoning behind this conclusion is that the prior instruction of the shareholders by special resolution functions in a similar way to ex post facto ratification of the director's breach of duty by the passing of an ordinary resolution of the shareholders in terms of sec 239 of the CA 2006. In such a case, the directors would not be held liable to the company for a breach of duty. Furthermore, the shareholders who made the instruction to the directors in terms of regulations 4 of Schedule 1, Schedule 2, and Schedule 3, to the Model Articles, would not be held liable to the company, since they are deemed to con-

<sup>137</sup> CA 2006, sec 251.

stitute the corporation. However, one point worth noting is that if the company subsequently entered into insolvent liquidation, it may be that post-liquidation, a liquidator appointed over the estate of the company would be able to recover some of the company's losses in an action against the shareholders who instructed the directors to take this management decision.

*20.1. CASE STUDY (instructions regarding illegal/disadvantageous management decisions)*

- 94 If the shareholders of C-Corporation gave advance authorisation to the courses of action at (a)-(f) by ordinary or special resolution, then D will not be liable. See the response to question 20 above.

*20.2. . CASE STUDY ((instructions regarding distribution of profits)*

- 95 No, D would not be liable to the company or any of its shareholders and it is not possible to hold individual shareholders liable for corporate decision-making. Finally, D would have no power or duty to prevent such a distribution, although if the company is on the brink of insolvency, then D ought to be mindful of his duty to the company to take into account the interests of the company's creditors, and also to take care to engage in conduct which amounts to wrongful trading under sec 214 of the IA 1986.

*20.3. CASE STUDY (instructions regarding covert return of contributions)*

- 96 The answer is the same as that which applies for question 20.2 above, notwithstanding that the transaction would likely constitute a breach of D's duty of loyalty in terms of secs 171 and 172 of the CA 2006. The reason for this is that the transaction has been authorised by a majority of the shareholders of C-Corporation, i.e the equivalent of an ordinary resolution has been passed. However, it should be stressed that if C-Corporation subsequently entered into insolvent liquidation, it would be open to a liquidator to seek to rescind the contract concluded between C-Corporation and S1. Moreover, D ought to be mindful of his duty to the company to take into account the interests of the company's creditors, and also to take care to engage in conduct which amounts to wrongful trading under sec 214 of the IA 1986. It is also possible that a liquidator could attack the transaction as a transaction concluded at an undervalue in violation of sec 238 of the IA 1986, on which, see the response to question 24.1 below.
- 97 Turning to the alternative 1, D would be in breach of the duty of loyalty in terms of secs 171 and 172 of the CA 2006. Since a majority of the shareholders have not given advance authorisation to the transaction, D would be liable to C-Corporation. As such, S2 and S3 could attempt to instruct the board of C-Corporation to commence litigation against D by passing a shareholder resolution. However, the problem here for S2 and S3 is that a special resolution, ie 75% would be required in terms of regulations 4 of Schedule 1, Schedule 2,

and Schedule 3, to the Model Articles. As such, S2 and S3 would not succeed in compelling C-Corporation to raise legal proceedings against D to have C-Corporation annul the contract by rescission. Once again, it is worth noting that it is not possible to hold individual shareholders liable.

- 98 Finally, with regard to alternative 2, the facts narrated may mean that D had breached sec 177 of the CA 2006. It is worth noting that D would have complied with the statutory duty imposed by sec 190 of the CA 2006, since D passed a shareholder resolution commanding more than a simple majority of the votes, ie in excess of what is required for an ordinary resolution. As for the status of sec 177, the question is whether the shareholder resolution cures the breach of that provision. Arguably, it ought to relieve D from liability by analogy with sec 239 which requires an ordinary resolution to be passed to ratify a breach of the general duties in secs 171–177 on an ex post facto basis. However, there is a line of authority that certain breaches of director's duties are so egregious that they cannot be authorised by a majority of the shareholders in advance, or ratified by a majority of the shareholders ex post facto.<sup>138</sup> It is opined that this particular form of conduct on the part of D may fall into such a class of unauthorisable and unratifiable breach.

*20.4. CASE STUDY (instructions regarding covert return of contributions within a group of companies)*

- 99 In the above scenario, on the face of matters, D would be exposed to liability to C-Corporation or M-Corporation (as sole shareholder) for a breach of the general statutory duty in sec 172 of the CA 2006 to promote the success of C-Corporation. D knows that the loan transaction between C-Corporation and A-Corporation is disadvantageous to C-Corporation. As such, D is clearly aware that the loan is not for the benefit of C-Corporation. The effect of sec 178 of the CA 2006 is that C-Corporation would be entitled to rescind the loan transaction, eg by annulling the transaction. However, the fact that M-Corporation passed a shareholder resolution sanctioning the conclusion of the loan transaction completely transforms the legal position. The effect of that shareholder resolution is to provide D with advance authorisation to commit C-Corporation to the loan, which essentially exonerates D from liability. In other words, the ex ante shareholder resolution functions in the same way as an ex post facto shareholder resolution under sec 239 of the CA 2006 which provides ratification of D's conduct, thus relieving D from any potential liability in respect of a breach of sec 172 of the CA 2006.
- 100 It is very unlikely that M-Corporation would be exposed to liability to C-Corporation as its sole shareholder. In company law, shareholders do not owe

<sup>138</sup> See *KW Wedderburn*, Shareholders' Rights and the Rule in *Foss v Harbottle* [1957] 15 Cambridge Law Journal (CLJ) 194; *L Sealy*, The Director as Trustee [1967] 25 CLJ 83, CA 2006, sec 239(7) and *Franbar Holdings Ltd v Patel* [2008] BCC 885.

legal duties to their companies, unless it is possible to classify them as 'shadow directors' in terms of sec 251 of the CA 2006, which is a rare occurrence in practice. In order to recover from M-Corporation, C-Corporation would have to establish each of the criteria for the establishment of the torts of negligence or deceit, on which, see the responses to questions 23.1 and 23.2 below for more detail.

- 101 Turning to the first and second alternative scenarios, the change of facts would not alter the assessment above.

*D. Waiver of and agreement regarding indemnity*

*21. Right and scope of waiver against board and its members*

- 102 Owing to the broad and comprehensive effect of sec 232 of the CA 2006 – which treats provisions in a contract or the company's articles of association which exempt a director from liability for breach of duty as void (subject to certain limited exceptions) – the mechanism prescribed in sec 239 of the CA 2006 is the only means available for a company to effectively waive its right to claim against a director for damages in tort or in respect of a breach of the director's statutory duty in secs 171–177 of the CA 2006. Although the terms of sec 239 of the CA 2006 strictly do not provide for an agreement waiving the company's right to damages for breach of the director's duties, it does operate as a functional equivalent to such a waiver agreement. It is provided that the shareholders of the company in general meeting may pass an ordinary resolution duly ratifying the director's breach of duty, in which case, the directors are effectively relieved from liability. Section 239 provides that only the shareholders of the company have the right to represent the company in connection with such a decision to release the directors from liability.

*21.1. CASE STUDY (waiver of right to pursue already incurred claims)*

- 103 As explained in the answer to question 21, any such waiver would be void as a result of the terms of sec 232 of the CA 2006. Moreover, it would only be possible for the shareholders of C-Corporation to pass an ordinary resolution under sec 239 duly releasing D from liability for breach of duty on an *ex post facto* basis, ie after the liability of the directors to C-Corporation had been incurred. This is the impact of the word 'ratification' in sec 239 of the CA 2006. As such, any ordinary resolution passed by the shareholders under sec 239 of the CA 2006 prior to the attachment or crystallisation of any liability on the part of D for breach of a statutory duty in secs 171–177 of the CA 2006 would be ineffective. The one exception – in which case, the *ex ante* release of D may be legally effective – would be where the relevant decisions in respect of which D is seeking relief from liability, were taken as a result of the passing of an ordinary or special resolution of the shareholders in advance of the decision: see the responses to questions 19 and 19.1 above.

*22. Indemnifying the board and its members from liability vis-a-vis third parties in the event of prosecution*

- 104 Yes, indemnification by the company to the directors in terms of an indemnity agreement in respect of liabilities to third parties (not the company or one of its associated companies) is expressly permitted under sec 234 of the CA 2006, which directors that: ‘provision for indemnity against liability incurred by the director to a person other than the company or an associated company [is permitted in law].’
- 105 Certain conditions are attached for the indemnity agreement to be valid. First, the indemnity agreement will be void under sec 232 of the CA 2006 if it supplies an indemnity to the director in respect of any liability on his part to pay (i) a fine imposed in criminal proceedings, or (ii) a sum payable to a regulatory authority by way of penalty in respect of non-compliance with any requirement of a regulatory nature. Secondly, the indemnity agreement will also be ineffective if it protects the director from liability he has incurred in defending criminal proceedings in which he has been convicted, or in defending civil proceedings brought by the company, or an associated company, in which judgment has been given against him. In light of these provisions in sec 234 of the CA 2006, an indemnity agreement purporting to indemnify a director from liability for breach of duty where the director is sentenced to a term of imprisonment would be void and invalid in law. The final question is whether the board of directors would have the right to represent the company in connection with such an indemnity agreement, to which the answer is yes, since the CA 2006 does not prescribe that the shareholders must give prior authorisation to the decision of the company to enter into the indemnity agreement, eg by passing an ordinary or special resolution.

*22.1. CASE STUDY (limits of indemnity provisions)*

- 106 No, in the case of (a), (b) and the second part of (d) (re the order for D to pay a fine), C-Corporation would not be liable to pay the legal costs, court fees, fines or compensation/damages for which D is liable. If an indemnity agreement entered into by C-Corporation in favour of D provides that it will indemnify D in respect of liability to pay sums to third parties in the event that (i) he is convicted in criminal proceedings, or (ii) he is liable to pay a fine, then such an indemnity agreement does not meet the requirements of the ‘safe harbour’ provisions in sec 234 of the CA 2006. Instead, the circumstances will be subject to the general rule invalidating the agreement under sec 232 of the CA 2006. However, as regards (c) and the first part of (d) (re the award of compensation in favour of the co-worker), D would be covered by the third party indemnity agreement in terms of sec 234 of the CA 2006, and as such, D would be entitled to an indemnity from C-Corporation.

### III. Liability for Damage to Third Parties

#### 23. Board's liability towards third parties

107 Section 170(1) stipulates that the directors owe the statutory duties in secs 171–177 of the CA 2006 to the company, rather than to any individual shareholder or specific class or group of shareholders. The end result is that it is the company who can enforce a breach of such duties and the directors are not liable to the employees, suppliers, customers, etc. of the company. Although it is possible for a director to owe such duties to specific shareholders, such liability arises through the law of agency on the basis that the director assumes a fiduciary responsibility, rather than via company law.<sup>139</sup> Moreover, so far as the liability of the directors to creditors goes, there is some authority to the effect that the directors owe the statutory duties in secs 171–177 of the CA 2006 to the creditors of the company when the company is nearing insolvency. However, the better view is that the said statutory duties are owed by directors *to the company* (and not to the creditors themselves) to have regard to the interests of the company's creditors when the company is insolvent or borderline insolvent.<sup>140</sup> The end result is that the creditors of the company have no standing to sue the directors when decisions are taken which prejudice their interests. Only a liquidator of the company could raise an action for breach of duty owed to the creditors.

#### 23.1. CASE STUDY (board's instruction to inappropriate advice by sales representatives)

108 D will have no liability for breach of duty to P in company law, ie in respect of any breach of the statutory duties in secs 171–177 of the CA 2006. Of course, it is possible that D may be liable to compensate P for a breach of the duty of care owed by D to P in the law of negligence ie in the law of tort/delict. However, the imposition of such liability on D as a director in the law of tort is rare, since P would be required to establish that D had assumed personal responsibility to P and that P had reasonably relied upon the personal expertise of D, rather than C-Corporation.<sup>141</sup> Since there is no suggestion that P and D have dealt with each other in a personal capacity, it is very unlikely that the requirements of the tort would be made out. Accordingly, D will not be liable to P. If the alternative is adopted and D directly engages with P in the sales, then this changes the complexion of matters slightly. However, P would still be required to satisfy a court that D had assumed a responsibility

<sup>139</sup> *Peskin v Anderson* [2001] 1 BCLC 372.

<sup>140</sup> *West Mercia Safetywear Ltd. v Dodd* [1988] BCLC 250 (CA); *Kuwait Asia Bank EC v National Life Nominees Ltd.* [1991] 1 AC 187, 217 (PC); *Yukong Line Ltd v Rendsburg Investments Corporation (No 2)* [1998] 1 WLR 294 and *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch). See also A Keay, *Directors' Duties and Creditors' Interests* (2014) 130 Law Quarterly Review (LQR) 443.

<sup>141</sup> *Williams v Natural Life Health Foods Ltd* [1998] 1 WLR 830.



towards P and that P had relied on the expertise of D in a personal capacity when he acquired the product. Moreover, the court would adopt an objective evaluation as to whether it was reasonable for P to rely on D's expertise in such a case.

- 109 Personal liability may also arise under environmental law or product liability law. However, the potential for such personal liability under statute is not addressed in this report.

### 23.2. CASE STUDY (*presenting false annual statements to third parties*)

- 110 In this case, there would appear to be evidence of P relying on the personal expertise of D in deciding to invest in C-Corporation. It is also likely that a court would apply an objective assessment of the facts to conclude that it was reasonable for P to rely on the advice, expertise and know-how of D in such a context. As such, there is a good chance that D would be personally liable to P for a breach of the duty of care in the law of tort as regards any negligent behaviour on D's part.

- 111 Where D's actions are intentionally dishonest, then this is likely to constitute the tort of deceit.<sup>142</sup> In such a case, there is no requirement for P to establish an assumption of responsibility on the part of D towards P.

- 112 In the alternative scenario, yes, P may sue both D1 and D2. D1 and D2 will be acting in concert towards the commission of a tort. As such, D2 will be the primary tortfeasor and D1 the joint tortfeasor. It is sufficient that D1 and D2 have come together to engage in activities which ultimately prove to be tortious. It is possible for D1 to be liable as joint tortfeasor despite the fact that it was D2 who undertook the tortious act.<sup>143</sup>

### 23.3. CASE STUDY (*publishing an incorrect prospectus*)

- 113 In terms of sec 90 of the Financial Services and Markets Act 2000, D will be under a general duty of disclosure and this duty will be breached where untrue or misleading information is included in the prospectus or relevant information has been omitted from it. As such, D will be liable to pay compensation to P if P has suffered loss as a result of (i) any untrue or misleading statement in the prospectus, or (ii) the omission of any information required to be included in the prospectus. For such liability to be established, whether D intended to include untrue or misleading statements in the prospectus, or omit relevant information, is completely irrelevant. For other potential forms of

<sup>142</sup> *Standard Chartered Bank v Pakistan National Shipping Corp (No 1)* [2003] 1 AC 959.

<sup>143</sup> *Credit Lyonnais Bank Nederland* [1998] 1 Lloyd's Law Reports (Lloyd's Rep) 19 at 42–46, per Hobhouse LJ.

civil liability which might arise in this case, see the response to question 23.2, ie liability in tort law, eg deceit, or the law of negligence.

23.4. *CASE STUDY (violation of cartel law)*

- 114 No, unless P is able to satisfy the requirements for the establishment of the torts of negligence or deceit – see answers to 23.2 above – there would be no civil liability on the part of D to P in competition law. UK competition law does not provide for the imposition of civil liability on directors to third parties.

23.5. *CASE STUDY (infringement of competition law)*

- 115 No, unless P is able to satisfy the requirements for the establishment of the torts of negligence or deceit – see answers to question 23.2 above – there would be no civil liability on the part of D to P under the Consumer Protection from Unfair Trading Regulations 2008<sup>144</sup> or the Business Protection from Misleading Marketing Regulations 2008.<sup>145</sup>

24. *Company insolvency: liability of the board and its members towards the company's creditors*

- 116 No, the creditors of the company would have no right to recover from the directors or the board on an individual or personal basis. Although the terms of sec 172(3) of the CA 2006 preserve the common law duty of the directors to have regard to the interests of the company's creditors and there is some authority to the effect that the directors owe the statutory duties in secs 171–177 of the CA 2006 to the creditors of the company when the company is nearing insolvency, the better view is that the said statutory duties are owed by directors *to the company* (and not to the creditors themselves) to have regard to the interests of the company's creditors when the company is insolvent or borderline insolvent.<sup>146</sup> The end result is that the creditors of the company have no standing to sue the directors when decisions are taken which prejudice their interests.
- 117 However, it should be stressed that a liquidator appointed over the estate of the company when the company enters into liquidation would have two options in relation to proceedings against a director. First, the liquidator could seek to enforce the duty owed to the company under sec 172(3). However, more likely is that the liquidator raises a claim against the director for 'wrong-

<sup>144</sup> SI 2008/1277.

<sup>145</sup> SI 2008/1276.

<sup>146</sup> *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250 (CA); *Kuwait Asia Bank EC v National Life Nominees Ltd* [1991] 1 AC 187, 217 (PC); *Yukong Line Ltd v Rendsburg Investments Corporation (No 2)* [1998] 1 WLR 294 and *Re HLC Environmental Projects Ltd* [2013] EWHC 2876 (Ch).

ful trading' in terms of sec 214 of the IA 1986, ie that the director had continued to trade when he 'knew or ought reasonably to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.'<sup>147</sup> For further details, see the response to question 12 above.

#### 24.1. CASE STUDY (delay in filing for insolvency)

- 118 No, as noted in the response to question 24, although D will owe a common law duty to take into account the interests of C-Corporation's creditors – such as P1, P2 and P3 – when C-Corporation is insolvent or borderline insolvent, this duty is owed to C-Corporation only. Accordingly, D owes no direct duty to P1, P2 or P3 as the creditors of C-Corporation, who have no standing to sue the directors when decisions are taken which prejudice their interests.
- 119 The only party who may take action would be the liquidator of C-Corporation on the basis that D engaged in wrongful trading in terms of sec 214 of the IA 1986. Moreover, the liquidator may seek to annul the transactions between P1, P2 and P3 and C-Corporation on the basis that they amount to a 'transaction at undervalue' or a 'fraudulent preference'.<sup>148</sup> A transaction at an undervalue is a transaction entered into between C-Corporation by way of gift to another, whereby that other party provides for C-Corporation to receive no consideration, or value of the consideration received is significantly less than the value of the consideration provided by C-Corporation. Meanwhile, a fraudulent preference is a transaction between C-Corporation and a third party where the latter is one of C-Corporation's creditors or a surety or guarantor for any of C-Corporation's debts or liabilities, and C-Corporation does anything which has the effect of putting that third party into a position which, in the event of C-Corporation going into insolvent liquidation, will be better than the position the third party would have been in if that thing had not been done.

#### 25. General duties owed by the board and its members towards creditors and liability for breach

- 120 No, liability to creditors could only arise under the law of negligence in tort, on which, see the responses to questions 23 and 23.2 above. If a company enters into insolvent liquidation or administration, a liquidator or administrator of the company may raise proceedings against a director under sec 214 of the IA 1986 on the basis of the 'wrongful trading' provisions in order to recover some of the losses of creditors. If a director is found to have traded wrongfully in contravention of sec 214 of the IA 1986, the director will be personally

<sup>147</sup> IA 1986, sec 214(2)(b).

<sup>148</sup> IA 1986, secs 238 and 239.

liable in an amount to be specified by the court. For more comprehensive details about wrongful trading, see the response to question 12 above.

*25.1. CASE STUDY (personal liability for delay in filing financial statements)*

- 121 As explained above, P would not be entitled to sue D in company law for a breach of D's statutory duties. However, D may be liable to P in the law of negligence in the law of tort, on which see the responses to questions 23 and 23.2 above for the relevant criteria which must be satisfied for such a duty of care to arise. If there is no tortious liability, then P as a creditor will have no right to recover its losses directly from D. Only the liquidator of C-Corporation would have the power to raise proceedings against D in the law of wrongful trading under sec 214 of the IA 1986, on which, see the responses to question 12 above.

*26. Direct liability of the board and its members towards creditors*

- 122 No. See the responses above.

*27. Limiting the liability of the board and its members towards third parties*

- 123 No, provision for limitation of liability in this way is not permitted under law and any contractual provision to that effect would be void under sec 232 of the CA 2006. However, it would be valid for the company or a third party to grant a director an indemnity under any contract in respect of civil liability incurred by that director to any third party. This would cover any liability to a third party for breach of duty. Such an indemnity contract is expressly permitted under sec 234 of the CA 2006. For more detail, see the response to questions 22 and 22.1 above.

*27.1. CASE STUDY (limitation of liability)*

- 124 No, provision for limitation of liability in this way is not permitted under company law and any contractual provision to that effect would be void under sec 232 of the CA 2006. Instead, the liability to the third parties would have to be limited via a third party indemnity contract in compliance with the criteria set out in sec 234 of the CA 2006: see the response to questions 22 and 22.1 above for greater detail.

**IV. Procedural Law Aspects**

*28. Persons and corporate organs can be parties to a suit for damages*

- 125 The following parties cannot be party to any legal proceedings in which legal action is taken against a director for negligence, default, breach of duty or breach of trust: (a) an individual director, (b) the whole board, (c) the individual members of any supervisory board, (d) the whole supervisory board, (e)

the shareholders' meeting or (f) committees of all corporate organs. Only the company may sue a director for negligence, default, breach of duty, breach of trust.

- 126 However, if the company decides not to raise legal proceedings against a director for negligence, default, breach of duty or breach of trust, then an individual shareholder, ie (e) above, will be entitled to raise a statutory derivative claim against the directors on one or more of these grounds under secs 260–269 of the CA 2006 if the criteria set out in secs 263 or 268 are satisfied. If the shareholder is successful in his statutory derivative claim against the director for negligence, default, breach of duty, breach of trust, then any compensation or remedy will be for the benefit of the company, rather than the shareholder himself.

*29. Standing and requirements to sue for damages against the board*

- 127 It is the board of directors of the company that represents the company in a legal action for damages against the board. No special requirements are imposed for such a suit to proceed, although there would have to be a simple majority decision of the board in favour of raising such legal proceedings. If litigation was initiated which was not backed up by a majority board resolution in favour of it, the litigation would not be prejudiced, since it is assumed that the directors have the authority to commit the company to litigation, save in exceptional circumstances.<sup>149</sup>

*30. Legal representatives and conflicts of interests*

- 128 If a lawyer who had represented a company or its board of directors was instructed by a third party to raise legal proceedings for damages against that board, this would give rise to a conflict of interest for that lawyer under both the common law and the professional rules of the Law Society and the Law Society of Scotland. As such, the lawyer would be prevented from acting for the party who instructed him/her to sue the board of directors in the absence of informed consent, ie full disclosure to the third party and the latter's express consent to proceed with the litigation nonetheless. If such informed consent were given by the third party, the lawyer would be entitled to sue the board, subject to the rules of his/her professional body

*31. Pursuing damages against the board and its members: procedural rules and competent court*

- 129 The civil courts have the competence to hear such claims. Some of the civil courts have special divisions that hear corporate law disputes, eg the Commercial Court of the Outer House of the Court of Session.

<sup>149</sup> See CA 2006, sec 40 for director's authority and third parties.

## V. Insurance Law Aspects

### 32. General statutory and non-statutory rules regulating D&O insurance

- 130 D&O insurance has no specific legal regulation. Instead, the general law of insurance is deployed to regulate D&O insurance. D&O insurance is not regulated by the UK Corporate Governance Code, which simply recognises at sec A.1.3 that 'the company should arrange appropriate insurance cover in respect of legal action against its directors'. Deductibles are common in D&O insurance policies governed by English law, but there is no legal requirement or regulation for, or of such deductibles. The author is unaware whether it is common market practice for deductibles to be covered by the insurance policy.

### 33. D&O policies: parties, corporate representatives and the treatment of premiums

- 131 The common arrangement is for the company to enter into a D&O insurance policy with an insurer whereby its directors are the insureds under the D&O insurance policy in respect of certain risks, although the definition of the insureds is often extended to cover the company itself (i) where it indemnifies the directors, or (ii) where it is itself the subject of a claim. The company will pay the premiums, which obligation is usually set out and agreed in the service contracts of the directors covered under the policy. It is not standard practice for the premiums paid by the company to be deducted from the remuneration of the directors covered under the insurance policy. It will be the directors of the company who have the authority and right to represent the company in concluding the insurance contract, eg by a simple majority decision of the board in favour of the conclusion of such a contract.

### 34. Insured persons

- 132 The insured persons are the directors, and sometimes also the company, as explained in the response to question 33 above. Yes, it is standard practice for a group of directors, officers, and sometimes employees, to be insured in one D&O insurance policy in respect of a defined risk or event. Yes, it is possible – and actually quite common – for a group of directors to be insured, as well as senior employees of a subsidiary or an affiliate company, eg under a Corporate Group D&O Insurance Policy.

### 35. Standing to claim under a D&O policy

- 133 Since the company will be a party to the D&O insurance policy, the company will be entitled to claim for performance where the contingency has occurred. Third parties can only assert direct claims against the insurer where the provi-

sions of the Third Parties (Rights Against Insurers) Act 2010 are satisfied, eg the director who is the insured becomes bankrupt, insolvent or dies.<sup>150</sup>

*35.1. CASE STUDY (claims for performance by the company)*

- 134 If C-Corporation is a party to the contract with I-Insurance – which would be a common way of arranging matters in the UK – then C-Corporation would indeed be entitled to assert the claim directly against I-Insurance. However, if C-Corporation is a third party, then it could only go directly against I-Insurance if D had become insolvent, bankrupt or died, and a whole host of additional criteria under the Third Parties (Rights Against Insurers) Act 2010 have been satisfied.
- 135 It does not matter whether D goes into hiding. As for the bankruptcy of D, then if C-Corporation was a third party, it would have the right to bring proceedings against I-Insurance to enforce its rights against I-Insurance and it would be entitled to a remedy under the D&O insurance policy once the court has made a declaration to the effect that D is liable to it, or a judgement or decree is made to that effect, or an arbitral award in arbitral proceedings or by arbitration is made to that effect or an enforceable agreement with I-Insurance is reached to that effect.

*35.2. CASE STUDY (claims for performance by third parties)*

- 136 No, as a third party, P could only go directly against I-Insurance if D had become insolvent, bankrupt or died, and a whole host of additional criteria under the Third Parties (Rights Against Insurers) Act 2010 have been satisfied.
- 137 The fact that P has no direct contractual relationship with C-Corporation does not change the legal picture.
- 138 If D becomes bankrupt, then P would have the right to bring proceedings against I-Insurance to enforce its rights against I-Insurance and it would be entitled to a remedy under the D&O insurance policy once the court has made a declaration to the effect that D is liable to P, or a judgement or decree is made to that effect, or an arbitral award in arbitral proceedings or by arbitration is made to that effect or an enforceable agreement with I-Insurance is reached to that effect. However, it should be stressed that it would be rare for D to be found liable to P based on a breach of D's general statutory duties, a breach of a duty of care in tort or some other duty in tort, eg deceit.

<sup>150</sup> Third Parties (Rights Against Insurers) Act 2010, secs 2–7.

*36. Definition and occurrence of the insured event: D&O vs legal protection insurance*

- 139 The standard D&O Insurance Policy will tend to cover the following insured events, namely: any actual or alleged act, error or omission committed or attempted by an insured person arising from the performance of the insured person's duties solely in their capacity as the company's director, officer or employee including:
1. breach of any duty, including fiduciary or statutory duty;
  2. breach of trust;
  3. negligence, negligent misstatement, misleading statement or negligent misrepresentation;
  4. defamation;
  5. wrongful trading under sec 214 of the IA 1986 (or equivalent legislation);
  6. breach of warranty of authority;
  7. any other act, error or omission attempted or allegedly committed or attempted by an insured person solely because of their status as a director, officer or employee of the company.
- 140 Standard D&O Insurance Policies will provide that the insured event is taken to have occurred when it actually occurs or is alleged to have occurred. The company then has a period of time from the occurrence of the insured event to notify the insurer, eg fourteen days from the insured's first awareness of the occurrence of the insured event. If the company fails to notify the insurer within the prescribed time limits, then the company and the directors will not be covered by the policy protections.
- 36.1. CASE STUDY (costs of defending a director against a claim by the company)*
- 141 Yes, it is standard practice for D&O Insurance policies to include cover in respect of defence costs and the costs of representation in respect of civil and criminal cases arising from an insured event, even where C-Corporation is the party who is claiming against the director concerned.



*37. Scope of D&O coverage and the insurer's obligations D&O vs legal protection insurance*

- 142 Yes, it is standard for direct indemnification of the directors to extend to acts for which the corporate organisation is not legally required to indemnify the directors and officers, subject to standard exclusions for illegality, fraud, dishonesty, deliberate acts, fines, penalties, and punitive damages claims.
- 143 Yes, standard D&O Insurance policies will cover the company's losses which it is legally obliged or permitted to pay on behalf of a director arising from a claim against the director in respect of an insured event.
- 144 No, claims relating to securities and share offerings are generally excluded by insurers.
- 145 Yes, the terms of some D&O Insurance policies stipulate that the insurer will advance defence and legal representation costs to the company, but this is usually restricted to circumstances where the company is legally prohibited from granting an indemnity to the director or advancing such costs to the director itself. Advance payments may also be made to enable a director to defend allegations of fraud or dishonesty, provided that the insurer will be entitled to reclaim such advance costs where such allegations are proven in criminal or regulatory proceedings.
- 146 It is common practice for the insurer to have the right, but not the obligation, to appoint legal counsel and take control of the defence of the claim. The right of the individual insured person to appoint legal representatives is commonly limited, so that such person will have no option but to rely on the insurer's choice of legal counsel.

*37.1. CASE STUDY (advance payments for legal defence)*

- 147 No, if D engages in the lawsuit to defend himself, this will not constitute an insured event under a standard D&O Insurance Policy. Instead, it is the breach of duty itself that will constitute the insured event. Unless C-Corporation complies with the terms of the notification requirements set out in the D&O Insurance Policy, D will be off-cover. As such, he will have no right to be paid compensation for the costs of legal representation. Moreover, if C-Corporation notifies out of time, the standard policy exclusion in a D&O Insurance Policy will apply to classify D's litigation as 'prior litigation', which will mean that D is off-cover for the full period before the lawsuit is finally terminated.

*37.2. CASE STUDY (fines and imprisonment)*

- 148 The D&O Insurance Policy will not respond in respect of any of these payments, since standard exclusions apply to fines and criminal convictions, re-

ardless of whether they were negligently or intentionally committed by the director.

*37.3. CASE STUDY (pure economic loss/mass claims)*

149 D could only be held liable to the investors if the requirements for a duty of care in the law of tort were satisfied, on which, see the responses to questions 22 and 23.2 above. If the duty of care in the law of negligence in tort is made out, the courts would apply an objective test in order to determine whether D's opinion was 'wrong'. The D&O Insurance Policy would likely respond, in which case, D would be entitled to defence costs, costs of legal representation and an indemnity if he is found civilly liable to the investors. However, it should be stressed that some insurers exclude liability to directors such as D where the company, eg C-Corporation, enters into insolvent liquidation. As such, much depends on the extent of the cover agreed upon in the D&O Insurance Policy.

*38. Duties of D&O policy holders and insurers' right to participate in the claims handling process*

150 See the responses above regarding the standard terms of D&O Insurance Policies concerning the duty to notify and the insurer's right to step in and handle claims and conduct such claims, including the negotiation of any settlement. A consequence of breach of the notification obligation is that the parties are off-cover.

*39. Typical exclusions from coverage in D&O policies*

151 The following are typically excluded from cover in the standard D&O Insurance Policy:

1. Illegality, fraud or dishonesty on the part of the insured or the directors;
2. Liabilities in respect of fines, penalties or punitive damages claims;
3. Liabilities arising in respect of deliberate or conscious acts or omissions on the part of the director;
4. Claims under prior and pending litigation or retrospective date exclusions;
5. Claims or circumstances notified under a previous insurance policy;
6. Claims arising in the US which involve a claim by the company against the directors insured;

7. Liabilities relating to pollution or liabilities that are environmental in nature;
8. Liabilities in respect of personal injury, manslaughter or property damage;
9. Claims arising from public or private offerings of the company's shares or securities.

152 It ought to be highlighted that some of the above claims, liabilities and losses may be insured by an insurer as an extension to cover if a higher premium is paid by the company.

153 If claims, liabilities or losses connected with deliberate or conscious acts or omissions, illegality, fraud or dishonesty, etc. were on-cover in the D&O Insurance Policy, this would nonetheless be contrary to public policy. In such a case, the insurer would have the right to terminate the policy, since there is a rule of English and Scottish Insurance Law that the insured must not make a fraudulent claim, eg if the insured causes the event or risk insured. As such, the insurer would not be liable to pay out on any claim under the D&O Insurance Policy and the director would find himself off-cover.<sup>151</sup>

#### *40. Claim for determining the insurance coverage*

154 It is standard practice for D&O Insurance Policies to provide that in the event of a dispute between the insurer, the company and/or any insured director over cover, proposed settlement or continuing the defence of a claim, the insurer or the company may request that a legal opinion be procured from a mutually agreed Queens Counsel at the English, Scottish or Northern Irish bar, or equivalent in a different jurisdiction. Such opinion is treated as binding on the parties and will establish whether policy cover exists, and/or the defence of such a claim will continue or settlement will be agreed. It is common for the terms to stipulate that the costs of such an opinion will be met by the insurer.

#### *41. Differences between the legal position of the board or director*

##### *41.1. CASE STUDY (comparison of D&O insurance v exclusion of liability)*

155 The D&O Insurance Policy described in (a) would be valid in terms of sec 233 of the CA 2006. However, the term of D's contract of employment or conditions of appointment referred to at (b) would be void under sec 232 of the CA 2006. Therefore, D would not be entitled to rely on this exclusion of liability under his contract of employment or conditions of appointment.

<sup>151</sup> Insurance Act 2015, sec 12.