"Directors Duties and Liabilities in Corporate Insolvency in England and the US"

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TO MY MOTHER'S SOUL

ABSTRACT

Directors Duties and Liabilities in Corporate Insolvency in England and the US

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This thesis is an examination of directors duties and liabilities in the event of insolvency in England including Wales and the US. The main aim of the study is to compare the two legal systems' stance towards directors when their company is in financial depression or technically insolvent.

The thesis consists of ten chapters. The first chapter is a general introduction which draws a picture of the structure and scope of the study. Chapter two and six consider directors duties in general and in the event of corporate financial depression in England and the US respectively. Chapter three and seven examine the liabilities of directors of an insolvent company for breach of their duties in those two legal systems. In chapter four, disqualification of corporate directors in English law is studied. Chapters five and eight are an attempt to answer the question how directors of an English or American ailing company, accordingly, are provided with appropriate protection against the many liability provisions imposed by common law or statutes. In chapter nine, the unique device of the business judgment rule and its function in the US is reviewed. Finally, in chapter ten a detailed comparative study of the two laws concerned is carried out to analyse the solutions of each law for the questions and uncertainties in this area of the law.

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Chapter 1: General Introduction

In undertaking a subject for research, it is intended to answer one or some particular questions, or to examine one or more specific aspects of the area concerned. This examination requires a different method of evaluation when more than one jurisdiction is involved. That is because after reviewing the materials relevant to each system and through the imposition of dialectical reasoning, it is intended to consider the response of each legal system to the question, or its solution to the problem. The fruitful end of such a study is to make an evaluation of the solutions offered by the laws under consideration and to reveal advantages and disadvantages of one against the other in order to determine which legal system's solution is more advantageous.

Some advantages can be suggested for a law comparative study. The result of the work can be used as an aid to the legislators, and also as a component of the curriculum of law departments. The main use of a comparative work is its contribution to the systematic unification[1] or harmonisation of different laws.

A comparative study can be undertaken in different ways. In a comparative study of law, if the author just describes some aspects of two or more legal systems without comparing any feature of them, it is only "descriptive comparative" law.[2] But a comparative study of law in its real sense is to critically compare some specific aspects of the laws concerned, in order to suggest a solution for the problems in question or deficiencies of each legal system. Our study is based on the second or critical comparative study.

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[1] Konrad Zweigert & Kein Kotz, Introduction to Comparative Law, (Oxford: Clarendon Press, 1987) at 15.

[2] Ibid at 6.

The question may be raised as to the purpose of undertaking a subject- study for research. In the modern commercial relations, the role of corporations is a key one, not only in domestic but also in international relationships. That is because company's liabilities are guaranteed not just by its own assets but they are also recoverable from the controlling shareholders' as well as directors' personal assets in the case of fraud, breach of duty of loyalty and gross negligence. Moreover, dealing with a legal entity with a registered centre of administration or principal place of business is easier and more desirable than a natural person who may refuse to fulfil his contractual obligations.

In a company, two organs are very important, shareholders whose decisions are made in general meetings in the form of resolutions, and directors who control and manage the company in collective co- operation within the board of directors. This situation requires more consideration where both organs are dominated by the same persons. It is when directors or managing directors are controlling shareholders, and the privilege of limited liability may be abused.

The business and affairs of a company are managed by or under the direction of a board of directors.[3] The relationship between a corporate directors and the company and its stockholders stems from the fact that directors have the control and guidance of corporate business affairs and property, and hence the interests of the corporation and stockholders.[4]

From the early history of company law, the company's directors have owed duties and obligations to its members. Such duties have also been owed, as the new trend

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[3] Section 141 (a) of the Delaware General Corporation Law (Amd. 1992). See also the New York Business Corporation Law section 701 (McKinney 1965 & Supp. 1986). Likewise, the Revised Model Business Corp. Act (1984) in section 8. 01 (b) provides:
"All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation."
Likewise, in England Article 80 of Table A of the Companies Regulation Act 1985, provides that :
"Subject to the provisions of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by directors who may exercise all the powers of the company."

[4] *Ashman v. Miller*, 101 F. 2d (6th Cin. 1939) 85, 90- 91.

of law, to its creditors and society at large whose interests should be protected. However, sometimes those company's constituents have suffered from loss and damage through the abuse of the privilege of limited liability by its directors. The anxiety has attracted the attention of the legislature as well as lawyers that the company's directors may take shelter behind the company, and by abusing that privilege and escaping their responsibility, suffer no personal liability when the company is sinking into massive debts.

As a corporation approaches financial difficulties, a conflict of interests of shareholders and creditors becomes evident. That is because shareholders who find it a disadvantage to put their capital at risk, are reluctant to invest in the corporation, and sometimes particularly when they are shareholder- creditors or control the board of directors, may transfer its assets in a fraudulent way. In this situation, the deterrent role of law is the only means to protect the creditors' interests.

Global competition has also had an impact on the role of the modern board. Corporations have shed layers of their hierarchical structures to meet the demands of the world economy. In addition, directors have begun emphasising their policy and oversight function with greater vigour to meet foreign competition.

The reason why I chose the US, as the country that possesses "perhaps the most complicated legal structure that has ever been devised in man's effort to govern himself,"[5] as the comparator to English law, was to see how this member of common law family has developed and to what extent it has departed from its English common law roots, and finally to answer the question whether the solutions offered by one can be implemented by the other.

In studying US corporate law, it is not possible to examine all the States' laws, because 51 jurisdiction together with federal law can not be considered in a single work. The focus in the US part of research is on Delaware State law. That is because the governing law is that of the State of corporation. This State of corporation, as

[5] Griswold, Law and Lawyers in the United States. The Common Law under Pressure, (1967) 264.

the cases indicate, is Delaware.[6] The Delaware court system has been described as "the mother court of corporate law",[7] where fifty percent of Fortune 500 companies are incorporated.[8] Moreover, the Delaware corporation model has been the choice of 40% of all New York stock exchange companies, more than 50% of all fortune companies, and more than 8% of all companies incorporated in the past twenty five years.[9] Therefore, this legal system is the most appropriate choice for the purposes of this thesis. Other main jurisdictions such as New York law are referred to when necessary. State law not only determines the duties of directors but also determines how they may be found liable for their breach of such duties.[10] Furthermore, where appropriate, some institutions' projects or recommendations particularly American Law Institute's proposed draft on corporate governance and the Revised Model Business Act are used throughout the thesis.

At first, the rules of common law developed in both English and American laws are to be analysed.

In English law, the Companies Act 1985 and its predecessors, the Insolvency Act 1986 and the Company Directors Disqualification Act 1986 are employed as the statutory measures in the English part of this research. However, where necessary, the legislative background of each statute appeared in the reports prepared by the relevant committees such as Jenkins, Greene and Cork Committees are referred to accordingly to interpret the legislators' intention in enacting a particular provision.

In the US part of the research although, unlike the UK, the US has a written constitution, this advantage in the area of our study does not cover the obvious lack of statutory provisions, and the situation is not as clear as it seems at first. That is

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6 For the judicial references see Dennis J. Block, Nancy E. Barton and Stephen A. Radin, The Business Judgment Rule- Fiduciary of Corporate Directors (New Jersey Prentice Hall Law & Business 1993) 2 footnote 8.

7 *Kamen v. Kemper Fin. Servs., Inc*, 908 F.2d [1990] 1338, 1343.

8 Franklin Balotti & Frankelstein, The Delaware Law of Corporations and Business Organisations, (2d. 1990 & Supp. 1992), F- 1.

9 Curtis Alva, "Delaware and the Market for Corporate Charters: History and Agency", 15 Del. J. Corp. L. (1990) 885, 887.

10 Willis L. M. Reese & Edward M. Kaufman, "The Law Governing Corporate Affairs: Choice of Law and Impact of Full Faith and Credit", 58 Colum. L. Rev. (1958) 118, 1124.

because the Bankruptcy Code 1978 which one may expect to be the main statutory tool for this study, is not helpful. This problem lies in the philosophy behind the enactment of the Code itself. Congress adopted Bankruptcy Reform Act with the view to pushing managers of financially troubled firms toward reorganisation rather than liquidation. This view was based on the very fact that, reorganising a company was financially more efficient than liquidating it, because this not only preserves jobs and assets but it also prevents the imposition of considerably high expenses and costs on stockholders as security holders, employees, suppliers, and communities.[11] Chapter 11 is intended to provide a framework within which interested parties may negotiate for a financial reconciliation,[12] the scheme that has been always used versus liquidation.[13]

Other federal statutes are not more helpful than the Bankruptcy Code. The Securities Act 1933 and the Securities Exchange Act 1934 as other main federal acts do not refer to directors liabilities or duties in insolvency. Because the aim of those acts is described as protecting the investing public from losses due to the unavailability of relevant and reliable information, "and this aim was implemented by requiring that such information be publicly disclosed".[14]

Consequently, our main statutory source in the US part of the research is the Delaware General Corporation Law, though we utilise other States statutes particularly New York Business Corporation Law. As was mentioned, institutional efforts specially ALI's Principles of Corporate Governance: Analysis and Recommendations are widely used.

The major difficulty inherent in the US part of study is that both federal and State statutes including the Delaware General Corporation Law are silent as to the

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[11] Michael Bradley and Michael Rosenzweig, "The Untenable Case for Chapter 11", 101 Yale L. J. (1992) 1043-44.

[12] Christopher W. Frost, "Running the Asylum: Governance Problems in Bankruptcy Reorganisations", 34 Arizona L. Rev. (1992) 89, 92.

[13] Lynn M. Lopucki & William C. Whitford, "Corporate Governance in the Bankruptcy Reorganisation of Large, Publicity Held Companies", 141 U. Pa. L. R. (1993) 669, 800.

[14] Note, "Indemnification of Directors: the Problems Posed by Federal Securities and Antitrust Legislation", 76 Harv. L. Rev. (1963) 1412.

directors' liabilities in insolvency. This problem in some extent can be also seen in the American case law. It has been acknowledged even by the American lawyers that one reading US law in corporate insolvency area, will soon find that only a "few judges or scholars have taken this observation to heart."[15]

For the purposes of this study insolvency in English law means that defined in section 214(6) of the Insolvency Act 1986.[16] In US law, the insolvency is considered as a combination of definition given by section 1302 of the Delaware General Corporation Law,[17] and section 101(3) of the Bankruptcy Code,[18] to the effect that filing any petition under chapter 11 for reorganisation or under chapter 7 for liquidation means insolvency.

This thesis consists of three parts, English law, US law and comparative study. All these three parts are discussed under three main concepts, duties, liabilities, and protection of directors.

In order to study directors' liabilities, the reader should first become familiar with the preliminary concepts of liabilities related to their duties since violation of duty, and liability are considered as opposite sides of the same coin.[19] In other words, a director's liability is a result of his breach or disregard of his duty. Because the centrepiece of this research is directors' liabilities, their duties are reviewed to the extent that is necessary to explain those liabilities. Having an observation helps to answer this claim that directors duties "specially of large corporations not only do not do what the law envisages of them but, indeed, cannot fulfil the law's

[15] Douglas G. Baird & Thomas H. Jackson, "Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy." 51 U. Chicago L. Rev. (1984) 97.

[16] Section reads: (6) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

[17] The section reads: "a person is insolvent when the present fair saleable value of his assets is less than the amount that will be required to his probable liability on his existing debts as they become absolute and matured." The Uniform Fraudulent Conveyance Act s. 2, 7A U. L. A. 427, 442 (1918), offers a similar definition.

[18] 11 U. S. C. A. 101(31), which reads: "the sum of ... [the] entity's debts is greater than all of such entity's property, at a fair valuation."

[19] Claus J. Hopt, Directors' Duties to Shareholders, Employees and Other Creditors: A View from the Continent, (Edit. Ewan McKendrick) (New York: Claranden Press 1992) 115, 121.

requirements."[20] Even if this statement is academically correct, directors liabilities must be appropriate response to such breach of duties. Therefore, the concepts of duties and liabilities are truly opposite sides of the same coin.

One may question my study on the protection of directors as a matter out of the scope of the research and an additional work. Perhaps considering the title of the thesis may justify this view, but as will be seen, in many cases on directors' liabilities, whether in England or in the US, the judges even without application from the defendant director(s) have acknowledged the necessity of resorting to the available protective provisions or rules that means the two concepts are twin features of the same legal invention. Moreover, the law in both countries, particularly in the US have been showing a tendency for a more liberal perspective of directors liability which at the same time requires protection.

In the next chapter, duties of an English corporate director are examined. These duties in insolvency are apparently hanging over creditors' interests as the vulnerable group in this event, to whom directors' duties shift from shareholders. Before beginning with such responsibilities in insolvency, a review of duties in general is made to explain the roots of common law duty of care and skill and equity duties under the concept of fiduciary duties on the one hand, and the development led to the recognition of duties towards creditors, on the other hand.

Chapter three considers different liabilities provided by common law and several statutory provisions in the Companies Act as well as Insolvency Act. The liabilities in English law are defined under three well- recognised headings, namely fraudulent trading, wrongful trading, and misfeasance. Other concepts such as fraudulent conveyance are considered only when they have been decided under one of those concepts. The interesting result of this chapter is to show how traditional English common law has developed a well- statutory system abandoning even some of its old

[20] Christopher S. Axworthy, "Corporate Directors- Who needs them?", 51 MLR (1988) 273.

principles. Perhaps the provisions set out in section 214 for wrongful trading suffice to prove this radical departure.

In chapter four, disqualification of directors in insolvency, based on the Company Directors Disqualification Act and its predecessors, is to be reviewed. It is true that this concept is a special feature or an additional liability and supplementary punishment against delinquent directors and should be thus considered within liability chapter, because of its significant impact upon companies management, it is studied in a separate chapter. In this chapter, there has been an attempt to look at the subject in detailed from a new sight, and elaborate the fact that how this concept as a supplementary punishment has affected the directors' personal as well as business life. The noteworthy feature of this chapter is a detailed review of the historical development of law in this area.

The fifth chapter is an attempt to answer the question what kind of protection is available to an English director against these wide range of liabilities, and whether he is properly protected. Comparing the attitude of the English legislature on this issue with directors' liabilities and disqualification leads the reader to the conclusion that the protection provided is not appropriate. Even there are still some serious uncertainties about the extent of the available protective devices which necessitate an amendment of the statutory law.

Chapter six, as the first chapter of section two and a parallel to the same chapter in English law, considers the duties of US corporate directors. This chapter reveals the many common senses in this regard shared by both English and US laws rooted in the traditional common law.

In chapter seven, the debate on liabilities of the American corporate directors examines that how undeveloped and unclassified this legal system is in this area and how the lack of judicial and statutory recognition of a set of concepts for this purpose is evident.

The main advantage of US law which is a very well established protective system for its company directors, is evaluated in chapter eight, where a review of several statutory mechanisms shows the liberal and generous attitude of the legislature towards directors.

The final chapter of the second part, chapter nine, is a detailed examination of the business judgment rule as another advantage of this legal system. Although the rule reveals a particular protective feature of the US law, because it has some other functions such as being used as a measure for standard of due care, it is reviewed in a separate chapter.

The final chapter, which is the only chapter of the third part of the thesis, compares different aspects of the two laws, and evaluates the solutions offered by each law to the problems of the other. After considering advantages and disadvantages of one legal system against the other, in final conclusions some suggestions are offered to solve and overcome the deficiencies inherent in the two laws respectively.

At the end, there are some suggestions by the author for those who are willing to research in this field of law in the future.

As to the methodology of my work, a brief examination is necessary. This study is virtually theoretical based on library work. Cases as the main source, most particularly in US law, have been used throughout the thesis.

The main problem with which I faced during my research was the unavailability of materials related to the US law. This problem was more serious as to Delaware cases. Not only Delaware cases were not available in the Sheffield University libraries but also some main libraries throughout the country such as British Library, the library of the Institute of Advanced Legal Studies did not have this jurisdiction's cases, which was my choice of the US law.

To overcome these difficulties, I had visited British Libraries a numerous times. I had also visited the library of the Institute of Advanced Legal Studies as well as other research centres located in London.

I had to become an expert in using Lexis through which I extracted hundreds of Delaware cases and articles which I could not find in any library in the UK.

The Inter- Library Loan enabled to receive the materials which were not available in the UK, though for the ordered material to arrive, it took sometime 3-6 months.

To complete my search, I used other computing services such as Bids and internet. The Legal Journals Index was the most available way of search to make sure that no article or case was missed.

As a lawyer from a civil legal system where the higher education is heavily based on analytical study and taught courses, I needed to familiarise myself with the common law system, its rules and solutions, and the new way of academic work which is an absolutely research study.

On the other hand, coming from a Persian country where the only official language is Persian and English is a foreign language, I had to overcome my difficulties and improve my skills of reading, understanding, interpreting and writing in English.

This point should be noted that English law is central to the thesis, therefore, in the case of any ambiguity or confusion the reference is to be made to that law.

English law for the purposes of this thesis includes Wales and excludes Irish as well as Scottish law.

PART ONE:
ENGLISH LAW

Chapter 2: Directors Duties in English Law

2. 1 Introduction

In English law, directors owe duties to the company, to its shareholders and creditors, which may lead to civil proceedings for compensation. Additionally, they may find themselves criminally liable for over two hundreds offences arising from breach of such duties.[1] As will be seen, the rules relating to directors duties concern controversial matters.

The attitude of courts has radically changed so that while in the past the courts were reluctant to impose liability on directors for breach of their duties unless it gave rise to gross negligence, nowadays they seem stepping in the line with the new legislation of 1986 by demanding a more objective standard of conduct from corporate directors. Their duties which are classified under duty of care and skill on the one hand, and fiduciary duties on the other hand, should be considered in relation to misfeasance, specifically negligence, and wrongful or fraudulent trading accordingly.

The purpose of this chapter is not to engage to a great extent in a detailed debate of directors duties, but rather to introduce their duties so far as related to the next chapters on directors liabilities, namely wrongful- fraudulent trading and misfeasance, and disqualification. Moreover, as different aspects of breach of due care and skill in general and in insolvency will be examined under statutory provisions of misfeasance, fraudulent and wrongful trading respectively, such duties are to be studied in connection with and as an introduction for the above liabilities.

[1] David McIntosh, ".Open Declared on Company Directors", The Independent (1990 Jan. 9) 19.

In this chapter, first directors duty of care and skill and fiduciary duties in general are reviewed. The second part considers directors duties in insolvency or when their company has faced financial difficulty which focuses on duties to the company's creditors.

2. 2 Duty of Care and Skill

Duty of care deals with the manner of exercise of the powers and discretion of a director.[2] The duty of skill refers to the aspects and functions of expertise and qualification of directors, and to the standard applicable to the level of skill.

As to the history of duty of care, much credit has been granted to Lord Atkin, whose "neighbour principle" has been viewed as the foundation of duty of care. His principle that 'you are to love your neighbour' was introduced in *Donoghue v. Stevenson*.[3] The principle is submitted as the foundation of the law of negligence,[4] since in common law it is rare a single statement of a judge in a single case so significantly affects the development of the law,[5] as it happened in that case. However, the cause of action, in the instant case, was damages for personal injuries which is difficult to apply to financial loss. Moreover, the decision was neither intended, nor can be treated as being a general formula which will explain every conceivable case of negligence.[6] Therefore, as is suggested by Smith and Burns, it is the time that "the case was laid gracefully to rest in the tombs of the law reports."[7]

The most important step to introduce a test for the existence of duty of care was taken by Lord Wilberforce in *Anns v. Merton London Borough Council*.[8] In this

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2 The concept of duty of care was criticised by Buckland who thought that the duty of care was a "superfluous notion". W. Buckland, "The Duty to Take Care", 51 LQR (1935) 637.

3 [1932] A. C. 562, 580.

4 In *Peabody Donation Fund v. Sir. L. Parkinson & Co.* [1984] 3 All E. R. 529, 534 Lord Keith expressed that the law of negligence was founded on Lord Atkin's principle.

5 J. C. Smith and Peter Burns, "Donoghue v. Stevenson- The not Golden Anniversary", 46 MLR (1983) 147.

6 R. F. V. Heuston, "Donoghue v. Stevenson in Retrospect", 20 MLR (1957) 1, 23.

7 Smith and Burns, *op cit* at 163.

8 [1978] A. C. 728.

case, the judges referring to Lord Atkin's judgment in *Donoghue v. Stevenson,*[9] as the proper solution, agreed with Lord Wilberforece who said:

> " ... in order to establish that a duty of care arises in a particular situation, it is necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist."[10]

This view is now described as "out of fashion" in modern English law.[11] Likewise, Davies J. gave an example as to the existence of duty of care, when he said:

> "[A] duty of care exists only if X when making his statement knew or ought to have known that Y would rely on it for the purpose of such a transaction as Y did, in fact, enter into."[12]

Although the "neighbour principle" was an appreciated introduction to define the duty of care and the concept of negligence in its general sense, it is difficult to recognise such significance of the rule in some specific areas of the law, particularly corporation relationship. For example, in such an analogy the question is, who is the neighbour, to whom a corporate director's duties are owed, the company as a strictly separate personality, its shareholders, or its creditors? To answer this question, it seems an attempt is necessary to apply a more appropriate principle to directors duties than "neighbour principle". We will later address the question in our discussion of 'to whom directors owe their duties.'

2. 2. 1 Duty of Care Implications

It is believed that Common law imposes a very light duty upon directors, as to their level of care and skill and competence which they may reasonably be expected to demonstrate.[13] The main characteristics of such common law duties are; lack of

9 [1932] A. C. 562.

10 Ibid at 580. See also *Anns v. Merton London Borough Council* [1978] A. C. 728, 751- 2. This case was overruled by House of Lords' decision in *Murphy v. Brentwood District Council* [1990] 2 All E. R. 908.

11 Stephen Quinlan and David Gardiner, "New Developments with Respect to the Duty of Care in Tort", 62 Aus. L. J. (1988), 347, 361.

12 *Al- Nakib Investments (Jersey) Ltd. & Another v. Longcroft and Others,* [1990] 3 All E. R. 321 at 366.

13 Kevin Wardman, "Directors, Their Duty to Exercise Care and Skill: Do the Provisions of the Company Directors Disqualification Act 1986 Provide a Basis for the Establishment of a mere objective Standard"? Bus. Law. Rev. (1994) 7. This can be seen particularly in cases such as

expertise, non- attendance at general meetings and reliance on others etc., which had been regarded as matters of justification rather than fault.[14] The traditional common law, thus, seems operating to give directors a remarkable freedom to run companies even in some occasions incompetently. Provided that their behaviour falls short of the grossest negligence, they are unlikely to be held accountable.[15]

The main functions of duty of care which are duty of attention, attendance and reliance on others, and delegation of powers are discussed in the following sections.

2. 2. 1. 1 Duty of attendance and attention

In the past, it could be said that a director was not obliged to attend meetings because his appointment did not imply any obligation of attendance. In the absence of any contract or provision in the articles to this effect, a director was not required to devote whole or indeed any particular part of his time to the company.[16] For example, in *re Cardiff Saving Bank (Bute's Case)*[17] this question was considered. In this case, the Marquis of Bute became president of the Cardiff Saving Bank when he was only six month old, inheriting the office from his father. He attended only once in board meeting in thirty- eight years. Furthermore, he was unaware of irregularities which had occurred, and had received copies of reports and circulars issued by the bank which, in the court's view, justified him to believe the company's affairs were being conducted in conformity with the rules. The court was not prepared to hold him liable because it believed:

> " ... omission to attend the meetings of the bank was not the same as neglect or omission of the duties which ought to have been performed at those meetings; and that under circumstances B. was not liable"[18]

Overend & Gurney Co. Ltd. v. Gibb. [1872] LR 5 HL 480 at 487, *re Brazilian Rubber Plantations & Estates Ltd.* [1911] Ch. 425, 436, *Languas Nitrate Co. Ltd.* [1899] 2 Ch. 392, 435.

14 L. S. Sealy, "Reforming of the Law on Directors Duties", 12 Co. Law. (1991) 175, 176.

15 Vanessa Finch, "Who Cares about Skill and Care?" 55 MLR. (1992) 179.

16 *Re Forest of Dean Coal Mining Company* [1878] 10 Ch. D. 450, 452.

17 [1892] 2 Ch. 100.

18 Ibid at 101.

Here, Stirling J. was not prepared even to recognise that attending at meetings was a duty failure of which would lead to liability for breach of duty of care.

The second proposition of Romer J. in *Re City Equitable Fire Insurance Company Ltd.*[19] is a very well- known formula representing this view as follows:

> " A director is not bound to give continuous attention to affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever in circumstances he is reasonably able to do so."[20]

The implication of this head is that the non- attendance at general meetings is not a sufficient ground to hold a director liable for losses suffered by his company as a result of his non- attendance. However, in the last phrase of the proposition, a director is required to attend whenever he is reasonably able to do so. In this part of proposition, the expression "ought to attend" implies a somehow mandatory duty which seems inconsistent with the first line of that statement.

Gore- Browne is of the view that this part of Romer's judgment can, expressly or implicitly, be displaced by a contract between the company and its directors. In the absence of such agreement, the implication of the proposition is that a director whose non- attendance has caused losses to the company will not be held liable for those losses, neither will he be accountable because his attendance may have prevented his colleagues from taking a negligent decision giving rise to the loss.[21]

In *re Brazilian Rubber Plantations and Estates Ltd.*[22] Neville J. went further to say:

> "He is not, I think, bound to take any definite part in the conduct of the company's business, but so far as he does undertake it he must use reasonable care in its despatch. Such a reasonable care must, I think be measured by the care an ordinary man might be expected to take in the same circumstances on his own behalf"[23]

Even long before Romer J.'s famous judgment, Lord Bacon stated that a director's "business or pleasure may call him elsewhere and it would be a most unheard of

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[19] [1925] 1 Ch. 407.
[20] Ibid at 429.
[21] Gore- Browne on companies. (Jordans 44th ed.) Para. 27. 19. 2.
[22] [1911] 1 Ch. D 425.
[23] Ibid at 437.

thing to say that if anything wrong was done at a board meeting he being named among the directors but not present, he is liable for what is done in his absence."[24]

The question normally arises whether such a traditional approach can still be applied. It seems that in today's complicated and highly specialised business relationships, as a result of the rapid development of technology and commerce, there is no room for the principle developed in *Re City Equitable Fire Insurance Co Ltd.*, when the appointment of a director was part- time or honourable in nature. It is, thus, not justified to apply the requirement of attention and attendance to directors of different companies or different classes of directors ~~in~~ the same company equally. In other words, to apply the requirement, a distinction should be drawn between public and private companies, and between executive and non- executive directors.

The first and the most significant, and perhaps the only judicial precedent that took a different stand from the traditional view was *Charitable Corporation v. Sutton*,[25] where it was held that if directors were sued for gross non- attendance, and leaving the management entirely to others, they might have been guilty of the breaches of trust committed by others.[26] Similarly, in *Dorchester Finance Co. Ltd. v. Stebbing*,[27] the court held that it was not acceptable for directors not to attend board meetings, therefore, they were liable for losses incurred.

2. 2. 1. 2 Reliance on and delegation of powers to others

Directors particularly in large companies are not obviously able to carry out all functions themselves either because of lack of time or skill, therefore, they are entitled to rely on others. That is because business "can not be carried on upon principles of distrust. Men in responsible positions must be trusted by those above them, as well as by those below them, until there is reason to distrust them."[28]

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24 *re Montrotier Asphalte Company (Perry's Case)* [1876] 34 L. T. 716, 717.
25 [1742] 2 Atk. 400.
26 Ibid at p.5-7.
27 [1989] BCLC 498.
28 *Re National Bank of Wales, Ltd.* [1899] 2 Ch. 629, 673.

Romer J. in his third proposition in *Re City Equitable Fire Insurance Co. Ltd.*[29] acknowledged such a power conferred on directors as follows:

> "In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly."

However, if some specific powers or areas of responsibility are delegated to directors under a company's articles or through any process, then they will not normally be entitled to sub- delegate them to others. Except when such specific powers or discretion are vested in directors, there is no limitation on the extent to which directors can delegate their powers to others.[30] But it is not to be accepted as a good defence unless it is reasonable.[31] In order to recognise such a reliance as reasonable, there should be no ground for suspicion.[32] In *Dorchester Finance Co. Ltd. v. Stebbing*,[33] the court, for example, dismissed the defendant directors' argument that non- executive directors with some accounting experience were entitled to rely on the diligence of the auditors and do nothing themselves.[34]

It is also submitted that when there is no ground for suspicion, no supervision is necessary,[35] as it was pointed out by the Earl of Halsbury in *Dovey v. Cory*[36] where he said:

> "it can not be expected of a director that he should be watching the inferior officers of the bank or verifying the calculations of the auditors himself. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management."[37]

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29 [1925] Ch. 407, 429.
30 M. J. Trebilcock , "The Liability of Company Directors For Negligence", 32 MLR, (1969) 499, 507, Allan Mackenzie, "A Company Director's Obligations of Care and Skill", JBL, (1982) 460, 462, see also *Leeds Banking Company* [1866] L. R. 1 Ch. App. 561.
31 *Land Credit Co. of Ireland v. Lord Fermory* [1870] LR 5 Ch. App 763.
32 *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407, 429.
33 [1989] BCLC 498.
34 Ibid at 505.
35 *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407 at 430.
36 [1901] A. C. 477, 493.
37 Ibid at 486.

Because the so- entrusted officials are the agents and servants of the company but not of the directors, the directors are, thus, not responsible for their misdeeds. However, the directors may be held liable for personal negligence.[38] In *Land Credit Company of Ireland v. Lord Fermoy,*[39] Lord Hatherley L. C. confirmed the argument advanced by the counsels for plaintiff that the defendant director was appointed and paid by shareholders to protect them, and that he could not be allowed to say that he was not liable because he did not attend, or because he trusted his colleagues. His Lordship went on to state:

> "I am exceedingly reluctant in any way to exonerate directors from performing their duty, and I quite agree that it is their duty to be awake and their being asleep would not exempt them from the consequences of non- attending to the business of the company."[40]

Similarly, in *Norman and Another v. Theodore Goddard (a firm) & Others,*[41] Hoffmann J. held that a director was entitled to trust persons in positions of responsibility until there was reason not do so.

With regard to the line of decisions made by the courts,[42] it is justified for directors to trust officers or employees in performing administrative or subordinate functions within the company to discharge their duties honestly. In the result, directors in some cases could have escaped liability when accountants or other executive officers to whom they delegated functions of company's affairs, misrepresented the company's financial state or have breached other duties.[43]

The delegation of powers, in comparison with other implications of duty of care which so far have been reviewed, can be described as the only one on which there is

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38 Gower's Principles of Modern Company Law (London: Sweet & Maxwell 1992) 588.

39 [1870] L. R. 5 Ch. App. 763.

40 Ibid at 770. Likewise, in more recent case of *Department of Health and Social Security v. Wayte* [1979] 1 W. L. R. 19, it was held that a director should have had an eye on others.

41 [1991] BCLC 1028.

42 *Re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407, *Re Brazilian Rubber Plantations and Estates Ltd.* [1911] 1 Ch. 425, *Dovey v. Cory,* [1901] A. C. 477, 485, *Re Denham & Co* [1883] 25 Ch. D. 752.

43 Gore- Browne on companies, at 27- 043.

an unanimous agreement, and both traditional and modern common law are of similar position in its application or general definition.

2. 2. 2 Standard of Conduct

To assess the duty of care and skill some different standards of conduct have been recognised as subjective, objective and partly objective.

2. 2. 2. 1 Traditional or subjective view

This view which still follows the proposition delivered by Romer J. in *re City Equitable Fire Insurance Company Ltd.*,[44] denies the possibility of the application of even a partly objective standard of conduct. The courts have often applied the rule that directors are not required to demonstrate a special care and skill in serving on the board. However, it does not mean if they have possessed a special knowledge, they are not expected to give the advantage of that knowledge to their company while taking a business decision, specially in transacting a contract. The first case which referred to this standard was *re Brazilian Rubber Plantations & States Ltd.*,[45] where four directors of the company were induced to join the company as directors. Although they were said to have been ignorant, Neville J. did not hold them liable for losses incurred in a ruinous speculation in rubber plantations by concluding:

> "A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him to act, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance"[46]

However, the court stated that if the director possessed any special acquaintance with the rubber business, he was supposed to give the company advantage of his knowledge when transacting its business.

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[44] [1925] 1 Ch. 407.
[45] [1911] 1 Ch.D. 425.
[46] Ibid at 437.

It is widely agreed upon that the first proposition advanced by Romer J. in *re City Equitable Fire Insurance Company Ltd.*[47] represents this approach as follows:

> "A director need not to exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience."[48]

As will be seen, there is some disagreement among legal writers as to the implication of this part of Romer J.'s judgment. Most of leading commentators agree upon the point that this head implies nothing but simply a subjective formula for duty of care and skill.[49] Therefore, a director's knowledge, skill, and experience is the criterion to assess his performance.

2. 2. 2. 2 Objective test

The proponents of the objective test are of the view that in assessing a director's performance of his duty of care and skill, applying a merely subjective test not only leaves the interests of different constituencies of the company open to abuse on the part of unqualified directors, but it may also encourage incompetent individuals to join the board of directors. This opinion also takes account of the needs of modern business relationships which can no longer be satisfied by employing a subjective test. The first case representing this view was *Charitable Corporation v. Sutton*,[50] the case which was never followed.

In the light of this approach, the first proposition of Romer J. has been interpreted in a special way. Gower expressly points out that the proposition "prescribes a test which is partly objective (the standard of reasonable man), and partly subjective (the reasonable man is deemed to have the knowledge and experience of the particular individual),"[51] the interpretation which has received other commentators' support.[52]

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47 [1925] 1 Ch. 407.
48 Ibid at 428. See also *Gurney & Co. v. Gibb.* [1872] LR 5 (HL) 480.
49 L. S. Sealy, "Reforming the Law" 12 Co. Law (1991) 75, Farrar's Company Law, (London: Butterworth 1991) 397, Gore- Browne on Companies, (44th ed.) para. 27. 19. 1.
50 [1742] 2 Atk 400.
51 Gower, Principles of Modern Company Law at 587.
52 Mackenzie *op cit* at 461.

It is surprising to see both Gower's and Mackenzie's opinions were first posed prior to the enactment of the Company Directors Disqualification Act 1986 and the Insolvency Act 1986. However, comparing the language employed by Romer J. in that case and section 214(4) of the Insolvency Act, leads to the conclusion that in Romer J.'s holding, unlike that section, a negative language is employed. In other words, the proposition of Romer J. does not require a director to show a grater degree of care and skill expected of a reasonable man, but in contrast, it draws a ceiling on the performance of his duties where he is not bound to exhibit a greater degree of skill "may be expected from a person of his knowledge and experience."

2. 2. 2. 3 A third alternative

This prospect impressed both by the traditional and objective views, is based upon the argument that the attitude of today's business world to and, thus, its expectation from a corporate director has radically changed, so that a director is considered as a professional person with some managerial and accounting knowledge and minimum level of skill and diligence necessary to manage a company. Such minimum of skill and diligence varies depending upon the complication and size of the company. However, as a director possessing some particular knowledge, a minimum level of care and skill in serving public or specialised companies is inevitable. For example, a director is now required to lay the company's accounts before the company in general meeting.[53] Having some financial knowledge and accounting information is, thus, very necessary if a director is to manage a business competently.[54]

This view has been acknowledged by Mr. Justice Lightman who suggests that to mitigate the damaging consequence of corporate failure and insolvency, directors, specially those of publicly- held corporations should be required to be licensed as fit and proper persons to be directors. This licence should not be renewed in the case of

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53 Section 241 of the Companies Act 1985.

54 John Bouch, "Directors' Accounting Duties", JBL (1985) 447.

proven criminal conviction for an offence of dishonesty or a proven responsibility for a failure to file annual report.[55]

It has been suggested that an objective test should be applied but the one which does not discourage directors from improving their level of skill. Such a test varies with size of the company and complication of its activity. In other words, based on this formulation, a director is expected to exhibit the care and skill reasonably expected of a person who has undertaken their kind of role in their kind of company.[56] Moreover, this formulation empowers the courts to apply a reasonable test to particular facts of each case.

Under this view, even Romer J.'s first two propositions should be regarded in connection with the 1986 legislation. Farrar suggests that the propositions must be reconsidered in the light of the wrongful trading provisions,[57] the fact which has also been acknowledged by other legal writers. Finch, with reference to Farrar, making attempts to justify a relationship between section 214 and duty of skill, finds it difficult to do so, because this section only applies to insolvent liquidation cases but not to the company's whole trading life. However, she reaches the conclusion that it is "arguable that standards set by the duty of skill and care should be raised to reflect the objective nature of section 214."[58]

Hoffmann L. J.'s holding in *re D' Jan of London Ltd.*,[59] is a turning point in this regard, who for the first time adopted the measure provided in section 214 as an appropriate test for directors' conduct, and stated: "*In my view, the duty of care owed by a director at common law is accurately stated in section 214(4).*"[60]

This judgment which deserves to be considered as a significant move in the history of English case law, raises the question whether this holding should be viewed as

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55 Mr. Justice Lightman, "The Challenges Ahead: Address to the Insolvency Lawyers Association" JBL (1996) 113, 125.
56 Finch *op cit* at 202- 3.
57 Farrar's Company Law, 397- 398.
58 Finch *op cit* at 203.
59 [1994] 1 BCLC 561, 563.
60 The emphasis added.

violating the provisions of section 214(4) or as a development of the common law? In a civil law system, one can easily hold that judgment inconsistent with the statutory provisions, because section 214 limits the application of that hybrid standard only to insolvency cases. However, a common law lawyer finds no difficulty to argue that the limits provided in that section does not block the way of common law system to operate, and the judges are still empowered to deliver their opinions in the form of judgments as the main ground of common law. Moreover, the section does not prohibit the test concerned to apply in non- insolvency cases.

In proposing an appropriate standard of conduct some considerations should be taken into account:

i- The complexity and nature of the company operation. It is not easy to challenge the fact that the level of performance required from directors of a small family company can not be the same as that from directors of a giant multinational corporation with a complicated financial communication and astronomical turn-over. Today's courts are required 'to consider the size and the nature of the enterprise and the skills reasonably to be expected of a director in the role they have assumed.'[61]

ii- The qualifications possessed by director, the nature and the kind of task he is employed to perform. This point deals with the skill and qualification which a director has actually possessed on the one hand, and the level of expertise which his job requires from him on the other hand. A judgment cannot be regarded as consistent with justice principles if it holds a director, whose task is only to manage the employment affairs of the company with no accounting knowledge, to demonstrate the same level of performance as a finance director with a high accounting expertise.

iii- Being executive or non- executive director, since the latter is not required to demonstrate the same depth of experience as to the company's affairs as a full- time director. The importance of the role of non- executive directors which should be

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61 Finch *op cit* at 203.

encouraged is a significant point. In Birds' view, in applying a proper managerial standard which is lighter for non- executive directors, the difficulty that the courts face is their traditional reluctance to interfere with business decisions. Referring to a three propositions stated by Foster J. in *Dorchester Finance Co. Ltd. v. Stebbing,*[62] which are similar to those proposed by Romer J. in *re City Equitable Fire Insurance Company Ltd.*[63], he believes that they can safely be applied to a non- executive or part- time director, but not to an executive director who is also an employee of the company.[64] In that case, the same test of skill and care applied to both executive and non- executive directors. Likewise, Gower is of the opinion that the second head of Romer J.'s proposition applies only to non- executive directors from whom nothing more is expected than attendance at meetings.[65]

At the end, it is worth noting that under the Cadbury Code, the responsibilities imposed on directors have been increased. Moreover, the Cadbury Committee has proposed a representative- system to monitor the corporate affairs. These developments will require a new definition of the duty and standard of care.

2. 3 Fiduciary Duties

2. 3. 1. A Fiduciary Relationship

Fiduciary concept as a concept of equity was the trustee and the trusts being creature of the Court of Chancery and under its exclusive jurisdiction.[66] Although the law of trusts is a separate branch of law with its own textbooks and principles, the expression "fiduciary" was used and still is sometimes used in an indefinite and descriptive sense which embraces all trust- like status situations including the trust itself.[67] The term "fiduciary" is derived from the Latin "fiduciarius", implying a

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[62] [1989] BCLC 498.
[63] [1925] 1 Ch. 407.
[64] John Birds, "A Code of Directors' Duties", NLJ (1974) 1163, 1165.
[65] Gower's Principles of Modern Company Law at 589.
[66] J. R. Maurice Gautreau, "Demystifying the Fiduciary Mystique" 68 Can. Bar. Rev. (1989) 1.
[67] L. S. Sealy, "Fiduciary Relationships", CLJ (1962), 69, 72. [Thereafter Sealy, CLJ, (1962)]

trustee or one in a position of trust and as used in the law includes anyone holding the character of a trustee or the like,[68] while trust relationship falls within fiduciary concept.[69]

Corporate directors are fiduciaries and even in certain circumstances trustees as to any assets come into their hands and are not allowed to enter into contract with their company unless empowered by articles. This relationship described by Fry J. in *Ex p. Dale & Co.*[70] as follows;

> "What is a fiduciary relationship ? It is one in respect of which if a wrong arises, the same remedy exists against the wrongdoer on behalf of the principal as would exist against a trustee on behalf of the *cestui que* trust."[71]

This statement is considered as a description of a common feature of fiduciary relationship rather than a pervasive definition, when it is obvious that in order to find a general definition of fiduciary relationship they should be defined class by class to find out the rule or rules which govern on each class.[72]

In an interesting analogy, fiduciary relationships have been described as children of the forced marriage of agency and trust law, being drawn respectively from common law and equity concepts.[73] In dealing with conflict of interests, in respect of whether trustees or corporate directors are parties to such a conflict, the turn is to fiduciary concept.

The main element of a fiduciary duty is considering beneficiary's interests which operates not only as "a goal toward which the fiduciary must direct his assertions, but also provides a yardstick against which to assess the fiduciaries assertions of loyalty".[74]

To explain a fiduciary relationship, a range of theories such as "property theory", "unjust enrichment", "undertaking or contractual theory", and "undue influence"

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68 Ernest Vinter, "History and Law of Fiduciary Relationship and Resulting Trusts" (Cambridge: W. Heffer & Sons Ltd., 1955) 1.
69 Robert Flannigan, "The Fiduciary Obligation", 9 Oxford J. L. S. (1989) 285, 301.
70 *re West of England and South Wales District Bank, ex. p. Dale & Co.* [1879] 11 Ch.D. 772.
71 Ibid at 778.
72 Sealy, CLJ, (1962) at 73.
73 J. C. Shepherd "Towards an Unjustified Concept of Fiduciary Relationships" 97 LQR (1981) 51.
74 Ross Grantham, "Reforming the Duties of Company Directors" 12 Co. Law. (1991) 27, 28.

have been suggested. The first theory, "property theory", which seems to be the leading doctrine, includes all the situations where one person has control over property which in the court's view belongs to another. Guardians, bailiffs, and stewards as well as a person who receives a property for a purpose which can not be carried out, fall into this category.[75]

2. 3. 2 To Whom Directors Owe Their Duties

As was earlier mentioned in our discussion of "neighbour principle", the question is important that to whom a corporate director owes his duties. This question applies to both fiduciary and care duties.

It is well- recognised that directors owe their fiduciary duties to the company only and not to its individual shareholders, or a *fortiori* to a person who has not become a member as potential purchaser of shares.[76] Prentice is of the view that this statement does not mean that the interests of shareholders or creditors should not be taken into account by directors, rather it means that directors do not owe a "free- standing" duty because of their status to creditors or shareholders.[77]

It seems Prentice rightly believes that directors' duties to those constituencies are mediated through the corporation, and are not owed directly. Some judicial authorities have introduced the concept of the "corporate as a separate identity" as beneficiary.[78]

Although directors are required to act in the interests of the company as a separate personality, they are not expected to act on the basis of what is recognised as an economic advantage of the corporate entity, disregarding the interests of the members. In other words, when the members are entitled to receive a benefit, e. g. a

[75] For a detailed discussion of different theories defining a fiduciary relationship see Sealy L. S. "Some Principles of Fiduciary Obligation", CLJ (1963) 119, J. C., Shepherd *op cit* at 63, Gareth Jones, "Unjust Enrichment and the Fiduciary Duty of Loyalty", 84 LQR (1968) 472.

[76] *Percival v. Wright* [1902] 2 Ch. 421, *Dawson International Plc. v. Coats Patons Plc.* [1988] 4 BCC 305.

[77] D. D. Prentice, Directors, Creditors, and Shareholders (Edit. Ewan McKendrick) (Oxfor: Clarendon Press 1992) 73.

[78] *Charterbridge Corp. Ltd. v. Lloyds Bank Ltd.* [1970] Ch. 62.

payment of dividends, the directors should not use such a payment by directing all to the company so as to increase the size and wealth of the company.[79]

Because directors' duties towards the company have, at various times, been in conflict with their position to its individual members, or a particular group of the members, or its creditors, it is traditionally accepted that towards each of them directors owe no legal duties whatever, least of all towards the company's creditors.[80] This sense can be seen in Jenkins Committee report which stated:

> "no fiduciary duty is owed by a director to individual members of his company, but only to the company itself, and a *fortiori* that none is owed to a person who is not a member."[81]

Under the old rules of company law, directors' duties were regarded as being owed to the company only, and for this purpose the company's interests were equal to those of the members collectively, but not to the other groups' interests such as employees, creditors, customers and suppliers. According to this traditional approach, the law equates members of company to its shareholders until the statute-determined point of insolvency, unless the members agree otherwise.[82] However, the traditional view that directors' duties are owed to the company and its shareholders but not other groups, has been challenged as "too narrowly focused."[83] The best guideline in this regard is section 309 of the Companies Act 1985 which reads:

> "The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general as well as the interests of its members."

However, the section expresses that "the duty imposed by this section on the directors of a company is owed by them to the company (and the company alone)."[84]

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79 Ibid at 554.

80 L. S. Sealy, "Directors Wider Responsibilities- Problems: Conceptual, Practical and Procedural", 13 Monash ULR (1987), 164, 166. [Thereafter Sealy Monash ULR (1987)]

81 Jenkins Committee Report, Cmnd. 1749 (1982) Para. 89.

82 David A. Wishart, "Models and Theories of Directors' Duties to Creditors", 14 N. Z. L. U. L. Rev. (1991) 323, 353.

83 L. S. Sealy, Monash ULR (1987) at 169.

84 Subsection 2 of section 309 of the Companies Act 1985.

It seems the header of the section does not quite accord with its footer. In the header it refers to the interests of "the company's employees in general as well as the interests of its members", whereas in subsection (2) it emphasises on "the company (and the company alone)."

The only justification for employing this language is that because the legislature is not expected to contradict itself in the same section, the latter statement should be interpreted in compliance with the former by reasoning that the legislature's intention is to expressly exclude other parties, particularly employees from taking actions which in long term may destabilize the business relationship, and to put the right of taking action in the hands of the company alone, whether exercised by the board of directors or general meeting of its shareholders.

The development of the law has proved the need for broadening the scope of the rule to other groups in a company. When it is said 'the interests of the company wholly', the expression should be interpreted as company itself, its members, as stated by Lord Evershode in *Greenhalgh v. Ardene Cinemas*:[85]

> "....I think it is now plain that "*bona fide*" for the benefit of the company as a whole" means two things but not one thing. It means that the director must proceed upon what, in his honest opinion, is for the benefit of the company as a whole. The second thing is that the phrase, "the company as a whole" does not (at any rate in such case as the present) mean the company as a commercial entity, distinct from corporators: it means the corporators as a general body."

The recent judicial approach not only has showed a trend towards the concept "the company as a general body or as a whole" by admitting the present members within this concept, but it has also recognised an equivalent position for the prospective members. Such a stand can be seen in Mr. Justice Megarry in *Gaiman v. Nat. Assco. for Mental Health*,[86] where he pointed out that:

> "The interests of some particular section or sections of the company can not be equated with those ones of the company and I would accept the interest of both present and future members of the company as a whole ... ."[87]

[85] [1951] Ch. 286.
[86] [1971] Ch. 317.
[87] Ibid at 330.

Although in such cases as *Parke v. Daily News Ltd.,*[88] directors' obligation to have regard to the interests of employees was virtually rejected, having regard to some other cases such as *Re Welfab,*[89] the evolution of legislation on the issue, and more importantly the needs of modern business world, gives rise to the conclusion that directors are not only under a fiduciary obligation to consider the interest of the company itself and members, present and future, but also they must have regard to those of the company's employees as a part of the concept of "company as a whole or as a general body".

Modern management is of the view that although directors in running a company owe a duty to act *bona fide* in the best interests of the company and such a duty is owed primarily to the company but not to the individual shareholders, the concept of company is defined in equity by reference to shareholders as a whole but not to the company as identity distinct from its members.[90]

In the *Savoy case*[91] it was stated that the company meant both present and future members of the company, and directors had to strike a balance of long- term view against short- term interests of the present members, a view which was followed by Megarry J. in *Caiman v. National Association for Mental Health.*[92]

The interesting point, founded as a rule in *Foss v. Harbottle,*[93] is that if directors breach their duty, it is the company which can sue them but not shareholders. "Company" as an intact concept should be referred to in the case of uncertainty and in the end, it is the company who can sue for breach of its directors duty.[94]

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88 [1962] Ch 927.

89 (1990) BCC 600, 603. Here although among three offers directors concerned accepted the lower price offer only because it provided the company's employees security, Lord Hoffman J. did not feel that the directors' conduct to take into account the interests of the company's employees was in breach of their fiduciary duties.

90 Palmer's Company Law (London: Sweet & Maxwell 1992) v. 2, at 8. 505.

91 *Second Savoy Hotel Investigation*, Report of June 14, 1954, by Miller Holland, Q. C. (Quoted by Palmer's Company Law at 8- 505).

92 [1971] Ch. 317, 330.

93 [1843] 2 Hare 461.

94 For a detailed discussion of the development of the rule and its implications see the final chapter on "Comparative Study".

As a rule, so long as a company is a going concern, directors do not have to take creditors interests into account as was the case in *Multinational Gas & Petrochemical Co. v. Multinational Gas & Petrochemical Services Ltd.*,[95] where it was held that the directors owe their duties to the company only but not to the creditors, whether present or future, nor do they owe any duty to individual shareholders. However, as will be seen later, there is a tendency to consider the interests of creditors prior to insolvency.

As to the concept of a fiduciary relationship in context of company law, it seems the expression "future members" needs an explanation. With respects to those judges and commentators who have included this expression within the concept of "company" along with the present members, it seems some difficulties are inherent in such an interpretation. First, in none of those decisions or commentaries a definition or descriptive explanation has been given for "future or prospective members". Although one may say that "future member" is confined only in the future shareholders, it is not still clear while it leaves future employees and creditors behind. Secondly, it raises the question of why a company directors should take the interests of a group of unknown and non- existent members into their account when these members not only have no investment in the company yet, but are assumed as outsider to the company in its current and running situation. The argument that directors should sacrifice the interests of the present members for the prospective members' interests,[96] needs a highly justifiable reasoning. The only justification for considering the interests of future members is to interpret the word "company" as the economic and social interests of the society as a whole.

2. 3. 3 Implications of Fiduciary Duties

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95 [1983] Ch. 258, 288.

96 *Second Savoy Hotel Investigation*, Report of June 14, 1954, (Quoted by Palmer's Company Law at 8- 505).

2. 3. 3. 1 Fiduciary duty of good faith and bona fide

A corporate director is required to exercise the powers and discretion conferred on him by the company's Articles of Association or memorandum in good faith and *bona fide* in what he considers is in the best interests of the company and not for any collateral purpose as expressed by Lord Greene in *re Smith and Fawcett*[97] where his Lordship said:

> "they must exercise their discretion *bona fide* in what they consider- not what a court may consider- is in the interests of the company, and not for any collateral purpose."[98]

This implies that directors are expected to use their powers for which they were vested in them, otherwise they are to be held to account. If they abuse such authority by exercising it for an improper purpose they have breached their fiduciary duty of good faith.[99]

In respect of duty of good faith and *bona fide*, the main point is that this duty, unlike e. g. duty of care and skill which has some external demonstration, is something relevant to mental element of individuals as well as what they have done. The kind of test applicable to this duty should, thus, be consistent with the nature of the duty. The fact that acting in good faith and *bona fide* is subjected to the doee's intention and his mind activity is beyond doubt. The standard should, therefore, be a subjective one. The most relevant reference to the question can be seen in the statement of Lord Greene in *re Smith and Fawcett*,[100] where a totally subjective test was adopted. Because the subjective test 'deals with intention and incentive of directors, the courts find it difficult to determine the proper exercise of the duty and, thus, the delinquent director may escape liability.[101]

Although the courts in some particular circumstances may interfere and apply a reasonable test in order to prevent a wrongdoing which they assume contrary to the

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97 [1942] Ch. 304, 306.
98 Ibid at 306. The language employed, particularly the use of expression "any collateral purpose" has been criticised by Sealy as ambiguous. L. S. Sealy, Cases and Materials in Company Law, (London: Butterworth & Co. (Publishers) Ltd. 1992), 284.
99 Gower's Principles of Modern Company Law, 556.
100 [1942] Ch. 304, 306.
101 *Re Hutton v. West Cork Railway Co.* [1883] 23 Ch.D. 654, 671.

company's interests,[102] any attempt to apply an objective test to duty of good faith and *bona fide* is bound to fail. That is because doing so is not only inconsistent with the nature of the duty, but also imposes a heavy and unfair burden of proof upon the defendant directors, the task which in applying a subjective test is upon the plaintiff. However, the objective test introduced in section 214 of the Insolvency Act 1986 and in section 6 of the Company Directors Disqualification Act 1986 which is applicable in liquidation, is reviewed in our discussion of wrongful trading.

2. 3. 3. 2 Duty to act for proper purposes

In analysing the duty, the question may naturally arise that when a director is expected to act *bona fide* with loyalty, how can it be possible to conduct so but for an improper purpose? It has been recognised by some academic writers that the duty to act *bona fide* in the interests of the company and the duty to use powers for proper purposes are the same concept in different words,[103] therefore they both may be described as the two sides of the same coin. However, it respectfully seems these two duties are designated with different functions while working *bona fide* does not necessarily mean acting for proper purpose, the reverse is true. Furthermore, the majority of legal writers have examined these duties separately. There is also some judicial references to support the latter view. For example in *Hogg v. Cramphorn Ltd,*[104] referring to Lord Greene in *re Smith & Fawcett,*[105] Buckley J. held that his Lordship intended two separate duties; the duty to act *bona fide* in the best interest of the company, and the duty to act for a proper purpose, the opinion which also received support from Lord Wilberforce in *Howard Smith Ltd. v. Ampol Petroleum Ltd.*[106] In that case, the court held that although the respondents acted honestly, *bona fide* and within their powers, because the issue of new shares was intended for

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102 See for example, *R. v. Sinclair* [1968] 1 W. L. R. 1246, *Tett v. Phoenix Property & Investment Co. Ltd.* [1984] BCLC 559, 621.
103 L. S. Sealy, Monash ULR (1987) at 169.
104 [1967] Ch. 254.
105 [1942] Ch. 304.
106 [1974] A. C. 821.

an improper purpose, that was to reduce the proportionate shareholding of the majority shareholders below 50% and to maintain the board in control, it was liable to be set aside. It was also concluded that even if directors exercise their powers for a purpose different from that for which they were vested in, with a belief that such exercise of power is in the benefit of their company, they might still be liable.[107]

Birds suggests that English law has adopted a midway between the proper purposes as an aspect of 'to act *bona fide*' and a completely separate head of directors' duties.[108] However, somewhere else he acknowledges that the line between these two concepts is not clear, since the *bona fides* test is subjective and the proper purposes test is objective.[109] Moreover, in Birds' view, an improper purpose is ratifiable whereas *Mala Fides* is not.[110]

If a director exercises his power for an improper purpose, the court may interfere and set aside the transaction concerned. He should, thus, act within the proper limits, and powers vested in him for one purpose can not be used by him for a different purpose.[111] If they abuse such authority by exercising it for an improper purpose they have breached their fiduciary duty of good faith and will be liable.[112]

Although a director is said to have been required to make attempts in order to control the process of maximising returns and profits of the company,[113] the proper purpose is not maximisation of profits, because focusing on this point as the main aim of corporate directorship may lead to disregarding the interests of the company's components or even those of "the company as a whole or a general body."[114] For example, maximising the company's benefits might give rise to the environment pollution which is in detriment to the society' interests.

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107 Ibid at 834.

108 J. Birds, "Proper Purposes as a Head of Directors' Duties", 37 MLR (1974) 580.

109 J. Birds, "Making Directors Do Their Duties", 1 Com. Law. (1980) 67, 70.

110 Ibid at footnote 46.

111 *Re Cameron's Coalbrook Steam Coal & Swansea & Lougher Railway Co., Bennett's case.*[1854] 5 De G M & G 284 (Quoted by Mayson, French and Ryan, Company law, (London: Blackstone Press Ltd. (1993) 474).

112 Gower's Principles of Modern Company Law, 556.

113 Gerald M. D. Bean, "The Operator as a manager: A new Fiduciary Duty," JBL (1993) 24.

114 Keith Abbott Company law (London: Sweet & Maxwell 1992) 193.

Finally, if a director acts for several different or mixed purposes, the courts have to determine how to judge his conduct. It seems, the decisive factor that should be considered, is whether the proper purpose for which the powers and discretion conferred on directors was 'substantial purpose' as opposed to the other reasons. If the court is satisfied that the 'substantial purpose' which motivated the director to take an action is the proper one, it will not most likely set aside the transaction even if some improper purposes have motivated the directors. This view enjoys the case law support. For example, in *Howard Smith Ltd. v. Ampol Ltd.*,[115] Lord Wilberforce said that the "substantial purpose" was the factor upon which the court could decide the purpose by that the respondents were motivated.

2. 3. 3. 3 Prohibition against conflict of duty and personal interests

As an established rule, a fiduciary/ director is required not to place himself in a position in which his personal interests may be in conflict with his duty to his principal/ company. In other words, he should not act with divided loyalty. The rule is a product of trust cases, particularly *Keech v. Stanford*,[116] where the trustee was obliged to renew a lease for the beneficiary, a minor, but he instead renewed the lease for himself and claimed to be entitled to it beneficially. The court ruled that it must be held on trust on the same terms as the original lease. This decision has been described as an authority for the principle upon which persons in a "fiduciary" position are not entitled to make a profit from their situation.[117] The rule expressly was stated by Lord Herschell in *Bray v. Ford*,[118] as follows:

> "It is an inflexible rule of a court of equity that a person in a fiduciary position ... is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict."

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115 [1974] A. C. 821.
116 (1726) 25 E. R. 223.
117 Sealy, CLJ (1962) at 69.
118 [1896] A. C., 44, 51.

Likewise, in the leading case *Alexander v. Automatic Telephone Co. Ltd.*[119] the rule was viewed by the Rigby L. J. who took the view that:

> "Directors of companies are fiduciary donees of their powers, and as such are bound to exercise them, so as not to give themselves an advantage over other shareholders. They must act for the benefit of the company in every exercise of their duties. They must not make a secret profit out of their office."[120]

If a director, as fiduciary, enters into a contract which was supposed to be concluded for his company, the court may interfere and set aside the transaction in question, as it was the case in *Aberdeen Rly. Co. Blaike Bros.*,[121] where the court held the contract concerned liable to be set aside and concluded:

> "it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into agreements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect."[122]

As was mentioned that a director as a fiduciary should not put himself in a position through which his own interests conflict with his fiduciary duties to the company. Consequently, he should avoid taking secret profit from a contract to which the company is a party. Where a director makes a secret profit, it must be accounted for the company, whether or not he has acted honestly and in the best interest of the company, and whether or not he has benefited.[123] However, directors may escape liability for making such profits if they obtain a ratification from shareholders in general meeting.[124]

This rule also applies where in the performance of his office, the director uses confidential information or deprives the company of what has been described as a "corporate opportunity" for his own benefit. For example in *Industrial Development*

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119 (1900) 2 Ch. 56.
120 Ibid at 72.
121 [1854] 1 Macq 461.
122 Ibid at 471. See also *Imperial Mercantile Credit Association v. Coleman* [1871] 6 Ch. App. 558.
123 E.g. see *Regal(Hastings) v. Gulliver*, [1942] 1 All E.R. 378, per Lord Russell of Killowen.
124 This point was acknowledged by Lord Denning in *Phipps v. Boardman* [1967] 2 A. C. 46. Here, his Lordship stated that: "The relevant rule for the decision of this case is....that a person in a fiduciary position must not make a profit out of his trust, which is part of the wider rule that a person must not place himself in a position where his duty and his interest may conflict".

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Consultants Ltd. v. Cooley,[125] the defendant who took a contract of project which he was supposed to conclude it for the plaintiff company was held liable for using information that came to him while managing the company.[126]

The effects of the rule as to secret profit will be removed and, therefore, no breach of fiduciary duty is at issue if a director has disclosed his involvement as such and it is approved by the relevant organ of the company. Such a secret profit can, moreover, be ratified by shareholders in a general meeting.[127]

A director may be compelled to disgorge to his company any profit he gained by abusing opportunities arisen from his position as fiduciary. When a fiduciary/ director has turned "trust" property to his own pocket, he is to account as trustee. If he benefits himself from the company's facilities and opportunities, he will be also obliged to account as trustee.[128]

The courts' anxiety is to prevent any breach of loyalty by imposing the most stringent duty of loyalty upon a fiduciary based on the view that a fiduciary must be safeguarded from any unhealthy temptation and deterred from the mere contemplation of profiting from his position.[129]

Duty of directors not to compete with their company is, indeed, another form of non- conflict duty. According to this duty, a situation which may give rise to a conflict between directors' interests and his duties takes place when he is involved in a business competing with that of the company. However, Sealy believes that in the absence of an express provision in the terms of a director's service contract or an implied prohibition in a special case, for example where a business is highly competitive or the market is very restricted, no rule prevents him from being a director or a member of a rival company or from competing with the company for

125 [1972] 1 W. L. R. 443.
126 Ibid at 453.
127 A. J. Boyle "Fiduciary Duties: The continuing Problem of Effective Enforcement", Forum Internationale (1987) N 105. See also *Regal(Hastings) v. Gulliver*, [1942] 1 All E.R. 378.
128 L. S. Sealy, "The Directors as Trustee", CLJ, (1967), 91, 98. [Thereafter CLJ (1967)].
129 Jones, *op cit* at 472.

his own benefit.[130] However, the case of *Hivac Ltd. v. Park Royal Scientific Instruments Ltd.*,[131] challenged the above rule, where it was held that in a master/ servant fiduciary relationship, the latter is precluded from acting for a rival.[132] This is applicable where the director has an employment contract in particular company.

It is generally believed that this opinion does not apply to the directors in the modern company law. A person cannot be restrained from acting as a director of a rival company and, thus, "what he could do for rival company, of course, he could do for himself".[133] However, this flexible opinion is increasingly becoming impossible when a director of two rival companies are always at risk of not dealing with both fairly,[134] particularly it is true when a director of two rival companies likely finds one of his positions more advantageous than other, and takes one's side against the other.

2. 4 Directors Duties in Insolvency

Directors' duties in insolvency is subjected to their duties to the company's creditors. As to the question whether creditors' interests fall within the concept of the company's interests Lord Diplock said in *Lonrho Ltd. v. Shell Petroleum Co. Ltd.*[135] that "the best interests of the company are not necessarily those of the shareholders but may include those of the creditors."[136] But, Dillon J. in *Multinational Gas & Petrochemical Co. v. National Gas & Petrochemical Services Ltd.*,[137] seemed suggesting creditors interests are not included, where his Lordship stated that: "A

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130 Sealy, CLJ (1967) at 97. This rule was clearly pointed out in *London and Mashonaland Exploration Co. v. New Mashonaland Exploration Co.* [1891] W. N. 165, where the court held: "there was nothing in the articles which ... prohibited him from acting as a director of any other company; neither was there any contract, express or implied, to give his personal services to the plaintiff company and not to another company."

131 [1946] Ch. 169.

132 Lord Denning in *S. C. W. S. v. Meyer*, [1959] A. C. 324 was of the same opinion.

133 *London and Mashonaland Exploration Co v. New Mashonaland Exploration Co.* [1891] N. W. 165.

134 Gower's Principles of Modern Company Law, 571.

135 [1980] 1 W. L. R. 627.

136 Ibid at 634.

137 [1983] Ch. 258.

company owes no duty of care to future creditors ... so long as the company is solvent the shareholders are in substance the company." It should be noted that in this case the company was not in insolvency.

Insolvency is an event in which the risks shift from shareholders to creditors. It is, thus, reasonable to expect that all duties owed to the company and its members be confined within duties to its creditors. It is because on the onset of insolvency, the company's shareholders who have nothing to lose but have everything to gain, are motivated to continue trading, which is a perverse incentive created by the well-recognised principle of limited liability.[138] The courts have increasingly recognised that the creditors' interests may be harmed by directors transferring losses to creditors at the onset of insolvency so as to insulate shareholders from loss.[139]

2. 4. 1 Directors' Duties Before Insolvency

Creditors in corporate law are considered as contractual claimants and shareholders as owners of the corporation. Creditors are, thus, treated as not being entitled to anything more than what has been agreed under the particular debt/ sale/ service contract and shareholders as being entitled to unlimited claims on the remaining assets of the corporation.[140]

There seems to be a confusion and uncertainty over the stance of English law as to directors duties to creditors prior to liquidation. The traditional view was that directors duties are owed to the company and they are not trustees for the creditors, and therefore, have no duty to them.[141] The courts' reluctance to recognise directors duties to creditors prior to insolvency is a result of a traditional view, that in earlier cases the judges were not prepared to recognise any obligation to shareholders

[138] D. D. Prentice, "Creditor's Interests and Director's Duties", 10 Oxford J. L. S. (1990) 265.
[139] Ross Grantham, "The Judicial Extension of Directors' Duties to Creditors", JBL (1991) 1.
[140] Razeen Sappideen, "Fiduciary Obligations to Corporate Creditors", JBL (1991) 365, 366.
[141] *Wincham Shipbuilding & Boiler Co.* [1878] 9 Ch. D. 322, *Re Dronfield Silkstone Coal Co.* (1881) 70 Ch.D. 76, J. H. Farrar, The Obligation of a Company's Directors to Its Creditors Before Liquidation" JBL (1985) 413.

separate from the company.[142] Such sense is stated by Dillon J. in *Multinational v. Multinational Services*:[143]

> " A company, as it seems to me, likewise owes no duty of care to future creditors. The directors indeed stand in a fiduciary relationship to the company, as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future, or to individual shareholders."[144]

It should be noted that in that case the company was not insolvent, therefore, this holding can not apply to insolvency cases. The same view was taken by Nourse L. J. in *Brady & Avon. v. Brady & Avor.*,[145] where the company was in financial difficulty, as follows:

> "Admittedly existing creditors are interested in the assets of the company as the only source for the satisfaction of their debts. But in a case where the assets are enormous and the debts minimal it is reasonable to suppose that the interests of the creditors ought not to count for very much."[146]

However, there is now a clear tendency in English law to include a company's creditors within the group of interests.[147] In England,[148] following New Zealand[149] and Australia,[150] recent cases have indicated that such a duty is owed by directors to creditors even before company is insolvent, and even perhaps owed to them directly.[151] In *West Mercia Safetywear v. Dodd*[152] it was, as claimed,[153] intended that directors owed a duty to creditors before winding up.

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142 *Percival v. Wright* [1902] 2 Ch. 421.
143 [1983] Ch. 258.
144 Ibid at 288.
145 [1987] 3 BCC 535 , *reversed* [1988] 2 W. L. R. 1308.
146 Ibid at 552. Likewise, in *re Horsley & Weight Ltd.* [1982] 3 All E. R. 1045, 1055, Buckley L. J. was of the view that:
"It is a misapprehension to suppose that the directors of a company owe a duty to the company's creditors to keep the contributed capital of the company intact ... It may be somewhat loosely said that the directors owe an indirect duty to the creditors not to permit an unlawful reduction of capital to occur but I would regard it as more accurate to say that the directors owe a duty to the company in this respect ... .
147 Edward Jacobs, "Duties to Creditors", 7 Litigation (1987- 8) 310, 311.
148 *Lonrho Ltd v. Shell Petroleum Co. Ltd.*, [1980] 1 W. L. R. 627, *re Horsley & Weight Ltd*, [1982] 3 All E. R. 1045.
149 *Nicholson v. Permarkraft Ltd.* (1985) 1 NZLR 242, *David Neil & Co. Ltd. v. Neil* (1986) 3 N.Z.C.L.C. 99, 658.
150 *Kinsela & Another v, Russell Kinsela Pty. Ltd.*, (1986) 4 N. S. W. L. R. 722, *Jeffree v. N. C. S. C.* (1989) 15 A. C. L. R., 217.
151 David A. Wishart, "Models and Theories of Directors' Duties to Creditors", 14 N. Z. L. U. L. Rev. (1991) 323, 325.

Although in other common law jurisdictions the tendency requiring a duty to consider creditors interests is clearer, this attitude seems also imported into English law.[154] For example, the statement of Street J. in the Australian case of *Kinsela & Another v, Russell Kinsela Pty. Ltd.*,[155] which was confirmed by Dillon J. in *West Mercia*, may represent the English and Australian laws' stand. These jurisdictions are said to have gone further to recognise creditors interests as requiring protection at a stage much earlier than the onset of insolvency.[156]

With regard to the above opinions, it can be said that directors may have a duty to consider the interests of creditors. They may, thus, to be held liable for breach of duty if they, in running the company as a going concern, exclusively consider the interests of its shareholders even on the basis of general meetings guidelines.

This view is more justified if the plaintiff creditors can show that there have been some indications of financial depression which had been intentionally or unintentionally slipped by the defendant directors.

2. 4. 2 Directors' Duties to Creditors in Insolvency

Once a company becomes insolvent or even doubtfully solvent, the position of directors shifts from shareholders to creditors, and the primary interested persons are its creditors,[157] as was well stated in *Brady & Avon. v. Brady & Avor*:[158]

> "where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of existing creditors alone."[159]

The leading case of *West Mercia Safetywear v. Dodd*,[160] is a good example for this purpose, where the plaintiff, a subsidiary company owed £30, 000 to its parent

152 [1988] BCLC, 250.
153 Vanessa Finch, "Directors Duties Towards Creditors", 10 Co. Law. (1989) 23.
154 Denis Petkovic, "Directors' Duties and the Intrusion of Creditors' Interests", 4 JIBL (1989) 166, 167.
155 (1986) 4 N. S. W. L. R. 722.
156 Sappideen, *op cit* 365.
157 *Re Horsley, Ayerst v. C. & K. (Construction) Ltd.* [1976] A. C. 167, *re Instrumentation Electrical Services Ltd.* [1988] BCLC 550, *re Corbenstoke Ltd. (no. 2)* [1989] 5 BCC 767.
158 [1987] 3 BCC, 532 *reversed* [1988] 2 W. L. R., 1308.
159 Ibid at 552.
160 [1988] BCLC 250.

company. Dodd who was director of the two companies, both clearly insolvent, had guaranteed with a bank the debts of the parent company. As a result of the director's persuasion, the subsidiary company paid £4, 000 into the parent bank account as a part of repayment of its debts to the parent company. Dillon L. J. agreed with the liquidator's claim that the respondent breached his fiduciary duty towards his plaintiff subsidiary company because, in his Lordship view, while the company is insolvent the company is for all purposes "the creditors", the fact which was ignored by the defendant director, instead he attempted to guarantee his own position by requiring the parent company's debts. In this case, the learned judge referring to the well-known Australian case *Kinsela & Another v, Russell Kinsela Pty. Ltd.*,[161] as his own opinion, adopted that judgment as a voice of English law, where Street J. said:

> "In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where the company is insolvent the interests of the creditors intrude. ... It is in a practical sense their assets they are not the shareholders' assets that through the medium of the company, are under the management of the directors."[162]

In *Welfab Engineers Ltd.*,[163] the company which operated profitably until 1979 began a slow financial deterioration. The board reached the conclusion that if the company was to continue trading, its principal asset, a freehold property, would have to be sold. Among various offers, the directors accepted the lower, Thermaspan's offer, which undertook the whole company with a requirement to employ all of the company's employees including its directors. Hoffmann J. rejected the liquidator's claim that by turning down the higher price offer, Bell & Webster's offer, the directors breached their fiduciary duty to the company's creditors because, in his Lordship's viewpoint, the higher offer was uncertain, whereas by the Thermaspan's offer, the Welfab's liability for redundancy reduced the value of the higher offer.

161 (1986) 4 N. S. W. L. R. 722.
162 Ibid at 730.
163 [1990] BCC 600.

Hoffmann J., moreover, considered the fact that accepting the Bell & Webster's offer would have prevented Welfab's business from continuing.[164] The learned judge was of the opinion that if directors had not taken the concerned decision, the best alternatives were liquidation or receivership, while the decision was, in his opinion, in accordance with the recent developments in insolvency which intend to save business rather to destroy it. However, his Lordship taking the view that the directors were not "entitled to sell the company to save their jobs and those of other employees on terms which would clearly leave creditors in a worse position than a liquidation", went on to say that he did not think that an honest attempt to save business should have been judged by a strict standard, particularly with regard to the widespread unemployment and industrial devastation in the Midlands at the time. The defendant directors were, thus, not held liable for the alleged breach of duty.

This decision which raised the question as to what precisely is the concept of directors' duties to the company's creditors,[165] can be looked at from two different perspectives. According to the first view, although the well- established rule is that in insolvency all directors should benefit the company's creditors, here the court recognised a very wide discretion for directors to take the society's interests such as "unemployment" and "industrial devastation" into their account. This view accords with today's developing law and new modern business relationship. Second approach which was referred to by Hoffmann J. is a strict application of directors duties to creditors in insolvency based on which the first priority in taking a decision in such circumstances is creditors' interests alone. This view under which directors are not entitled to sell the company to save their own jobs or those of other employees is a strict application of interests of the company and its creditors.

The decision of Lord Templeman in *Winkworth v. Edward Baron Development Co. Ltd.*,[166] that seemed to be a plain attempt to clarify directors' duties to creditors,

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164 Ibid at 602.
165 Ross Grantham, "The Directors' Duties and Insolvent Companies", 54 MLR (1991) 576, 578.
166 [1986] 1W. L. R. 1512.

raised some questions and criticisms, specially for the wide language employed in that case,[167] where he said:

> "... a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confined to its creditors. A duty is owed by the directors to the company and to the creditors of the company to ensure that ... its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors."[168]

Lord Templeman, in dismissing the plaintiff's claim (the wife) that she was entitled to an equitable interest of the property concerned, reasoned, *inter alia,* that the claimant's failure to carry out her duties as a director to ensure hat the affairs of the company were properly conducted, gave rise to the prejudice of the creditors' interests, and prevented her from claiming an equitable proprietary interest in priority to the claims of creditors.[169] Sealy with regard to this decision rightly believes that if such a statement had prevailed over the past century and half, the principle of limited liability of company would never have begun.[170]

Lord Templeman, here, seems indicating that directors owe a duty to the company's creditors separate from the company itself, a duty which is directly owed to them. Moreover, the language employed in this judgment is so wide[171] that one may wonder it extends to cover creditors even during trading life of the company.

2. 5 Conclusion

In conclusion, so long as a company is solvent, in the absence of fraud or disloyalty, ratification or authorisation of a director's act in a general meeting may remove any

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167 John H. Farrar, "The Responsibility of Directors Shareholders for a Company's Debts" 4 Can. L. Rev. (1989) 13, 15

168 Ibid at 1516.

169 Ibid at 1517.

170 L. S. Sealy, "Directors' Duties- An Unnecessary Gloss", CLJ (1988) 175, 176.

171 C. A. Riley, "Directors' Duties and the Interests of Creditors", 10 Co. Law. (1989) 87, 91.

doubt about the validity of that act. However, once the corporation faces insolvency, the creditors' interests become relevant, and at this stage the shareholders and directors are no longer entitled to deal with the company's assets freely.[172]

It appears that some uncertainties undermine the effectiveness of the rules governing corporate directors duties, and as it has rightly stated by Farrar, the common law in this area "has failed to keep pace with modern developments and presents a lamentable out of date view of directors' duties."[173] The main ambiguity is the proper standard applicable to the duties. The standard introduced by the 1986 Act, particularly section 214, is not enough helpful to resolve the problem, since it is workable only in the course of liquidation.

The position of directors towards creditors prior to insolvency is another question. The traditional rule which does not require a director to consider the interests of creditors in normal life of the company as a going concern, now seems to have been challenged. The stand taken in such cases as *Welfab Engineers Ltd.*,[174] and *Winkworth v. Edward Baron Development Co. Ltd.*,[175] is a turning point in this respect. Although the new tendency represented by these two cases, particularly with their own facts, is not strong enough to shake the old rule, the matter is of such importance to concern the judges and commentators.

English law in the area of corporate directors duties requires a reconstruction as well as a clarification, the point which has already attracted the attention of the legal community. The change of the structure of corporate governance is at the top of various recommendations and proposals suggested by the EC and the Cadbury Committee. The Fifth Draft of Directive of the EC recommends some forms of control such as shareholders representation, either creditors or employees representation,[176] none of which can be regarded as the solution to the problem.

172 Neil Hawke, "Creditors' Interests in Solvent and Insolvent Companies", JBL (1989), 54, 56.
173 Farrar's Company Law, at 396.
174 [1990] BCC 600.
175 [1986] 1 W. L. R. 1512.
176 J. Welch, " The Fifth Draft Directive- A False Dawn?" EUR. L. R. (1983) 101.

Central to the Cadbury Code[177] is a code of best practice which is intended to achieve the necessary high standard of corporate behaviour.[178] The code also contains some recommendations as to the structure of the directorship board. The code which is a proposed best practice for listed companies, has been described as unenforceable, because it is unlikely that the companies which are unwilling to comply with the recommendations, will voluntarily join the code.[179]

Perhaps if such proposals as Cadbury Committee be extended to cover other aspects of corporate governance and its enforceability be guaranteed by the legislature, it can be used as guideline by the courts to avoid differing decisions on corporate directors duties.

177 In 1992 May the Cadbury Committee published its final draft on the Financial Aspects of Corporate Governance. The code contains four headings; Board of Directors, Non- Executive Directors, Executive Directors, and Controls of Reporting. Apart from the narrowness of the code which deals only with financial aspect of corporate governance, the Committee's reliance on self-regulation is highly optimistic. See V. Finch, "Board Performance and Cadbury on Corporate Governance", JBL (1992) 581, 594, V. Finch, "Corporate Governance and Cadbury: Self-regulation and Alternatives", JBL (1994) 51.

178 Blenyth Jenkins, "Cadbury's Crunch", 89 LSG (1992 Dec. 9) 11.

179 Charlotte Villiers, "Draft Report by the Cadbury Committee on the Financial Aspects of Corporate Governance", 13 Co. Law. (1992) 214.

Chapter 3: Fraudulent- Wrongful Trading and Misfeasance

3. 1 Introduction

One of the main problems of dealing or contracting with a failed or troubled party is the risk of a limit on availability of resources for the payment or recovery of damages. This risk is increased in the case of a limited company when there is a legal limit resulting from the shareholders' limited liability.[1]

As an experience elicited from a very long line of decisions- making process, there is a general consensus among lawyers, bankers, and other groups, directly or indirectly, involved in the corporate activities, that the privilege of limited liability enjoyed by the members of a company has been abused by dishonest, incompetent and even unreasonable businessman. One of the primary aims of company law is to protect creditors against this abusive use of the privilege of limited liability by corporate directors and managers.

Since 1920's- 1930's in the line with the necessity of supporting business through *Salomon* principle,[2] that company as a legal person with separate identity and its own duties, liabilities, rights and assets, is responsible for its own debts, there have been concerns over the question of how to avoid the ruinous consequences of abusive use of such privilege at the expense of the company's creditors. These concerns constituted a heavy pressure from various bodies interested in this field, particularly the courts and lawyers, demanding an essential review as to liability of those who conduct the business wrongly, by looking behind the corporate identity so

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[1] Leo Flynn, Statutory Liability for culpable Mismanagement (ed. H. Rajak) Insolvency Law & Practice, (Sweet & Maxwell 1993) 135.

[2] *Salomon v. Salomon & Co. Ltd.* [1887] AC 22

that its owners or officers be held liable for running its business improperly not merely dishonestly. Those efforts impressed the legislature, in particular with regard to the position of unsecured creditors as the most vulnerable sector affected by the insolvency, when secured creditors, specially financiers, have the ability to control or monitor the financial activities of the company.

To assure creditors in their dealing with a company, to safeguard the proper use of limited liability, and prevent the corporate directors and officers of abusing or misusing this privilege, the legislators on the basis of common law rules, introduced various legal measures.

Misfeasance, which now includes negligence is the oldest common law remedy for this problem. It was also the earliest matter which was the subject of legislation.

In this chapter the three leading concepts of directors liability, namely fraudulent trading, wrongful trading and misfeasance are studied.

Fraudulent trading will be examined first, both as a criminal offence and as a civil action, then the issue of the beneficiary of the proceedings, and other matters considered in judicial decisions.

In the second section, wrongful trading will be reviewed, including philosophy and the development of wrongful trading through statutory and case law, particularly the duties of directors in approaching insolvency with the view to minimising the loss to the company.

Finally, it is intended to review the different aspects of directors' breach of duty of care and loyalty under misfeasance including negligence.

3. 2 Fraudulent Trading

Fraudulent trading is both criminal and civil liability whose successful prosecution may lead to the perpetrator being fined or imprisoned, and whose aim is to protect persons, properties and community from dishonest use of corporate form. Thus, fraudulent trading provisions are important as a mechanism for protecting business relationships, as has been shown by the large number of determined cases.

The offence of fraudulent trading may in some aspects seem a vague concept, specially its very tough standard of proof has caused the courts to be reluctant in making a liability order of fraudulent trading. However, the chief importance of the section is not in relation to the breadth but to the muscle of the law.[3]

3. 2. 1 Elements For Fraudulent Trading

Although it is true that the word 'fraud' has different meaning in different contexts, there is no doubt that the essentials of the concept in all situations are the same.

A fraudulent trading offence, like other crimes, requires three basic components; mental element, actual element, and statutory element.

3. 2. 1. 1 mens rea- mental element

The mental element, as the main component part of fraudulent trading involves dishonesty, or a deliberate intention which itself is described as an 'intent to defraud'. In determining whether the offence of fraudulent trading has occurred, an ingredient of dishonesty is essential, and no judge is entitled to convict a defendant of offence of fraudulent trading unless such a dishonesty is proved. Such a view can be seen in the unreported case of *R. v. Poster Plywood Co. Ltd.*,[4] where the Common Sergeant stated:

> "What must be proved is that this man took a deliberate part in the calculated carrying on of the business at the expense of the creditors of that business knowingly perfectly well that was no prospect of the creditors being paid.... All you have got [in this case] is the fact that [this company] continued to trade when....it would have been better if it had not. Well, this is nothing like enough to charge a director or a person concerned in the management of it with fraudulent trading."

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[3] Glanville Williams, Textbook of Criminal Law (London; Stevens & Sons 2ed ed. 1983) 900.
[4] Cited by Michael Levi Phantom of Capitalists (London; Heinemann 1981) 148.

It is true, as said Conti, that in the absence of a "specific liability statute irrespective of intent, criminal liability will not as a general rule be imputed without dishonesty in the part of the directors."[5]

It has been suggested that from view of complications of proving the existence of the mental element, and the fact that the relevant conduct is adequately covered by other areas of criminal law, the most appropriate course is to abolish the offence, or failing that, never to charge it. Arguments such as these have led some commentators to suggest the abolition of the proceedings.[6]

An interesting description of the words 'defraud' and 'fraudulent purpose' has been put forward as "those words connote actual dishonesty involving, according to current notions of fair trading among commercial men, real moral blame."[7] In *re Gerald Cooper Chemicals Ltd.*[8] the word "intent" was used in the sense that a man must be taken to intend the natural or foreseen consequences of his act.

In the civil case of *re Williams C. Leitch Brothers Ltd.*[9] Maugham J. described "the carrying on of the business of the company" as a sufficient course of conduct for this purpose:

> " .... if a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment of those debts, it is in general, a proper interference that the company is carrying on the business with intent to defraud...."[10]

But the difficulty of proving whether the director believed that there was a reasonable prospect of paying the debts, which is to be assessed by a subjective standard, still exists. The defendant directors may advance any justification based on

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[5] Richard Conti, "Criminal Liability of Directors under Company Law", The Australian Director (1986) 37, 38.

[6] Peter Allderidge "The Mental Element of the Crime of fraudulent Trading" JBL (1984), 505, 509.

[7] *re Patrick and Lyon Ltd.* [1933] 1 Ch. 786, 790, See also *Cunliffe v. Goodman* [1950] 2 K. B.237 at 253, *re a Company No. 001418 of 1988*, [1990] BCC 526, *Welham v. Director of Public Prosecutions* [1961] A. C. 103 at 123 per words of Lord Radcliffe.

[8] [1978] 2 All E. R. 49.

[9] [1932] 2 Ch 71, 77.

[10] Ibid at 77.

that they honestly believed for example that there would be prosperity after depression.

In the criminal case of *R. v. Grantham,*[11] the mental element of fraudulent trading was defined as:

> "a man intends to defraud a creditor, either if he intends that the creditor shall never be paid or alternatively if he intends to obtain a credit or carry on obtaining credit when the rights and interests of the creditor are being prejudiced in a way which the defendant himself has generally regarded as dishonest."

The Cork Committee in its recommendations suggested that a fraudulent trading should be defined as "an offence to carry on the business dishonestly; and right that in the absence of dishonesty, no offence should be committed."[12]

The House of Lords has suggested the view that "intent to defraud" should have a standard meaning, which includes dishonesty.[13]

The crime could be committed even by deceiving creditors into making payment for goods which had never been ordered by them[14].

Although there has been no clear statement as to whether the words of 'dishonesty' and 'intent to defraud' are precisely the same in meaning, it seems both those expressions are the result of a calculated action emerging from a deliberate intention and naturally involve *mala fide*. Some commentators have felt that 'dishonesty' is distinguishable from 'fraud', but not as its element and that the word "dishonesty" is chosen because it was something which layman could easily recognise when they see it, whereas the word "fraud" may involve technicalities which have to be explained by a lawyer.[15] According to this view, if one tries to pin down "dishonesty" in English case law, he will soon realise that he is aiming at a constantly moving target.[16]

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11 [1984] 2 WLR 815.
12 Report of the Review Committee on Insolvency and Practice Cmnd 8558, par. 1777, 1982.
13 *Scott v. Metropolitan Police Commissioner* [1975] A. C., 819, 838.
14 *R. v. Kemp* [1988] 4 BCC 203.
15 D. W. Elliott, "Dishonesty in Theft: A Dispensable Concept", CLR, (1982) 396.
16 Ibid at 395.

The meaning of dishonesty should, indeed, be defined as something relevant to the state of mind but not a course of conduct, which could not be established independent of the knowledge and belief of the respondent. To determine whether a person has acted dishonestly, first his conduct should be measured by the ordinary standards of reasonable and honest people and, if so, the fact should be taken into account that whether the defendant himself was aware that his conduct was, according to those standards, dishonest.[17]

As to the question how to determine a dishonesty, some guidelines have been suggested in the criminal case *R v. Landy & Others*[18] as follows:

> "The dishonesty to be proved was dishonesty in regard to the defendant actual beliefs and intentions in the particular circumstances. Accordingly, in directing the jury the judge was required to stress the ingredient of dishonesty and should have directed the jury that what mattered was the state of mind of the defendants themselves and not what reasonable men in their circumstances would have believed or intended[19]....The dishonesty to be proved must be in the minds and intentions of the defendants. It is to their states of mind that the jury must direct their attention."[20]

A consideration of the judgments and decisions which so far been have made, particularly the above- mentioned cases, reveals how far the views taken by the courts to determine the matter differ. It can be said that the standard of proof required for fraudulent trading is an subjective one, which should be proved by positive steps. In one case such standard of proof is 'notions of fair trading among commercial men which requires real blame' but not merely the existence of knowledge,[21] whereas in another case the state of mind of defendant, but not belief of reasonable people is sufficient.[22]

[17] *R. v. Ghosh* (1982) 2 All ER 689.
[18] [1981] 1 All E. R., 1172.
[19] Ibid at 1173.
[20] Ibid at 1181.
[21] *re Patrick and Lyon Ltd.* [1933] 1 Ch. 786, 790, See also In *Cunliffe v. Goodman* [1950] 2 K. B.237, 253.
[22] *R v. Landy & Others* [1981] 1 All E. R., 1172.

As it was suggested in the case of *Re White and Osmond Parkstone Ltd.*[23] the criterion to determine real intention of the company's directors should be that what was their view at the relevant time. For this purpose all circumstances such as financial position, the accounting and filing system of its documents, the knowledge of the directors of business accounts and the like should be taken into account.

3. 2. 1. 2 actus reus- actual element

By actual element it is meant that the respondent in question has done something which can be described as an external demonstration of what he had in mind. In the case of fraudulent trading, carrying on the business of the company in fraudulent manner suffices to establish a presumption of fraudulent trading offence.

The expression of *actus reus* has been chosen as an equivalent meaning of criminal act or actual element of an offence. Therefore, this element has been described as a 'conduct' required to be proved.[24]

In order to be a party to fraudulent trading, a person must do something positive, mere intention or inadequate action will, thus, be insufficient. In *Re Maidstone Building Provisions Ltd.*[25] it was alleged that the applicant, who had been secretary and financial adviser to the company which subsequently became insolvent, had not adequately performed his duties of advising the directors on financial matters and that, consequently, he should bear personal responsibility for the company's debts. Although that case was in relation to civil liability under section 332, the same reasoning would apply to the criminal offence. In this case, Pennycuick VC held, however, that even if these allegations could be proved, no liability could fall on the applicant under section 332 since:

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23 Unreported case [1960] June 30, cited by John Farrar, "Fraudulent Trading and Creditors Duties" JBL (1976) 221, 222

24 Williams "Textbook of Criminal Law" at 146.

25 [1971] 1 WLR 1085.

> "... someone is not party to carrying on a business if he takes no positive steps at all, so in order to bring a person within the section must show that he is taking some positive steps in carrying on the company's business in a fraudulent manner".

The meaning of expressions "carried on" and "carried out" of the company's business were contrasted by Templeman J. *re General Cooper Chemicals*[26] where he stated:

> "[Section 332] is aimed at the carrying on of a business....and not at the execution of individual transactions in the course of carrying on of the business. I do not think that the words "carried on" can be treated as synonymous with "carried out"...."

In *re Sarflax Ltd.*[27] it was held that "the collection of assets acquired in the course of business and the distribution of the proceed~~s~~ of theses assets in discharge of business liabilities," could be considered as a carrying on of the business.

The question may arise, if a director carried on the business of the company with intent to defraud creditors, namely with obvious and real dishonesty, for a while without incurring further debts and liability, would he still be liable?

Here, two approaches may be distinguished. According to the first, as a rule of criminal law or at least in some offences, an act is not always necessary to constitute a crime. For example, where there is a duty to be fulfilled, the mere omission or failure of doing so is sufficient. To support the argument, the point should be referred to the manner of enactment of sections 458[28] and 630 of the Companies Act 1985 which were presented in separate provisions and under different headings. By such an enactment it was, under section 458, meant to impose criminal punishment but not civil liability, when a crime has been committed but no loss has been incurred.

The second approach relies on the nature of the crime of fraudulent trading itself. On the basis of this view, the criminal action in fraudulent trading is 'carrying on business of the company' which is a positive step with obvious external effects. There

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26 [1978] 2 All ER 49, 53.

27 [1979] Ch. 592.

28 Section reads: "If any business of a company is carried on with intent to defraud creditors of the company or creditors of any other person, or for any other fraudulent purpose, every person who was knowingly a party to the carrying on of the business in that manner is liable to imprisonment or a fine or both.

This applies whether or not the company has been, or is in the course of being, wound up."

is no question of failure or omission in the case of fraudulent trading, when no duty to do something is required. In other words, the duty relating to fraudulent trading is a negative act which is not to carry on the business. More importantly, having a review of the decisions made on the matter shows the reluctance of the courts to make an order of liability for fraudulent trading, unless they are fully satisfied that both actual and mental elements are proved.

Furthermore, it is not often possible to carry on a troubled business without causing more liabilities, while it means more expenses for employees' salary, rent and maintenance expense and other current expenses.

Both those views face some difficulties. The former does not seem consistent with the legislators' intention, when a positive action as 'carrying on business' is required, when in the latter, one may argue that deciding to cease trading is a positive action, but not a negative duty.

3. 2. 1. 3 Statutory element and its development including civil remedy

The introduction of the criminal offence of fraudulent trading was, for the first time, recommended by the Greene committee on Company Law Amendment as follows:

> "Our attention has been directed particularly to the case (met with principally in private Companies) where the person in control of the company holds a 'floating charge and, while knowing that the company is on the verge of liquidation, "fills up" his security by means of goods obtained on credit and then appoints, a receiver ... We consider that not only should the person whom the Court finds to have been guilty of fraudulent trading, etc., be subjected to unlimited personal liability, but any security over assets of the company held by him or on his behalf, and assigned to anyone save a *bona fide* holder for value, should be charged with the liability. Further, trading of this character should be made a criminal offence".[29]

The committee intended to deal with a particular aspect of the crime of fraudulent trading which was holding floating charges by a debenture holder in order to secure his own interests over creditors. But what appeared in the section of fraudulent

[29] Greene Committee Report on Company Law Amendment, Cmnd. 2657, at p. 28 (1926).

trading in the Companies Act 1928 was a concept with a wider scope so as to enable the courts to consider any act with intent to defraud creditors in winding up.

As a result of Greene Committee's recommendations, fraudulent trading as a legal sanction both with criminal and civil liabilities for the first time appeared in the Companies Act 1928, section 75. These provisions were repeated in section 275 of the Companies Act 1929.

Section 332 of the Companies Act 1948, which repealed section 275, played a significant role up to the enactment of the Companies Act 1985 and the Insolvency Act 1986. The only changes appeared in the new Act, were the addition of a year to the period of imprisonment and giving the court a discretion to consider either the imposition of a fine or imprisonment or both.

Although a limited number of cases for fraudulent trading were brought before courts during 1928's- 1948's, it is not clear why the legislators felt the penal sanction set out in the Act 1929 were not satisfactory. Such an increase in the criminal penalty was a result of Cohen Committee's recommendations in 1945. Moreover, the committee recommended the extension of the section 'to other persons who were knowingly parties to the frauds'. These recommendations appeared in the Companies Act 1947 which subsequently repealed by the Companies Act 1948.

It was suggested by Jenkins Committee in 1962[30] that the provisions to be extended so as to include directors who had acted recklessly or incompetently in relation to the company's affairs. Furthermore, the Committee recommended a power to be granted to the courts on the basis of which they could order the public examination of all directors or other officers of an insolvent company, where there was a prima facie case of culpability or of such impropriety, reckless or incompetence which could lead to disqualification.[31] These proposals were not, however, implemented in the Companies Act 1981.

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30 The Report of the Company Law Committee, Cmnd. 1749, para. 497 (1962).
31 Ibid at Para. 503.

The fraudulent trading provisions of the Companies Act 1981 was a repetition of its predecessor. However, a small change appeared in the Act on the basis of which the liability could apply to the subjects irrespective of whether the company was in the course of winding up.

The Cork Committee's recommendations in 1982 were a great achievement in the history of company law, particularly in relation to company directors' duties and liabilities. The committee intended to draw a strong line between fraudulent trading and the newly introduced concept 'wrongful trading. The committee was of the view that the civil liability should have been transmitted to the new section as wrongful trading and what was left of the section 332 of the Companies Act 1948 to be reintroduced as fraudulent trading.[32] However, what appeared in the Companies Act as a result of those recommendations were significantly different from the proposals.

In the new legislation, besides civil liability introduced as wrongful trading in a separate section, fraudulent trading again constituted both civil and criminal liability. It was to happen when in the Cork Committee's view the fraudulent trading provisions were intended to include only criminal punishment, since 'the phrase " fraudulent trading" should in future be reserved for trading which is of such a nature that it constitutes an offence under what is left of section 332'.[33]

The enactment of 1985 was a startling evolution on the matter. Under the Act, not only fraudulent trading was, with minor amendments, left untouched,[34] but also a civil liability termed as 'wrongful trading' with its own effects and grounds was introduced.[35]

There were some ambiguity as to sections 458 and 630 of the Companies Act 1985 which could give rise to confusion. Section 458 of the Act was concerned with criminal liability for fraudulent trading, whereas section 630 dealt with civil liability. The question may arise whether enactment was intended to apply those sections in

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32 Ibid at Para. 1779.

33 Ibid at Paras. 1779 and 1781.

34 Sections 458 and 630 of the Companies Act 1985.

35 Schedule 6 of the Insolvency Act 1985, and Insolvency Act 1986.

different situations depending on whether or not the company was in course of winding up. In other words, the first section imposing penal liability was applicable in the event of fraudulent trading irrespective of whether the company is being wound up, whereas the latter only dealt with civil liability in winding up.

To support the view, it can be said; (i) Those sections, unlike their predecessor, were presented in two different chapters and under different headings. This could mean that the purpose of each section was different; (ii) The main requirements including 'carrying on the business of the company' and ' intent to defraud creditors.... or for any fraudulent purpose' in both sections were precisely the same. This is contrary to the rule to the effect that the legislators is then supposed to avoid of any unnecessary and fruitless repetition; (iii) Section 630 dealt with the matter in the event of winding up, whereas section 458 is concerned with the liability in all occasions.

With respect to the legislators, it seems those two sections should be read together in all cases where a fraudulent trading offence takes place, and to be enacted in a single section providing both civil and criminal liability.

The enactments of 1986 is usually considered as a significant statutory evolution on the subject. Section 213[36] of the Insolvency Act repealed section 630 of the Companies Act 1985 and schedule 6 of the Insolvency Act 1985 and now contains the applicable provisions of fraudulent trading. It deals with civil liability of fraudulent trading, while section 458 of the Companies Act 1985 deals with the criminal aspect of fraudulent trading.

The main characteristic of this section is that it empowers the court to declare a defendant, "liable to make such contribution (if any) to the company's assets as the court thinks proper," while in the old Act, the court could make such declaration

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[36] The section reads (1) [Application] If in the course of winding up of the company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, The following has effect.
(2) [Court may hold person liable] The court on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks fit".

with no "limitation of liability for all or any of the debts or liabilities of the company."[37]

3. 2. 2 Who Is a Creditor?

Under this heading the question is, who is a creditor? More specially, who is to take benefit from a fraudulent trading proceedings?

The meaning of word "creditor" has attracted a great deal of attention of the courts. There has been a consensus among judges that the expression "creditors" should include present as well as prospective or potential creditors, the expression which is used to describe customers. In the criminal case *R. v. Seillon*[38] it was held that the expression 'creditor' includes 'contingent creditors'. Here, the jury was directed that "creditor" should be interpreted to include "persons whom defendant feared would pursue him with legal claim in court".

In another criminal case, *R. v. Kemp*,[39] Henry J. suggested that word "creditors" must include 'potential creditors. Relying on the *re Seillon* case he went on to say that 'on any construction one could exclude potential creditors by ignoring the additional words to be found in the statute, which is impermissible. If the words added anything to the section, they must apply to potential creditors as being the nearest thing to creditors and, therefore, they must apply to customers'.

It should be noted that the word "creditor" may have different meaning in different contexts. In company law the word should simply mean any person to whom the company owes some money. For example, unpaid suppliers of goods can be viewed in this category. Such a sense can be implied from *R v. Kemp*,[40] where it was held that fraudulent trading could be committed simply by deceiving customers into paying for goods that had not been ordered by them.

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37 Harry Rajak, "Company Directors- The End of an Era?- 1", 139 NLJ (1989) 1374, 1375.
38 [1982] Crim. L. Rev. 676.
39 [1988] 4 BCC 203, 209.
40 [1988] 4 BCC 203.

Now, the question is, how the courts indicate that the sums recovered should be distributed among the beneficiaries. The courts used, before the legislation 1986 came into force, to have a wide discretion to order distribution of the recovered moneys from the respondent among creditors. In *William C. Leitch Brothers Limited*[41] Maugham J. did not think that it was open to him to decide whether the recovered amount of money (if any) must be distributed by the liquidator among the creditors, who have been defrauded; or whether it should have gone into the general assets in the liquidation; but he believed that he had to fix an amount for which, under the declaration, the respondent was responsible. The learned judge seemed of the view that it was the court's discretion to distribute the sum to one or some particular creditors. In *re Cyona Distributions,*[42] it was expressed by two of the judges that whereas the moneys recovered will normally accrue for the benefit of creditors, generally this was not so where an individual creditor takes the action. The third judge disagreed.

However, in *Re William C. Leitch Brothers Limited (NO. 2)*[43] the court ordered the proceeds of the fraudulent trading action go to the general assets available for distributing among all creditors but not to be paid to the applicant creditors.

Under section 213, the court may declare the wrongdoer " liable to make such contributions (if any) to the company's assets as the court thinks proper". It is, rightly, suggested that such statement makes it clear that any sum recovered must go to the general funds for the benefit of the whole body of creditors, whereas under the previous provisions the court was empowered to order the particular recovered money go to the account of a particular creditors.[44]

However, the courts seem still to recognise some discretion to order a distribution to a particular party as they think fit. In *Re L Todd (Swanscombe) Ltd*[45] where the

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41 [1932] 2 Ch 71, 77.
42 [1967] Ch 889.
43[1933] Ch 261.
44 L. S. Sealy & D. Milman, Annotated Guide to the 1986 Insolvency Legislation (London. CCH Editions Limited, 2ed ed 1988), 228.
45 [1990] BCLC 454.

fraudulent act was selling scrap metal for cash without making a separate charge for VAT, Harman J. took the view that the defendant defrauded the VAT authorities and real blame would be attached to him, and he was, thus, liable to the Crown.

3. 2. 3 Miscellaneous Matters in Case Law Development

Despite rapid case law development in many areas of law, the evolution of fraudulent trading through judicial decisions has been slow. Nevertheless, this fact does not affect the importance of its part as a legal device within company law development as a whole.

In the civil case of *re William C. Leitch Brothers Ltd.*,[46] which was the first case on fraudulent trading, Maugham J. thought that the lack of reasonable prospect of being able to pay debts to the directors' knowledge was sufficient to establish a case of fraudulent trading, whereas he took a different view in re *Patrick & Lyon Ltd.*[47] In the former case an "actual dishonesty" or "real blame" was not required to satisfy the allegation. In other words, the learned judge applied a considerably wide concept of fraudulent trading by which a defendant could easily be caught by the provisions. But in the latter case, he dismissed the summons when in his opinion the strict standard of proof which was "actual dishonesty" was not available. Here, he narrowed down the concept from the description he made in the case of *re William C. Leitch.*

Such an attitude by the same judge within only one year and in two cases with similar facts seems odd. To justify the complexity stemming from such treatment, it has been suggested that those two decisions can be reconciled by arguing that the statement in *re Patrick & Lyon* reflects the true substantive legal position while the earlier only gives practical guidance on the evidence required[48]. Such a reasoning not only does not respectfully clarify the ambiguity arising out of the court's conduct in

[46] [1932] 2 Ch 71.

[47] [1933] Ch 786, 790.

[48] John Farrar, "Fraudulent Trading" JBL, [1980], 431.

its decision- making, but also highlights the need for a more clarification of the reasoning itself.

In the unreported case of *Re White & Osmond Parkstone Ltd.*[49] Buckley J. acknowledging the interpretation of Maugham J. in *Leitch,* pointed out that there was nothing wrong with carrying on the business of the company by directors, when to their knowledge, it was not able to meet all its liabilities as they fell due, but it would be wrong if they allowed the company to incur credit by carrying on the business when it was clear to them that the company would *never* be able to satisfy its creditors. However, in his lordship's view it was not a blame if directors carried on the business with belief that the situation will be improved, and "the clouds will roll away and the sunshine of prosperity will shine upon them again."

It has been suggested that on the basis of this judgment, trading with the lack of liquidity and even in a situation of actual insolvency is not sufficient to satisfy the requirement of fraudulent trading.[50]

In comparison with those two cases, *re William C. Leitch Brothers* and re *Patrick & Lyon Ltd., re White & Osmond* is a moderate judgment. However, in this case, the court's decision is rather in the line with the judgement of *re Patrick & Lyon,* requiring a full and strict satisfactory proof is an obvious feature of both judgments. As a result, continuing to trade with the belief that such crucial situation will be improved, is not sufficient to establish a presumption of the charge even when the company is faced with depression.

In *re L Todd (Swanscombe) Ltd.*[51] the liquidator of the company which went into voluntary winding up sought a declaration under section 630 of the Companies Act 1985 that M, a director of the company, had knowingly been a party to the carrying on of the company's business with intent to defraud its creditors and was liable for debts of the company of some £70,000. The defendant admitted that he had been

49 (1960) 30 June.
50 John Farrar "The Meaning of Intent" to defraud in Section 332 of the Companies Act 1948" JBL, [1984] 358.
51 [1990] BCLC 454.

convicted of fraudulent evasion of VAT, and he had intended to defraud HM customs and Excise but not other creditors.

In this case, Harman J. found the respondent guilty of carrying on the business with intention to defraud the creditors and, therefore, held him liable for £70,000, being the value of VAT debts and penalties owed by the company, but would not extend liability to cover all debts incurred during carrying on trading while insolvent. Here, it had not been proved that the defendant had intended to defraud all other creditors.

The question may arise whether a single transaction suffices to establish the offence of fraudulent trading. The point was scrutinised in *re Gerald Cooper Chemicals Ltd.*[52] In this case, the respondents contended that a single transaction could not amount to "carrying on the business to defraud creditors" within the meaning of section 332 (1), and that they could not knowingly be parties to the carrying on of the business with intent to defraud the company's creditors, because they had no powers of management or control over the carrying on of the business and did not assist it. The court found that the respondent, C Ltd., would have carried on its business with intent to defraud its creditor, H Ltd., where it obtained the purchase price in advance knowing that it could not supply the subject of contract, indigo, and would not repay the deposit.

In that case, it was held that to establish an offence as such, it was sufficient even if only one creditor was defrauded by one transaction or action, provided that the transaction could properly be described as a fraud on a creditor committed in the course of carrying on the business.

The relationship between a parent and subsidiary company and liability of the former for the latter's debts for fraudulent trading has been discussed in some cases. There was an attempt by Templeman L. J. in *re Southard & Co. Ltd.*[53] to explain such a relationship where he stated:

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[52] [1978] 2 All E. R., 49.
[53] [1979] 1 WLR 1198.

> "A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies ... declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary."[54]

Such a statement implies no liability for a parent company or its directors for the debts of its subsidiary. Moreover, the words seem do not distinguish between different situations.

In *Augustus Barnett & Son Ltd.*[55] an order was sought by the liquidator of Augustus Barnett Ltd, a subsidiary of Ramasa, to make the parent company liable for the debts of Augustus under section 332 of the Companies Act 1948. The allegation was that Rumasa had induced the customers of Augustus into continuing to deal with it by issuing letters of comfort and making statement of continued support. However, there was no allegation of fraudulent conduct against the subsidiary' directors when they, with good faith, continued to carry on trading on the basis of Rumasa's promises. Hoffman J. dismissed the case, because, in his Lordship's opinion, in order to establish a liability under the current section of fraudulent trading, a finding of fraudulent intent was necessary. More importantly, here, there was no allegation of fraudulent conduct.

There was no doubt that the creditors of Augustus continued to deal with it only and only on the basis of promised support on the part of Rumasa, and they suffered from losses when Rumasa refused to fulfil its assurances. In this case, no one could say that the parent company had no responsibility. Given there was no actual intention to defraud the Augustus' creditors, particularly when the existence of such an intention was not alleged, those creditors could seek an order under other legal causes of action, particularly under tort law rules.

Nowadays, the courts are likely to consider such an activity within the provisions of wrongful trading under concept of 'shadow directorship.' However, in this case, if

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54 Ibid at 1208.
55 [1986] BCLC 170.

fraudulent trading conduct was proved, the directors of the parent company, Rumasa, would have been made liable as shadow directors and as parties to the carrying on the business of the subsidiary company, Augustus, in fraudulent manner.

There was an attempt by His Honour Bromley QC in *re a Company No. 001418 of 1988*[56] to clearly distinguish between the two concepts of compensatory and penal damages in a fraudulent trading proceedings.

In this case, an application was brought by the liquidator against director of the company for fraudulent trading. The company went into creditors' voluntary winding up in 1986, when an estimated deficiency owed to unsecured creditors of some £212,000 was proved. In 1984, the company was not in a position to pay the Crown and ordinary debts. However, the respondent continued to receive a significant sum as remuneration. In the instant case, His Honour Bromley QC found the amount of remuneration very high "for a company in such a state." The learned judge found that from the end of July 1984 the respondent had no reason to think that the company could pay its debts as they fell due or shortly thereafter. Therefore, there was "real blame according to current notions of fair trading" in his causing the company to continue to trade.[57] The learned judge took the view that so far as the sum for which the respondent was declared to be responsible is compensatory, it was appropriate to limit it to the amount of the debts of creditors proved to have been defrauded by fraudulent trading. The maximum compensatory sum was the amount of trading loss during the period of fraudulent trading.

As was seen, this view was also taken by some other judges such as Harman J. in *re L Todd (Swanscombe)*.[58]

3. 3 Wrongful Trading

56 [1990] BCC 526.
57 Ibid at 551.
58 [1990] BCLC 454.

3.3 Wrongful Trading

3. 3. 1 Philosophy Behind the New Provisions

As is clear from the above examination of fraudulent trading, the necessity of proving dishonesty was a very difficult task for the applicant. The result was disappointing for the applicant as well as creditors who suffered loss through directors' delinquency and looked to justice for recovery.

Prior to the introduction of the wrongful trading provisions, a director could carry on trading while insolvent with merely the genuine belief that the clouds would be roll away and the sunshine of prosperity would shine upon him and his company again.[59] Many cases brought under fraudulent trading section failed, and this left the burden of costs as a result of the unsuccessful proceedings.[60] Such expenses had to be paid by whole body of creditors, when action was taken by liquidator, and if the applicant was an individual creditor, the expenses were to be paid from his own pocket. However, the courts required a higher degree of proof than what was established by the applicant. Consequently, an owner- director, like the respondent of the case of *re Patrick & Lyon Ltd.*,[61] who had allowed his company to continue trading while insolvent only for the purpose of validating a floating charge in his own favour, would escape liability for fraudulent trading because his action was not proved to be motivated by a dishonest design.

The other problem was the lack of clear grounds available to the courts to determine the main element of fraud, dishonesty. Making contrasting decisions with almost similar facts by the same judge was, thus, not surprising.[62]

With regard to those considerations, the provisions relating to fraudulent trading appeared to be ineffective to protect the interests of company's creditors. The penal element together with the reference to fraud, caused the courts to demand a strict

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[59] *re White & Osmond (Parkstone) Ltd.* [1960] 30 July (unreported).

[60] *re Patrick & Lyon Ltd.* [1933] Ch 786, 790, *Augustus Barnett & Son Ltd.* [1986] BCLC 170, *re General Cooper Chemicals* [1978] 2 All ER 49, 53.

[61] [1933] Ch 786, 790.

[62] For example compare *re William C. Leitch Brothers Ltd.* [1932] 2 Ch, 71 and *re Patrick & Lyone Ltd.* [1933] Ch 786.

standard of proof which could deter possible winning- claimants for recovering compensation from delinquent directors, even when there was a strong ground.

As a result, the Cork Committee proposed an alternative basis for seeking compensation as wrongful trading which is based on unreasonable rather than fraudulent behaviour. The Committee considered that requiring the victims to prove dishonesty was inappropriate. Compensation, in their view, ought have been available to those who suffered predictable loss not only as a result of fraudulent conduct, but also unreasonable behaviour.[63] The Committee, therefore, proposed a wholly civil remedy without need of proving dishonesty and, thus, the criminal standard of proof was not required.[64] The belief was that this remedy would be found attractive by the bankers concerned as monitoring the conduct of doubtfully solvent companies.[65]

An examination of the contents of the Committee's recommendations, however, leads to the conclusion that what appeared in the Act[66] was significantly different from those proposals. Some of recommendations were totally or partly ignored by Parliament. In the final "Proposed Draft Clause"[67] for wrongful trading, carrying on to continue the business wrongly would be established if 'any business of the company is carried on with intent to defraud creditors of the company or creditors of any other person or otherwise for any fraudulent purpose'.[68].

As to this part of proposal, one may raise the question that whether part (a) is a requirement for liability under wrongful trading provisions, or merely an alternative

63 Report of the Review Committee on Insolvency and Practice Cmnd 8558, Para. 1777 (1982).
64 Ibid Para. 1778.
65 Ibid Para. 1779.
66 Section 15 of the Insolvency 1985.
67 The 'proposed draft Clause' as Responsibility for Wrongful Trading cited in Para. 1806 as follows:
(1) A company shall be trading wrongfully within the meaning of this section if:
(a) any business of the company is carried on with intent to defraud creditors of the company or creditors of any other person or otherwise for any other fraudulent purpose, or
(b) at a time when the company is insolvent or unable to pay its debts as they fall due it incurs further debts or other liabilities to other persons without a reasonable prospect of meeting them in full.
68 Para. 1806 (1) (a).

for part (b). It will be a very odd conclusion if part (a) was intended as a requirement for wrongful trading. It will be odd and unjustifiable because the Committee introduced the concept of wrongful trading due to meet criticisms and inadequacies emerged from the fraudulent trading provisions, particularly its requirement of a strict standard of proof.[69] Moreover, such a requirement appears to be in contradiction not only with the committee's intention of introducing a new merely civil personal liability 'without proof of fraud or dishonesty,'[70] but also it seems the same as the main element of fraudulent trading offence in section 213(1) of the Insolvency Act 1986.

The other possibility is to take part (a) as an alternative for part (b), or an option for legislators to choose one of them as a ground for wrongful trading. However, accepting the second possibility as the Committee's intended choice, does not either absolve it from criticism. If the Committee intended the part concerned to operate as an option or alternative, it should have been clarified. Furthermore, when the concept of wrongful trading was aimed at resolving the difficulties of strict standard of proof necessary in fraudulent trading cases, introducing part (a), even as an alternative seems in obvious contrast to such an objective and, therefore, unacceptable and unnecessary.

According to the Cork Committee, an application for wrongful trading could be brought by the company's liquidator, its Official Receiver, receiver, manager, administrator, and even individual creditors or contributors, but under section 214[71]

69 Paras. 1759, 1776.
70 Para. 1778 (a).
71 Section reads:
"(1) Subject to subsection(3) below, if in the course of winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.
(2) This subsection applies in relation to a person if -
(a) the company has gone into insolvent liquidation,
(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and
(c) that person was a director of the company at that time;

the only person entitled to bring the action is liquidator. Perhaps the reason for this, was that Parliament intended to put the right of taking such a serious action in the crucial event of insolvency into the hands of a qualified authority, liquidator, and to prevent individuals to harass directors by abusing the right. Section 214 is a copy of its forerunner, section 15 of the Insolvency Act 1985. However, the addition of 'shadow director' is the only change to the new section.

It is noteworthy that section 214 is not entitled as "wrongful trading" in the Insolvency Act, and wrongful trading is a side- noted of "Penalisation of Directors and Officers" in that Act, which was an invention of the Cork Committee in chapter 44 and several related paragraphs in that chapter.

The first case in which there was a statement on wrongful trading was *re a Company (No. 00359 of 1987).*[72] In this case Gibson J. was of the view that there was a reasonable possibility that the liquidator might be successful in bringing an action under section 214. Although the case was not an action for wrongful trading, the interesting point was the suggestion of the learned judge of such a possibility.

3. 3. 2 Director- Shadow Director

The concept of the 'shadow director' was first introduced by section 3 of the Companies Act 1917. According to the section, the expression "director" "shall include any person who occupied the position of a director and any person in accordance with whose directions or instructions the directors of a company are accustomed to act."

While section 214 (7) provides that "In this section 'director' includes a shadow director." it is, thus, necessary to make a distinction between the concepts of 'director' and 'shadow director'. The extension of liability to a shadow director is of considerable importance, not only due to its affect on the financier or financial advisors / creditors, but also on a parent company which may be held liable for its

[72] [1987] 3 BCC 160, or as *International Westminster Bank Plc v. Okeanos Maritime Corp* (1987) BCLC 450.

subsidiary, where it has been involved to a considerable extent in the management of a company:

3. 3. 2. 1 Creditor or director?

The problems of interpretation were to some extent caused by the failure to implement the clear provisions suggested by the Cork Committee. The main problems created are, how to apply wrongful trading provisions to directors and, more importantly, how to distribute amount of money recovered.

What has attracted the judges concerns in some wrongful trading cases, is to clarify the position of a creditor, financier or financial or advisor / creditor on one hand, and legal person liable as shadow director under wrongful trading section on the other hand. The clarification of the matter becomes more significant and complicated when a financial advisor / creditor, e.g. a bank, is a debenture holder and at the same time might become liable to contribute to the company's assets as a shadow director.

In the Cork Committee Report, the expression "officer" was suggested to include any person in accordance with whose directions the directors had been accustomed to act. This definition appeared in section 214 of the Insolvency Act 1986 under 'shadow director' which was defined by section 741(2) of the Companies Act 1985, and incorporated into the insolvency legislation by section 251 of the Insolvency Act. Thereafter, it was often used in Companies Act,[73] Insolvency Act 1986,[74] and the Company Directors Disqualification Act 1986.[75]

The case of *re a Company (No 005009 of 1987)) Ex Parte Copp. and Another*[76] is of great importance in this respect, because it was the only case in which a claim was brought against a bank as shadow director. Moreover, in this case, the bank's application to strike out a liquidator's claim against it for wrongful trading failed.

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[73] Sections 309(3), 317(7), 320- 324.
[74] Sections. 206, 208, 209, 211, 214, 216, 249, and 251.
[75] Section 4, 6, 9, and 22(5).
[76] [1988] BCC 424.

Here, the company had for a while traded profitably until it lost its major customer which seriously affected its financial position. Prior to the loss, the bank allowed the company substantial unsecured overdraft on its current account. After financial deterioration and on the basis of a report made by the inspectors appointed by the bank, the latter took a debenture secured by a fixed charge on the company's receivable and other property and a floating charge over what was left. Thereafter, all the proceeds of trading were paid into a particular account operated by the bank and no drawings were allowed without its consent. The crucial point was that the company followed recommendations in the report as required by the bank. Subsequent to insolvent liquidation of the company, the liquidator sought a declaration holding the bank liable for wrongful trading as shadow director for its direct involvement into the company's affairs prior to the insolvent liquidation.

In that case, the liquidator based his claim on the ground that " the actual directors of the company did not exercise any real authority or free will in the direction of its affairs."[77] The court, acknowledging that the debenture was basically invalid, since according to section 245 of the Insolvency Act there was no consideration, refused to strike out the claim because on the materials available, the liquidator's claim for wrongful trading was not "obviously unsustainable".

Knox J. seemed prepared to take the view that the definition of shadow director under section 251[78] was wide enough in scope to apply to the case when the directors in question acted in accordance with the recommendation of the bank by creating security for its overdraft. Although in the end the bank was not held liable as shadow director, the court's treatment was an obvious sign of the possibility of holding a bank liable for wrongful trading and alarming for the bank to deal with such companies more carefully and not interfere in their affairs.

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[77] Ibid at 426.

[78] Section states:

"Shadow director in relation to a company, means a person in accordance with whose directions or instructions the directors of the company are accustomed to act."

The holding caused anxiety among legal writers who were concerned with its impact on professional advisors,[79] so that some called for amendment of the definition of "shadow director" [80]

In *Re Lo- Line Electric Motors Ltd.*[81] the court disagreed with Official Receiver's argument that the respondent was a shadow director within the meaning of section 741 (2) of the Companies Act, because the definition referred to a board of directors acting in accordance with a person's instructions.[82]

As to the case of a bank as shadow director some points should be carefully taken into account:

i) Interpreting the section so as to impose liability on such a financial institution as shadow director is not envisaged as an outcome of wrongful trading cases. The only reported case containing a claim against such a person under section 214 is *re a Company (No 005009 of 1987) Ex Parte Copp. and Another.*[83] Although the importance of the case is beyond doubt, it does not suffice to establish a rule to be followed in the future cases.

ii) In relation to a financier or financial advisor / creditor, more particularly a bank, there should be some specified factors on the basis of which liability of a bank be decided. The mere recommendation from a bank which attempts to support an ailing company to carry on trading, should not establish an inference of 'shadow directorship position'. The more acceptable ground can be the nature of legal relationship between the company and a financial institution as creditor. The account should, as suggested by a legal writer, be taken of[84] whether their relationship is a contractual one. If so, whether it does imply a subordinative relationship, on the ground of which there is an obligation imposed on the company to follow the bank.

79 Stephen Gillespie, "Wrongful Trading: Policy and Practice", 6 J.I.B.L., (1989) 272.
80 Stephen Girvin, "Statutory Liability of Shadow Directors", Jurid. Rev. (1995) 414, 417.
81 [1988] BCLC 698.
82 Ibid at 706.
83 [1988] BCC 424.
84 Edward Jacobs, "Wrongful Trading", 10 Bus. L. Rev., (1989) 180, 181.

iii) It has widely been recognised that for this purposes acting in compliance with a bank or parent company should be continuous or habitual not occasional. Therefore, acting in accordance with an instruction or direction on only one occasion does not establish a subordinative relationship.

It seems the courts should not impose wrongful trading liability if a debtor company followed a bank's recommendations even habitually, only because it had a fear that the bank might take step to put it into liquidation. However, if recommendations backed by threat of putting the company into insolvent liquidation, it may be taken as inference of subordinative relationship.[85]

The courts should consider discouraging impact of a wide application of the concept of 'shadow director' to the banks, and consider each event as a matter related to the particular facts of each case rather than a rule.

3. 3. 2. 2 Controlling shareholder

Another form of shadow directorship could be controlling shareholder, specially a holding company which dominates the company by appointing directors through its casting vote in general meeting. Although it is submitted that a financial failure of a company only should affect the individual directors of that company but not directors of its subsidiary,[86] a holding company is at risk of being held liable as shadow director when the subsidiary has no separate economic existence, personnel or premises. Furthermore, the imposition of liability under section 214 becomes inevitable when the directors of the former are also those of the latter.

A particular circumstances may arise when a holding company decides to withdraw its support from a financially troubled subsidiary, with the knowledge of strong possibility of the subsidiary falling into insolvent liquidation, as it was the case in *Augustus Barnett & Son Ltd.*[87]

85 Harry Rajak, " Shadow Director", 3 Law for Business [1991] 54, 55.
86 R. E. Adkins, "The Liability Attaching to Directors and Other Officers of a Parent Company where a Branch or subsidiary Fails in Another Country", 1 I. L. & Practice (1985) 71, 72.
87 [1986] BCLC 170.

The important point in the recent case of *re Hydrodan (Corby) Ltd.*[88] was the question on the relationship of a parent company with its subsidiary, in which there was an exhaustive statement delivered by Millett J. on different types of directors and their responsibility. Here, Hydrodan (Corby) was a wholly owned subsidiary of Landsaver, which in turn was indirectly a wholly owned subsidiary of Eagle Trust Plc. The company went into liquidation and its liquidator sought a declaration to make two directors of the Eagle Trust liable as shadow directors. The application of two directors to strike out the claim was successful. However, if an allegation had been made against the parent company as a shadow director, it would by implication have been successful.

In this case, two respondents were indeed directors of Eagle Trust, but Millett J. did find it difficult to extract a relationship as such between the respondents and the company.[89]

The main point emerged from the case was that, even when a body corporate was a shadow director of a subsidiary it does not lead to the conclusion that its directors are liable as shadow director of the subsidiary. Millett J. disagreed with the liquidator's submission that where a body corporate is a director of a company, whether it be *de facto*, *de jure* or shadow director, its own directors must *ipso facto* be shadow directors of the company.

In his application, the liquidator claimed that the two respondents "personally acted as *de facto* or shadow directors" of Hydrodan. Millett J. did not agree with the reasoning and pointed out that the definitions of "*de facto* and shadow director" were different. However, he held that:

> "Attendance of board meetings and voting with others, may in certain limited circumstances expose a director to personal liability to the company of which he is a director or to its creditors: But it does not , without more, constitute him a director of any company of which his company is a director."[90]

88 [1994] 2 BCLC 180.
89 Ibid at 185.
90 Ibid at 184.

The problem may arise that in such a situation a parent company would be held liable to contribute to the subsidiary's assets as shadow director under section 214. In other words, the parent company would be liable to pay for its subsidiaries directors wrongful activities.

The holding of Millett J. in this case appears to be more justified when both parent company and the subsidiary are insolvent. This holding leads to the conclusion that a contribution to the subsidiary's assets does not have to be made by the parent company at the expense of its creditors. Such a conclusion seems intended in enacting section 214. Here, although the company was a wholly owned subsidiary of Eagle Trust plc., it did not seem to the court sufficient to establish a shadow directorship relationship. The conclusion reached and test taken by Millett J., here, has been criticised as higher than the statutory definition.[91]

In *Re Kuwait Asia Bank EC v. National Mutual Life Nominees Ltd.*[92] the issue was an appeal from a New Zealand Court of Appeal. There was an allegation against a bank. The two employees of the bank were directors of an insolvent company of which the bank was shareholder of 40 per cent of shares. Moreover, those two directors out of five directors of the company were appointed by the bank.

In this case, a New Zealand money broker ("AICS") which went into liquidation in 1986 took deposits of which National Mutual Life Nominees Ltd. ("NMLN") was the trustee for the depositors. The depositors sued "NMLN" for breach of trust and sought contribution in proceedings against the bank and AICS's directors and auditors for allegedly acting fraudulently and/ or negligently by giving certificates containing false and misleading representations and breaching their duties.

The reason for suing the bank was that it was substantial shareholder and allegedly a shadow director of the company and, therefore, responsible for monitoring proper business conduct of AICS's business.

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91 N. R. Campbell, "Liability for Shadow Director", JBL (1994) 609, 613.
92 [1990] BCC 561.

Lord Lowry held that the bank was not vicariously liable to NMLN as employer or principal or personally liable for breach of trust, because in the absence of fraud or bad faith the bank as a person controlling the appointment of those directors had no duty to make sure that its nominees discharged their duties as directors properly. Consequently, it was held that the bank could not be liable as shadow director simply because the directors were not accustomed to act on the directions and instructions of the bank. In this case, the claimants could not provide the court with any evidence that the two respondents acted or were accustomed to act in accordance to the bank's directions or instructions.

One may argue that to hold a parent company liable as shadow director, its situation while insolvent should be distinguished from its trading life. As a result, in the former situation the imposition of a liability on the parent company is unlikely to benefit the creditors of the subsidiary while the company itself has some creditors. Neither is it fair to benefit the creditors of the subsidiary at the expense of those of its parent.

Likewise, the case of *Augustus Barnett & Son Ltd.*[93] is a good example of such a relationship. The creditors of Augustus Barnett (subsidiary) continued to deal with it only on the basis of promised assurances of Rumasa (parent company), and they suffered losses when Rumasa refused to fulfil its assurances. The court took the view that the assurances made by Rumasa may have constituted it a party to the carrying on the business of its subsidiary and liable as shadow director. Thus, in this case, had wrongful trading been a possible cause of action, the conclusion would be that it would have been likely to be successful.

Apart from the case of a financier or financial advisors/ creditors, it seems under any circumstances the judges should not consider an advisor, whether legal or individual, as shadow director under section 214 when their relationship is merely an advisory one. There should be a strong distinction between being a party to the carrying on the business and giving merely some advice or recommendations.

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93 [1986] BCLC 170.

This point has been considered by the legislature at the end of its statement on 'shadow director as "person is not shadow director by reason only that the directors act on advice given by him in a professional capacity."[94]

3. 3. 3 Re Produce Marketing Consortium- A Turning Point

The case of *re Produce Marketing Consortium Ltd.*[95] should be classified as the leading case on the issue of wrongful trading. Some issues have emerged from the case which have attracted the attention of the legal community. The question of a financier or financial advisor/ creditor as shadow director, discussed in previous section, is followed by the question of the beneficiary of such a contribution.

In this case, Knox J. was of the view that the floating chargee would take all sum recovered under the proceedings and if there were any remaining amount, would go to the ordinary creditors' account. This holding was influenced by the misfeasance case of *re Anglo- American Printing and Publishing Union*[96] as one of the oldest ones on misfeasance in which the sum recovered was swallowed by floating charge security. A review of misfeasance case law proves that the *re Anglo- American* judgment was recognised as a rule in subsequent misfeasance proceedings.

The Knox J.'s judgment may be supported by the reasoning that in both statutory sections in relation to wrongful trading and misfeasance, the contribution is to be made to "the company's assets". However, the judgment of Knox J. has been criticised. It has been claimed that the admission of this judgment as a rule frustrates the purpose of wrongful trading provisions.[97]

Sealy also believes that although this part of judgment to order the proceeds of a wrongful trading to go to the floating chargee rather than unsecured creditors, is justified by the wording of section 214 and previous case law stand in such cases as

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[94] Section 251 of the Insolvency Act 1986. Section 742 (1) the Companies Act 1985, and section 22 (5) of the Company Directors Disqualification Act 1986.

[95] [1989] 5 BCC 569.

[96] [1895] 2 Ch 891.

[97] Andrew Hicks "Advising on Wrongful trading"- pt. 1 14 Co. Law. (1993),16, 18, pt. 2, 14 Co. Law [1993] 55, see also generally Fidelis Oditah, "Wrongful Trading", LMCLQ, (1990) 205.

Re Anglo- Austrian Printing & Publishing Union,[98] where proceeds of misfeasance were paid to the holder of floating chargee, Knox J.'s holding is contrary to the philosophy of the section which is to protect trade creditors.[99]

In *re Produce Marketing Consortium Ltd.*[100] Knox J. did not seem prepared to establish a rule as such, when in the same case he described the intention of Parliament in enacting the section as requiring a director to make contribution to the assets of the company which, in his Lordship's opinion, was its creditors.[101] He restated the matter in the same judgment as follows:

> "what is ordered to be contributed goes to the company's assets for the benefit of the general body of creditors".[102]

This part of judgment seems inconsistent with the final view of the learned judge that the recovered sum had to go to floating chargee.

However, the holding is consistent with the old system as evidenced by *re William Leitch Brothers Ltd. (No. 2)*,[103] where it was held that the recovered money was to go to the general assets available for distribution among all creditors.

Moreover, in agreement with Sealy's view there is another point in the construction of section 214 which can be taken in support of the judgment in question. In Cork Committee's proposed draft, an action for wrongful trading could be brought by the company's liquidator, Official Receiver, receiver, manager, administrator, and even individual creditors or contributory, whereas under section 214 such an action can be taken only by liquidator. Does this mean Parliament intended the proceeds of the action be available to the liquidator for distribution among all creditors rather than to a secured creditor or particular group of creditors?

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98 [1895] 2 Ch 891.
99 L. S. Sealy, "Wrongful Trading", CLJ (1989) 357, 377.
100 [1989] 5 BCC 569.
101 Ibid at 594.
102 Ibid at 597.
103 [1933] Ch. 261.

The judgment of His Honour Judge Jack QC in the recent case of *Re Sherbornes Associate Ltd.*,[104] is a good example of this wide discretion of the courts under section 214. In that case the learned judge said:

> "Section 214 provides in effect that if a liquidator can establish a factual situation, he may request the court to declare the director should make a contribution to the company's assets, the amount of which is in the court's discretion."[105]

Any attempt to recognise the holding of Knox J. in *re Produce Marketing Consortium Ltd.*[106] as a principle applicable to other cases not only frustrates the purpose of the wrongful trading section, but it also makes a liquidator operate on behalf of a debenture holder, and take action at the expense of the general body of creditors in order to only benefit a floating chargee. Is that the effect which the section intended to give, and is it fair? The answer is certainly negative. Nobody can argue that the Cork Committee and Parliament intended the section to benefit a floating chargee to the detriment of unsecured creditors, particularly those who suffered loss as a result of wrongful trading. There is no doubt that the main objective of the Committee's proposals and the statutory provisions in relation to insolvency by Parliament was to protect the general body of creditors in general, and unsecured creditors in particular. The manner of drafting the Act and the wording of wrongful trading section appears to be a source of confusion. To satisfy the real intention of the legislators, the courts should exercise their discretion conferred on them in section 214 in the words "as the court thinks proper", the discretion which should, at first stage, benefit creditors who suffered loss after the financial depression.

The complexity inherent with the judgment of Knox J. in the concerned case is that a beneficiary, in almost all cases a financial advisor/ creditor, of a contribution order under section 214 may, at the same time, be held liable as shadow director to make

104 [1995] BCC 40.
105 Ibid at 46.
106 [1989] 5 BCC 569.

such a contribution to the company's assets, in simple words to repay itself. This does not seem to be what the section intended to give effect.

The other interesting point emerged from this case, was the question over nature and purpose of wrongful trading provisions. Prior to this case, there was no challenge over the purpose of the proceedings as purely civil. However, in this case the respondents contended that the character of section 214 was both compensatory and penal,[107] whereas the counsel for liquidator took the view that the provisions gave a purely civil remedy.[108] In Knox J.'s view the jurisdiction under section 214 was primarily compensatory rather than penal.[109]

The wording of judgment does not appear to totally deny the provisions as having a somehow penal feature. It may seem odd. But a mandatory disqualification which is imposed as a result of a contribution order should not be ignored. By considering the nature and aim of a disqualification order[110] the treatment of Knox J. to the purpose of wrongful trading proceedings might be justified.

Finally, as to the amount for which the respondent to be declared liable, Knox J. said that it is the amount "by which the company's assets can be discerned to have been depleted by the director's conduct which caused the discretion under section 214 to arise." His Lordship acknowledged that Parliament had deliberately chosen very wide words of discretion, therefore, it would be undesirable to spell out limits on this discretion. In fixing the amount of declaration, he considered the fact that, in that case, there was no fraudulent intent.[111] This part of Knox J.'s judgment is partly in the line with the holdings of His Honour Bromley QC in *re a Company No. 001418 of 1988*,[112] and Harman J. in *re L Todd (Swanscombe)* both fraudulent trading cases.[113]

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107 Ibid at 570.
108 Ibid at 597.
109 Ibid.
110 See Chapter 4: "Disqualification of Directors"- Nature and Aim.
111 *re Produce Marketing Consortium Ltd.* [1989] 5 BCC 569, 597.
112 [1990] BCC 526.
113 [1990] BCLC 454.

3. 3. 4. Objective Test- Departure from Common Law Rule

The main feature of the duties under section 214 which is basically different from those which have so far been recognised as the traditional common law duties, is its introduction of a new standard of conduct. It is a crucial point to be addressed whether the standard of proof is based on objective or subjective test for the purposes of the wrongful trading provisions.

It should be noted that in English case law the traces of the idea can be found when the courts did not totally refused the possibility of applying such a test to the company directors.[114]

Historically, the common law has assessed directors' duty of care and skill only by subjective test.[115] The judges do not doubt to apply such a test to the cases before them. However, the provisions of wrongful trading seem for the first time in the history of English law have departed from this traditional view and built up a new legal approach with its own consequences. The imposition of an objective standard is a real departure from the traditional subjective criterion applied by the courts in ascertaining the level of skill and care which is expected of directors.

The advantage of the imposition of a standard with an objective element is that incompetent directors may be deterred from entering into the arena of corporate management with the threat of personal liability catching them.

The Cork Committee Report was quite clear on the point that the test for wrongful trading should be objective and the standard of proof should be that of the ordinary, reasonable man.

Section 214 (4) provides a double test for determining the facts which the directors ought to have known. It provides two factors as standards of conduct which together shows a tendency to the objective as follows:

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114 *re Equitable Fire Insurance* [1925] 1 Ch 407.

115 See for example *Brazilian Rubber Plantations & Estates Ltd.* [1911] 1 Ch D 425.

"(4) For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which be known or ascertained, or reached or taken, by a reasonably diligent person having both-

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that director has.

The first part obviously employes a standard which may be higher than what is possessed by the respondent. Therefore, such excuses as the lack of experience, inattendance or reliance on other officers in the honest belief, which under a subjective test are considered in favour of the defendant, under this head are not justifiable.

Part (b) provides that the level of skill and care will be more difficult where a director has possessed a higher level of general knowledge , skill and experience than may be expected of a director in his position.

This subsection should be read together with subsection (5) which provides that a director's function as to his company includes all those which entrusted to him irrespective of whether or not he carried them out personally, or a particular function is delegated to other officers.

As the language of the section implies, the individuals' qualifications may impose a higher test on them than required by their functions. Therefore, a director with a particular expertise or responsibility is more at risk. The court will take account of all specific circumstances. For example, a director in a large company with sophisticated procedures and equipment is expected to perform a higher standard than a director with only a limited role in the company and little or no management function.

Cooke believes that the wording of section 214 is an invitation to the courts to exercise hindsight substituting their own judgment for that of corporate directors by which a corporate director:

> "is required to prove that he acted according to the standards of a hypothetical person with hypothetical knowledge in a hypothetical situation and with hypothetical motives. Such a defence must be impossible."[116]

If his general knowledge, skill and experience exceeds that required for the job, then he is expected to discharge his responsibilities in accordance with those skills. He is ,thus, judged according to the appropriate standard expected either for the job or that he possesses, whichever is higher. Therefore, it is of particular importance that the lack of adequate expertise necessary for a particular job does not excuse a director from liability to reach the inevitable conclusion.

There should be a distinction between an executive and non- executive directors and between managing director and those with little involvement in the company's running. It also seems necessary to distinguish finance or production directors with a more detailed information of its business and ordinary managers.

However, the lack of expertise necessary for a job does not excuse a director from failing to reach the basic standard and reaching inevitable conclusion, as for example to insolvency of the company.[117]

The application of objective test to directors' responsibility is a new experience in English company law, but the courts seem successfully overcoming the problem of clarifying the scope and defining the test. The main uncertainty in this respect is the criterion of the reasonable man. Whether a reasonable man is a person with a high experience, and expected to do what is the best to the company and its creditors, or he is required to do what reasonably could be done. It is an important point which should be regulated by the courts and be considered by the legislator in the future enactments, so as to be applicable as a rule with regard to the changing time and the need of modern business world.

3. 3. 5 Particular Duties Under Wrongful Trading Provisions

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116 David J. Cooke, "Limited Liability Abolished", I.L.& Practice (1988) 157, 158.
117 T. E. Cooke & Andrew Hicks, "Wrongful Trading- Predicting Insolvency", JBL, (1993) 338, 339.

Under the wrongful trading provisions, directors have a range of duties and responsibilities if not performed adequately, the imposition of liability most likely catches them.

3. 3. 5. 1 Duty of Monitoring and Prediction

The expression 'prediction' has been used as a duty of directors of a financially troubled company. However, such a concept is not mentioned in the Act. The Act expressly requires directors of a company to know or ought to have concluded that there is no reasonable prospect that the company avoids going into insolvent liquidation. Such a statement is taken in the sense of prediction. The notion of 'prediction' reveals the main thrust of the legislature's intention.

By monitoring the company's affairs, directors can reach a conclusion that the company is going into depression. Therefore, to predict the company's final destination before it becomes too late, it is necessary for a director to have a systematic and constant monitoring. How successful a director is in predicting and facing a financial depression depends on the existence of a proper monitoring system.

In some statutory provisions, having good accounting records is described as a duty of companies directors, breach of which mostly leads to disqualification of the director in question from being a director or being involved in any form of management of any company.[118]

The Institute of Directors has recommended that directors of a company must have all the time financial information which is up to date and accurate. The earlier problem is identified the wider is the range of options. The reverse is true, the more serious problem becomes, the more difficult it is to deal with. Therefore, speed in taking a proper action is significantly essential.[119]

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118 Section 3 of the Company Directors Disqualification Act 1986.
119 "Institute of Directors; Guidelines" Guideline 1, Bus. L. Rev., (1991) 79.

In *re Produce Marketing Consortium Ltd.*,[120] although the accounts were not available to the directors, they had an intimate knowledge of the business and must had known that the turnover was seriously down in the previous year. In the Knox J.'s point of view "the preparation of accounts was woefully late."

Under sections 221(1) and (2) (a) of the Companies Act 1985, there is an obligation on companies to cause accounting record to be kept so as to disclose with reasonable accuracy the financial position of the company at any time. The directors are also obliged to prepare a profit and loss account for each financial year and a balance sheet at the end of it.[121] In *re Purpoint ltd.*[122] the company's accounts were so inadequate that there was no possibility for directors to monitor the company's financial position.

The main question from view of preventing liability under section 214 is how, and on the basis of which factors, a director can monitor and predict insolvent liquidation. The knowledge to be imputed in testing whether or not the director could monitor insolvency is not limited to the documentary materials at the given time. The factual information should also be ascertained.[123]

The obvious sign for this purpose is the loss of major customer or contract by the company. In *re MC Bacon Ltd.*,[124] for example, the company was faced with serious business difficulties when its main customer terminated its business with the company. As a result, the lender bank pressed for a security as a condition for its continued support. Likewise, in *re DKG Contractors Ltd.*[125] withdrawal of credit by a major supplier was an obvious sign for the directors to conclude that their company was in critical position.

120 [1989] 5 BCC 569.
121 Section 227 (1) and (3) of the Companies Act 1985.
122 [1991] BCC 121.
123 *re Produce Marketing Consortium Ltd.* [1989] 5 BCC, 569, 595.
124 [1990] BCLC 234.
125 [1990] BCC 903.

The loss of key employees may also be considered by directors as an indication of their company's position as serious.[126]

More difficult question in this respect is how to determine the precise time when a director is expected to predict insolvency. In *re Purpoint Ltd.*[127] the main question was the date when the respondent ought to have known that there was no reasonable prospect that the company could avoid going into insolvent liquidation. Vinelott J. held that the date had to be pushed back to the end of 1986 when it was obvious to the respondent that the company's going into insolvency was inevitable. The difficulty which the court faced was that because of total failure of the respondent to prepare and keep proper accounting records, it was not possible to find out the extent of the respondent's liabilities. In the Vinelott J.'s view, the only solution was to quantify the loss caused by continuation of trading after the end of 1986 by adding the debts owed to creditors after 1 January 1987 and unpaid when the company ceased trading.

In *re Sherborne Associates Ltd.*[128] the court examined the matter as:

> "It would not be fair to the respondents to permit the liquidator to pick a series of subsequent dates, or to invite the court to pick a subsequent date, saying of such a date or dates that at least then the conclusion that there was no reasonable prospect that Sherborne would avoid insolvent liquidation should have been reached. Such a case would have required the examination of each date for this purpose."

It may seem unfair to attempt to push back the liability point to an earlier time when financial difficulty was less immediate and warning signs less obvious. By doing so the courts would expect a very high standard of a monitoring system and push back commencement of liability to an early date.

3. 3. 5. 2 'Every Step' to Be taken

126 Cooke & Hicks, *op cit.*
127 [1991] BCC 121.
128 [1995] BCC 40.

Section 214, after setting up liability for wrongful trading and its requirements, in providing the limit on the declaration, states a provision which reads:

> (3)"The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took *every step*[129] with a view to minimising the potential loss to the company's creditors as ... he ought to have taken."

The expression 'every step', then was referred to as a criterion to mitigate against the respondents liability. If the director in question satisfies the court that he has taken 'every step' which he ought to have taken with a view to minimising the loss to the company's creditors, the court shall not order him liable to contribute to the company's assets.

It seems this expression was not employed in the subsection in order to define a limit on the extent of compensation, but rather to set out directors' responsibilities or duties, nor was it used as an independent legal concept. However, the expression, then, appeared to give effect not only as a duty of directors to minimise loss to the company's creditors, but more importantly it became to be a means of relieving against liability under the wrongful trading section.

Sealy and Milman believe that Parliament deliberately replaced the expression of "every reasonable step" proposed by the Cork Committee with "every step",[130] perhaps to widen the range of actions or steps which fall within this expression.

The construction of this subsection is described as "clumsy", particularly the phrase "assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation" is a repetition and irrelevant.[131]

The discussion of monitoring and prediction of insolvency is a preliminary stage for taking every proper step with a view to minimising the loss to the company's creditors. In other words, predicting an impending financial difficulty does not

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129 Emphasis is added.

130 Sealy & Milman, Annotated Guide to the 1986 Insolvency Legislation, at 231.

131 Donna MCkenzie, "Wrongful Trading- A Paper Tiger" Jurid Rev. (1995) 519, 523.

relieve against directors' liability, when they have failed to take every necessary action. The question of which step should be exactly taken seems a matter left to the courts' discretion to determine if the steps necessary are those which have been taken by the respondents. However, cases which have so far been decided are not helpful. A corporate directors should be aware of all steps they should take before an action against them is filed. In this respect, the law still seems short of clarity.

Some commentators have criticised the wording of the phrase "every step" by arguing that even if the liquidator suggests that one measure or step, no matter how small its effect, could have reduced the loss to the company's creditors, the whole defence fails,[132] which means "the defence is in practice unstateable".[133]

Section 214 does not provide any definition or guidance as to what is "every step". A variety of options can be classified within the meaning of 'every step' by taking one or some of which a director of a financially troubled company may safely escape liability under wrongful trading. The importance of monitoring the company is evident at this stage, when the earlier predicting financial depression or insolvency is a result of the better monitoring the company's activities.

Before deciding whether carry on the business or cease trading, a director of a company faced with financial problem should refer to professional experts in this field. The only case in which reference to the advice of competent professionals has been suggested is *re DKG Contractors Ltd.*[134], where Mr. Justice Weeks Q. C. pointed out:

> "Before trading in the manner in which they did, they ought to have sought some advice at least, and I think it is significant that the only offer advice which was made to them was not taken up."

If such professionals, for example accountants or solicitors are available in the company, consulting them is more effective because they have clear background of the company's affairs, otherwise the directors are required to seek advice of such

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132 Cooke, *op cit* at 117.
133 MCkenzie, *op cit* at 528.
134 [1990] BCC 903, 912.

experts outside the company. The important point in seeking such advice is the level of expertise and care of those professionals. The best advisors in this respect are insolvency practitioners.

The other possibility which may be accepted as a positive step by the court is what has been suggested by the Institute of Directors, that directors are entitled to seek advice upon whether it is feasible for the company to obtain a moratorium to enable it to resolve its problem without being involved in formal insolvency.[135]

A director of illiquid company should avoid causing the company to be involved in liquidation procedure which imposes a major cost, by resorting such insolvency procedures depending to the particular circumstances of the case, as voluntary arrangement, or administration receivership. In such a situation if he could not make a voluntary arrangement, petitioning to the court for an administration order may be the best step which he ought to have taken.

If in the directors' belief there is possibility of keeping the company surviving, they may convene a meeting of company's creditors, informing them of the situation and seek their support for a proper arrangement. Negotiating with one or two major creditors may be a helpful step in the court's view, most particularly in a large company, for a moratorium or any reasonable solution saving the company.[136]

Resignation is unlikely to be taken as a positive step. Conversely, taking such a decision may deteriorate the position of the respondents. This issue was considered in the case of *re MC Bacon Ltd.*,[137] where one of the respondents retired from active management and handed over its control to the son of one of them, when the company was in serious financial difficulty. Although the case was not a wrongful trading one, the effects of the retirement of the directors proved that the resignation or retirement can not be counted on in the sense of 'every step' under wrongful

135 "Institute of Directors; Guidelines" Guideline 3, Bus. L. Rev., (1991) 79.
136 See generally Hicks, *op cit* pt.2 at 55.
137 [1990] BCLC 324.

trading. Here, as the result of the resignation, the lender bank refused to continue its support unless its debts were secured.

In brief, there is a considerable number of actions which can be recognised as "every step" under the wrongful trading proceedings. Given the actions above- mentioned are those which constitute the vocabulary of "every step", the question still remains is which one should be taken as satisfactory to the court. It seems the respondent is required to take the step that is most reasonable, appropriate, and effective to minimise the loss to the company's creditors. This view is consistent with the legislators' intention of "every step with the view to minimising the potential loss to the company's creditors."

3. 3. 6 General Conclusion on Wrongful Trading

As was seen, the result of the criticisms on the hardness of subjective test of proof required by fraudulent trading which was considered as a serious obstacle to the courts discretion, was the Cork Committee Report which introduced by the legislature in section 15 of the Insolvency Act 1985 and subsequently in section 214 of the Insolvency Act 1986 under wrongful trading provisions.

The importance of introducing the wrongful trading provisions is beyond doubt. Some commentators have given a major credit to the wrongful trading concept. Prentice describes this development as a significant development in company law which "greatly altered the topography of the law in this field, and as one of the most important development in company law in the present century."[138] He gives some reasons to justify his suggestion. First, the provisions of wrongful trading section is another exception to the general rule that a director is not personally liable for his companies' debts, and exception to the principle of limited liability, since carrying on trading while illiquid or insolvent even with honest belief creates liability for directors. Secondly, as a traditional rule of common law, duty of care and skill owed

[138] D. D. Prentice, "Creditors' interests and Directors' Duties", 10 Oxf. JLS. (1990) 265, 277.

by directors to the company is to be assessed by a subjective standard which releases incompetent or inexperienced but honest directors from liability, whereas under wrongful trading provisions, an objective standard is also applied.

In *re Produce Marketing Consortium Ltd.*[139] Knox J. explained this development as follows:

> "Two steps in particular were taken in the legislative enlargement of the court's jurisdiction. First, the requirement for an intent to defraud and fraudulent purpose was not retained as an essential, and with it goes the need for what Maugham J. called "actual dishonesty involving real moral blame"....The second enlargement is that the test to be applied by the court has become one under which the director in question is to be judged by the standards of what can be expected fulfilling his functions, and showing reasonable diligence in doing so...."

It is believed that wrongful trading section has encouraged directors to face up to decision- making on insolvency more responsibly and, therefore, the instrument has been well effective,[140] since it has threatened directors to be held liable if they abuse the privilege of the limited liability principle.[141] Indeed, this device which has been considered a "Sword of Damocles"[142] for company directors has applied to several cases in the past ten years.

As to the question whether this legal device has reached the result aimed at to resolve the problems inherent in fraudulent trading and to protect creditors adequately, it is said that while in 1989- 1993 there had been 92, 500 companies insolvencies in England and Wales, having only four cases reached the courts reveals the fact that liquidators are reluctant to take an action as such, because of the lack of personal assets without which suing a director is wasting of time as well as money. Moreover, the high expense involved in pursuing such proceedings is described as another reason for such reluctance.[143]

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139 [1989] 569, 594.
140 Andrew Hicks, "Wrongful trading- Has It been a failure"? 8 I. L. & Practice, (1993) 134, 135.
141 Prentice, *op cit* at 277.
142 Joe Bannister, "Wrongful Trading: The Courts Speak," 5 I. L. & Practice (1989) 30, 31.
143 Patricia Godfrey and Sarah Nield, "The Wrongful Trading Provisions- All Bark and No Bite", I. L. & Practice (1995) 139, 140.

Although these facts are true, considering them as the main weaknesses of the proceeding of wrongful trading is not justified, because in other legal proceedings such as fraudulent trading and misfeasance, the same difficulties exist, and such problems are not typical to wrongful trading cases.

Claiming that effectiveness of the proceedings is beyond any doubt, is not only because it, as has been suggested, operates as a welcome additional weapon,[144] but also appears to be a new jurisdiction on the basis of a peculiar standard in common law history, imposing a minimum objective standard on the directors in the benefit of creditors. Most of cases brought under the section have been proceeded successfully. As a result, the applicants have had an extra opportunity to take an action for both fraudulent and wrongful trading or drop[145] the former and take the advantage from the latter without the need to prove the strict standard of a criminal intention. Also worth noting that it is impossible to tell how many cases where a wrongful trading action has been threatened have been settled out of the courts by the directors concerned including an offer of compensation.

3. 4. Misfeasance

Misfeasance was the earliest proceedings among other liabilities of corporate directors in insolvency, such as wrongful trading and fraudulent trading. Misfeasance has a very old case law background as well as a statutory history dating back to two and half centuries, over a century before the first statutory provisions came into effect in 1862. However, there has been no clear classification of the grounds or causes of the proceedings, nor has been an attempt to determine the boundaries and the exact scope of the summons. The judgments which so far have been made, reveal an obvious confusion in determining the extent of misfeasance. This confusion could

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144 Andrew Hicks, *op cit* at 60 and Fidelis Oditah, *op cit* at 222.

145 For example in the case of *re Produce Marketing Consortium Ltd.* [1989] 5 BCC, 569 at 571 the fraudulent trading claim was dropped at the outset of the hearing.

be more clearly noticed until up to 1986 Act when the section was widened so as to bring negligence within the meaning of misfeasance. Having regard to the length of the legislative process, it is not clear why no serious attempts have been made to regulate the provisions of the section in compliance with the needs of developing law and the demands of modern business relations. The statutory provisions not only have not been helpful to resolve some problems arisen in many cases, but they themselves create some ambiguities.

Negligence is a concept of common law applicable to a wide range of matters including corporate directors, professionals etc.

3. 4. 1 Statutory Background

The first statutory provisions as to the liability under misfeasance proceedings appeared in section 165 of the Act 1862. According to the section, if:

> "in the course of Winding up of any Company under this Act, it appears that any past or present Director, Manager, Official Receiver or other Liquidator, or any Officer of such Company has misapplied or retained in his Hands or become liable or accountable for any Moneys of the Company, or been guilty of any misfeasance or breach of trust in relation to the Company, the Court may, on the Application of any Liquidator, or of any Creditor or Contributory of the Company, examine into the Conduct of such Director, Manager, or other Officer, and compel him to repay any Moneys so misapplied or retained or for which he has become liable or accountable, together with Interest after such Rate as the Court thinks just, or to contribute such Sums of Moneys to the Assets of the Company by way of Compensation in respect of such Misapplication, Retainer, Misfeasance or Breach of Trust, as the Court thinks just."

Those acts were classified under heading "power of the court to assess damages against delinquent directors and officers".

The Companies Act 1890[146] was almost a repetition of the previous misfeasance provisions. However, the section was widened so as to catch any person who had taken part in the formation or promotion of a company. Section 333 of the Companies Act 1948, which repealed its forerunner, section 215 of Companies Act

146 Section 10.

1908, did not introduce any change to the section. A century after the introduction of the first Act on misfeasance, Jenkins Committee recommended the following revolutionary change to the proceeding:

> "(d) Section 333(1) should be amended by substituting for "breach of trust in relation to the company" a reference to any breach of duty in relation to the company which would involve civil liability at the suit of the company. The effect of this change would be to bring an actionable negligence of directors and others within the scope of the section."[147]

Aside from some extension to the scope of the section as a result of Jenkins Committee's recommendations,[148] over a century, the main structure of the section remained intact. Section 212 of the Insolvency Act 1986, which repealed section 631 of the Companies Act 1985, followed Jenkins Committee recommendations by replacing the expression of "breach of trust" by the phrase of "breach of any fiduciary or other duty" to include negligence and any breach of other duty. It was a very significant statutory development in this regard. However, the wording of the provisions of this section bears a confusing conclusion, when it reads:

> "(1) This section applies if in the course of winding up of a company it appears that a person who (a) is or has been an officer of the company, ...has *misapplied* or *retained*, or *become accountable* for any money or other property of the company, or been *guilty of any misfeasance or breach of any fiduciary* or *other duty in relation to the company.*"[149]

If it happens, the court may compel the defendant to contribute to the company's assets by the way of compensation.

Has the legislature, by using the disjunctive word ", or" intended to draw a distinction between misapplication or retention of the company's property and others on the one hand, and misfeasance and other acts set out in the section on the other hand?

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147 Surprisingly, there is no suggestion as to misfeasance in the report of the Cork Committee 1982.
148 Report of the Company Law Committee Cmnd. 1749 (1962).
149 Emphasise added.

From view of language employed in the section it seems misfeasance has been distinguished from those acts mentioned in the section. To support the idea; regarding the line of legislative process on the proceedings, beginning with section 165 of the Companies Act 1862 in which the same language had been employed, reveals the will of legislators as such; there is no such proceedings entitled as 'misfeasance, but in all enactments prior to the 1986 legislation, the word "misfeasance" was a sub- heading of "power of court to assess damages against delinquent director etc.", and as an act under heading "summary remedy against delinquent directors etc."

However, the above idea is not free from challenge. All matters set out in the section fall within the concept of misfeasance and counting misfeasance among others is intended only as an example or emphasise. Moreover, the use of the disjunctive word ", or" is no more than a loosely linguistic disregard since this manner is usually used to emphasis on a concept by setting out its different meanings; a review on the case law interpreting the section shows that the real intention of Parliament that there is no separate category of misfeasance differing from other matters in the section;[150] finally declining to recognise the second view leaves a more complicated question, what is the meaning of misfeasance and which actions fall within its scope?

The first approach seems of a stronger position. However, considering the intention of the legislators, the judgements so far made on misfeasance and the attitude of lawyers to the whole section 212 as misfeasance proceedings, and from view of preventing more confusion, accepting the second argument seems more justified.

It is appropriate to bring into treatment the provisions in Company Directors Disqualification Act 1986 relating to 'misfeasance'. Section 9 of the Act as to "matters for determining unfitness of directors" refers to Part 1 of Schedule 1 of the Act when the court is to determine whether a person's conduct as a director or shadow director of any particular company or companies makes him unfit to be

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150 For example see *North Australian Territory Company, Archer's Case* [1892] 1 Ch 322, *National Fund Assurance Company* [1878] 10 Ch 118.

concerned in the management of a company. The following matters set out in Part 1 of Schedule 1 are applicable in all cases irrespective whether or not the company is in insolvency:

> "1 Any misfeasance or breach of any fiduciary or other duty by the director in relation to the company. 2 Any misfeasance or retention by the director of, or any conduct by the direct giving rise to an obligation to account for any money or other property of the company."

Those matters are the same as the acts mentioned in section 212.

3. 4. 2 Concept and Nature of the Proceedings

3. 4. 2. 1 Meaning

The meaning of misfeasance is to be considered prior to and after the Insolvency Act 1986 on one hand, and both its narrow and wide concept on the other hand.

Prior to the latest legislation, misfeasance had a meaning of any misapplication or retention or liability for property or money of the company or being guilty of misfeasance or breach of trust. The recognition of such meaning was expressed by James J. in *re Canadian Land Reclaiming and Colonizing Co.; Coventry & Dixon's Case*:[151]

> "I am of opinion also the word "misfeasance" in that section means misfeasance in the nature of a breach of trust, that is to say, it refers to something which the officer of such company has done wrongly by misapplying or retaining in his own hands any moneys of the company, or by which the company's property has been wasted, or the company's credit improperly pledged."[152]

The inclusion of negligence in the section by previous Acts was a question which was answered from different approaches. Negligence expressly was excluded from scope of misfeasance in *re B. Johnson & Co. (Builders) Ltd*:[153]

> "it was not every kind of wrongful act which was comprehended by the section and that a case of common law negligence was not within the section; and that on the facts, the

151 [1880] 14 Ch. D 660.
152 Ibid at 670.
153 [1955] 1 Ch 634, 635.

> matter should not be allowed to proceed, since the charges did not amount to more than ordinary claims for negligence at law."

Although in some cases the courts did not refuse to accept actions for negligence under the section,[154] it seems until up to the Act 1986 the statutory provisions did not contain any right, or did not express any right, of bringing negligence within meaning of misfeasance.

The Act 1986 appeared to widen the scope of the proceedings so as to catch a director guilty of breach of any fiduciary or other duty in relation to the company. Therefore, it became to operate as 'summary procedure which used to be called a misfeasance summons but has been extended to include breach of any duty including the duty of care'.[155] In other words, any negligence and disloyalty leading to loss to the company falls now within the proceedings.

The narrow concept of misfeasance appears to be only applicable to the cases of misapplication or retention of the company's property, and the improper performance of some act which a person may unlawfully do.[156] However, there is no authority in English law to show the recognition of the narrow concept by the courts or Parliament. In its wider meaning, misfeasance includes not only any treatment of the company's property leading to liability, but also those acts resulting in breach of any fiduciary or other duty in relation to the company. However, in some cases, the courts have suggested that the scope of misfeasance might extend so far as to include acting as director without proper qualification.[157]

Such an attitude to the concept of misfeasance seems to be even wider than "nonfeasance" which is the omission of an act that a director ought to do. The reference to the nonfeasance cases by law under misfeasance proceedings, except

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154 See for example *re Brazilian Rubber Plantations & Estates Ltd.*[1911] 1 Ch 425, and *re City Equitable Fire Insurance Co.* [1925] 1 Ch. 407.

155 Per Hoffmann L. J. in *re D'. Jan of London Ltd.* [1994] 1 BCC 562, 562.

156 Black, Black's Law Dictionary (St. Paul, Min: West Publishing Co. 1990) 1000.

157 Per. Bramwell L. J. in *Coventry & Dixon's Case* [1880] 14 Ch. D 660 at 672. However, in *Thomas v. Quartermaine* [1887] 18 Q. B. D. 685, 694 Brown L. J. stating that "there is no such thing as negligence in the abstract" disagreed.

where there has been a breach of trust, has been doubted by comparing nonfeasance with sins of omission and misfeasance with sins of commission.[158]

One may contend that acting as director without qualification is a positive activity in breach of duty. It is difficult to justify such argument within the misfeasance provisions. The tendency to give the language of the section a wide interpretation that the courts originally willing to give it, has been criticised. According to this view, the section was not to apply in every case in which a company in liquidation has or had a right of action against one of its officers.[159]

3. 4. 2. 2 Nature of misfeasance

As to the nature of misfeasance, it is widely recognised that the section has both a procedural aspect and compensatory result. The best clarification of true nature of the proceedings can be seen per Bramwell, L. J. in *Coventry and Dixon's case*:[160]

> "The section authorizes the court to direct personal chargeable under it to pay a sum of money by way of compensation. Therefore, the official liquidator has to shew, first of all, the misfeasance, and then the damage in respect of which the company is to be compensated. .... This is not a section for punishing a man who has been guilty of misfeasance, but for compensating the company in respect of the loss occasioned by his misfeasance."

The section does not create any new liability or new right, but only provides a summary of mode enforcing rights which must otherwise have been enforced by ordinary procedure of the courts.[161]

A century less a quarter after the *Coventry and Dixon's Case* , the issue was referred to in the case of *re B. Johnson & Co. (Builders) Ltd.*[162] In that case, the section was described as:

> "a procedural section which created no new cause of action and that the acts covered by the section were wrongful according to the established rules of law and equity"[163]

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[158] For example, per Fry J. in re *Wedgwood Coal and Iron Co.* [1882] 47 L. T. 612, 613 cited and supported by Maugham J. in *re Etic Ltd.* [1928] 1 Ch 861,872.

[159] Per. Maugham J. in *re Etic, Ltd.* [1928] 1 Ch 861, 871.

[160] [1880] 14 Ch. D 660.

[161] Ibid at 670.

[162] [1955] 1 Ch 634.

Having regard to those explanations leads us to the conclusion that the nature of misfeasance is distinguishable from that of other liabilities of a corporate directors which so far we have examined. In the case of wrongful or fraudulent trading, for example, there is no pre- existing right for the company. The right of suing the director in question is established when the director carry on trading while insolvent in the case of wrongful trading, or carry on to continue business with intent to defraud creditors of the company or those of any other person in a fraudulent trading case. Therefore, the provisions of misfeasance is a means or procedure for restoring its property or recovering damages suffered by the company. For example if the property of the company retained by its director, the company is entitled to sue him until the property has been returned to it, but not more, whereas in the case of wrongful trading the court is empowered to hold the respondent liable to contribute to the company's assets as the court thinks fit, without any limitation.

Unlike the case of misfeasance, in wrongful trading the court is not required to consider that the amount of contribution is equal to liabilities and debt incurred by director's conduct as such.

3. 4. 3 Grounds for Misfeasance- A Case Law Review

There are some grounds for misfeasance set out in section 212 in most of which the loss incurred by the respondent is obvious. Any misapplication or retention of the company's property requires loss to the company. As the essence of the proceedings is compensatory, there is no jurisdiction to make a compensation order unless a pecuniary loss to the company is proven.[164] This view has been criticised as unsatisfactory, as it confuses the need for a wrongdoing to be established on the one hand, with a separate need for pecuniary loss to have been resulted from the wrongdoing, on the other hand.[165]

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163 Ibid at 635.

164 *Re Etic Ltd.* [1928] 1 Ch 861, 874.

165 Fidelis Oditah, "Misfeasance Proceedings Against Company Directors", JBL (1992) 207.

In brief, to bring a misfeasance case before the court, the alleged conduct complained of should be actionable.

The breach of duty as an important ground for misfeasance contains a big variety of directors' activities ranging from selling a car belonging to the company at an undervalue to depleting its assets by taking them away from the creditors' reach. The main feature of breach of duty is breach of duty of care, negligence, and breach of fiduciary duty.

3. 4. 3. 1 Breach of fiduciary duty

Fraudulent preference or acting while interested have been considered by the courts as cases of breach of fiduciary duty or disloyalty.

In *Liquidator of West Mercia Safetywear Ltd. v. Dodd & Anor*,[166] the ingredient of the case was a fraudulent preference allegation. The summons was an appeal by the liquidator of the company, West Mercia, against a decision from a chancery court that the director ,"D", had not breached any duty, to or in relation to the company in transferring £4,000 of the company's money to its parent company, "D Ltd", of which the respondent was also a director.

In May 1984, both the companies were insolvent. While both the companies were put into creditors' voluntary liquidation and transfers of money between their accounts was not permissible, Dodd instructed the company's bank to transfer £4,000 to the overdrawn account of the Dodd company, with the intention of reducing the overdraft of the Dodd company which Mr. Dodd had personally guaranteed.[167]

Dillon L. J. was of the view that the decision was "misfeasance on the part of Mr. Dodd as a director who owed a fiduciary duty to the West Mercia company in making that transfer by way of fraudulent preference", and he knew, since he was advised that it was in fraud of the company's creditors.

166 [1988] 4 BCC 30.
167 Ibid at 32.

In this case , his Lordship dismissing the decision of the court of instance, held that:

> "Mr. Dodd was guilty of breach of duty when, for his own purposes, he caused the £4,000 to be transferred in disregard of the interests of the general creditors of this insolvent company. Therefore, the declaration sought in the notice of motion ought to be made as against Mr. Dodd."[168]

Therefore, the defendant director was held liable to pay £4,000 and interest.

In *re Welfab Engineers Ltd.*[169], the two former directors were sued for breach of their fiduciary duty to the company. They allegedly gave priority to the preservation of the business and the jobs of the employees including themselves, by accepting the lower offer for selling the company's freehold premises. In the court's opinion, the directors in question were entitled to take the view that if the business was not a task they were required to undertake, they were entitled to choose one of the options open to them, which was a sale that would allow the company to continue or to go into receivership or liquidation.

Therefore, the summons were dismissed on the ground that the directors concerned were not in breach of their duty. Hoffmann J. was also of the view that the directors acted honestly and reasonably, therefore, entitled to be excused from liability under section 727 of the Company Act 1985. In this case, the learned judge did not find the evidence laid by the liquidator before the court sufficient to render the respondents liable within section 212 for misfeasance.

It seems that, although the developments of new insolvency law, as considered by his Lordship, had recognised any reasonable attempt to save the business, account should have been taken of the fact that any attempt is allowed when it is in the best interest of the company, particularly its creditors. In the present case, such an attempt was not effective to save the business. In other words, in taking any step with the view to saving the business, there should be a reasonable possibility of keeping the company surviving, otherwise putting it into liquidation at the first stage seems more justified. Moreover, in that case, the difference between the offer

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168 Ibid at 33.

169 [1990] BCLC 883.

accepted and the nearest one, particularly with regard to the financial distress of the company was, unlike the court's belief, quite high.[170]

In *Re Derek Randall Enterprise Ltd.*,[171] the company went into creditors' voluntary liquidation on 1 October 1985. Between February and May Mr. Randall, a director of the company, received secret commissions totalling £78,000 which he should have accounted to the company, but instead he paid into his personal account. As a result of company's financial difficulties, Mr. Randall decided to guarantee the company's overdraft up to limit of £90, 000, £88. 500 of which was paid by Mr. Randall into the "guarantee account", which was then charged to the bank as security for his liability under guarantee. The bank was authorised to apply the money in discharge of the company's debt, once repayment had been demanded. When in September 1985 the bank called on Mr Randall's guarantee, the money was transferred to the company's account to reduce its overdraft. The liquidator claimed repayment of the £78,000 with interest. In response to the liquidator's application for restitution of the £78,000 under misfeasance proceedings, the director in question contended that the sum of money concerned was a part of the £88, 000 paid into the "guarantee account". In other words, the company received its moneys when it applied to reduce its overdraft. The director, in his affidavit in defence, admitted the relevant facts concerning the commissions, and said that a total sum of £78, 000 had been received by him in respect of such commissions.[172]

Millett J. agreed with the respondent's reasoning and held that 'there is plainly no longer any liability to restore that money to the company.'[173] An appeal from the decision was dismissed.

The court's decision has been challenged on the grounds that; first, the £78, 000 was not the company's property, because the respondent received secret commissions in

170 The freehold property was sold for £110, 000 conditional to taking over the company's workfoce by purchaser, whereas the nearest offer was £125, 000.

171 [1990] BCC 749.

172 Ibid at 750.

173 Ibid at 751.

breach of his duty of loyalty. Secondly, when the company had no proprietary claim, the payment of the money into "guarantee account" could not be considered as restitution. Moreover, the judgment undermines the rule which denies any set off to delinquent director.[174]

The argument challenging the Millett J.'s judgement from view of the settled law rules seems justified. However, some points may clarify the treatment of the law to the matter. The director had a duty to pay the amount of money necessary to fill the 'blocked account' from his own pocket, when it was a guarantee indicating his personal liability for the company's debts. However, he paid the secret commissions as a part of his personal guarantee. Does it mean he returned them to the company's account? If the law regulates that the sums of money for such a guarantee account was to be paid by the person in favour of whom it operated, as it seems so, the answer certainly is negative. Therefore, the company did not receive the money which the respondent obtained in breach of his fiduciary duty, and the court should have ordered the respondent to return it to the company's account.

Whether an allegation of *ultra vires* falls within the ambit of breach of duty of care or breach fiduciary duty depends on the lack or existence of loyalty. The case of *re National Fund Assurance Company*,[175] is a good example of the former situation. In this case, the respondents were guilty of acting *ultra vires* and breach of trust by paying shareholders out of capital. The company had never made any profit and wound up with a deficiency of £100,000.

The liquidator applied for an order to make the directors in question jointly or severally liable for deceiving the public and acting for a dishonest purpose. In the court's belief, the misapplication of the company's property by directors was evident and they were, thus, held liable for breach of trust within section 165 of the Companies Act 1862. The court did not accept the argument that the respondents had acted *bona fide* when, as the court thought, it was impossible in a Court of

174 Oditah, *op cit* at 225.
175 [1878] 10 Ch 118.

Justice to call a particular act *bona fide* simply because a man says that he did not intend to commit a fraud.[176]

The interesting point in this case was the treatment of the concept of breach of trust by the court. It was said to be equivalent to the misapplication of the property,[177] or as deceiving public and acting not for an honest purpose.[178] Such an attitude to the section, unlike the appearance of its provisions, seems consistent with the real intention of the legislators, that any misconduct of this type should fall within the concept of misfeasance.

In *re North Australian Territory Company, Archer's Case*,[179] a similar question arose. But, here, there was an allegation of *mala fide*. In this case, "A" agreed to become a director upon the terms that, if he had at any time desire to part with the shares which he was to take in order to be qualified as a director, the promoter should had purchased them from him at the price which he would pay. All arrangements were done and after the director's resignation, he was paid as agreed and the promoter accepted a transfer of shares.

It was held that the respondent benefited himself from a secret agreement in breach of his fiduciary duty as agent of the company which incurred loss to the company, therefore accountable.[180]

Re Claridge's Patent Asphalte Company Ltd.,[181] is representing the situation where the defendants has acted *Ultra vires* but honestly. The facts of this case were that in order to increase profits, directors decided to embark a new scheme for making tar-macadam roads. For this purpose a subsidiary company, Clarmac Roads Ltd., was promoted in which a Williamson would have one- third of the venture.

Before doing anything, the directors sought the advice of the company's solicitors that whether or not it was *ultra vires*. The solicitors who laid the issue before a well-

176 Ibid at 128.
177 Ibid.
178 Ibid per. Counsel for liquidator at 121
179 [1892] 1 Ch 322.
180 See also *Pearson's Case* [1877] 5 Ch. D. 336, *Hay's Case* [1875] 10 Ch App. 593.
181 [1921] 1 Ch. 543.

known barrister were told that the scheme was not an *ultra vires*, but it would be better if an alteration was made to article 68 (Reserve Fund) so as to enable the directors to apply any reserve to this purposes. In an extraordinary general meeting, the alteration was made and the scheme was approved.[182] As a result, the Clarmac company was registered with a capital of 6500 shares. The parent company, the Claridge company, subscribed £6334 in payment for 4334 shares and 2000 debentures, and Williamson took the remaining shares which was one- third of the debenture. To recover the reserve fund, the Claridge company borrowed the money from its bankers. In 1914 July, when due to war the Clarmac company was in financial difficulty, the Claridge company deposited the 2000/. debentures with the Clarmac company's bankers to secure an overdraft with the belief that the situation would be temporary. However, the Clarmac company went into voluntary liquidation. Consequently, the deposit was swallowed by the overdraft and that amount lost to the Claridge company. Nearly two years later, the Claridge company itself went into compulsory winding up and its liquidator brought an action seeking a declaration that the investment by Allback and the general manager of the 6334 "in taking up the 4334 shares and 2000/. debentures in the Clarmac company was a misfeasance or misapplication of the Claridge's fund."

Astbury J. acknowledged that the promotion of the Clarmac company and investment of its fund in that venture may have been a misapplication of the Claridge company. He, however, said that the respondents acted based on professional advice and there was nothing to show them dishonest.[183] The learned judge went on to say that the defendants did their utmost for the benefit of the *cestui que* trust company but not their own interest. Therefore, he relieved Allback under section 279 of the Companies Act 1908, while there was no sufficient evidence against the general manager.[184]

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182 Ibid at 544.
183 Ibid at 547.
184 Ibid at 549.

With regards to the effects of the case in which there was an honest belief to help the ailing company on one hand, and the legislators' intention reflected in section 279 to relieve a respondent director in such situations from liability on the other hand, justify the judgment of Astbury J. in this case.

3. 4. 3. 2. Negligence

As was already mentioned, the section covers both breach of duty of care and breach of fiduciary duties. This sense is expressed by the misfeasance section when it holds a director "guilty of any breach of fiduciary or other duty in relation to the company."

To determine which acts fall within the ambit of misfeasance, we need to refer to the common law or equity rules reflected in numerous judgments. However, as a principle developed by the courts, there is no doubt that a breach of duty of care and skill or negligence is distinguished from that of fiduciary duty by the element of loyalty.

As we have seen, prior to 1986 legislation, negligence was not clearly specified as a matter within ambit of misfeasance, and in some cases it was recognised as a separate legal concept.[185]

Negligence is one of the oldest concepts of common law. The Act 1986 overcame any doubt as to the inclusion of negligence in misfeasance, though prior to the Act, in some cases the action for negligence was brought under misfeasance proceedings. The earliest case law authority on negligence is *Charitable Corporation v. Sutton,*[186] in which some rules on the matter were established with reference to liability for breach of duty of care as:

> "Directors may be guilty of acts of commission or omission, of malfeasance or non-feasance ... If some persons are guilty of gross non- attendance, and leave the

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185 *Re B. Johnson & Co. (Builders) Ltd*, [1955] 1 Ch 634, 635.
186 [1742] 2 ATK 400.

management entirely to others, they may be guilty by this means of the breaches of trust that are committed by others."[187]

As to the meaning of negligence, different concepts have been suggested such as negligence "as a state of mind which opposes an intentional action, which is done not with the desire of producing a particular result, by carelessness or indifference."[188] The expression negligence is also often used in the sense of careless conduct without reference to any duty being imposed to take care.[189]

The concept with which this study deals refers to breach of duty of care imposed by either common law or statute on corporate directors.

3. 4. 3. 2. 1 Types of negligence

The breach of duty of care might arise from gross negligence, ordinary negligence or even from an inactivity. In discharging his duties a director is required not only to act honestly but he must also exercise some degree of both skill and diligence.[190] In the past, in order to impose liability on a director, the degree of negligence required was to be "culpable" or "gross negligence",[191] and the respondent was to be held liable only for gross negligence but not ordinary one. The difference between those types of negligence was remarked in *re Brazilian Rubber Plantations & Estates Limited*,[192] as follows:

"It has been laid down that so long as they act honestly they can not be made responsible in damages unless guilty of gross negligence[193]..... In truth , one can not say a man has been guilty of negligence, gross or otherwise, unless one can determine what is the extent of the duty which he is alleged to have neglected.[194] Breach of trust, I think, is mentioned to include breach of duty."[195]

187 Ibid at 405 per Lord Hardwicke.
188 Charleston & Percy Charleston & Percy on Negligence, (London, Sweet & Maxwell Ltd. 8th ed. 1990) 3.
189 Ibid at 5.
190 *re City Equitable Fire Insurance Co.* [1925] 1 Ch. 407, 427.
191 *Turquand v. Marshall* [1869] 4 Ch App. 376, *re National Bank of Wales Ltd.* [1890] 2 Ch 629, 671.
192 [1911] 1 Ch 425.
193 Ibid at 436 per. Neville J..
194 Ibid at 437.
195 Ibid at 440.

However, the negligence whether ordinary or gross is submitted as incurring some loss, as was stated in *Bentinck v. Benn*:[196]

> "Misfeasance under the section must be misfeasance in the nature of a breach of trust resulting in a loss to the company."[197]

In *re County Marine Insurance Company, Rance's Case*[198] Lord Justice James held the respondents liable because" there was a gross neglect of duty on the part of directors."

In view of some judges distinguishing between those sorts of negligence seems to be playing with words rather than a distinction with a legal effect as Baron Rolfe J. pointed out in *Wilson v. Brett*:[199]

> "I could see no difference between negligence and gross negligence. That it was the same thing, with the addition of a vituperative epithet."[200]

Such a requirement as gross negligence, was justifiable when directors were, mainly, part time and without particular expertise. Therefore, the courts were reluctant to impose upon them a high test of care and skill. Moreover, some courts were of the view that since shareholders appointed the amateur directors to pay less for them, they must have born the consequences and risk of their own appointment.[201] This opinion received some criticisms on the ground that shareholders are not the only sector may suffer from a depression of the company. Other groups including creditors, employees and the society as a whole would be affected as a result of insolvency.

In determining the extent of the duty allegedly have been neglected, the courts have been faced with some difficulties. In *re City Equitable Fire Insurance Co.* Romer J. confessed that he had difficulty in understanding the difference between those two types of negligence, except when they were used for the purpose of distinguishing

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196 [1887] 12 App. Cas. 652, 669.
197 See also *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd. and Others:* [1983] BCLC 461, 481 Per May J.
198 [1870] 6 Ch. App. 104, 119.
199 [1843] 11 M & W 113.
200 Ibid at 115.
201 *Turquand v. Marshall* [1869] 4 Ch App. 376 Per Hartherly at 386.

between two kinds of duties in two separate situations. It seems that the distinction between ordinary negligence and gross negligence is subjected to the degree of diligence shown by a director rather than in type of the duty omitted or breached.

The developments of business relations and the tendency of the legislators which is reflected in section 214 of the Insolvency Act 1986 reveals a newly recognised rule that a director may be liable for negligence irrespective of that distinction.

3. 4. 3. 2. 2 Situations giving rise to a negligence action

It is difficult to identify all situations giving rise to a liability for negligence. Any commission or omission in breach of duty of care even an inactivity may lead to liability. Over two and half centuries, the history of case law on negligence shows a wide discretion exercised by the courts in determining the matter.

The question may arise that whether can a director be liable for negligence resulting from a misstatement made honestly? Prior to 1964, as a general rule, such a possibility had not been recognised. In *re National Bank of Wales,*[202] this sense was stated as:

> "A director does not warrant the truth of his statements; he is not an insurer. But if he makes misstatements to his shareholder he is liable for the consequences, unless he can shew that he made them honestly, believing them to be true, and took such care to ascertain the truth as was reasonable at the time."[203]

Here, obviously a director is not to be held liable if he made a misstatement unintentionally and honestly, but with a "reasonable" care "at the time". The last condition may imply liability for making such a misstatement only for gross but not ordinary negligence.

In *Heskell v. Continental Express Ltd.*[204] this rule was clarified. In that case, it was expressed that 'negligent misstatement can never give rise to a cause of action.'[205]

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202 [1899] 2 Ch. 629.
203 Ibid at 675.
204 [1950] 1 All E. R. 1033.
205 Ibid at 1042 per Mr. Justice Devlin.

For the first time in *Hedley Byrne v. Heller,*[206] an important exception was established to the rule for persons occupying a contractual or fiduciary position, e. g. corporate directors. In this case, it was unanimously agreed upon that any misrepresentation, whether written or spoken, even made honestly could result in liability for its maker, provided it could be proved that the person in question had assumed responsibility for his information or advice. It seems the special relationship was intended to mean a contractual or fiduciary relationship. Finally, in the court's view, in order to hold the director liable, the existence of loss to the company was required.

The refusal or failure to purchase and maintain some required shares qualification has been taken into account by the courts as a breach of duty and a ground for misfeasance. In *Coventry and Dixon's case,*[207] for example, two directors of the company failed to satisfy an article of the company by which they were required to hold a hundred shares as 'qualification shares'. There was no claim of misfeasance. However, as soon as the company became wound up, the liquidator sought an order to render them liable for misfeasance in acting as directors to contribute to the company's assets the value of those shares, or to contribute such other sums by the way of compensation as the court would think just.

In this case, although the Court of First Instance did not doubt to hold the respondents liable to contribute to the assets of the company as requested by the liquidator, this judgement was unanimously reversed by the Court of Appeal, when in the view of the Appeal's judges no loss was incurred by the conduct of the respondents.

The Court of Appeal took a measure for its judgement which was whether the company had lost anything through the respondents' conduct. In the court's opinion, there must have been some act resulting in some actual loss to the company. In the finding of the court, nominating and acting as director in violation of the articles

206 [1964] A. C. 465.
207 [1880] 14 Ch. D 660.

without proper qualification did not make the appellants liable for misfeasance when their conduct was in a manner as if they had duly been appointed as directors with qualification shares.[208]

The decision of the Court of Appeal, here, seems challengable from some aspects. First, the qualification shares required by a company articles usually aimed at persuading directors to manage the business and to guarantee their conduct in the best interest of the company. The interest of the directors in the company's running reflected in such qualification shares may prevent them of taking risky steps, particularly in the case of financial difficulty. Secondly, the statement of James J. of the Appeal Court that the respondents could not be held liable for misfeasance because such requirement was not provided by law, is not respectfully justified. The learned judge did not think that since the contents of a company's articles are not in contrary to the settled law rules or public policy, they had effect as the law, nor did he believe that by accepting the articles of the company, the respondents were bound by an implied contract to fulfil some expressed or implied duties including holding the required number of shares.

In the old case law, an inactivity or non- attendance was not a breach of duty of care. The second proposition introduced by Romer J. in *re City Equitable Fire Insurance Co.*[209] represents such an approach. Here, the entrusted powers by his fellows to a managing director were abused for fraudulent purposes. The director in question had entered figures in Balance Sheet as 'cash in hand' and 'loans in calls' which were principally loan to himself and the cash substantially included £73,000 in a firm of stockbrokers, of which he was a partner. The co- directors were held negligent, but they were excused under the Articles of Association intended to protect them. In that case, the non- attendance of a director to the board meetings was not taken as a breach of his duty of care because he had difficulty to attend the board meeting in London while he was living in Aberdeen.

208 Ibid at 670.
209 [1925] 1 Ch. 407.

In *re Cardiff Savings Bank Marquis of Bute's Case,*[210] although the president of the bank attended only one board meeting within 38 years, the court did not hold him liable for breach of his duty of care, when in the court's point of view the non-attendance was not the same as the neglect or omission of duties which ought to have been fulfilled.

However, the attitude of the court in the earliest case of *Charitable Corporation v. Sutton*[211] on negligence is different. In this case, forty five out of fifty directors were held liable for gross negligence because they left the affairs of the company to five of their fellows and the latter caused the company to lose a great deal of money.

3. 4. 4 General Conclusion on Misfeasance

The discussion of misfeasance has an appearance of complexity. It has been described as a procedural summons without creating a new right or liability, and a mode of recovery or collection of the pre- existing rights.

As was already discussed, the improperly drafted provisions on misfeasance could reveal a misleading conclusion. There is no statutory provision as misfeasance, but misfeasance has been included in the section as an act among others and under different headings.

One doubts of proper applicability of misfeasance to all those acts set out in section 212 and look for a new title for the section. Does such enactment show the doubt of legislature of suitability of the expression "misfeasance" for the purposes of the section? If so, is not it time to seek for a more comprehensive heading to cover the acts and matters mentioned in the section including misfeasance itself? If not, the section should be properly redrafted under misfeasance.

Although the nature of the section has been described as having a purely compensatory nature, the account should be taken of the liability provided in section

210 [1892] 2 Ch. 100.
211 [1742] 2 ATK 400.

9 of the Company Director Disqualification Act 1986 which prohibits the respondent, for a while, from being involved in the management of a company.

3. 5 Conclusion

In analysing liability provisions, one may examine them severally or together as a collective measurement of a legal system. Each concept of those we have so far studied has its own advantages and weaknesses, which can be elicited more clearly in comparison with the others.

Since 1928 until 1986 when the new Companies Act came into force, the courts have been faced by some difficulties in determining fraudulent trading cases. The provisions of fraudulent trading from time to time had created a civil liability and a criminal offence which had the same constituent elements. The cases show the courts' reluctance to attribute a civil liability in the absence of dishonesty and their insistence on a high standard of proof for dishonesty.

There is a small number or no prosecutions each year for fraudulent trading not all of them successful. The most difficulty which has barred the development of the law in this respect has been recognised as "strictness of standard of proof" of the crime. This problem seemed so disappointing to some legal writers that they suggested the removal of the section from company law.[212]

Although the problem has been solved by introducing the new sanction as 'wrongful trading', regarding the provisions of fraudulent trading as something more than a legal instrument is not a legal attitude. Fraudulent trading section has played an effective role in the nearly last seventy years and it is difficult to assess how high was the rate of delinquency by companies directors, if this sanction would never have been introduced.

[212] Allderidge, *op cit.*

On the other hand and in comparison with wrongful trading, misfeasance is not attractive to an insolvency practitioner, particularly when the grounds for wrongful trading overlap with those of a misfeasance proceedings.[213] Therefore, when wrongful trading proceedings is available, misfeasance is not a recommended way of recovery. The subjective requirement for a misfeasance action does not persuade a liquidator to pursue the company's assets through it. Such a test may not be difficult to be proven in the case of retention of the property of the company, whereas in other cases of misfeasance it is for the applicant to show the respondent's misconduct, for which he is required to rely upon the traditional common law subjective standard of proof.

The other feature of a misfeasance proceedings which desuades an applicant in pursuing the assets of the company through it, is availability of the relief under section 272. The attitude of the courts to the application of such relief so far has been hope- giving to the applicant directors and consequently, disappointing for the applicant for a misfeasance action. As a result, if an applicant for an action for misfeasance can define his action within the concept of wrongful trading, he will most likely drop misfeasance action.

The only interesting point in misfeasance proceedings, if compared with wrongful trading, is its wide range of various plaintiffs. A creditor, official receiver, liquidator or a contributory, with the leave of court, have power to bring a misfeasance action.

In return, there are some criticisms on the wrongful trading section; the seriously complex position of a floating charge and its effects on a contribution recovered challenges the purpose of the provisions; the ambiguity of some concepts such as 'every step' which reduces the effectiveness of the provisions, are problems which have weakened, and in the future decision- making will affect such effectiveness. One asks how a director of a troubled company can make sure he has taken all step necessary as required by the expression "every step".

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213 Sally Wheeler, "Swelling the Assets for Distribution in the Corporate Insolvency", JBL (1993) 259.

Misfeasance has a very old case law background, whereas the file record of commentary work by commentators is sadly poor. It is true, particularly in comparison with other proceedings of the directors liabilities, and more particularly with regard to number of misfeasance cases brought before the courts which is considerably high. Such reluctance or disinterest of English legal writers to discuss the subject might be a result of influence of the belief that misfeasance is only a procedure of recovery which does create no new right or liability.

It is not justified to suspect whether those liability provisions are useful, neither is it acceptable to claim one of them should be abolished as suggested by Allderidge,[214] only because it involves some weakness, nor am I prepared to agree with Cooke who claims that the wrongful trading provisions has abolished limited liability principle.[215]

Who can doubt on the fact that how greatly these liability provisions been effective in regulating and correcting the conduct of corporate directors, specially those directly or indirectly, as shadow director, involve in corporate management with the intention to defraud its creditors particularly the public as whole.

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[214] Allderidge, *op cit*.
[215] Cooke, *op cit* at 118.

Chapter 4: Disqualification of Directors

4. 1 Introduction

Under Section 34 of the Road Traffic Offenders Act 1988[1] a driver must be disqualified if he commits some types of driving offences. Such a punishment in the public's as well as justice's eyes seems not only just but also it appears to be necessary to prevent other drivers from endangering people's lives and threatening the public peace.

The purpose of this chapter is to consider the reasons why disqualifying a driver for his dangerous or reckless driving, which may incur loss to others or in its worst possibility claiming a life, is acceptable, but the imposition of the same penalty on a company directors who drive the corporation into destruction, leave tens, or hundreds unemployed with the disastrous effects on their family, cause losses to its creditors as well as members under the privilege of limited liability is not fair.

In scrutinising directors' duties and liabilities, particularly in the event of insolvent liquidation, having a detailed discussion on the different aspects of disqualification of company directors is necessary. That is because a breach of duty or misconduct gives rise to liability and in many cases leads to the imposition of a disqualification order. Section 10 of the Company Directors Disqualification Act 1986[2] shows a close link between disqualification and these liabilities.

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[1] The section provides that:
"Where a person is convicted of an offence involving obligatory disqualification, the court must order him to be disqualified for such period not less than twelve months as the court thinks fit unless the court for special reasons thinks fit to order him to be disqualified for a shorter period or not to order him to be disqualified"

[2] Thereafter any reference to the Company Directors Disqualification Act 1986 is shortened as the 1986 Act.

Although this power to disqualify operating as a punitive, prohibitive or protective device, is a new concept, it has found a special room among other legal instruments and concepts as to directors liabilities and has played an effective, though sometimes controversial role in company law, particularly in corporate management relationships. Consequently, it is necessary to survey the issue in detail.

A disqualification is to be imposed upon a director even if he has not committed an active wrongdoing, but he has failed to demonstrate the standard of skill and care reasonably expected of him, or to perform his functions for which he was appointed to fulfil.[3]

In this chapter, some primary features of disqualification such as the background, nature and aim of disqualification will be studied. Grounds for making a disqualification order, including unfitness under section 6, wrongful or fraudulent trading are examined.

After discussing how to relieve a disqualified director of the harshness of a disqualification order, I will consider the effects of such an order.

Finally, I will evaluate the discussion on disqualification in the conclusion.

4. 2 Background

In order to prevent directors from committing a misconduct or breach of duty by abusing the privilege of limited liability, the legislature felt it was necessary to provide a new instrument with a more prohibitive effects. This necessity was explained by Nourse J in *re Civica Investments Ltd.*:[4]

> "The power of disqualification by the companies courts was evidently introduced in order to add a new and more effective sanction to the powers to impose fines which have for many years been possessed by courts of summary jurisdiction."[5]

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[3] Schedule 1 and section 6 of the Company Directors Disqualification Act 1986.

[4] [1983] BCLC 456.

[5] Ibid at 457.

The idea of using such a legal instrument as disqualification was for the first time discussed by the Departmental Committee on the Companies Act 1925 and introduced by the Companies Act 1928. Section 75 (4) of the Act provided that in the case of fraudulent trading, the court had power to order the director in question, without the leave of court, not to be a director or in any way be concerned or take part in company management for a period not exceeding five years.

Disqualification as a formula was subsequently reintroduced in the Companies Act 1929. However, the scope of disqualification was considerably widened by this Act. Under this legislation, not only the provisions stated in its predecessor precisely restated in section 275, but also the previous provisions were extended to embrace any fraud committed to the company in its formation or promotion since its formation.[6] It is worth noting that the Act applied to the company directors as well as any legal person by the expression of "a person". This expression was used in the 1929 Act in order to cover not only natural persons, but also legal persons, e.g. companies which were appointed as directors of other companies. However, the first cases brought before the courts in 1920's were those of undischarged bankrupts and personal insolvent who mismanaged companies.

The Companies Act 1948, in section 187 dealt with undischarged bankrupts acting as directors and with persons who had been involved in company management. The Act in section 188(a) prescribed disqualification following a conviction in connection with the promotion, formation and management of a company. It also empowered the court to make a disqualification order if in the case of winding up it appeared to it that a person was guilty of fraudulent trading, whether convicted or not, or of an offence in relation to the company or guilty of any breach of duty.[7] The use of expression "any breach of his duty to the company" seems a significant development in the Companies Act 1948.

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[6] Section 217.

[7] Section 188(b).

The Insolvency Act 1976 provided that the court may disqualify a person if he had been a director of two companies which have successively gone into insolvent liquidation within five years,[8] and his conduct as a director of those companies made him unfit to be concerned in the management of a company.[9] Under section 28(1) of CA Act 1976, the court also had power to disqualify a person for "persistent default". Under this new concept, the court was empowered to make a disqualification order if a director had been persistently in breach of the companies legislation requiring any return, account, or other document to be filed with, sent, or notice to be given to the registrar of companies.

Some points seem to be noticeable in the Insolvency Act 1976; first, the requirements for making a disqualification order were provided in a more logical order than the previous Companies Acts; secondly, a new requirement which was two successive insolvencies within five years should have been satisfied; and most importantly the requirement that the conduct of director to show him unfit to be concerned in a company management was a basic development in the legislation.

Section 93 of the Companies Act 1981 widened the scope of section 28 of the 1976 Companies Act to prohibit directors concerned from acting as liquidators, receivers and managers of a company's property. Those provisions were consolidated in the Companies Act 1985 section 300 which was the predecessor of section 6 of the Company Directors Disqualification Act 1986. Moreover the time period of disqualification which previously did not exceed five years, was, except in the case of persistent defaults, increased to fifteen years.

The enactments of 1986, taken together, reflected the major changes introduced as a result of the Cork Committee Report, more particularly the Company Directors Disqualification Act 1986 should, rightly, be described as a revolutionary development in the evolution of company law on the matter.

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8 Section 9 (a).

9 Ibid at (b).

Under section 6 of the Act 1986, the court has a duty to make a disqualification order where satisfied; that (a) the person is or has been a director of a company which has at any time become insolvent, (b) his conduct as a director of that company makes him unfit to be concerned in the management of a company.

In determining a disqualification, account should be taken of some general factors including breach of duty owed by director to the company, and misapplication of the company assets.[10] In the case of insolvency, the court is also directed to consider some further maters, including the extent of director's responsibility for the insolvency and for the failure of the company to supply goods which have already been paid for, or any involvement with any preference invalid in the court's view and failure to comply with the duties imposed on a director by the Insolvency Act 1986 during the course of insolvency proceedings.[11].

The Secretary of State will apply or may direct an application to be made by the official receiver for a disqualification order.[12]

4. 3 Nature and Aim of Disqualification

At first glimpse, the materials used and the cases referred to in the discussion of aim and nature of disqualification seem to be implying the same thing in different ways or looking at the same point from different views, thus, meaning that dividing them into two separate issues, is unnecessary and fruitless. Perhaps, this is the reason for not making a distinction between the nature and aim of disqualification by some such commentators as Dine. However, she acknowledged the fact that a "considerable confusion exists in determining the nature of this legislation and its proper use."[13]

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[10] Part 1 of Schedule 1 of the Company Directors Disqualification Act 1986.
[11] Ibid Part 2.
[12] Section 7 of the Company Directors Disqualification Act 1986.
[13] Dine Janet Wrongful Trading- Quasi- Criminal Law? (ed. Harry Rajak) Insolvency Law & Practice, (Sweet & Maxwell 1993) 174.

Given those two subjects are built on some similar materials, or even the same grounds, the results sought are basically different. In other words, the nature of disqualification deals with the substance and true nature of the matter, the question which may, therefore, arise is from which view disqualification should be looked at. Whereas the aim of disqualification dealing with the purpose of the subject looks at the end of the tunnel, and the approach is to find out the conclusion which is intended to be achieved. However, a circular relationship between the two concepts is obvious.

4. 3. 1 Nature of Disqualification

The determination of the nature of disqualification may help to identify the consequences and effects of such an order particularly on the disqualified person.

Although a clear classification of the nature of disqualification has not been introduced, some different classifications may be proposed. It has been suggested that to determine its true nature many different aspects shown by proceedings must be examined. For example, if the proceedings have some similarity to criminal cases, some features important in criminal cases are evident.[14]

As regards the judgments made on the matter, two opinions as well as a third doctrine with a hybrid feature can be distinguished. The first approach describes the imposition of a disqualification order as a penal sanction with punitive effects,[15] precluding a disqualified person from participating in an important part of his livelihood, namely from being involved in the management of a company in any way. In brief, such an order limits the freedom of the disqualified person which is a punitive punishment. Vinelott J. in *re Stanford Services*,[16] regarded disqualification

[14] Janet Dine, "The Disqualification of Company Directors", 9 Co. Law. (1988) 213.

[15] Kewin Wardman, "Directors, Their Duty to Exercise Care and Skill: Do the Provisions of the Company Directors Disqualification Act 1986 Provide a Basis for the Establishment of a More Objective Standard?" Bus. Law Rev., (1994) 71, 72.

[16] [1978] BCLC 607, 620.

as a penalty for breach of duty, and recognised the public interest as a significant element for such penalty.

The second approach looks at disqualification as a sanction with a protective or civil substance. In *re Churchill Hotel (Plymouth) Ltd. and Others*[17] Peter Gibson J. in response to the argument of counsel for the respondent that the proceedings for disqualification were quasi- criminal proceedings with very serious consequences for the respondent, rejected the quasi- criminal nature of proceedings and stated that 'these are civil, not criminal proceedings'.[18]

In the leading case of *re Lo- Line Electric Motors Ltd.*[19] Sir Nicolas Brown-Wilkinson V. C. after making a full statement of the facts, particularly the purpose of the legislation as protective, concluded that 'since the making of disqualification order involves penal consequences for the director, it is necessary that he should know the substance of the charges that he has to meet'. In this statement although there is a gesture to penal consequences of a disqualification order, other facts and indications[20] in the judgment show a trend to the protective doctrine.

Under third approach disqualification is described as a quasi-criminal. In *re Crestjoy Products Ltd,*[21] Harman J. with reference to other judgments in such cases as *re Lo-Line Electric Motors Ltd.*[22] stated that section 6 'has been described by many judges as not intended purely as a penal section'. Restating the judgment of Sir Nicolas Browne- Wilkinson V. C in the latter case as his own view, his Lordship went on to make a comparison between section 6 of the Company Directors Disqualification Act 1986 and its predecessor, section 300 of the Companies Act 1985. Harman J. described the proceedings under section 6 as very serious, whereas these under the

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17 [1988] BCLC 342.
18 Ibid at 344.
19 [1988] BCLC 698.
20 For such indications see the statement of Sir Nicolas Browne- Wilkinson V. C. in the same case on the aim of disqualification.
21 (*Secretary of State v Godard and others*) [1990] BCC 23.
22 [1988] BCLC 698.

former were not penal, because they, in the judge's point of view, in no way prevented a man from trading. The learned judge concluded that:

> "when I am faced with a mandatory two- year disqualification, if facts are proved, the matter becomes more nearly penal, or at least, for the individuals faced with it than under the former situation where a judge could, in the exercise of his discretion, say that although the conduct had been bad yet he was now convinced that a disqualification should not be made because, for example, the respondent had learnt his lesson".

Here, although the application made by Secretary of State was dismissed, because it was beyond the time limit, the facts of the case and comments posed in the judgment, are very helpful in determining the nature of disqualification.

With regard to all the afore-mentioned opinions, the results of discussion can be as follows: Since disqualification has been adopted as a legal sanction, the tendency seems have been in favour of the theory of disqualification having a penal nature. Nowadays there is, among legal writers, an increasing trend to introduce the protective principle as an alternative for its rival.[23] However, there are some obvious indications challenging this tendency. The attitude of the legislature by laying down such harsh provisions as section 6 and schedule 1 of the Company Directors Disqualification Act 1986 with a mandatory character, has disappointed the supporters of the civil doctrine.

The distinction made by Harman J. in *re Crestjoy Products Ltd,*[24] between section 6 of the Act 1986 and section 300 of the Companies Act 1985 is justified upon the basis that the proceedings under the former are penal or nearly penal whereas under section 300 have no such effect when in no way it prevented a man of trading.[25]

Furthermore, the immediate consequence of a disqualification order is to prohibit the respondent from being involved in a particular part of his business life which is an

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[23] See for example Andrew Hicks, "Disqualification of Directors- Forty Years on", JBL, (1988) 27, 29. [Thereafter Hicks, JBL, (1988)], Charles Drake, "Disqualification of Director The Red- Card", JBL (1989) 474, 479.

[24] (*Secretary of State v Godard and others*) [1990] BCC 23.

[25] Ibid at 26.

obvious limitation on his individual freedom. There is no doubt as to the punitive nature of such harsh limitation.

4. 3. 2 Aim of Disqualification

As it was mentioned in the last discussion, there is an immediate and circular relationship between aim and nature of disqualification. Therefore, we formulate the aim of disqualification based on classification of its nature. However, we propose a third view with a different meaning as civil not equal to protective.

For the aim of disqualification two views as the nature of disqualification as either punitive or civil have been suggested. According to the protective theory, the aim of disqualification is to protect creditors and the public from the misdoing of reckless or dishonest directors. Parliamentary papers, particularly the Cork Committee Report stated that the policy of disqualification to protect the public interest from dishonest, and incompetent directors was the primary aim of disqualification.

It has been argued that where disqualification has a punitive and deterrent effect, its primary purpose is protective, which removes an offending person from the sphere of corporate direction and management.[26] The courts have often recognised that the purpose of disqualification provisions is to protect the public, but not to punish directors. In *re Lo- Line Electric Motors Ltd.*[27] Sir Nicolas Browne- Wilkinson V. C. stated the theory in a clear statement:

> "The primary purpose of the section is not to punish the individuals but to protect the public against the future conduct of companies by persons whose past records as directors of insolvent companies have shown them to be a danger to creditors and others. Therefore the power is not fundamentally penal...."

In *re Rolus Properties Ltd,*[28] Harman J. pointed out that "the legislation was not primarily punitive; it was for the protection of the public against inadequate, dishonest or otherwise unfit persons being directors of companies."

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26 Hicks *op cit* at 29.
27 [1988] 1 Ch 477.
28- [1988] 4 BCC 446.

On the other hand, the punitive theory of the aim of disqualification interprets the purpose of disqualification as a penal sanction or a means to punish delinquent directors and prohibit them from acting as directors or being involved in the management of a company in any way.

The purpose of a disqualification is described by Wheeler as not a private issue such as the recovery of money, that is the reason for the DTI involvement as upholders of the public interest.[29] He is of the view that disqualification should be decided on the basis of a penal principle which takes into account the culpability of the director in question.[30] Another commentator although accepting that disqualification is more concerned as a technique not to punish directors but to protect the public, thought it was more draconian than a fine and even imprisonment.[31]

Dine in her earlier article took the view that "the imposition of a disqualification has decidedly criminal overtones," from which no compensation results.[32] However, she seems to have somehow changed the view in her latest comments, where she states that the disqualification provisions are of both criminal and protective use, and adds that the judges are not in agreement over the point that disqualification is a significant interference with the liberty of the individual.[33]

In *re Sevenoaks Stationers (Retail) Ltd.*[34] where Dillon J. obviously accepted the idea of disqualification within protective purpose saying "it is beyond doubt that the purpose of section 6 is to protect the public and in particular potential creditors from losing moneys through companies becoming insolvent ...", some problems are said[35] to have arisen for supporters of this doctrine. According to the Companies Acts, the accounting obligations are imposed on the company and all directors equally, whereas in this case one of directors involved, H, was held disqualified for three

29 Sally Wheeler, Disqualification of Directors: A Broader View (ed. Rajak) 195.
30 Ibid at 175.
31 Drake *op cit* at 474.
32 Janet Dine, "Disqualification Orders", 9 Co. Law. (1988) 97, 98.
33 Janet Dine, Wrongful Trading- Quasi- Criminal Law? (ed. H. Rajak) 173- 74.
34 [1990] BCC 765.
35 Sally Wheeler, "Re Sevenoaks- Continuing the Search for Principle", 6 I. L. & Practice (1990) 174, 175.

years, two years shorter than the appellant. It was because his financial awareness was not at the same level as the latter's and that the appellant, C, was more experienced than H, and had some accountancy training. As taking account of such matters as mitigating factors can be found only in criminal cases rather than civil, this attitude was in compliance with the penal rather than protective theory. The second problem was the function of some mitigating factors. In the view of both the court of first instance and the Court of Appeal, the absence of personal gain and the loss of the respondent's own money was considered as a main mitigating factor, which is again in compliance with the penal but not protective purpose of disqualification.[36]

The facts considered in the study of the aim of disqualification can lead to the following conclusions.

i) In the discussion of both the aim and nature of disqualification the protective approach has been used as the main theory opposing the punitive view. However, it seems, a very important point which has never, in any context, whether proposal drafts, parliamentary papers, or legal writings and cases been discussed, is the assessment of the validity of the use of "protective" in the sense of civil or as opponent for the "punitive" or criminal concept. By the protective concept, disqualification is intended to protect creditors, public interests or others who may be affected by the result of reckless, dishonest or even incompetent conduct of directors. Can not it imply a prohibition not precisely in the punitive sense nor in the civil one, but as a third sense through which the protection of the company's creditors, its members, and the public interests is aimed to be achieved?

In order to clarify the point, it is appropriate to consider the imposition of a disqualification order on a driver in which the law may not intend to punish him for his improper conduct committed in driving, nor is it obviously intended by such prohibition to recover any remedy or compensation. The most likely possibility is a protective consideration on the basis of which, the legislators' intention was neither

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36 Ibid.

to punish the driver concerned, nor was it to compensate a victim, but to protect the public by removing such reckless persons from the road. In the result, protective view theory may be classified as a third principle different from those of punitive and compensatory.

ii) In reply to the criticism that the legislation has not satisfied the expectations of protecting creditors or investors,[37] and in response to the question of whether disqualification of a delinquent director has achieved its aim to protect the public interest, or on the basis of the punitive theory, to punish misdoer directors, it should be said that disqualification is a efficient sanction added to others in public interest.[38] Moreover, having a survey on the process of 20 years decision- making on corporate insolvency, and a comparison between the growth rate of number of corporate insolvency cases and that of individuals, figure 1, shows an increase in corporate insolvency cases from 4,000 in 1974 to 20, 825 in 1993, and within the same period, the individual insolvency cases shows an startling increase from 6, 000 to 36, 000. Whereas, the number of cases leading to corporate insolvency had a considerable drop from 14, 000 in 1986 to 12, 000 in 1987 and 10, 000 in 1988. The latter development took place at the time when the new legislation, particularly section 6 came into practice.[39]

* Right side columns company insolvencies

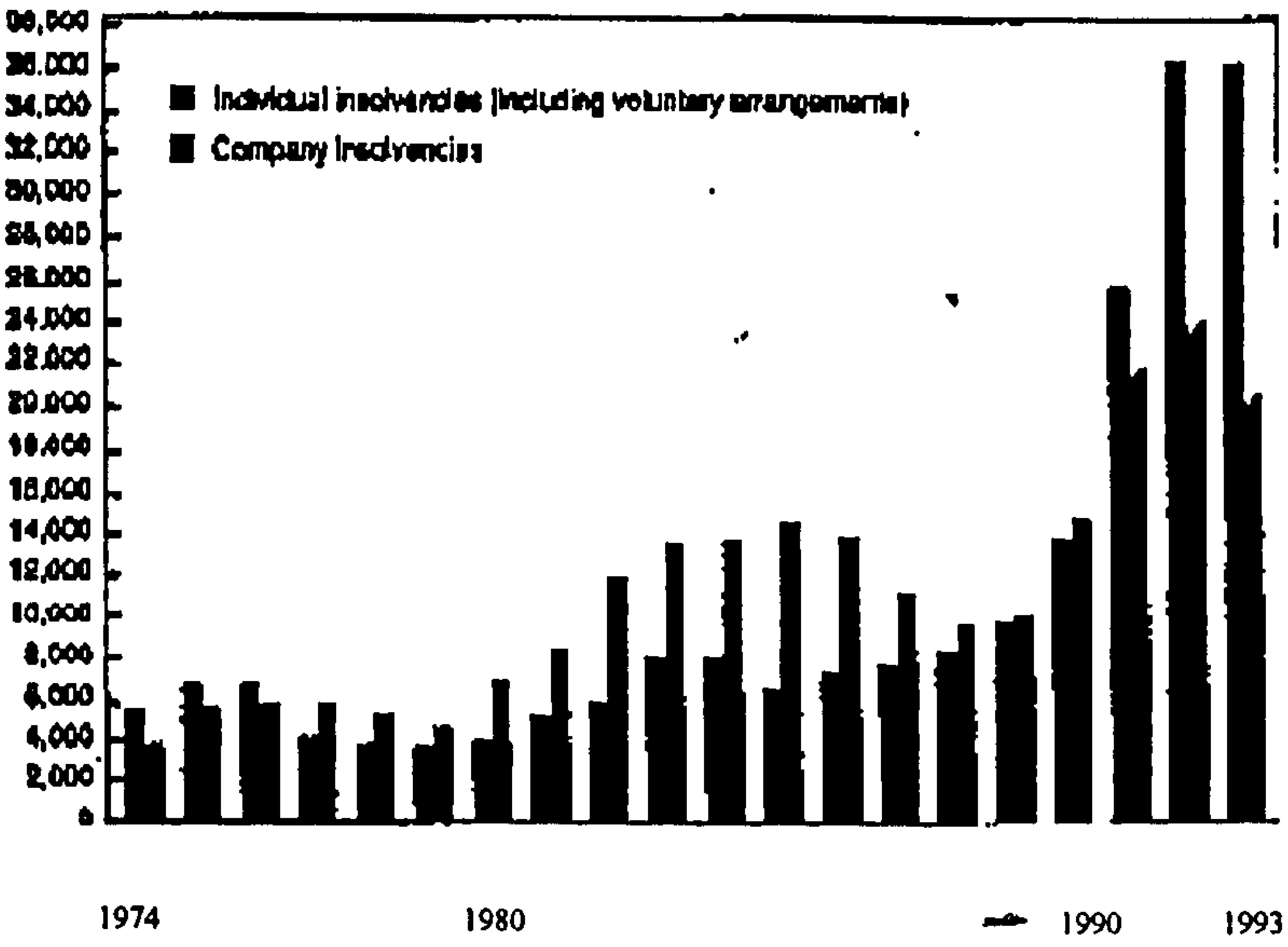
* Left side columns Individuals Insolvencies

Table 1: Level of Insolvency in 20 years 1974 to 1993

37 Vanessa Finch, "Disqualification of Directors: A Plea for Competence", 53 MLR (1990) 385.

38 Such a meaning is implied in the words of Nourse J in *re Civica Investments Ltd.* [1983] BCLC 456, 457.

39 Information extracted from the General Annual Report for 1993 on Insolvency Presented by the Insolvency Service of the Department of the Trade and Industry.



4. 4 Applying for a Disqualification Order

An application for a disqualification order is brought either by the Secretary of State or, in the case of compulsory liquidation if the Secretary of State directs, it may be brought by the Official Receiver.[40]

This rule is strictly applied by the courts. A court shall strike out proceedings if the application for a disqualification order is not brought by one of those authorities. In *re Probe Data Systems* (No. 1)[41] Miller J. refused to allow an application by the Secretary of State for leave to amend an originating summons for disqualification, because the summons had been brought in error by the Official Receiver. That was because the company was in creditors' voluntary liquidation, but not compulsory winding up. The reason on which the learned judge based his decision was that the mistake for which an amendment could be adopted had to be a genuine one as to the name or identity of the actual party, whereas in the present case, he believed, it was a mistake of law as to who had a cause of action.

The legislators refused to allow such an action be brought by a private party. In discussing the white paper and in reaction to the question whether to authorise not only a liquidator but also creditors and other interested parties to apply for a

40 Section 7 of the Company Directors Disqualification Act 1986.
41 [1989] BCLC 561.

disqualification order, it was said that the proceedings were a matter of public interest which should have been separated from private or personal emotions or interest.[42]

Once a company falls in insolvency, a report by an insolvency practitioner is to be made to the Department of Trade and Industry containing the practitioner's findings of the company's situation. The insolvency practitioner swears an affidavit, and if the company is in compulsory winding up, the Official Receiver as the liquidator is required to make a report containing such matters as accounting records, company's minutes and any statement helpful in discovering its directors' conduct.

According to section 7(2), an application seeking such an order shall not be made after the end of the period of 2 years beginning with the day on which the company of which that person is or has been a director became insolvent, except with leave of the court. In *re Copecrest*,[43] an extension of time under section 7 (2) was granted, because in the court's view the delay was caused by the directors in their dealings with the insolvency practitioners and this delayed the reports of their conduct to the Secretary of State.

The words and language of section 7(2) seems clear and simple, but the courts in practice have faced some difficulties in this respect.

Some courts in granting the leave specified in the above section, relate their decision in this regard to the degree of possibility of getting the respondent disqualified. For example, in *re Polly Peck International Plc (No. 2)*,[44] the Secretary of State sought leave under section 7(2) to bring proceedings for a disqualification order against four directors of PPI under section 6. The first question which the court was to answer was whether it could extend the time when there was a delay.

In the court's view, even before determining the extension of time, it should have been decided whether there was enough chance to have a successful case of

42 Sally Wheeler, Disqualification of Directors: A Broader View, (ed. Rajak) 195.
43 (*Secretary of State for Trade & Industry v. McTighe & Another*) [1994] 2 BCLC 284.
44 (*Secretary of State for Trade & Industry v. Ellis & Others*) [1994] 1 BCLC 574.

disqualification. In other words, the issue of the extension of time was subjected to the strength of the case for disqualification. After examining the evidence against the defendants, the court was not satisfied that the case could result in a disqualification order. Therefore, the court did not think necessary to grant the leave sought by the Secretary of State.

The crucial point for a court to decide whether an application is out of time, is to determine the point from which the company became insolvent. Obviously, the definition of insolvency is a significant point in order to determine the period of two years. The authority defining the meaning of insolvency for this purposes is section 6 of the 1986 Act, which defines insolvency as:

> "(2) For the purposes of this section and the next, a company becomes insolvent if-
>
> (a) the company goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up,
>
> (b) an administration order is made in relation to the company,
>
> (c) an administrative receiver of the company is appointed

The language employed in that subsection particularly parts (b) and (c), as acknowledged by Sealy,[45] reveals that the meaning of insolvency intended in the section is not necessarily insolvency in a business sense, but an artificial one. Now, the important point is to determine the event with which the two- year time begins running. In *re Tasbian Ltd.*[46] the Official Receiver brought an appeal against the registrar's decision that an application for a disqualification order was out of time. The Official Receiver had sought an order against the defendant on 8 November 1988, since an administrative receiver was appointed on 24 September 1986, and a winding up order was made on 10 November 1986.

In the present case, to determine the insolvency, two factors existed; the time of winding up order and the appointment of an administrative receiver. The registrar had based his decision upon the second factor.

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[45] L. S. Sealy, Disqualification and Personal Liability of Directors, (Oxfordshire: CCH Editions Limited 1993) 27.

[46] [1989] 5 BCC 729.

In response, the Official Receiver said that the construction of section 7(2) inserted the word "first" before the word "day" and concluded that where there were more than one event occurred, there had to be more than one two- year period starting with the last event. Gibson J. disagreed with this argument and held:

> "That seems to me to be impermissible, given that the subsection can be given a rational meaning without the addition of other words."[47]

Section 16(1) introduces a provision which requires a person intending to apply for a disqualification order to give not less than ten days' notice of his intention to the person against whom the order is sought. The requirement which is a decisive point in determining the two- year limit time under section 7(2), has been a controversial matter in some cases. In *re Cedac Ltd.*,[48] to decide whether to grant a leave sought by the Secretary of State under section 7(2) to commence new proceedings seeking a disqualification order against the respondent out of time, the court examined the respondent's argument that the ten days specified in section 16(1) was meant ten clear days' notice. In this case, although the court struck out the originating summons because the notice was not made in ten clear days, it granted the Secretary of State leave to commence new proceedings.

Here, the court found that no application could be made to the court for a disqualification order unless and until that obligation had been performed by the giving of notice in compliance with the terms of section 16(1).[49] Furthermore, the court emphasised the fact that since allegations such as disqualification were seriously damaging to the respondent, the statutory provisions such as section 16(1) had to be observed as a valuable safeguard for an intended respondent to those proceedings. Therefore, "parliament must have regarded the notice procedure as an important part of scheme for disqualification proceedings." However, the court

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[47] Ibid at 731.
[48] [1990] BCC 555.
[49] Ibid at 562.

acknowledged that there was no provision in the Act to the effect that the proceedings would be nullified by failure to comply with the statutory procedure.[50] Nevertheless, in *re Crestjoy Products Ltd.*[51] Harman J. like Miller J. acknowledged the serious effects and nearly penal nature of disqualification, but refused to extend the time for disqualification application to be made, because, in his view, the Secretary of State had not presented any sound and satisfactory ground for his application.

4. 5 Grounds for Disqualification

To make a disqualification order, some grounds have been provided by the statute, whether applicable in insolvency or when the company is a going concern. The legislature in the Company Directors Disqualification Act 1986 has classified three categories of grounds for disqualification including "general misconduct",[52] "unfitness",[53] and "other cases".[54] The courts do not seem have followed this classification in their decision- making process. For instance, in *re GSAR Realisations Ltd.*[55] a disqualification order was granted under section 6. The charge was obviously a wrongful trading conduct under section 10 of the 1986 Act. Therefore, section 6 can be defined as the ingredient of an application for disqualification rather than a ground for it.

4. 5. 1 Section 6- Unfitness

Section 6 is, undoubtedly, the main development in the issue of disqualification and liability of corporate directors. In comparison with other statutory provisions relating to disqualification, this section has been the most attractive one to applicants for a

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50 Ibid at 563.
51 [1990] BCC 23.
52 Sections 2- 5 of the Company Directors Disqualification Act 1986.
53 Ibid sections 6- 9.
54 Ibid sections. 10- 12.
55 [1993] BCLC 409.

disqualification order and in many cases has led to the grant of a disqualification order against the respondent.

Section 300 of the Companies Act 1985, the predecessor of section 6, was in some aspects different from its successor. Under the previous provision, to disqualify the respondent, two successive insolvencies within five years were necessary. Moreover, under the previous provision, unlike the present one, a disqualification order was not mandatory.

Under section 6, in order to make a disqualification order, the court must be satisfied that the defendant is unfit to be concerned in management of a company. In *re Bath Glass Ltd.*[56] Gibson J. expressed this aspect of the section as:

> "To reach a finding of unfitness the court must be satisfied that the director has been guilty of a serious failure or serious failures, whether deliberately or through incompetence, to perform those duties...."[57]

To deal with unfitness account should be taken of some matters such as the director's performance in the failure and his past conduct to judge his future conduct, his genuineness of intent, particularly if shown by investing his own money when the company is in financial trouble, and finally his acting on professional advice.[58]

4. 5. 1. 1 Mandatory disqualification

As a rule, to determine disqualification, the court has a discretion to make a disqualification order against a director where it is authorised to do so. When a disqualification is imposed, it has also discretion as to the period of the order depending on the seriousness of the director's misdoing. However, section 6 has introduced a significant exception to this rule, where once the court is satisfied that the conduct of the respondent is so inappropriate as to make him unfit to remain in

[56] [1988] 4 BCC 130.
[57] Ibid at 133.
[58] David Henry, Disqualification of Directors: A Review from the Inside (ed. Rajak) 23.

his position as director or being involved in management of a company, it is obliged to disqualify him for a minimum period of two years.[59]

The Cork Committee in its final recommendations proposed a mandatory disqualification, when the requirements for unfitness are satisfied, stating "the court should be required, not merely empowered to prohibit him from doing so for at least some minimum period."[60]

The legislators followed the Committee in this respect, when under section 6 the "court shall make a disqualification order against a person in any case where, on an application under this section it is satisfied....". The legislators deliberately used the word "shall" instead of "may", or "is empowered" or "has discretion", to oblige the court to grant such an order when it is satisfied that the respondent is unfit to serve as a director.

Under section 300 of the Companies Act 1985 the court obviously had a wide discretion to refuse to disqualify the director concerned. Such discretion can be seen in *re Churchill Hotel (Plymouth) Ltd.*[61] where Gibson J. stated:

> "If all three conditions are satisfied then the court may make a disqualification order. Thus, the court in the exercise of that discretion, is not obliged to make a disqualification order".[62]

It seems although under the new section making a disqualification order is obligatory, the court still has some discretion not to continue the proceedings leading to disqualification by concluding that it is not satisfied that the respondent is unfit. For example, in *re Bath Glass Ltd.*,[63] in the court's view, although the conduct of director in question had been imprudent and, in part, improper, it was not so serious to justify a finding of unfitness.

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59 See, e.g., *Re Swift 736 Ltd.* [1992] BCC 93, where two directors, husband and wife, were held disqualified for three and two years accordingly.

60 Insolvency Law & Practice- Report of the Review Committee Cmnd. 8558 Par. 1817 (1982).

61 [1988] BCLC 341.

62 Ibid at 343.

63 [1988] BCC 130.

4. 5. 1. 2 Matters to determine unfitness

To determine unfitness, the courts are required to have regard to the matters set out in Part I, when the company is a going concern and to the matters in Part II of Schedule I of the Company Directors Disqualification Act 1986,[64] in the case of an insolvent company. Part I includes such matters as any misfeasance or any breach of duty by the director in relation to the company or any misapplication or retention or any conduct by the director giving rise to an obligation to account for any money or other property of the company. The main considerations leading to unfitness in the course of insolvency are the extent of directors' responsibility for the insolvency, for any failure by the company to supply any goods or services which have been paid for, and the extent of their responsibility for the company entering into any transaction or giving preference ... .[65]

Although my own view, reflected in the conclusion, is that the matters on the ground of which an unfitness should be determined are those strictly set out in section 6- 9, as regards the treatment of the courts in their decision- making under section 6 it seems they feel free to apply this concept and its mandatory nature in a very wide range of matters. For example, the court in the 1995 case of *re Moorgate Metals Ltd.*[66] made a disqualification order against the two respondents, H and R, for four and ten years respectively. In this case, the defendants formed a two-man enterprise, M Ltd., which went into compulsory winding up with losses of half a million pounds. Mr. R, an already three times bankrupt whose application for discharge had been refused, was an undischarged bankrupt at the time of the company's incorporation, which was an offence under section 11 of the 1986 Act. H, a recently discharged bankrupt, invited by R to join the company, while he was aware of R being an undischarged bankrupt. R was in sole charge of buying or selling and H was responsible for finance and administration of the company. R contended that he was

64 Section 9 of the Company Directors Disqualification Act 1986.
65 These matters will be discussed later under misfeasance as a ground for disqualification.
66 [1995] 1 BCLC 502.

not a director but a *de facto* director for which there was no definition in the Act as a director. He claimed he had acted as an expert in metal industry. However, he accepted that he 'controlled the company's entire trading operation.'

The court, referring to some cases such as *re Lo- Line Electric Motors Ltd.*,[67] *Re Tasbian Ltd.* (3)[68] and *re Cargo Agency Ltd.*[69] where in the court's view the word "director" included a *de facto* director, did not agree with this contention, and found him a 'thoroughly dishonest, irresponsible and unscrupulous person.'[70]

4. 5. 1. 2. 1 Breach of commercial morality for failing to pay the crown debts

Perhaps breach of commercial morality has been one of most controversial issue for determining unfitness. The main ground for determining unfitness of a defendant director has been breach of commercial morality for not paying the Crown debts.

There are two approaches as to Crown debts and their difference from ordinary debts. In the traditional case law view, breach of commercial morality is equivalent to a failure to pay crown debts leading to the respondent unfitness. The position of the Crown as an involuntary creditor took a great deal of the Cork Committee's attention.[71] In the Committee's point of view, although the Crown is an involuntary creditor in respect of unpaid tax, it has powers to impose penalties, and possessed remarkable powers enabling it to obtain information, particularly powers of entry where necessary, search and seizure.[72] Moreover, many suppliers of goods see themselves in the same situation as the Crown without having any real choice. The committee, thus, concluded that 'sympathy for the misfortune of an involuntary creditor was not a sufficient ground for setting aside the cardinal principle of rateable distribution of an insolvent company's estate.'[73]

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67 [1988] BCLC 698.
68 [1991] BCLC 792.
69 [1992] BCLC 686.
70 *Re Moorgate Metals Ltd.* [1995] 1 BCLC 502, 520.
71 Para. 1412.
72 Para. 1413.
73 Para 1414.

There appears to be a reluctance among commentators to support this view. However, it has received support from the case law authorities. In *re Stanford Services Ltd. & Others*[74] the failure to pay Crown debts was treated as more serious than the failure to pay commercial debts, because in the court's belief the Crown was an involuntary creditor. In the instant case Vinelott J. stated:

> ".... the directors ought not to use moneys which the company is currently liable to pay over to the Crown to finance its trading activities. If they do so and if, in consequence, PAYE, National Insurance contributions and VAT become overdue and, in a winding up, irrecoverable, the court may draw the inference that the directors were continuing to trade at a time when they ought to have known that the company was unable to meet its current and accruing liabilities, and was unjustifiably putting at risk moneys which ought to have been paid over to the Crown as part of the public revenues to finance trading activities which might or might not produce a profit."[75]

The same view was clearly adopted by Sir Nicholas Browne- Wilkinson V. C. in *re Lo- Line Electric Motors Ltd. & Others,*[76] when he thought that an ordinary commercial misjudgment was in itself insufficient to satisfy a disqualification order, but stated that the director in question had behaved "in a commercially culpable manner in trading through limited companies when he knew them to be insolvent and in using the unpaid Crown debts to finance such trading."[77]

The opposing view to the traditional approach considers the Crown debts and ordinary debts as being in the same position. This approach is supported by some legal writers particularly Wheeler who believes that the Crown debts are no longer viewed as more commercially immoral than other debts but as a piece of evidence like any other.[78]

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[74] [1987] BCLC 607. See also *Ipcon Fashion Ltd.* [1989] 5 BCC 773. Here, the director was disqualified for five years for conducting contrary to commercial morality for not accounting for PAYE and VAT but paid himself and his wife, while the company was insolvent. Similarly, in *re Swift 736 Ltd.* [1993] BCLC 19, the defendant was disqualified for two years, because some of companies, all insolvent, of which she was director obtained credit by withholding PAYE and VAT due to the Crown.

[75] Ibid at 617.

[76] [1988] 1 Ch. 477.

[77] Ibid at 492.

[78] Wheeler *op cit* at 175.

Dillon J. in *re Sevenoak Stationers (Retail) Ltd.*[79] was of the view that non- payment of any Crown debts was not 'automatically treated as evidence of unfitness' of the directors concerned. The learned judge, thus, found it necessary to look more closely in each case to see what the significance of the Crown debt was.[80] This judgement seems in the line with the holding of Hoffmann J. in *re Dawson Print Group Ltd.*[81] In this case, the person in question was a director of two companies which both fell into insolvent liquidation with massive debts and liabilities including PAYE, national insurance contributions, VAT, and ordinary debts. An application under section 300 of the Companies Act 1985 was made by the Official Receiver for a disqualification order. Here, Hoffmann J. rejected the counsel for the official receiver's argument that the unpaid money of PAYE, national insurance contributions and VAT were quasi-trust's money but not company's property and, thus, failure to pay them constituted a breach of commercial morality leading to the directors' unfitness to be concerned in a company's management. Hoffmann J. concluding the failure to pay the Crown debts in the commercial world's view were not a breach of commercial morality giving rise to unfitness, dismissed the application for disqualifying the defendant director.[82]

With regard to the recent decisions, an obvious tendency to treat the Crown and ordinary debts equally, appears to replace the traditional approach. There is an increase in the number of cases in which the courts showed reluctance to accept the traditional view when there is no obligation for directors to keep Crown's money in a separate account.[83] However, it should be noted that although there are some judicial comments in favour of such a tendency, the majority of courts still look at the Crown debts as special. The judgment of Harman J. in *re Cladrose Ltd.*[84] can be referred to as a good example of this majority's view when it was held:

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79 [1990] BCC 765.
80 Ibid at 779.
81 [1987] 4 BCLC 601.
82 Ibid at 604. Compare with *re Bath Glass Ltd.* [1988] BCC 130 , 133, where in the Gibson J.'s view causing the company by directors to use Crown moneys to finance trading activities was considered as relevant misconduct leading to unfitness.
83 *re Sevenoak stationers (Retail) Ltd.*[1990] BCC 765, 768.
84 [1990] BCLC 204.

> "In determining whether a disqualification order should be made, the non- payment of Crown debts was to be treated as a more serious matter than the failure to pay other ordinary creditors."[85]

His Lordship made attempts to justify his viewpoint by considering employees' interests and the Crown position as an involuntary creditor. In the result, the traditional view is still obviously dominant one.

4. 5. 1. 2. 2 Misfeasance

A particular section for disqualification as misfeasance is not provided by the Company Directors Disqualification Act 1986. However section 9 of the Act for determining disqualification under section 6 refers to the matters mentioned in Schedule I. Those matters are the same as those ones provided in section 212 of the Insolvency Act 1986 which is recognised as a misfeasance section.

In *re Rolus Properties Ltd. & Anor*,[86] the director was charged with misfeasance under section 9 of the Insolvency Act 1976, now section 6- 9 of the Company Directors Disqualification Act, for not keeping books, making no statutory returns, and preparing no accounts.

In the present case, the defendant was director of some companies which went into compulsory winding up within two years. Harman J. did not find the respondent "a fit person to be a director of a limited company " while "... the public ought to be protected from his incompetence." Therefore, he was disqualified for two years.[87]

Likewise, in *re Travel Mondial (UK) Ltd.*,[88] the respondent was charged with misfeasance, particularly failing to ensure that the accounts were audited or annual returns filed, and using Crown moneys. The defendant was also accused of using the name of a previous company that had already gone into liquidation, "phoenix syndrome". Here, Browne- Wilkinson V- C found the case serious, because of

85 Ibid.
86 [1988] 4 BCC 446.
87 Ibid at 449.
88 [1991] BCC 224.

"abuse of the position of a limited company, with substantial lack of probity." Therefore, a nine years disqualification was imposed.[89]

Likewise, in *re GSAR Realisations Ltd.*,[90] at the instance of the company's bank, Barclays Bank Plc., the company instructed a firm of accountants to carry out a limited investigation of its financial affairs. The report seen by the director in question suggested that the company was insolvent. One year later when it became evident that the financial situation of the company was deteriorating, another report estimating the financial state of the company, showed a deficiency of £347, 000 against creditors. However, the director did not perform his duty to prepare a statement of affairs for the company.[91] The director's treatment of the company's financial affairs, specially his failure to make the required statement, was considered by Ferris J. as 'a degree of indifference to his duties which constitutes unfitness.'

In *re CSTC Ltd.*[92] an application was brought under section 6 by the Secretary of State for Trade and Industry against two directors, 'V' and 'J', for several charges including misapplication and lack of care to clients' funds, causing the company to trade while insolvent, and permitting the company to pay excessive remuneration to the directors. As to the first charge, the court found 'V' seriously responsible and, in the court's view, 'J' failed to control accounting chaos. As to the second complaint, the court did not find him blameworthy, while in its view, there was a genuine prospect that "the introduction of fresh capital and changing trading circumstances would enable the company to survive properly." Finally, the court found them guilty of two years excessive payment which the company could not afford. They were ordered to be disqualified for six and two years accordingly.

89 Also in *re Heypak Homecare Ltd.* (No. 2) [1990] BCC 117, a three years disqualification order was imposed upon two directors of the company for transferring the company's stock in a new company in a way which rendered them unfit. Similarly in *re Pamstock Ltd.* [1994] 1 BCLC 716, the respondent received a disqualification order of two years for issuing cheques which were dishonoured, not filing accounts and returns, and continuing to trade while insolvent.

90 [1993] BCLC 409.

91 Ibid at 411.

92 (*Secretary of State for Trade and Industry v. Van Hengel & Anor*) [1995] BCC 171.

It is necessary to explain the relationship between section 212 of the Insolvency Act 1986 and section 6. As was discussed in the previous chapter in our discussion on directors' liability for misfeasance, it is well established that section 212 is the statutory authority for misfeasance. On the other hand, the matters set out in section 6 for unfitness are almost the same as those provided in section 212. It is justified to regulate those matters under misfeasance as a ground for disqualification different from section 6. It seems more justified because the matters set out in Schedule I (referred to by section 6) are not more serious than, for example, fraudulent trading under section 10 of the Company Directors Disqualification Act 1986. Therefore, a mandatory disqualification under the former, where the courts' power to make a disqualification order under the latter is discretionary, seems unconvincing.

4. 5. 2 Wrongful Trading

By section 10 of the Company Directors Disqualification Act 1986, where the court makes a declaration under section 214 of the Insolvency Act 1986 that a person is liable to make a contribution to a company's assets whether or not an application for such an order has been made by any person, the court may make a disqualification order, if it thinks proper.

The exercise of the court's power under this head is plainly discretionary but not mandatory. Therefore, if a contribution under section 214 is made and even if a disqualification order against the respondent has been requested, the court has discretion to dismiss the request by refusing to disqualify such person.

Unfortunately, the case law record on this particular matter is not helpful. It is not because the concept of wrongful trading is newly introduced,[93] but most importantly because of the court's discretionary power which likely does not lead to a successful proceeding and, thus, it discourages the applicants to file their action for a disqualification order under wrongful trading section. Instead they prefer to bring

[93] It is not the reason since, as we have seen, a considerable number of cases on wrongful trading have successfully been decided.

proceedings against the directors for wrongful trading under section 6 in order to guarantee a successful proceeding for disqualification as making a disqualification under the latter, unlike the former, is mandatory.[94]

It is not clear, where the matters for determining a disqualification action under section 6 are set out in section 9 and Schedule I, why the courts accept the allegations for disqualification grounded on wrongful trading to be brought under section 6, unfitness. To justify the treatment of the courts, one may argue that the matters set out in the above provisions do not confine the power of the court in those matters but the courts are required to disqualify the person in question under section 6 when they are satisfied that he is unfit to serve as a director, whatever the cause of application is, as was expressed in *re Bath Glass Ltd.*.[95] In that case, Gibson J. drew a distinction between disqualification for wrongful trading under section 10 and disqualification for unfitness under section 6, but his Lordship was of the view that for the court to be satisfied under section 6, no specific single offence was necessary and the term of the director's conduct was deliberately chosen with so great generality. The learned judge concluded that any misconduct of the respondent for this purpose may have been relevant even if it did not fall within a particular section of the Companies Act or Insolvency Act.[96]

In this case, Gibson J. seems indicating that not only wrongful and fraudulent trading but also any other wrongdoing whether or not within the scope of Companies Act or Insolvency Act can be viewed in determining a director's unfitness. This view is respectfully very wide whose recognition is a matter of the future judges' attitude.

In *re Cargo Agency Ltd.*[97] Harman J. was of the view that it was obvious from the accounts that from about August 1987 a prudent director plainly ought to have realised that the company was insolvent, and that without a very substantial

94 See for example, *re Travel Mondial (U. K) Ltd.* [1991] BCC 224, *re GSAR Realisations Ltd.* [1993] BCLC, 409 *re Cargo Agency Ltd.* [1992] BCLC 686.
95 [1988] 4 BCC 130.
96 Ibid at 133.
97 [1992] BCLC 686.

additional funds, for which there was no apparent immediate prospect, it was unable to pay its creditors as they fell due and was continuing to increase its debts month over month.[98] A disqualification order was imposed for two years.

In *re GSAR Realisations Ltd.*,[99] *inter alia*, it was alleged, that the director in question had caused the company to trade after September 1988 when he knew or ought to have known that the company was unable to pay its debts. From Ferris J's point of view, there was clear evidence that the respondent permitted the company to trade after it had become insolvent. The learned judge concluded that the defendant's conduct demonstrated "his unfitness to be concerned in the management of the company."[100]

The above mentioned cases, but one, were decided under section 6, namely unfitness, where the main or the only ground for those cases was carrying on trading while insolvent, namely wrongful trading. It seems in the next enactment it should be clarified whether wrongful trading is a separate ground from section 6 for disqualification or a matter to determine unfitness under that section. Depending on which one is the case, the result will be different. In the first situation, no application for disqualification under section 6, when the cause is a wrongful trading, should be accepted, whereas by accepting the second possibility, the courts are obliged to disqualify the respondent for unfitness on the basis of wrongful trading liability.

4. 5. 3 Fraudulent Trading

Fraudulent trading as a ground for unfitness' leading to disqualification has been provided by the Company Directors Disqualification Act 1986 in two different

98 Ibid at 387, 389. In *Firedart Ltd.* [1994] 2 BCLC 340, the defendant was also ordered to be disqualified for six years for trading while insolvent.

99 [1993] BCLC 409.

100 See also *re Travel Mondial (U. K) Ltd.*[1991] BCC 224. Likewise in re *Stanford Services Ltd & Others* [1987] 3 BCC 326 which was brought under section 300 of the Companies Act 1985, the director concerned was, among three more charges, charged of causing the company to trade after the point when he ought to have known that it was insolvent. The court found him unfit to act as a director of a company, therefore as a public interest consideration disqualified him for two years. In *re Lo- Line Electric Motors Ltd. & Others* [1988] 1 Ch. 477 also Sir Browne- Wilkinson V. C. found the respondent liable for allowing the company to trade while insolvent.

occasions based on the nature of liability resulting from the offence. In other words, the nature of fraudulent trading set out in section 213 of the Insolvency Act, and referred to in section 10 of the 1986 Act is a civil one, contribution, although emerged from a criminal liability, whereas the substance of liability in section 458 of the Companies Act 1985 referred to by section 4 is a purely punitive punishment. This distinction is also acknowledged by Sealy who is of the view that to disqualify a defendant under section 10, a declaration of contribution under section 213 of the Insolvency Act is needed. Moreover, unlike section 10, the requirement of insolvency is not required by section 4.[101]

As a natural result, this question may arise that what exactly is difference between the two sections? In both sections 4 and 10 the exercise of the courts' power to disqualify respondent is obviously discretionary but not mandatory. Moreover, the maximum period of disqualification under both is the same, fifteen years. Consequently, the treatment of the legislators of both matters without considering the criminal nature of liability under section 458 may seem unconvincing.

To clarify the point, having a brief look at contents of those two sections is necessary. Under section 458, a director who carries on business with intent to defraud creditors "is liable to imprisonment or a fine or both", and section 213 provides that such person is to be liable to make such contributions (if any) to the company's assets as the court thinks fit.

The only reasoning for the different attitude of the legislature to the same matter may be the different nature of those sections. The legislature classified the grounds for disqualification in separate sections; in section 4 including "fraud" which is the ground for disqualification with its penal substance, and section 10 where the ground of disqualification is contribution, with a civil nature.

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[101] Sealy, Disqualification and Personal Liability of Directors, 24.

4. 6 Relief from Disqualification

The harshness and discouraging effects of disqualification orders particularly when it is mandatory, not only on the business livelihood of the disqualified person but also on his private- family and the company's employees have attracted heavy criticisms from lawyers as well as businessmen. In response to such effects of disqualification some possibilities have been suggested, which may mitigate against the harshness of a director's disqualification. It should be noted that apart from the matters recognised as relieving factors against such harsh impact, except in section 6, all other sections relevant to directors disqualification bear a very wide discretion left to the court whether or not to disqualify a delinquent director by using the word "may".

It is also worth noting that before the enactment of the 1986 Act, there was no mandatory disqualification under the predecessor of section 6, section 300, and the courts were empowered to exercise their discretion under this section like other disqualification cases.

4. 6. 1 Limited and Conditional Orders

Although the mandatory nature of disqualification under section 6 seems tough, the courts are empowered to exercise their discretion by permitting a director to continue to act as a director under some particular circumstances while disqualified.

In making a disqualification order, this question may arise why the court should be directed to disqualify a director by imposing an absolute prohibition from being concerned in any form of any company's management, but it should not be able to disqualify a person from being concerned in management of all except some certain companies? this is because in respect of that company the disqualified person may be more useful than harmful, or the court may let him act as a manager without having a seat on the board of directors, while in all cases the public interest may not be protected by full disqualification. The reverse is true. Sometimes the protection of the public interest requires that not to make a director, particularly when he is well experienced, completely unemployable.

If such partial, limited or conditional orders are made instead, it can also reduce the court's reluctance to make disqualification orders because of their deep and unrecoverable effects on the social life of the disqualified person. If the court is empowered to make a disqualification order, or give a leave, why it should not be authorised to make a limited or conditional order. The decision- making process shows the courts have not hesitated to regularly exercise their discretion for such purpose.

In re Matthews Ltd.,[102] although Gibson J. refused to accept the director's argument that although his conduct as director of two successive failed company was unsatisfactory, he had learned his lesson and his subsequent management of a third company was justified and the public did not, therefore, need to be protected by disqualification, the learned judge indicated that he would view sympathetically any future application for leave by the respondent to continue as a director of the third company on the condition that it was converted into an unlimited liability company.

In some circumstances a specific aspect of public interest may influence the court's judgement. In *re Majestic Recording Studios Ltd,*[103] the defendant was permitted to continue as a director of a specified company under supervision of an independent accountant appointed by the court on the condition that the audited accounts would be filed by a specified date. Likewise, in *Re Lo- Line Electric Motors Ltd. & Ors,*[104] the director was allowed to keep his position as director of two family companies so long as a named person remained a director with voting control.[105]

102 [1988] 4 BCC 513.
103 [1989] BCLC 1.
104 [1988] 4 BCC 415.
105 In *re Cargo Agency Ltd,* [1992] BCC 989, although the two defendant directors were disqualified for two years under section 6, Harman J. granted one of them the leave to carry on as a general manager or director of a particular company of which he was a director for sometime. Likewise, in *Gibson Davies,* [1995] BCC 11, the leave granted to the disqualified person to act as a director of a particular company for the period of disqualification.

The same situation can be seen in *re Chatmore Ltd.*[106] in which the director in question formed a company to acquire the business of his father's company which subsequently went into insolvent liquidation. The new company was also after a short time wound up due to insolvency. A disqualification order for two years was made, but on the application of the defendant's counsel for special leave to continue to act as a director of a particular company of which the respondent had been a director for two years, the court allowed him to keep his position as a director of that named company for one year on the condition that he held a board meeting every month at which a representative of the company's auditors would attend. The director was granted the right to apply for a new leave at the end of one year period.

4. 6. 2 Mitigating Factors

For granting a partial, limited or conditional order some factors may be taken into account by the courts. For example, the personal position of the respondent and the impact of a disqualification order on his family or on the employees and society as a whole when the director in question is a key- man in management, are considerable factors to mitigate against a disqualification order.

There should be a distinction between disqualification cases where the cause of unfitness of the defendant director is fraud, and those cases where he is held unfit for breach of duty of care or negligence. In the first situation, the respondent should not expect a leave to be granted even if some mitigating factors are available, but in the latter case, the court feels free to exercise its discretion to relieve him from liability.

4. 6. 2. 1 Reliance on professional advice

Reliance on professional advice is one of the most important mitigating factors by which, in some cases, the courts have refused to disqualify the respondent. In *re Douglas Construction Services Ltd.*,[107] for example, the court refused to disqualify

106 [1990] BCLC 673.
107 [1988] BCLC 397.

the directors in question. It should be noted that because this case was brought under section 300 of the Companies Act 1985, the court was not anyway obliged to impose disqualification on the defendants. The main factor in the directors' favour was their reliance on the professional advice. Harman J. was impressed by their conduct of putting their own money into the company and the equally important, the fact that they relied on professional advice. The learned judge, therefore, concluded that the directors' conduct did not amount to cynical exploitation of limited liability or gross incompetence.[108]

However, in some cases reliance on the professional advice and leaving the whole company's affairs to other officers has not been considered as a convincing reason. In *Cladrose Ltd.*[109] the court held that such reliance on the advice of an advisor or professional did not give rise to the shrinking of the obligations of a director by leaving all company's affairs to others. The same view was taken in *re Majestic Studios Ltd.*.[110] Here, the director had not deliberately involved himself in the company's financial affairs. Annual accounts and returns were not filed for various periods and the company went into insolvent liquidation with a massive debts to the Crown and others. The court said that he was unfit to be concerned in the company management by reasoning that he was not entitled to shirk his duties by leaving everything to others.

4. 6. 2. 2 Effects on employees

Some courts are also reluctant to make a disqualification order because of its effects on employees. They have, when the conduct of the directors in respect of that company has appeared to it suitable and specially the need to save the employees' jobs, exercised their discretion to mitigate against the disqualification order.

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108 The same view was taken in *Rolus Properties Ltd.* [1988] BCC 446, 499. Here, Harman J. took the fact into his account as a mitigating factor in the defendant favour that "he had obtained suitable qualified professional assistance to fill what appear to have been" the respondent deficiencies.

109 [1990] BCLC 204.

110 [1989] BCLC 1.

In *re Majestic Recording Studios Ltd.*[111] the director concerned was held unfit, but because of the harshness of its effects on the employees the court gave the director a leave to continue as director of one company under certain conditions.

Such factor alone seems difficult to persuade the judges not to make a disqualification order or to grant a conditional or limited order. Other factors such as the respondent's conduct and the order impact on his business freedom and the public are relevant.

4. 6. 2. 3 Other factors

Some other factors such as inexperience, youthful, losing the defendant his own money and the impact of an order as such may impress the judges to refuse to make a full order or to grant a leave. For example, in *re Douglas Construction Services Ltd.*[112] although the court was satisfied that the director in question had mismanaged two insolvent companies of which he was a director, it refused to disqualify him. That was because he had put a substantial sum of his own money into the business, and this point was considered by the court as a basic mitigating factor.

The courts may also take account of youthfulness and low experience of a director to mitigate against disqualification.[113] The reverse is true. Sometimes the high expertise of the respondent may seem to be damaging to the public if a disqualification order against such an effective person is made. In such circumstances the court may prefer to make a general disqualification order with a leave to take part specifically in a particular company management.

4. 7 Effects of Disqualification

111 [1989] BCLC 1.
112 [1988] BCC 397.
113 Janet Dine "Disqualification of Directors", 12 Co. Law. (1991) 8. [Thereafter Dine Co. Law. (1991)]

The primary consequence of a disqualification order is that the disqualified person shall not, without leave of the court, be a director, liquidator, administrator, receiver or manager of a company's property or in any way , whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company.[114] Also if a person who acts as a director on the instructions of person whom he knows to be an undischarged bankrupt or to be subject to a disqualification order, he is liable to its creditors for debts and liabilities incurred by the company during the period he was involved so.

A disqualified person is not merely prohibited from participating in any form of company management, his taking part in as an independent management consultant to a company may give rise to an offence. By a full disqualification, the person in question not only is taken off the board, but also he may virtually become unemployable and incapable of living in the company's sphere.[115] If a person against whom such an order has been made, contravenes it by engaging in the management of a company, his involvement is considered as a criminal offence for which he may in the case of indictment be punished by no more than two years imprisonment or a fine or both, and if it tried summarily, by no more than six months imprisonment and a fine up to £1,000 or both.[116]

In *R v. Campbell.*,[117] the director was disqualified for five years. However, he continued to act as a financial adviser to a company which faced financial difficulties. In response to his charge for acting while disqualified, he argued that, as an independent person, simply advising the company but not being involved in the decision- making process, he could not be recognised as being involved in company's management. The court rejecting this argument, stated that the provision is intended to make it impossible for a disqualified person to be a part of management or central direction of the company's affairs, whereas the defendant acted as a consultant

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[114] Section 1 (1)], the Company Directors Disqualification Act 1986.
[115] Andrew Hicks "Disqualification of Directors", JBL (1988) 41.
[116] Section 13.
[117] [1984] BCLC 83.

advising financial management and reconstruction of the company. Moreover, the court refused to accept the argument of the counsel for the defendant that by adopting such a wide interpretation of the section it would lead to the conclusion that a disqualified person can not be sure of the extent to which he could be involved in the company's affairs. The court took the view that the section had clearly directed the disqualified person to seek the court's leave if he had intended to take part in the management of any company.

The question may arise whether a disqualification order leads to an automatic vacation of the director's office. It seems difficult to accept this because a disqualified person must resign from the date of the order, otherwise he will face liability. According to table A article 81 of the Companies Act, the office of a person prohibited from being a director or becomes bankrupt "shall be vacated". The same phrase was contained in section 182 and Table A of Article 88 of the Companies Act 1948. The words "shall be vacated" may imply an automatic vacation of the office in the case of disqualification.[118] Hicks believes that it seems automatic disqualification cannot be acceptable because it contains the risk of catching innocent people which is in contradiction with natural justice. It also discourages appointment of non-executive directors as well as company doctors when the company has gone into financial distress.[119] It is respectfully difficult to agree with the first criticism because when a director is held unfit, whether a disqualification is automatic or not, it does not catch innocent people.

One may feel that the concept of "automatic disqualification" is an Australian legal concept, but this point has been also considered by the drafts- makers of the 1986 Act. The Cork Committee clearly proposed the imposition of "automatic disqualification" against an individual debtor who 'has been adjudicated bankrupt and, so long as he remains undischarged.'[120]

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118 Andrew Hicks " Making and Resisting Disqualification Orders" 8 Co. Law. (1987) 343, citing *IRC v Heaver ltd* [1949]2 All ER 367, and *Craven-Ellis v Canons Ltd* [1936] 2 All ER 1066.
119 Hicks, JBL, (1988) at 39, 41.
120 Par. 1764.

The harshness of an order as such, particularly its discouraging effects on individuals, always has been criticised as the main disadvantage of the proceedings. It has been said that although this reason that to take the matter into account as serious with regard to the possibility of permitting the director to continue under licence may mitigate harshness of disqualification, it is still a considerable limitation of individual freedom if the licence is to be obtained from the court.[121]

This sanction seems to be a crucial punishment even more oppressive than fine or even imprisonment, particularly in its mandatory form under section 6. In other words, disqualification as a strict limitation may be in contradiction with the doctrine of individualism and free trade of common law. A disqualification order is, indeed, a serious restriction on the individual liberty as expressed in the case of *Secretary of State for Trade and Industry v. Langridge*,[122] when Balcombe L. J. said that "while a disqualification order is not in itself penal, it is clearly restrictive of the liberty of the person against whom it was made .... ."

To justify the effects of such an order, one may consider the public interest as the main purpose of the proceedings by arguing that although the removal from corporate employment causes severe hardship to the disqualified director and his family, the protection of the collective interests of the public must outweigh the harsh impact on the individual.

4. 8 Conclusion

The subject of disqualification is capable of being described as one of the most controversial subjects in the area of directors liability in particular, and in company law in general. This sanction has played a very significant role in this sphere since its introduction in 1928. As to the aim of the proceedings two main approaches are penal and civil or protective theories. Here, in all cases and commentaries, the

121- Janet Dine Co. Law. (1991) at 9.
122 [1991] 2 W. L. R. 1343, 1350.

meaning of protective and civil have been used with the same sense and within the same theory. As it was already discussed, putting both civil and protective under the same conceptual umbrella is not appropriate. The legislators may not have intended to punish a driver nor to recover the damages suffered by victim, but to protect the people on the road and the society as a whole. The same reasoning goes to disqualification for a corporate director who drives the company.

The significant problem inherent in the issue of disqualification is the mandatory nature of disqualification under section 6 of the Act 1986. As was already discussed, it is not clear whether the mandatory disqualification can be issued only based on matters set out in schedule I (referred to by section 6) of the Act. If so, two more questions must be answered; first, why do the court let an application for an order as such be filed under section 6 for other causes such as wrongful trading? And more crucially, why such matter as breach of duty even without faithlessness can lead to a mandatory disqualification but a crucial cause such as fraudulent trading has, statutorily, no such effect. Accepting this possibility requires a basic amendment as to section 6 and mandatory disqualification. If not, namely the disqualification order is not confined in the matters mentioned in the above schedule as stated by Gibson J. in *re Bath Glass Ltd.*[123].

The criticism on the harshness of the period of disqualification particularly when there is a mandatory minimum of disqualification has not been alleviated by the reasoning that the disqualified director has opportunity to apply to the court for a permission to continue to act as a director under specified conditions.

In order to classify the grounds for disqualification more logically, it would be an idea to put the offence of fraudulent trading provided in sections 4 and 10 together under the same head.

The lack of unanimity among the judges as to the real position of the Crown debts is another problem. Even most recent judicial authorities are in disagreement on the

123 [1988] 4 BCC 130.

issue. Some cases have recognised the Crown as having a special position as an involuntary creditor,[124] and some others have refused to follow this approach as a rule.[125] It is a matter which should be resolved by a enforceable decision from the House of Lords or the legislature's interference.

124 See for example *re Stanford Services Ltd.* & Others [1987] 3 BCC 326, and *re Lo- Line Electric Motors Ltd. & Others* [1988] 477.

125 For example, *re Cladrose Ltd.* [1990] BCLC 204.

Chapter 5: Protection of Directors in English Law

5. 1 Introduction

There is no need to be highly expert in English law to see how tightly a director is surrounded by a variety of civil and penal liabilities. In the past decade, since the legislature has permitted insurance to be purchased by companies under the amended version of section 310, a large range of liabilities have been provided. While the liability entailed in wrongful trading with its objective standard has given the court a wide power to impose liability on directors, the Company Directors Disqualification Act 1986 in section 6 has provided another device by which directors may be prevented from operating in the business sphere.

One may wonder whether there are sufficient protections against this potential wealthy liabilities. If not, how may a qualified, competent, and honest individual be interested in serving on the board and leave himself as an open target to attacks on the part of several possible groups of claimants, such as the company itself, its shareholders, creditors, and public or governmental departments?

Section 310 of the Companies Act 1985 renders void any provision contained in a company's articles of association or in a contract with the company or otherwise, exempting directors from and indemnifying them against liability. However, it allows insurance to be purchased and maintained against an officer's liability, the possibility which before the amendment and until 1989 was strictly prohibited. There are also some exceptions to the rule of prohibition of indemnification including indemnity against a successful defence costs, liability in a case where the defendant is relieved from liability under section 727 of Companies Act 1985, or when he is acquitted.

On the other hand, section 727 offers a wide discretion to the courts empowering them to relieve a director from his personal liability under particular circumstances when certain requirements are met.

In this chapter, first, the issues contained in section 310 including exemption from, and insurance or indemnification against directors liability are examined.

In the second part of this chapter, section 727, its judicial importance in the development of company law, particularly its relationship with wrongful trading, misfeasance, and other cases which do not fall within the ambit of those sections, and the extent of its application with regard to the courts' discretion is reviewed.

5. 2 Exemption, Insurance and Indemnity

Section 310 of the Companies Act 1985 in subsection (1) invalidates any provision in a company's articles of association or any contract with the company or otherwise which seeks to exempt a director or other officer or auditor of the company from, or to indemnify him against any liability which by virtue of any rule or law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company. In section 310 (2), the legislature has permitted the purchase of insurance against directors liability, that authorises companies to indemnify their officers in some cases.

The provisions of section 310 have been subject of legal writers' examinations. But, there has been little by way of interpretation of this section, and the leading judicial authority *Movitex Ltd. v. Bulfield*[1] is the only helpful case in this regard.

5. 2. 1 Exemption from Liability

5. 2. 1. 1 Statutory and judicial background

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[1] [1988] BCLC 104.

The precursor of the present section 310 was section 78 of the Companies Act 1928, and it was followed by section 152 of the Companies Act 1929. The immediate forerunner of section 310 was section 205 of the Companies Act 1948, which repealed the Companies Act 1929 in this regard.

The aim of section 152 has been said,[2] was to resolve the mischief arising from Neville J.'s holding in *re Brazilian Rubber Plantations & Estates Ltd.*[3] and Romer J.'s judgment in *re City Equitable Fire Insurance Co. Ltd.*[4] The result of *re City Equitable Fire Insurance* which is described as a "public scandal",[5] persuaded the Board of Trade to appoint the Greene Committee. The committee considering the judicial precedent of the above two cases stated:

> "We consider that this type of article gives a quite unjustifiable protection to directors. Under it a director may with impunity be guilty of the grossest negligence provided that he does not consciously do anything which he recognises to be improper ... To attempt by statute to define the duties of directors would be a hopeless task and the proper course in our view is to prohibit articles and contracts directed to relieving directors and other officers of a company from their liability under general law for negligence and breach of duty or breach of trust."[6]

The Companies Act 1948 in section 205 adopted the same language but with a minor change as its predecessor. This section was described, by the Cohen Committee, as an anti- indemnity provision,[7] when they said "we consider that a general provision for exempting trustees from liability should be prohibited but that enabling clauses as distinct from indemnity clauses should be permitted."[8]

The matter was, for the first time, judicially considered in *re Brazilian Rubber Plantations & Estates Ltd.*[9] where the wrongdoing was alleged to have been gross

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2 Jalil Asif, "The Effect of Section 310 of the Companies Act 1985 on Directors' and Officers' Insurance and on Auditors' Professional Indemnity Policies", Prof. Neg. (1989) 209, Colin Baxter, "Demystifying D & O Insurance" 15 Oxf. JLS (1995) 537, 541.
3 [1911] Ch. 425.
4 [1925] Ch. 407.
5 C. D. Baker, "Disclosure of Directors' Interests in Contracts", JBL (1975) 181, 186, Asif, *op cit* at 210.
6 Greene Committee on Company Law Amendment, Cmnd. 2657 para 46 (1925- 6).
7 Ralph Instone, "The Scope of Companies Act 1948, S. 205", 98 LQR, (1982) 548.
8 Cmnd. 6659 Para. 64.
9 [1911] Ch 425.

negligence in circumstances in which the defendant directors were said to have caused the company to enter into a contract, and then failed to terminate the contract once they found out about a report which stated that the contract was fraudulently prepared.

Although in the final analysis, the directors were held not to have been negligent, their default being attributed to mere "error of judgment", the court had to consider the effect of the articles of association which contained a provision purporting to exempt directors from liability. The following article fell to be construed:

> "151. No director or any other officer of the company shall be liable for the acts, receipts, neglects, or defaults of any other director or officer, or ... for any other loss, damage, or misfortune whatever which shall happen in the execution of the duties of his office or in relation thereto, unless the same happens through his own dishonesty."

The court, considering the contents of that article, held that:

> "This article is intended to relieve directors who act honestly from liability for damages occasioned even by their negligence, where such negligence is not dishonest."

Neville J did not think it was illegal "for a company to engage its directors upon such terms," and therefore, his Lordship thought that no action by the company "against its directors for negligence, where no dishonesty was alleged, could have succeeded."[10]

In *re City Equitable Fire Insurance Co.*[11] the directors in question were charged by the official receiver with negligence in discharging their duties as directors. One of the articles of the company's association provided:

> "...none of [the directors, auditors, secretary and other officers for the time being of the company] shall be answerable for the acts, receipts, neglects or defaults of the other or others of them, ... or for any insufficiency or deficiency of any security upon which any moneys of or belonging to the company shall be placed out or invested, or for any other loss, misfortune or damage which may happen in the execution of their respective offices ... unless the same shall happen through their wilful neglect or default respectively."

10 Ibid at 440.
11 [1925] Ch. 407.

In that case, after an exhaustive examination of the meaning of negligence, in particular "willful negligence", Romer J. categorised the directors' conduct under "unwilful" neglect and, therefore, subject to the protection provided by the above articles. His Lordship explaining the construction of the article, stated:

> "its true construction, to excuse the auditors from being answerable for loss occurring in relation to their office, except in the particular events which are therein specified- namely, those which happen by or through their own wilful neglect or default- and that it would be improper to describe as a misfeasance any act or omission of the auditors which, having regard to that article, would not result in their being answerable for the loss which may be occasioned thereby".

The court concluded that the article modified the *prima facie* obligation of the defendants.

As to the court's decision in the above case, the account should be taken of the fact that almost all commentators have referred to the case for explaining or supporting their view as to directors' position. However, it seems not easy to extract from the above judgment a rule applicable to directors' position. That is because in that case, the possible modification of duties of auditors but not directors was at issue. But, one feels that the court's attitude to the matter was to designate a rule, irrespective of the class of officers to which the defendants belonged.

The importance of the case is that it raised the issue of exemption of officers' duties years before the first statutory provision came into effect.

The first and the only case which has so far examined section 310 is *Movitex Ltd. v. Bulfield.*[12] In this case, an action was taken against directors of the company for self-interest, because they had caused the company's certain property to be transferred to another company of which they were also members and directors, when it appeared that the company was unable to complete the sale. The company's articles had modified the self- interest rule and permitted a director to be interested in a contract with his company provided he made full disclosure of his interest. Article 100(iv) provided that the latter prohibitions did not apply to "any contract or dealing ... with

[12] [1988] BCLC 104.

a corporation where (his) sole interest is that he is a director or other officer, member or creditor thereof. Here, Vinelott J. suggested a formula as the "true principle". This principle, in his Lordship view, was:

> "that if a director places himself in a position in which his duty to the company conflicts with his personal interests or his duty to another, the court will intervene to set aside the transaction without inquiring whether there was any breach of the director's duty to the company. That is an overriding principle of equity. The shareholders of the company, in formulating the articles, can exclude or modify the application of this principle. In doing so they do not exempt the directors from the consequences of a breach of a duty owed to the company."[13]

Birds suggests that this solution may indicate that directors can be relieved from liability for breach of any duties which do not cause damage to the company. However, he rejects this solution, because directors "can not be relieved from liability under any statutory duties, nor from failure to act *bona fide* in the interests of the company" and even from "failure to display reasonable care and skill"[14]

Vinelott J. did not define or explain the full extent of the principle, the application of which would allow modification or exclusion by means of the corporate articles. But one agrees with Birds' interpretation of this part of the judgment, may find the above solution in contrary to English case law and legislature's attitude that have never recognised such a solution, which seems to be a sort of exemption from liability.

Considering the judgment through a different view from that taken by Birds, irrespective of the importance given to this part of Vinelott J.'s holding by many of legal writers, it does not seem that it has clarified questions as to the extent of exclusion and modification of duties authorised by the law. However, the fact should not be ignored that it is the only judicial precedent ever referred to the matter.

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13 Ibid at 121.

14 John Birds, "Excluding the Duties of Directors", 8 Co. Law. (1987) 32. [Thereafter Birds, 8 Co. Law. (1987)].

5. 2. 1. 2 Extent of exemption under section 310

It is believed that section 310 does not prohibit an exemption or indemnity granted after the occurrence of the event resulting to the liability, because the language of section refers to the future rather than the past when it reads "of which the directors may be guilty".[15]

Having a review of the section, either linguistically or conceptually, does not respectfully lead the reader to the conclusion that it concerns only prospective occurrences. The wording of section seems absolute, drawing no distinction between liability arising from the past and future events. But, in support of the above interpretation one may argue that the reference to the future means ratification.

As to the scope of application of section 310, there has been a strong disagreement among commentators. According to the traditional view, the section has a prohibitive effect in relation to any company's articles or contract excluding the officers' liability for breach of their duties. This approach considers the section as rendering void any provision which exempts a director from liability for breach of an existing duty, but it does not affect provisions which modify the extent to which a duty is owed. Prior to the judgment of Vinelott J in *Motivex Ltd. v. Bulfield,*[16] Gower and Gore- Browne were of the above view.[17] Gower who supported this approach, believed that the effects of section 310 was that liability for breach of duty could not be excluded, but the scope of the duty could be modified by the articles.[18]

The solution proposed in the 43th edition of Gore- Browne on Companies that a provision may, without infringing section 205, reduce a duty but not exempt a director from liability for breach of it, was rejected by Vinelott J. in that case, because the learned judge believed that the words 'for exempting' lead to:

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15 Steven Turnbull & Vanessa Edwards, "Companies Act 1989: Directors' and Officers' Liability Insurance", 134 SJ, (1990) 768.
16 [1988] BCLC 104.
17 Gore- Browne on Companies, (Bristol: Jordan 43rd ed.) para. 27- 34, Gower, Principles of Modern Company Law (London: Sweet & Maxwell 4th ed.), at 601.
18 Gower, Principles of Modern Company Law (London: Sweet & Maxwell 3rd ed.) at 531- 32.

> "the absurd result that an article could, without infringing s 205, modify a director's duty to use reasonable skill and care in the conduct of the company's affairs and so avoid a liability for damages for breach of duty which would otherwise arise, a conclusion which seems to me manifestly in conflict with the purpose of the section."[19]

The second approach construes the contents of section 310 as prohibiting exemption both from the scope of the duty and from the consequences of a breach of a duty. The literal effect of section 310 is, thus, to avoid all forms of exclusion from liability, drawing no distinction between exemptions from the scope of duty and exemptions from the consequences of a breach of duty.[20]

According to this opinion, the interpretation of section 310 that it allows modification of the duty even where the effect of such a modifying provision is to release a director from owing any duty at all,[21] is rejected as "exactly the sort of 'contracting out' which the Greene Committee sought to prohibit",[22] and "defeat what seems to have been the aim foremost in the minds of the Greene Committee in recommending section [310]".[23] That is because the section avoids an article that shields a director from any liability 'which would otherwise attach to him.'

Some commentators who support the modern view, have criticised the idea of possibility of modification of duties as contrary to the purpose behind the section intended by the Greene Committee, since the main feature of being fiduciary is exercising some duties.[24] Pennington believes that a company's articles or a service contract cannot exempt a director from his duty of care and skill, or from fiduciary duties imposed by law. He proposes a typical formula in this regard upon which a director's duties provided by the general law may be increased but not diminished.[25]

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19 *Motivex Ltd. v. Bulfield*, [1988] BCLC 104, 117- 18.
20 Roger Gregory, "The Scope of the Companies Act 1948, Section 205", 98 LQR (1982) 413, 414-5.
21 J. L. Parkinson, "The Modification of Directors' Duties", JBL (1981) 335, 339.
22 Asif, *op cit* at 211.
23 John Birds, "The Permissible Scope of Articles Excluding the Duties of Company Directors" 39 MLR (1976) 396. [Thereafter Birds, 39 MLR (1976)].
24 Ross Cranston, "Limiting Directors' Liability: Ratification, Exemption and Indemnification", JBL (1992) 207- 8.
25 Robert R. Pennington, Directors' Personal Liability, (London: Collins Professional Technical 1987).

The editors of Gower and Gore- Browne in their latest edition have adjusted their opinion in compliance with the Vinelott J.'s judgment.[26] Gore- Browne's editors adding something more, categorise some duties as the non- excludable duties of directors which, in their view, seek to prevent a director from damaging the company's interests, as; the duty to show proper care and skill, or the duty not to misappropriate the company's property or any statutory provisions imposed on directors. Gore- Browne Editors referring to the Vinelott J.'s judgment states:

> "the general rule imposing accountability for secret profits as well as that avoiding a transaction involving a conflict of duty and interest, would, on Vinelott J.'s analysis be excluded, so long as the director acts in good faith."[27]

Distinction between duties as excludable and non- excludable is also followed by another commentator who believes that section 310 only invalidates articles which exempt directors from liability for breach of duty. Whilst the non- conflict duty may be released in this way, the duty to act in good faith and the duty of care may not, because where release is equivalent to permission to injure the company, such a release will be repulsive to the fiduciary relationship between director and company. It is not open to a company, therefore, to circumvent section 310 by including a provision in its articles releasing the whole range of directors' duties.[28]

Birds was also of the above opinion and thought section 448 of the Companies Act 1948 (now section 727), was an appropriate alternative to mitigate the harshness of section 310.[29] Birds says that 'it is surely preferable to have technical, though honest, breach of duty forgiven by the court than never brought to the light because of provisions in articles of association'.[30] He concludes that excluding any duty is void under section 310 'despite the fact that, literally read, section refers only to exclusions of liability being void'. However, in conclusion he does not reject the

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26 Gower, Principles of Modern Company Law (London: Sweet & Maxwell 5th ed. 1992) at 573-4. Gore- Browne on Companies, (Bristol: Jordan 44th ed.) para. 27. 21- 3.
27 Ibid.
28 Parkinson, *op cit* at 344.
29 Birds, MLR (1976) at 394.
30 Ibid at 397.

possibility "to modify these duties somewhat, by absolving a director from liability for making a profit by disclosure to the board."[31]

As was already mentioned this view has been criticised as contrary to the purpose behind the section intended by the Greene Committee.[32]

This criticism respectfully seems a misunderstanding of Birds' interpretation, because it disregards his earlier statement of view where he firmly recognised any modification of duties on the basis of section 310 as "defeat" of the philosophy behind the provisions. Moreover, this fact should be taken into account that Birds wrote his article in 1976, long before the *Movitext Ltd. v. Bulfield*[33] case was decided and the major amendment of 1986 in this regard had taken place. Therefore, Birds' opinion, as one of editors of Gore- Browne's work should be regarded in consistent with the view pointed out in the latest edition of that work.

To answer the question whether or not section 310 allows modification of duties, is a difficult task. That is because drawing distinction between exemption from liabilities and modification is not always possible.

So long as the statutory authority in this regard is not amended to give a guidance, the solution is to rely on the only judicial authority ever delivered in *Movitext Ltd.* which prohibits the modification of duties.

5. 2. 1. 3 Validity of ratification and approval

The important related question in this regard is the possibility of ratifying or approving an action considered as breach of duty by a majority in a general meeting. The effects of ratification is to prevent any action to be taken by minority shareholders against directors. However, such a ratification does not prevent shareholders to bring their own action providing that it is within the exceptions

31 Ibid at 401.
32 Cranston, *op cit.*
33 [1988] BCLC 104.

introduced in *Foss v. Harbottle*,[34] in the form of derivative action. On the other hand, by an approval, a director can be released from liability. The validity of such approval was confirmed by Lord Russell in *Regal (Hastings) Ltd. v. Gulliver*,[35] as:

> "[The defendants] could, had they wished, protected themselves by a resolution ... of Regal shareholders in general meeting. In default of such approval liability to account must remain."

On a wide interpretation of the word "or otherwise" in section 310, it seems any attempt by shareholders to approve in advance or ratify a breach of directors duties, or by the board to release a delinquent director have been rendered void.[36]

It has been stated that by accepting the view that section 310 in its true construction nullifies any exemption from the scope of a director's duty and from the consequences of a breach of his duty, a shareholders' resolution should not, therefore, absolve such duties or their consequences, because section 310 applies to "any provision, whether contained in the articles of a company's association or ... otherwise,"[37] which includes a resolution. However, a distinction must be made between a authorisation and ratification. It is said that a ratification by shareholders in a general meeting of a breach of a fiduciary duty is valid. Even a release in the absence of a ratification can be effected, when a board of directors decides that it was *bona fide* in the interests of the corporation not to sue one of its members because of legal costs, damages to the company's reputation and more importantly losing a qualified member.[38]

One may argue that, when ratification Ex *Post Pacto* of breach of duty is permitted, there is no point in preventing authorisation of a breach of duty in advance by a provision in the articles. But, ratification of breach of duty should be distinguished from authorisation, because the latter means nothing but the exemption which is

34 [1843] Hare 461. The exceptions are as such: i) When the misdoing complained of is an illegal or *ultra vires* transaction ii) When the matter concerned can not be decided by a simple majority but a special majority. iii) When the right of individual shareholders have been infringed iv) Where ratifying a matter by majority involves fraud on minority.

35 [1967] 2 A. C. 134.

36 Cranston, *op cit* at 206.

37 Instone, *op cit* at 549.

38 Cranston, *op cit* at 200.

prohibited by section 310. That is because approving or authorising breach of duty in advance means granting the right to the director to misconduct ensured of getting away with his wrongdoing without punishment which may be rightly considered contrary to public policy and deterrent effect of the duty.

Indeed, there are many examples demonstrating that the company in a general meeting can ratify breaches of duty by its directors except when the conduct concerned has been committed dishonestly or fraudulently.[39]

Law Society Standing Committee on Company Law was not prepared to accept a strict interpretation of section 310 which would render void a shareholders' resolution to approve in advance or ratify a breach of duty, but it believed the section should have been amended to catch such resolutions.[40] Likewise, the Department of Trade and Industry in a consultative document on section 310 also suggested that the section should have been amended to clarify the fact that it did not invalidate resolutions of shareholders waiving or ratifying directors' breaches of duties.[41]

In some cases, it has been held that any act giving rise to taking away a company's assets or involving self- interest cannot be ratified or approved by shareholders.[42]

On the other hand, some commentators have drawn distinction between the duties breach of which are ratifiable and those which can not be ratified. Gore- Browne, for example, enumerates ratifiable breaches of duties as; obtaining a secret profit in circumstances not involving any misappropriation or misapplication of company's property,[43] failure to disclose an interest in a contract to which the company is a party,[44] breach of duties of care and skill,[45] and using a power of allotment for

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39 *Bamford v. Bamford* [1970] 1 Ch. 212, *North- West Transactions Co. v. Beatty* [1887] 12 App Ca. 589, *Grant- United Switchback Railways Co.* (1888) 40 ChD 135.
40 John Birds, "Director's Insurance and s. 310", 7 Co. Law., (1986) 209.
41 John Birds, "Reform of Section 310", 9 Co. Law. (1988) 221.
42 E. g., see *Cook v. Deeks* [1916] 1 A. C. 554. In this case, the court held that the directors' decision in appropriating a contract belonged to the company to themselves, could not be ratified.
43 *Regal(Hastings) Ltd. v. Gulliver*, [1967] 2 A. C. 134, 150.
44 *North- West Transactions Co. v. Beatty* [1887] 12 App Ca. 589.
45 *Pavlides v. Jensen* [1956] Ch. 565.

improper purpose.[46] However, such breaches of duties which involve dishonesty, an unlawful act, and fraud on the minority cannot be ratified.[47]

With respects, it seems even in such duties as obtaining a secret profit, where often a *Mala fide* exists, a ratification may be considered in contrary to public policy, unless a full disclosure is made, and the company decides to let off.[48]

5. 2. 1. 4 Section 310(1) and Article 85 of Table A

There have been some comments on the relationship between section 310 and Article 85 of the Table A of the Companies Act 1985, or its predecessors Articles 78 and 84 of Table A of the Companies Act 1948. The question is whether those articles are exceptions to the exemption prohibited by section 310(1), or a natural consequence of development of the common law without necessary connection with that section? Because the issue relates to self- interest question, it is worth restating the rule of conflict of interest which was illustrated by Lord Herschell's judgment in *Bray* v. *Ford*[49] as follows:

> "It is an inflexible rule of the Court of Equity that a person in a fiduciary position ... is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict."[50]

That statement as one of the oldest equity rule in this regard obviously prohibits any conflict of interest on the part of fiduciary, but at the same time allows some exception to that inflexible rule. To answer the question of whether there can be any analogy between the above rule and its exception on the one hand, and the prohibition rule in section 310 and Article 85 or its forerunners on the other hand, it is necessary to review the comments made on the matter.

46 *Bamford v. Bamford.* [1970] Ch 212.

47 *Daniels v. Daniels* [1978] Ch 406. Also Parkinson takes the opinion that breach of good faith duty is not ratifiable. Parkinson *op cit* at 342, whereas the duty of the proper purpose is potentially ratifiable and the duty could be released by the shareholders in a general meeting. Ibid at 344.

48 *Imperial Mercantile Credit Ass. v. Coleman* (1873) LR 6 HL 189.

49 [1896] A. C. 44.

50 Ibid at 51.

Baker believes that because an interested director has a duty under general law to disclose his interest to the shareholders' general meeting and that the duty, by those articles, replaced with a duty of disclosure to the board of directors, it is, thus, a sort of modification of the duty. However, this modification is regarded in-consistent with section 205 of the Companies Act 1948, predecessor of section 310, unless Article 84(3) is conditional to Article 84 (1) of Table A of the Companies Act 1948.[51]

This conclusion is doubted by Parkinson, because the duty in question is a duty of director not to place himself in a position, where his private interest may conflict with his duty to the company, and the rule that a director may not be interested in a contract with his company is an application of that duty. The interested director is in breach of his duty, unless it is ratified by the shareholders in a general meeting. Parkinson concludes that the effect of the Articles is not merely a modification, because the board is not substituted for the general meeting, and the former is not to authorise breach of duty, but such a breach has been authorised by Article 84, or this Article has released a duty. Therefore, it is a conditional exclusion rather than modification. As to Article 78, Parkinson is of the view that it excludes the duty altogether and conditionally permits a director to be interested in a contract in which his company is also interested.[52]

Birds has a typical view, when he says: "the Articles in Table A which do seem to exclude a duty must be treated as exceptional, but valid because of their appearance in a statute."[53] He first construes section 205 as establishing a rule prohibiting any exclusion of duty, the rule which is apparently violated by those Articles, and then he considers this exclusion, though a violation, valid because of its statutory force.

Rule and Brar first submit that "nobody would have doubted that it contravened s. 205 and therefore void," however, they admit that there can be a possibility of reconciling the Articles with the section.[54] Their attempt seem to have led to the

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51 Baker, *op cit* at 191- 92.
52 Parkinson, *op cit* at 337
53 Birds, MLR (1976) at 401.
54 Rule & Brar, *op cit* at 7.

conclusion that even without authority in those Articles, a director's interest in a contract with his company can be ratified or approved, on the condition that any material information is disclosed. Consequently, those articles are not necessary.

Finally, the Gower's editors now reject any possibility of reconciling section 310 with exclusion of the over- riding equitable principle in Article 85 without doing violence to the section. They, therefore, suggest that the article, after being appropriately amended, might be translated into the sections of the Act, and to amend section 310 to "exclude from its ambit any transactions pemitted under those sections."[55]

With respects to those commentators, it seems in order to make a reasonable analogy of section 310 and Article 85, and Lord Herschell's definition of conflict of interest, and also to solve the uncertainty of relationship between the section and that Article, the solution advanced by Gower is the appropriate one, based on which the legislature in the next amendment of the Act may add a condition to the prohibition in section 310(1) which might be as follows: "unless exclusion, or exemption authorised within the ambit of Article 85 of Table A of this Act."

5. 2. 2 Indemnification and Insurance

In English law, it is believed, a company has never been prevented from purchasing and maintaining insurance for itself against breach of duty, nor has it prohibited directors from personally insuring themselves against claims brought by their company or third parties.[56] Moreover, there was nothing in the previous form of section 310 to prevent a company from insuring itself against damages it may have suffered by reason of a director's breach of duty.[57]

In practice, prior to the 1989 amendment of section 310, some companies tried to circumvent the prohibition under section 310 by arranging a division of premiums between directors and their company in which the directors subscribed towards a

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55 Gower, Principles of Modern Company Law (5th ed.) at 574.
56 Louis G. Doyle, "Defining the Scope of Directors' Indemnity Insurance", SJ (1991) 957.
57 John Birds, "Directors' Duties of Care and Liability Insurance" (ed. Rider) The Regulations of the British Securities Industry (London: Oyez Publishing 1979) 119.

fraction, usually one- tenth of the premium of such a policy from their salary or other personal assets.[58]

During 1835 to 1880, liability insurance was not sold at all in England, because doing so was considered in contrary to public policy,[59] based on reasoning that insurance would undermine the incentive provided by negligence liability for potential defendants to take reasonable care, if those defendants could shift that liability to their insurers. However, the importance of national interests outweighed the above reasoning and shipowners were excluded from the rule.[60]

5. 2. 2. 1 Desirability of insurance

The business managers are faced not only by the uncertainty of when loss may occur, but also with the uncertainty as to the level of the costs. In the business life, when the risks are great and the potential losses are high, the businessmen normally seek for protection against such potential risks, by taking out insurance policies.[61]

The significant advantage of buying insurance coverage for corporate directors is that in English law, unlike the United States law, the availability of indemnification from the company is strictly confined in the situations set out in section 310 (3) (b). In other words, a director can be indemnified only when he has been successful in defending an action, or when the court is satisfied that section 727 of the Companies Act 1985 can be invoked. Consequently, in the case of inapplicability of section 727, insurance is the only protective legal way which can cover such a considerable gap resulting from the lack of any appropriate protection.

Irrespective of the very discretionary application of section 727 and the rare availability of indemnification, in the present English law, insurance is the only protection on which corporate directors can rely. Moreover, it could be the best

58 Doyle *op cit* at 957.

59 Martin Davies, "The End of the Affair: Duty of Care and Liability Insurance", 9-10 Leg. Stud., (1989- 90) 69.

60 bid.

61 Gwilym Williams, Understanding Insurance, (London: Waterlow Publishers Ltd. 1983) 1.

means of recovery, when the corporation financially is unable to pay for indemnification.

Insurance is also suggested as an external management control. According to this suggestion, since company's directors insurance market is a competitive one, it differentiates between good and bad risks, and fixes premium levels accordingly. For doing so, the insurance companies gather information and scrutinise companies and their insured directors.[62] The most considerable advantage of insurance is its encouraging effect on responsible directors to take justifiable risks without fear of potential personal liability. The existence of an insurance, as the main or, in some occasions, the only protective devices, may encourage qualified directors to take part in management of companies, particularly as non- executive directors.

Wyatt Co. in its survey, in an attempt to explain the necessity of the use of liability insurance, argued that purchasing and maintaining an insurance policy not only does not impose an extra cost upon companies, but it may reduce the costs to the firm. That is because the directors as risk bearers, where insurance is not available, demand a very high level of salary compensation.[63] Furthermore, insurers monitor the performance of directors, particularly when intending to renew a policy. Besides, the costs of litigation will not be imposed upon the defendant director, but it is the insurer who takes over the conduct of defence.[64]

On the other hand, the harmful effects of insurance on directors to perform their obligation with due care and diligence, is of a significant concern. It has been argued that insurance may undermine the public policy rules and encourage reckless and unqualified individuals to get involved in a company management and insulate themselves from liability at the expense of the company. However, considering the other side of the coin, directors liability insurance may limit moral hazard by the fact

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62 Vanessa Finch, "Who Cares about Skill and Care?" 55 MLR (1992) 211.

63 Wyatt Co. UK Directors and Officers Liability Survey (1993- 4) (Quoted by Vanessa Finch, "Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance", 57 MLR (1994) 888, 900).

64 Birds "Directors' Duties of Care and Liability Insurance" at 122.

that the insurance industry monitors potential delinquent directors, notably when insurers impose some restrictions or conditions upon some specific individual directors or corporations.[65]

The biggest danger of an insurance is that the court, aware of the existence of such a coverage, could impose undesirably high standards of care and skill and hold directors liable for taking a simple bad decision.[66]

The practice of selling the insurance only through the company has been criticised based on the reasoning that it encourages management either to pay directly premiums for the individual directors' policy or to reimburse them for their expenditure. Such a practice and use of corporations' funds is considered improper. Therefore, it has been suggested that the insurance should be sold to corporate directors individually instead of to corporations.[67]

With regard to all advantages and disadvantages, and reasoning behind agreements and disagreements on insuring directors against personal liability, it is obvious that corporations and owners of business have found it advantageous to purchase insurance, when doing so, unlike a driver insurance, is not mandatory.

5. 2. 2. 2 Scope of section 310: insurance and indemnification

Under the original version of section 310,[68] any insurance policy indemnifying a director or other officers against liability for negligence, irrespective of whether insurance was effected by the director himself or its corporation was void.[69]

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65 Finch, 57 MLR (1994) 888.

66 Birds, "Directors' Duties of Care and Liability Insurance" at 123.

67 Josef W. Bishop, "New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability", 22 Bus. Law. (1966) 112.

68 The section reads: "(1) This section applies to any provision, whether contained in a company's articles or in any contract with the company or otherwise, for exempting any officer of the company or any person (whether an officer or not) employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law or otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company.
(2) Except as otherwise provided by the following subsection, any such provision is void."

69 Allen B. Afterman Company Directors and Controllers, (1979), at 123, Birds, 7 Co. Law. (1986) 20.

The question may be raised over the scope of the current version of section 310, when it allows the company to purchase and maintain insurance against "any liability ... in respect of any negligence, default, breach of duty or breach of trust" of which the director may be guilty in relation to the company. Does it mean a policy covering other wrongdoing such as wrongful trading is to be set aside by a court as invalid? The current version of section 310(3)(a) introduced a major change to the extent of the section and widely permitted purchasing insurance by adding the following subsection:

> "This section does not prevent a company (a) from purchasing and maintaining for any such officer or auditor insurance against any such liability".

The question requires a scrutiny of whether prohibitive language of section 310 applies to indemnity against liability resulted from occurrences which are not in relation to the company, when the wording of the section obviously refers to "any negligence, default, breach of duty ... in relation to the company." Does it imply that a company is permitted to indemnify its directors against any liability to third parties? The more crucial question is the interpretation of the expression of "in relation to the company".

The Law Society's Standing Committee on Company Law suggested that such extenuation was "misconceived".[70] But, Gower believes that the section is applicable to third parties.[71]

It seems that conduct in relation to the company covers any action directly or indirectly relates to the company. On this wide interpretation, any conduct on the directors' part leading to liability under any provision of the Companies Act or the Insolvency Act or other relevant regulation, falls within the above expression.

Moreover, there is no implication in the provisions of section 310 to prohibit insurance or indemnification against liability to third parties' actions, as long as such liability is a result of acting and incurring losses "in relation to the company".

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70 Memorandum of April 1988 at 1. (Quoted by Colin Baxter, "Demystifying D & O Insurance", OJLS (1995) 537, 543).

71 Gower, Principles of Modern Company Law (5th ed.) at 574.

The issue of insurance against liability for wrongful trading is more controversial. It is believed that insurance against such liabilities as wrongful trading, as long as not committed deliberately, is permissible.[72] However, the issue has not been subject of comments by legal writers, nor is there any case law authority to clarify the real position of the matter in company law. The editors of Gower also seem of the view that liability under section 214 can be covered by insurance.[73]

As to indemnification against corporate directors liability, in English law, the rule provided in section 310 is an obvious prohibition.[74] However, this rule is not absolute but it permits some exceptions. The extent of application of the section to indemnify a director is confined in two strict situations: First, indemnification is available for the costs of a defence in which a director has been successful. The expression of "any liability incurred" has been interpreted as costs of defence. It is justified when the language of section 310 (1) in prohibiting indemnification at first stage lays down a rule which later in subsection (3) permits some exclusions.

As to indemnification for a successful defence expenses, this question may arise that when, as a procedural rule, the loser party of the case is required to pay for the other party's costs of proceedings, in what circumstances the indemnity provided by section 310 can operate, where it says 'indemnify any such officer or auditor against any liability incurred by him in defending any proceedings (civil or criminal) in which judgment is given in his favor or he is acquitted'? Perhaps we should wait for a judicial decision on this interpretation.

On the other hand, it is clearly justified to provide a director with indemnification as such in a proceedings where "he is acquitted".

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72 Turnbull & Edwards, *op cit* at 769.

73 Gower, Principles of Modern Company Law (5th ed.) at 575.

74 "310(3)(b) reads:

"This section does not prevent a company (b) from indemnifying any such officer or auditor against any liability incurred by him (i) in defending any proceedings (whether civil or criminal) in which judgment is given in his favour or he is acquitted, or (ii) in connection with any application under section 144(3) or (4) (acquisition of shares by innocent nominee) or section 727 (general power to grant relief in case of honest-and reasonable conduct) in which relief is granted to him by the court."

Second sort of indemnification which refers to section 727 of the companies Act 1985,[75] is a result of incentive behind section 727 rather than section 310. It should be noted that any payment as indemnification under this part of section can be made only when there is a successful defence, having the defendant relieved under section 727, or when he is acquitted.

5. 2. 2. 3 Changes of market or crisis?

According to the Wyatt Survey, the uptake of directors and officers cover has sharply increased so that the percentage of companies surveyed by the Wyatt, purchasing insurance increased from 46 per cent in 1991 to 62 per cent in 1993- 4.[76] Since the 1989 amendments, the volume of directors liability has sharply been increased, so that majority of the top 500 companies have purchased such cover.[77] Moreover, there has been an increase in premiums. However, such an increase in premiums which may assume in other markets as a natural consequences of economic development should not be defined as a crisis in insurance market.

The effects of insurance market changes in the United States was of such depth that it affected even social aspects of American community. Such disastrous result of insurance crisis in that country in any way can not be compared with some limited changes in the United Kingdom directors insurance market.

Reinsurance process has been submitted as the cause of the loss of market flexibility in the UK. Insurance companies in fear of the risks, bought insurance cover in order to protect their business against such a risk, paying out their own policies. The problem which insurers in commonwealth countries including UK faced was a result of the dominance of the US on the world markets,[78] that inevitably transmitted the effects of its insurance market crisis to the Continental insurance industries.

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75 Section 144 (3), (4), (acquisition of shares by innocent nominee) is outside of our discussion.
76 Wyatt Co. U. K Directors and Officers Liability Survey (1993- 4).
77 Cranston *op cit* at 197.
78 Davies, *op cit* at 81.

5. 3 Relief under section 727

5. 3. 1 Background

In comparison with other protective mechanisms available to a director in English law, namely insurance and indemnification, the relief[79] under section 727 of the Companies Act 1985 is over a century old. In other words, until the amendment of statutory provisions on insurance in 1989, the relief under section 727 and its predecessors was the only effective protection for corporate directors.

Although the extent of application of the section[80] is limited to the matters set out in section 212 of the Insolvency Act 1986, there seems to be a tendency to justify the application of the relief to wrongful trading and other cases by giving an unrestricted and wide interpretation to the meaning of wrongful trading in order to categorise it within concept of breach of duty for the purpose of section 727.

The model for section 727 was first introduced in the shape of section 3 of the Judicial Trustees Act 1896.[81] Under this section, if it appeared to the court that a trustee who had acted honestly or reasonably was liable for any breach of trust and ought fairly to have been excused for the breach of trust, the court may relieve him wholly or partly from personal liability for the same. Section 3 of the Judicial Trustees Act 1896 was intended to cover trustees, and more importantly was confined to the breach of trust. However, the section was expanded by section 279 of the Companies Act 1908 and applied not only to 'any proceeding against a director, or person occupying the position of director of a company',[82] but most notably to cover liability for negligence.

[79] In this discussion any reference to "relief" is intended the relief under section 727 of the Companies Act 1985 or its predecessors accordingly.

[80] In this discussion any reference to "the section" is meant section 727 or its predecessors accordingly.

[81] The provisions of this section was repeated in section 61 of the Trustee Act 1925.

[82] The expression of "trustee" did not appear in this section.

A major change came with the Companies Act 1929, section 372.[83] According to this Act, the scope of section was widened to include "default, breach of duty, or breach of trust." Furthermore, the beneficiary of the relief which in the previous Act was "a director or person occupying the position of director of a company" was replaced with "a person to whom this section applies."

Section 448 of the Companies Act 1948 which was, with minor changes, repealed by section 727 of the 1985 Companies Act, introduced some more changes to the law in this regard. The words of "a person to whom this section applies" were replaced with the expression of "an officer of a company or a person employed by a company as auditor (whether he is or is not an officer of the company)." This change was made to grant the relief to all officers including directors, as well as auditors, irrespective of whether or not the latter are officers.

Section 727 provides a relief for director when the court holds him liable in respect of negligence, breach of duty or breach of trust, if it is satisfied that he had acted reasonably and honestly, having regard to all the circumstances of the case.[84]

Although there have been several decisions concerning this section, there is little in the way of academic comments on the impact and importance of the section.

5. 3. 2 Scope of Section 727

A wide range of matters are covered by the relief under section 727. Despite the fact that the matters set out in the section and those stated in section 212 are almost the same, confining the relief to those matters has been questioned by the courts and

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83 It is worth noting that *re Gilt Edge Safety Glass, Ltd.* [1940] Ch. D. 237 was decided under this section.

84 Section 727 of the Companies Act 1985 reads:
"(1)If in any proceedings for negligence, default, breach of duty or breach of trust against an officer of a company ... it appears to the court hearing the case that the officer ... is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as it thinks fit."

commentators. As will be seen, there are clear indications in some cases to support this tendency.

5. 3. 2. 1 Relationship between section 727 and section 214

Although the extent of application of the section in its strict sense may be confined to traditional duties imposed on company directors, there has been a tendency to justify the application of the relief to wrongful trading cases by giving an unrestricted and wide interpretation to the meaning of wrongful trading in order to categorise it within the concept of breach of duty for the purposes of section 727. At first sight, it is difficult to find any implication in the Insolvency Act 1986 on the basis of which one can claim that the legislature intended section 727 relief to be available to directors against whom wrongful trading proceedings have been initiated. Parliament refused to accept the proposal of the Cork Committee for availability of a relief in exactly the same terms as those used in section 727 when considering the extent of liability under section 214.[85]

The first case which dealt with this issue was *re Produce Marketing Consortium Ltd.*[86] The point arose at an interlocutory stage. In this case, Knox J. did not agree with the directors' submission that they had conducted the business honestly and reasonably, and they were, thus, entitled to the relief under section 727. His Lordship accepted the argument of counsel for liquidator that there were some indications in the wording of the two sections which revealed the legislature's intention that the two sections were not to be used in conjunction. In Knox J.'s view, section 214 required that the directors' conduct to be assessed both by objective and subjective standard, whereas under section 727, the same conduct was to be viewed solely

[85] Insolvency Law & Practice: Report of the Review Committee, Cmnd. 8558 1982. According to Para. 1806 (3) (b) of the report:
"as an officer of the company ... ought to have known, that the company's trading was wrongful; provided that if upon such application it appears to the court that *such a person has acted honestly and that having regard to all the circumstances of the case he ought fairly to be excused* that the *court may relieve him*, either wholly or in part, from personal liability on such terms as it may think fit." Emphasis added.
[86] [1989] 5 BCLC 513.

subjectively. In the court's view, it was difficult to find out how Parliament could have intended "both section 214 and section 727 of the several acts to be operated by the same judge and at the same time." The learned judge, therefore, concluded that section 727 was inoperative in the context of section 214 proceedings.

In *DKG Contractors Ltd.*,[87] a subsequent section 214 case, the court took a different view from the above mentioned judgment. John Weeks Q. C., sitting as a Chancery judge, dismissed the respondents' application under section 727 not because the section could not be applied in conjunction with section 214 , but because he thought that the respondents did not act reasonably. He held that:

> "... neither Mr. nor Mrs. Gibbons acted dishonestly. Neither of them had any knowledge of company law of the concept of limited liability. ... I do not think that they deliberately traded in the manner in which they did in order to avoid personal liability. However, I do not think that they acted reasonably."[88]

The learned judge also took into account the situation of the unpaid outside creditors as a factor not to apply the section 727 relief.[89]

The above judgment seems to have implied applicability of section 727 in the case of wrongful trading, if in its discretion, the court considered the respondent acted honestly and reasonably. If the court was, thus, convinced that the directors in question had acted reasonably, it would likely exercise its discretion to relieve them from responsibility. In result, Mr. Justice Week Q. C.'s holding in *DKG Contractors* is in disagreement with the Knox J.'s judgment in *re Produce Marketing*.

However, accepting these sections as working in conjunction may frustrate the objective of wrongful trading. In support of this approach, it should be noted that the introduction of wrongful trading took place long after the enactment of section 727, and Parliament could not have intended to provide the relief against a future statutory liability of directors. Therefore, it may be argued that the relief is applicable only in the case of directors' liability under the Companies Act, but not under the

87 [1990] BCC 903.
88 Ibid at 912.
89 Ibid at 913.

Insolvency Act. On the other hand, one can also argue that, though Knox J. pointed out that "section 214 in terms, of course, does not impose a duty in literal sense,"[90] the main element of a wrongful trading liability which is carrying on trading while insolvent, is a breach of negative rather than a positive duty. To support this view, the account should be taken of the Cork Committee proposal in paragraph 1806 (3) (b) where they offered a relief for wrongful trading liability the same as that provided by section 727. Furthermore, the concept of wrongful trading can be considered within a wide interpretation of "default" set out in section 727. It seems, with regard to the view taken in the case of *DKG Contractors Ltd.*, this is an attractive approach. The corollary of this is that to avoid liability, the directors must cease trading once they know or ought to have known that the company was in financial trouble or insolvent. It may even be a duty to take some appropriate actions, for example calling for an extraordinary meeting of the company's shareholders, or enlisting the assistance of an insolvency practitioner.

5. 3. 2. 2 Applicability of section 727 to misfeasance

The applicability of section 727 to liability for misfeasance has been examined in several cases. To relieve a respondent under the section, three requirements are to be satisfied, namely he has acted honestly, reasonably, and ought fairly to be excused with regard to all circumstances of the case. If these requirements are met, the courts usually grant such a relief to the respondent, but if one of these requirements is not present, the court will turn down an application under section 727. In the case of *J. Franklin & Son Ltd.*,[91] e. g., the court refused to grant the relief to the respondent. The matters complained of were making some payments as remuneration improperly, and invalidity of the appointment of one of the defendant directors.

In that case, payment of some sums was in a general meeting passed when there was no appropriate quorum and one of the members present in the meeting was not

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90 *re Produce Marketing Consortium Ltd.* [1989] BCLC 513, 518.
91 [1937] All. E. L. R. 43.

actually a director because he did not fulfill a duty to register as holder of qualification shares. The respondents contended that the payments in question were properly made, and even if not, they should have been relieved from liability under provisions of section 372 of the Companies Act 1929. Crossman J. although finding it difficult to attack such payments, he could not justify a relief under the circumstances of the case and concluded:

> "I feel that I can not, in the circumstances, hold under section 372 that this lady, having improperly received sums from the company, ought fairly to be excused from receiving money which did not belong to her, and be allowed to retain that money."[92]

The court after examining the three requirements required for the relief, notably having regard to all the circumstances of the case including those connected with appointment of the respondents, found it difficult to relieve them from liability. In Crossman J.'s view, the two directors who authorised the payment pursuant to the resolution and the third director who actually received the sums pursuant to the resolution, were liable to refund these sums to the company.

Similarly, in *Guinness Plc v. Saunders & Another*,[93] the court rejected the defendant director's plea for the relief, because with regard to the circumstances of the case, where the defendant received a £5m wrongfully from the company, the court found it impossible to exercise its discretion under the section to relieve the respondent from liability. That was because his claim for the relief was based on the same ground as he claimed compensation for the services he had rendered. Moreover, he had been in possession of the company's property.

Likewise, in *Dorchester Finance Co. Ltd. & Another v. Stebbing & Others*,[94] two directors of Dorchester Finance Ltd. were charged with negligence, and a knowingly reckless participation in the misapplication of the company's assets. The court rejected the defendants' reliance on the relief under section 727 because, in the

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92 Ibid at 46.
93 [1988] BCLC 43, *denied* [1990] BCLC 402.
94 [1989] BCLC 498.

court's view, they did not satisfy the two main requirements for relief, namely acting reasonably and that they ought fairly to be excused.[95]

In *re Kirbys Coaches Ltd.*,[96] where directors were sued for negligence. Hoffmann J. held that the burden of satisfying the court that the respondents ought to be relieved, was upon themselves.[97] The respondents, here, refused to give particulars required by the liquidator and ordered by the registrar in support of their claim that they had acted honestly and reasonably and, thus, ought to have been excused from liability. The court held that it was for the respondents to show that they had acted honestly and reasonably and ought fairly to have been excused.

The case of *re Welfab Engineers Ltd.*[98] was an obvious application of the relief under section 727 in relation to a negligent conduct. In this case, the alleged misconduct was breach of duty. The same judge stated his view in favor of the applicability of the relief to negligence as follows:

> "I therefore consider that the respondents were not in breach of duty and that the summons must be dismissed. If I were wrong in this, I would consider that the respondents had acted honestly and reasonably and ought fairly to be excused from liability under s 727 of the Companies Act 1985."[99]

The court concluded that the defendant directors had acted honestly and reasonably and, if they had breached their duty, they ought to have been excused.

In the recent case of *re D' Jan of London Ltd. Copp v. D' Jan*,[100] Hoffmann J. exercised his discretionary power to excuse the respondent from liability. However, the learned judge posed some comments which opened a new horizon on the matter. In this case, Hoffmann J. examined the test of reasonableness required by section 727. His Lordship's view that how one could have acted reasonably and at the same time negligently, challenges the test recognised in section 727. He thought it:

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95 Ibid at 506.
96 [1991] BCC 130.
97 Ibid at 131.
98 [1990] BCLC 833.
99 Ibid at 838.
100 [1994] 1 BCLC 561.

> "may be odd that a person found to have been guilty of negligence, which involves failing to take reasonable care, can ever satisfy the court that he acted reasonably. Nevertheless the section clearly contemplates that he may do so and it follows that conduct may be reasonable for the purposes of section 727 despite amounting to lack of reasonable care at common law."[101]

Thus, Hoffmann J. appeared to distinguish between a negligent conduct for purposes of section 727 and that at common law. However, he did not elaborate, nor did he give any ground for doing so. In that case, the respondent was excused from some of, but not all, liability which he would otherwise have incurred.

Here, the court seems proposing a new standard of care even lighter than that traditionally recognised in common law, which is only applicable for purposes of section 727. Finally, the learned judge seems to have relied on the particular facts of the case before him. In that case, the court stressed that although the company had its own separate identity because the respondent, the former controlling director, was holder of 99% of shares, it would be reasonable that the respondent personally took risk in relation to his own property, with regard to the extent of his shareholding, whereas his action would have been unreasonable in relation to one else's property or shareholding.

Did his Lordship mean if the respondent was not the majority shareholder, he would not have been granted the relief? It seems so. He also seemed respectfully prepared not to take into account the fact that the majority shareholder's interests is replaced by those of its creditors, and the society as a whole when a company is troubled. It seems respectfully difficult to agree with the opinion that the holding shareholder was not responsible because he dealt with his own property when, as a preliminary rule of company law, a company's assets belong to itself as a legal person.

Hoffmann J.'s holding in the above case did not follow his previous judgement in *re Kirbys Coaches Ltd.*.[102] In this case, the court applied the relief under section 727 generously, whereas in the former the same judge seems to have granted a partial

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101 Ibid 564.
102 [1991] BCC 130.

relief only by considering some factual circumstances of the case such as the defendant being a holding shareholder.

Considering the line of decisions made, shows an increasing reluctance to grant the relief under section 727 easily even in the case of a misfeasance action.

5. 3. 2. 3 Extending the relief to other cases

Most of cases arose out of misfeasance proceedings are decided under what is now section 212 of the Insolvency Act 1986. But there are number of other cases where the matters originated otherwise. Therefore, the courts should first decide whether to proceed the case before them within the ambit of the section. In *re Whithttaker v. Bamford (Allsop.)*,[103] for example, where the charge was breach of trust, the respondents applied for relief under section 3 of the Judicial Trustee Act 1896. In that case, Cozens- Hardy M. R. refused to apply a restricted meaning to the relief and stated:

> "I can see no ground for narrowing or limiting the application of the wide words of the section, "any breach of trust" are emphatic words. The statute was obviously designed to protect honest trustees, and it ought not to be construed in a narrow sense."[104]

Hamilton L. J. who found the section to be "comprehensive and unrestricted" agreed with Hardy M. R.'s view. Likewise, Swinfen Eady L. J. said:

> "The language of s. 3 is wide, and a narrow construction ought not to be placed on it. It was intended to give power to the Court to relieve a trustee in proper cases. The word "is or may be liable" appear to point doubtful questions of construction. In my opinion the case of a trustee committing a breach of trust by paying the wrong person, in consequence of acting upon an erroneous construction is within the section, and the Court has jurisdiction to relieve against the personal liability."[105]

However, in *Customs & Excise Commissioners v. Hedon Aloha Ltd. & Others*[106] the court took a totally different stance by refusing to recognise a wide application of the section. In that case, when it appeared that the company was unable to pay a

103 [1914] 1 Ch. 1.
104 Ibid at 11.
105 Ibid at 21.
106 [1981] 2 W. L. R. 791. The significance of this case is its being examined by several judges of the Appeal Court.

£18,080 in a general betting duty, an action was filed against two of its directors. One of the defendant directors pleaded that he had entirely acted honestly and reasonably and, thus, entitled to the relief under section 448 of the Companies Act 1948. In the Court of Appeal, several judges examined the matter and refused to grant the relief. Ackner L. J. examined the meaning of default for the purpose of section 448 and suggested that an unrestricted construction should not be given to the word "default". Griffiths L. J. in agreement with Ackner J. pointed out that:

> "In my judgment section 448 has no application to the present claim. Although the section is expressed in wide language it is in my view clearly intended to enable the court to give relief to a director who, although he has behaved reasonably and honestly has nevertheless failed in some way in the discharge of his obligations to his company or its shareholders or who has infringed one of the numerous provisions in the Companies Acts, that regulate the conduct of directors."[107]

The court concluding that there was no allegation of misconduct or breach of duty, went on to say that the allegation was not a default within the word in section 448. The other point which was considered by the judges in the instant case was whether or not a third party claim fell within the scope of the section. In that case, there was an unanimous agreement among the judges on the point that such claims were outside the reach of the section. Stephenson L. J. took the opinion that:

> "... the proceedings in which relief could be granted must be proceedings for the negligence, default, etc. of the director ... . Furthermore, the language of section 448 of the act of 1948 was apt to describe the area in which a company director might be in breach of his duties to the company, and the ambit and concern, the context and matrix, of the section was company law and the relation of the officer ... of a company to the company and not to third persons."[108]

Ackner L. J. agreed with his colleague's view and stated that the true ambit of the section was restricted to claims by or on behalf of the company or its liquidator against the directors for their personal breach of duty.[109] Consequently, it was held that the relief under section 448 was not available to third parties claims.

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107 Ibid at 800.
108 Ibid at 796.
109 Ibid at 798.

It is worth noting that though in *re Produce Marketing Consortium Ltd.*[110] there was no question of a third party claim, Knox J. referring to the views posed in *Customs & Excise Commissioners*, took a stance in agreement with that taken in the latter case that the relief under section 727 was not available to third parties claims.[111]

The question whether acting *ultra vires*[112] falls within the ambit of section 727 has been examined in some cases. For example, In *re Claridge Patent Asphalte Company, Ltd.*[113] the liquidator of the Claridge Company, in compulsory liquidation, sued the directors for acting *ultra vires*, claiming that the investment by the directors of £6334 in taking up the 4334 shares and 2000 debentures in the Clarmac company was *ultra vires* the Claridge company, and thereby invalid or was a misfeasance or misappropriation of the company's funds.[114] Both counsel for the defendant directors and Astbury J. acknowledged that the respondents' conduct was *ultra vires.* However, the learned judge considered the fact that although the respondents had no power to carry out the scheme, they were advised that they could do so, with full approval of the company's shareholders. Astbury J. rejecting the liquidator's contention that section 279 was not applicable in the case of *ultra vires* held that it was an application of breach of trust on the part of defendant directors. The learned judge went on to say:

> "In my opinion s. 279 clearly applies to a case of ultra vires. All applications of a company's money ultra vires the company are in fact breaches of trust on the part of directors. The language of s. 279 is perfectly wide and general, and I see no reason for limiting the generality of that section to breaches of trust where no question of ultra vires comes in."[115]

Therefore, his Lordship held that the court ought to have relieved the respondent from his personal liability under section 279.

110 [1989] 5 BCLC, 513.
111 Ibid at 516.
112 This concept has been abolished by section 35 of the Companies Act 1989.
113 [1921] 1 Ch. 543.
114 Ibid at 545.
115 Ibid at 548.

Such statement does obviously challenge Ackner J.'s opinion in *Customs & Excise Commissioners v. Hedon Aloha Ltd. & Others*[116] where his Lordship applied a strict and narrow concept of the word "default".

The noteworthy point as to this case was the investment of the company's fund by the respondent wrongfully, which was an obvious implication of breach of trust, and therefore within the scope of the relief under section 279, with no need to find out whether or not it was *ultra vires.*

In *re Duomatic Ltd,*[117] an action was brought by the company's liquidator alleging that the defendant director had wrongfully received remuneration. The court refused to exercise its discretion under section 448 of the Companies Act 1948 to relieve the respondent, not because the matter was outside the section's scope, but rather because the defendant, in the court's view, did not act reasonably. Buckley J. thought the director had not been acting "in a way which a man of affairs dealing with his own affairs with reasonable care and circumspection could reasonably be expected to act in such a case."[118]

As to the matters discussed under the scope of the section, whether misfeasance, wrongful trading or other cases, it seems, as Astrbury J. rightly stated, the language of section 727 was deliberately designed general to cover any breach of duty. In a wide interpretation of the meaning of breach of duty and default set out in that section, any misconduct should fall within the scope of the relief, which even includes wrongful trading. However, as to the latter, the still unresolved problem is its objective test which cannot be reconciled with the totally subjective standard required in section 727. Therefore, in order to apply the relief to a section 214 case, a statutory amendment seems necessary.

116 [1981] 2 W. L. R. 791.
117 [1969] 1 All E.R. 161.
118 Ibid at 171.

5. 3. 3 Extent of the Courts Discretion

The extent of the discretion granted to the courts to accept or reject a defendant director's application for the relief is a matter which requires a detailed examination. To examine the issue, the reference, first of all, should be made to the provisions of the section itself. There are clear indications in the section that the power of the court is absolutely discretionary but not mandatory. The section states "If ... it appears to the court", but not "if it is proven" or "if it is shown". Thus, the sole authority to decide whether it has appeared to the court or not is the court itself. The requirements provided for invoking the relief, namely the respondent "has acted *honestly, reasonably*, and that *having regard to all the circumstances of the case*[119] ... he ought fairly to be excused", grant a wide and flexible discretion to the court hearing the case. As to the requirement whether a defendant director has acted reasonably, the question may be raised what sort of criterion should be employed by the court. Gore- Browne argues that while the first two requirements can be proven, the third one which is left to the courts' discretion is not easy to prove.[120] There is no precise definition for the expression "reasonable", and it is subject to people's understanding. The other parts of the section are not helpful in this regard. The case *DKG Contractors Ltd.*[121] is a good example, in which the court dismissed the respondents' application for a relief, not because the relief was inoperative in a wrongful trading case, but mainly because, in the court's view, they had not acted reasonably. It is not surprising if in another case with the same facts, a different judge would find the respondents' conduct reasonable.

The last requirement, "having regard to all the circumstances ... of the case" is more ambiguous. It appears to permit the judges to examine all or any aspect of the company's business and director's conduct in weighting the evidence for and against the relief.

119 Emphasis is added.
120 Gore- Browne on Companies, (44th ed.) Para. 21- 05.
121 [1990] BCC 903.

Finally, the other expression in the section which contains an absolute discretion and wide power for the courts is "that the court may relieve him", which means, even when the three above mentioned requirements are satisfied, the court will have no obligation to relieve the respondent from liability, otherwise the legislature would use the obligatory word of "shall" or "will",[122] instead of "may". If one of those requirements is not thus, met, the court has no power to grant the relief. But when all the requirements are available, to decide whether or not to relieve the respondent, depends only upon the court's discretion when "it thinks fit".

It is quiet understandable that the section should have been drafted in such a wide terms. Otherwise, any hint of providing an obligatory exercise of power for the courts in this respect would put the judges in a difficult situation, where they would not think fit to grant the relief to a delinquent director, even where all those requirements are satisfied.

The above situation which is related to subsection 727(1), is the case when the court itself reaches the conclusion that the defendant director ought fairly to be excused. But, as subsection (2)[123] provides, a respondent himself is also entitled to apply for the relief, if he has reason that he will or might be held liable. The court on the respondent's application has, again, the same power whether to relieve him.[124]

Therefore, with regard to all requirements of the section and particular circumstances of each case, a respondent being relieved from liability is also a matter of circumstances. If his case is brought before a judge who applies a wide and general interpretation of the concepts, the respondent may, most likely, be given the

122 In supporting this argument, the account should be taken of section 6 of the Company Directors Disqualification Act 1986, where the legislature by employing the word "shall" intended to provide an obligatory disqualification for directors in the circumstances concerned.

123 Subsection (2) of section 727 provides:

"If any such officer or person as above- mentioned has reason to apprehend that any claim will or might be made against him in respect of any negligence, default, breach of duty, or breach of trust, he *may apply to the court for relief*; and the court on the application *has the same power to relieve him* ... ." Emphasis added

124 See, e. g., *re Produce Marketing Consortium Ltd.* [1989] BCLC 513, *DKG Contractors Ltd.* [1990] BCC 903, *Saunders & Another* [1988] BCLC 43, *denied* [1990] BCLC 402.

relief,[125] whereas if his case is proceeded by another judge who interprets legal expressions in a strict way, an application for the relief may likely be rejected.[126]

In conclusion, the relief under section 727 of the Companies Act 1985 has effectively played a role in protecting corporate directors. However, the courts have failed to overcome ambiguities inherent in the section. The section is in need of amendment, in particular to clarify or expand its ambit in relation to wrongful trading cases.

5. 4 Conclusion

Irrespective of subsection (3) of section 310, which permits indemnification for costs in some specified situations, protection of corporate directors in English law can be considered under two heads; First, insurance under section 310 (2), and secondly, the relief under section 727 of the Companies Act 1985.

There are some ambiguities inherent in those two statutory protections. As to insurance, the first problem, particularly in small companies, is its being bought and maintained subject to the financial ability of the company. When a company finds purchasing such a cover financially difficult, it pays a lower price for an insurance policy with a limited coverage. The main difficulty for insuring directors is the lack of any judicial precedent to reveal the real attitude of the courtroom to different aspects of an insurance, such as precise definition of the extent of its application and more importantly the limitations on insurance.

The weakness of section 727 is that the relief under the section may not be applied even when all requirements for its operation are satisfied. In other words, the discretion of the courts to decide whether or not to apply their discretion under the section is so wide that it cannot be counted on by directors as a reliable protection.

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125 See, e. g. Astbury J.'s holding in *Claridge's Patent Asphalte Company* [1921] 1 Ch 543 and comments of Cozens- Hardy M. R., Hamilton L, J., and Swinfen Eady L. J. in *re Whithtaker v. Bamford (Allsop)*, [1914] 1 Ch 1.

126 For example see the judgment of Ackner J. in *Customs & Excise Commissioners v. Hedon Aloha Ltd. & Others* [1981] 2 W. L. R. 791, who applies a restrict meaning of the relief which is not applicable to "default".

The interesting point in this discussion is the relationship between section 727 and section 310. Section 310 has been described as another side of the coin to section 727 with some basic similarities. The differences between the two sections, according to this view, is that section 310 is confined to negligence etc., "in relation to the company", whereas section 727 extends to negligence, etc. generally, including duties to third parties.[127] On the other hand, section 727 has been suggested as an appropriate alternative to mitigate the harshness of section 310.[128]
With respect, although the relationship between the two sections is beyond doubt particularly reference to section 727 by section 310, it is difficult to recognise such a close relationship between them as the two sides of the same coin. Because background, operation, and the scope and requirements of application of either is obviously different. Furthermore, in considering such a relationship, the fact should be taken into account that the relief under section 727 is a product of common law, whereas insurance under section 310 is a result of the increasing need of development of industrial and commercial relationships.

Finally, the result of this discussion raises the question whether there is any further protection necessary. It seems, with regard to traditional attitude of English law towards corporation relationship, the law obviously lacks a tolerance, which would prevent it from providing more protection on a large scale. This is because doing so may prejudice appropriate performance of directors duties. However, as insurance is a form of indirect indemnification, it is desirable and justified to expand the extent of the application of indemnification as a rule to all liabilities which are insurable.

127 Cranston, *op cit* at 206.
128 Birds, MLR (1976) at 397.

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PART TWO: US LAW

Chapter 6: Corporate Directors Duties in the U. S. Law

6. 1 Introduction

As the "institutional integrity of a corporation depends upon the proper discharge" of a director's fiduciary duties,[1] to study directors liabilities, their duties should inevitably be examined first.

Directors act as corporate fiduciaries and are, thus, obliged to conduct business with prudence and diligence.[2] They are fiduciaries to the corporation on the one hand, and to its shareholders and creditors on the corporation behalf on the other hand.[3]

Directors' duties are said to have developed mainly from the rule that if the directors were interested in a corporate action, then that decision was voidable at the suit of the corporation or that of its shareholders unless it was approved by independent directors, and also was fair to the corporation.[4]

In speaking on directors duties in the US law, the reference should be made to the concept of "fiduciary". That is because the only duties provided for corporate directors in the corporate relationship are those been classified within "fiduciary" context.

This classification of directors duties which has a long history of recognition, is now under question. For the first time, the American Bar Association[5] proposed that the word of "fiduciary" should not have been used for corporate directors. This view

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[1] *Francis v. United Jersey Bank*, 432 A 2d (N. J. 1981) 814.
[2] *Briggs v. Spaulding*, 141 U. S. (1891) 132.
[3] Deborah Demott, "Beyond Metaphor: An Analysis of Fiduciary Obligation", Duke L.J. (1988) 87, 116-18.
[4] William Roberts, "Searching for a Paradigm for the Fiduciary Duties of Corporate Directors", 21 Memphis State Univ. L. Rev. (1991) 501.
[5] American Bar Association Committee on Corporate Laws 1984.

which has been followed by the American Law Institute,[6] has been criticised on the ground that even agent and everyone working for a corporation is a fiduciary, and if a corporation director does not want to be a fiduciary, he will then have to denounce the power in managing other people's property.[7]

The doubt posed by those two institutions on the directors status as fiduciary is not justified, since this fiduciary status in the US law is of a long history.

It is believed[8] that the foundation of the rule of directors as a class similar to that of trustee was laid in *Pepper v. Litton*,[9] where Justice Douglas pointed out that:

> "A director is a fiduciary ...So is a dominant ~~or~~ controlling stockholder or group of stockholders. Their powers are powers in trust. ... Their dealings with corporation are subjected to rigorous scrutiny."[10]

Traditionally, there is a strong recognition among the courts and commentators that fiduciary duty of directors, as the most powerful and important element underlying the corporate system,[11] consists of two separate categories: the fiduciary duty of care and the fiduciary duty of loyalty.[12] In *Norlin Corp. v. Booney, Pace, Inc.*,[13] the court expressly pointed out its recognition for this classification and stated:

> "A board member's obligation to a corporation and its shareholders has two prongs, generally characterised as the duty of care and the duty of loyalty."

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6 ALI, Principles of Corporate Governance: Analysis and Recommendations (Tentative Draft NO. 11, 1991).

7 Norwood P. Beveridge, "The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self- Interested Director Transaction", 41 Depaul L. R., (1992) 655, 687- 88.

8 William Knepper and Dan A. Bailey, Liability of Corporate Officers and Directors, (Charlottesville, Virginia: The Michie Company Law Publishers 1988) 11.

9 308 U. S. (1939) 295.

10 Ibid at 306.

11 Nell Minow, "Shareholders, Stakeholders, and Boards of Directors", 21 Stetson L. Rev. (1991) 196.

12 Morey W. McDaniel, "Bondholders and Corporate Governance", 41 Bus. Law. (1986) 413, 449, Marcelle R. Joseph, "When Is a Company up to Sale? The Case Against Revlon Duties", Annual Survey of American Law (1990) 271, 274, Morey W. McDaniel, "Bondholders and Stockholders-Fiduciary Duties to Bondholders", 13 J. Corp. L. (1988) 267, *Frances T. v. Village Green Owners Association*, 42 Cal. 3d. (1986) 490, 508, Sandra K. Miller, "What Standards of Conduct Should apply to Members and Managers of Limited Liability Companies", 68 St. John Law Rev. (1994) 21, 39, *Smith v. Van Gorkom,* 488 A.2d (Del. 1985) 858, 872- 73, Minow, *Supra* No. 8 at 202, B. M. Animashaun, "The Business Judgement Rule; Fiduciary Duties and Liabilities of Corporate Directors", 16 Southern Univ. L. Rev., (1989), 345, 347, James Farinaro, "Target Directors' Fiduciary Duties: An Initial Reasonableness Burden", 61 Notre Dame L. Rev. (1986) 723.

13 77 F. 2d 255, (2d Cir. 1984) 564.

However, some commentators have suggested that directors are under three duties: duty to act carefully which generally is known as duty of care, duty to act loyally, and duty to act lawfully,[14] while they do not make a clarification on the precise concept of acting lawfully, the concept which is an extremely wide one.

On the other hand, the leading legal writers Knepper and Bailey addressing the case of *Gearhar Industries,. Inc. v. Smith International, Inc.*,[15] are of the view that "corporate officers and directors owe three duties to the corporations they serve: Obedience, diligence, and loyalty."[16] The duty of obedience, deals with directors powers and their applicability within the authority conferred upon their corporation whether by charter, articles of incorporation, and bylaws. If their conduct exceeds their authority, this will be considered as *ultra vires*.[17]

The difficulty with which a reader of the US corporate law sometimes faces in this area is the line between the duty of loyalty and the duty of care which is not always clear.[18] For example, in an article a commentator discusses the duty of care in the context of duty of non- conflict,[19] while duty of non- conflict of interests is an obvious implication of duty of loyalty but not duty of care.

As the 'duty of care is the basic negligence concept',[20] in the discussion of liability for negligence, the reference will inevitably be made to the elements and materials related to the duty of care.

On the other hand, because the duty of care is the main element of the business judgment rule, and inquiry into duties of directors begins with that rule,[21] we will also address fiduciary duties of care in our discussion on the business judgment rule.

14 Melvin A. Eisenberg, "The Duty of Care of Corporate Directors and Officers", 34 Corporate Practice Commentator (1992- 3) 320, See generally Dennis J. Block et al., The Business Judgment Rule: Fiduciary Duties of Directors,.(Englewood Cliffs: Prentice Hall Law & Business 4th ed. 1993) 1.

15 741 F.2d (5th Cir. 1984) 707, 719.

16 Knepper and Bailey, Liability of Corporate Officers and Directors, at 9.

17 Ibid.

18 Leo Herzel, Richard Shepro & Lawrence Katz, "Next to the Last Word on Endangered Directors", Harv. Bus. Rev., (1987) 38, 43.

19 Animashaun, *op cit.*

20 Joel Seligman, "The New Corporate Law", 59 Brook. L. Rev., (1993) 1, 49.

21 Joseph Hinsey IV, "The Business Judgment Rule and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality", 52 George Washington L. Rev.

The purpose of this chapter is to review directors duty to their corporation as going concern which includes fiduciary duties of care and loyalty. In the second part of this chapter, it is intended to discuss directors duties when their corporation is financially troubled, whether insolvent or nearly insolvent. The theories of "trust fund doctrine" and "agency rule", that are suggested to define such duties in this crucial point are also examined.

6. 2 Duties in General

6. 2. 1 Duty of Care

As a general principle, a director is required to use reasonable care, namely being properly informed before taking any action or making a decision. The expression "reasonable care" implies a general and flexible test which is subject to considerations such as the scale of the decision or action, the limitation and availability of time for making the decision, the cost of transaction concerned, and the recommendations made by subordinate officers.

Duty of care is interpreted as a "reasonable director standard", which can be considered as another way of determining the reasonableness of the decision- making process.[22] This duty also requires directors in performance of their corporate responsibilities, to inform themselves prior to making a business decision of all material information reasonably available to them.[23]

The concept of duty of care has been evaluated by some commentators as vague. That is because there is no common understanding of what directors are supposed to do, only that they are expected to do it with due care.[24] Some have gone further to

(1984) 605, Barry Reder, "The Obligation of a Director of a Delaware Corporation to Act as an Auctioneer", 44 Bus. Law. (1989) 257.

22 Minow, *op cit* at 202.

23 *Aronson v. Lewis*, 473 A. 2d (1983) 805, 812.

24 William Manning, "Touring the Horizon with the Business Judgment Rule", at 13 (Draft October 10 1983) available at the George Washington Law Rev. Library (Quoted by Tamar Frankel, "Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance", 52 George Washington Law Rev. (1984) 705, 707.)

describe the duty as useless which should be eliminated, by reasoning that only a few judicial decisions are based on duty of care,[25] while some others have denied the duty at all as "out of existence".[26]

6. 2. 1. 1 Standard of duty of care

Traditionally it is recognised that a standard of due care is coupled with application of the business judgment rule. The duty employs the same standard as is used by tort law, namely "a reasonably prudent man" standard.[27]

It is claimed that there is a disparity between the courts and legislative attitude towards directors duty of care. While in the former a director's decision is judged in terms of what a reasonably prudent man would have done in similar circumstances, in the latter the standard has been interpreted as requiring directors to devote only very modest amounts of time and effort in managing a corporation's business.[28]

However, there is almost a consensus among commentators and courts on the appropriate standard applicable to directors' performance in the discharge of their duties. Delaware case law is clear in this regard, although with no evidence of any attempt to develop the level of standard of directors' conduct. According to the Delaware Supreme Court in *Graham Alice Chalmers Mfg. Co.*,[29] directors "are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."[30]

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25 Kenneth E. Scott, "Corporation Law and the American Law Institute Corporate Governance Project", 35 Stanford Law Rev. (1983) 927, 937.
26 Weiss, *op cit* at 587.
27 Charles Hansen, "The Duty of Care, the Business Judgment Rule and The American Law Institute Corporate Governance Project", 48 Bus. Law (1993) 1355, 1356, Krishnan Chittur, "The Corporate Director's Standard of Care: Past, Present, and Future" 10 Del. J. Corp. L. (1986) 505, 539.
28 E. J. Weiss, "Disclosure and Corporate Accountability", 34 Bus. Law. (1979) 578, 587, See also *Bates v. Dresser*, 251, U. S. (1920) 524, *Graham v. Allis- Chalmers Mfg.* Co. 41 Del. Ch. 78, 188 A. 2d (Sup. Ct. 1963) 125.
29 188 A. 2d. (Del. 1963) 125.
30 Ibid at 130. See also *Blasius Industries Inc. v. Atlas Corp.*, 564 A. 2d (Del. Ch. 1988) 651, where a strict standard applied to directors' actions which required directors to demonstrate a "compelling justification".

In this respect, case law of other jurisdictions has followed the main corporate jurisdiction, Delaware. In the New York case of *Francis v. United Jersey Bank*,[31] directors were held to have owed a duty to "discharge their duties with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."[32]

The Restatement (Second) of Trusts lays a standard of care which had already been employed in some cases on corporate directors as:

> "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as men of ordinary prudence exercise in dealing with his own property."[33]

The same standard applied in *Pool v. Pool*.[34] In that case, the court analysed the measure for assessing the conformity of director conduct to the standard as:

> "the measure of care required is ordinary and reasonable care, such a reasonably prudent, careful and skilful man exercises in the conduct of his own affairs, and they are liable for losses when they fail to exercise such care. A failure to conform to this standard is held to constitute gross negligence."

As Beveridge says, it is not clear that whether the expression "his own property" sets a higher standard than that of a man of ordinary prudence 'under similar circumstances in like positions'.[35] Moreover, the measure for assessing a director performance, here, seems too vague, where a director is required to display the same care as he does to his own affairs. Such a test is inconsistent with the standard of conduct advanced earlier in the same judgment, where the directors were asked to exercise such "diligence, care, judgment and skill which ordinarily prudent men would exercise under similar circumstances in like positions".[36] That is because a person may conduct his own affairs recklessly, but that behaviour can not be

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31 432 A.2d (N. J. 1981) 814.

32 Ibid at 820.

33 The Restatement (Second) of Trusts section 174 (1959).

34 So. 2d (La. Ct. App. 1943) 132.

35 Norwood P. Beveridge, " The Corporate Director's Duty of Care: Riddles Wisely Expounded," XXIV Suffolk Univ. L. Rev. (1990) 923, 936.

36 *Pool v. Pool.* So. 2d (La. Ct. App. 1943) 132, 134- 5. Similarly, in *Briggs v. Spaulding*, 141 U. S. (1891) 132, 133, it was held that Directors should "exercise ordinary care and prudence."

accepted in relation to others' business or property, particularly in a fiduciary/ beneficiary or director/ corporate relationship.

Likewise, statutes and proposals have recognised the case law position. Under Indiana statute, like Delaware, for a director to discharge his duties, he should act in good faith, with care an ordinarily prudent person in the same position would exercise under similar circumstances and in a manner he reasonably believes to be in the best interests of the corporation.[37]

According to section 717 of the New York Business Corporation Law:

> "Directors and officers shall discharge the duties of their respective positions in good faith and with degree of diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions."[38]

Similarly, section 35 of the Model Business Corporation Act is a good example which states:

> "A director shall perform his duties as a director ... in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances."

As to the standard proposed in section 35, some negative and positive comments have been advanced by commentators. It is said,[39] that it does no more than codifying the existing Delaware standard expressed in *Graham Alice Chalmers Mfg. Co.*.[40]

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[37] Ind. Code Ann. (West Sup. 1987) Section. 23- 1- 35-1(a).

[38] See also the Revised Model Business Corporation Act which seems clearer on the matter provides that a director shall discharge his duties as a director:
"(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation." The Revised Model Business Corporation Act, section 8.30(a) (1984).
American Law Institute, proposes a standard with similar elements:
"(a) A director or officer has a duty to the corporation to perform the director's and officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." ALI, Principles of Corporate Governance: Analysis and Recommendations 4. 01 (Proposed Final Draft 1992) 180- 1.

[39] S. Samuel Arsht & Joseph Hinsely IV, "Codified Standard- Same Harbor But Chartered Channel: A Response", 35 Bus. Law. (1980) 945, 951.

[40] 188 A. 2d. (Del. 1963)125.

The interpretation of section 35 as it demands a varying standards of care among directors according to their skill and experience,[41] is rejected by arguing that the standard of care to "which all directors must adhere is the same, while they all must exercise such care as an ordinary prudent person in a like position would use under similar circumstances."[42]

Veasy and Manning are of the view that such expression may lead the courts to make fundamental changes in the business judgment rule application, since section 35 requires that a court determines the reasonableness of the defendant director's belief that his conduct was in the best interests of the corporation. Therefore, it entitles the court to make inquiry into business decisions which are insulated from scrutiny by the business judgment rule.[43] However, they conclude that there is no statute preferable to that section in its present form.[44]

6. 2. 1. 2 Functions of duty of care

The duty of care is said to have been broken down into two elements: time and attention devoted to corporate affairs on one hand, and the skill reflected in business decision on the other hand.[45] Other views include other such duties as duty of inquiry in the duty of care.[46]

Duty of skill, in the United States law, is not separated from but a part of the duty of care. This duty is defined as a special form of competence arisen from acquired learning and talent developed by special training and experience in a trade and profession. A fiduciary will be liable for any loss incurred due to lack of such skill.[47]

41 E. Norman Veasy, William Manning, "Codified Standard- Safe Harbor or Uncharted Reef", 35 Bus. Law. (1980) 919.
42 Arsht & Hinsely IV, *op cit* at 952.
43 Veasy & Manning, *op cit.*
44 Ibid at 946.
45 Kenneth E. Scott, *op cit* at 932.
46 American Bar Association, Comments on Corporate Laws, Corporate Director's Guidebook, 33 Bus. Law. (1978) 1596, 1600- 3.
47 Restatement (second) of Torts. Sections 298- 99A (1965) (Quoted by Eisenberg *op cit* at 331).

However, the skill required from a corporate director is more lenient than that in tort or other professions.[48]

6. 2. 1. 2. 1 Duty of inquiry

The main implication of the duty of care in the US law is duty of inquiry which requires a director to inform himself of all material information relevant to the decision concerned, since failure to do so may deprive him from protection of the business judgment rule.[49] Therefore, corporate managers should be required by statute or case law to take all corporation's client groups into account in taking a business decision.[50] To become properly informed, a director should, thus, take convincing signals indicating financial problems of the company into his account through reliable sources. He should not even await the matter to be brought to the general meeting if the trouble is serious.[51]

This point was addressed in *Platt Corp. v. Platt*,[52] where the court held:

> "It is the obvious duty of directors to know what is transpiring in the business affairs of their corporation. They cannot assume the responsibilities of their fiduciary position, then simply close their eyes to what is going on around them and thereby avoid the consequences by the mere failure to act. While corporate directors are not liable for errors of judgment, nevertheless, the law holds them accountable for that which they reasonably should have known or discovered in the discharge of their duties .... ."[53]

According to the Delaware Supreme Court in *Graham Alice Chalmers Mfg. Co.*,[54] where the defendant directors were charged with failure to become adequately informed of the material information and to prevent a possible antitrust action, the court held them liable. However, the court acknowledged that:

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48 Eisenberg, *op cit* at 331.

49 *Barnes v. Andrews* 298 F. (S. D. N. Y. 1924) 614.

50 Larry D. Soderquist, Robert P. Vechio, "Reconciling Shareholders' Rights and Corporate Responsibility: New Guidelines for Management", Duke L. J. (1978) 891, 842.

51 William Manning, "The Business Judgment Rule and the Director's Duty of Attention: Time for Reality", 39 Bus. Law. (1984) 1477, 1484, See also *Bates v. Dresser*, 251 U.S (1920) 254.

52 249 N. Y. S. 2d (Sup. Ct. 1964) 1.

53 Ibid at 6.

54 188 A. 2d. (Del. 1963)125.

> " ... absent cause for suspicion there is no duty upon directors to install and operate a system to ferret out wrongdoing which they have no reason to suspect exists."[55]

The holding of *Francis v. United Jersey Bank*,[56] has formulated the duty of inquiry as follows:

> "Directors are under a continuing obligation to keep informed about the activities of the corporation ... . Directorial management does not require a detailed inspection of day- to- day activities, but rather a general monitoring of corporate affairs and policies. While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of statements."[57]

In the court's view, the respondent was under an obligation of basic knowledge and supervision of the company's affairs, which:

> "included reading and understanding financial statements, and making reasonable attempts at detection and prevention of the illegal conduct of other officers and directors. She had a duty to protect the clients ... ."[58]

The American Law Institute referring to the duty of inquiry, has proposed the standard applicable to it as:

> "The duty in Subsection (a) includes the obligation to make or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor."[59]

The similar language which has been employed by almost all courts, law institutions, and commentators on the standard of directors' conduct, removes any doubt about the fact that the US legislature and its judicial system have no desire to make any change in the level of standard by laying a higher standard, e. g. adopting a more objective standard of conduct.

6. 2. 1. 2. 2 Duty of attention and attendance

Duty of attention and attendance as another branch of duty of care has been referred to in some cases. Duty of attention is defined in terms of attention of the flow of

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55 Ibid at 130.
56 432 A.2d (1981) 814.
57 Ibid at 821- 22.
58 Ibid.
59 Principles of Corporate Governance: Analysis And Recommendations (Proposed Final Draft 1992) 4. 01(a)(1).

matters brought before directors. A lapse of attention to some discrete item would not constitute a breach of duty unless it was showed that at the time that item was of major significance.[60]

In *Francis v. United Jersey Bank,*[61] the court stated that the defendant director did not actively take part in the business:

> " and knew virtually nothing of her corporate affairs. She briefly visited the corporate offices in Morristown only in one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to ensure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law."[62]

Ordinary attention is sufficient "if nothing has come to [the directors'] knowledge to awaken suspicion of the fiduciary ...".[63] However, though the trend of case law is that boards of directors have a duty to remain informed only about significant corporate matters, it is said that they may have also an overriding duty to investigate when they have notice of circumstances that would raise the suspicions of reasonably prudent men.[64]

The US courts and commentators' stand towards delegation of powers and reliance on other, does not follow the same line. While some courts takes the view that directors can not delegate their duty to manage corporate enterprise',[65] others particularly the Delaware Supreme Court in *Graham Alice Chalmers Mfg. Co.*[66] indicate that directors:

> "are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong .... ."[67]

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60 William F. Kennedy, "The Standard of Responsibility for Directors", 52 George Wash. L. Rev. (1984) 625, 649.
61 432 A.2d (N. J. 1981) 814.
62 Ibid at 819 -20.
63 *Briggs v. Spaulding*, 141 U. S. (1891) 132.
64 Stephanie M. Phillips, "Duty of Directors with Respect to Potential Violations of U. S. Law by Foreign Subsidiaries", 13 Vand. Trans. L. (1980) 1, 23.
65 *Adams v. Clearance Corp.* 121 A. 2d. (1956) 302.
66 188 A. 2d. (Del. 1963)125.
67 Ibid at 130.

Section 141(e) of the Delaware General Corporation Law permits boards of directors to delegate authority to, and rely on information received from, officers and employees of the company.[68] Moreover, the New York Business Corporation Law in section 717 permits that:

> "In discharging their duties, directors and officers, when acting in good faith, may rely upon financial statements of the corporation presented to them ... ."

Furthermore, the reliance on others by directors is in some circumstances permissible under the Revised Model Business Corporation Act,[69] and the American Law Institute.

The American Law Institute's proposed draft contains both delegation of powers and reliance on others, as states:

> ("1) In performing his or her duty and functions, a director or officer who acts in good faith, and reasonably believes that reliance is warranted, is entitled to rely on information, opinions, reports, statements ... decisions, judgments and performance ... prepared, presented, made or performed by:
>
> (a) One or more directors, officers, or employees of the corporation ...
>
> (b) Legal council, public accountants, engineers, or other persons when the director or officer reasonably believes merit confidence."[70]

Although mere non- attendance at directors' meetings does not lead to breach of fiduciary duty of care, it does not excuse his failure to supervise the business properly.[71] It is suggested that, if delegation and reliance will continue to limit liability to cases in which the director completely abdicates his function, perhaps the analysis is better carried out under the duty of loyalty.[72]

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68 Section 141(e) states: "A member of the board of directors, or member of any committee designated by the board of directors, shall, in the performance of his duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports, or statements presented to the corporation by any of the corporation's officers or employees."

69 Revised Model Business Corporation Act (1984) [RMBCA], section 8. 30(b). Under this section: "In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by : 1) one or more officers or employees of corporation, 2) legal counsel, public accountants, or other persons as to matters or 3) a committee of the board of directors of which he is not a member ... ".

70 ALI, Principles of Corporate Governance: Analysis and Recommendations 4. 01 (Proposed Final Draft 1992).

71 *Dinsmore v. Jacobson*, 242 Mich. (1928) 192, 218.

72 James L. Griffith, "Director Oversight Liability: Twenty-First Century Standards and Legislative Controls on Liability", 20 Del. J. Corp. L.(1995) 653, 685.

6. 2. 2 Duty of Loyalty

6. 2. 2. 1 Definition of director's fiduciary status

Duty of loyalty, as the most important fiduciary duty of corporate directors,[73] is designed to prohibit unfaithfulness,[74] fraud, bad faith, and self- dealing by corporate directors, and to discourage and prevent directors from denying corporate benefits to the shareholders particularly minority shareholders for their own interests.[75] Therefore, one of the most important features of the duty is to prevent directors from diverting profits from shareholders' pocket into their own.[76] The duty of loyalty requires that a director should not stand on both sides of the transaction or have any financial interest in the transaction other than the "benefit which devolves upon the corporation or all stockholders."[77]

The American Bar Association has described the duty of loyalty as follows:

> "By assuming his office, the corporate director commits allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own. The basic principle to be observed is that the director should not use his corporate position to make personal profit or gain other personal advantage."[78]

Under duty of loyalty, a director owes loyalty and allegiance to the corporation, a loyalty that is undivided, and an allegiance that is influenced in action only by considerations of the welfare of the corporation.[79] A fiduciary is forbidden by the

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[73] Seligman, *op cit* at 3.
[74] *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F. 2d (. Cir. 1984) 255, 264.
[75] Lawrence E. Mitchell, " The Fairness Rights of Corporate Bondholders", 65 N. Y. Univ. L. Rev. (1990) 1165, 1191.
[76] E. Merrick Dodd, "For Whom Are Corporate Managers Trustees?", 45 Harv. L. Rev. (1932) 1145, A. A. Berle, "For Whom Corporate Management Are Trustees: A Note", 45 Harv. L. Rev. (1932) 1365.
[77] *Aronson v. Lewis*, 473 A.2d (1984) 805, 812.
[78] American Bar association Comment on Corporation Laws, (rev. ed. 1978), 33 Bus Law. (1978) 1591, 1599.
[79] *Litwin v. Allen*, 25 N. Y. S. 2d (Sup. Ct. 1940) 667, 677- 78.

law from doing anything which is adverse to the best interests of the corporation and its shareholders.[80]

The statement made in *Pepper v. Litton*,[81] which contains a range of prohibitions that a fiduciary is required to consider in managing the beneficiary's business, is a good description of a fiduciary position as well as his duties as follows:

> "He who is in ... a fiduciary position cannot serve himself first and his *cestuis* second. He can not manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He can not by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He can not utilise his inside information and his strategic position for his own preferment. He can not violate rules of fair play by doing indirectly through the corporation what he could not do directly. He can not use his power for his personal advantage and to the detriment of the stockholders and creditors ... ."

The position of corporate directors as fiduciary also has been addressed in *Guth v. Loft*,[82] where the Delaware Supreme Court stated that:

> "[C]orporate officers and directors ... While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. ... The rule that requires an individual an unselfish loyalty to the corporation demands that there shall be no conflict between duty and interests. The occasions for the determination of honesty and good faith and loyalty conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale."[83]

The recognition of the above statements defining the position of corporate directors as fiduciary in the context of duty of loyalty, requires an undivided faithfulness to the corporation and its shareholders, the main feature of which is avoiding self- dealing and conflict of interests.

6. 2. 2. 2 Functions of and miscellaneous issues on duty of loyalty

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80 David J. Gass, "Departing Directors, Officers and Employees and the Limits of Their Fiduciary Duties", Mich. Bar. J. (1993), 650 651, Tamar. Frankel, "Fiduciary Law", 71 Cal. L. Rev. (1983) 795.

81 308 U. S. (1939) 295.

82 5 A. 2d (Del. 1939) 503.

83 Ibid at 510.

As was seen, in a corporation relationship there are great temptations and opportunities for a director, officer or controlling person to advance his own interests against those of the corporation, controlling corporation or its shareholders. The function of duty of loyalty is to monitor the use of the control of power over corporate transactions. Therefore, the proper exercise and the extent of the directors' powers on the one hand, and monitoring the use of powers in discharging their duties on the other hand, is a significant factor. In principle, the extent of a fiduciary responsibilities depends upon the scope of his powers. In other words, the "greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty".[84] In a transaction of which a director and his company are parties, the interests of directors are always in conflict with those of shareholders.[85] While directors are shown to have a financial interest in a corporate transaction, the business judgment rule ceases to shield them or the transaction. The duty of loyalty imposes an obligation on directors to avoid conflict of interest in transactions, and to act in the best interest of the corporation and its shareholders. In this respect, the duty of loyalty relates to the business judgment rule, since the rule protection "can only be claimed by disinterested directors whose conduct otherwise meet the tests of business judgment."[86] On the other hand, it is said that in duty of loyalty analysis, there is no proper place for the business judgment rule, since the latter was developed as a defense to duty of care violations.[87]

If the plaintiff challenging the transaction in question establishes that there was involvement of directors' personal interests or self- dealing in the transaction, then there will be no place for the business judgment rule application.[88] However, it

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84 Austin W. Scott, "The Fiduciary Principle", 37 Cal. L. Rev. (1949) 538, 540.

85 John C. Coffee, "Shareholders versus Managers: The Strain in the Corporate Web", 85 Mich. L. Rev. (1986) 1, 16, Oliver E. Williamson, "Corporate Governance", 95 Yale L. J. (1984) 1197, 1198-200.

86 *Aronson v. Lewis*, 473 A.2d (1984) 805, 812.

87 Kenneth Scott, "Corporate Law and the American Law Institute Corporate Governance Project", 35 Stan. L. Rev. (1983) 927, 940.

88 *Cinerama, Inc. v. Technocolor*, No. 8358, 1991 W.L. 111134, at 10 (Cited by Dennis J. Block, Michael J. Maimone and Steven B. Ross, "The Duty of Loyalty and the Evolution of the Scope of Judicial Review", 59 Brook. L. Rev. (1993) 65, 73).

seems the business judgment rule protection is workable where a fully informed majority of disinterested directors properly exercise its judgment in good faith to approve the transaction.

The director's duty of loyalty mainly deals with taking up a corporate opportunity. However, the concept of corporate opportunity may vary from state to state, and may change depending to the State's criteria for its identification,[89] such as the relationship to the corporation's business and disclosure of the opportunity to the corporation.[90] Duty of loyalty requires a director to avoid appropriating a business opportunity available to his corporation.[91]

In response to the question how a court should determine if a breach of loyalty has taken place, it is suggested that the court should take account of the difference between the terms of the challenged transaction and the terms of comparable transactions involving independent parties with no "control" relationship. According to this suggestion, if the transaction concerned involves homogeneous and traded goods, it will be easy for the court to find out the difference between the transaction and the market price.[92] However, it will be difficult to apply this reference, because many of cases involve goods and services that are not fungible and for which there is no trading market price available.[93]

The question may be raised that since the breach of loyalty is a matter of motivation, how can a court determine and connect a respondent's action with his intention? In some cases this point has, whether explicitly or implicitly, been determined. In *Cheff v. Mathes*,[94] the court upheld the directors' purchase of a dissident shareholder's stock, since in the court's view, there was a reasonable threat to the continued existence of the corporation under the dissident shareholder's plan of amassing

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89 Stanley A. Kaplan, "Fiduciary Responsibility in the Management of the Corporation", 31 Bus. Law. (1976) 883.
90 *Guth v. Loft*, Inc., 23 Del. Ch. (1939) 255.
91 *Kerrigan v. Unity Sav. Association*, 68 Ill. 2d. (1974) 20 (Quoted by Knepper and Bailey, Liability of Corporate Officers and Directors, at 100).
92 Kenneth Scott *op cit* at 939.
93 Ibid.
94 41 Del. Ch., (1964) 494.

control. Conversely, in *Condec Corp. v. Lunkenhelmer Co.*,[95] where corporate directors decided to issue additional shares with intention to frustrate the plaintiff's effort to purchase a controlling interests in the company, the court agreed with the plaintiff that the issuance of the additional shares was an invalid attempt by the respondents to advance their personal interests and, thus, did not pursue a business purpose.[96]

As can be seen in the light of those two cases, a determination of director's intent in struggles for control is a difficult task. That is because in each case the motivations of directors to maintain control led to different conclusions as to the propriety of such motivations.[97]

6. 3 Duty In Insolvency

In examining directors duties in insolvency, the first question which may arise is the corporate creditors position and whether the directors owe any duty to this sector of corporate constituencies, if so when and under which circumstances. A corporate director may not know when his duty to its creditors begins. It is because he may not be able to rely on the company's balance sheet as a reliable indicator of solvency.[98] Therefore, defining the point when this duty begins is crucial.

6. 3. 1 Is a Corporate Creditor Owed A Duty Before Insolvency?

The main advantage of imposing a fiduciary duty of loyalty on directors to creditors, is that victim creditors have an additional right to recover against directors who

95 143 Del. Ch.,(1967) 353.

96 Ibid at 357.

97 Walter R. Hinnant, "Fiduciary Duties of Directors: How Far Do they Go?" 23 Wake Forest L. Rev. (1988) 163, 170.

98 Lewis Davis et al., "Corporate Reorganisation in the 1990's: Guiding Directors of Troubled Corporations Through Uncertain Territory", 47 Bus. Law. (1991) 1, 3.

failed to exercise due care and allowed others to misappropriate corporate assets at the creditors' expense.[99]

Most US jurisdictions, particularly Delaware, indicate that the dominant duty of directors is that to shareholders, on the basis of the argument that any duty owed to creditors is contractual rather than fiduciary.[100] However, creditors become beneficiary of such fiduciary duties once the company falls into insolvency,[101] or approaching insolvency.[102]

Generally, the fiduciary duty of loyalty and duty of care do not extend to a corporation's creditors. This is based upon the fact that creditors do not have an existing property right or an equitable interest which supports these duties when a corporation is solvent.[103] The claims of creditors of a financially healthy corporation that the directors have a duty to them have failed.[104] That is because the courts traditionally have been reluctant to extend the fiduciary duty to creditors of the corporation who are considered as mere holders of contractual rights.[105] Therefore, the courts have not required the directors to consider the creditors' best interests.

A corporate director may, thus, be held liable if he benefits creditors at the expense of shareholders. For example in *Revlon Inc. v. McAndrews & Forbes Holding Inc.*,[106] where the directors allegedly favoured the bidder in his proposed transaction because he was committed to support the company's debt security, the court took the view that a board of directors in discharging its duties "may have regard for other constituencies", if " rationally related benefits to the shareholders."

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99 Laura Lin, "Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors", 46 Vand. L. R. (1993) 1485, 1516.

100 *Katz v. Oak Indus.* 508 A 2d. Del. Ch. (1986) 873, 879, (Quoted by Coffee *op cit* at 18) *Harff v. Kerkorian*, 324 A.2d (Del. Ch. 1974) 215, 222.

101 *Pennsylvania Co. for Insurance on Lives & Granting Annuities v. South Broad St. Theatre Co.*, 174 A. (Del. 1934) 122, 116.

102 Vladimir Jelisavcic, " Corporate Law- A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the 'Vicinity of Insolvency': Credit Lyonnais v. Pathe", J. Corp. L. (1992) 145, *Katz v. Oak Industries* 508 A.2d (Del. Ch. 1986) 873, 879.

103 *Simons v. Cogan*, 549 A.2d (Del. 1988) 300, 304.

104 Meredith M. Brown, "When Corporation Is Financially Troubled, Director's Role Changes", Nat'l L. J. (1991 May 20) S10.

105 *Simon v. Gogan*, A. 2d (Del. 1988) 300, 304.

106 506 A. 2d (Del. 1986) 173.

6. 3. 2 An exception to the Rule- Directors Duties upon Insolvency

The rule that directors owe their duties to corporation and its shareholders is not an absolute principle with no exception. The exception to this principle is insolvency. The insolvency exception to the rule may give rise to liability for a troubled company's directors in respect of conduct which they did not view as wrongdoing.

Directors of an insolvent corporation have a primary duty of care to the creditors, the duty which should apply when the corporation is arguably solvent but financially troubled and all directors' actions and decisions must be weighed from the view point of the creditors whose assets are at stake in insolvent situations.[107]

However, the exercise of the exception has been criticised by arguing that once the corporate is insolvent, the recognition of a fiduciary duty enforceable by creditors against directors of a nearly insolvent company which is still a going concern would allow an inappropriate interference in corporate management by creditors which may prevent responsible directors from preserving the corporation for the benefit of both stockholders and creditors.[108]

These critics observe only one feature of the reality and ignore the fact that leaving the control of an insolvent corporation to its board of directors, specially when the board is still shareholders- appointed one, may leave the corporation and its assets as an open target for depletion or abuse on the part of its directors or shareholders.

The insolvency exception should not give rise to personal liability for directors until it is clear that a director knew or should have known the corporation was insolvent. In order to protect directors, the burden should be placed upon the creditor to show that the director either knew or should have known of the corporation's serious financial condition,[109] but did not take proper measurements to prevent loss.

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107 Michael L. Cook & Carlyn S. Schwards, "At a Troubled Company, Officers and Directors Owe Creditors First", Nat'l L. J. (1987) 22, 24, Martin J. Bienenstock, "Conflict Between Management and Debtor in Possession's Fiduciary Duties", 61 Cincinnati L. R. (1992) 543, 567.

108 Norwood P. Beveridge, "Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?" 25 St. Mary's L. Rev. (1994) 589, 621.

109 Stephen R. McDonnell, "Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden From Shareholders to Creditors" ,19 Del. J. Corp. L. (1994) 177, 208- 209.

The rationale for the shift upon insolvency is that creditors become the equitable owners of the corporation, because they are the only parties with an interest in the corporation's assets.[110] Thus, directors of a company which faces financial trouble, no longer represent stockholders, but due to the insolvency become trustees,[111] or quasi- trustees of the corporation's assets for the benefit of its creditors.[112]

This exceptional situation has been addressed in *Commodity Futures Trading Commission v. Weintraub.*[113] In that case, the US Supreme Court held that:

> "Bankruptcy causes fundamental changes in the nature of the corporate relationships...[o]ne of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors."[114]

In another case, a federal court of appeal stated that "when the corporation becomes insolvent, the fiduciary duties of the directors shift from the stockholders to the creditors."[115] The outcome of this situation is that a board of directors may be personally liable to creditors for rendering the company insolvent by intentionally causing the company to consummate a fraudulent transfer of its assets, even in the form of a leveraged buyout, particularly when such transfer benefited shareholders. For example in *Clarkson Co. Ltd. v. Shaheen,*[116] the defendants claimed that the duty of directors sprang forth only to the corporation but not creditors, "until it is clear that the corporation is no longer a going concern." In the court's view, such a contention reflecting New York State policy of preserving the corporate assets of insolvent corporation for the creditors,[117] emphasised that corporate insolvency shifted the directors duty of care from its shareholders to its creditors.[118] If directors,

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110 Steven R. Gross et al., "Shifting Duties: Directors Face Risks in Workout", Nat'l L.J. (1991 Apr. 15) 19.

111 *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d (4th Cir. 1982) 973, 977.

112 *Clarkson Co. Ltd. v. Shaheen*, 660 F. 2d. Cir. (1981) 506, 512, *Pennsylvania Co. For Insurance v. South Broad St. Theatre Co.* 20 Del. Ch. (1934) 220, *Asmussen v, Quaker City Corp.*, 18 Del. Ch. (1931) 28.

113 471 U. S. (1985) 343.

114 Ibid at 355.

115 *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F. 2d (4th Cir. 1982) 973, 976- 7.

116 660 F. 2d. Cir. (1981) 506.

117 Ibid at 512.

118 Ibid.

thus, do not make their attempts to preserve corporate assets for its creditors, they have breached their fiduciary duties and may be held liable.

As to whether directors of an insolvent corporation still owe any duty to its stockholders, the courts are divided. Some courts have taken the view that in the verge of insolvency its directors no longer represent the stockholders' interests, and their fiduciary obligations shift "from the stockholders to the creditors,"[119] while some other courts have held that directors of an insolvent corporation have their fiduciary duties to its creditors first and stockholders second.[120]

6. 3. 2. 1 Trust Fund Doctrine v. Agency Theory

As to fiduciary duties of directors of a corporate in the "vicinity of insolvency", two opposing opinions have been identified. The first view which is called as the "agency doctrine" is based on agency law, and provides that an agent for a disclosed principal is not liable for the contracts of the principal, neither is he liable to a third party for failure to discharge the duty of care to the principal.[121] However, the agent may be held liable to third party for his own torts and for such actions as trespass or conversion.[122] This rule applied for many years by the company courts. For example in *Clark v. Lawrence*,[123] it was held that creditors could not sue directors for mismanagement.

According to the agency theory, corporate directors are the exclusive agents of stockholders, and the creditors' rights are entirely governed by private contracts.[124]

The "trust fund doctrine" which expresses the majority's view, provides that under certain circumstances, namely in the verge of insolvency, directors have duties to creditors.[125] The doctrine is based on the fact that upon the occurrence of a

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119 *FDIC v. Sea Pines Co.*, 692 F. 2d (4th Cir. 1982) 973, 977.

120 *Stanford Fork & Tool Co. v. Howe Brown & Co.*, 157 U. S. (1895) 312, *Bank Leumi- Le Israel, B. M. v. Sunbett Industries, Inc.*, 485 F. Sup. (S.D.Ga.1980) 556, 559.

121 Restatement (Second) of Agency sections 320 and 328 (1957).

122 Ibid section 343.

123 5 F. Cas. (C. C. D. Mass. 1856) 888. (Quoted by Beveridge *op cit* at 593).

124 William A. Klein & J. Mark Ramsyer, Cases and Materials on Business Associations: Agency, Partnerships, and Corporations (1991) 720. (Quoted by Jelisavcic, *op cit* at 146).

125 William M. Fletcher, Cyclopedia of the Law of Private Corporations (Perm. ed. 1986) 849.

corporate insolvency, its stockholders have no stake in the corporation's assets,[126] and they, thus, no longer represent the interests of stockholders,[127] instead they owe their duties to the corporate creditors. Furthermore, the nature of the directors duties shifts from long- term value maximisation to preservation of existing asset value for eventual distribution among creditors.[128]

It is said[129] that the idea of extending the directors' duties to creditors under the doctrine dates back to 1824, when Joseph Story J. in *Wood v. Drummer,*[130] held that the assets of an insolvent corporation represent a "trust fund" that must be kept for the favour of creditors.

In some cases, the courts have based their holdings on "trust fund doctrine". For example in *Pepper v. Litton,*[131] the Supreme Court held that corporate directors had fiduciary duties to creditors as well as stockholders.[132] The Delaware courts have also addressed the "trust fund" theory in several cases. For the first time when the doctrine appeared in a Delaware Supreme Court case was in 1944 where in *Bovay v. H. M. Byllesby & Co.,*[133] which was a clear case of fraud, the court stated:

> "An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund doctrine for the benefit of creditors. The fact which creates the trust is insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency."[134]

In another Delaware case, *Asmussen v. Quaker City Corp.,*[135] the court faced the question whether directors of an insolvent company could prefer certain creditors

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126 Ibid at 423.
127 *Harff v. Kerkorian*, 32 A.2d (Del. Ch. 1974) 215, 219, *Katz v. Oak Indus. Inc.* 508 A.2d (Del. Ch. 1986) 873, 879.
128 Gregory V. Varallo & Jess A. Finkelstein, "Fiduciary Obligations of Directors of the Financially Troubled Company", 48 Bus. Law. (1992) 239, 244, Citing *Hollins v. Brerfield Coal & Iron Co.* 150 U.S. (1893) 371.
129 John Coffee, "Court Has New Idea on Directors' Duty", Nat'l L. J. (1992 March 2) 18, McDonnell, *op cit* 110.
130 30 F. Cas (1824) 935.
131 308 U. S. (1939) 295.
132 Ibid at 307.
133 38 A. 2d (Del. 1944) 808.
134 Ibid at 813.
135 156 A (Del. Ch. 1931) 180.

over others where the favoured creditors were not corporate insiders. Here, the court found it clear that "all courts recognise a 'trust fund' doctrine of some sort."[136] In the court's view, the difficulty was the definition and the limits of the concept that corporate assets are a "trust fund" for the benefit of creditors upon the occurrence of insolvency.[137] The court concluded that even in the case of a clear insolvency, no trust exists to prevent directors from preferring some creditors over others. However, the court did not reject the possibility of liability arising from a strict application of the doctrine.[138]

The Delaware case of *Credit Lyonnais Bank N. V. Netherland v. Pathe Communication Corp.*,[139] as a well- known leading case in this regard, deserves a detailed examination. In that case, Chancellor Allen of the Delaware Chancery Court underlined directors duties to the creditors of an insolvent company as:

> "At least when a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise."

The case of *Credit Lyonnais Bank N. V. Netherland v. Pathe Communication Corp.* arose of a leveraged buyout (LBO), an effort to sell a division of MGM- Pathe Communication Corp. quickly and cheaply so that fil ing bankruptcy petition would be delayed. Paramount Communication Corp. (PCC) controlled by Giancarlo Parretti acquired MGM in a LBO transaction. After the transaction was completed, Parretti took measures to assert control over MGM board of directors which contravened an agreement between him and Credit Lyonnais Bank Netherland, N. V. (CLBN), sponsor of the transaction.

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136 Ibid at 181.
137 Ibid.
138 Ibid at 182. The same court three years later took a different view in *Pennsylvania Co. for Insurance v. South Broad Street Theatre Co.* 174 A. (Del. Ch. 1934) 112. In this case, the court held that directors and others in a position of control over an insolvent company could not prefer their own claims as creditors over the claims of outside creditors. Ibid at 116.
139 NO. 12150 (Del. Ch. 1991) Lexis 215 at 1 (Cited by Robert Morrison, "Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais", 19 Iowa J. Corp. L. (1993) 61).

In order to complete the transaction, Parretti misrepresented borrowed funds as equity investments.[140] As a result of Parretti misrepresentation, CLBN insisted Parretti limit his control over MGM, which led to a Corporate Governance Agreement, (CGA) based on which a new board including CLBN was set up. The new board of MGM was empowered to block any sale in excess $1 million. According to the CGA, Parretti could regain his control over MGM's board on the condition that he could reduce MGM's aggregate debt to CLBN below $125 million. CLBN claimed that under the CGA it could remove Parretti from the board because he had breached the CGA by interfering with MGM's management. Parretti moved to dispose of MGM key divisions at a low price, which would impose most of the risk upon MGM's creditors, while its stockholders received almost all benefits from the action, and he could according to the CGA have remained in control of MGM.

In that case, the court held that because the corporation, MGM, was in the "vicinity of insolvency", Parretti's actions were unacceptable,[141] and he breached his fiduciary obligation. Chancellor Alan based his decision on the ground that the board of directors "had an obligation to the community of interests that sustained the corporation to exercise judgment in an informed, good faith effort to maximise the corporation long- term wealth creating capacity."[142]

It seems that, with regard to his decision, Chancellor Allen means maximisation of creditors interests rather than those of shareholders, once the corporate is in the verge of insolvency or technically insolvent.

In *Geyer v. Ingersoll Publications Co.*,[143] the Delaware Court of Chancery held that a corporate directors owe a fiduciary duty to it's creditors upon "insolvency in fact" or at the moment when its liabilities exceed the fair market value of its assets.

In the above case, Ingersoll, the defendant, was the controlling stockholder, president, and chairman of the new corporation, and Mr. Geyer, plaintiff, was an

140 Ibid at 14- 20.
141 Ibid at 108.
142 Ibid at 107- 109.
143 621 A.2d (Del. Ch. 1992) 784.

employee and the only other shareholder. In 1988, Ingersoll Publishing used a $ 2 million note to repurchase Mr. Geyer's shares of the stock. The Ingersoll Publishing company defaulted on the note in 1991. Mr. Geyer alleged that the default arose from Mr. Ingersoll's fraudulent conveyance of the company's major assets to a third party in return for personal benefits, thereby, he breached his duty as a director of Ingersoll Publications, while Ingersoll Publications was indebted to Mr. Geyer. Here, the court held that in the verge of "insolvency in fact" a director had a fiduciary duty to the corporation's creditors.[144] The court disagreed with the defendant's assertion that statutory proceedings were necessary to invoke the insolvency exception, which would cause a director's fiduciary duty to "shift" from the corporation's shareholders to its creditors.[145] The court based its decision on the Delaware case of *Bovay v. H. M. Byllesby & Co.*,[146] and concluded:

> "the fact which creates the trust [for the benefit of creditors] is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency."[147]

The Vice- Chancellor Chandler interpreted this language as switching a director's fiduciary obligation imposed for the benefit of the corporate stockholders during solvency to the corporation's creditors at the moment when it becomes insolvent.[148] With regard to the recent decision as it puts the director of a financially troubled Delaware corporation at grave risk of incurring personal liability during periods of questionable solvency, it is said that while Delaware has historically rejected a strict application of the trust fund doctrine, the exact standard to which directors have to attain and the level of protection afforded to their business decisions has never been clarified.[149] Therefore, personal liability may be imposed on a director of a financially troubled Delaware corporation for good faith decisions which he believed in

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144 Ibid at 786.
145 Ibid at 788- 90.
146 38 A.2d (Del. 1944) 808.
147 *Geyer v. Ingersoll Publications Co.*, 621 A.2d (Del. Ch. 1992) 784, 787.
148 Ibid at 788.
149 *Unocal Corp. v. Mesa Petroleum Co.*, 494 A.2d (Del. 1985) 946.

conformity to the duty of care rules,[150] the process which may give rise to the loss of qualified directors fearing personal liability.[151]

6. 3. 2. 2 Steps to be taken

When a corporation faces financial trouble, the American directors like those in any other legal system are expected to decide how to handle the problem or conduct the situation. A variety of decisions or actions can be taken by them. They may make attempts to sell the company to a third party, or to restructure the company's debts through and out of court settlement with its creditors and to file a petition under chapter 11 of the Bankruptcy Code for reorganisation or a bankruptcy petition for liquidation under chapter 7 when there is no hope of saving the corporation.

The first task of a director of a corporation in financial difficulties is to assess the scale of problems with which he may face in discharging his responsibility by taking an appropriate step. In such circumstances the corporate directors should take account of all information supplied by accountants, counsel and others. Although balance sheet is a source of information, because corporate directors may not be able to rely on balance sheet as an appropriate indicator of solvency, they will not know when they owe their duties to creditors.[152]

It is true that business organisations do not generally become financially troubled overnight. The problems giving rise to such financial difficulty are usually cumulative and built up over long period, sometimes years.[153] But as soon as a corporation falls into insolvency, its directors begin to examine their pre- bankruptcy decisions which are now under examination by various hostile constituencies.[154]

The question which *Credit Lyonnais Bank N. V. Pathe*[155] left unanswered and has been often raised by commentators, is where is corporation in the "vicinity of

150 McDonnell, *op cit* at 194.
151 Ibid at 207.
152 Ibid at 3.
153 M. Freddie Reiss & Theodore G. Phelps, Identifying a Troubled Company, (Dominic DiNapoli et al., 1991) 7.
154 Varallo & Finkelstein, *op cit* at 239.
155 NO. 12150 (Del. Ch. 1991) Lexis 215 at 1.

insolvency"? The answer to this question is of significant importance, because at this crucial point the directors knew or should have known that which steps they ought to have taken.

The appropriate model which has been suggested is the use of accounting information, summarised in the form of financial ratios to measure the point when a corporation approaching insolvency. The advantage of this model is said to be its objectivity.[156] The formulation introduced by some commentators and courts for this purpose is Z- score which is factor derived from average of a corporation's financial ratios used in predicting insolvency. The formulation that has been explored by Altman,[157] is described as a reliable method which has demonstrated its accuracy and ability to predict insolvency and can, thus, be used by directors and creditors to determine when their corporation is in the "vicinity of insolvency".[158]

The Z- score formulation is constituted of five elements follows as:

Z= 1.2 (X1)+ 1.4 (X2)+ 3.3 (X3)+ 6 (X4)+ 1(X5)[159]

The critical Z- score values are 1.81 and 2. 99, since the first score or less alarms that the corporate is in the "vicinity of insolvency", whereas the second score or over that indicates the corporate financial health.[160] The indicators such as slowing down shipments, the fall of products quality, decline in sales, lowering cash balance, and more importantly losing some key customers should be taken as serious into account by the corporate directors as awaking.[161]

6. 4 Conclusion and Suggestions

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156 Jelisavcic, *op cit* at 164.

157 Edward I Altman, "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy", 23 J. Finance (1968) 589.

158 Jelisavcic *op cit* at 170.

159 X1= Working Capital, namely current assets minus current liabilities.
X2= The ratio of retained earnings over total assets.
X3= The ratio of retained earnings before interests and taxes over total liabilities.
X4= The ratio of book value of equity to total liabilities.
X5= The ratio of sales to total assets.
Z= Overall index.

160 Reiss & Phelps, Identifying a Troubled Company 27.

161 Ibid at 8- 9

As to directors duties to their company as a going concern, the US law still suffers from some confusion leading to misunderstanding.

As was seen, this vagueness has led some commentators to not only the conclusion that the duty of care is a useless legal concept which should be eliminated,[162] but also to deny the existence of the duty.[163]

The claim of these commentators on the duty of care reminds us of the followers of the philosophic school who believed that this world is not an existing reality but a dream. There is no academic justification for denying the existence of duty of care where it is the basic element of liability for negligence on basis of which a numerous cases have been decided. The contention of the uselessness of the duty of care is not less unjustifiable than denying its existence all together. If the claim of uselessness of the duty means that it should be developed to meet the modern business needs, it is understandable. However, if it means, as it is the case here, that the duty does not have a significant factor in legal relationship and should, thus, be removed, it can not be adapted to the realities surrounded today's business relations.

Regarding directors duties in insolvency, it seems the American law is now settled. This stability is a result of the insolvency exception to the rule that directors owe their duties only to the corporation and its shareholders.

It is justified to make a connection between the above mentioned rule and the "agency theory" on the one hand, and the "trust fund" doctrine and the insolvency exception on the other hand. The US law, particularly Delaware law, on the basis of "trust fund" doctrine recognises that in the "vicinity of insolvency" corporate directors represent its creditors rather than its shareholders.[164]

162 Manning, *op cit* at 13

163 Kennth Scott, *op cit* at 937

164 Gross et al., *op cit* at 19, *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d (4th Cir. 1982) 973, 977, *Clarkson Co. Ltd. v. Shaheen*, 660 F. 2d. Cir. (1981) 506, 512, *U. S. Spitzer*, 261 F. Sup. (S. D. N. Y. 1966) 754, 756, *Pennsylvania Co. For Insurance v. Soyh Broad St. Theatre Co.* 20 Del. Ch. (1934) 220, *Asmussen v, Quaker City Corp.*, 18 Del. Ch. (1931) 28, *Futures Trading Commission v. Weintraub.*, 471 U. S. (1985) 343, *FDIC v. Sea Pines Co.*, 692 F. 2d (4th Cir. 1982) 973, 977, *Harff v. Kerkorian*, 32 A.2d (Del. Ch. 1974) 215, 219, *Katz v. Oak Indus. Inc.* 508 A.2d (Del. Ch. 1986) 873, 879.

The problem inherent in the doctrine and the insolvency exception is the typical stance of US law in the Bankruptcy Code, chapter 11, namely reorganisation scheme. That is because under chapter 11, the American legislature's intention is to save and reorganise a troubled company, the immediate beneficiary of which is shareholders rather than the creditors. The aim of the scheme obviously is in conflict with the creditors' attempt and desire to receive their debts through liquidation process as quickly as possible. Consequently, the US law has no choice but to make a reconciliation between the insolvency exception reflected in the "trust fund" doctrine and the regulations of chapter 11.

The question is now, what kind of solution is to be recommended in order to resolve such ambiguities? It is said that the Delaware General Corporation Law should be amended to provide a clear standard of corporate insolvency and to specify whether a troubled company's directors owe a duty to its creditors, if so, under what conditions. It is particularly necessary and justified, while such uncertainty may discourage promoters from choosing Delaware as a state of incorporation.[165]

Some other commentators have taken the view that State law in the area of directors' fiduciary duties is in serious need. Therefore, it is time that Congress considered "buttressing the state law duties of loyalty and care with concurrent federal legislation." However, this legislation "should fully preempt state law and should be no broader than its demonstrated need."[166]

This view has been rejected since it "ignores the significance courts and legislatures place on disinterested directors and the important role which directors play in the governance of modern- publicly- held corporations."[167]

To resolve the confusion and vagueness inherent in the US law in this area, all aspects of this complicated legal system should be taken into account. As was seen in discussion of the "trust fund" doctrine and reorganisation under chapter 11, any

165 Alan Tompkins, "Directors Duties to Corporate Creditors: Delaware and the Insolvency Exception", 47 SMU L. Rev. (1993) 165, 194.

166 Seligman, *op cit* at 62- 63.

167 Dennis J. Block, Michael J. Maimone and Steven B. Ross, "The Duty of Loyalty and the Evolution of the Scope of Judicial Review", 59 Brook. L. Rev. (1993) 65, 66.

newly emerged rule may stand against another principle or statutory regulation. Perhaps the stance of Delaware courts law to refuse to apply a strict concept of the "trust fund" doctrine in this context is more understandable.

Chapter 7: Directors Liabilities for Breach of Their Duties

7. 1 Introduction

The main problem in reviewing directors' liability emerges from the difficulty inherent in directors duties themselves, as explained by Dalhuisen and Daluilen as follows:

> "the duties of directors and officers are not themselves clearly defined and as consequence there is no perfect clarity as to the liability of directors and officers in the case of (alleged) mismanagement."[1]

The result of such unclarity is "a patchy system which as yet lacks coherence for want of a clear definition of the general standard of care and of the precise fiduciary duties."[2]

The State and federal statutes are silent on directors liabilities for mismanagement vis a vis company or third parties. Such liabilities as said by Dalhuisen is addressed by case law rather than State or federal law, particularly Bankruptcy Code.[3]

The classification of the claimants in actions against directors in the US is not clear. However, according to a survey made by the Wyatt Company of 979 American corporations in 1982 with assets ranged from under $10 million to over $5 billion, stockholders are the most important source of claims against directors and officers. Employees or former employees are in the second place while customers are in the third place, and the governmental claims rank fourth.[4]

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[1] J. H. Dalhuisen & Jury M. Daluilen on International Insolvency and Bankruptcy, (New York Matthew Bender 1986) 3.08[2] [b] P. 2- 371.

[2] Ibid.

[3] Ibid at 2- 364.

[4] The Wyatt Company, 1982 Comprehensive Report: Directors and Officers Liability/ Fiduciary Liability" 45 at 17- 18 (1982) (quoted by Julie J. Bisceglia, "Practical Aspects of Directors and

The survey does not explain the precise position of the creditors, but it seems this position should be sought in the third place for the customers. Moreover, in the US the shareholders are sometimes the plaintiffs, even when the corporation assets are undervalued or it is financially depressed.

As was discussed in the previous chapter, directors' duties towards their corporation and its creditors are classified under two main concepts; fiduciary duty of care and loyalty. The liabilities of directors in this thesis are viewed under breach of those two duties. In the first part of this chapter, a director liability for breach of duty of care, negligence, will be examined.

In the second part, directors liability for breach of their duty of loyalty is studied. In this part, the attempt is to highlight some cases involving a fraudulent intent but decided under breach of duty of loyalty, which is a result of the lack of recognition of a fraudulent liability in civil context similar to fraudulent trading in English law.

7. 2 Liability for Negligence

7. 2. 1 Defining a Negligent Conduct

> "The ado about the liability of directors for mere negligence is like the proverbial shaving of pigs- much squeal and little wool, at least for the stockholders."[5]

It is the view of one of the leading commentators, Bishop, as to the directors and officers liability for negligence in the US. One may also find this opinion applicable to the liability for breach of duty of loyalty by arguing that while having a corporate director held liable for breach of duty of care is so difficult as mentioned in the above statement, it is harder to hold him accountable for breach of duty of loyalty or fraud and any other intentional improper behaviour. This point has been raised in *Bayer v. Beran*[6] where the court stated:

Officers Liability Insurance- Allocating and Advancing Legal Fees and the Duty to Defend" 32 UCLA L. Rev., (1985) 690, 693).

[5] J. Bishop, "Sitting Ducks and Decoy Ducks; New Trends in the indemnification of Corporate Directors and Officers", 77 Yale L. J., (1968) 1078, 1095.

[6] 49 N. Y. S. 2d (Sup. Ct. 1944) 2.

> "it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest."[7]

However, the confusion in the above statement is that the liability for negligence is related to "fraud, or improper motive, or personal interest," in the absence of which a negligence liability can, as the above statement expresses, not be imposed. The above expression diminishes the clear and well- recognised distinction between a liability for negligence and liability for disloyalty and fraud.

Breach of duty of care is defined by either a failure on the part of the director concerned to obtain adequate information before acting or by his failure to pay appropriate attention to a decision.[8]

Some theories have been proposed to explain the philosophy and purpose of imposing liability on a director for an allegedly negligent conduct. Soderquist has introduced a set of views in an attempt to formulate the liability. According to one of these theories, the aim of holding a director liable for negligence is to direct the future behaviour of the negligent directors who are blameworthy. The purpose of imposing a negligence liability is not merely to deter or dissuade directors from misconducting their corporate business but, as it was the case in the *Van Gorkom* case, rather to direct and correct their behaviour in a desired way.[9]

On the other hand, a negligence liability is viewed as compensatory measure by which the company and its injured constituencies, particularly creditors may recover losses. The imposition of this liability upon a director which is a result of his blameworthiness, should be determined when the loss is attributable to the plaintiff.[10]

The last theory defining the purpose of holding a director liable for his negligent behaviour, considers punitive aspect of liability. According to this view, the aim of imposing such liability on the respondent is to punish him for his wrongdoing which

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[7] Ibid at 6.
[8] *Anderson v. Lewis*, 473, A. 2d (Del. 1984) 805, 812.
[9] Larry D. Soderquist, "The Proper Standard for Directors' Negligence Liability", 66 Notre Dame L. Rev. (1990) 37, 44.
[10] Ibid at 44- 5.

is a blameworthy action, because he has benefited himself at the expense of the corporation, its shareholders, or its creditors.[11]

A distinction can be made as to the purpose of imposing liability for negligence between the two main types of negligence cases, namely vicarious and non- vicarious accountability. In the first type of these suits, represented by the English case of *Charitable Corporation v. Sutton*,[12] a defendant director who is wildly imprudent, causes loss to the corporation. In such cases, the aim is to hold a director accountable because of his failure to supervise the business in the corporation's interests, though he is not directly responsible for the loss.[13]

The second type of negligence cases is said to involve some acts by directors which directly give rise to loss to the company. This sort of cases, unlike the former, are non- vicarious, which involve recklessness or incompetence. The question which is to be answered in this class of cases is whether the wrongdoing is one that the law will force the defendant to recover the loss resulted from the negligent conduct.[14]

This theory has been also acknowledged by Weiss, who believes the courts have taken the stand that directors are only to be held liable for negligence when the plaintiff can prove the corporation has suffered loss through the negligent action.[15]

As has been implied by Dyson, such a classification is neither necessary nor is it of any use. Moreover, the distinctive line between these two types of cases is not clear. More particularly, it is difficult to identify this classification in the US law context, since its first part is represented by an English case.

Besides enforceable events and uncontrollable external forces, "most [business] authorities agree that management is the major cause of financial failure."[16] However, it is believed that despite both statistics on financial failure and a

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[11] Ibid. These theories seem similar to those proposed for imposing disqualification on a director in English law.

[12] (1742) 2 Atk. 400.

[13] Richard B. Dyson, "The Director's Liability for Negligence", 40 Ind. L. Rev. (1963-5) 341.

[14] Ibid at 343.

[15] E. J. Weiss, "Disclosure and Corporate Accountability", 34 Bus. Law. (1979) 578, 587. See also *Barnes v. Andrews*, 298 F. (S. D. N.Y. 1924) 614.

[16] G. Engler, Business Financial Management, (rev. ed. 1978) (Quoted by Christy, *Infra* at 108).

consensus among business authorities as to the role of management in financial and economic failures, "courts rarely find corporate management liable for the failure of the business they supervise."[17]

Breach of fiduciary duty of care, for example non- attendance resulting in misappropriation of company's property by corporation's directors, may give rise to liability for its directors, while in the *Heit v. Bixtby*[18] type cases, even indifference has been found a cause of liability. In the present case, the court found the respondents liable for "absolute indifference".

7. 2. 2 Standard of Liability for Negligence

To impose liability for monetary damages, the courts and commentators often recognise some such standards as ordinary negligence or gross negligence. It is suggested that an ideal standard of liability can be one which serves one of these ends: (i) the future of directors' conduct will be monitored in a desired way by imposing liability on a blameworthy director; (ii) the damages attributable to the improper conduct of the director to the corporation, its shareholders, or a class of its client will be recovered; (iii) punishment is imposed on a blameworthy director.[19]

The measure for due care in the Delaware law is "gross negligence". The case law is not helpful enough in clarifying the standard for due care. In *Rabkin v. Philip Hunt Chemical Corp.*[20] the Delaware Chancery Court expressed that in Delaware it is now settled that "gross negligence" is "the appropriate legal standard." However, the court acknowledged that "the question of what must be pleaded to state a claim for gross negligence in this context remain problematic."[21] The court citing *Allaun v. Consolidated Oil Co.*,[22] held that "in the corporate area, gross negligence would

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[17] J Gordon Christy, "Corporate Mismanagement as Malpractice: A Critical Reanalysis of Corporate Managers' Duties of Care and Loyalty", 21 Houston L. Rev. (1984) 105, 109.
[18] 276 F. Supp. (E. D. Mo. 1967) 217.
[19] Soderquist, *op cit* at 55.
[20] 547 A.2d (1986) 963.
[21] Ibid at 970.
[22] 16 Del. Ch. 318, 147 A. (1929) 257, 261.

appear to mean 'reckless indifference to, or a deliberate disregard of the stockholders".[23]

The case of *Smith v. Van Gorkom*[24] is an obvious example for the standard of gross negligence adopted by Delaware when, "director liability is predicated upon concepts of gross negligence."[25] This standard was also adopted in *Aronson v. Lewis,*[26] and *Pool v. Pool,*[27] where the court analysed the measure for assessing the conformity of director conduct to the standard as:

> "In some jurisdictions the only for which directors are liable is gross negligence, or gross negligence which would warrant an imputation of fraud ... "[28]

Also in 1990 the standard was described in *Tomczac v. Morton Thiokol, Inc.*[29] as "[i]n corporate context....means reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." The courts have generally been reluctant to hold directors liable for mere loss when gross negligence is not established. This idea seems even more applicable when a big percentage of members of boards are outside directors.[30] Some other cases have referred to the concept of "the ordinary prudent man in his own affairs"[31] as a proper standard. Such a distinction is described as having developed no significant differences in outcome.[32]

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23 *Rabkin v. Philip Hunt Chemical Corp.* 547 A.2d (1986) 963, 970.
24 488 A.2d (1985) 858, 893-94.
25 Ibid at 837.
26 473 A. 2d (Del. 1984) 805, 812.
27 So. 2d (La. Ct. App. 1943) 132.
28 Ibid at 135- 36.
29 Del. Ch. Ap., (1990) 5.
30 "Outside director" which is a concept used in the United States corporation law applies to part-time directors who are not the company's officers. However, they are highly experienced and mostly former corporate officers. This concept is very similar to or the same as that of non- executive director in English law. The 1970's witnessed a major change in the structure of the board of corporate management which resulted from pressure from Washington and Wall Street for increasing the number of independent outside directors. However, the percentage of outside directors on the boards of largest 1000 industrial companies has dropped from 63.2% to 57.5% in 1986, the first decline since 1966. Laurie Baum, "The Job Nobody Wants", Bus. Wk. Sept. 8 1986, 56.
31 *Hun v. Gary,* 82 N. Y. (1980) 65.
32 Dyson *op cit* at 344

The main question as to the determination of directors' liability is how and on the basis of what criterion they should predict the conduct may lead to liability for negligence. It has been suggested that in order to evaluate the proper standard for liability, it is necessary to clarify the concept of good faith in this context, since the "good faith standard" is an ideal one because of its focus on the blameworthiness element.[33]

Surely, if there is a state of mind, it must be subjective. The "good faith" standard as suggested above, can not be a proper standard for this purpose, because it is not a clear standard for directors' business behaviour and a difficult one to prove, particularly because it is a matter of mind for which an external demonstration is required. Furthermore, the "good faith" standard can not apply to breach of duty of care, negligence, while it is the material element of duty of loyalty with its own requirements and consequences.

The question has been also raised as to whether different standards should be applied to different types of corporations. For example, whether banks or other financial institutions should be treated the same as non- banking corporations. Perhaps the only State distinguishing between those two concepts is Massachusetts. This State has established different provisions for non- banks and banks when, the standard of liability in the former is gross negligence,[34] whereas that is ordinary one in the latter.[35] Such a distinction has not been seen in other States where the majority apply the standard of ordinary negligence in both cases. This distinction seems justified because, the possible class of plaintiffs for banks are unique. Moreover, the assets with which banks deal and more importantly, the special nature of banking business may require a higher degree of performance from other types of business directors.[36]

7. 2. 3 Pre- Van Gorkom Cases

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[33] Soderquist, *op cit* at 52.
[34] *Greenfield Save. Bank v. Abercrombie*, 211 Mass. (1912) 252.
[35] *Uccello v. Golden Foods, Inc*, 352 Mass. (1950) 319.
[36] Dyson, *op cit* at 343.

The main feature of the pre-Van Gorkom cases was that the courts would not easily dismiss allegations of an absence of due care "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."[37] In *Francis v. United Jersey Bank,*[38] e. g., the primary issue was whether a corporate director was personally liable for negligence for failing to prevent the misappropriation of trust funds by other directors who had been also officers and shareholders of the corporation. The present case involved a close corporation with three shareholder-directors, and the plaintiffs were trustees in bankruptcy of Pritchard & Baird Intermediaries Corp. (Pritchard & Baird), a reinsurance broker or intermediary.[39] The trial court described the payments as fraudulent conveyances and entered judgment of $ 10,355,736.91, including damages on account of the directors' negligence in permitting payments from the corporation of $ 4,391,133.21.[40]

The Appellate Division affirmed the First Instance Court's decision, but found that the payments were a conversion of trust funds, rather than fraudulent conveyances of the assets of the corporation.

The Supreme Court agreeing with Appellate Division, took the view that the critical question was not whether the respondents' misconduct was fraudulent conduct or acts of conversion but:

> "Rather, the initial question is whether Mrs. Pritchard was negligent in not noticing and trying to prevent the misappropriation of funds held by the corporation in an implied trust. A further question is whether her negligence was the proximate cause of the plaintiffs' losses."[41]

In the court's view, the respondent was negligent because she was not active in the corporation's business she managed and 'knew virtually nothing of its corporate affairs.'[42] The Court concluding that "if Mrs. Pritchard had read the financial

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[37] *Conley v. Gibson*, 355 US. (1957) 41, 45- 6.
[38] 432 A.2d (N. J. 1981) 814.
[39] Ibid at 816.
[40] Ibid at 716- 817.
[41] Ibid at 917.
[42] Ibid at 820.

statements, she would have known that her sons were converting trust funds,"[43] found the estate liable for the deceased director's failure to attempt to forestall a massive fraud perpetrated by the remaining two directors, her sons. The court awarded damages of over $10 million.

The court's decision made it clear that "[a] director is not an ornament, but an essential component of corporate governance. Consequently, a director cannot protect himself behind a paper shield bearing the motto 'dummy director."[44]

The leading case of *Litwin v. Allen*,[45] which has been described as the first modern and wrongly decided case on directors liability,[46] contains some interesting points. This case was decided on the ground of a simple negligence. The facts were that in 1929, when the disastrous economic depression hit the US and Europe, the clients of J. P. Morgan & Co., a banking corporation, set up a corporation, Alleghany, for investment in railroad securities.[47] Alleghany became in need of $10 million to pay for some projects in various States, while due to borrowing limitation in its charter, this size of loan was impossible. Morgan agreed to transactions designed as a substitute for a loan. The plan was that Morgan bought $10 million of debenture stock issued by the subsidiary of Alleghany, Missory Pacific Railroad. Alleghany retained the option to repurchase the debentures at the price paid by Morgan within six months in order to prevent the stock of falling into outsiders' hands.[48] The Morgan company, upon the directors of the Guaranty Trust Company of New York, one of its subsidiaries, decided to sell a $3 million participation in the Alleghamy transactions to the Guaranty Trust Company.[49] However, when as a natural result of epidemic financial depression, the market value of debentures fell disastrously, and Alleghany did not exercise its option,[50] the shareholders of the Trust Company sued

[43] Ibid at 826.
[44] Ibid at 823.
[45] 25 N. Y. S. 2d (1940) 667.
[46] Soderquist, *op cit* at 37.
[47] *Litwin v. Allen*, 25 N. Y. S. 2d (1940) 667, 679.
[48] Ibid at 692.
[49] Ibid at 693.
[50] Ibid at 695.

its directors for negligence in approving the company's participation in the Alleghany transactions. The court held that:

> "Directors are liable for negligence in the performance of their duties....whether or not a director has been negligent, depends on the facts and circumstances of a particular case ....A director is called upon 'to bestow the care and skill' which the situation demands".[51]

The court did not find any sound reason for the respondents' action and held them liable because "the entire arrangement was so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice."[52]

In that case, as a result of the current situation, it was clear to any reasonable prudent man that engaging in such a transaction with a seriously financially troubled company was risky. However, the defendant directors, while aware of deteriorating economic situation, approved the plan to invest their company's assets in an arrangement which was designated to rescue another deeply troubled corporation with no chance of obtaining gain. In other words, the respondents knew or should have known that the possibility was loss rather than gain. However, as the court rightly decided, the wrongdoing was breach of duty of care but not breach of duty of loyalty. Here, there was no fraud or an intentional improper behaviour, nor a motion of self- dealing.

7. 2. 4 Van Gorkom Case: More Than a Turning Point

It is not exaggeration to describe *Smith v. Van Gorkom*,[53] a highly leveraged buyout case,[54] as one of the most important cases in the history of US corporate law. That is because this case not only resulted in a radical development in the directors

[51] Ibid at 678.
[52] Ibid at 699.
[53] 488 A.2d (1985) 858.
[54] A leveraged buyout ("LBO") is defined as: "in a "LBO" transaction, an investor group borrows funds to purchase the target company. In this situation, the target company assumes its obligations and pledges its assets in order to secure repayment of the loans. Robert J. White, "Leveraged Buyouts and Fraudulent Conveyance Laws Under the Bankruptcy Code- Like Oil and Water, They Just Do not Mix", Annual Survey of American Law (1991) 357, 362.

protection statutes, but also it caused major changes in the standard of care of directors conduct.

In that case the court decided that the board of directors had been grossly negligent in failing to inform themselves adequately as to the leading defendant's role in forcing the sale of the company and in establishing the per share purchase price, and failing to inform themselves of the intrinsic value of the company.[55]

The *Van Gorkom* story began in 13 September 1980, with a meeting between Trans Union's Chairman and Chief Executive Officer, Jerome Van Gorkom, and corporate take-over specialist, Jay Pritzker. It happened when it became evident to Trans Union Corporation's senior management that, as a result of the company's inability to utilise large tax write-offs, the corporation's stock was undervalued.[56] Without consulting the corporation's board of directors, Van Gorkom, who was also the owner of 65,000 shares,[57] suggested to Pritzker a $55 per share cash-out merger with a company Pritzker controlled. After several meetings within a week, Pritzker made the offer Van Gorkom had suggested and they agreed on a price of $55 per share.

In the same week, Van Gorkom called a special and emergency meeting of the board of directors comprised of ten members, five outside and five inside directors, for the following Saturday September 20, without advising the directors of purpose of the meeting.[58] The board of directors was not provided with a copy of the proposed merger document. Van Gorkom only disclosed the proposed transaction to his senior management team for the first time one hour before the meeting. Despite an obvious negative reaction by all but the two officers with whom Van Gorkom had earlier consulted, Gorkom continued with the board meeting as scheduled.[59]

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[55] *Smith v. Van Gorkom* 488 A.2d (1985) 858, 874.

[56] The stock had traded at prices ranging from $24-1/4 to $39-1/2 per share over a five-year period. Ibid. at 866.

[57] Ibid. at 866.

[58] Ibid. at 867.

[59] Ibid at 867- 868.

In the board meeting, Van Gorkom did a twenty-minute verbal presentation in which he summarised the conditions of the proposed transaction. Van Gorkom stated that the free market would judge whether $55 was a fair price, because the proposed agreement permitted Trans Union to receive competing offers for ninety days. Van Gorkom did not reveal that he, but not Pritzker, was the one who had suggested the $55 price. In the meeting, the president of Trans Union spoke in favour of the transaction. The corporation's chief financial officer, Romans, had expressed his opposition to the merger at the earlier management meeting, but his recommendation was neither requested by nor given to the board. However, Romans did not say anything at the September 20 board meeting except that he had no idea of the proposal until that morning, and that calculations he had done in the past "did not indicate either a fair price for the stock or a valuation of the Company."[60] Furthermore, he stated that in his opinion "$55 was 'in the range of a fair price,' but 'at the beginning of the range." Counsel advised the board that a fairness opinion was not required by law, and that the directors might be sued if they failed to accept the offer.[61] After about two hours discussions, the board of directors approved the transaction, and the merger agreement was signed by Van Gorkom at a social event hosted by himself that evening. Neither Van Gorkom nor any other director read the agreement prior to signing.[62] Trans Union, omitting any reference to the corporation's limited right to receive higher offers, announced its "definitive" merger agreement on September 22.[63] The transaction was approved by 69.9% of the shareholders.[64]

The Trans Union's shareholders later filed an action against the Trans Union corporation, its directors, Jay Pritzker and others, seeking either rescission of the merger or damages from the board.[65]

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[60] Ibid. at 868- 869.
[61] Ibid at 868.
[62] Ibid at 869.
[63] Ibid.
[64] Ibid at 870.
[65] Ibid at 863- 64.

7. 2. 4. 1 The Supreme Court v. Chancery Court

In the *Van Gorkom* case, the Delaware Court of Chancery found the defendant's action adequately informed and, thus, held them entitled to the business judgment rule protection[66] since, in the court's view, the shareholders were properly aware and informed, and they refused to set aside the vote.[67]

But, the Delaware Supreme Court reversing the lower court's holding, held the respondents liable for breaching their fiduciary duties to the company, and referred to gross negligence as the appropriate standard of care applicable to directors' liability. The court considered the defendant directors as grossly negligent, because they failed to inform themselves adequately as to the terms of the merger agreement and the relevant facts as to their approval of transaction, particularly by approving the sale after a very short examination.[68]

The court held that, despite the presumption that directorial judgments are informed judgments, the Trans Union board's September 20 decision to sell the company for $55 per share, did not constitute an exercise of informed business judgment, since they did not adequately inform themselves as to the role Van Gorkom played in the "sale" of the Company, neither did they make attempt to verify the per share purchase price. Moreover, the respondents were uninformed as to the intrinsic value of the Company and were grossly negligent in approving the "sale" of the Company upon two hours' consideration without prior notice, and without the exigency of a crisis or emergency.[69]

In rejecting the defendants' argument that their actions were subjected to section 141(e) of the Delaware General Corporation Law, under which a director was entitled to rely upon reports made by corporate officers, or rely under stockholders vote as a remedy for the board's failure to apply an informed business decision

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[66] Ibid at 864.
[67] Ibid at 884.
[68] Ibid at 874.
[69] Ibid at 874.

process to the situation, the court asserted a director's right as such, but concluded that none of the statements made at the board's meeting, at which the merger was approved, were qualified as reports worthy of protection because:

> "At a minimum for a report to enjoy the status conferred by section 141(e), it must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind reliance. Considering all of the surrounding circumstances calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity, therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever the directors were duty bound to make reasonable inquiry of Van Gorkom and Romans ... ."[70]

The main factor on which the court based its decision was that the $55.00 price was accepted by directors without making a study to make sure whether the price was the best to the stockholders' interest, and that no consideration was given to the possibility of recessing the meeting for a few hours (or requesting an extension of Pritzker's deadline) in order to elicit more information either from management or the company's investment banker, who was already "known to the Board and familiar with Trans Union's affairs."[71]

The majority view in Van Gorkom in holding the defendant directors liable was stated by Justice Andrew Moore as the case "does not stand for new law. The court just was applying old law to egregious facts".[72]

The court was not impressed by the fact that the merger price was a substantial premium over the current market price, or by the fact that the directors were not required to take a full study to find out whether or not the $55.00 was a fair price for the company, since they had enough experience and expertise and long history of dealing with the company. More importantly, the court did not take account of the fact that the merger was very beneficial for Trans Union.[73]

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70 Ibid a 874.

71 Ibid at 869.

72 Stephen Radin, "The Director's Duty of Care Three Years After Smith v. Van Gorkom", 39 Hastings L. J. (1988) 707, 719, (Citing Victor, "Rhetoric Is Hot When the Topic Is Take-overs", Legal Times (1985) 7.)

73 Ibid at 873.

7. 2. 4. 2 Rejudging the Van Gorkom decision

The question is which court was correct in its decision whether to recognise the directors as being entitled to the business judgment rule protection or to hold them liable for their breach of duty of care, the Chancery Court or the Supreme Court?

The question can be answered from two different views. The first approach which is in agreement with the Chancery Court's decision, does not consider a director accountable in a Van Gorkom type situations. This is not because the respondent may be entitled to the protection of the business judgment rule, but mainly because the board of directors' decision to approve the sale concerned was not in detriment to the corporation's interest, rather in the *Van Gorkom* case circumstances it was the most beneficial to it. Therefore, according to this view, if the plaintiff can not prove any loss to the company, its shareholders or creditors resulting from the board of directors' decision, the court should not hold them liable for simply taking a harmless negligent decision. Perhaps in support of this view the best available precedent is *Barnes v. Andrews*,[74] where it was held that:

> "The plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss, and what loss it would have avoided."[75]

Some courts have refused to impose personal liability on negligent directors when the plaintiffs have been unable to prove that diligent execution of the directors' duties would have precluded the losses.[76]

In the line with this view, the Chancery Court's decision in dismissing the allegation against directors and applying the business judgment rule to their action, is justified because the Trans Union Company's directors not only did not incur any loss, but the merger price was a substantial premium over the current market price, and they had enough expertise on the market to make an informed decision in the business judgment context. In support of this view again, the fact should be taken into

[74] 298 F. (S. N. Y. 1924) 614.

[75] Ibid at 616.

[76] See e. g. *Briggs v. Spaulding*, 141 US (1891) 132.

account that half of the members of the Trans Union board of directors were outside directors to whom a more lenient standard of conduct than that of inside directors should apply. Moreover, the majority shareholders approved the sale, and all material information as to the transaction had then been disclosed. Furthermore, the counsel had warned the directors that if they failed to accept the $55 per share offer, they may have been sued.

The second view, which is consistent with the Supreme Court's decision, is that even though there was no evidence of loss to the corporation, the substance of the decision in question was highly risky and grossly negligent. In the Van Gorkom case, the Supreme Court based its decision in holding the defendant directors liable not only upon the fact that they did not make proper effort in establishing a per share price and to become adequately informed of all information as to the deal, but more particularly because they approved the sale after a two- hour meeting which was insufficient for approving such a significant sale.

7. 2. 4. 3 The impact of the Van Gorkom case on development of the law

> "For a half of a century, the law on directors' negligence liability has been in muddle. The problem began when a New York trial court wrongly decided *Litwin v. Allen*,[77] the long- term leading case holding directors liable for negligence management, without a jurisprudential underpinning and without an understanding of just what was behind the directors conduct."[78]

Therefore, the decision of Van Gorkom was the most important case of directors' liability for negligence at least since 1940.[79]

The Van Gorkom decision has been considered as either consistent with legal precedent,[80] or a fatal blow to the directorial management system that had taken two

[77] 25 N. Y. S. 2d (1940) 667.
[78] Soderquist, *op cit* at 37.
[79] Ibid at 41.
[80] Bayless Manning, "Reflection and Practical Tips on Life in the Boardroom After Van Gorkom", 41 Bus. Law., (1985) 1, 5.

hundreds years to develop.[81] It is contended that the Gorkom case does not represent a significant change either in the law itself or its application, but it has constituted a novel interpretation of the facts.[82] The decision is also said to have undermined one of the most well- recognised realities of today's business relationships, which is that business opportunities become available under extreme time constraints. That is because "quick business decisions can often mean the difference between being the first to a market product or business failure."[83]

As a result of this decision many outside directors found out that the risk involved in corporate decision- making was not worth it. Therefore, it became difficult to find competent individuals willing to serve as directors, unless those individuals were compensated by a high reward which would have to be weighted against the risk of having a personal liability imposed for negligence.[84]

One of the main consequences of the *Van Gorkom* case was its serious impact on the insurance market which threatened outside directors with the possibility of extensive personal liability. As a result of the decision, the availability and cost of directors liability insurance became a significant concern of corporations,[85] since it was unavailable or astronomically expensive.[86] Moreover, the Delaware legislators could not resist the increasing criticisms of the *Van Gorkom* case outcome and amended its corporate laws by introducing a new provision to empower a corporation to amend its articles of incorporation to provide that corporate directors may not be held liable for financial damages to the corporation or to its stockholders for a breach of fiduciary duty of care amounting to gross negligence to the corporation. There was a widespread response to the Van Gorkom decision by most of States. The result was

[81] Herzel, Katz, "Smith v. Van Gorkom: The Business of Judging Business Judgment", 41 Bus. Law. (1986) 1187.
[82] *James S. Altschul, "Corporate Directors' Liability in the US."*, Int'l Financial L. Rev. (1986) 33.
[83] R. K. Bean, "Corporate director liability", 65 Denver. U. L. R., (1988) 59, 64

[84] Robert Hamilton, "The Duties of Corporate Directors and the Draft Fifth Directive: Lessons from the United States", 4 JIBL (1988) 152, 157.
[85] Manning, *op cit* at 5- 6.
[86] For a detailed discussion of such impact see the chapter on "Protection of Directors in the US".

a radical change in the standard of directors' conduct. The States took part in a "race to the bottom" to amend their corporate statutes in order to protect their directors against personal liability.

7. 2. 5 Post- Van Gorkom Cases

As will be seen, these cases have been decided under shadow of the shock created by the Van Gorkom decision, the main characteristic of which is not holding a defendant director liable except when there is an unquestionable case of breach of duty.

The case of *Lewiss v. Honeywell Inc.*[87] is of significance, because the court refused to hold the defendant directors liable. In that case, three directors of the company who were high ranking executives of Honeywell were charged of acting in an uninformed manner by declining an all- cash offer by Sperry Corporation, at a 37 percent premium over market price. It was also alleged that the directors' rejection of the offer was done without consulting the corporate investment advisor and failed to disclose the offer and his decision to shareholders.

The court upheld that although the directors' failure to disclose and submit the offer to an investment banker could be considered in the plaintiff's favour, it found it insufficient evidence of negligence, because:

> "A rejection of an offer at a premium over market price and a failure to disclose that action to shareholders may or may not be informed. The commission or omission of those acts does not, by itself, establish the degree of enlightenment or ignorance of the decision makers."[88]

The court did not find the allegations satisfactory, since they could not:

> "... establish that the defendant directors rejected (and refused to negotiate) the Sperry Offer without having properly informed themselves of the critical facts relating to the merits of that offer or that the directors, while having such information, chose to ignore it in making their decision."[89]

[87] Del. CH. (July 28 1987) 93, 565, quoted by Radin, *Supra* at 727.
[88] Ibid at 97, 535.
[89] Ibid at 10.

A comparison between the above case and the Van- Gorkom decision leads us to the conclusion that the element of "being properly informed" is a decisive factor in holding a defendant director liable or entitled to the business judgment rule protection. In the *Van Gorkom* case, the court held the respondents liable for making an uninformed decision irrespective of the fact that the transaction in question was, in its own kind and under those particular circumstances, the most beneficial to the corporation, whereas in *Lewiss v. Honeywell Inc.* the court found the respondents' decision protected by the business judgment rule, no matter whether or not it was beneficial to the corporation.

One wonders, if the court of the present case held the directors liable for their rejection of a beneficial transaction, would not it still be a justified judgment?

Similarly, in *Grobow v. Perot,*[90] the court dismissed the case allegedly involved directors' failure to exercise an informed business judgment in considering a proposed transaction. The court built its holding upon the fact that the plaintiff had alleged that the day before the full board was to meet, a meeting of a special committee chaired by an outside director examined and approved the transaction. Moreover, the court acknowledged that there was no allegations on the part of plaintiff that the special committee "failed to consult with and consider the views of financial or legal advisors before recommending to the full board that it approves the transaction"[91]

In *Rabkin v. Philip A. Hunt Chemical Corp.,*[92] some consolidated class actions were filed in the Delaware Court of Chancery on behalf of the minority shareholders of Philip A. Hunt Chemical Corp. (Hunt) challenging the merger of Hunt with its majority shareholder, Olin Corporation (Olin). The plaintiffs claimed that the proposed Olin- Hunt merger price was grossly inadequate. They outlined their contentions as breach of duty of entire unfairness and allegedly taking an uninformed

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[90] 526 A. 2d (Del. Ch. 1987) 914.
[91] Ibid at 926.
[92] 547 A.2d (1986) 960.

decision, which was rejected by the court. The Vice Chancellor granted the defendants' motion to dismiss the allegations on the ground that there could be no relief on the basis of the plaintiffs' claims and that, in the court's view, absent claims of fraud or deception, a minority shareholder's rights in a cash- out merger were limited to an appraisal.[93] The court made its judgment based on the plaintiff's statement that their counsel met with a special committee of outside directors prior to giving its recommendation as to a cash- out of minority shareholders, and that this special committee found the price "fair but not generous", and that it "unanimously recommended that Olin consider raising the merger price."[94] However, when Olin refused to increase the price, the special committee following further meetings "reported to the Hunt's board of directors that it found $20 to be fair and recommended the approval of the merger."[95] The court concluded that from the facts present, "no inference could be drawn either that the Hunt directors were uninformed or were grossly negligent in recommending the merger."[96] However, the Appeal Court found that the Trial Court had erred in dismissing the plaintiffs' action and permitted them to file their proposed amendment to the pleading.[97]

The rationale based on which the cases following Van Gorkom were decided, have been described as "a judicial hodge- podge, ranging from a strict adherence to the business judgment rule to mixing of the business judgment rule and the duty of loyalty into one theory."[98]

Perhaps this statement is correct as far as acknowledging the courts confusion emanating from the lack of clear rules or criteria for liability for breach of duty of loyalty. The Van Gorkom case not only did not result in setting some rules for

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[93] Ibid at 960- 62.
[94] Ibid at 969.
[95] Ibid at 970.
[96] Ibid at 971.
[97] *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d (1985) 1099, 1108.
[98] James E. Kaye, "Corporate Law: Statutory Development in Directors' Liability- State Response to Smith v. Van Gorkom", Annual Survey of American Law (1988) 429, 440- 1.

negligent liability but persuaded the courts to take a more cautious stance in making such a liability order to avoid another Van Gorkom crisis.

7. 3 Liability for Breach of Duty of Loyalty

Liability for a breach of duty of loyalty is traditionally incurred when corporate directors are in a way interested in the transaction they are asked to approve. Directors are "interested" under Delaware law if they either expect to derive a personal financial benefit from a contract or appear on both sides of a transaction.[99] In some cases, disloyalty may emerge from a gross recklessness more than an intentional conduct. For example, directors have been held liable for causing their corporation to enter a transaction which they knew it could result in a loss but never in a gain for the corporation.[100]

The crucial case of breach of fiduciary duty of loyalty is fraudulent conduct on the part of directors, whether to defraud creditors by carrying on an insolvent business or obtaining personal gains at the creditors' or shareholders' expenses.[101]

The primary rule in a fiduciary duty of loyalty analysis is having an undivided loyalty to the beneficiary / corporation. Any division of loyalty will be taken by the courts as serious, since "there is no safe harbour for such divided loyalties in Delaware, when directors of a Delaware corporation are on both sides of a transaction they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."[102]

7. 3. 1 Appropriation of Corporate Opportunity

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99 *Aronson v. Lewiss*, 473 A.2d (Del. 1984) 805, 812.
100 *Litwin v. Allen*, 25 N. Y. S. 2d (Supp. Ct. 1940) 667.
101 *Logue Mechanical Contracting Corp.*, 106 Bankr. (1989) 436, *Clarkson Co. Ltd. v. Shaheen*, 660 F. 2d. Cir. (1981) 506, 512.
102 *Gottlieb v. Heyden Chemical Corp.*, A.2d (1952) 57, 58.

In taking or appropriating a company's opportunity, there are some aspects that need to be addressed, for example whether a director is allowed to do so when his corporation is unable or refuses to take up the opportunity after adequate disclosure of information. To whom this disclosure should be made, to an independent board or a general meeting of the shareholders. The fact is submitted that the corporate business opportunity is the corporation's property and its appropriation by its director will be considered to be a misappropriation of the corporate assets. Thus, it has been said that the difficulty in applying this rule is how to determine whether or not the business opportunity concerned did belong to the corporation.[103]

In Delaware, case law views the corporate opportunity as an indication of the rule that a director has the utmost good faith and undivided loyalty to his corporation.[104] Other States are of similar stance in this regard. In the New York case of *Meinhard v. Salmon,*[105] the defendant, a manager of a company who was also a trustee of a trust, renewed a lease for the corporation he controlled instead of the trust. Here, Cardozo J. held:

> "The very fact that Salmon was in control with exclusive powers of direction charged him obviously with the duty of disclosure, since only through disclosure could opportunity be equalised ... He was managing co- adventurer. For him and for those like him, the rule of undivided loyalty is relentless and supreme."[106]

However, there are some exceptions to this rule. For example when an opportunity comes to a director in his own private capacity rather than in his capacity as a director, and the opportunity is the one which because of the nature of the enterprise is not relevant for the corporation, and it has no interest in it, the director may take the opportunity for himself.[107]

To determine an alleged appropriation of the corporate business opportunity by its directors, some elements are decisive to be considered. The business opportunity

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[103] *Miller v. Miller,* 301 Minn. (1974) 207, 222 (Quoted by Knepper and Bailey, Liability of Corporate Officers and Directors, at 102).
[104] *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d (Del. 1980) 957.
[105] 249 N. Y. (1928) 458.
[106] Ibid at 466, 468.
[107] *Guth v. Loft, Inc.*, 5 A. 2d (Del. 1939) 503, 510.

should be the one which is consistent with the nature of the corporate business activity, namely an appropriation which could be acquired by the corporation. Therefore, if the corporation is in need of property or any sort of opportunity related to the corporate activity, but this available opportunity was appropriated by its directors, they may be held liable for breach of their fiduciary duty of loyalty irrespective of whether or not the corporation suffered any loss or benefited from the appropriation.[108]

The other point which is significant in this regard is the financial ability of the corporation to acquire an opportunity available to it. If due to financial inability the corporation could not take the opportunity its directors are permitted to take it up for themselves. Even in such a situation, in order to prevent any possible claim of bad faith, the directors are better to disclose it to an independent board or to general meeting of shareholders.

It has been decided that a director may not be absolved of liability for appropriating an opportunity unless the corporation is insolvent. In other words, if the corporation is merely unable to pay its current bills, the director is not entitle to do so.[109]

However, if the corporation is unable, refuses, or fails to take the opportunity for any reason, a director may appropriate it with no fear of being held personally liable for breach of his duty of loyalty.[110]

Perhaps the best example of failure or refusal of a corporation to avail itself of an opportunity, is when an approval of shareholder general meeting for this purpose is required by by-laws, but the general meeting refuses to approve the acquisition of the opportunity by the corporation. In such a situation, nobody can blame corporate directors for appropriating the opportunity.

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[108] *Farber v. Servan Land Co.*, 662 F.2d (5th Cir. 1971) 375 (Quoted by Knepper and Bailey, Liability of Corporate Officers and Directors, at 102).
[109] *Klinicki v. Lundgren*, 67 Ore. App. (1984) 160.
[110] *Thicho Timber v. Sayer*, 236 Mich. (1926) 40 (Cited by Knepper and Bailey, Liability of Corporate Officers and Directors, at 105).

7. 3. 2 Involvement in Conflict of Interest

7. 3. 2. 1 Liability for conflict of interest

Reference to liability for conflict of interest has a long history dating back to 1846, when in *Michoud v. Girod*[111] Mr. Justice Wayne stated:

> "The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self- interest and integrity. ... In this conflict of interest the law wisely interposes. It acts not on the possibility that, in some cases, the sense of that duty may prevail over the motives of self- interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self- interest will exercise a predominant influence, and supersede that of duty."[112]

Some courts have shown reluctance to make a liability order against a director while his interest does not conflict with that of his corporation, or when he has not obtained a gain at the corporation's expense. In *re Xonics, Inc.*,[113] for example, the committee of creditors of Xonics filed an action against the chairman and chief Executive officer of Xonics, Charles F. Havertly, for alleged breach of fiduciary duty of loyalty to the corporation creditors by negotiating the sale of the corporation's assets at less than fair value to Elscint, Inc.. The critical point supporting the claim was that the defendant director in his negotiation arranged for an employment contract with the buyer company, Elscint, Inc., upon which he would be employed by Elscint as its director, once the sale was completed.

The court considered the point that Havertly recommended the transaction to the Xonics' board as the best one available to the corporation, when the corporation "would probably be pushed into either voluntary or involuntary bankruptcy or reorganisation" if no sale were concluded within two weeks,[114] and that "an independent board, after all disclosure of the insider's deal approved the

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111 4 How. (1846) 503.
112 Ibid at 554.
113 99 B. R. (Bankr. N. D. Ill. 1989) 870.
114 Ibid at 874.

transaction."[115] In the court's view, Xonics' directors had not breached their fiduciary duties of loyalty to the corporate creditors, and they did not have to stay with Xonics by refusing employment with Elscint to avoid a breach of the trust owed to Xonics' creditors.[116]

In the Delaware leading case of *Gimbel v. Signal Companies, Inc.*[117], the plaintiff, a stockholder of signal company, which had some subsidiaries, sought an order to ban the sale of one of these subsidiaries. The plaintiff claimed that there was not a proper notice of the special meeting of the board of directors of Signal, at which the proposed sale was approved and authorised, and that the proposed sale required authorisation by the majority of the outstanding stock of Signal pursuant section 271(a) of Delaware General Corporation Law.[118] Moreover, he alleged that the sale price was "wholly inadequate," and that certain personal motives by certain directors motivated them in making the business decision.[119]

Chancellor Quillen was of the view that "it is not our law that shareholder approval is required upon every major restructuring of the corporation," neither was necessary to go beyond the statute.[120] The court rejected the plaintiff's claim that the respondents had a personal motivation in the proposed sale constituting self-dealing, where "no indication of self-dealing on the part of the Board of Directors as such would taint the proposed transaction or neutralise the effect of the business judgment rule".[121]

In some other cases, the courts in scrutinising an alleged breach of duty of loyalty on the part of a director or majority of a board of directors, have distinguished the facts relating to each director's conduct refusing to make a collective liability order.

[115] Ibid at 876.
[116] Ibid.
[117] 316 A. 2d (Del. Ch. 1974) 599.
[118] Section 271(a) requires majority stockholder approval for the sale of "all or substantially all" of the assets of a Delaware corporation.
[119] *Gimbel v. Signal Companies, Inc.*. 316 A. 2d (Del. Ch. 1974) 599, 605.
[120] Ibid at 606.
[121] Ibid 609- 10.

The Delaware case of *Cede & Co., Inc., v. Technicolor, Inc.,*[122] is a good example in this respect. Some interesting points emerged from the case, which have not, perhaps because of being a recently delivered decision, been examined by commentators yet. The causes of action, in this case, were breach of fiduciary duty of loyalty and fraud.

The story began in 1970, when Technicolor was still a wealthy corporation with a long and prominent history in the film / audio- visual industries. However, by the late seventies, it experienced decline in competitiveness taking losses that were "unacceptable" and out of control.[123] To overcome the situation, some efforts were initiated by Kameraman, Technicolor's chief executive officer, in order to reduce costs at Technicolor's film laboratories and to resolve other inefficiencies. His plans, such as "One Hour Photo" ("OHP"), at first seemed effective, but finally ended up with a loss of $5. 2m.

The Technicolor's financial difficulty persuaded Perelman, a controlling shareholder and chairman of MacAndrews & Forbes Group, Inc., (MAF), to bid for the acquisition of Technicolor.

For this purpose, Perelman sought Mr Sullivan's, one of Technicolor's directors, assistance through an intermediating.[124] On the following Monday, September 13, Sullivan instructed his secretary to call his stockbroker and place a purchase order for ten thousands shares at market price. A week after his joint meeting with the intermediating and Perelman, Sullivan informed Kameraman of his negotiation with Perelman, but he did not mention anything about increasing his holdings in Technicolor's stock. Through Sullivan's mediation, Kameraman and Perelman met on October 4, when the price of the sale, the effect of acquisition on Kameraman's employment contract, and the point that Sullivan would continue as director after the completion of the sale and a finder's fee for him were also discussed.

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[122] 634 A.2d (1993) 345.
[123] Ibid at 351.
[124] Ibid at 352.

In another meeting, on October 12, Kameraman and Perelman agreed upon all matters except price and financing.[125] In a further private meeting, Kameraman and Perelman agreed that Sullivan would receive a $150, 000 for introducing the parties. Their further meeting resulted in an agreement on a price of $23 per share, and Kameraman's employment as a director of the new company.[126] Two days later, Kameraman called a special meeting of Technicolor's board of directors, in which all *nine members of the board were present, three of them Lewis, Isham, and Bjorkman.* "had only limited knowledge of the proposed sale of the company," three others "were told nothing of Technicolor's sale prior to the meeting."[127]

In the meeting, Kameraman explained the history of his negotiation with Perelman, and counselled the board that $23 per share was a "good" price, because it was ten times "core" earnings of between 2. 30 and 2.50 per share. He also outlined the terms of his contract with MAF and Sullivan's finder's fee of $150, 000.[128]

After a presentation by outside counsel and investment banker, "the board unanimously approved the Agreement and Plan of Merger with MAF, and recommended to the shareholders of Technicolor the acceptance of the offer of $23 per share." In a meeting at the January 24 1983 shareholders, 89% of the shareholders voted to repeal the super- majority amendment and in favour of the proposed merger.[129]

The Delaware supreme court's stance; An action was brought by Cinerama, the owner of 201, 000 shares, representing 4. 405% of the common stock shares of Technicolor, against seven of the nine members of the Technicolor's board at the time of merger, MAF, and Perelman as chairman and controlling shareholder of MAF, for alleged fraud, breach of fiduciary duties and unfair dealing, requiring the

[125] Ibid at 354.
[126] Ibid at 356.
[127] Ibid.
[128] Ibid at 357.
[129] Ibid.

merger to be declared void for lack of unanimous directors' approval of repeal of super- majority provision of Technicolor's certificate of incorporation.[130]

According to the Delaware Supreme Court, the Chancery court "found that 'the Board as a whole' had not breached its collective duty of loyalty." However, the court held Sullivan liable because, in the court's view, "Sullivan [had] made money on the transaction ... and apparently engaged in or instituted some trades in Technicolor's stock while in possession of non- public information."[131] The court found also Sullivan guilty of bad faith "specially [regarding] his co-operation with Mr. Perelman before Kameraman met with Perelman."[132]

In the Supreme Court's view, Chancellor Alan of the Delaware Chancery Court "found the evidence sufficient to conclude that Director Sullivan had been disloyal because of his interest in the transaction."[133] Chancellor Alan was of the view a director's self- interest in a third- party transaction as not material unless sufficient to create a reasonable probability: i) "that the independence of judgment of a 'reasonable person in the director's position would be affected; and ii) that such a director's self- interest would have affected the collective decision of the board."[134]

As to the decision of the Delaware Supreme Court in *Cede & Co., Inc., v. Technicolor, Inc.*, though generally speaking justified, the ground of the holding requires some examination. The court, here, based its decision in holding Sullivan liable mainly on the ground that the respondent obtained personal benefits particularly the $150, 000 finder's fee. It seems the liability could not have been imposed on the basis of the finder's fee concerned, because Kameraman was aware of the matter and he was the one who supported the payment in his meeting with Perelman. Otherwise, Kameraman should have also been held liable for breach of fiduciary duty of loyalty because of his participation in the negotiation involving such an illegal

130 Ibid at 358. "Certificate of incorporation" in most States is termed as "articles of incorporation".
131 Ibid Footnote 24.
132 Ibid.
133 Ibid at 358.
134 Ibid.

benefit for Sullivan. Moreover, the finder's fee and its aspects was disclosed to the general meeting formed to decide the sale.

Therefore, there was no ground for the liability verdict against Sullivan except his purchase of ten thousands shares of the corporation's stock after his meeting with Perelman which was not disclosed until the transaction was completed.

7. 3. 2. 2 Who is interested

A director becomes interested when he votes on a transaction involving his personal interests. In such circumstances, the director should refrain from self- dealing. Under traditional common law principles, as a general rule, the transactions between corporation and its interested directors was voidable, irrespective of whether or not it was fair or approved by disinterested directors.[135] However, the law accepted a more liberal view by not holding voidable such transaction when it was approved by a disinterested majority of his fellow directors and was not proven to be unfair to the corporation or its stockholders.[136]

The Delaware law, like many other states, adopted this formulation as a "safe harbour",[137] the formulation which appeared in section 144(a) of the Delaware General Corporation Law, and provides that no contract between a director and his corporation shall be voidable if a majority of disinterested directors approves the contract and if the material facts as to his interest are disclosed.

The ALI also gives a definition of an interested director as follows:

> "A director or officer is interested in a transaction if: 1) the director or officer or an associate of the director or officer, is a party to the transaction, or 2) The director or officer has a business, financial or familial relationship with a party to the transaction, or 3) the director or officer, or a person with whom the director or officer has a business, financial or familial relationship, has a material personal interest in the

[135] B. M. Animashaun, "The Business Judgement Rule; Fiduciary Duties and Liabilities of Corporate Directors", 16 Southern Univ. L. Rev., (1989), 345, 350, citing *Munson v. Syracuse Geneva & Corning R.*, 103 N. Y. (1886) 59 73.

[136] Harold Marsh, "Are Directors Trustees, Conflict of Interest and Corporate Morality", 22 Bus. Law. (1966) 36, 39- 40, Animashaun, *op cit* at 350.

[137] *Schereiber v. Bryan*, 396 A.2d (Del. Ch. 1978) 512, 518.

transaction, or 4) The director or officer is subject to a controlling influence by a party to the transaction, or a person who has a material pecuniary interest in the transaction".[138]

Delaware cases steadily declare that the Delaware corporate directors have a fiduciary duty to the corporation and their shareholders not to further their own interests in disadvantage of those of their corporation. In *Guth v. Loft*,[139] the Delaware Supreme Court referred to the rule as:

> "[C]orporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders."[140]

In viewing a self- interested transaction, although the duty of loyalty in corporate law area emerged from the duty of loyalty under agency law, the application of the duty in the latter is different, because in corporate law, a self- interested director deals with a subordinate, an equal, a superior, the board, or the shareholders.[141]

7. 3. 3 Standard of "Fairness" to Assess Self- interestedness

To examine a contract between a corporation and its director, the courts often apply the "fairness test". As was mentioned in the earlier chapters,[142] the traditional view was that any contract between a director and his corporation was voidable. This resulted from an analogy being drawn between a trust position and that of a corporate director. But very soon it appeared to be a troublesome analogy, since the extent of freedom required by the latter to manage the business was broader. It was more problematic when a corporation was in need of loan, but its directors could not, as a consequence of this prohibition, provide it with the loan.[143] Therefore, the

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138 American Law Institute, Principles of Corporate Governance: Analysis and Recommendations Section 1. 23 (Proposed Final Draft 1986).

139 5 A. 2d (Del. 1939) 503.

140 Ibid at 510.

141 Melvin Aron Eisenberg, "Self- interested Transactions in Corporate Law", 32 Corporate Practice Commentator (1990- 91) 256, 257.

142 See the discussion of "Directors Duties in US".

143 See e.g. *Twin- Lick Oil Co. v. Marbury*, 91 US (1875) 587.

law changed its view in this regard by allowing such contracts, provided there was an approval of disinterested majority of board of directors representing corporation. However, there was still fear of the practical possibility of an interested majority using its influence for its own personal interests. This concern persuaded the courts to establish a new standard as "fairness" test.[144] The burden of proving "fairness" of contracts is upon the proponent of the transaction once an interest of a director is shown.[145] The courts consider the standard of "fairness" as a factual determination which is dependant upon the facts of each case as well as the courts' interpretation of these facts.[146] This test is a matter of fair price which is a set between " the lowest price a seller will accept and the highest price a buyer will pay."[147]

The standard has been expressed in the Delaware case of *Sterling v. Mayflower Hotel Corp*[148] as follows:

> "The requirement of fairness is unflinching in its demand that where one stands on both sides of a transactions, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."[149]

Similarly, in *Allied Chemical & Dye Corp. v. Steel & Tube Co.*,[150] this measurement was considered as:

> "Fairness or unfairness of the price . . . must be judged in the light of the conditions as they existed at the time of the execution of the contract."[151]

There has, so far, not been an attempt by the legislator or the courts to formulate the test of "fairness of price". However, some cases such as the Delaware case of *Allaun v. Consolidated Oil Co.*,[152] have explained the use of price as a factor to determine the "fairness test". In that case the court stated that:

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[144] Ibid.
[145] *Pepper v. Litton*, 308 US. (1939) 295, 306.
[146] *Ransome Concrete Mach. Co. v. Moody*, 282 F. (1922) 29, 34.
[147] Ronald J. Gibson, "A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers.", 33 Harv. L. Rev. (1981) 819, 825.
[148] 93 A.2d (1952) 107.
[149] Ibid at 110.
[150] 14 Del. Ch. (Ch. 1923) 1.
[151] Ibid at 95.
[152] 147 A. (Ch. 1929) 257 .

> "It is not every disparity between price and value that will be allowed to upset a proposed sale. The disparity must be sufficiently great to indicate that it arises not so much from an honest mistake in judgment concerning the value of the assets, as from either improper motives."[153]

The fairness standard can be applied even when the board of directors are not a party to the contract in question but its approval is required, where they may be indirectly involved. This is the case, when the approval of the board of directors of the target company is required before a proposed transaction, merger or sale of assets, is to be put before the shareholders. Such an approval or consent of the target's board is a pre- requirement, provided by statutes,[154] not only for the importance of the directors' co-operation with the transaction proceeding, but most significantly because any merger or sale of assets is, without such an approval, impossible.

The situation seems more crucial when the target's board rejects a proposed transaction beneficial to the shareholders, and uses its pre- eminent position to forestall a potentially valuable merger or take- over which is a result of its high authority position in a public corporation.[155]

The question remains whether the 'fairness test' may be used as a "stand alone" test or only as a subsidiary measure after the question of disclosure and consent have been adequately addressed. Eisenberg has suggested that the employment of a disjunctive test would be satisfied, if either the director or senior executive makes a full disclosure or the transaction is concluded at a fair price.[156] As to the question whether "fairness" test or "fairness of price" without disclosure is sufficient, he has argued that the suggestion that fairness of price is sufficient without need of disclosure, may increase the court scrutiny into the corporate decision- making process. In other words, it would remove decision- making from the corporation's hands and place it in the hands of the court.[157] In his discussion, Eisenberg refers to

[153] Ibid at 261.
[154] Delaware General Corp. Law s. 251 (merger), s. 271 (sale of assets).
[155] Gilson *op cit* at 825.
[156] Eisenberg *op cit* at 257.
[157] Ibid.

an argument that a distinction should be made between a director's failure to disclose a conflict of interest, and his failure to disclose some or one material fact as to the transaction itself, since a failure to disclose a conflict of interest may be fatal, whereas failure to disclose a material fact may not. Eisenberg holds the premise of this argument as "wrong" that the disclosure of a conflict of interest by the director concerned places the corporation on as if it was dealing with a third party, and consequently there is no need to press the director to disclose more information than a third party has to do.[158]

It seems the afore- mentioned judicial decisions do not offer a clear formulation, on the basis of which a board of directors can satisfy the test of " fair price", particularly when the board or some of its members are obviously or heavily interested in the transaction concerned. The situation is more crucial when among various offers for a transaction, the lower price offer is, in long- term more beneficial to the corporation because of its social and economic advantages, e. g., for giving more security to the corporation's employees, or providing the corporation with an option to repurchase the shares or assets in sale under particular circumstances.

Perhaps, the more justified suggestion is to interpret a "fair price" test as the most beneficial offer available to the corporation under the present circumstances of the case, which may vary case to case. Any decision, thus, to evaluate a "fairness of price" test, must be made with regard to all socio- economic aspects of the transaction in question.

7. 4 Liability for Quasi- Fraudulent and Wrongful Conduct

As was earlier mentioned in the introduction, among those cases brought for breach of duty of loyalty, there are some fraudulent events that are treated as a matter of civil rather than criminal liability. These cases are, however, filed under liability for

[158] Ibid.

disloyalty. When such a case is brought before the court, the liability imposed is similar to a case of breach of loyalty. The question whether or not the plaintiff filed such action as a case of fraud but the court proceeded it as a case of breach of fiduciary duty, does not change the conclusion that directors liability, except liability for fraudulent conveyance, in the US is often confined in liability for breach of fiduciary duty. *Logue Mechanical Contracting Corp.*[159] is a good example of this class of cases where in an action taken by Logue Mechanical Contracting Corp.'s creditors, it was alleged that the directors and the only shareholders of the company, had breached their fiduciary duty of loyalty. In this case, Logue Mechanical Contracting Corporation was formed in 1977 of which Arthur H. Logue was controlling shareholder and the chairman of the board of directors as well as the president of the corporation. His son William M Logue was the only other shareholder and the corporation's vice- president, and Helen M Logue secretary and director of the corporation.

At the fiscal year ending August 31, 1983 financial statements showed a loss of $55, 876 and a decrease in working capital of $77, 383. In order to overcome the depression, Arthur Logue made loans to the company "as a separate entity, not as an 'alter ego' of himself."[160] These loans were made as "real and genuine", and for "the purpose of benefiting the corporation."[161] However, by the end of 1985, it had no secured or priority debts, but a $147, 572, 30 on deposit in the bank.

The corporation filed a petition under chapter 11 of the Bankruptcy Code for reorganisation. As a result of continuing trading from January to September, the amount on deposit declined to $37, 186, 59, and it lost some jobs immediately after filing the reorganisation petition, and could get no contracts during the nine month chapter 11 proceedings. While the corporation was caused to continue, "substantial

[159] 106 Bankr. (1989) 436.
[160] Ibid at 488.
[161] Ibid at 439.

payments were made to Arthur and William Logue in the form of wages, benefits, and rents despite the lack of business activity."[162]

The court rejected the defendant directors' assertion that their decision should be judged by the business judgment rule, and that the payment of salary and rents in question were a fair exchange for the valuable services they had rendered.[163] The court took the view that:

> "Continued operation benefited only the Logues to the detriment of the Corporation and its creditors. Evidence clearly shows that almost immediately after the filing of the petition, the Corporation ceased all operations and had no hope of reorganising. Yet, the Logues, as the Corporation's stockholders, officers and directors elected to continue operations and receive payments in the form of salaries and rents in furtherance of their self-interests."[164]

The court went on to determine that the Logues had violated their fiduciary obligation to their corporation and its creditors, because:

> "The evidence indicates that it was clear immediately after the filing that the Corporation could not reorganise. ... the Logues continued to operate the business solely for the benefit of receiving salaries, benefits and rents. A reasonable person using ordinary skill, care and diligence would have immediately ceased operations and proceeded to liquidate the business to maximise the return to creditors."[165]

Finally, the defendant directors were held liable for the decrease in cash balance from $96, 551, 93 in March 31, to $37, 186, 59 through September 1986. Therefore, they were to reimburse the corporation for the difference of $59, 363, 34.

Similarly, in the leading case of *Clarkson Co. Ltd. v. Shaheen*,[166] an action was filed by trustees against Shaheen and five other directors to recover moneys advanced or loaned by Newfoundland Refining Company Limited NRC to John Shaheen and companies related to him (the Shaheen group). At trial, the jury found that Shaheen and his companies owed a total of $ 50 million to NRC which included $ 30 million,

[162] Ibid.
[163] Ibid.
[164] Ibid at 440.
[165] Ibid at 440- 41.
[166] 660 F. 2d. Cir. (1981) 506.

consisting of loans made by NRC to the Shaheen group during 1974 and 1975.[167] Of the six Shaheen corporations to which NRC loaned money, Shaheen was a director and controlling person of each. The loans were made at the instigation of the directors and they participated by signing cheques.[168] The loan and advancement was made when NRC was insolvent, with no fair consideration. Therefore, it was found fraudulent to creditors and in violation of the New York Debtor and Creditor Law. Moreover, a Promissory Note and Letter Agreement executed in October 1975 was also found fraudulent for the same reasons. The defendants immediately before transmitting 'effective control' of NRC to its creditors, converted a demand note for $45 million due from Shaheen affiliates into a long- term note and postponed all payments for 10 years, for which NRC received no consideration.

It was ordered that the Shaheen group repay the $50 million in loans, the five directors jointly and severally were held liable with the Shaheen group for the $ 30 million fraudulently loaned in 1974 and 1975, as well as liable for the $23 million damages caused by entering into the Promissory Note. The court also declared Note null and void. The $30 million sum assessed against the directors for breach of their fiduciary duty owed to creditors was apportioned according to the percentage amounts assigned by the jury against each.[169] The jury also found that:

> "the five individual defendants had breached their fiduciary duty to NRC and its creditors with respect to (a) the making of loans and advances in 1974 and 1975, and (b) the making of the Promissory Note of October 1975."[170]

The court was of the view that liability of the directors must be based on:

> "a finding that the directors knew or should have known of advances being made for less than a fair consideration while NRC was insolvent.[171] ... Likewise, there was sufficient evidence to support the finding that the directors knew or should have known that the "loans" were made when NRC was insolvent and without fair consideration.[172]

[167] Ibid at 508.
[168] Ibid at 510.
[169] Ibid.
[170] Ibid at 511.
[171] Ibid at 512.
[172] Ibid at 513.

The court finally upholding the jury's decision that directors were liable for "breach of their fiduciary duties owed to creditors", concluded that the $30 million loan without consideration, while NRC was insolvent,[173] and the conversion of the demand note to a term note was a fraudulent transfer "with intent to delay and defraud creditors."[174]

In the above mentioned case, which in substance is similar to *Logue Mechanical Contracting Corp.*,[175] some points which formed the basis of the court's reasoning are important. The main consideration is existence of a fraudulent or bad faith on the part of the defendant directors with "intent to defraud creditors."

The two recent cases are the obvious examples of decisions in which the court clearly have addressed a fraud under concept of breach of duty of loyalty. In the US corporation law, such liabilities are, indeed, considered under liability for breach of duty of loyalty. That is because not only there has not been a statutory provision defining a fraudulent liability for this particular purpose, but because the courts and commentators prefer to avoid imposition of a criminal liability on a director for his misconduct. In the two above cases, the only liability imposed on the director was civil liability, which was the recovery and reimbursement of the plaintiff creditors, rather than a criminal one such as imprisonment.

7. 5 Conclusion

In reviewing liability of a corporate director in the US law, some ends can be summarised. It seems the distinction between the liability for breach of duty of care and that of duty of loyalty is not clear enough in some cases.[176] There is no doubt that the Van Gorkom decision caused some radical changes in protection statutes in favour of corporate directors, but as was seen in post- Van Gorkom cases, it pushed

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173 Ibid at 515.
174 Ibid at 511.
175 106 Bankr. (1989) 436.
176 For example see *Bayer* v. *Beran*, 49 N. Y. S. 2d (Sup. Ct. 1994) 2.

the courts to a position to decide directors' liability with extra caution which always is not necessary. Consequently, an obvious reluctance can be seen among the judges to hold directors liable for negligence. It is not all a positive development. The Van Gorkom decision while caused the legislature to introduce some historical protective statutory provisions, should have in the same line persuaded the courts as well as lawmakers to provide some definitions and rules to clarify any uncertainty which may affect the efficiency of the deterrent effect of the liability.

It is not difficult to claim that the US post- Van Gorkom courts in the arena of corporate directors liabilities for breach of duties generally and for that of negligence particularly have worked under shadow of the Van Gorkom case's nightmare.

Moreover, there is a considerable uncertainty in the courts' view in determining whether or not a defendant director is liable for breach of fiduciary duty of loyalty. As was already mentioned, a comparison between some cases such as *Smith v. Van Gorkom*[177] and *Lewiss v. Honeywell Inc.*,[178] gives rise to the question that what are exactly the factors or criteria for the courts to make their judgment; having a properly informed decision or its beneficiality to the company or a third one? Which one is more decisive?

The *Van Gorkom* case represent the application of the first factor, where the court was not prepared to take the significant fact into its account that, though the defendants were not informed in their decision- making process, this was not a total lack of information. As the Delaware Chancery Court held in the above case, the directors had sufficient expertise on the market price. Their decision was, therefore, properly informed. Furthermore, the court did not consider the fact as important point that there was no more beneficial offer than the one accepted by the company's directors. Instead the court could have used this fact as a ground for its judgment that the defendant directors should have given a chance for a higher offer before accepting the offer in question.

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[177] 488 A.2d (1985) 858.

[178] Del. CH. (July 28 1987) 93, 565, quoted by Radin at 727.

In the second case, *Lewiss v. Honeywell Inc.*, though the court was clear on the point that the directors did not consult an investment banker for declining the all-cash offer, nor did they disclose the offer which was very beneficial to the corporation, it refused to hold them liable for negligence. That was because the defendants were, thus, not totally uninformed in making their decision.

It seem the circumstances of the above cases are similar to those of the Van Gorkom case, however, the court of *Lewiss v. Honeywell Inc.* dismissed the allegation of negligence, whereas the conditions for holding the defendants liable were more available than those in Van Gorkom case. Is it because of cautious stance of the court resulted from the Van Gorkom phenomenon, or due to lack of a statutory or uniformed set of rules governing neglect conduct of corporate directors, particularly in Delaware? The same criticism goes to a liability for breach of duty of loyalty. For example, while in *Cede & Co., Inc., v. Technicolor, Inc.*,[179] the defendant director was held liable for having a financial interest in the transaction in question and bad faith in negotiating the sale with the buyer before the corporation's chief executive met with the buyer. However, in this case, the defendant who discussed his employment contract with the buyer company was not found guilty of disloyalty.

With regard to the above discussions, it is now time for Delaware introduced a new concept to replace the concept of disloyalty where a fraudulent intent to defraud the corporate creditors exists.

[179] 634 A.2d (1993) 345.

Chapter 8: Insurance and Indemnification against, and Elimination of Directors' Liabilities

8. 1 Introduction

The US law in arena of corporate directors liability has witnessed some major changes and developments in the last decade. On the one hand, there were circumstances arising in basic changes in the directors liability insurance market which gave rise to serious difficulties for corporations in obtaining or renewing their directors and officers' liability insurance, and on the other hand, the increasing interference by courts in the corporate decision- making process threatened to diminish the business judgment rule's traditional insulation of corporate decision-makers[1] from liability. Both these circumstances caused fears over the discouraging effects of these changes on directors and officers. Therefore, as a result of increased demand on the part of directors for more protection from personal liability, other protective alternatives were proposed.

The issue requires a carefully observation, because overprotecting directors by the corporation might reduce the deterrent effect of legal sanction and diminish the purpose behind the imposition of liability on delinquent directors and, thus, encourage wrongdoing behaviour. On the other hand, having underprotected directors may deprive the corporation of the ability to attract competent individuals to the boardroom.[2]

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1 James J. Hanks, "Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification", 43 Bus. Law. (1988) 1207- 08.

2 Josef W. Bishop, "Sitting Ducks and Decoy Ducks; New Trends in the Indemnification of Corporate Directors and Officers", 77 Yale L. J., (1968) 1078, Note, "Liability Insurance for Corporate Executives", 80 Harv. L. Rev. (1967) 648, [Thereafter 80 Harv. L. Rev. (1967)], Josef F. Johnston "Corporate Indemnification and Liability Insurance for Directors and Officers", 33 Bus.

Corporate directors need to protect themselves either by direct indemnification or insurance against the consequences of breach of their duty or negligence, or by persuading their corporation to enter a chapter cap provision into the corporate certificate or otherwise, eliminating or limiting their liability.

Providing directors with protection against legal actions is considered a necessity for safer and more confident business. The availability of protection reduces the discouraging effects of the insurance crisis to directors and, therefore, the possibility of their resignation. When protection is available to a director whether in the form of insurance, indemnification, or charter cap, it is easy for him to take risks in good faith. Conversely, if such protection is not available, he may avoid taking any sort of risky business decision in order to decrease the possibility of being caught by various liability provisions.[3] If directors are left without proper protection, they may refuse to serve on the board as a director. It may, thus, not only discourage inside directors but also outside directors, because the latter are part time with a modest benefits, and are not required to demonstrate a high level of skill and diligence. In the US, the protection of directors has been formulated first by States laws in the forms of indemnification, insurance and elimination or limitation of liabilities and secondly, by an American developed common law rule known as the business judgment rule.

This chapter considers indemnification, insurance against and elimination or limitation of liability. The business judgment rule which also operates as a protection measure is studied in the next chapter.

8. 2 Indemnification and Insurance

Although it is well recognised that insurance is an indirect form of indemnification, most commentators usually examine directors liability insurance separately from

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Law., (1978), 1993, Note, "Public Policy and Directors' Liability Insurance", 67 Colum. L. Rev. (1967) 716 [Thereafter 67 Colum. L. Rev. (1967)].

3 Dale A. Oesterle, "Limits on a Corporation's Protection of Its Directors and Officers from Personal Liability", Wis. L. Rev. (1983) 513, 514, Alfred F. Conard, "A Behavioural Analysis of Directors' Liability for Negligence", Duke L.J. (1972) 898-900.

direct indemnification or reimbursement. It is understandable, because in a direct indemnification there are only two parties; the corporation which reimburses its directors, and the directors as beneficiaries, whereas in the case of insurance, a third party, namely insurer company exists.

To justify indemnification of directors by their corporation, some commentators have compared a relationship of a director and his corporation with that of an agent and his principal. According to this view, it is an established rule that an implied promise on the part of principal to indemnify his agent for losses which are the direct and natural consequence of the execution of the agency including counsel's fees expended in litigation based on such acts, as well as damages resulting from acting in good faith to third parties for an alleged wrongdoing.[4] But case law does not show a tendency to recognise an obligation for the corporation to do so in the absence of any by-laws, contract or resolution.[5]

8. 2. 1 Indemnification

At common law, an employee or agent was entitled to be indemnified, provided that the employee was successful in the primary suit.[6]

Judges also allowed indemnification on the condition that the litigation had been beneficial to the corporation.[7] Some courts applied a wide interpretation of beneficial litigation concept. According to this approach, the indemnification of a litigation was beneficial when, it could attract competent individuals into service. In *Solimine v. Hollander*,[8] the court approved an indemnification when, in the court's view, it could attract "responsible business men to accept the post of directors". This rationale can

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[4] Bishop, *op cit* at 1065.

[5] *Du Duy v. Crucible Steel Co.*, 288 Fed. (W. D. Pa. 1923) 583, (Quoted by Bishop, *op cit* at. 1066).

[6] Allan M. Terrel, "Indemnification of Employees", 5 Del. J. Corp. L. (1980) 265- 6, *Moricoli v. P. S. Mgt. Co.*, 104, Ill. App. 3d, (1982) 234 , *Johnson v. Suckow*, 53 Ill. App. 3d (1977) 277.

[7] William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors, (Virginia: the Michie Company 4d. ed. 1988) 20. 01.

[8] 19 A.2d (1941) 344, 348.

be even seen behind recent judicial decisions. For example, a Delaware court in *Green v. Westcap Corp.*,[9] held that:

> "[The statute] had as its objective that capable persons would be more willing to serve as corporate officers and directors by being provided with indemnification for their expenses in defending against attacks upon their conduct as corporate officers and directors."[10]

8. 2. 1. 1 Statutory and judicial authorisation

The first statutory indemnification, which was copied by Delaware and many other States, was introduced by New York State in 1941.[11] The enactment of the indemnification statute was a reaction to the case of *New York Dock Co. v. MacCollom*,[12] and permitted corporations to indemnify their directors. Prior to the decision in this case, directors were entitled to be reimbursed the expenses incurred while acting as agents. However, in that case, it was held that there was no implicit obligation imposed upon the company to indemnify its directors against legal expenses, even if his defence had been successful.

Delaware, two years later, introduced its first statutory indemnification provision.[13] However, the Delaware statute was repealed in 1967 and its new version became to be a model for the most modern indemnification statutes.[14] According to the 1967 statute, a corporation was authorised to indemnify its directors and officers for expenses, fines, judgment, and settlement costs in third party suits, provided they had acted in good faith and in a manner they reasonably believed to be in or not opposed to the best interests of the corporation.[15]

The current Delaware statutory provision relating to directors' indemnification is similar to the 1967 law. Section 145(a) of Delaware Law states:

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9 492 A.2d (Del. Sup. 1985) 260.
10 Ibid at 262- 63.
11 N. Y. Laws Ch. 35 s. 1 (1941).
12 16 N. Y. S. 2d (Sup. Ct. 1939) 847.
13 44 Del. Laws (1943) 125.
14 Knepper & Bailey, Liability of Corporate Officers and Directors, at 20. 04.
15 Del. Gen. Corp. Law s. 145(a)(1967).

> "A corporation may indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that he is or was a director, officer, ... against expenses (including attorneys' fees), judgments, fines and amount paid in settlements actually and reasonably incurred by him in connection with such action, suit or proceedings if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceedings, had no reasonable cause to believe his conduct was unlawful...."[16]

The purpose of indemnification, including insurance explained by Folk[17] as "the invariant policy of Delaware legislation on indemnification is to 'promote the desirable end that corporate officials will resist what they consider' unjustified suits and claims" and "to encourage capable men to serve as corporate directors, secure in the knowledge that the expenses incurred by them in upholding their honesty and integrity as directors will be borne by the corporation they serve'."

As to this subsection, some points need to be noted. The subsection introduced a permissive or discretionary but not obligatory provision. A corporation may, thus, voluntarily oblige itself to indemnify its directors through by- laws or contracts. As stated in the legislative text, subsection (a) is applicable only to third parties actions, but not those brought by, or in the right of the corporation.

Likewise, New York has authorised an indemnification[18] which is described as representing a balance between "providing protection and maintaining a check on aberrant behaviour."[19]

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16 Del. Gen. Corp. Law s. 145 (a) (Amd. 1992).

17 Ernest L. Folk, III, The Delaware General Corporation Law, (1972) 98.

18 N. Y. Bus. Corp. Law s. 721 (McKinney 1994). The section reads:
"The indemnification and advancement of expenses granted pursuant to, or provided by, this article shall not be deemed exclusive of any other rights to which a director or officer seeking indemnification or advancement of expenses may be entitled, whether contained in the certificate of incorporation or the by-laws or ... provided that no indemnification may be made to or on behalf of any director or officer if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled."

19 Sara R. Slaughter "Statutory and Non- Statutory Responses to the Director and Officer Liability Insurance Crisis" 63 Ind. L. Rev. (1987) 181.

It seems under New York statute no indemnification is permitted when a director is held liable for violation of his duty to his corporation.

The important question is as to the extent a corporation can indemnify its directors, and more importantly, the means through which the corporation may indemnify its directors; whether by charters, bylaws or other forms of contract, by decision of a majority of shareholders, or by resolution of directors. The more important question is whether an indemnity can be provided against future damages.

As to the earlier question, it seems an indemnity provision can appear in a certificate of incorporation, bylaw, a resolution of shareholders or the board of directors. However, in order for such a protective device to be effective, it should have been approved by shareholders. Concerning the second question, one may claim that any obligation on the corporation's part to indemnify its directors for damages which may be incurred in the future could be challenged on the public policy basis, because it leads to the conclusion that the directors, aware of such protection, may act recklessly without due care. This argument seems weak and unjustified. Because for the same reason upon which an insurance, covering prospective damages is considered consistent with public policy, a direct indemnification as such should, thus, be held valid. Moreover, in order for an indemnification to be effective, some requirements such as acting in good faith and in a manner that the director reasonably believed to be in the best interests of the corporation, should be met.

However, a federal court in an unsuccessful derivative suit defence held the defendant director entitled to indemnification on the basis of a contract which provided in return for indemnification the director would resign before termination of his employment contract.[20]

Section 145(d) provides the procedure of the implementation of an indemnification and those who can determine its entitlement as follows:

> "Any indemnification under subsection (a) and (b) of this section (unless ordered by a court) shall be made by the corporation as authorised in the specific case upon a

[20] *Mooney v. Willys- Overland Motors, Inc.* 204 F. 2d (3d Cir. 1953) 888.

> determination that indemnification of the director, officer, ... is proper in the circumstances because he has met the applicable standard of conduct set forth in subsection (a) and (b) of this section."[21]

As to this subsection, it is suggested that entitlement to indemnification whether permissive or mandatory, whether by statute, by- law or contract is not automatic, but must be made by the appropriate decision maker authority.[22]

It appears that the authority of the decision- maker is limited to ensuring the requirements have been met, but not to determine its entitlement. Moreover, this subsection has referred to subsections(a) and (b) which both are discretionary but not to subsection (c) which is obviously mandatory.

8. 2. 1. 2 Expenses of defence

In respect of expenses of defence, case law has long recognised the reimbursement of directors' expenses for their successful defence in a derivative action. For example, in *Solimine v. Hollander*[23] the court stated that the directors' successful defence had aided the corporation by defending the "corporation image" and they were, thus, entitled to the reimbursement of such expenses. However, the corporation could not indemnify a director for the costs of a successfully defence if such defence did not directly benefit the corporation.[24]

In the 1930's, indemnifying directors involved in corporate litigation for legal expenses was easily justifiable. However, for the first time in the New York case of *New York Dock Co. v. MacCollom*[25] the court held that a corporation could not indemnify its directors for legal expenses even if they had successfully defended a derivative action suit. The court built its reasoning on the ground that the

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21 Del. Gen. Corp. Law s. 145 (d) (Amd. 1992).

22 E. N. Veasy, Jesse A. Finkelstein, and C. Stephen Bigler, "Delaware Supports Directors with a Three- Legged Stool of Limited Liability, Indemnification, and Insurance", 42 Bus. Law., (1987) 399, 408.

23 19 A.2d (Ch. 1941) 344.

24 *N. Y. Dock Co. v. McCollom, 173 Misc.* (1939) 1069.

25 16 N. Y. S. 2d (1939) 847.

corporation could only invest in the projects which directly benefited the corporation, whereas in the court's view, legal fees did not meet this criterion.[26]

The Delaware General Corporation Law in section 145(b) has expressly expanded indemnification provisions to the expenses of defence. The section provides that:

> "A corporation may indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in his favour by reason of the fact that he is or was a director, officer ... against expenses (including attorney' fees) actually and reasonably incurred by him in connection with the defence or settlement of such action or suit if he acted in good faith and in a manner he reasonably believed to be in or not to opposed to the best interest of the corporation ..." [27]

This subsection is distinguished in several ways from subsection (a);[28] First, it permits only defence expenses including attorney's fees but not indemnification of judgment or payments for settlements; Secondly, this subsection does not provide indemnification "in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper";[29] Thirdly, unlike subsection(a), this subsection applies to actions brought by or in the right of corporation.[30]

It seems, when under subsection (b) the rule is that a defendant director can be indemnified against any expense of defence in an action brought by, or in the right of

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26 Ibid. The line of this sort of decisions followed by the other New York case of *Bailey v. Bush Terminal Co.*, 46 N. Y. S. 2d 877, *affd.* 48 N. Y. S. 2d (Sup. 1943), 324 where referring to common law rules any right for reimbursement was denied.

27 Del. Gen. Corp. Law s. 145 (b) (Amd. 1992).

28 For a discussion on subsection 145 (a), see *supra* "Statutory Authorisation" for indemnification.

29 Ibid.

30 Veasy, Finkelstein, and Bigler, *op cit* 405.

corporation, the expenses of defence in a third party action should be preferably permitted.[31]

8. 2. 1. 3 Mandatory or discretionary indemnification?

In most jurisdictions, either a statute or common law provides indemnification for legal expenses including attorneys' fees, when a litigant wins the case.[32] However, it is said that Delaware case law has not established any criterion to answer the question of the extent corporations may go in indemnifying their directors and officers beyond the statutes.[33]

In *Green v. Westcap Corp. Delaware*,[34] the court held that an officer who was successful on the merits in being acquitted of criminal charges, was entitled to indemnification, and that the respondent did not have the additional burden of proving that he acted in good faith in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, as required by section 145(a) (b).[35] Indemnification statutes generally provide for mandatory indemnification when a party has been successful on the merits or otherwise. Most State laws adopting the expression "or otherwise" on the basis of the fact that a director is not required to establish his eligibility for mandatory indemnification on the merits if he has a valid procedural defence.[36] However, the Delaware law, which allows a partial mandatory indemnification is the best example for this purpose. Section 145(c) has introduced a mandatory indemnification as follows:

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31 Besides subsection (b), section 145(e) also authorises corporations to pay expenses including attorneys' fees incurred by a director or officer in defending any civil, criminal, administrative or investigative action, suit or proceeding in advance, of final disposition of those legal procedures, upon receipt of an undertaking by or on behalf of the director or officer to repay such amount, if it is determined that he is not entitled to indemnity by the corporation. Del. Gen. Corp. Law s. 145 (e) (amd. 1992).

32 Oesterle, *op cit* at 546.

33 Knepper &. Bailey, Liability of Corporate Officers and Directors, at 20- 13.

34 492 A.2d (Del. Sup. Ct. 1985) 260.

35 Ibid at 264- 5.

36 Dennis Block Et. Al. The Business Judgment Rule: Fiduciary Duties of Corporate Directors (Englewood Cliffs: Prentice Hall & Business 1993) 564.

> "To the extent that a director, officer, employee, or agent of a corporation has been successful on the merits or otherwise in defence of any action, suit or proceeding referred to in subsection (a) and (b) of this section, or in defence of any claim, issue or matter therein, *he shall be indemnified*[37] against expenses (including attorney's fees) actually and reasonably incurred by him in connection therewith."[38]

By enacting the provision in a mandatory language, here, Delaware legislature has imposed an obligation on corporations to indemnify their directors in a successful defence. The wording of this subsection raises the question whether even when there is no indemnity requirement in the by-laws or contract, and when the requirements mentioned in the subsection are met, the obligation to indemnify the directors is actually imposed on the corporation. There is no reason to doubt about this conclusion, because Delaware legislature by the phrase of "shall be indemnified" intended to provide a mandatory indemnification.

Therefore, any agreement or bylaw removing such mandatory effects, may be set aside as ineffective. Conversely, any agreement or by-law imposing the duty to indemnify its directors by the corporation beyond the statutory limits in section 145(c), should be considered enforceable.

Prior to 1981, the New York legislature provided a mandatory indemnification, but it was required that the defence should have been wholly successful, whereas in 1986 and as a result of increasing demand for more protection for directors, New York applied a change to its statute by removing the requirement of "wholly successful".[39] According to the new provision, even where success has been partial, indemnification is allowed.[40]

However, in the original form of the statute, indemnifying directors in a not wholly successful action was not entirely prohibited. Such an indemnification could be awarded by the decision of the board constituted of disinterested directors, or by the

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37 Emphasis added.

38 The Delaware General Corporation Law s. 145(c).

39 The drafters of the Model Business Act have defined a wholly successful as "only if the entire proceeding is disposed of on a basis which involves a binding [of] non- liability." Rev. Model Bus. Corp. Act s. 8. 25 official cmt. at 250 (1992).

40 N. Y. Bus. corp. Law s. 722(c) (McKinney 1993).

board upon an opinion of "independent legal council", or by the shareholders decision when the defendant directors had met the applicable standard of conduct.[41] Furthermore, according to section 723(a), a "person who has been successful, on the merits or otherwise, in the defence of a civil or criminal action ... shall be entitled to indemnification as authorised in such section." The legislature by the expression of "shall be entitled", here, intended a mandatory indemnification in the mentioned events concerned.

As was mentioned, Delaware law provides a mandatory indemnification without any restrictions. Such view has received a full-support from judicial decisions which recognise public policy considerations as the sole restrictions.[42] In *Mooney v. Willys-Overland Motors, Inc.*[43] the court held that to obtain an indemnification beyond the statutory provisions "an independent legal ground must be shown in every case".[44] Unlike mandatory indemnification, which is automatic, a discretionary indemnification is something dependant upon the facts of each case. To permit such an indemnification, it is required to prove a finding that the party seeking indemnification has met the applicable standards of conduct. The standards of conduct are to be satisfied when the director has "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."[45]

8. 2. 1. 4 Expanded and non- exclusive indemnification

Some States have expanded directors' and officers' indemnification by eliminating the traditional distinction between third party and derivative suits. Under this solution, by concluding a contract, those statutes permit corporations to provide greater indemnification rights to their directors and officers.

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41 Ibid s. 724(c).

42 *James v. Getty Oil Co.*, 472 A.2d 33 (Del. Sup. 1983) (Quoted by Knepper &. Bailey, Liability of Corporate Officers and Directors, at 20- 14).

43 204 F. 2d (3d Cir. 1953) 888.

44 Ibid at 896.

45 Del. Gen. Corp. Law s. 145(a) (1983 & Amd. 1992).

Indiana in this respect has a special view. The Indiana indemnification statute draws no distinction between actions brought by, or in the right of the corporation and those brought by third parties. Moreover, it extends indemnification to a judgment, settlement, penalty, fine as well as reasonable expenses, including counsel's fees.[46]
North Carolina has, on the other hand, permitted its directors to indemnify themselves without the need of approval of its shareholders.[47] This is considered as a departure from the traditional rule that the contracts between the directors and their corporation should be approved by a disinterested body.[48] This State also permits indemnification in the case of a derivative action in which the plaintiff is successful.[49]
However, it is difficult to justify permitting indemnification when directors are held liable in a shareholder derivative action, because such an indemnification requires payment of damages from defendant director to the plaintiff company and then, by means of the indemnification, from the latter to the former.[50]
California case law has refused to allow indemnification in derivative actions. In *Wickersham v. Crittenden,*[51] the court held that any indemnification would deplete the purpose of a derivative action in which the respondent had been held liable, because such a reimbursement was nothing but a payment of shareholders' money to those who failed to exercise their fiduciary obligations to the corporation and its shareholders, and it was, thus, unfair.

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[46] Ind. Code s. 23-1-37-4 and 8. (Quoted by Knepper &. Bailey, Liability of Corporate Officers and Directors, at 20- 7). In most indemnification statutes, the actions brought by, or in the right of the corporation are distinguished from those by third parties, where the action is lost on the merits or settled. In suits by a third party including direct actions by a shareholder or governmental suits, the statutes are more liberal, whereas in actions brought by, or in the right of the corporation, indemnification is permitted for legal expenses, provided that the case is settled and the expenses actually and reasonably incurred by the director. In the second sort of cases, if the defendant is held liable for breach of his duty to the corporation, no indemnification is permitted without the court's approval. Model Bus. Corp. Act s. 5 (1967 & 1980).
[47] N. C. Gen. Stat. s. 55- 19 (a)- (b) (Sup. 1986).
[48] Thomas Lee Hazen, "Corporate Directors' Accountability: The Race to the Bottom- the Second Lap", 66 N. C. L. R. (1987) 171, 178.
[49] N. C. Gen. Stat. s. 55 (1982).
[50] Lee Hazen, *op cit* at 174.
[51] 106 Cal. 329 (1895) 603.

The effect of an expanded provision is that the courts are empowered to establish broader boundaries for indemnification. Therefore, by-laws or contracts exceeding the statutory limits are valid, provided that, in the court's view, they have not offended public policy.[52]

The main feature of this expanded indemnification is its non- exclusivity. According to a non- exclusive indemnification, pursuant to a certificate of incorporation, shareholder resolution or an indemnification agreement or contract, a corporate program may be established in order to indemnify its directors beyond the limitations of the statute.[53] This mechanism which is called non- exclusive indemnification, for the first time was introduced by section 145(f) without any restrictions.[54] Subsection (f) has been criticised by some legal writers as too liberal and in some occasions contrary to public policy when, for example, a by-law or agreement provides indemnification in favour of a director in spite of a finding in a derivative action that he has breached his fiduciary duty to the corporation.[55]

This criticism seems sound only when the breach of fiduciary duty is the breach of duty of loyalty, but not breach of duty of care.

Likewise, New York has authorised indemnification,[56] which is described as representing a balance between "providing protection and maintaining a check on

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52 S. S. Archt & Walter K Stapleton, "Delaware's New General Corporation Law: Substantive Changes", 23 Bus. Law. (1967), 75, 80.

53 Block Et. Al, The Business Judgment Rule: Fiduciary Duties of Corporate Directors at 580, 616.

54 Del. Gen. Corp. Law s. 145 (f) (Amd. 1992). According to section 145 (f):
"the indemnification and advancement of expenses provided by, or granted pursuant to the other subsections of this section, shall not be deemed exclusive of any other rights to which whose seeking indemnification or advancement of expenses may be entitled under by- law, agreement, or vote of stockholders or disinterested directors or otherwise, both as to the action in his official capacity and as to action in another capacity while holding such office."

55 Johnston, *op cit* at 1993, Josef W. Bishop, The Law of Corporate Directors and Officers: Indemnification and Insurance (Boston: Warren, Gorham & Lamont, Inc. 1982). 6.03[1][a].

56 N. Y. Bus. corp. Law s. 721 (McKinney 1994). The section reads:
"The indemnification and advancement of expenses granted pursuant to, or provided by, this article shall not be deemed exclusive of any other rights to which a director or officer seeking indemnification or advancement of expenses may be entitled, whether contained in the certificate of incorporation or the by-laws or ... provided that no indemnification may be made to or on behalf of any director or officer if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled."

aberrant behaviour".[57] As it is understood from the Revision Note to the present section, unlike the Delaware statute, the New York law has a feature of exclusivity, according to which an indemnification provision should be consistent with the statute.[58] However, with regard to the header of section 721 which describes it as "non- exclusivity of statutory provisions for indemnification of directors and officers" on the one hand, and its similarity to section 102(f) of the Delaware law on the other hand, it is not clear how these two sections are distinguished with this characteristic.

It seems, under New York statute, like Delaware, no indemnification is permitted when a director is held liable for violation of his duty to his corporation.

8. 2. 2 Insurance

Insurance is a means of providing directors and officers with benefits which they cannot obtain through indemnification or liability eliminating or limiting statutes. In the absence of public policy limitations, insurance can be an officer's or director's only available source of relief when a corporation is unwilling or unable to extend indemnification.[59] Corporations should be authorised to purchase insurance for their directors against losses even those which are not indemnifiable, so long as the premium payments are considered reasonable compensation for services rendered.[60]

Directors' liability insurance was introduced as a result of the stock market crash and the enactment of the Federal securities laws in the 1930s, in order to protect

[57] Slaughter *op cit* at 181.

[58] N. Y. Bus Corp. Act s. 721 (Revision Note 1994), The note reads:
"The purpose of this section is to make clear that the provisions which follow relating to indemnification of directors and officers are exclusive and establish a policy from which no material deviation is permissible. The addition of this section was induced by the need to clarify the extent to which statutory provision for indemnification imposes a limitation upon the freedom of corporations to provide for such indemnification."

[59] J. Erik Groves, "Corporate Law and Director Liability: Who Is Really Sitting On the Three-Legged Stool and Why North California Should Care" 24 Wake Forest L. Rev. (1989) 160.
It is difficult to agree with this view as a pervasive one, when most States have adopted an amendment similar to section 102 of the Delaware law, whereas still state of Vermount and some districts have not allowed purchasing a directors liability insurance.

[60] Note, 80 Harv. L. Rev. (1967) at 667.

directors against liability from shareholder suits, when statutory indemnification rights were less express or expansive than under current law claims and insurance.[61] A corporate directors' liability insurance can be concluded in two forms; two insuring clauses in two policy forms and one insuring clause in two parts in one policy. The traditional liability insurance coverage of directors and officers consisted of two distinct parts in one policy.[62] The first part, namely "Directors and Officers Liability Insurance", which is direct or personal part of policy, reimburses the directors for losses for which they have not been indemnified by the corporation. Under the "direct" insuring clause, the coverage does not apply if the individual insured are indemnified or entitled to indemnification by the corporation, but the language is different in various policies. The second part of policy, "Corporation Reimbursement", in which directors have no direct role, is dealt with by the insurance company and the corporation. This coverage reimburses the corporation for amounts which are lawfully permitted or required to expend in indemnifying its directors and officers. Most of claims are made under the first part.[63]

8. 2. 2. 1 Statutory authorisation

Apart from Vermont State and districts of Columbia and Puerto Rico, all other States and districts have authorised corporations to purchase and maintain liability insurance for their directors and officers.[64] The New York Law allows insurance coverage as follows:

> "(b) No insurance under paragraph (a) may provide for any payment, other than cost of defence, to or on behalf of any director and officer: (i) If a judgment or other final adjudication adverse to the insured director or officer establishes that his acts of active and deliberate dishonesty were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or *other advantage*[65] to which he was not

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61 Roberta Romano, "What Went Wrong With Directors' and Officers' Liability Insurance?", 14 Del. J. Corp. L. (1989) 1, 4.
62 Note, 80 Harv. L. Rev. (1967) at 650, Joneston, *op cit* at 2013.
63 Knepper &. Bailey, Liability of Corporate Officers and Directors, at 21- 02.
64 Ibid at 21. 03.
65 Stress added.

legally entitled, or (ii) in relation to any risk the insurance of which is prohibited under the insurance law of New York."[66]

Knepper and Bailey have suggested that by including the words "or other advantage", the New York legislature may have prohibited insurance other than for defence costs when a director is held to have violated the duty of loyalty.[67] In the same discussion, they take the firmer view that "the New York law prohibits insurance coverage except for defence costs".[68]

The Delaware law in this regard is clear. According to the Delaware General Corporation Law:

"A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation,....against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not his corporation would have the power to indemnify him against such liability under the provisions of this section."[69]

The very wide and clear language of the section indicating an insurance policy, is consistent with public policy, valid and enforceable. The other significant feature of this section is a clear distinction between indemnification and insurance. Furthermore, as the section expresses, a corporation can purchase insurance for its directors even when it is not empowered to indemnify them.

8. 2. 2. 2 Limits on insurance

The important consideration concerning limits of liability insurance is the conduct of the insured. A person can, thus, only insure himself against losses caused by unintentional, but not by wilful wrongdoing.[70] Any intentional misconduct including fraud, conversion, corporate waste, taking corporate opportunities, and self dealing and any action contrary to public policy rules are all embraced in the definition of

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66 N. Y. Bus. Corp. Law s. 726(b).
67 Knepper &. Bailey, Liability of Corporate Officers and Directors at 21. 04.
68 Ibid.
69 Del. Gen. Corp. Law s. 145 (g) (Amd. 1992).
70 See generally Mary C. McNeely, "Illegality as a Factor in Liability Insurance", 41 Colum. L. Rev., (1941) 26.

advancing other's interests to those of the corporation at its expenses and, thus, excluded from insurance coverage.

It has been implied that a director can insure himself against such liability to the corporation.[71] However, with regard to an examination of the nature of the director's conduct and purpose behind the civil liability, this approach has been challenged by arguing that such insurance is contrary to public policy in virtually all cases.[72]

There is no doubt that breach of duty of loyalty or disloyalty is not insurable when the immediate goal of the wrongdoer is personal benefit. For establishing a breach of duty presumption, the difficulty is that in many cases of disloyalty the director's personal benefit is not obvious enough, particularly when such benefit is indirect. Sometime his gain may be less than the corporation's loss.

As it is the case in all other protective means, public policy is viewed as the most significant limitation on directors liability insurance. Under the traditional "public policy", courts refused to enforce insurance policy, "the tendency of which is to endanger the public interests or injuriously affect the public good or which is subversive of sound morality."[73]

The approach that directors and officers liability resulting from wilful or intentional misconduct should not be insurable,[74] has been criticised as ignoring a growing line of cases, which enforces insurance policy against liability caused by the insured's intentional misconduct in order to provide full compensation to injured parties.[75]

The important point concerning public policy issue is insurability of punitive damages. In this respect two opposing opinions can be distinguished. The first view considers punitive damages as not having an identifiable deterrence, but a

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[71] Josef W. Bishop, "New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability", 22 Bus. Law. (1966) 92.
[72] Note, 67 Colum. L. Rev. (1967), 719.
[73] *Ritter v. Mutual Life Co.*, 169 U. S. 139, (1898) 154.
[74] Johnston, *op cit* at 2027, Note, 80 Harv. L. Rev. (1967) at 655- 57.
[75] Oesterle, *op cit* at 551, (Quoting Farbstein & Stillman, "Insurance for the Commissions Torts", 20 Hastings L. J. (1969), 1219).

supplementary compensation which are not prohibited by public policy from being insured.[76] In some cases, particularly Alabama case law, punitive damages have been held within policy coverage and recoverable.[77]

The second approach which is adopted by majority, describing punitive damages as penal rather than compensatory takes the view that if such punishment is to be recognised as insurable, the deterrent effect intended for the damages would be destroyed.[78] Under Florida law, public policy absolutely prohibits indemnification against liability for punitive damages whether or not expressly covered by the insurance contract.[79] There is also a consensus among commentators that punitive damages, as a matter of public policy, should not be included within the scope of insurance coverage.[80]

An insurance company which is unwilling to indemnify the insured against punitive damages awards, may disclaim such liability in the insurance policy. It is claimed that in the absence of such disclaimers, insurance policies should be extended to cover punitive awards.[81]

It seems even in the absence of disclaimers, the court may by relying on public policy considerations hold that punitive damages are not within the scope of the insurance. Even when an indemnification does not wipe out a judgment in favour of the corporation, public policy, nevertheless, may require the director to pay personally for judgments against him. Therefore, it has been suggested that indemnification by the corporation should be forbidden where the directors liability to outsiders is intended to deter disfavoured conduct.[82]

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76 Note, "Public Policy Prohibits Indemnification Against Awards of Punitive Damages", 63 Colum. L. Rev. (1963) 944, 950- 951, [Thereafter 63 Colum. L. Rev. (1963)].

77 See, e. g., *American Fid. & Cas. Co. v. Werfel*, 230 Ala. (1935)552, *Capital Motor Lines v. Loring* 238 Ala. (1939) 260.

78 Note, 67 Columbia L. Rev. (1967), at 719

79 *Northern National Gas Co. v. McNulty*, 307 F. 2d (5th cir. 1962) 432.

80 Logan, "punitive Damages in Automobile Cases" Ins. L. J. (1961) 1036.(Quoted in Note, 63 Colum. L. Rev. (1963), 947).

81 Ibid at 951.

82 Note, Indemnification of Directors: The Problems Posed by Federal Securities and Antitrust Legislation, 76 Harv. L. Rev. (1963) 1408.

8. 2. 2. 3 Expenses of defence

Although some leading commentator have mentioned that "no duty or obligation is imposed by the typical directors and officers policy for insuring such expenses,[83] it seems an insurer is requires to defend an insured against all actions brought against him on the allegation of the facts and circumstances covered by the policy.[84]

Also a duty to defend as a result of "reasonable expectation" can be imposed by a court, when the court following a general rule resolving contractual uncertainties in the insured's favour, orders insurers to defend actions which they maintained were not covered by the insurance contract. The court in imposing such additional liability mostly rely on the fact that most insurance contracts are adhesion contracts.[85] Consequently, an insurance company cannot be sure of not being ordered to defend an action when it had not explicitly contracted to do so, even when it thought it had contracted not to do so.[86]

A director appears to have to hire and pay for his attorney until the end of suit, when the insurance company will repay him the amount he has spent for legal fees. However, depended on the policy terms, the insurance company may become obliged to pay for legal expenses.

It should be noted that the insurance company is to pay the costs of the directors' defence, but not those of the corporation itself. If, therefore, the directors have spent money to defend their corporation, no claim of reimbursement will be heard. The problem arises when the director and his company are sued in one lawsuit together. It is suggested that to solve any difficulty in such an occurrence, the costs of defence should be allocated between the insured director and the uninsured corporation. The problem will still be remaining if the claims against the corporation and its director

83 Knepper &. Bailey, Liability of Corporate Officers and Directors, at 21-09.
84 Julie J. Bisceglia, "Practical Aspects of Directors' and Officers' liability Insurance- Allocating and Advancing Legal Fees and the Duty to Defend", 32 UCLA L. Rev. (1985) 690, 705.
85 *Insurance C. of N. Am. v. Sam Harris Constr. Co.*, 22 Cal. 3d (1978) 409, 583.
86 Ibid.

are not in the same level. To overcome the difficulty, the simplest way is that the corporation and its director hire their counsel separately.[87]

8. 2. 2. 4 Insurance crisis

> "On Hawaiian island of Molokai, pregnant women who want a doctor in attendance when they give birth fly to neighbouring Oahu or Maui. The five Molokai doctors who once delivered have stopped doing so because malpractice insurance would cost them more than the total of any obstetrical fees they could hope to collect."[88]

The insurance crisis in the United States can be divided into two periodical classifications: the first precedes 1984 and the second relates to 1984 onwards. Before 1984, the expanding coverage and falling prices were the obvious characteristics of insurance. However, after 1984 the US trade community experienced a serious crisis resulting in a sky rocket increasing of premiums and deductibles. As insurance protection declined, directors and officers seemed to be more vulnerable to financial hardships resulted from liability orders. Consequently, some directors resigned their jobs, and corporations had serious difficulty to recruit to those posts.[89] According to the 1985 Wyatt Directors and Officers Liability Insurance Survey:

> "18.5 percent of the companies it surveyed for its 1984 Directors and Officers Liability Survey, had experienced claims against their directors, up from 7.1 percent ten years earlier. [This is] an increase of 182 percent. At the same time, the average cost of defending these claims had risen dramatically from $181,500 per claim ten years ago to $461, 000 today. [Moreover] the percentage of claims paying over $1 million rose from 4.8 to 8.3 percent, and the average settlement award [rose] from $385,000 to $583,000."[90]

There had been a reverse circulation in this regard between 1983- 1986 hardening the directors' situation. On the one hand, the number of claims was rising and the judgment value of claims increasing, when the degree of protection offered by

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87 Bisceglia, *op cit* at 716.
88 "Sorry, Your Policy Is Cancelled", The Time, (March 24 1986) 26.
89 Baum, " The Job Nobody Wants", Bus. Wk. Sept. 8 (1986) 56.
90 The 1985 Wyatt Directors and Officers Liability Insurance Survey.

insurers was decreasing, and on the other hand, the insurers adding exclusive clauses astronomically increased the premiums to 15,00%- 2,000% higher than their previous levels.[91] For example prior to 1985 directors premiums for large companies were less than $200, 000 for as much as $100.00 million coverage insurance, whereas, less than a year later they were increased in some cases to $1 million for $50 million coverage.[92]

The reports indicate that many directors resigned from their positions or refused to renew their service contracts when liability insurance was unavailable, and many competent individuals refused to serve as directors when their companies had lost insurance,[93] so that only within six months in 1987 some leading companies such as the Control Data Corporation, the Continental Steel Corporation, the Lear Petroleum, South Texas Drilling & Exploration Inc., and Skyes Dataronics lost their directors when their insurance policies ended.[94] Not only commercial enterprises were hit by the crisis, but also municipal authorities and other governmental entities experienced an extreme increase in premiums or a serious unavailability of market insurance coverage altogether. In some parts of the country, the jails had no choice but to close, releasing some prisoners and suspend police patrols until insurance coverage was obtained.[95] Even, because of fears over uninsured liability, the fourth of July celebrations were cancelled.[96] Some governmental services rashly reacted to the crisis by suspending public services and removing all playground equipment from their public parks.[97] Other services such as plans for experimental bus- rail line were cancelled when no insurance coverage was available.[98]

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91 Olson, "The Directors and Officers Insurance Cap: Strategies for Coping", Legal Times, (March 3 1986) 25, Slaughter, *op cit* at 182.

92 Thomas C. Lee, "Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care", 136 Univ. Pa. L. Rev. (1987) 239, 253.

93 Romano, *op cit* at 50.

94 Lewis, "Director Insurance Drying up", N. Y. Times, (Mar. 7, 1986) at Dl, col.3.

95 "Sorry, Your Policy Is Cancelled", at 27- 28, "Business Struggling to Adopts Insurance Crisis Spreads", Wall St. J. (21 Jan. 1986) 31.

96 George L. Priest, "The Current Insurance Crisis and Modern Tort Law", 96 Yale L. J. (1987) 1522.

97 "Sorry, Your Policy Is Cancelled", at 33.

98 "Business Struggling to Adopts Insurance Crisis Spreads", at 31.

Despite the statutory authorisation for Delaware corporations to purchase and maintain D & O liability insurance, many corporations faced difficulties in obtaining or maintaining sufficient coverage at a reasonable cost. Many insurers offering D & O liability insurance withdrew from the market or restricted the coverage offered.[99]

What was the cause of the crisis? For the crisis a large range of theories are suggested by commentators.[100] However, most of them refer to the sudden increases in insurance premiums and the occasional withdrawal of insurance coverage during early 1986. The cause of crisis is described as unclear.[101] Nevertheless, it is believed that the important cause for the insurance crisis in the 1980s was more relevant to economic performance. The increase in bankruptcy cases concerned the insurers, when their insured have been often sued by bankruptcy trustees and shareholders.[102]

The *Gorkom* case, from view of law injected a major shock into insurance market. The indirect consequence of holding corporate directors liable in that case, was a harder and more expensive insurance to get.

Some commentators have referred to the directors insurance system itself and its self- inflicted through competitive underpricing and questionable management as the main cause of the crisis.[103] The insurers raised the premiums because they suffered heavy losses on directors policies, expecting bigger losses,[104] which was a result of the companies competitive rate cutting on commercial property- liability.[105]

It is difficult to suggest a particular factor as the sole or even the main cause of the insurance crisis. Various factors can be identified, each of them had an effective role in creating and developing the crisis. The role of legal system in deteriorating the situation, specially some decisions such as the *Gorkom* case was not less effective

99 David Hilder, "Liability Insurance Is Difficult to Find Now for Directors, Officers", Wall St. J., (July 10, 1985) at 1, col. 6.

100 For a details of theories for the insurance crisis see Priest, *op cit* at 1521.

101 Romano, *op cit* at 4.

102 Ibid.

103 Lee, *op cit* at 254.

104 Hilder, *op cit* at 21.

105 "Business Struggling to Adopts Insurance Crisis Spreads", at 31.

than the economic system's fluctuations. Therefore, the belief that the legal system is not the cause of the crisis and, consequently, reforming the law will not resolve the effects of industry's problems,[106] is partially correct.

The interesting suggestion as to the crisis is that the directors and officers learned that "the insurance crisis they experience is not a crisis at all- it is an opportunity".[107] One may feel this view as justified as long as it means that the crisis at least brought corporate directors the opportunity to press for the unique mechanism of protection under section 102 (b)(7), namely elimination and limitation of liability.

8. 2. 2. 5 Alternatives to insurance

Since the raise of insurance crisis, there has been an increasing trend among corporations to use other alternatives as substitutes or supplements to the traditional insurance policy. Usually such alternatives are employed in conjunction with corporate charters and by-laws or with separate indemnification contract agreements.

8. 2. 2. 5. 1 Captive insurance companies

These sort of companies are wholly owned subsidiaries, formed in order to maintain insurance on behalf of the parent and affiliated companies.

Such alternative is considered to be a self- insurance scheme when it is capitalised by the parent company and there is no risk- sharing between separate entities.[108] Therefore, captive insurance is a type of indemnification with the same public policy restrictions. Moreover, because insurance premiums are not deductible, the corporation may be faced with tax problem.[109] It has been suggested, to overcome

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106 Lee, *op cit* at 254- 5.

107 Christopher Farrell, "If Directors Are Doing Their Job, They Do not Need Insurance", Bus. Wk, (Sep. 8 1986) 55.

108 J. Phil Carlton & M. Guy Brooks, "Corporate Director and Officer Indemnification: Alternative Methods for Funding", 24 Wake Forest L. Rev. (1989) 61, Veasy, Finkelstein, and Bigler, *op cit* at 420.

109 Dennis Block Et. Al. "The Business Judgment Rule: Fiduciary Duties of Corporate Directors", at 621.

the problem, the corporation should form a subsidiary with a separate identity from the parent company and with actual risk distribution.[110] However, the courts may disregard the separate corporate status of the entities on the reasoning that due to close connection between a parent and its captive subsidiary, the arrangement as a scheme is made to avoid indemnity laws.[111]

The Internal Revenue Service (IRS) usually refuses to allow deductions for premiums paid to captive insurance subsidiaries,[112] even though premiums paid to commercial insurers are deductible. According to the IRS, premiums are not deductible where there is no shifting or distributing of the risks of loss.[113]

There are some cases which may be used as guidance in this regard. For example, in *Beech Aircraft Corp. v. United States,*[114] the parent company established a captive subsidiary in order to provide itself and its directors with products liability insurance. The court refused to accept the arrangement as a real insurance scheme because, in its view, the taxpayer corporation, Beech, failed to prove a true risk transfer. In the court's view, it was doubtful that the capitalisation of the subsidiary, about $150, 000,00, could cover a loss of several million dollars excess coverage.[115] However, in *Fitting Co. v. United States,*[116] the court rejected the claim of the Internal Revenue Service that the premium payments were reserves held by the subsidiary to cover parent's contingent losses. Here, the court found the evidence of a distribution of risk and allowed the taxpayer to deduct the premiums.

California permits buying insurance by corporations for their directors and officers from a wholly or partly owned company.[117] It appears that the California law

110 Ibid at 622.
111 Slaughter *op cit* at 194.
112 Rev. Rul. 77- 316, 1977- 2 C.B. 54.
113 Rev. Rul. 77- 316, 1977- 2 C.B. 53-4.
114 84- 2 U. S Tax Cas. (CCH) 85, 400, Aff'd, 797 F.2d(10th Cir. 1986) 920.
115 Ibid at 85, 404.
116 606 F. Sup. (N. D. Ohio 1985) 136.
117 Cal. Corp. Code s. 317 (i).The section provides:
"(1) the insured corporation's articles of corporation authorise such arrangement; or
(2) the insurance company is a duly licensed and operated insurance company under applicable insurance law, the claims processing by the insurance company is not subject to the direct control of the insured corporation, and there is some manner of risk sharing between the insurance company

recognising the captive insurance arrangement has attempted to resolve the criticism of lack of risk- sharing.

8. 2. 2. 5. 2 Captive groups insurance

To resolve the problem inherent in captive insurance companies, some corporations have chosen captive groups as a new alternative. On the basis of this scheme, an insurance company is jointly formed by separate corporations in which the risk is to be distributed among all the members of the group, therefore, there is no tax problem. However, this alternative also involves some problems such as its availability only to the corporations with a stable financial status. Furthermore, reaching a common approach by all members always is not easy.[118]

8. 2. 2. 5. 3 Fronting arrangement

On the basis of this alternative, a typical policy is issued by commercial insurer to the corporation, and the corporation or its captive insurer will reimburse or reinsure the carrier for some or all of the amount paid in excess of the premium. Under this program, the carrier will be paid a fixed non- refundable amount for agreeing to the scheme, and in return the corporation will be compensated if the premiums exceeded losses.[119] This alternative has been viewed as another form of indemnification provided by the corporation to its directors and, thus, subject to the same public policy limitations and tax problem as other alternatives.

8. 2. 2. 5. 4 Advisory board

The other alternative which a corporation may establish to resolve the commercial insurance crisis, is to substitute its traditional board with an advisory one. Under this

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and the insured corporation, on the one hand, and some unaffiliated person or persons on the other."

118 Carlton & Brooks, *op cit* at 64.

119 Slaughter, *op cit.* at 190.

scheme, the advisory board is formed of former directors who serve with no compensation and binding vote on company policy.[120]

This alternative has been viewed as ineffective, because plaintiffs and the courts may consider it as an internal arrangement, and impose liability upon directors who actually caused the corporation to suffer losses. The main problem inherent in this alternative, is its contravention with public policy principles. That is because when a director is confident that he will not be liable for his conduct, he may not exercise his business judgment as carefully as he does in normal situations. Furthermore, this scheme transfers all burden of responsibility to the chief executive and leaves him without any protection from liability.[121]

8. 3 Elimination and Limitation of Liability

The statutory elimination or limitation of directors liability is a newly introduced legal institution, designed to respond to the consequences of some judicial decisions such as *Smith v. Van Gorkom,*[122] and to reduce discouraging effects of insurance crisis on corporate management and, thus, provide directors with a new protective instrument.

The idea of limiting or eliminating directors liabilities for the first time was proposed by the American Law Institute (ALI) in the early 1970's.[123] The ALI in one of its earliest proposals recommended a dollar cap on directors' liability for breaches of duty of care.[124]

The immediate cause for the enactment of a new law to this effect was a sharp change in the market for directors and officers' liability insurance, as well as the large increase in the amounts paid out under directors and officers liability insurance

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120 Galante "The Director and Officer Crisis: Corporate Boardroom Woes Grow", Nt'l. L. J., (Aug. 4 1986) at 30 col. 1.

121 Louden, "The Liability of Advisory Boards", 10 Directors and Boards, (Spring 1986) 19- 20.

122 488 A.2d (Del. 1985) 858.

123 Lee Hazen, *op cit* at 174.

124 American Law Institute, Principles of Corporate Governance and structure: Restatements and .Recommendations s. 7. 06 (Tent. Draft. No. 1 Ap. 1. 1982).

policies. As a result, the insurance policies became much more expensive and difficult to obtain. Moreover, the amounts which insurers were willing to cover were being reduced. The fact may have been also taken into account by the legislature in enacting the new protection device, that smaller corporations financially were unable to avail their directors of indemnification, or unable to afford the promised indemnity.[125]

8. 3. 1 Delaware Approach: Amendment of Section 102(b)

In 1986, the Senate Bill which amended section 102 of the Delaware Corporation General Laws, adding subsection (7) to the section, was signed by the Delaware Governor. The amendment which was a result of the recommendations of the Corporation Law Section and Executive Committee of the Delaware State Bar Association, observed the insurance crisis, and the need for a substitute protection for Delaware corporate directors as the main incentive behind the proposal.

Under the new section, a corporation is authorised to amend its articles of incorporation to provide that its directors may not be held liable for financial damages to the corporation or to its stockholders for a breach of fiduciary duty amounting to gross negligence to the corporation. Section 102 (b) provides:

> " ... the certificate of incorporation may also contain any of ... the following matters:
>
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation; (iii) under section 174 of this title [the section dealing with conflict of interest]; (iv) for any transaction from which the director derived an improper personal benefit."[126]

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[125] Michael W. Mitchell, "North Carolina's Statutory Limitation on Directors' liability", 24 Wake Forest L. Rev. (1989) 118, 120.

[126] Del. Gen. Corp. Law s. 102 (b) (7) (Amd. 1992). Section 174 provides that directors shall, under certain circumstances, be jointly and severally liable for wilful or negligent violations of certain requirements concerning stock repurchases and redemption and the payment of dividends.

Delaware charter option statute, thus, permits a corporation's articles to contain provisions which limit or eliminate personal liability of directors for money damages, but such provisions do not limit or eliminate liability for breach of duty of loyalty or for intentional misconduct, or when improper personal benefits are involved.

Under section 102, exemption of directors from personal liability can be total or partial. In the first situation, a director will not be held liable for his breach of duty of care or negligence at all, whereas in the latter case, the exemption may be limited to a specific amount of money, which is recognised as dollar cap. A charter cap option can also provide some limitations on directors liability, instead of eliminating liability. These provisions have been applied by the courts in some cases,[127] particularly in the case of *Zirn v. VLI Corp.*[128] where the court held that the respondent was not protected by a charter provision under section 102(b)(7) from the allegation of breach of duty of disclosure when the duty of disclosure that, in the court's view, was included in duty of loyalty, was not covered by the statute. Similarly, in *A. C. Acquisitions Corp. v. Anderson, Clayton & Co.*,[129] the Delaware Chancery Court prohibited the defendant company's board from proceeding with a self- tender offer.[130] The court held that the respondent's conduct was " likely to be found to constitute a breach of duty of loyalty", and that the defendant's good faith belief was not enough to eliminate his liability when he has breached his duty of loyalty.[131]

It seems that the Delaware courts in this respect have taken different views. In *Siegman v. Tri- Star Pictures, Inc.*,[132] the court ignoring the restrictions introduced by section 102(b)(7) of the Delaware Code implied that a corporation might amend

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127 E. g. *Stroud v. Grace*, 16 Del. J. Corp. Law, (1991)1588.

128 621 A.2d (Del. 1993) 773, 783.

129 519 A. 2d (Del. Ch. 1986) 103.

130 Ibid at 107. Tender Offer is defined as:

"An offer to purchase shares made by one company direct to the stockholders of another company, sometimes subject to a minimum and/ or a maximum that the offeror will accept, communicated to the shareholders by means of newspaper advertisements and ... by a general mailing to the entire list of shareholders, with a view to acquiring control of the second company. Used in an effort to go around the management of the second company, which is resisting the acquisition." Black, Black's Law Dictionary (St. Paul, Min.: West Publishing Co. 1990) 1469.

131 Ibid at 115.

132 Unreported case No. 9477 (Del. Ch. May 30 1989).

its certificate of incorporation to eliminate or limit the liability of its directors for breach of duty of loyalty. In the instant case, the plaintiff had contended that the amendment of Article Sixth was "invalid as a matter of law, because" it eliminated or restricted "the directors' liability to the corporation or its shareholders for breaches of their fiduciary duty of loyalty, in violation of 102(b)(7)."[133] The court held that:

> "At least one scenario (and perhaps others) could plausibly be constructed where [Tri-star's Certificate of incorporation] would eliminate or limit the liability of Tri- Star directors for breach of their fiduciary duty of loyalty- a result proscribed by section 102(b)(7). That possibility is alone sufficient to warrant the denial of defendants' motion to dismiss."[134]

However, on the one hand, the court went on to point out that:

> "Sixth would arguably operate to eliminate or limit the directors' liability for breach of their duty of loyalty to Tri-Star or its shareholders. I conclude that it would."[135]

And, on the other hand, it concluded that:

> "Any more comprehensive or definitive declaration of the validity of Article Sixth must await a later procedural stage where the merits may be explored in greater depth than was done here."[136]

It is now, under the Delaware law, possible for corporations to exempt their directors from liability even for gross negligence.[137] It may mean that the Delaware law leaves the shareholders and other interested parties without proper cover for the damages incurred by some irresponsible directors.[138] As a result of the Delaware's liability-eliminating statute, in the case of a director's breach of fiduciary duty of care, the corporation and its members are not to be compensated. Moreover, the statute has decreased the efficiency of the deterrence which liability provisions imply, when the director's liability for some particular misconduct has already been diminished. The Delaware law provides the Delaware corporations with an

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133 Ibid at 234.
134 Ibid at 236.
135 Ibid.
136 Ibid.
137 Lee, *op cit* at 272.
138 Ibid at 273.

opportunity to place their directors in a position superior to that held when director insurance was a primary means of protection.

8. 3. 2 Other States and Institutes

Most of States in 1985- 6 followed the Delaware law in this respect, including Arizona, California, Michigan, New Jersey, New Mexico, New York, Oklahoma, Pennsylvania, Texas and Washington.

Some States such as Virginia have chosen their own way. Virginia has introduced a mandatory dollar cap on directors liability which is limited to the mandatory amount specified in the articles or, if approved by the shareholders, in the by-laws, as a limitation on officer or director liability, or to the greater of $100. 000 or the amount of cash compensation received by the director during 12 months prior to the act or omission for which liability was imposed unless the articles or bylaws, approved by shareholders, specify a lower limit.[139] The important point in the Virginia charter cap is its applicability to both officers and directors, while Delaware- type statute refers only to directors. The other characteristic of the Virginia statute is that the ceiling of relief can be lowered by charter provision but obviously can not be raised.[140] Under Virginia law, any wilful misconduct or a knowing violation of criminal or Federal or state securities is excluded.[141]

The Model Business Corporation Act also permits a certificate of incorporation to contain a charter provision "eliminating or limiting the liability of a director to the corporation or its shareholders for money damages, for any damages, or any action taken, or any failure to take any action, as a director, except liability for a financial benefit received by a director to which he is not entitled" and "an intentional infliction of harm on the corporation or the shareholders". A violation of the Model

[139] Va. Code Ann. s. 13. 1-692. 1 (Supp. 1987).
[140] Ibid at 13-692, 1A.
[141] Ibid.

Business Act imposes liability on director for unlawful distributions, and "an intentional violation of criminal law."[142]

Likewise, the American Law institute (ALI) in its proposed final draft has suggested the adoption of a limitation on the amount of damages that can be recovered against officers and directors for duty of care violations that do not:

> "(1) involve a knowing and culpable violation of law by director or officer (2) show a conscious disregard for the duty of the director or officer to the corporation under circumstances in which the director or officer was aware that the conduct or omission created an unjustified risk of serious injury to the corporation; or (3) constitute a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant's duty to the corporation; and the director or officer, or an associate did not receive a benefit that was improper."[143]

The ALI in one of its first proposals recommended a dollar cap on directors' liability for breaches of the duty of care.[144] However, its proposed final draft provides that a provision in certificate of incorporation which "limits damages against an officer or a director for such a failure to an amount not less than such person's annual compensation from the corporation should be given effect".[145]

Such a limitation is said to have been justified mainly on grounds of fairness. That is because the potential liability where a limiting provision applies would be excessive in relation to the nature of the defendant's misdeed and the economic benefits expected from serving the company.[146] The ALI project's limitation on damages is confined only to violation of the duty of care and is not applicable to breach of duty of loyalty.

The main problem of the proposal is the lack of a judicial precedent. According to ALI, "no American decision has been discovered which addresses a charter provision

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142 Model Business Corp. Act s. 2. 02(b) (4).

143 The American Law Institute; Principles of Corporate Governance: Analysis and Recommendations s. 7.19 (Proposed Final Draft 1992).

144 Ibid s. 7. 06 (Tent. Draft. No. 1 Ap. 1. 1982).

145 Ibid s. 7.19 (Proposed Final Draft 1992).

146 Ibid Official Comment (c).

limiting liability for due care violations".[147] Because the effectiveness of the proposal depends on each court's treatment of it, until the legislature indicates its approval, it has been suggested as an unreliable way of protection.[148]

A leading commentator has described the ALI's proposal as the best choice, conditional to a proposed modification added at the end of section 17. 7(a) as reads:

> "provided that when damages would equal zero under this rule, or likewise be insignificant in view of extent of the director's breach of her duty and of the injury caused thereby, positive or additional damages should be assessed ..."[149]

8. 3. 3 Impact of an Elimination or Limitation Provision

The function of section 102(b)(7) is not to alter or eliminate a director's fiduciary duty to act with due care, but merely permits a corporation to insulate directors from personal monetary liability to the corporation or its stockholders for a failure to satisfy that duty. Thus, under Delaware law, directors continue to be sued for acting with the lack of due care in their corporate oversight responsibilities and in the decision-making process.[150]

The applicability of a charter cap is a great concern of shareholders who view it as equal to the unavailability of monetary damages against directors. That is because it may deprive them or the corporation of any effective remedy when a shareholder is not aware of corporate action by directors until such action is completed. Therefore, shareholders may have no effective remedy for injury occasioned by the directors' action. Section 102(b)(7) may, thus, limit remedies available to a shareholder who has a valid claim against a board of directors for violation of its fiduciary duties, even if the directors' conduct involved gross negligence. This argument is not justifiable, because an amendment under section 102 can not be made without appropriate approval of shareholders. Consequently, by adopting such an amendment,

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[147] Ibid at 54 (Tent. Draft No. 7, 1987).

[148] Slaughter, *op cit* at 198.

[149] C. Lee, *op cit* 279.

[150] Franklin Balotti & Mark J. Gentile, "Elimination or Limitation of Directors Liability for Delaware Corporations": 12 Del. J. Corp. L. (1987) 4, 15.

shareholders have already and voluntarily obliged themselves to the consequences of their own decision.

The elimination of personal monetary liability should not lead directors to neglect or disregard their fiduciary duties. An amendment under section 102 should supplement the protections of directors afforded by director liability insurance and would supplement various indemnification rights available to directors. Most importantly, adoption of an eliminating or limiting provision may assist a corporation in continuing to attract and retain highly qualified individuals to serve as directors. It also permits directors to make more entrepreneurial decisions in the exercise of their independent business judgement on behalf of the company by reducing undue concern over potential liability. Adoption of a provision authorised by section 102 may be viewed favourably by insurers, and usually have a positive effect upon the availability, amount, cost, and scope of coverage of such insurance.'[151] Many corporations have adopted charter cap to take advantage of section 102(b)(7), and others are considering proposing such amendments.

In light of the overall benefit to corporations through limiting directors' liability, adoption of an amendment authorised by that section is highly desirable on the one hand, and risky on the other.

The question may be raised whether the limitation or elimination of directors liability is applicable to all types of suits taken by any constituency of the company. In response to the indication that such protection should operate to shield a director from monetary damages including actions brought by creditors, it has been argued that such exemption for third party actions politically and even constitutionally may be difficult to achieve.[152] Although the applicability of protection to directors liability for alleged violation against third party, particularly creditors, seems

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[151] Leo Herzel, Richard Shepro & Leo Katz, "Next-to-Last Word on Endangered Directors", Harv. Bus. Rev., (Jan.-Feb. 1987) 38.

[152] American Corporate Counsel Association, Task Group on Liability of Directors and Officers, Reports on Legislative Models 4 (1987) 11-2.

uncertain, judicial precedent shows a tendency to the coverage of third party claims by such protection.[153]

The major concern is whether or not third parties are bound by a charter provision eliminating or limiting directors' liability. It seems not justified to bind a person who had no participation in entering such a charter provision into the certificate of the corporation to its consequences.

It should be noted that a chapter cap option authorised by Delaware law applies only to directors, but not to officers, employees or agents of the corporations.[154]

8. 4 Conclusion

Some commentators believe the protection provided by indemnification is even more than that permitted by insurance.[155] Insurance provides a director with protection and insulate him from the burden of personal liability, but it "has never totally protected directors against the risk of monetary liability".[156] However, the examination of indemnification and insurance has shown that purchasing liability insurance for directors is more beneficial to the corporations as well as its directors than indemnification. Economically, a corporation can secure its directors from liability by a fixed premium to the extent of its financial ability, where in a direct indemnification which is a bilateral agreement between the corporation and its directors, any reimbursement will be paid directly from the corporation's pocket, particularly when such indemnification has not been insured.

As to elimination and limitation of liability, though protecting directors from due care liability is desirable, total elimination from such liability may be unjustified. With regard to this point, the ALI has made attempts to make a balance between

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153 For example see *Francis v. United Jersey Bank* 432 A.2d (N J. 1981) 814.

154 Dennis Block Et. Al. "The Business Judgment Rule: Fiduciary Duties of Corporate Directors", at 614, Balotti & Gentile, *op cit* at 12.

155 Donald E. Pease, "Outside Directors: Their Importance to the Corporation and protection from Liability", 12 Del. J. Corp. L. (1987) 25, 71.

156 C. Wiggins, "Delaware's Directors and Officers Liability Law: A "Windfall" for Directors", Legal Times, (18 Aug. 1986) 11 col. 1.

promoting the careful discharge of directors duties and encouraging decision-making by supporting limitation of liability but not total elimination. Delaware legislature's solution to the directors' insurance crisis is described both conceptually and practically inappropriate, and an improper response to the crisis. If directors are to have no liability for their conduct and decisions taken by them, the role of laws imposing liability becomes recommended standards.[157] Moreover, it is suggested that, by eliminating directors' potential liability, the Delaware law effectively frustrates the main aim of liability provisions, which is compensation.[158] It may also affect business by requiring that potential creditors to check for such a provision in the certificate of incorporation of every customer with whom they deal with. Finally, the purpose of the provision which is to attract qualified director into service is irrelevant in the case of insolvency, where creditors likely are involved in litigation against the directors.

Although it is justified to challenge the deterrence- diminishing effect of a section 102 charter cap option, this argument ignores the background and environment in which it was considered necessity to introduce a new and effective device to overcome the ruinous impact of insurance crisis on one hand, and the courts increasing interference with business decision- making on the other hand.

Perhaps the description of section 102(b)(7) as an only enabling provision is more justified.[159] Therefore, for the section to have effect, stockholders' approval is required to amend a corporation's certificate of incorporation in order to incorporate such a provision.

The "three- Legged Stool" designed by the Delaware legislature is aimed at not diminishing risk of directors being personally liable, but rather to alleviate the risk placed upon them when they have acted in good faith but with a wrong calculation.

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157 Lee *op cit* at 256, Slaughter *op cit* at 199.

158 Note, "Indemnification of Corporate Directors: A Disincentive to Corporate Accountability In Indiana", 17 Val. U. L. Rev. (1983) 230.

159 Balotti & Gentile, *op cit* at 12.

It is time to have added the fourth and oldest leg, namely the business judgment rule to the stool. The device which emerged from case law and never happened to appear in legislation, has operated as an effective protective means. The very significant distinction between the fourth leg, which will be examined in the next chapter, and others is that the last one is dependant on the courts' discretion, whereas in other devices it is the choice of corporation to provide their directors with indemnification, insurance, or a limiting or eliminating provision, of course except in the case of mandatory indemnification.

Chapter 9: The Business Judgment Rule

9. 1 Introduction and Background

The business judgment rule has always been viewed as a centrepiece of corporate governance in US company law, and in dealing with directors' duties and liability a detailed reference should be, therefore, inevitably made to the rule. That is because the main element of the rule is duty of care Moreover, it defines and regulates the standard of due care. The rule has other functions which are relevant for the purposes of this thesis. Its use as a protection measure against directors liability was perhaps the main and even only incentive for its introduction by the courts, though it developed so far that to operate as an offensive tool clothed in the "special litigation committee" and the "demand rule", by resorting to the latter a committee of disinterested directors moves to dismiss an action against their defendant colleagues. Therefore, a detailed study of the rule, its functions, and its today's position in corporate governance relationships is necessary.

The rule is a result of judicial recognition that decisions made by directors in good faith and in the exercise of business judgment should not be reviewed by the courts. As is stated by a New York court, it is true that "the directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions."[1]

It is suggested that the business judgment rule owes its development to the English common law principles[2] growing from the case of *Charitable Corporation v.*

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[1] *Kmin v. American Express Co.*, 383 N. Y. S.2d (1943) 807, 810- 11.

[2] Dennis J. Block & H. Adam Brussin, "The Business Judgment Rule and Shareholder Derivative Actions: Via Zapata", 37 Bus. Law. (1981) 31, Dennis J. Block etal., The Business Judgment Rule: Fiduciary Duties of Directors,.(Englewood Cliffs: Prentice Hall Law & Business 4th 3d. 1993) 1.

Sutton,[3] and it "has been a part of common law for nearly two centuries".[4] However it is believed that in the United States, the rule for the first time emerged from the case of *Percy v. Millaudon*,[5] in 1829 when the court held that:

> "... the occurrence of difficulties ... which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen. ... The test of responsibility therefore should be not the certainty of wisdom in others, but the possession of ordinary knowledge, and by showing that the error of the [director] is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it."

The idea of the business judgment rule began to develop in the second half of the last century, the period of dominance of the economic and political theory, well- known as the *laissez- faire* doctrine.[6] In 1847 in *Godbold v. Branch Bank*,[7] the Alabama Supreme Court issued a statement in its holding which clarified the rule as follows:

> "The undertaking implies a competent knowledge of the duties of the agency assumed by them, as well as a pledge that they will diligently supervise, watch over, and protect the interests of the institution committed to their care. They do not in our judgment undertake that they possess such a perfect knowledge of the matters and subjects which might come under their cognisance, that they cannot err, or be mistaken, either in the wisdom or legality of means employed by them."[8]

In this case, the board of directors of a bank appointed one of its members as agent for the bank to collect money and manage some particular bank affairs. In return, the board voted to pay him an extra $500 a year. An action was brought against one of the authorising directors in order to recover the payments as unlawful.[9] The court

[3] 2 Atk. (1742) 400.
[4] Krishnan Chittur, "Corporate Director's Standard of Care, Past, Present and Future", 10 Del. J. Corp. L. (1986) 505.
[5] (La. 1829) 77- 8.
[6] J. Gordon Arbuckle, "The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint", 35 Gorge Wash. L. Rev., (1967) 565.
[7] 11 Ala. (1847) 191.
[8] Ibid. See also *Bodell v. General Gas & Electric Corp.* 15 Del. Ch. 420, 140 A. (Sup. Ct. 1927) 264, where the Delaware Supreme Court described the business judgment rule as: "If in the particular case there is nothing to show that the directors did not exercise their discretion for what they believed to be in the best interest of the corporation, certainly an honest mistake of business judgment should not be reviewable by the court."
[9] Ibid at 199.

absolved the defendant from liability because his misconduct, in the court's view, was a result of his honest misunderstanding of the law.

The philosophy behind the promotion and development of the rule was explained in *Auerbach v. Bennett.*[10] The New York court stated that the "business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments".

As to the recognition of the rule by the legislature, it should be noted that there are "no statutory formulations of the business judgment rule",[11] and the rule is a case law establishment.

9. 2 Definition and Presumption of the Rule

The business judgment rule is a judicial outgrowth of the duty of care,[12] or a specific function of the directors' duty of care to the situation, where after a reasonable investigation, the directors take an action which they honestly and reasonably believe to be in the corporation's best interests, but as a result of a miscalculation, turns out to have been in error. The rule, as a part of the development of legal concept relating to the control and management of corporations has been examined in some judicial decisions. It was defined in *United Copper Sec. Co. v. Amalgamated Copper Co.*,[13] as follows:

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion intra vires the corporation, except where the directors are guilty of

[10] 393 N.E.2d (N.Y. 1979) 994.
[11] ALI, Principles of Corporate Governance: Analysis and Recommendations s. 4. 01 (c) Official Comment (Proposed Final Draft, March 31 1992) at 227.
[12] William M. Fletcher, Cyclopedia of the Law of Private Corporations (Perm. ed. 1986) 849.
[13] 244 U. S (1917) 261.

misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment ...."[14]

The case of *Warshaw v. Chalhoun*,[15] gave a definition of the business judgment rule indicating the requirements of the rule as follows:

"In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of directors will not be interfered with by the courts. The burden of showing the existence of bad faith or abuse of discretion rests upon the plaintiff who charges that the corporate action was taken to benefit the majority at the expense of the minority."[16]

According to this statement, the court would not interfere with the directors' business decisions unless the plaintiff has shown the existence of bad faith, gross abuse of discretion or gross negligence.

Perhaps one of the clearest definitions of the rule was offered in *Aronson v. Lewis*,[17] as "an acknowledgement of the managerial prerogatives of Delaware directors under section 141(a) ... ." The Model Business Corporation Act does not define the rule and leaves it to the courts:

"In view of continuing judicial development, section 8. 30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of directors conduct set forth in this section. That is a task left to the courts and possibly to later versions of the Model Act".[18]

Indeed, the business judgment rule is a presumption that directors in their decision making have satisfied the requirements necessary to take benefit from the rule protection. This presumption is based on the rationale that directors who are responsible for managing the corporation have the best access to the necessary information. Because directors are required to act in the best interests of the corporation and its shareholders, and are vested with a broad discretion in their

[14] Ibid at 263- 4 .
[15] 43 Del. Ch. 148, 221 A. 2d (Sup. Ct. 1966) 487.
[16] Ibid at 157- 8, 221 A. 2d at 492- 93.
[17] 473 A.2d (Del. 1984) 805, 812.
[18] Model Business Corp. Act s.8. 30 cmt.(1984).

decision- making conduct, they are the ones who can make the most appropriate decision.[19]

The American Law Institute (ALI) which is described as "perhaps the most elite group of lawyers in the United States selected from the ranks of distinguished scholars and practitioners",[20] has suggested a set of principles on corporate governance. Its proposal on corporate governance which has been subject of criticism and analysis,[21] contains some recommendation on the rule. The ALI has, in defining the rule, used the expression of "a safe harbour", stating:

> "[T]he business judgment rule has offered a safe harbour for directors and officers who make honest informed business decisions they rationally believe are in the best interests of their corporation."[22]

In some commentators' views, the business judgment rule is considered not to be strictly a "presumption", but a:

> "statement of the circumstances (informed basis, good faith, honest belief) under which a court will not substitute its judgment for that of directors, either to hold them liable or to invalidate a transaction they have approved."[23]

In *Robinson v. Pittsburgh Oil Refining Corp.*,[24] the Chancellor described this presumption as follows:

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[19] Scott V. Simpson, "The Emerging Rule of the Special Committee- Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interests", 43 Bus. Law. (1988) 671.

[20] "Jonathan R. Macey, The Transformation of the American Law Institute", 61 Geo. Wash. L. Rev. (1993) 1212, 1216

[21] Kathryn N. Fine, Project, "The Corporate Governance Debate and the ALI Proposals: Reform or Restatement?" 40 Vand. L. Rev. (1987) 693, 695, Joel Seligman, "A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project" 55 Geo. Wash. L. Rev.(1987) 325, 328, Melvin Aron Eisenberg, "An Overview of the Principles of Corporate Governance," 48 Bus. Law (1993) 1271, 1271, "Symposium on Corporate Governance", 48 Bus. Law. (1993) 1267, "Symposium on Corporate Governance" 8 Cardozo L. Rev. (1987) 657; Symposium: "The American Law Institute's Principles of Corporate Governance, 61 Geo. Wash. L. Rev. (1993) 871, Elliott Goldstein, "CORPRO: A Committee That Became an Institution", 48 Bus. Law. (1993) 1333, 1334-35. Marjorie Fine Knowles and Colin Flannery, "The ALI Principles of Corporate Governance Compared with Georgia Law", 47 Mercer L. Rev. (19951) 1, William J. Carney, The ALI's Corporate Governance Project: The Death of Property Rights?, 61 Geo. Wash. L. Rev. (1993) 898, 898.

[22] ALI, Principles of Corporate Governance: Analysis and Recommendations Official Comment to s. 4. 01 (c) (Proposed Final Draft, March 31 1992) at 228.

[23] R. Franklin Balloti and James J. Hanks, "Rejudging the Business Judgment Rule", 48 Bus. Law.(1993) 1339.

[24] 126 A. (Del. Ch. 1924) 46.

> "the [defendant] directors of the defendant corporation are clothed with the presumption which the law accords to them of being actuated in their conduct by a bona fide regard for the interests of the corporation whose affairs by the stockholders have committed to their charge."[25]

According to the Vice Chancellor in that case, the presumption of the business judgment rule operates as a secure cover protecting honest directors from liability. In *Davis v. Louisville Gas & Electric Co.*[26] the court referring to the main element of such presumption, namely good faith stated that:

> "The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve."[27]

The leading case of *Aronson v. Lewis*,[28] is a significant guidance in this regard, where the Supreme Court of Delaware stated that:

> "It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption."[29]

On the basis of the *Aronson* case, directors' business judgment will be respected by a court unless the directors abuse their discretion. It is the plaintiff's burden to rebut this presumption. Therefore, in a case where the compliance with the business judgment rule is at issue, the plaintiff must plead facts to overcome the presumption of the rule, failure of which would end the proceedings in the respondent's favour. However, if the plaintiff removes the presumption of the rule, the court will not only

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[25] Ibid at 48.
[26] 142 A. (Del. Ch. 1928) 654.
[27] Ibid at 659. The same view was taken in *Cole v. National Cash Credit Assocoation,* 156 A. (Del. Ch. 1931) 183, where the court held: "There is a presumption that the business judgment of the governing body of a corporation, whether at the time it consists of directors or majority stockholders, is formed in good faith and inspired by a bona fides of purpose." Ibid at 188.
[28] 473 A. 2d (Del. 1984) 805.
[29] Ibid at 812. See also *Kaplan v. Centex Corp.* 284 A. 2d (Del. Ch. 1971) 119, 124.

review the question whether the defendant directors fulfilled the due care obligations, but also whether the transaction was fair.[30]

9. 3 Formulation and Standard of the Rule

To describe the rule, a variety of formulations have been proposed. The rule is commonly described as insulating directors from personal liability,[31] or as "validating corporate dealings."[32] In *Spring's Appeal*,[33] the rule was formulated as:

> "[directors] are not liable for mistakes of judgments, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the powers and discretion confined to the managing body."[34]

A leading commentator has proposed a formulation which seems a comprehensive statement of the rule which follows:

> "A corporate transaction that involves no self- dealing by, or other personal interest of, the directors who authorised the transaction will not be enjoined or set aside for the directors' failure to satisfy the standards that govern a directors' performance of his or her duties, and directors who authorised the transaction will not be held personally liable for resultant damages unless: (1)the directors did not exercise due care to ascertain the relevant and available facts before voting to authorise the transaction; or (2) the directors voted to authorise the transaction even though they did not reasonably believe or could not have reasonably believed the transaction to be for the best interest of the corporation; or (3) in some other way the directors' authorisation of the transaction was not in good faith."[35]

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[30] Marshal L. Small, "Conflict of Interests and the ALI Corporate Governance Project", 48 Bus. Law., (1993) 1373. (Quoted *Shamrock Holdings, Inc., v. Polaroid Corp.*, No. 10075 (Del. Ch. Mar. 17, 1989)).

[31] *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d (3d Cir. 1978) 259, 274, *denied* 439 U. S. (1979) 1129. (Quoted by Ralph A. Peeples, "The Use and Misuse of the Business Judgment Rule in the Close Corporation", 60 Notre Dame L. Rev., (1985) 457).

[32] *Nanfito v. Tekseed Hybrid Co.*, 341 F. Supp. (D. Neb. 1972) 240, 243, *aff'd*, 473 F. 2d (8th CIr. 1973) 537.

[33] 71 Pa., (1872) 11.

[34] Ibid at 24 .

[35] S. Samuel Arsht, "The Business Judgment Rule Revisited", 8 Hofstra L. Rev., (1979) 93, 111-112.

As to the test applicable to the rule, some standards of conduct have been proposed in evaluating a business decision. In the arena of Delaware corporation law, the standard of "gross and palpable overreaching" for a while concerned the courts as the business judgment rule standard. For example, in *Getty Oil Co. v. Skelly Oil Co.*,[36] the Delaware Supreme Court held that "the court will not interfere [with the business judgment of a parent corporation] absent a showing of 'gross and palpable overreaching'".[37] A similar view was posed by a Delaware Chancery Court in *Meyerson v. El. Paso Natural Gas Co.*,[38] when the court described a business decision as a judgment "with which the court should not interfere absent a showing of 'gross and palpable overreaching'".[39] Likewise, in *Panter v. Marshal Field & Co.*,[40] the court dismissing the plaintiffs' allegations held that the " ... courts will not interfere with the exercise of business judgment by corporate directors". The court applied the same standard.[41]

In these cases, the courts have applied the standard of "gross and palpable overreaching", which was only fit to the relationship of parent company and its subsidiaries, as a rule applicable to other cases. Reviewing the cases in which the standard of "gross and palpable overreaching" has been equated to the business judgment rule test, attests that almost all those cases have involved a parent-subsidiary relationship.[42] It is, thus, believed that Delaware courts by applying this standard as the test of the business judgment rule, have contributed to the contemporary confusion surrounded the business judgment rule.[43]

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[36] 276 A. 2d (Del. 1970) 883.
[37] Ibid.
[38] 246 A. 2d (Del. Ch. 1967) 789.
[39] Ibid 794.
[40] 486 F. Supp. (N. D. Ill. 1980) 1168.
[41] Ibid 1194. The holding was upheld by the higher court upon the reasoning that the decision was made by majority of directors who were independent and outside directors with no interest or little interest of preserving their position. Fed. Sec. L. Rep. (CCH), 97, 929 at 90, 738.
[42] In *Sinclair Oil Corp. v. Levien*, 280 A.2d (Del. 1971) 717, e. g., the court also determined that "gross and palpable overreaching" was equivalent to the business judgment rule test.
[43] Arsht, *op cit* at 102.

Against those judicial precedents viewing "gross and palpable overreaching" as the business judgment rule test, in several cases, Delaware courts have applied "gross negligence". This concept as the standard of the rule was addressed in *Aronson v. Lewis.*[44] In this case the court stated that:

> "While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of *gross negligence*."[45]

It seems the standard of 'gross negligence' which is also the standard of determining liability for breach of duty of care, is the appropriate measure for rebutting the presumption of the rule.

9. 4 Requirements

In order for a defendant director to enjoy a business judgment rule protection, some requirements should be satisfied. The main factors which have frequently been applied as the requisites of the rule are, acting in good faith, the absence of personal interest or self-dealing,[46] taking an informed decision which reflects a reasonable effort to become familiar with the relevant and available information,[47] and taking an actual decision with a reasonable belief that the decision serves the corporation's best interests.[48]

The *Aronson* court emphasised two elements as the main requirements of the business judgment rule, the duty of loyalty or the duty not to have a conflict of interest, and the duty to be informed and to act with requisite care.[49] The court described these factors as common principles that govern the application and operation of the rule that apply generally to all actions of the board of directors. A

[44] 473 A. 2d (Del. 1984) 805.

[45] Ibid at 812, Emphasis added. The same measure was adopted by the court in *Smith v. Van Gorkom*, 488 A.2d (1985) 858, 873.

[46] *Lewis v. S. L & E, Inc.*, 629 F.2d 764, (2d Cir. 1980) 769.

[47] *Aronson v. Lewis*, 473 A.2d (Del. 1984) 805 812.

[48] *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d (2d Cir. 1980) 357, 382.

[49] *Aronson v. Lewis*, 473 A.2d (Del. 1984) 805, 812.

similar view was adopted in *United Copper Sec. Co. v. Amalgamated Copper Co.*[50] where the court stated that if a director seeks this protection only should demonstrate good faith and due care, and fulfil a fiduciary duty. The ALI also proposed that, a director discharges his duties to his corporation when he has acted:

> "in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and similar circumstances."[51]

9. 4. 1 Due Care Requirement

In dealing with a decision complained of, the courts first review the duty of care requirement to determine whether the directors in making the business judgment in question have taken account of all relevant information.[52] A proper business judgment includes both substantive and procedural due care.[53]

The due care requires directors to inform themselves of all material information available to them before making any business decision. Moreover, they are asked to act with requisite care in discharge of their duties. This sense has been taken into account by the ALI in recognising a duty as "properly discharged" when the decision 'is informed with respect to the subject of the business judgment to the extent the director ... reasonably believes to be appropriate under the circumstances.'[54]

In the leading case of *Aronson v. Lewis*,[55] the court held that the directors seeking the rule's protection had a duty to "inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."[56]

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[50] 244 U. S. (1917) 261.

[51] ALI, Principles of Corporate Governance: Analysis and Recommendations s. 4. 01 (a) (Proposed Final Draft, March 31 1992).

[52] *Thomas v. Kempner*, 398 A.2d (Del. Ch. 1979) 320, 323-24.

[53] *Grobow v. Perot*, 539 A.2d (Del. 1988) 180, 189.

[54] ALI, Principles of Corporate Governance: Analysis and Recommendations s. 4. 01 (c) (2) (Proposed Final Draft, March 31 1992).

[55] 473 A. 2d (Del. 1984) 805.

[56] Ibid at 812.

The decision of *Smith v. Van Gorkom*,[57] in this regard had a significant effect on corporation law relating to directors. In that case, the court did not apply the rule when, in its view, the defendant directors failed to inform themselves of all information reasonably available to them.[58]

Consequently, the determination of whether a business decision was an informed one is subject to "whether directors have informed themselves prior to making a business decision of all material information reasonably available to them".[59]

9. 4. 2 Loyalty Requirement

A director seeking to take benefit of the business judgment rule protection, should act in genuine good faith. In order for a director to avoid an allegation of breach of duty of loyalty which precludes him from the rule protection, he should not have an interest in the negotiation concerned, otherwise and in the case of establishing an assumption of conflict of interests, the court may likely refuse to apply the business judgment rule protection and ask directors to show that their actions were fair and reasonable to the corporation.[60]

A director who has acted with view to protecting his position in office,[61] or guaranteeing his own control over the corporation, cannot expect the business judgment rule protection available, even when he believed such attempts were in the best interests of the corporation.[62] However, in *Johnson v. Trueblood*,[63] where directors were charged with authorising the sale of corporate stock with the

[57] 488 A.2d (1985) 858. Also in *Gimbel v. Signal Cos., Inc.*, 316 A.2d (Del. Ch. 1974) 599, 615 the court did not find the defendant directors entitled to the rule protection because they acted 'without information that they can be said to have passed on an unintelligent and unadvised judgment.' Ibid at 872.

[58] For a detailed discussion and the facts of the case, see the chapter of "Directors' Liability for Breach of Duty."

[59] *Stoner v. Walsh*, 772 F. Supp. (1991) 709, 801.

[60] See e. g., *Fliegler v. Lawrence*, 361 A. 2d (Del. 1976) 218.

[61] *Kaplan v. Goldsmat*, 380 A. 2d (Del. Ch. 1977) 556, *Baron v. Allied Artists Pictures Corp.*, 337 A.2d (Del. Ch. 1975) 653.

[62] *Bennett v. Propp*, 187 A.2d (Del. Sup. Ct. 1962) 405, 408, *Petty v. Penntech Papers, Inc.*, 347 A.2d (Del. Ch. 1975) 140, 143.

[63] 1629 F. 2d (3d Cir. 1980) 287.

intention of preserving their control over the corporation, the business judgment rule applied to the allegations because, in the court's view, the rule was applicable unless the "sole or primary motivation" for the challenged decision was to retain the control. The court rejecting the plaintiff's contention that if the purpose of perversion played any part in directors' motivation, the business judgment rule was inapplicable and it was, thus, upon directors to justify their conduct, held:

> "The business judgment rule ... validates certain situations that otherwise would involve a conflict of interest for the ordinary fiduciary. The rule achieves this purpose by postulating that if actions are arguably taken for the benefit of the corporation, then the directors are presumed to have been exercising their sound business judgment rather than responding to any personal motivations."[64]

The same view was adopted in *Panter v. Marshal Field & Co.*,[65] where the directors were sued for acting in bad faith and for personal gain by rejecting a tender offer proposed to preserve themselves in office. The court dismissing the plaintiffs' allegations held that:

> "When directors act in good faith, they enjoy a presumption of sound business judgment ... which court will not disturb if any rational business judgment purpose can be attributed to their decisions."[66]

Moreover, the good faith required is a subjective one which is acting in the honest belief that the decision in question was in the best interests of the corporation. This point expressed by the Delaware Supreme Court in *Guth v. Loft*,[67] where the court held:

> "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders ... ."[68]

To preclude the application of the rule as a defence, the plaintiff should prove that the director in question knowingly violated a statute or a public policy rule,[69]

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[64] Ibid at 292.
[65] 486 F. Supp. (N. D. III. 1980) 1168.
[66] Ibid 1194. The holding was upheld by the higher court upon the reasoning that the decision was made by majority of directors who were independent and outside directors with no interest or little interest of preserving their position. Fed. Sec. L. Rep. (CCH), 97, 929 at 90, 738.
[67] 5 A. 2d (Del. 1939) 503.
[68] Ibid at 510.
[69] *Graham v. Allis- Chalmers Mfg.* Co., 188 A.2d (Del. Sup. Ct. 1963) 125.

otherwise the presumption of good faith is still valid. The ALI also states that a director who takes a business judgment, fulfils his duty if he 'rationally believes that the business judgment is in the best interests of the corporation.'[70]

9. 4. 3 Independence Requirement

Independence of directors is a main requirement for directors to benefit the rule protection. The independence requirement in most cases[71] and by some legal writers[72] has been equated with disinterested. This view is justified when there is a direct connection between being independent and disinterested, because a director can not be interested and at the same time independent. The reverse is true. Where a director stands directly or indirectly to benefit from a decision, his independent business judgment is tainted by doing so.[73]

The business judgment rule presumes an independent decision and is only, thus, applicable when the directors are disinterested. However, because of close connection between ownership and directorship, and the presence of potential conflict of interests in the close corporation,[74] the assumption of independence may not, in the circumstances, be possible. Therefore, the personal interests always is not separated from the corporate welfare,[75] and the rule should carefully apply to the close corporations, or not to apply at all.

The *Aronson v. Lewis*,[76] case has described this requirement in detail:

> "The requirement of director independence inheres in the conception and rationale of the business judgment rule. The presumption of propriety that flows from an exercise of business judgment is based in part on this unyielding precept. Independence means

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70 ALI, Principles of Corporate Governance: Analysis and Recommendations s. 4. 01 (c)(Proposed Final Draft, March 31 1992).

71 *Abramowitz v. Posner*, 513 F. Sup. (S. D. N. Y. 1981), 120, *Galef v. Alexander*, 615 F.2d (2d cir. 1980) 51.

72 Block etal., The Business Judgment Rule: Fiduciary Duties of Directors, at 22.

73 Arsht, *op cit* at 115.

74 "A corporation whose shares, or at least voting shares, are held by a single shareholder or closely-knit group of shareholders. Generally, there are no public investors and its shareholders are active in the conduct of the business." Black's Law Dictionary, (Minnesota: West Publishing Co. 1983) 180.

75 Peeples, *op cit* at 485. (Quoted *Galler v. Galler*, 32 Ill. 2d 16, (1965) 27).

76 473 A.2d (Del. 1984), 805.

> that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."[77]

In order for the plaintiff to prove a director's interestedness, he should demonstrate a financial gain,[78] or any other specific allegation such as preserving his seat on the board of directors. The allegation of being interested should attack the independence of the board majority, otherwise the court may likely dismiss the allegation. Even the lack of independence may still not remove the presumption of the rule if the challenged decision or conduct has been approved by a majority of disinterested directors.[79]

In addition to the above mentioned requirements for effectiveness of the rule, some other conditions can be set out, the more important of which is "requirement of action". According to this requirement, as it has been pointed out in *Aronson v. Lewis*:[80]

> "the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision to refrain failed to act."[81]

It respectfully seems that even if a director refuse to act, namely in the case of omission, the rule is still applicable.

9. 5 Functions of the Rule

Some functions have been recognised for the rule. It offers directors a wide discretion necessary to take proper actions which they honestly believe to be in the best interests of the corporation, and to formulate the corporation policy effectively

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[77] Ibid 816. ALI refers to the matter, recognising a decision protected by the rule when the director "is not interested ... in the subject of the business judgment". ALI, Principles of Corporate Governance: Analysis and Recommendations s. 4. 01 (c) (1)(Proposed Final Draft, March 31 1992).

[78] *Grobow v. Perot*, 539 A.2d (Del. 1988) 180, 188.

[79] *Marciano v. Nakash*, 535 A.2d (Del. 1987) 400, 405 (Quoted by Block etal., The Business Judgment Rule: Fiduciary Duties of Directors, at 24).

[80] 473 A. 2d (Del. 1984) 805.

[81] Ibid at 813.

without fear of personal liability or judicial scrutiny.[82] The rule has an encouraging effect on directors to serve on the board of companies management.[83] It precludes or at least limits the courts' interference into decision- making policy of corporate management.

9. 5. 1 Defensive Use

The defensive use is the main incentive behind the business judgment rule. Under this theory a director, who has made a misjudgment in good faith in performance of his duties, should be relieved from personal liability. It has traditionally operated as a shield to protect directors from liability for their honest decisions. Furthermore, making inquiry into the details of decision- making policy of corporations by the courts, when it requires a expertise, is not justified. Therefore, the function of the rule is to limit the scope of judicial review as to such policy. However, even in such particular case, the inquiry cannot go further than to find out whether the director made a reasonable effort to avail himself of all necessary information for the challenged decision.[84]

The rule also may protect directors in the case of alleged breach of duty of loyalty.[85] In order for a director to take the benefit of protection provided by the business judgment rule against allegations of breach of duty of loyalty, his actions should not be motivated by self- interests,[86] otherwise the presumption of loyalty ceases. If the personal interests of the director concerned is shown, and he can not prove that the challenged transaction was fair to the corporation, the liability is most likely to be imposed.[87]

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[82] *Cramer v. General Telephone & Electronics Corp.*, 582 F. 2d (3d. cir. 1978) 274.

[83] This point was acknowledged by *Percy v. Millaudon*, 77 (La. 1829) 78, where it was held that: "The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in falliable human beings. No man would undertake to render a service to another on such severe conditions."

[84] *Thomas v. Kempner*, 398 A 2d. (Del. Ch. 1979) 320, 323- 324.

[85] *Cuth v. Loft*, 5 A. 2d (Del. 1939) 503, 510.

[86] *Gall v. Exxon Corp.* 418 F. Supp. (S.D.N.Y. 1976) 508, 515.

[87] *Tanzer v. International Gen. Indus.*, 402 A. 2d (Del. Ch. 1979) 382, 386.

As long as the rule protects directors from imprudent decisions made in good faith or from the unfortunate consequences of reasonable decisions it is desirable, but when it results in the relaxation of fiduciary obligations, it must yield to the primary societal interest in shareholder protection.[88]

9. 5. 2 Offensive Use

The rule also has an offensive function which can be exercised through special litigation committees consisted of independent and disinterested directors. It has been exercised by directors not only as a defence means against personal liability, but also as a device to block derivative suits brought by shareholders against the board of directors or the corporation. As will be discussed later, this application of the rule is one of the oddest and most complicated phenomenons in the US corporation law.

9. 5. 3 As a Measurement of Due Care

As was mentioned, the business judgment rule is an implication of duty of care. In other words, the definitions and formulations have so far offered for the business judgment rule, are mainly based on the duty of care materials such as taking an informed decision. Therefore, for defining the rule, the reference should inevitably be made to the duty of care elements. For example, ALI formulates the rule, according to which a director does not violate his duty with respect to the consequences of a business judgment if he:

> (1) is not interested in the subject of the business judgment (2) is informed with respect to the subject of the business judgment to the extent the director and officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation."[89]

The close connection between this subsection and subsection(a) which formulates a duty of care is obvious. In this respect the Model Business Corporation Act is a

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[88] Thomas C. Wagner, "The Business Judgment Rule Imposes Procedural Requirements on Corporate Directors- Smith v. Van Gorkom", 14 Florida State U. L. Rev., (1986) 126.

[89] ALI, Principles of Corporate Governance: Analysis and Recommendations s. 4. 01(d) (Proposed Final Draft, March 31 1992).

good example.[90] However, section 8. 30(a) of the Revised Model Business Corporation Act seems clearer on the matter. Under the section a director shall discharge his duties as a director:

> "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation."[91]

With regard to the above formulations, it is worth noting that the rule was first developed as an application of the duty of care. However, it gave rise to some new rules such as the "special litigation committee", the power to dismiss a derivative action from which sprang another rule, namely the "demand rule".

9. 6 Special Litigation Committee- Offensive Use of the Rule

The 1970's witnessed extensive attempts by corporations to designate special committees of independent and disinterested directors to investigate the allegations put forwarded by shareholders against directors. Such committees are empowered to move to dismiss the case upon finding that it is not in the best interests of the corporation.[92]

Prior to the development of special litigation committees, courts had restricted the boards' authority to decide whether to maintain the shareholders claims when a majority of the board's members were involved in the alleged wrongdoing.[93]

There are several reasons why corporations prefer to terminate many derivative actions as early as possible. First, the legal expenses for such actions are extremely

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90 The Model Business Corporation Act section 35 reads: "A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances."

91 The Revised Model Business Corporation Act, section 8.30(a) (1984).

92 *Gall v. Exxon Corp.*, 418 F. Supp. (S. D. N.Y. 1976) 508.

93 Alan Higbee, "The Misapplication of the Business Judgment Rule to Dismiss Shareholder Derivative Suits Against Directors", XXXIII U. FLorida L. Rev., (1981) 598. (Quoted *Continental Sec. Co. v. Belmont*, 206, N. Y. (1912) 7, 15- 19, *Montgomery Light Co. v. Lashey*, 121 Ala. (1899) 131).

high. It is not only because many of these actions are complex, but more importantly, because the corporations are required to pay for several separate teams of lawyers. Secondly, derivative actions interrupt the corporation business when the board of directors, particularly the top management are engaged in such legal proceedings. Perhaps the most important reason for the termination of a derivative action is the necessity of avoiding any procedure which may taint the corporation reputation.

As to propriety of special litigation committees, some views have been posed. According to the traditional approach, consistent with the rationale of the business judgment rule, limiting judicial inquiry to reviewing the independence of members of such committees, validates the decision of the disinterested directors.[94] The modern approach, not giving a great attention to the judgment business rule, doubts about the independence and disinterestedness of such a committee,[95] when the committee is a creation of the board of directors, with sympathy for their colleagues.[96]

The case of *Erie Railroad Co. v. Tompkins*,[97] was a turning point in derivative action cases in which the Supreme Court clearly drew limitations on taking a derivative action by shareholders. According to the court, such an action was not permitted except when directors had a duty to file the suit, but refused to do so, and this refusal led to a breach of trust.

Until 1992, legitimacy of the power of such a special litigation committee had been acknowledged by five State statutes,[98] namely Alaska,[99] Indiana,[100] Minnesota,[101] North Dakota,[102] and Virginia.[103]

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[94] Ibid.
[95] *Zapata Corp. v. Maldonado*, 430 A.2d (Del. 1981) 779, 787.
[96] Wagner, *op cit* at 111.
[97] 304 U. S. (1938) 64.
[98] ALI, Principles of Corporate Governance: Analysis and Recommendations, Reporter Note to s. 7. 08) (Proposed Final Draft, March 31 1992).
[99] Alaska Stat. s. 10.06. 435(F).
[100] Indina Code Ann. s. 23- 1- 32- 4.
[101] Min. Stat. s. 302A, 243.
[102] N. D. Cent. Code, s. 10- 19. 1-49.
[103] Va. Code s. 13. 1- 673 (D).

American Law Institute in its Proposed Final Draft has made attempts to suggest an obligation for the courts to dismiss a derivative action against a director, a senior executive, or a person in control of the corporation, or an associate of such a person, if requested by the "board of directors or a properly delegated committee thereof has determined that the action is contrary to the best interests of the corporation and has resulted the dismissal of the action."[104]

9. 6. 1 The Disinterestedness and Power of the Committee

The question of who is an independent and disinterested director is significant, because the plaintiff may move to challenge the impartiality of the members of the special litigation committee by arguing that they are directly or indirectly interested in the challenged transaction. Therefore, it is the question of who is empowered to determine whether or not proceeding a derivative action is in the best interests of the corporation.

As was mentioned, some commentators have doubted if there is any director truly independent and impartial from their colleagues.[105] However, this point in most cases has not attracted the judges' agreement.[106] The court in *Auerbach v. Bennett*[107] held that 'to disqualify the entire board would be to render the corporation powerless to make an effective business judgment with respect to prosecution of derivative action.'

The major problem inherent in the requirement of disinterestedness is the manner of appointment of the special litigation committee's members. It seems justified that disinterestedness and independence of a litigation committee is arguable when they

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104 ALI, Principles of Corporate Governance: Analysis and Recommendations, s. 7. 08 (Proposed Final Draft, March 31 1992).

105 Note, "The Business Judgment Rule in Derivative Suits Against Directors", 65 Cornell L. Rev. (1980) 600.

106 *Gall v. Exxon Corp.*, 418 F. Supp. (S.D.N.Y.1976) 508, 515.

107 47 N. Y. 2d (1979) 619, 633.

are appointed after the action is taken, and more particularly where the defendant directors take part in the appointment.[108]

It is necessary to find out by what source and upon which statutory or judicial authority, the board of directors is empowered to move to dismiss a derivative action through a special litigation committee formed by themselves. Until *Auerbach v. Bennett*,[109] there was no judicial authority of highest State court examining the legitimacy of the exercise of such power of corporate directors.[110] In that case, a committee of independent and outside directors was formed to investigate the allegation of a foreign payment and to decide whether it was in the best interests of the corporation to pursue the case. The committee moved to dismiss the case upon finding that it was very costly, wasting the management's time, with a little chance of success. Moreover, the committee dismissed a claim against a third party. The court, in this case, recognised the exercise of such power and went on to say:

> "As all parties and both courts below recognise, the disposition of this case on the merits turns on the proper application of the business judgment doctrine ... that doctrine bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes....Derivative claims against corporate directors belong to the corporation itself. As with other questions of corporate policy and management, the decision whether and to what extent to explore and prosecute such claims lies within the judgment and control of the corporation's board of directors...".[111]

Here, though all the parties were in agreement on the power of the directors, the court ruled that because a derivative action belongs to the corporation, therefore, it was subject to its directors decision.

The first Delaware case in this respect is *Abbey v. Control Data Corp.*,[112] which involved charges stemmed from illegal payments admittedly made by the corporation to certain foreign entities. Control Data Corp.'s (CDC) board of directors reacted to

[108] Dennis J. Block & H. Adam Brussin, "The Business Judgment Rule and Shareholder Derivative Actions: Via Zapata", 37 Bus. Law. (1981) 31, 58.
[109] 47 N. Y. 2d(1979) 619.
[110] Block & Brussin, *Op cit* at 45.
[111] *Auerbach v. Bennett,* 47 N. Y. 2d (1979) 619, 621, 629.
[112] 603 F. 2d (8th Cir. 1979) 724, *cert. denied,* 444 U.S. (1980) 1017.

the action by creating an autonomous "Special Litigation Committee" to investigate the charges as well as to determine whether the suit was in the best of the corporation. The committee was composed of seven of CDC's "outside" directors holding responsible positions in government and business. None of the committee's members had been named as a defendant, and there was no indication that any member was interested in or informed of the foreign payments.[113] The committee found the action not in the best interest of the corporation because:

> "(1) the defendants had not been directly involved in the payments, nor had they personally profited from them; (2) the defendants had fully cooperated with the Justice Department and the committee; (3) legal action against the defendants could significantly impair their ability to manage corporate affairs; (4) the foreign payments were a customary business practice at the time they were made and were intended to serve the business interests of CDC; and (5) disclosure of the details of the payments might endanger certain CDC employees."[114]

In this case, the court disagreed with the plaintiff that the business judgment rule was not applicable in dismissing a derivative action against directors for breach of duty, because:

> "it is a decision by the directors of the corporation that pursuit of a cause of action based on acts already consummated is not in the best interest of the corporation. Such a determination, like any other business decision, must be made by the corporate directors in the exercise of their sound business judgment."[115]

For the first time in the history of the long- standing "business judgment rule", here, the court found the rule applicable even in criminal cases by holding that "we find no merit to his argument that the rule is inapplicable where the defendant directors are charged with criminal misconduct."[116]

The decision has received heavy criticism as "falling into the trap of assuming that the business judgment rule confers authority upon a board to terminate derivative

113 Ibid at 727.
114 Ibid.
115 Ibid at 730.
116 Ibid.

actions, without coming to grips with the question of whether derivative suits against directors ought to be beyond directorial control altogether."[117]

Fortunately and not surprisingly, that decision was reversed by the Supreme Court of the United States,[118] otherwise the legal community had to spend much time in curing this shocking injury in the body of corporation law.

However, in *Galef v. Alexander*[119] the court strongly dismissed the idea that a defendant against whom a derivative action is filed can be described as disinterested, irrespective of whether or not he benefited from the challenged transaction. In that case, the court held that:

> "[In] all of the cases relied upon by the district court ... the court has indeed allowed directors to preclude pursuit of a corporate claim, but in each the directors who made such a determination were not alleged to have authorised or approved the challenged transaction, and they were not made defendants in the lawsuit. We are not aware of any case that has determined that directors against whom a claim has been asserted and who have determined that the claim against them should not be pursued, do not stand in a dual relation which prevents the unprejudiced exercise of judgment."[120]

A similar development can be seen in *Burks v. Lasker*,[121] where the special litigation committee moved to dismiss the allegations brought by two of the stockholders. The Federal District Court affirmed the decision upon finding that the plaintiff shareholders had failed to meet their burden of establishing that the minority directors were interested.[122] However, the holding was reversed by the second circuit court. The court drawing a distinction between independent and non-independent directors stated that:

> "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned."[123]

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[117] Block & Brussin, *op cit* at 46.
[118] *Abbey v. Control Data Corp.*, 444 U.S. 1017; 100 S. Ct. 670; 1980 U.S. LEXIS 314; 62 L. Ed. 2d (1980) 647.
[119] 615 F. 2d (2d Cir. 1980) 51.
[120] Ibid at 60.
[121] 441 U. S. (1979) 471.
[122] 426 F. Supp. (S.D.N.Y.1979) 844.
[123] 567 F.2d at 1212.

In the above judicial decisions, the courts have taken different views over the independence and disinterestedness of the members of such committees. However, reviewing those cases leads to the conclusion that prior to the *Zapata* case, the courts took the view that where the directors were disinterested, their motion to dismiss a derivative action was valid, unless otherwise was proven.

9. 6. 2 Zapata- the New Trend

Prior to *Zapata Corp. v. Maldonado,*[124] the clear direction of the State and Federal courts was to approve the decision of disinterested boards or special litigation committees in terminating derivative litigation.

The *Zapata* case[125] is a turning point relating to the application and interpretation of a specific function of the business judgment rule, namely the position and role of the special litigation committee. It is rightly suggested that these three cases may mark the end of "the clear trend in corporate law".[126]

In 1970 Zapata's board of directors adopted a stock option plan which granted certain officers and directors of Zapata options to purchase Zapata common stock at $12.15 per share in five separate instalments, ending July 14, 1974. The plan was ratified by Zapata's stockholders. Zapata was also planning a tender offer for 2,300,000 of its own shares. The tender offer was expected to be announced just prior to July 14, 1974, and it was predicted that the effect of the announcement would increase the market price of Zapata stock from $18-$19 per share to near the tender offer price of $25 per share. Zapata's directors, most of whom optionees, knew that if the options were exercised after the date of the tender offer announcement, the optionees would incur substantial additional federal income tax liability. They were also aware that this additional liability could be avoided if the

[124] 473 A.2d (Del. 1984) 805.

[125] *Maher v. Zapata Corp.*, 490 F. Supp. (S. D. Tex. 1980) 348, *Maldonado v. Flyyn*, 485 F. Supp. (S. D. N. Y. 1980) 274, *Maldonado v. Flynn* 1, 413 A.2d (Del. Ch. 1980) 1251.

[126] S. Andrew Bowman, "The Business Judgment Rule and the Litigation Committee: the End of a Clear Trend in Corporate Law", 14 Ind. L. Rev., (1981) 617, 631.

options were exercised prior to the announcement. 'That was because the amount of capital gain for federal income tax purposes to the optionees would have been an amount equal to the difference between the $12.15 option price and the price on the date of the exercise of the option: $18-$19 if the options were exercised prior to the tender offer announcement, or nearly $25 if the options were exercised immediately after the announcement.'[127]

With the view to reducing the amount of federal income tax liability that would be incurred by the optionees in exercising their options, the directors accelerated the date on which the options could be exercised to July 2, 1974, when the optionees exercised their options and the directors requested the New York Stock Exchange to suspend trading in Zapata shares pending "an important announcement". On July 8, 1974 as a result of announcement of the tender offer by Zapata, the market price of Zapata stock promptly rose to $24.50.[128]

In 1975, and without making demand, one of Zapata's shareholders, Maldonado, brought a derivative action on behalf of Zapata and its stockholders, alleging that accelerating the time for the exercise of the defendants' stock options constituted a breach of the fiduciary duty by the directors owed to Zapata and its stockholders, because it "deprived Zapata of a federal tax deduction in an amount equal to that saved by the optionees because the options were exercised on July 2, 1974, when the price of Zapata stock was $18.8125, rather than on July 14, 1974, when the price of Zapata stock was at or near $24.50."

In 1979, Zapata's directors formed and appointed an independent litigation committee ("the committee") composed of two outside newly appointed directors to investigate the claims asserted in the actions, in order to determine whether those suites served the best interests of the company.

After an investigation, the committee found all the three actions were contrary to Zapata's best interests, because, in its view there was no material injury to the

[127] *Maldonado v. Flynn* 1, 413 A.2d (Del. Ch. 1980) 1251, 1254.
[128] Ibid.

company. Moreover, in its' view, there was no chance of success to proceed the actions due to lack of merits and the case was not only highly costly but would waste the time of management and the corporation publicity. Therefore, the committee instructed counsel for Zapata to seek dismissal of all the pending suits.

Pursuant to the Committee's directive, Zapata moved for dismissal of this action or alternatively for summary judgment in its favour. In support of its motions, Zapata relied upon the doctrine of corporate law that the board of directors is empowered to make the business decisions of the corporation, and they are the ones but not the stockholders, who manage its business affairs.

The New York court noting that Delaware court had not addressed the issue, found the business judgment rule applicable "even where some of the board members are disqualified from participating in the board's decision...".[129] However, the court after an exhaustive review of some Federal and Delaware cases, held that although a special litigation committee was empowered to terminate a derivative action, the shareholders could always file an individual action or a class action on behalf of all the shareholders.[130]

The Delaware court took a different view and moved to limit the extent of power of such a committee. This case was a revolutionary change in the judicial viewpoint in which the traditional approach that a litigation committee could terminate a derivative action was diminished. The Delaware Chancery Court reviewing the application of the business judgment rule held:

> "under well settled Delaware law, the directors cannot compel the dismissal of a pending stockholder's derivative suit which seeks redress for an apparent breach of fiduciary duty, by merely reviewing the suit and making a business judgment that it is not in the best interests of the corporation."[131]

The court after examining the application of the rule concluded:

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[129] *Maldonado v. Flynn*, 485 F. Supp. (S. D. N. Y. 1980) 279.
[130] Ibid at 281.
[131] *Maldonado v. Flynn* 1, 413 A.2d (Del. Ch. 1980) 1251, 1257.

"... an analysis of the character of a derivative suits shows that the business judgment rule is irrelevant to the question of whether the committee has the authority to compel the dismissal of this suit."[132]

Finally, the court expressed the view that under settled Delaware law, the directors do not have the right to compel the dismissal of a derivative suit brought by a stockholder to remedy an apparent breach of fiduciary duty by the directors in relation to the corporation and its stockholders after the directors have refused to institute legal proceedings, because the stockholder then possesses an independent right to redress the wrong.[133]

However, the court's decision that a stockholder, once demand is made and refused, possesses an independent, individual right to continue a derivative suit for breaches of fiduciary duty over objection by the corporation,[134] was found by the Supreme Court of Delaware as "erroneous".[135]

The decision of the *Zapata* case which was later followed by Delaware courts, put an end to the traditional trend which gave a wide discretion to a special litigation committee to dismiss a derivative action. In the unreported case of *Lewis v. Fuqua,*[136] the plaintiff brought a stockholder derivative suit claiming that directors of the defendant Fuqua Industries diverted an opportunity of the corporation to repurchase common stock to themselves for their own personal benefits. A special litigation committee based on whose recommendations the corporate defendant moved to dismiss the stockholder derivative suit, when it found that the suit was not in the interests of the corporation, was appointed to investigate the claims. The Chancery Court held that the motion was to be denied, because there was no showing that the special litigation committee was independent or that the committee established a reasonable basis for its conclusions. Furthermore, in the court's view,

[132] Ibid.
[133] Ibid at 1262.
[134] Ibid. Also see *Maldonado v. Flynn*, 485 F. Supp. (S. D. N. Y. 1980) 279, 281.
[135] *Zapata Corporation, V. William Maldonado*, 430 A.2d 779;783.
[136] Unreported case, No. 7188. Spring, 1986 (Cited in 11 Del. J. Corp. L., (1986) 928.

dismissal of the suit at this juncture would not have been in the best interests of the corporation.[137]

9. 6. 3 Demand Rule

The main restriction for shareholders to bring a derivative action against the corporation or its directors is recognised as the "demand rule."[138] This adds a degree of finality to the decision of the board of directors whether or not to initiate or maintain a derivative action against their wrongdoer colleagues. According to this rule, a shareholder is required, before filing any derivative suit, to apply to the board of directors requiring them to take the appropriate action.

The rule is a result of the necessity of the plaintiff shareholders' showing that they have tried all the available means to recover their damages, as a prerequisite to bring a derivative suit. The law in virtually every jurisdiction, in which the issue has been addressed, is that a determination by a board of directors to refuse a demand to file a derivative action is, like any other business decision, to be assessed in accordance with the business judgment rule.[139] The rule is believed to have been recognised over a century ago[140] by the United States Supreme Court in *Hawes v. Oakland.*[141] In that case, the court upheld the board of directors' decision to refuse a demand as consistent with the business judgment rule's protection.[142]

In *Corbus v. Alaska Treadwell Gold Mining Co.,*[143] where a shareholder tried to prevent the corporation of paying an allegedly illegal licence fee to the State of Alaska, the court clearly described the board's refusal to let a derivative action be

137 Ibid.

138 Kon Sik Kim, "The Demand on Directors Requirement and the Business Judgment Rule in the Shareholder Derivative Suit: An Alternative Framework", J. Corp. L. (1981) 511.

139 Dennis J. Block, Stephen Radin, and James P. Rosenzweig, "The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade", 45 Bus. Law. (1989) 492.

140 Ibid.

141 104 U. S., (1881) 450.

142 Ibid at 462.

143 187 U. S. (1903) 455.

filed by shareholders as "in accordance with the business judgment rule", and a natural result of the application of the rule, when a demand was not made.[144]

The question may be raised whether applying the rule in all circumstances is necessary. The drafters of the Model Business Act argue that requiring a demand in all cases is recommended because it "does not impose an onerous burden upon" shareholders.[145]

In several cases, failure to make the required demand has not prevented shareholders from bringing an action. It is more justified when shareholders can show that making a demand on the board would be fruitless.[146] To demonstrate this fruitlessness, the shareholders should prove that the board of directors is dominated by the alleged wrongdoers and because of personal interests, some or all members of the board cannot be independent or disinterested. Therefore, the demand may be excused and the derivative action:

> "...can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way."[147]

In the Delaware case of *Sohland v. Baker*,[148] the court disagreed with the directors' refusal to sue after sufficient demand was made on them and held that the plaintiff shareholder could proceed upon finding that the right to take an action was vested in the shareholder. Moreover, there was no sufficient reason for such refusal.[149]

In Delaware, in the absence of any guidance from the Supreme Court, the Chancery Court had laid down and developed its own rule that demand was excused if the plaintiff's allegations raised a "reasonable inference" that the action of the directors

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144 Ibid at 463.

145 "Comment on Corporation Laws- Changes in the Model Business Corporation Act Amendment" 44 Bus. Law. (1989) 543.

146 *Libof v. Wolfson*, 437 F.2d (5th Cir. 1971) 121, 122, *Nussbacher v. Continental Ill. National Bank & Trust Co.*, 518 F.2d (7th Cir. 1975) 873, 877.

147 *Ash v. I.B.M. Inc.*,353 F.2d (3d Cir. 1965) 491 at 493, *denied*, 384 U. S. (1966) 927.

148 15 Del. Ch. 431, 141 A. (1927) 277.

149 Ibid at 443.

was not protected by the business judgment rule.[150] The Delaware Supreme Court rejected the court of chancery's "reasonable inference" test by adopting a standard of "reasonable doubt" for the guidance of trial judges.[151]

It is suggested that with regard to the *Aronson* case, in Delaware law, demand always is required, except when a majority of the board is interested in the alleged transaction which is seriously doubtful if the business judgment rule is invokable.[152]

9. 7 The Business Judgment Rule in Judicial Scrutiny

The effectiveness of the business judgment rule, as the product of case law, depends on the extent to which the courts respect it. The courts' treatment of the rule is, thus, a significant factor in developing the law in this area.

The main confusion is the scope of the courts' discretion in invoking and applying the rule, particularly when satisfying the rule requirements by the directors in question is doubtful. It is suggested that there is a close connection between the importance and potential effects of the board's decisions on the corporation and the level of scrutiny the court may apply. The more a decision affects the ownership interests of shareholders, the more the court may be willing to scrutinise the decision.[153]

In several cases, it has been recognised that if the value of transaction decided by the directors falls within a range of values which even reasonable and fully informed people may take different views, their decisions should not be questioned by the court. In *Sinclair Oil Corp. v. Levien,*[154] the court expressed that "the business

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[150] *Lewis v. Aronson,* 466 A.2d (Del. Ch. 1983) 375, 381; *Haber v. Bell*, 465 A.2d (Del. Ch. 1983) 353.

[151] Donald E. Pease "Aronson V. Lewis: When Demand Is Excused and Delaware's Business Judgment Rule". 9 Del. J. Corp. L. (1984) 39.

[152] Dennis J. Block & H. Adam Brussin, "Termination of Derivative Suits Against Directors on Business Judgment Grounds: From Zapata to Aronson", 39 Bus. Law., (1984) 1503, 1523.

[153] Bayless Manning, "Reflection and Practical Tips on Life in the Boardroom after Van Gorkom", 41 Bus. Law., (1985) 1, 5.

[154] 280 A. 2d (Del. 1971) 717, 720.

judgment will not be disturbed if [it] can be attributed to any rational business purpose." Likewise, in *Puma v. Marriott*,[155] the court was of the view that:

> "since the transaction complained of was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uniformed opinion for that of the experienced, independent board members."[156]

The courts, while recognising that it is not their business to interfere with the corporate directors decision- making, in the case of any conflict of directors' interests with their duties, preserve the right to inquire into the challenged decision. For example in *Bayer v. Beran*,[157] minority stockholders took a derivative action for negligence, waste, and improvidence in instituting an extensive advertising program using the wife of a director who had control over the board, when the company received offers of more business than it could handle.[158] The court here held that:

> "The board ... is placed in a position where selfish, personal interests might be in conflict with the duty it owed to the corporation. That being so, the entire transaction must be subjected to the most rigorous scrutiny to determine whether the action of the directors was ... inconsistent [with the company's] interest."[159]

After a careful examination, the court did not find any breach of fiduciary duty as such on the part of the directors. A similar view was taken in *Cramer v. General Tel. & Elec. Corp.*,[160] when the court examining the extent of courts' discretion held that:

> "[W]e do not think that the business judgment of the directors should be totally insulated from judicial review. In order for the directors' judgment to merit judicial deterrence, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing. In addition, when the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment."[161]

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[155] 283 A.2d (Del. Ch. 1971) 693.
[156] Ibid at 696.
[157] 49 N. Y. S. 2d (Sup. Ct. 1944) 2.
[158] Ibid at 9.
[159] Ibid at 9- 10.
[160] 582 F.2d (3d Cir. 1978) 259.
[161] Ibid at 275.

On the other hand, the courts scrutinise a director's business decision if it can be shown that he made his decision with a reckless disregard of the best interests of the corporation and its shareholders. The leading case in this regard is *Gimbel v. Signal Companies, Inc.*.[162] In this case, the plaintiff, a stockholder of Signal company, owning some subsidiaries, sought an order to ban the sale of one of subsidiaries of the Signal company. The plaintiff claimed that the sale price of $480m was considerably lower than the fair price, $761m. Here, although the court stated that a presumption that the board had acted in good faith and their judgment would not be disturbed when it could be attributed to a rational business purpose,[163] it took the view that 'this does not mean, however, that the business judgment rule irrevocably shields the decisions of corporate directors from challenge".[164] The court acknowledged that "there are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based simply on gross inadequacy of price. This is clear even if language of fraud is used."[165] In that case, the court was of the view that the rule would not protect directors' decision when they have "acted so far without information that they can be said to have passed an unintelligent and unadvised judgment".[166]

The same judicial attitude can be seen in *Smith v. Van Gorkom*,[167] the leading case in this regard, which caused significant changes in the law relating to directors. In this case, the court obviously refused to apply the business judgment rule to relieve the defendant directors from personal liability, and held them liable because, in the court's view, the directors 'did not adequately inform themselves as to the defendant's role in enforcing the sale of the company and in establishing the per share purchase price' and 'were uninformed as to the intrinsic value of the company'.[168]

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[162] 316 A. 2d (Del. Ch. 1974) 599.
[163] Ibid at 608- 609.
[164] Ibid at 609.
[165] Ibid at 610.
[166] Ibid at 615.
[167] 488 A.2d (1985) 858.
[168] Ibid at 874.

There is an obvious similarity between the court's judgment in this case and *Gimbel v. Signal Companies, Inc.*, because in both cases the main cause for liability was making an uninformed decision.

The *Gorkom* case has been criticised as a misperception which caused the Delaware Supreme Court to depart from traditional business judgment rule principles.[169] Another criticism with which the *Gorkom* decision faced is that the courts substitute their determination of the adequacy of information for that of more qualified professional directors.[170] However, this perception of the *Gorkom* case has been rejected by some other commentators who believe that the case is not a departure from previous business judgment rule decisions, nor is it a harbinger of judicial activism in the corporate era, but it "remains a coherent explication of a long-existing, fundamental safeguard for corporate management."[171]

9. 8 Conclusion

The business judgment rule, on the one hand operates as a protective means, and on the other hand as a measurement of fiduciary duty of care. The rule with some of its particular characteristics is distinguished from other protection concepts. Unlike a charter cap provision, the business judgment rule under particular circumstances, may protect directors from breach of duty of loyalty.[172] More importantly, the rule is not a statutory concept but an implication of judges' thoughts, whereas other protective mechanisms including indemnification, insurance, and elimination or limitation of liability are statutory provisions. The recent crisis and increased interference of the courts with directors decision- making which obviously has

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[169] Schwartz & Wiles, "Business Judgment Rule Clarified by Delaware's Trans Union Decision" Nat'l L. J. (July 8, 1985) 1, 42.

[170] Daniel Fischel, "The Business Judgment Rule and the Trans Union Case", 40 Bus. Law., (1985) 1437, 1441.

[171] Wagner, *op cit* at 124

[172] *Cuth v. Loft*, 5 A. 2d (Del. 1939) 503, 510, *Gall v. Exxon Corp.* 418 F. Supp. (S.D.N.Y. 1976) 508, 515

weakened the position of the rule and led to the enactment of 1986 in Delaware and other States, should be considered in connection with this particular characteristic. In other words, in contrast with other protective means, whose extent and restrictions of applicability are defined by the relevant statutes, the rule is subject of the courts' discretion. In invoking the rule, courts have a wide discretion whether or not to apply it. The best example is the case of *Smith v. Van Gorkom*,[173] in which the court exercised its discretion in not applying the rule.

The significant advantage of the rule, in comparison with a liability limitation or elimination provision, is that it is in all situations including insolvency applicable, whereas the application of the charter cap in the latter event is unjustified. Moreover, a direct indemnification protection is not workable when the corporation is financially unable or unwilling to reimburse.

The offensive use of the rule in the form of the special litigation committee has been strongly criticised as demonstrating "the erosion of a shareholder ability to derivatively protect the corporation and its shareholders from ravages of directors' malversation," when "with bastardised application of the business judgment rule, burden of proof falls on the shareholder to rebut the independence or good faith of the litigation committee."[174]

The power of the board of directors to veto a derivative action bears a significant potential abuse of the business judgment rule by the board, because the business judgment rule only protects the litigation committee's decision to dismiss, but does not give an independent authority for the dismissal itself.[175] This power is, thus, neither necessary nor desirable as a protective device for the legitimate oversight of corporate by the board. Consequently, the possibility of abusing the power of the board of directors to terminate a shareholder's derivative action requires an alternative. This alternative can be the courts that make inquiry into a derivative

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[173] 488 A.2d (1985) 858. Also see *Gimbel v. Signal Cos., Inc.*, 316 A.2d (Del. Ch. 1974) 599, 615.
[174] Bowman, *op cit* at 635.
[175] Higbee, *op cit* at 613.

action and dismiss it if not in the best interests of the corporation.[176] It can be done by invoking the requirement of rule 23. 1 of the Federal Rules of Civil Procedures which provides that "[t]he derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interest of the shareholders or members similarly situated in enforcing the right of the corporation or association."[177] The statutory solution by relying on States laws has also been recommended as the effective means to overcome the difficulties inherent in the derivative actions.[178]

There is no doubt that the last amendments of indemnification statute on the one hand, and the welcome charter cap option by almost all States following Delaware law on the other hand, have lowered the role and importance of the business judgment rule to the second place. However, with regard to the current situation, the law community, courts, and legal writers should consider the rule function as if the limiting or eliminating provision has never been introduced. Indemnification or elimination devices as statutory provisions can be removed by the legislature or not be employed by the corporations, because their employment is not mandatory, whereas the business judgment rule as a common law rule will be in effect and invokable.

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[176] Kim, *op cit* at 23.

[177] Fed. R. Civ. P. 23. 1. See also. *Maldonado v. Flynn* 1, 413 A.2d (Del. Ch. 1980) 1251, 1263, in which Vice Chancellor Hertnett said: "aggrieved stockholders Delaware corporations ought to be able to expect that an impartial tribunal, not a committee appointed by the alleged wrongdoers, will decide whether a stockholder's derivative suit alleging breach of fiduciary duty has any merit."

[178] See generally John C. Coffee & Donlald E. Schwartz, "The Survival of the Derivative Suits: An Evaluation and a Proposal for Legislative Reform", 81 Colum. L. Rev. (1981) 261.

PART THREE: COMPARATIVE STUDY

Chapter 10: Comparative Study and Conclusion

10. 1 Introduction

In our study, it appeared that the two contrasted legal systems enjoy some common ideas as the result of maintaining the traditional common law or equitable rules on the one hand, and differ in some points which have resulted from different socio-cultural as well as economic- political ideals of each community. To elaborate the causes of differences, thus, there must be an examination of these ideals that form the dominant ideology of the two societies. By the 'dominant ideology' is meant the ground on which the cultural- political and economic perception of a nation is based. In this chapter I shall try to explain this dominant ideology and its impact on socio-cultural and economic- political aspects of the US and English societies. Corporate directors' duties as the main common principles and similarity in the two laws are also comparatively examined. In a review of directors' liabilities, there is an attempt to answer the question how US law has failed to define and classify these liabilities under an appropriate set of conceptions, whereas English law in this regard has specially introduced some concepts for this purpose, in particular in the event of insolvency. This very fact is more noticeable in the case of disqualification where, unlike highly developed concept of disqualification in English law, US law has newly recognised the imposition of such a penalty on only executive directors in their violation of the Securities Acts.

However, it is to be proven that the US company law is more protective than English law towards its directors. The US legislature generously has permitted corporations to provide their directors with protection by enter ing some provisions to such effect into their certificate of incorporation or articles of association, or even in an external contract. Moreover, the business judgment rule with its different functions is an exclusive advantage of the former law.

Finally, in our conclusion, briefly referring to some basic comparative points of the two legal systems, we answer the question whether harmonisation or codification of those two laws is necessary, and if so whether it is feasible. I will suggest the line of the thesis for further study for the future researchers.

10. 2 Different Societies Still within the Same Legal System?

Although the first generation of the new Americans was European, mainly British, and they conveyed the common law rules to their new homeland, some deep changes were to happen in all aspects of their life- style. These changes were accelerated by the arrival of new non- British immigrants. The new Americans, 85% of the population of whose first generation were British immigrants,[1] wished to be distinctive. The American has wanted to be a new man neither a European nor the decedent of a European, rather "an American, who leaving behind him all his ancient prejudices and manners, receives new ones from the new mode of life he has embraced, the new government he obeys, and the new rank he holds."[2] It is true they have tried hard to seem the American exceptionalists.

The fundamental objective of today's American society was freedom with "the quality of character necessary for the creation of a free republic", but this aim seems to have been replaced by the well- recognised principle of "individualism", that might eventually isolate the Americans one from another.[3] This, in an American view means "anything that violates our right to take for ourselves, judge for ourselves, make our own decisions, live our lives as well as see fit, is not only morally wrong, it

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[1] Richard Maidment & Anthony McGrew, The American Political Process (California: SAGE Publications Ltd. 1991) 13.

[2] J. Hator St. John de Crevecoeur, Letters from an American Farmer (New York: Penguin Books, 1981) 63-4.

[3] Robert N. Bellah et al, Habits of the Hearts- Individualism and Commitment in American Life, (California: University of California Press 1985) Introduction at viii.

is sacrilegious."[4] Surprisingly, one can easily find out how strongly this belief has been exercised by the American even in their international relationships. As Bellah states, the thinking about American society is narrowly focused on its political economy. In his view, "this focus makes sense in that government and the corporations are the most powerful structures in our society and affect everything else, including our culture and our character."[5]

This contention is perfectly true, but there is something more. Corporations, cartels, and trusts are even more powerful than the government. Indeed, they are the real master- players behind the scene, who have a say in structuring and forming the government and affect its domestic and international policies. An unbiased expert in the American political life may confirm that the president in his substantial decisions has to strike a balance between the interests of these giants firms and those of the public. Thus, the vociferous demand for banning or restricting the freedom of carrying guns is not heard in Congress, though it is used a pressure lever in election campaign by rival parties.

On the other had, considering this complicated system optimistically, one may fairly observe this development as the adventurous aspect of American life- style, the aspect which was the main ingredient of the historical immigration that led to the creation of the republic of America. So long as the American community keeps a high profile of its economic- political position, this adventurous aspect is likely to produce prosperity, of course with its long- term cultural- moral disadvantages.

Political culture as the "dominant ideology" has been constructed and imposed by those who control the levers of economic and political powers to justify their dominance and maintenance of capitalism. This dominant ideology is so powerful, Katznelson and Kesselman claim, that the economic and political arrangements "appear not merely as the best possible arrangements but as the only possible ones."[6]

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[4] Ibid at 142.

[5] Ibid at 275.

[6] I Katznelson and M. Kesselman The Politics of Power (New York: Harcourt, Brace & Jovanovich 1979) 29.

Interest groups play a decisive role in the United States economic- political livelihood, and they operate as an important constituent element of the American political process. This has led to the well- known phenomenon of "specialism of lobbying". The interest groups enjoy their influence through hiring the services of professionals lobbyists.[7] This informal but practically well- recognised role as a part of today's American political life, which obviously also affects the legislative process, is mediated by the parties. Lobby groups are now more powerful than ever and promote the interests of the parties they formally or informally represent. This development has gone further than domestic affairs, and has been concerned with international relations, particularly after the second world war.

The interest groups are acting in the form of very well- organised committees as political action committees (PACs) that emerged almost together with the new republic of America. Tocqueville who had carefully studied this phenomenon in 1835 said:

> "Americans of all ages, all conditions and all dispositions constantly form associations. ... Whenever at the head of some new undertaking you see the government of France, or a man of rank in England, in the United States you will be sure to find an association."[8]

They share information about candidates through active networking among themselves mostly based in Washington with branches in other States.[9] The events that have taken place in the Middle East after the second world war, particularly in the Persian Gulf region involving the United States, have been strongly a follow up of economic- political desires of some powerful interest groups in the decision-making policy circles in the White House or Congress.[10]

Even the political aspect of the legal system of the American law has raised some debates among American lawyers, who have made attempts to define the applicable

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[7] Maidment & McGrew, The American Political Process at 134- 35.

[8] Alexis de Tocquoville, Democracy in America (New York: Alfred A. Knopf 1963) 2: 106.

[9] Larry J. Sabato, PACT Power- Inside the World of Political Action Committees (New York: W. W Norton & Company 1984) 144.

[10] For a detailed discussion of these particular lobby groups' role in the US politics, see Hedrick Smith, The Power Game (Glasgow: William Collins Sons & Co. Ltd 1988) Chapter 9 at 297- 373.

ideal to today's American society. Romano in a well- recognised attempt tried to answer the question whether American society is ruled by the concept of "atomic individualism" or "corporatism". In explaining the influence of political ideals on conceptions of the corporations in relation to corporate law reform, he suggests that in a corporatist society, the focus is on an organic conception of community which is a hierarchical organisation,[11] whereas according to the first ideal, the individual is the centrepiece of political and social life.[12] The leading company law commentator, Berle, relates the second ideal to the concept of corporation. He gives a great deal of credit to the role of corporate managers whose function is considered as that of disinterested public servants who provide the community with the stability necessary for the achievement of the corporation conception,[13] this conception is "collective soul" and the "conscience-carrier of twentieth century American society."[14] The managers, in Berle's view, further the goals of the community or whole corporation including shareholders, rather than their own interests,[15] and "run their affairs in the interests of their security holders".[16]

From those ideals, corporatism or atomic individualism, which one is serving another? In other words, which one is the eventual aim? While individualism and capitalism in the West, most particularly in the US, are twin concepts, corporatism can be considered as a vehicle for promoting those two conceptions. In first glance, it seems so. But a careful consideration proves that corporatism is increasingly becoming a new concept for individualism, and the corporation as special individual. Compared with the extreme individualism in the American perspective, the English perception of the dominant ideology is different. This ideal is also individualism, but an absolute conservative one, 'conservative individualism.' In this society, as a result

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[11] Roberta Romano, "Metapolitics and Corporate Law Reform", 36 Stan. L. Rev., (1984) 923, 934.
[12] Ibid at 938.
[13] Adolf A. Berle, Power Without Property (New York: Harcourt, Brace & Co. 1959) 20 3, 8.
[14] Adolf A. Berle, The Twentieth Century Capitalist Revolution (New York: Harcourt, Brace & Co. 1955) 148.
[15] Adolf A. Berle, "Corporate Powers as Powers in Trust" 44 Harv. L. Rev. (1931) 1049.
[16] Adolf A. Berle, "For Whom Corporate Managers Are Trustees: A Note" 45 Harv. L. Rev. (1932) 1365.

of the English traditional view, economy is based on capitalism system, and individualism is the dominant ideal. Therefore, individual in its real sense is in a superior position to the corporation.[17]

One agreeing with this theory, should not be surprised why the life of conservative governments in this country is much longer than others. In the light of this conclusion, the slogan of the conservatives, 'new labour- new danger' is, irrespective of its merits, more understandable. For such an extreme conservative society any basic changes means 'new danger'.

This conservatism not only in economic- political life but also in socio- cultural relationship is evident. That is why many people belonging to different religious-cultural sectors, find this country safer than other Continental societies[18] and even than the United States for their values and particularly their families.

The conservatism ideology can be traced in the process of the development of law. A comparison between English law and that of the US in the area of our research, proves that even non- protective and somehow oppressive stance of English law towards its corporate directors is a reflection of its socio- cultural as well as political ideal, "conservative individualism".

10. 3 Directors' Duties- The Main Similarity of the Two Laws

Although it is acknowledged that comparative work, particularly in relation to the US and English law, on directors' duties to shareholders and creditors is much more

[17] It should be noted that during the Thatcher's government, there was an extreme wave of Americanising the English political and cultural life. However, afterwards there has been serious attempts to confront the impact of that development. For example, politically for the first time after the II World War the UK government together with other EC States took stand against the US decisions and opposed the American sanctions against Cuba and secondary sanctions against Iran. Culturally, the UK policy makers surprised the world by putting a ban on the "CRASH" film which had been already screened in the US, Canada, Australia and some European countries.

[18] For example compare this situation with the Germany where racial violence is becoming a feature of daily- life of the society, or with France, as the contender of flag- bearer of freedom in Europe, where a Muslim school- girl has to choose between leaving the school or her scarf, which she considers as a part of her believes.

difficult than it seems at first glance,[19] it appears from our study on different aspects of directors' duties, liabilities, and protection of directors that directors' duties are, in the main, similar in the two legal systems. However, some developments taken place in English law are worth comparing with its comparator.

10. 3. 1 A Conceptual Question

As we have seen, the courts and commentators in the US are in consensus on the classification of directors' duties, as fiduciary duties of care and fiduciary duty of loyalty.[20] In English law, those duties are categorised under directors' duty of care and fiduciary duties. In other words, while in the US all directors duties toward their corporation, its shareholders and creditors fall within the general concept of "fiduciary duties", in England, the word of "fiduciary" is used as a narrow scope as loyalty in US law.

What is the root of this disparity and which classification is correct? Before answering this question, the fact should not be ignored that US law is still considered as a branch of [English] common law.

Black's Law Dictionary which represents the American law vocabulary, defines the term "fiduciary" as:

> "The term is derived from the Roman law, and means (as a noun) a person holding the character of a trustee, or a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candour which it requires ....

[19] Claus J. Hopt, Directors' Duties to Shareholders, Employees and Other Creditors: A View From the Continent, (Edit. Ewan McKendrick) (Oxford, New York, Toronto: Clarendon Press 1992) 115, 116.

[20] Morey W. McDaniel, "Bondholders and Corporate Governance", 41 Bus. Law. (1986) 413, 449, Marcelle R. Joseph, "When Is a Company up to Sale? The Case Against Revlon Duties", Annual Survey of American Law (1990) 271, 274, Morey W. McDaniel, "Bondholders and Stockholders-Fiduciary Duties to Bondholders", 13 J. Corp. L. (1988) 267, Sandra K. Miller, "What Standards of Conduct Should apply to Members and Managers of Limited Liability Companies", 68 St. John Law Rev. (1994) 21, 39, *Smith v. Van Gorkom,* 488 A.2d (Del. 1985) 858, 872- 73, B. M. Animashaun, "The Business Judgement Rule; Fiduciary Duties and Liabilities of Corporate Directors", 16 Southern Univ. L. Rev. (1989) 345, 347, James Farinaro, "Target Directors' Fiduciary Duties: An Initial Reasonableness Burden", 61 Notre Dame L. Rev. (1986) 723.

> A person or institution who manages money or property for another and who must exercise a standard of care in such management activity imposed by law or contract; e.g. executor of estate; receiver in bankruptcy; trustee."[21]

The definition has appeared in two separate paragraphs. Here, since the dictionary does not use numeric system, there is a confusion that whether i) these two paragraphs should be read together under a single definition, or ii) they separately connote two different meanings. The first possibility which is inconsistent with the US judges and Lawyers' interpretation of the word "fiduciary", gives the expression a wide ambit including both duty of care and loyalty, while the second view implies two different meanings. The first possibility is more justified, although the language employed seems more consistent with the latter.

It seems the word fiduciary in its Latin origin includes both duty of care and loyalty, the view which is adopted by the US courts, but in its modern and specific sense it illustrates some such elements as good faith and non- conflict of interests, the interpretation which is consistent with the English law stance.

The other conceptual question is relating to duty of skill. Although in English law the efforts to draw a clear distinction between the consequences and illustrations of duty of care and skill is not satisfactory, this system has at least recognised such a distinction and separated the duty of skill from the duty of care.

However, US law seems to have considered both terms in a single concept without making any attempt to define a duty of skill. One may regard this as a result of the American lawyers' and courts' attitude to apply a general single expression for different concepts, as it is the case in their application of "fiduciary" to mean both duty of care and loyalty.

10. 3. 2 Standard of Conduct- Objective or Subjective?

The standard to assess directors' exercise of their duties seems different in the two legal systems. In English law, the traditional rule has been to apply a subjective

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[21] Black, Black's Law Dictionary (St. Paul, Min.:West Publishing Co. 1990) 625.

standard, as referred to in the case of *re Brazilian Rubber Plantations & States Ltd.*,[22] where a director was required "to act with such care as is reasonably to be expected from him to act, having regard to his knowledge and experience." This is a very subjective test and the director's behaviour is to be judged based on the knowledge and skill he possesses but not what is required by the company's business. Here, the honest belief of the director is sufficient, anybody who claims the contrary has the burden of proof. In *re City Equitable Fire Insurance Co. Ltd.*,[23] almost a similar standard was employed. In this case, a director was asked to act as "may reasonably be expected from a person of his knowledge and experience." Perhaps the court, here, intended to impose a tougher standard than that in the former case where a director's conduct was compared with another person of his knowledge and experience. Although some leading commentators have suggested that Romer L. J.'s statement in that case prescribes a test which is partly objective,[24] it seems the nature of test is still subjective. Nevertheless, in comparison with *re Brazilian Rubber Plantations & States Ltd.*, the standard employed in the former shows a tendency to the objective test.

But, English law shifted from its traditional subjective view to a radical objective one by introducing a double test in section 214(4) of the insolvency Act 1986. However, it seems there is a new judicial trend to apply the section 214 standard to non-insolvency cases. The strong statement of Hoffmann L. J. in *re D' Jan of London Ltd.*,[25] where his Lordship said: "In my view, the duty of care owed by a director at common law is accurately stated in section 214 (4)", may lead to a radical change to the standard of directors' performance of their duties.

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22 [1911] 1 Ch.D. 425, 437.
23 [1925] Ch. 407.
24 Gower, Principles of Modern Company Law (5th ed.) at 587, A. L Mackenzie "A Company Director's Obligations of Care and Skill", JBL (1982) 460, 461.
25 [1994] 1 BCLC 561, 563.

In the US, and particularly in Delaware, this standard is "a reasonably prudent man"[26] that is based on a "care which ordinarily careful and prudent men would use in similar circumstances."[27] Hamilton has suggested that the American standard of care and skill embodying the concept of "an ordinarily prudent person in a like position" is partly an objective one. Therefore, he advises that aged, infirm, and ill directors should resign from the board of directors if they cannot actively participate in the board of directors.[28] To justify his view, he compares the above standard with that in *re City Equitable Fire Insurance Co. Ltd.*,[29] and concludes that unlike the US, the test in assessing English directors' performance is subjective.[30]

This conclusion is respectfully misleading. That is because the above English case was decided over seventy years ago, and since that time the objective test was introduced in Insolvency Act and Company Directors Disqualification Act 1986, two years before Hamilton's article was published. However, it is true that the above standard used in many American cases is similar to the objective test introduced in section 214 of the Insolvency Act. On the other hand, it is difficult to agree totally with Hamilton's interpretation that the standard of "an ordinarily prudent person in a like position" is partly objective, while this standard is based on what the director "reasonably believes to be in the best interests of the corporation".

10. 3. 3 Duties to Creditors in Insolvency: English Law Stance Is Clearer

In English case law, there is a consensus among the judges that once a company is in financial trouble, directors' duties shift from shareholders to creditors.[31] The case

26 Krishnan Chittur, "The Corporate Director's Standard of Care: Past, Present, and Future" 10 Del. J. Corp. L. (1986) 505, 539.

27 *Graham Alice Chalmers Mfg. Co.*, 188 A. 2d. (Del. 1963) 125, 130, followed by other States: *Francis v. United Jersey Bank*, 432 A.2d (N. J. 1981) 814, *Briggs v. Spaulding*, 141 U. S. (1891) 132, 133, *Pool v. Pool.*, So. 2d (La. Ct. App. 1943) 132. Also this standard was reformulated in the Revised Model Business Corporation Act, section 8.30(a) (1984).

28 Robert Hamilton, "The Duties of Corporate Directors and the Draft Fifth Directive: Lessons from the United States", 4 JIBL (1988) 152, 153.

29 [1925] Ch 407.

30 Hamilton, *op cit* at 153- 4.

31 *Brady & Avon. v. Brady & Avor*:[1987] 3 BCC, 532 *reversed* [1988] 2 W. L. R., 1308, *re Horsely, Ayerst v. C. & K. (Construction) Ltd.* [1976] A. C. 167, *re Instrumentation Electrical*

of *Welfab Engineers Ltd.*[32] appears to have taken a different view from the majority, where preserving the employees' jobs outweighed the immediate interests of the corporate creditors, and the society's long- term interests was a significant factor. Therefore, this case should be considered as an exceptional one.

This shift of duties in the verge of insolvency is also recognised by US law as an exception to the rule that directors' duties to creditors are contractual rather than fiduciary.[33] Unfortunately, the Bankruptcy Code is silent over corporate directors' fiduciary duties towards its creditors upon insolvency.[34]

This exceptional rule is based on the "trust fund" doctrine which opposes the rule of "agency theory". Nevertheless, this exception has been challenged by some American commentators who consider it as an interference in corporate management's affairs, particularly when the company is solvent but faced by financial depression.[35] Moreover, in the latter legal system, the view that upon the occurrence of insolvency the stockholders are no longer real parties in interests and do not, thus, benefit from directors fiduciary duties, has been strongly rejected, because it is contrary to the scheme and purpose of reorganisation which is designated to rescue the debtor in possession of which first of all its stockholders are to benefit.[36] It is true that despite such challenges to the propriety of creditors' rights in the onset of company insolvency or financial difficulty, the "trust fund" doctrine is the dominant view, but in comparison with the English law stand on the matter, US law still suffers from some lack of clarity.

Services Ltd. [1988] BCLC 550, *re Corbenstoke Ltd. (no. 2)* [1989] 5 BCC 767, *West Mercia Safetywear v. Dodd*, [1988] BCLC 250, *Winkworth v. Edward Baron Development Co. Ltd.*, [1986] 1W. L. R. 1512.

32 [1990] BCC 600.

33 *Commodity Futures Trading Commission v. Weintraub.* 471 U. S. (1985) 343, *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F. 2d (4th Cir. 1982) 973, 976- 7, *Clarkson Co. Ltd. v. Shaheen*, 660 F. 2d. Cir. (1981) 506.

34 Meredith M. Brown, "When Corporation Is financially Troubled, Director's Role Changes", Nat'l L. J. (1991 May 20) S10.

35 Norwood P. Beveridge, "Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?", 25 St. Mary's L. Rev. (1994) 589, 621.

36 Harvey R. Miller, "Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations", 23 Seton Hall L. Rev. (1993) 1467, 1469.

Barrett has suggested that England until recently, unlike some of the United States jurisdictions, had not approved the principle that the interests of the company's creditors merit special consideration by directors where the company is insolvent.[37] The judgment of Jessel M. R. in *Wincham Shipbuilding Boiler and Salt Co.*[38] is considered as a general rule in English law where he said that: "directors are trustees for the shareholders, that is, for the company ... but directors are not trustees for the creditors of the company." Barrett relies on the American case of *Whitfield v. Kern*,[39] as the rule adopted by some American States, where it was held that "upon the insolvency of the ordinary private corporation a *quasi* trust relationship arises between its directors and creditors."

It is significant to answer the question what kind of measures directors of an English and US ailing corporation may take to save the company from eventual fall into liquidation. This question relates to rescue scheme designated by each legal system. The US law solution in this regard is the unique and well- known scheme of reorganisation under chapter 11 of the Bankruptcy Code.[40] In this system and in a reorganisation case, the role of directors is regarded significant for two reasons. First, because of their past control over the business affairs, they possess a huge source of information. Secondly, during reorganisation, the directors are the most adequate individuals for negotiating contracts with third parties.[41] Moreover, their experience is significant not only in helping a reorganisation plan, but also for co-operating with the trustee and the committee of creditors under section 1102 of the Bankruptcy Code.[42] However, the key decision- making authority is the US Trustee which may appoint a trustee or examiner and supervise the committee of creditors.

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[37] Reginald Barrett, "Directors' Duties to Creditors" 40 MLR (1977) 226, 227.
[38] [1878] 9 Ch.D 322.
[39] 192 A. (1937) 48.
[40] 11 U. S. C. A. (1993), the relevant sections are 1101 to 1174.
[41] Christopher W. Frost, "Running the Asylum: Governance Problems in Bankruptcy Reorganisation" 34 Arizona L. Rev. (1992) 89, 90.
[42] 11 U. S. C. A. section 1103 (c) (1993).

It is worth noting that whether shareholders after filing a bankruptcy petition still have some power to influence the board of directors' decisions or to appoint a new board is not clear. It has been held that if shareholders are not satisfied with a proposed plan of reorganisation, they may move to elect a more pro- shareholder board.[43] However, in another case, this view was rightly challenged, because upon the occurrence of insolvency, the corporate shareholders lose the right to elect directors, since "the shareholders would no longer be the real parties in interest."[44]

In English law, the administration procedure seems the most comparable to the reorganisation scheme in the US, since both are insolvency but not liquidation devices, and intended to reorganise or save the company. Under section 8(3)(a) of the Insolvency Act 1986, the main aim of an administration order is "the survival of the company, or the whole or any part of its undertaking, as a going concern," which is very similar to reorganisation. The crucial action which directors of an ailing corporation, who are willing to save the company as well as to prevent further loss to its creditors, may take, is to apply for an administration. This is provided in section 9 of the Act, where the company directors, along with company itself and its creditors, are the main parties which may apply for such an order. The directors have also the power to bring the petition on the company's behalf as a separate entity.

However, compared with a US chapter 11 reorganisation scheme where corporate directors still perform most of their powers, in English law once a company is put under an administration order, its directors become subject to the control of the administrator. The latter not only can 'do all such things as may be necessary for the management of the affairs',[45] but he is also empowered 'to remove any director of the company and to appoint any person to be a director of it, whether to fill a vacancy or otherwise.' This extreme extension of administrator's powers goes further when any power conferred on the directors by the statutes or by the memorandum or articles

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[43] *Heck's*, 112 B. R. (Banks. S. D. W. Va. 1990) 775, 798.
[44] *Johne-Manville Corp.*, 801 F.2d (2d Cir. 1986) 60, 65.
[45] Section 14(1)(a) of the Insolvency Act 1986.

of association, which could be exercised in such a way as to interfere with the exercise by the administrator of his power, are not exercisable without the administrator's consent. The consent may be given either in general management of the company's business or in a particular case.[46]

10. 4 Liability of Directors- English Law in Upper Hand

10. 4. 1 The Source of Liability

In our study of directors liabilities in English company law, there was quite an exhaustive examination of the historical background of the statutes and legislative process. One feels that English law as the mother of one of leading legal systems, common law, is still based on the traditional common law rules derived from cases. It is true that most statutory provisions can be traced through new perception of the traditional common law rules such as duty of care or through equity principles the good example for which is a fiduciary position. However, the judges are nowadays required to comply with the wording of the statutory provisions and real intention of the legislator, rather than their colleagues' contemplation in their decision- making process. For example, a judge's holding will be reversed when he has followed the traditional common law rules in assessing a respondent's conduct which imposes a subjective standard in a wrongful trading case, rather than the provisions of section 214 of the Insolvency Act 1986 which has obviously departed from those rules.

Today's English company law, particularly relating to corporate officers and directors is statutory law. The courts are obliged to interpret and apply the statutory provisions irrespective of whether it is in agreement with the common law principles or previous judicial decisions. As to the subject of this study, directors liabilities in corporate insolvency, the first statutory provision on misfeasance proceedings was enacted in 1862.[47] This was followed later in other legislation on directors liabilities

[46] Ibid subsection (4).
[47] Section 165 of the Companies Act 1962.

for acting and conducting business with intention to defraud its creditors. In 1928 the first fraudulent trading provisions appeared in the Companies Act, section 75(4). Here, another significant move can be seen in regulating corporate directors duties and liabilities, which was the imposition of an additional or supplementary liability, that was later introduced in the form of a formula known as "disqualification" in section 275 of the Companies Act 1929.

The last step in this development was the introduction of a new and controversial concept as "wrongful trading" in the shape of section 214 of the Insolvency Act, together with new obligatory provisions of section 6 of the Company Directors Disqualification Act.

In the United States company law, there is no particular statute to regulate directors liabilities in insolvency. Therefore, the courts in their decision- making rely on the common law and company law rules based on their own interpretation of such principles. In this law, liabilities of directors of an insolvent corporation are discussed separately from those of a bankrupt debtor in possession under chapter 11.[48] It is said that under the Bankruptcy Code, bankruptcy of a corporation shall not release its directors from any liability under the State or federal laws. This is to preserve the creditors' rights against negligent or dishonest directors.[49] However, the Bankruptcy Code has been criticised because of the extent of authorisation it provides for the bankruptcy courts to impair the rights of creditors, particularly those of secured creditors.[50] Chapter 11 and bankruptcy jurisprudence focuses on the concept of reorganisation as a proceeding during which a debtor corporation can be

48 H. R. Miller, "Corporate Governance in Chapter 11; The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations." 23 Seton Hall L. R. (1993) 1467, 1485.

49 G. Stanley Joslin, "Corporation Officers and Directors: Involvements in Bankruptcy", Corporate Practice Commentator (1968- 9) 141, 146.

50 Frank R. Kennedy, "Secured Creditors under the Bankruptcy Act" 15 Ind. L. Rev. (1982) 477, 499.

rehabilitated, jobs saved, capital preserved, and creditors repaid.[51] But the Code is surprisingly silent as to directors' liabilities in or on the verge of insolvency.

In the absence of any statutory provisions or codified rules, public view and the role of pressure groups indeed play an important role in affecting the courts' decisions. A good example for this, is the reaction of legal and business sectors to the Delaware Supreme Court's decision in *Smith v. Van Gorkom*.[52]

Delaware, as the leading company law jurisdiction, does not seem prepared to take the reign of a new movement for curing this old and obvious injury by introducing some statutory regulation on corporate directors liabilities in general and their liabilities in insolvency in particular, as it did in liabilities elimination provisions.

10. 4. 2 Who Takes the Action?

In England, when a company is insolvent, under sections 213 and 214 of the Insolvency Act, the only person entitled to bring a fraudulent or wrongful trading suit is the liquidator, whereas according to section 212, an action for breach of duty or any other misconduct set out in that section can be brought by not only the corporate liquidator and official receiver, but it may be also commenced and proceeded by a creditor or any contributory. As a rule in English company law reflected in those statutory provisions and exercised by the courts, if in the course of winding up it appears to any of those authorities accordingly that one of the wrongs mentioned in the above sections has been committed by a director, the latter may be sued. Therefore, to take such an action, the company must be wound up. Otherwise, and outside the winding up, it is the directors who may do so, and in the case of the director's refusal, a shareholder is permitted to apply to the court for an order on the ground that the company's affairs have been conducted prejudicial to its members'

51 Donald R. Korobkin, "Rehabilitating Values: A Jurisprudence of Bankruptcy", 9 Colum. L. Rev. (1991) 717, Mike Roberts, "The Conundrum of Directors' Duties in Nearly Insolvent Corporations", 23 Memphis State Univ. L. Rev. (1993) 273, 274.

52 488 A.2d (1985) 858.

interest.[53] Moreover, the Secretary of State has the right to apply for such an action.[54]

In contrast, in the US, the matter can be considered from two views, when the company is insolvent but no petition for bankruptcy is filed, and the situation when the formal procedure for filing such a petition is proceeded. Upon insolvency or illiquidity and before filing a bankruptcy petition under Bankruptcy Code, only one group of claimants can be recognised. With regard to the *Smith v. Van Gorkom*[55] case, corporate shareholders can sue its directors for their alleged breach of duties. In that case, all the story took place when the corporation's stock was undervalued, or it was technically insolvent.[56] However, the plaintiffs were its shareholders but not creditors or trustees.

This is obviously a result of the lack of any statute regulating the conduct of directors in insolvency in US company law. The case was brought before filing the bankruptcy petition, the shareholders were, thus, the only authorised persons for doing so, since because members of the board of directors were charged with negligence they could not take the case as plaintiffs.

After filing the petition, two classes of claimants have the right to sue corporate directors. The first group are the corporate creditors. There is no statutory authority to permit this group of claimants to bring their suit before filing such a petition even when they can show that due to the deteriorating situation of the company, they are interested parties to the company's affairs. Once a bankruptcy petition is filed, section 362(a) of the Bankruptcy Code imposes an automatic duty that prevents creditors from pursuing collection of their debts against the debtor,[57] and most of the weapons which were in the hands of shareholders or creditors prior to and upon insolvency respectively, are removed or ineffective. In this situation, creditors are

53 The Companies Act 1985, section 459.
54 Ibid section 460.
55 488 A.2d (1985) 858.
56 Ibid at 866.
57 U. S. C. A. section 362(a) (Supplement 1995).

forbidden from enforcing State law rights and remedies against the debtor in possession, thus, directors personally are desirable targets for an insolvent corporation' creditors.[58]

Therefore, the decisive point, here, which allows creditors to interfere, is filing a petition for bankruptcy but not actual insolvency, and the cases in which creditors have been plaintiffs are bankruptcy cases. For example in *re Xonics, Inc.*,[59] the committee of creditors of the Xonics company brought the action against its directors for alleged breach of fiduciary duty to the corporation creditors. Similarly in *Logue Mechanical Contracting Corp.*,[60] the company's creditors were the claimants.

The second and the main category of plaintiffs for the alleged directors' misconduct, is trustees or trustees in bankruptcy. In *Francis v. United Jersey Bank*[61] as well as *Clarkson Co. Ltd. v. Shaheen.*[62] for example, the suit was commenced by trustees in bankruptcy.

In this respect, there is a confusion over the position of company directors who become trustees of the company. In most cases, directors of a troubled company are appointed as trustees of the estate created by filling bankruptcy petition. Although the courts prefer to appoint an independent trustee in order to administrate the estate, when an independent trustee is not appointed, the board of directors is to operate the company as a debtor in possession and "shall perform all functions and duties ... of a trustee".[63]

The question may be raised that in such a case, if there is a case of directors' delinquency prior or upon its insolvency, do they take the action as trustees against themselves or some of their colleagues? What will happen if they refuse to do so?

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[58] Kimberly Colby Harris, "The Impact of Bankruptcy on Liability of Corporate Directors", <u>Bankr. Dev. J.</u> (1987) 289.
[59] 99 B. R. (Bankr. N.D. Ill. 1989) 870.
[60] 106 Bankr. (1989) 436. For the story and fate of these two caes see Chapter 7: Directors Liabilities for breach of their Duties.
[61] 432 A.2d (N.J. 1981) 814.
[62] 660 F. 2d. Cir. (1981) 506.
[63] 11 U. S. C. section 1106 (Supplement 1995).

Regrettably, there is no case to address the question. However, one may compare the position of directors, here as trustees, with their position when the corporation is a going concern on one hand, and the position of creditors, here, with shareholders outside the bankruptcy on the other hand, and conclude that the same rules which apply to derivative actions and the role of the special litigation committee are applicable here. But this analogy does not work in an insolvency case, not only because there is no statutory or judicial authority to allow that conclusion, but because the rules applicable to an insolvency or bankruptcy situation are different. Obviously, the only justified suggestion, in the presumed case, appears to be that the creditors can take their own suit with no need to refer to the board of directors, now operate as trustees, and apply to the court for the replacement of those directors with an independent and disinterested trustee.

10. 4. 3 Fraudulent and Wrongful Trading, and Misfeasance- the American Perception

We studied corporate directors' liabilities in English law under three headings, fraudulent trading, wrongful trading and misfeasance. While the last one has a judicial record even prior to its introduction by the legislature, the two other concepts are inventions of the law- makers.

A court in England and Wales can now with no difficulty apply one of those proceedings to a wrongdoing committed by a corporate director.

But, in dealing with US law in this field, the first problem which the reader faces is the lack of such a codification or even any judicial guidance in recognising or defining those concepts. It has been acknowledged by some American commentators and can be elicited from cases on directors liabilities, that in the United States these liabilities are classified within four contexts: i) breach of duty of care (negligence), ii) conflict of interests or self- dealing (disloyalty), iii) appropriation of corporate opportunity, iv) and statutory liability.[64] The third category is considered in case law as an implication of the second, breach of fiduciary duty of loyalty, while the fourth category is related to liabilities under Securities Act, Securities Exchange Act, Fraudulent Conveyance Act and Bankruptcy Code, none of which except some provisions of the last one, if any relevant, is within our study. In other words, the source of our study in US is case law, under two concept of breach of duty of care and loyalty.

Those concepts in the US case law are neither recognised nor are they defined. Moreover, from view of the American judges and commentators, holding a director liable even for breach of duty of care is very unusual,[65] which means it is rare and more difficult to have a director liable for breach of duty of loyalty or fraudulent conduct. This difficulty is made greater by the lack of a clear definition of directors liabilities which in some cases makes it particularly difficult to define the line between liability for negligence and fraud.[66] The confusion over a distinction between directors liabilities in the US can be seen even in some leading cases such as *Francis v. United Jersey Bank*,[67] where the court explained the conduct of the defendant as fraudulent conveyance and ordered him liable for negligence. Whereas in an English court it may never happen that the judge in a negligence case speaks of a fraudulent conduct, though that view was corrected by the US Supreme Court.[68]

All American cases with similar facts to those of wrongful or fraudulent trading cases in English law have been considered and decided under breach of duty of loyalty or fraudulent transfer of the company's assets. In *Logue Mechanical*

64 Russel K. Bean, "Corporate Director Liability", 65 Denver Univ. L. R. (1988) 59.
65 Joseph W. Bishop, "Sitting Ducks and Decoy Ducks; New Trends in the Indemnification of Corporate Directors and Officers", 77 Yale L. J., (1968), 1078, 1095. See also *Bayer v. Beran*, 49 N. Y. S. 2d (Sup. Ct. 1944) 2, 6.
66 See for example *Bayer v. Bayer*, 49 N.Y.S. 2d (Sup. Ct. 1944) 2, Richard B. Dyson, "The Director's Liability for Negligence", 40 Ind. L. Rev. (1963- 5) 3431, 371, citing *Prokson v. Bettendorf*, 218 Iowa (1934) 1376. *Conrick Houston Civic Opera Ass'n*, 99 S.W. 2d (Tex. Cin. App. 1936) 382.
67 432 A.2d (N.J. 1981) 814.
68 Ibid at 817.

Contracting Corp.,[69] for example, the company's creditors alleged that the directors concerned had breached their fiduciary duty of loyalty. The respondents, here, continued to trade in order to pay themselves in the form of salaries, benefits and rents to the detriment of the corporation and its creditors, while the company ought to have ceased all operations. This caused a considerable decline in the amount on deposit and loss of some jobs. The defendant directors did so when they knew that their company could not be rescued from liquidation and they "had no hope of reorganising" the corporation.[70]

In the above case, the corporate directors' conduct was a clear act of carrying on the business to defraud its creditors, since it was evident to the respondents that their corporation could not survive financial depression, but instead of filing a petition for bankruptcy, they filed a reorganisation proceedings with intent to further their own personal interests at the creditors' expense.

Another case parallel to the English fraudulent trading concept is the case of *Clarkson Co. Ltd. v. Shaheen.*[71] Here, the claim was filed under breach of fiduciary duty of loyalty, and the court in its judgment expressly held the defendant liable as such, but the court acknowledged that because the loan and advancement in question was made with no fair consideration, and a Promissory Note and Letter Agreement executed when the company was insolvent, it was, thus, fraudulent to creditors.

In this case, a statement was made by the judge which was very similar to some provisions of fraudulent and wrongful trading sections. The court, here, held the respondent liable on "the finding that the directors *knew or should have known* that the "loans" were made *when NRC was insolvent* ... ."[72] This part of the judgment is very much like this piece of section 214 of the Insolvency Act "that person *knew or ought to have concluded* that there was no reasonable prospect that the company

[69] 106 Bankr. (1989) 436.
[70] Ibid at 440.
[71] 660 F. 2d. Cir. (1981) 506. For the details of this and the above case see Chapter 7: Directors Liabilities for breach of their Duties.
[72] Ibid 513. Emphasis added.

would avoid going into *insolvent liquidation.*"[73] In the same case, the jury found the directors liable for "breach of their fiduciary duties owed to creditors",[74] which was a fraudulent transfer "*with intent to delay and defraud creditors.*"[75] Comparing that part of the holding with this part of section 213 of the Insolvency Act that "If ... it appears that any business of the company has been carried on *with intent to defraud creditors of the company*"[76] leads us to the conclusion that concepts similar to fraudulent and wrongful trading have already been considered by the US judges, but it requires an attempt to regulate them under proper provisions in the form of statute, or at least to reach a common recognition by the courts.

As to liability for misfeasance, section 212 of the Companies Act has set out a wide range of acts giving rise to a director liability. The US case law has recognised all those matters under breach of duty of care and loyalty. It is the only common ground between the two legal systems on the corporate directors liabilities. That is because in both laws not only a director is held responsible for similar acts, but most importantly because the standard of conduct is subjective. Although, unfortunately and unlike English law, in the US that procedure is not addressed in a particular statutory provision, case law in this regard is clear. However, it seems the courts in the two countries do not employ the same measure in assessing a corporate director's conduct. Delaware takes the same measure as used to be taken in the past by the English courts which is "gross negligence".[77] But, nowadays in England specially after the introduction of the objective standard in section 214, and the judgment of Hoffmann L. J. in *re D' Jan of London Ltd.*,[78] the line between "ordinary negligence" and "gross negligence" is fading.

[73] Emphasis added.
[74] Ibid at 515.
[75] Ibid at 511. Emphasis added.
[76] Emphasis added.
[77] Compare for example the Delaware cases of *Smith v. Van Gorkom* 488 A.2d (1985) 858, at 893-94, *Aronson v. Lewis.* 473 A. 2d (Del. 1984) 805, 812, *Rabkin v. Philip Hunt Chemical Corp.* 547 A.2d (1986) 963, *Allaun v. Consolidated Oil Co.*, 16 Del. Ch. 318, 147 A. (1929) 257, 261 with the English cases of *Turquand v. Marshall* [1869] 4 Ch App. 376, *re National Bank of Wales Ltd.* [1890] 2 Ch 629, 671.
[78] [1994] 1 BCLC 561, 563.

10. 5 Disqualification of Executives: New but Arguable in the US Law

10. 5. 1 The US Introduces Its Own Version of Disqualification

For the first time in the US corporate law, the Securities Enforcement Remedies and Penny Stock Reform Act 1990 (the Remedies Act) permitted that in an enforcement action by the Securities Exchange Commission (SEC) upon finding that a defendant director or officer has violated either section 17(a)(1) of the Securities Act 1933, or section 10(b) of the Securities Exchange Act 1934, a federal court may, additional to monetary penalties, order the defendant to be suspended or barred temporarily or permanently from acting as a director or officer of any public company.[79]

The legislative history of the Remedies Act dates back to 1987 when the National Commission on Fraudulent Reporting recommended that: the SEC should "seek [congressional] authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company."[80]

The US version of disqualification is in the earliest stage of its development, while the English experience has seven decades of history. However, the need for regulating disqualification in a statutory form had been acknowledged by the American lawyers, who called for providing a power to disqualify an executive director and officer in order to prevent any confusion over the existence and scope of such authority.[81]

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79 The Act provides that "In any proceedings under subsection (b), of this section, the court may prohibit conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated section 77q(a)(4) of this title from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 78*l* of this title or that is required to file reports pursuant to section 78o(d) if the person's conduct demonstrates substantial unfitness to serve as an officer or director of any such company." 15 U.S.C.S. 77t (e) (1995).

80 Report of the National Commission on Fraudulent Financial Reporting (1987) 1, 66.

81 Allan M. Dershowitz, "Paper Label Sentences: Critique", 86 Yale L.J. (1977) 626.

It should be noted that the Americans were familiar with such a conception in non-corporate law areas. In several federal statutes, disqualification had been permitted. For example, the Federal Deposit Insurance Act 1950 permits disqualification of a person who is held liable for any criminal offence involving dishonesty or breach of trust from serving as a director, officer, or employee of a federally insured bank.[82]
With regard to judicial background of corporate directors disqualification in the US, and its prospect in the English case law, it is true that while the judges in the latter began applying disqualification only after the enactment of the Companies Act 1928, the US Federal Courts have recently begun to disqualify corporate executive directors and officers.[83]

10. 5. 2 The Court or a Regulatory Agency to Decide Unfitness?

The Remedies Act bill provides that the SEC may, in an administrative compliance action under section 15(c)(4) of the Exchange Act,[84] make a conditional or unconditional, and either permanent or temporary suspension or bar order against any person found to have failed to comply, or to have been the cause of the failure to comply with sections 12, 13, 15(d) or 16(a) of the Act, if the SEC is satisfied that such an order is "in the public interest."[85]
Moreover, even prior to the Remedies Act, SEC had power to seek an injunction where it is satisfied that a person "is engaged or [is] about to engage in any acts or practices which constitute or will constitute a violation" of the Securities Acts.[86]
In English law, the Department of Trade and Industry may be a parallel to SEC of the US in this regard, though with different power and authority. So long as the SEC

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[82] 12 U.S.C. section 1829 (1995). Labour law also permits a disqualification on the ground of the Labour-Management Reporting and Disclosure Act of 1959, 29 U.S.C. sections 401-531 (1995).
[83] For example in *Cooke v. Teleprompter Corp.*, 334 F. Supp. (S.D.N.Y. 1971) 467, 47, the court stated that "in a civil action to disqualify a director ... the quantum of proof will be less than that required to obtain a criminal conviction."
[84] 15 U.S.C. 78o(c)(4) (1988).
[85] H.R. 975, 101st Congress., 1st Session 135 Congress. Record. H272 (1989) Section 201.
[86] 15 U.S.C. section 77t(b) (1988) (The Securities Act 1933); 15 U.S.C. section 78u(d) (1988) (Securities Exchange Act 1934).

function is to prepare reports on directors and officers' conduct and to take actions against them when it finds it appropriate, it runs in the same line as DTI. However, SEC is authorised to go much farther by acting as "more than a party to an action". This commission "by order shall censure, place limitations on the activities, functions, or operations of , suspend for a period not exceeding twelve months, or revoke the registration"[87] of an individual from acting in a vast range of capacities, the role which in the English law is absolutely left to the courtroom. Such a power vested in SEC by the Remedies Act is indeed a job of the courts rather than a regulatory agency like SEC.[88]

Putting this wide discretion into hands of a non- judicial authority may leave the runners of business organisations vulnerable to interference or abuse which is contrary to the American legislature well- established view, particularly its protective stance towards corporate directors reflected in the business judgment rule and other protective States legislation.

10. 5. 3 Purpose and Nature of Disqualification

As was seen, there is no unanimity among English commentators and judges over the purpose of disqualification proceedings. However, I suggested that the aim and purpose of the proceedings could be equally a civil- penal and protective one. In US law there seems to be confusion over the issue. Barnard explains the purpose and philosophy behind the Remedy Act as "barring a defendant from future service as a corporate officer or director is an expeditious mechanism, short of incarceration, for removing him from temptation and the likelihood of renewed misconduct ."[89]

McDermott gives three different statements of purpose of disqualification which are similar to those purposes suggested for disqualification in English law. On one hand,

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87 15 U.S.C. Section 78o(b)(4) (1995).

88 Jayne W. Barnard "The Securities Law Enforcement Remedies Act of 1989: Disenfranchising Shareholders in Order to Protect Them", 65 Notre Dame L. Rev. (1989) 32, 70. [Thereafter Barnard Notre Dame L. Rev.] citing *Kennedy v. Mendoza-Martinez*, 372 US. (1963) 144, 167.

89 Jayne W. Barnard, "When Is a Corporate Executive "Substantially Unfit to Serve"? 70 North Carolina Law Rev. (1992) 1489, 1494.[Thereafter Barnard North Carolina Law Rev.]

he describes provisions as intended to penalise an officer or director of a business organisation for his misdoing,[90] and on the other hand, he is of the view that because a disqualification order damages the defendant's "future employment opportunities it serves as a monetary penalty, even for those defendants who have no present ability to pay a substantial fine."[91] This view is obviously consistent with a civil approach on the purpose of disqualification. McDermott adopting that deterrence is not the only theory of punishment underlying disqualification, takes the opinion that the protection of society may justify disqualifying those who have demonstrated their readiness to commit an offence.[92] It seems McDermott is not certain on one of those suggestions, but appears to lay down a single view with a three penal- civil and protective purpose.

The US case law is not helpful in this respect. However, it seems disqualification is considered by commentators as having a criminal nature. Barnard obviously acknowledges the punitive nature of disqualification when she states that a "disqualification from employment has historically been regarded as a punishment in criminal proceedings."[93]

10. 5. 4 Other Comparative Aspects of Disqualification

There are some features which distinguish the disqualification in English law from that in the Remedies Act 1990 in the US.

The major distinction is the event of insolvency which is the main feature of the disqualification in the former law, particularly under sections 6 and 10 of the Company Directors Disqualification Act 1986, whereas there is no such requirement for making a disqualification order under the latter law. Therefore, it is difficult to use cases decided under the Company Directors Disqualification Act as a model to

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90 Martin F. McDermot, "Occupational Disqualification of Corporate Executives: An Innovative Condition of Probation", 73 J. Crim. L. (1982) 604.
91 Ibid at 616.
92 Ibid at 617.
93 Barnard 65 Notre Dame L. Rev. at 70, See generally McDermot, *op cit* particularly 607- 8.

determine substantial unfitness under the Remedies Act, since the insolvency requirement is described as 'a feature of British national revenue policy rather than of any policy relating to the protection of investors.'[94]

The grounds for disqualification of which unfitness is the leading factor, have been set out in the English Act of 1986. The US Act of 1990 refers to the power of a federal court to disqualify when it finds the defendant "substantially unfit", the concept which is now the main concern of American commentators in their interpretation of disqualification. In English law, although the legislators have not defined "unfitness", the measures to determine unfitness are set out in Part I, when the company is going concern, and in Part II of Schedule I of the Company Directors Disqualification Act 1986, when it is insolvent.

However, it is said that some certain grounds for unfitness such as incompetence, physical or mental incapacity are sufficient to support a finding of unfitness under the Remedies Act, while other grounds such as interpersonal discord, neglect of duty or usurpation of corporate opportunity may not be helpful in this regard.[95]

Moreover, the fact should be carefully taken into account that a pre- requisite for the application of the Remedies Act 1990 is liability under the Securities Exchange Act 1934 and the Securities Act 1933, though the substantive terms of this legislation is out of our discussion, whereas disqualification provisions provided by the 1986 Act cover a vast range of matters covered by the Insolvency Act, Companies Act and some common law rules.

Furthermore, the English disqualification provisions apply to corporate directors but not officers, apart from their position as executive or non- executive, whereas the disqualification permitted under the Remedies Act, embracing both officers and directors, applies only to those in an executive capacity.

The other major distinctive point in this regard, which is also a basic criticism of the Remedies Act, is the lack of any relief available to a disqualified director or officer.

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[94] Barnard, 70 North Carolina Law Rev. at 1501.
[95] Ibid at 1496.

The court has a very wide discretion to determine whether the defendant is unfit and hence hold him disqualified. This extensive power is more questionable when no measure is provided by the Act to define the limits on the courts' discretion.

The English law in this regard is in a more favourable position, where a court is authorised to grant a leave to the disqualified director to carry on to act as a director while disqualified, based on such considerations as reliance on an expert advice, the effects of such an order upon the company and its employees.

However, one may try to justify this obviously weak aspect of the Remedies Act by arguing that the disqualification in section 6 of the 1986 Act, on the basis of which most of recent disqualification cases in English law have been decided, is of a mandatory nature, whereas the courts' power in the Remedies Act by stating "the court may", is absolutely discretionary. But this argument cannot justify such a big deficiency of the Act, when the question is not the harshness of the disqualification provisions, but rather the improper drafting of a crucial part of the Act.

It is worth noting that although the Remedies Act provides no means of granting a leave or lifting the bar, the Supreme Court on one occasion has indicated that such relief can be granted only upon a "clear showing of grievous wrong evoked by new and unforeseen conditions"[96]

The other criticism which relates to the above mentioned point is the question of the period of a suspension or bar order against a corporate executive officer or director under the Remedies Act, and its comparison with that in the English Act of 1986. The minimum period of time for disqualification of an English director is two years and the maximum time of such an order in very serious cases of unfitness is fifteen years. Whereas not only there is no such a minimum period for a suspension or bar order in the Remedies Act, but also the court may permanently bar or suspend the defendant executive, the power which may be considered as dangerously unwise,

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96 *United States v. Swift & Co.*, 286 US. 106, (1932) 119, cited with approval in *SEC v. Blinder, Robinson & Co.*, 855 F.2d 677 (10th Cir. 1988), cert. denied, 109 Sup. Ct. (1989) 1172, noted by Barnard 65 Notre Dame L. Rev. at 62.

particularly since it comprehensively prohibits a suspended or barred executive from acting in any public corporation as a director or officer, irrespective of the nature of the business.

It is not clear why, while the US Congress had experienced some enactment on the same matter in non- corporate area,[97] it took such a tough stand towards executive directors and officers of public corporations.

In addition to the above- mentioned deficiencies of the disqualification mechanism under the Remedies Act, some other criticisms have been acknowledged by the American commentators such as its inconsistency with the legislative history of the federal securities laws which have been designed to minimise interference with matters of corporate governance.[98]

Moreover, it is in contrast with the philosophy and purpose behind the business judgment rule that corporate directors are the ones who are well- suited in managing business affairs rather than the courts.[99]

Comparing the attitude of the English legislature to disqualification in the 1986 Act with the US legislators' stand in the Remedies Act 1990, leads us to the conclusion that the English legislature by introducing its new version of disqualification followed the same line on treating corporate directors, but there seems to be a major difference between the Remedies Act message and the well- recognised rule of the business judgment rule on the one hand, and other States protective statutes such as elimination of directors liability, indemnification and insurance on the other hand.

Does it mean there is a disagreement on how to deal with corporate directors and officers liabilities between federal and States laws?

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97 For example see the Federal Deposit Insurance Corporation, 12 U.S.C. s. 1829 (1988).

98 George W. Dent, "Ancillary Relief in Federal Securities Law: A Study in Federal Remedies", 67 Minn. L. Rev. (1983) 865 909, Barnard, 65 Notre Dame L. Rev. at 43.

99 *Kmin v. American Express Co.*, 383 N. Y. S.2d (1943) 807, 810- 11. Dennis J. Block & H. Adam Brussin, "The Business Judgment Rule and Shareholder Derivative Actions: Via Zapata", 37 Bus. Law. (1981) 31, Dennis J. Block et. al., The Business Judgment Rule: Fiduciary Duties of Directors,.(Englewood Cliffs: Prentice Hall Law & Business 1993) 6-7.

10. 6 US Law Is More Protective

Every legal system has provided some means to absolve its directors and officers from liability in order to reduce their concern over taking risky business decisions that they honestly consider to be in the best interests of their corporation. It is justified that the directors in managing their corporation take risky business judgments which in some occasions incur losses to the corporate shareholders or its creditors. Such losses may lead to an action against the directors concerned for allegedly causing the losses. Therefore, directors who have exercised their duties in good faith should be protected from personal liability.

A review of and a comparison between the protection provided by the two legal systems, obviously leads to the conclusion that US law, particularly Delaware law is more protective to the corporate directors.[100] Perhaps the reaction of the US law community to the Gorkom decision is an obvious evidence to prove this claim. The decision of Gorkom was described by the president of National Association of Corporate Directors as creating "perilous time for corporate directors",[101] and "the straw that broke the camel's back".[102] A Legal writer said that the Gorkom case so scared directors and their insurers that the Delaware legislature which is followed almost by two- third of other States, passed a statute eliminating directors' liability for negligence.[103] Some leading commentators stated that the decision in Gorkom shocked the corporate world,[104] and "exploded a bomb".[105] It was also criticised as

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[100] B. A. Animashaun, "The Business Judgment Rule; Fiduciary Duties and Liabilities of Corporate Directors", 16 Southern Univ. L. Rev. (1989) 345, 349.

[101] Glaberson and Powel, "A Landmark Ruling That Puts Board Members in Peril, Bus. Wk., (1985) 56, 57.

[102] Mauro, "Liability in the Boardroom", Nation's Bus. (May 1986) 46.

[103] Larry D. Soderquist, "The Proper Standard for directors' negligence Liability", 66 Notre Dame L. Rev. (1990) 37.

[104] Stephen Radin, "The Director's Duty of Care Three Years After Smith v. Van Gorkom", 39 Hastings L. J. (1988) 707.

[105] Bayless Manning, "Reflection and Practical Tips on Life in the Boardroom After Van Gorkom", 41 Bus. Law., (1985) 1.

"dumbfounding", a "serious mistake"[106] and "one of the worst decisions in the history of corporate law".[107] It was called "a distinct threat to the ability of companies to attract responsible directors".[108]

There is not a similar reaction in the history of English company law even to more oppressive decisions against directors. In contrast, the tendency among English commentators is a tougher judicial response to the corporate directors delinquency.

10. 6. 1 Indemnification and Insurance

Indemnification and insurance are products of the American legal and business needs and developments rather than those of the traditional common law rooted in English law. This industry is at best represented and developed in Delaware. The extent of authority provided by section 145 (a) of the Delaware law in comparison with section 310(1) of the English Companies Act, is so wide that it provides not only indemnity against expenses of defence, irrespective of whether or not the defendant director has had a successful defence, but also it permits indemnity against "judgments, fines and amount paid in settlements actually and reasonably incurred by him in connection with such action, suit or proceedings". This authority is granted to the corporations to indemnify their directors against any such actions. The US legislature has employed the words "the corporation may indemnify" to reveal the permissible nature of the protection. Therefore, procedure and extent of the indemnity is subject of the corporation's decision or any mutual agreement between the corporation and its directors. So long as the terms of such an agreement or decision do not contravene public policy principles or limits set out in the section including action "in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation," they are valid and enforceable.

106 Leo Herzel, Davis, and Calling, "Smith Brings Whip Down on Directors' Backs", Legal Times of Washington, (May 1985) 14, 15.
107 Daniel Fischel, "The Business Judgment Rule and the Trans Union Case", 41 Bus. Law. (1985) 1455.
108 Borden, "First Thoughts on Decision in Delaware on Trans Union", N. Y. L. J. (February 1985) 1.

In contrast, English law has refused to recognise any sort of indemnification except in a very limited extent against liability for expenses of defence, only when the "judgment is given in his favour or he is acquitted" or in connection with any application under section 144(3) or section 727.

On the other hand, the Delaware law offers some more protection in the form of indemnity. While English law just does not prevent a corporation to indemnify its directors for expenses of their successful defence, the Delaware law imposes an obligation upon Delaware companies to indemnify their directors in a similar situation by saying "he shall be indemnified."[109]

In comparing the two laws in this regard, the interesting point is that while besides wide indemnification permitted by the Delaware law, it provides an obligatory indemnity against expenses in a successful defence, the English law even does not recommend, nor does it require the indemnification in the latter situation, but in most "does not prevent a company" of doing so. The language employed in section 310(1) obviously reveals the reluctance of English Parliament to provide corporate directors with such an indemnification.

Baxter comparing with the US law, thinks in English law:

> "The position under the most liberal indemnification statutes is not much different from that obtaining as a result of the combination of the Companies Act section 727 and the virtually unrestricted freedom of shareholders to provide indemnities after a loss has arisen."[110]

With respect, as will be seen, the protection provided by section 727 is not more generous than that under the business judgment rule. Moreover, the freedom of shareholders to provide indemnity is, as was mentioned, restricted to the expenses of a successful defence. There is indeed nothing in English law, either in statute or case law, to allow any indemnification for loss even after its occurrence. Conversely, the statute's prohibitive language is clear, and the only exception to that prohibition is subsection (3).

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109 Section 145 (c) of the Delaware General Corporation Law.
110 Colin Baxter, "Demystifying D & O Insurance", OJLS (1995) 537, 564.

As to insurance, the main concern is background and the root of this industry in the two countries. At the outset, it is necessary to note that directors insurance liability is an American export, which has been with its policy provisions, substantially unaltered, imported by English law.[111] Therefore, a reader of English law in this specific area, should not wonder why this legal system had treated it as an unwanted external industry, and why English law has not offered anything in this regard.

The US insurance liability for directors had been purchased in the 1930's, and the 1941 New York law which was copied by Delaware law in the form of section 145(g), permitted purchasing and maintaining insurance, whereas its English comparator after a half of century only removed its prohibition.

The Delaware law allows insurance to be purchased not only against directors and officers liabilities, but also against liability of employees and agents of the company. But English corporations are not prevented from purchasing insurance liability for their directors, officers and auditors. Furthermore, the extent of D & O Insurance liability permitted by the Delaware law is much wider than that in English law, since the former permits such protection even against those liabilities which the corporations are not empowered to indemnify. This apparently means that the scope of authorisation to purchase insurance is even wider than that of indemnification, while indemnification in English law is prohibited. On the other hand, the wide language deliberately employed by the Delaware law, leaves no doubt that such insurance can be purchased not only against liabilities to the corporation, but also against those to third parties. English law does not prevent insurance against liability "of which he may be guilty in relation to the company." If this expression is interpreted in a strict sense, it means such protection is permitted to the company itself. However, if the words 'in relation to the company' are considered as any matter or action connected to it, including a third party action resulting from an

[111] Ibid at 538.

alleged wrongdoing by director in the performance of his duties to the company, a third party action should be also considered within the ambit of the section.

10. 6. 2 Elimination of Liability

Compared with other protection means and provisions, the issue of "charter cap" option or liability eliminating or limiting provision is a distinguishing feature. Although it is now an American legal institution, indeed, it was English law that for the first time judicially recognised a protection device as such, where in *re Brazilian Rubber Plantations & Estates Ltd.*[112] the court relieved respondents from personal liability based on one of articles of the corporate articles of association which provided that no "director or any other officer of the company shall be liable" for negligence, default or any commission or omission resulting in loss or damages in the absence of his own dishonesty. This provision was an obvious form of elimination of liability. Fourteen years later, the decision of Romer J. in *re City Equitable Fire Insurance Co.*[113] which was considered as a "public scandal" caused a roar of criticism. In that case, the court considered the defendant's conduct grossly negligent. However, relying on a similar article to that in *re Brazilian Rubber Plantations & Estates Ltd.*, it said that the article modified the *prima facie* obligation of them, and the directors were not, thus, held liable.

The English company law lacked an appropriate flexibility to accommodate this type of protection. Thus, the Board of Trade appointed the Greene Committee to examine the nature of this liability. Their recommendation that there should be a prohibition of any exemption from liability appeared in section 78 of the Companies Act 1928.

Comparing the above development in England with that in the US, almost half of century later, the Delaware Senate amended section 102(b) of its General Corporation Law to permit generously such a protection.

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112 [1911] Ch 425.
113 [1925] Ch. 407.

The authority to eliminate a corporate director, like indemnification, is a matter left to the corporation and shareholders, who voluntarily enter into such elimination or indemnification provisions. The main characteristic of this mechanism which distinguishes it from other protection devices, is the limited extent of its application to the company and not to third parties, in particular to creditors when it is insolvent.

10. 6. 3 Section 727 and the Business Judgment Rule

Section 727 and the Business Judgment Rule are both the oldest protection devices in the two legal systems, and both are virtually subjects to the very wide courts' discretion. At first glance, section 727 of the Companies Act 1985 appears to be very similar to the American business judgment rule, since the main requirements for a director to enjoy the protection of the business judgment rule and section 727, are acting honestly and reasonably with due care.

However, in spite of this similarity, because of different treatment by the two legal systems of the subject, the differences between those two legal concepts are in fact substantial. First, the business judgment rule is the product of judicial development emerging from the original common law. In contrast, the ancestry of section 727 is a statutory provision. Secondly, the relative lack of case-law on section 727 and ambiguities inherent in its application mean that there remain some uncertainties about the extent of its operation.[114] The situation regarding the business judgment rule is different. The rule has, since its inception, been constantly applied, and the courts have exercised their discretion once the main requirements of the rule, namely acting informed and in good faith, are satisfied. If a court refuses to relieve a director, where there is a possibility of relieving him, it can expect a backlash of criticisms from academics and commentators.[115] Thirdly, there has been no serious academic discussion by the English commentators on the various aspects of section

114 See especially *re Produce Marketing Consortium Ltd.* [1989] 5 BCLC, 513; *re D' Jan of London Ltd, Copp v. D' Jan*, [1994] 1 BCLC 561

115 As it was the case in *Smith v. Van Gorkom*, 488 A.2d (Del. 1985) 858.

727 or its potential impact on the development of the law as it affects company directors. This seems curious given a general concern among these commentators as to the harshness of some statutory liabilities, more particularly disqualification and wrongful trading. It is surprising to see no serious attempts to clarify and discuss this potentially very effective mechanism of protection, whose application could alleviate the harshness of those statutory liabilities and, thus, satisfy those commentators' concerns.

In contrast, the business judgment rule has dramatically developed through a large volume of case law. Furthermore, it found its way outside the courtroom into the boardroom, when it inspired the formation of the "special litigation committee." In addition, numerous comments have been made on the different features of the rule, and semi-governmental institutions and associations such as American Law Institute and the American Bar Association have contributed to the development of the rule.

In conclusion, it is worth pointing out that the American commentators have created much from nothing, while the British are still dithering. It is still not too late. Section 727 of the Companies Act 1985 presents an ideal opportunity for English law to fill an obvious gap in the area of the protection of its company directors from harsh statutory and common law liabilities. In doing so, much could be learnt from the US experience.

10. 7 The Business Judgment Rule and the Foss v. Harbottle Case

Providing directors with more business judgment protection is suggested as the best long- term solution to prolong the US historical economic prosperity. According to this theory, the weight given to directors' business decisions was an effective element which raised the US as an economic leader.[116] The development of the business judgment rule is indeed partly a result of this view.

[116] Paul H. Zalecki, "The Duties of Corporate Directors in a Takeover Context: A Rationale for Judicial Focus upon the Deliberative Process", 17 U. Toledo L. Rev. (1986) 313, 334.

The question is whether there is any rule or provision in English law with equivalent effect to the business judgment rule. Although in this legal system there is no statutory or judicial recognition of such provision, there are some indications in English case law similar to the business judgment rule in US law. For example, Scrutton L. J. in *Shuttleworth v. Cox Bros. & Co.*[117] stated that "it is not the business of the court to manage the affairs of the company. That is for the shareholders and the directors." A similar view was taken by Lord Davey in *Burland v. Earle*,[118] where his Lordship held that:

> "The court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so. Again, it is clear law that in order to redress a wrong done to the company, to recover moneys or damages alleged to be due to the company, the action should prima facie be brought by the company itself."[119]

These comments in fact belong to the past, when even making liability exemption or elimination provisions in company's articles of association was permissible.[120]

In English law, the only comparable but not quite similar situation to the offensive use of the rule, as demonstrated by the function of special litigation committee, is the well- known and controversial rule in *Foss v. Harbottle*.[121] The rule that primarily indicates that the cause of action to sue the directors, is vested in the company and exercised by the board of directors. This rule which is discussed within the concept of protection of minority shareholders, "is not a rule of substance, but of procedure."[122]

It should be noted that the main concern of minority shareholders is how to institute proceedings against a delinquent director whose conduct is considered by them in detriment to the company's interests. Should they initiate the action on their own

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117 [1927] 2 K. B. 9, 23.
118 [1902] A. C. 83.
119 Ibid at 93.
120 For example see *re Brazilian Rubber Plantations & Estates Ltd.* [1911] Ch. 425 and *re City Equitable Fire Insurance Co. Ltd.* [1925] Ch. 407.
121 (1843) 2 Hare 461, 67 ER 189.
122 L. S. Sealy, Cases and Materials in Company Law, (Butterworth & Co. (Publishers) Ltd. 5th ed.) 453.

personal right or on behalf of the company? The concern is, here, the shareholders' *locus standi* in derivative actions. This point is apparently related to the fact that directors' duties are owed to the company as a legal entity rather than to shareholders individually,[123] based on which *Foss v. Harbottle* restricted the role of derivative action brought by the individual shareholder.[124] As a result of that case, which produced a great injustice,[125] no individual shareholder is entitled to sue the company's director or enforce the company's right, but it is the board of directors that is the appropriate organ of the company to file the action on its behalf.[126]

Before *Foss v. Harbottle*, the courts seemed prepared to interfere in partnerships and other bodies' affairs,[127] but on the condition that such interfere was necessary.[128]

The rule in *Foss v. Harbottle* not only has been regarded as a major legal institution in English law, but some other common law jurisdictions particularly Australian law in this respect have been developed under shadow of that decision.[129] The outcome of the *Foss v. Harbottle* case was that, if the company suffered from a wrong, it is suffered by itself as an independent entity rather than by its members and, therefore, only the company is allowed to take an action but not its individual shareholders.

The rule is criticised as ignoring "the equally simple fact that the company as a whole is an abstraction, and that somebody must always act on its behalf."[130] If the board of directors refuses to allow a proceedings against themselves, it is a general meeting of shareholders that determine whether to sue the delinquent directors.[131]

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123 Paul L. Davies, Directors' Fiduciary Duties and Individual Shareholders (ed. E. McKendrick) Commercial Aspects of Trusts and Fiduciary Obligations (New York: Oxford University Press 1992) 84.

124 Such an action in nature but not in form has been described as a derivative action so far as is "derived" from the corporate right of action. B. A. K. Rider, "Amiable Lunatics and the Rule in Foss v. Harbottle", CLJ (1978) 270, 271.

125 Muir Hunter, "The Civil Liability of Company Directors in the United Kingdom", 9 Int'l Bus. Law. (1981) 231.

126 *Shaw & Sons (Salford) Ltd.* [19350 1 K.B. 113.

127 Colin Baxter, "The Role of Judge in Enforcing Shareholders' Rights", CLJ (1983) 96, 99.

128 *Walworth v. Holt* (1841) 4 Myl. & Cr. 619, cited by Baxter.

129 L. S. Sealy, "The Rule in Foss v. Harbottle: The Australian Experience", 10 Com. Law. (1990) 52.

130 Tom Hadden, Company Law and Capitalism, (London: Weidonfeild and Nicolson 1977) 275.

131 *Wallersteiner v. Moir (No. 2)* [1975] 1 All E.R. 849, 857.

There are some exceptions to the rule in *Foss v. Harbottle* that are described by Lord Wedderburn as "not essentially exceptions at all" but situations in which, the rule cannot apply.[132] These exceptions are *ultra vires* and illegality, special majorities, personal benefits, and fraud by those in control.[133]

The post- *Foss v. Harbottle* cases have followed the rule. For example in *Mozley v. Alston*,[134] where two shareholders filed a bill against twelve directors of the company for exercising their powers illegally retaining the seal and property of the company, Lord Cottenham L.C. referring to the rule in *Foss v. Harbottle*, recognised that the rule was applicable in the present case, because in his Lordship's view, the injury was not to the plaintiffs' personally, but to the corporation.[135]

Similarly, in *MacDougall v. Gardiner*,[136] the Appeal Court upholding a decision of the chairman of the meeting, taken based on a majority vote of the shareholders to adjourn the meeting and ignore the call by some shareholders including the plaintiff for taking a poll, held that "it is the company, as company, which has to determine whether it will make anything that is wrong to the company a subject- matter of litigation, or whether it will take steps itself to prevent the wrong from being done."

However, there has been some disagreement over the definition of the exceptions to the rule, particularly the question whether a breach of fiduciary duty is a cause of derivative action by minority shareholders. The case of *Daniels v. Daniels*,[137] is a good example to explain the rule's exceptions. In this case, the plaintiffs, minority shareholders, alleged that the defendant directors, a husband and wife, who were also majority shareholders, had sold a land belonging to the company, controlled by the defendants, at a very substantial undervalue to the wife. Templeman J. disagreed with the defendant's contention that there was no cause of action, because the

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132 K. W. Wedderburn, "Shareholders' Rights and the Rule in Foss v. Harbottle" CLJ (1957) 194, (1958) CLJ 93.
133 *Edwards v. Halliwell*, [1950] 2 All ER 1067.
134 (1847) 1 Ph 790.
135 See also *Bamford v. Bamford* [1970] Ch 212.
136 [1875] 1 Ch. D. 13.
137 [1978] Ch 406.

pleading did not involve the allegation of fraud. The learned judge proposed a principle on the basis of which "a minority shareholder who has no other remedy may sue where the directors use their power intentionally or unintentionally, fraudulently or negligently in a manner which benefits themselves at the expense of the company."[138] Templeman J. seems suggesting a wide extent of exceptions to the rule. According to his Lordship's view, a minority shareholder may file a derivative action against directors not only for breach of fiduciary duties, which have been already under question as an exception, but also for breach of duty of care and negligence.

Templeman J. is not alone in his generous interpretation of the rule, though Lord Wedderburn states that the decision of Templeman J. in *Daniels v. Daniels* did not infringe, nor did it extend the minority shareholders' rights.[139] Furthermore, the Court of Appeal in *Heyting v. Dupont*,[140] did not dismiss the possibility that an action for misfeasance in the absence of fraud could be filed by a minority shareholder.[141]

This critical judgment has encouraged the courts in their recent decisions to apply a narrower interpretation of the rule. For example in *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. & Others (No. 2)*,[142] the court gave a wider interpretation of the right of minority shareholders to bring a derivative action. In this case, the plaintiff, Prudential, the shareholder of nearly 3% of Newman shares brought an action against two directors of the company, B and L, on behalf of itself and all other shareholders (except B and TPG), claiming equitable damages in favour of the Newman company for breach of fiduciary duties, and on behalf of itself claimed common law damages for conspiracy, and finally on behalf of Newman's shareholders for preparing misleading and tricky circular and damages for

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138 Ibid at 414.
139 K. W. Wedderburn, "Minority Shareholders and Directors' Duties", 41 MLR (1978) 569.
140 [1964] 1 W. L. R. 843.
141 See also *Russell v. Wakefield Waterworks Co.* [1875] L. R. 2 Eq. 474.
142 [1980] 2 All ER 841.

conspiracy. The facts of the case were that the defendants directors who were also directors of the TPG company, induced the majority shareholders of the Newman company to purchase the assets of TPG at a substantially overvalue while the latter was in serious financial difficulty, with the view of transferring the assets of the ailing company.

It was contended that no derivative action would lie because, the defendants did not have voting control of Newman. The defendant directors also raised the question of whether the plaintiff as a minority shareholder could maintain the derivative action.

Vinelott J. disagreed with the contention, and held that permitting minority shareholders to bring an action on behalf of the company, was not confined to cases where alleged wrongdoer had voting control of the company, but it could be applied "whenever the wrongdoer was shown to be able by manipulating his position in the company to ensure that the majority would not allow a claim to be brought for the alleged wrong." Moreover, the court acknowledged that to bring such an action, it was not necessary to establish fraud, and the showing of some breach of fiduciary duty sufficed.

However, the Court of Appeal found the Court of First Instance in error in dismissing the defendants' application for the determination, as a preliminary issue, of the question whether the plaintiff was entitled to maintain the derivative claim, because in such an action brought by the minority shareholder, the question "whether in fact the company was controlled by the alleged wrongdoers should first be determined before the derivative action itself was allowed to proceed."[143] Cumming-Bruce, Templeman and Brightman L. JJ believed that "the Prudential were the wrong plaintiffs", and if the defendants "defrauded Newman then the proper plaintiff was Newman."[144] The court concluded that:

> "In our view, whatever may be the properly defined boundaries of the exception to the rule [that is the rule in *Foss v. Harbottle* (1843) 2 Hare 461, 67 ER 189], the plaintiff ought at least to be required before proceeding with his action to establish a prima facie

[143] [1982] 1 All ER 354.
[144] Ibid at 368.

> case (i) that the company is entitled to the relief claimed and (ii) that the action falls within the proper boundaries of the exception to the rule in *Foss v. Harbottle*."

This judgment is rightly described as ill- considered decision which "leaves the unfortunate trial judge with the impossible task of ruling on such matters as 'fraud' and control" without proper evidence.[145]

Likewise, in *Devlin v. Slough Estates Ltd.*[146] a minority shareholder sought a declaration that the accounts of the defendants company should continue to show a contingent liability for damages in certain foreign litigation to which the company was a party. He argued that he had a personal right to take an action as a shareholder, or a derivative action on behalf of the company. The plaintiff relied on one of articles (Article 150) of the company's articles of association which provided that directors were duty bound to prepare and lay before the company in general meeting, and distribute to the members individually, accounts in accordance with the Companies Act. Dillon J. disagreed with the plaintiff's motion and held that the directors' duty under article 150 was a duty to the company itself rather than to the individual shareholders.

By this, his Lordship obviously meant that based on the *Foss v. Harbottle* rule, the plaintiff was not a proper complainant and it was, thus, the company that could initiate the action.

The case of *Smith & Others v. Croft & Others (No 2)*[147] is a leading case in this regard, where the court chose a different view by giving a narrow interpretation of the exceptions of the rule, particularly the self- interests exception. In this case, the plaintiffs, the holders of 14.44% shares, sued the holders of shares carrying 62.5% of the voting rights, who were the executive directors of the company, companies associated with the company's directors, and the chairman. The plaintiffs claimed that the executive directors had paid themselves excessive remuneration, the associated companies had received payments intended to benefit executive directors

145 L. S. Sealy, "More Bleak News for the Minority Shareholders", CLJ (1987) 398, 399.
146 [1983] BCLC 497.
147 [1987] 3 All ER 909.

rather than the company, and the company's moneys were used to enable the associated companies illegally to purchase the company's shares.

The court did not recognise the plaintiffs as the proper plaintiffs and they were, thus, barred from bringing their action. Here, Knox J. pointed out that "where what is sought is compensation for the company for cost caused by *ultra vires* transactions, the wrong in my judgment is a wrong to the company, which has the substantive right to the redress." However, the learned judge acknowledged that "where minority shareholder is seeking to prevent an *ultra vires* transaction or otherwise seeking to enforce his personal substantive rights, the wrong which needs redress is the minority shareholder's wrong."[148] His Lordship went on to say that if there was a valid reason preventing the company from suing, that reason equally would prevent the minority shareholder from suing on its behalf. Therefore, he was to be defeated on two points, "first by any ground preventing him from exercising his procedural remedy and secondly any ground preventing the company from exercising its substantive rights."[149] Furthermore, the court took the majority shareholders' view as an indication in determining whether a minority shareholder can proceed an action as such. That is because, the court stated, the ultimate question was whether the plaintiff was being improperly prevented from bringing the proceedings, which would not be the case if the plaintiff was prevented from bringing his action by an appropriate organ of the company.[150] The learned judge concluded that because a majority of shareholders independent from the defendants opposed the proceedings, therefore, it should have been struck out.

This conclusion has obvious similarities with the reasoning behind the "special litigation committee" as an aspect of the procedure under the business judgment rule in the United States. However, here, the special or independent committee

[148] Ibid at 945.
[149] Ibid at 947.
[150] Ibid at 956, 957.

constituted of independent shareholders, but not disinterested directors.[151] However, the procedural and principles of the special litigation committee in the United States is obviously different from *Smith & Others v. Croft & Others.* Moreover, US law, as submitted, is both generous in scope and more readily available than tradition- bound English judges.[152]

In the above case, knox J. was not prepared to accept that there was a possibility of self- interest and that the action was most likely within the ambit of the exceptions to the rule, by which the plaintiff was entitled to proceed the action.

The courts have introduced a strict interpretation of the exceptions to the rule, and do not seem prepared to generalise their perception of, e. g., *ultra vires* as an exception, in order to provide minority shareholder with more chance to have his action dealt with before the court. However, as the line of judicial decisions shows, the courts seem prepared to take a more liberal attitude to the minority shareholders' *locus standi* in derivative actions,[153] proving a tendency to ease the strict rule of *Foss v. Harbottle*. For example in *Hogg v. Cramphorn*,[154] the court held that, although the company was the proper plaintiff, the shareholder's action against directors for improper disposition of company's moneys would not be barred.

The legislature appears to have noticed the gap in this part of company law. The result of the legislators' consideration is section 459 of the companies Act 1985,[155] which provides a means for a shareholder to sue the company's directors for alleged misconduct, as follows:

> "A member of a company may apply to the court by petition for an order under this part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of

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151 Boyle is also of the view that Knox J's judgment was influenced by the special litigation committee in US law. Anthony Boyle, "The Judicial Review of the Special Litigation Committee: The Implications for the English Derivative Action after Smith v. Croft", 11 Co. Law. (1990) 2.

152 Clark C. Havighurst, "The Shareholder's Derivative Suit in the United States", JBL (1967) 282, 228.

153 Anthony Boyle, "Minority Shareholders' Suits for Breach of Directors' Duties", 1 Co. Law. (1980) 3.

154 [1967] Ch 254.

155 This section was first introduced in the Companies Act 1948 in the form of section 210, and was repealed by section 75 of the Companies Act 1980.

its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."[156]

As it can be seen, the stance of this statutory section is not quite consistent with the strict and perhaps oppressive function of the rule. This statement of the statute has indeed effectively removed or in a great extent reduced the restrictions of the rule. The section does not clarify the procedure of the courts' examination. However, it seems that it is subject to the courts' discretion to decide whether to accept a minority shareholder's application as such.

One feels that this section provides the minority shareholder an additional right to those exceptions to the rule in *Foss v. Harbottle* to alleviate the strict prohibition of the rule.

Many cases have been decided under this section and its predecessors. For example, in *re Sam Weller & Sons Ltd.*,[157] where the plaintiff shareholders, the holder of 42.5% of the shares, sued the directors for not increasing its dividend in 37 years under the proper circumstances for doing so, Peter Gibson J. held that under those circumstances when the policy of low dividend payments was in the interests of the defendant and his sons, it was unfairly prejudicial to the plaintiffs.

In *re Elgindata Ltd.*[158] though Warner J. accepted that serious mismanagement of a company's business could constitute a conduct as unfairly prejudicial to the interests of minority shareholders, he did not find the circumstances of the case as such.

It is worth noting that in *Foss v. Harbottle*- like situation, there is no formal committee like special litigation committee under the business judgment rule, but any defendant director or majority shareholder is entitled to move to challenge a derivative action if it is not in the ambit of the exceptions of the rule, or in relation to section 459 of the Companies Act 1985.

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[156] According to section 11(b) of Sch. 19 of the Companies Act 1989, "unfairly prejudicial to the interests of some of its members" substituted the phrase "unfairly prejudicial to the interests of its members generally or of some part of its members".
[157] [1990] BCLC 80.
[158] [1991] BCLC 959.

At the end, it is interesting to add that, the attitude of both legal systems to the rules accordingly is radically changing. While in England section 459 may in long- term isolate and finally diminish the *Foss v. Harbottle* rule, and there is also a strong call for more statutory reform on both the substantive and procedural aspects of the derivative action,[159] in the United States, after the *Zapata* case, there is an obvious readiness to remove or considerably reduce the power of the litigation committee.

10. 8 Final Conclusion and Suggestion for the Further Researches

As the final conclusion, the results of our study can be summarised as follows:

i- English law concerning corporate directors liabilities specially in insolvency or in the vicinity of insolvency is more classified and even more developed than US law. Introducing some specific concepts such as wrongful and fraudulent trading and misfeasance under which directors duties and liabilities in insolvency are defined and the extent of their responsibilities is clarified, is a significant strength of English law against its American comparator. Moreover, disqualification with its sophisticated and highly developed operation in comparison with the newly limited recognition of the concept by the US law- makers, is another major advantage of English law.

ii- As has been obvious throughout this research, US law is more protective which means English is conversely more oppressive towards corporate directors. Several protective devices that have been recognised by the former grant a great deal of power to the corporations to protect their directors against personal liabilities short of fraud or disloyalty.

Except the Business judgment rule which is a contemplation of judges and product of the American common law, the other protection means such as indemnification or insurance against and elimination or limitation of liability are statutory provisions

[159] Anthony Boyle, " Minority Shareholders' Suits for Breach of Directors' Duties", 1 Co. Law. (1980) 3, 7.

that cannot be categorised under the traditional common law rules, but they are the results of the development of company law as well as modern business needs. Furthermore, the business judgment rule is a power conferred on the courts to exercise it as matter of their discretion, whereas other protection measures, as mentioned above, are to be decided by the corporations themselves. In other words, the latter is an additional entitlement granted to the companies whether or not to oblige themselves to legal consequences of those provisions, and there is, thus, no interference on the part of judicial or regulatory authorities.

On the other hand, the protections available to an English director are all, except the rule in *Foss v. Harbottle*, statutory. Unlike the liability insurance which is an import of the United States, the relief under section 727 is virtually a discretionary power vested in the courts with no obligation to exercise it even if all requirements are met.

iii- English law in the area of our research is obviously discretionary. Regarding directors liabilities, the courts are empowered with a discretionary authority to hold a delinquent director liable for fraudulent and wrongful trading. In both sections 213 and 214 of the Insolvency Act, the legislature has employed the expression the court "may declare" the defendant to make a contribution, which reveals the discretionary nature of the power vested in the courts and their freedom to exercise it as they "think fit". The courts have a similar discretion under section 212 of the Act to hold a director liable for misfeasance. As to disqualification, except the mandatory feature of section 6 of the Company Directors Disqualification Act, other provisions imposing disqualification are discretionary.

The US law in this regard is of different view. That is not only because there is no recognition of a set of concepts on directors liabilities as recognised in English law, but mainly because there is no specific statutory regulations imposing liability on directors for breach of their duties. Unfortunately, in the absence of any statutory provisions it is not possible to determine whether US law is discretionary or not, because in this situation the courts' decision whether or nor to hold a wrongdoer liable is left to the judges' discretion, and is a matter of their interpretation of the facts before them.

However, considering the protective aspect of the American company law towards company directors, one can claim that any statutory provisions in relation to directors liabilities will most likely be more discretionary than the English law.

10. 8. 1 The Application of This Study to the US and English Laws

The applicability of this research to those two legal systems can be answered from two different perspectives. First, the two laws are still considered under common law or in a more scientific classification under Anglo- American legal family. Does this common sense justify a harmonisation of them at least in the area of our research? Or is it necessary?

One may suggest that because these two legal systems belong to the same legal family, and historically the today US was formed first by the British and ruled by the English Crown for centuries, and more importantly because the UK is still politically a strategic ally of the United States not only in Europe but in almost all international events, therefore the law of these two allies are in need of a harmonisation.

But, there are some disadvantages for the proposal, on the ground that even if one agrees with the above considerations, it might justify a harmonisation of the two laws only in the field of international public law. That is because, though the law is affected by political considerations, private law, in particular company law is a matter of business rather than politics. Even if company law involved with politics, this politics is domestic rather than international. Furthermore, there are huge social and political differences between a society such as the US ruled by a modern federal republic and a country under traditional monarchy like the UK. In today's commercial competition which has led to different regional or continental commercial- political blocks, it is difficult to force these two societies into the same legal rules. Besides, such a harmonisation may undermine the very well- recognised position of the English common law as a result of dealing with the politically strong and economically wealthy United States, which will not be a desirable idea for an English lawyer or lawmaker.

But, there are many experiences could be learnt from each law by the other through the present research- study, the implementation of which may in long- term keep the legal systems in the same legal family.

English lawmakers, the judges as well as legal writers considering the highly protective feature of the American law towards corporate directors, may step forward for striking a balance between the seemingly oppressive liability provisions on the one hand, and the insufficient protective measures available to English company directors on the other hand. This aim may be achieved if not by introducing a liability exemption provision as was recognised in *re Brazilian Rubber Plantations & Estates Ltd.*[160] and similar to the US liability elimination provision, because obviously such measure cannot be accommodated in the conservative English law, at least it can be reached by expanding the extent of indemnification to judgments and settlements. Moreover, For this purpose, the English legislators may recognise a wider application for the relief under section 727 to cover wrongful trading and to clarify the confusion over its application to liability for breach of trust.

Likewise, there are more lessons for the American to learn from the English experiences. As was seen, the United States company law in the arena of directors liabilities is quite in the need of basic changes and development. To fill the deficiencies, the first step is to recognise a set of appropriate concepts similar to those adopted by English law. However, so long as this recognition has not appeared in a legislation, the fear of another *Van Gorkom* crisis exists.

The other positive move may be the extension of the disqualification recognised in the Remedy Act 1993 to companies executive as well as non- executive directors for violation of their duties in insolvency.

160 [1911] Ch 425.

10. 8. 2 Suggestions for the Future Researchers

Though there are many unresolved problems and questions in English company law each of them can be undertaken as a subject for Ph.D. However, with regards to our research as a comparative work, a study with similar feature is more desirable. This thesis has been an opportunity to bring into consideration some gaps and deficiencies of English law in the light of the United States law. Therefore, the results of this work in the line with the present thesis can be implemented for a research on the single system for the European community in the area of company directors' duties, liabilities and protection in insolvency or nearly insolvency.

Although there is no consensus about the meaning of harmonisation itself,[161] the need for becoming familiar with and work more efficiently on the Community law with the view to harmonising the member States' laws, has been acknowledged by commentators.[162]

In some areas of company law such as the registration of companies, maintenance and alteration of capital and so on, the national legislation has been harmonised. However, the Fifth Draft Directive dealing with corporate governance is under discussion by council of ministers.[163] The Directive which concerns the supervision of corporate management and employees representation, has not been welcomed by some English lawyers who consider it as "false dawn".[164]

Article 14 of the Draft Fifth Directive provides civil liability for the board of directors which is considered as imposing more sever standard than the existing common law and statutory duties in English law.[165]

The UK government has already opposed some of the Directive provisions, for example the scheme of employees participation and more significantly the imposition

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161 Thomas M. Gaa, "Harmonisation of International Bankruptcy Law & Policy: Is It Necessary? Is It Possible? Int'l Lawyer (1993) 881, 882.

162 J. G. Collier & L. S. Sealy, "European Communities Act 1972", 32 MLR (1973) 1, Erik Werlauff, "The Development of Community Company Law", E. L. Rev. (1992) 207.

163 Geoffry Fitchew, "The European Diminution in Company Law", 13 Co. Law. (1992) 5.

164 Jane Welch, "The Fifth Draft Directive- A False Dawn?" E. L. Rev. (1983) 83.

165 Anthony J. Boyle, "Draft Fifth Directive: Implications for Directors' Duties, Board Structure and Employees Participation", 13 Co. Law. (1992) 6, 8.

of joint and several liability on directors for breaches of duty by one or more members of the board.[166]

If I were to start a new research and had some expertise in one of main European languages, Spanish, German or French, I would work on a comparative work between English and one of European [civil] legal systems with intent to regulating some comprehensive rules for a single European law. Such a study will be more advantageous when experiences of American law are also implemented. It is not only because, for example, the French courts under the Draft Convention on Bankruptcy have exclusive jurisdiction to pronounce upon the liquidation and its effects,[167] but also because there have been some changes in some of European laws towards corporate directors different from other members. For example, while majority European countries impose more liabilities on their corporate directors with the view to protecting the interests of creditors, a legal system like French law, unlike its previously vigorous measures, has taken a more liberal stance towards directors "to preserve business, and above all employment, regardless of creditors' interests.'[168]

In addition to the above reason for desirability of taking English and a European civil law as the subject of further research, the fact is important that any single law for the community has to regard the principles of both common law and civil law.

If the future study is not to be a comparative one there are, as was mentioned, still many unanswered questions and ambiguities which this study has not, because of limited time and space, referred to. For example, one may review other directors

166 Note, "Government Critical of Fifth Directive" 11 Co. Law. (1990) 72. The subject of European law is out of our research, therefore this brief comment suffices to reveal the importance attached to the issue. For further discussion about harmonisation of EEC law see John Lowry, The Harmonisation of Bankruptcy Law in Europe, the Role of the Council of Europe" JBL (1985) 73, Muir Hunter, "The Draft EEC Convention- A Further Examination" 25 ICLQ (1976) 310, Muir Hunter, "The Draft Bankruptcy Convention of the European Economic Communities." 21 ICLQ (1972) 682, Muir Hunter, European Bankruptcy: The New Dimension of Insolvency" 127 NLJ (1977) 195, S. N. Frommel, "Reform of the Ultra Vires Rule: A Personal View", 8 Co. Law. (1987) 11, john H. Farrar, The EEC Draft Convention on Bankruptcy" JBL (1972) 256, Ian Fletcher, "The Proposed Community Convention on Bankruptcy and Related Matters", 2 E. L. Rev. (1977) 15.

167 Clare Connerton, "Directors' Liability and the EEC Draft Convention on Bankruptcy", JBL (1977) 8, 16.

168 R. E. Floyd, "A Tougher Time for Directors- Are the French Out of Step" 4 I. L. & P. (1988) 75

liabilities in insolvency that are not within misfeasance, wrongful and fraudulent trading, the liabilities resulted from an action taken by the liquidator in the company's name. It also desirable to study other sectors' liabilities other than directors in such event.

Table of Statutes

1. English Statutes

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Companies Act 1981.
Companies Act 1985.
Insolvency Act 1976.
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Company Directors Disqualification Act 1986.

2. US Statutes

California Corporation Code.
Delaware General Corporation Law (1967, 1986).
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