COMPANY DIRECTORS' POWERS, DUTIES AND LIABILITIES: AN ANALYSIS OF COMPANY LAW IN THE UNITED KINGDOM.

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TO MY MOTHER AND FATHER
TO MY WIFE MERVAT
&
TO MY DAUGHTER, THE LITTLE DEENA
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DECLARATION

I HEREBY DECLARE THAT THIS THESIS WAS COMPOSED BY MYSELF AND THAT THE WORK CONTAINED HEREIN IS MY OWN, EXCEPT WHERE OTHERWISE STATED.

IBRAHEM AMOSH
NOTE

IN THIS THESIS, THE TERMINOLOGY OF SCOTS LAW IS USUALLY DEPLOYED. HOWEVER, WHEN DEALING WITH ENGLISH CASES, THE TERMINOLOGY OF ENGLISH LAW IS USED.
This thesis is an analysis of directors' powers, duties and liabilities under British Company Law. It consists of ten chapters, the first of which is an introductory one. The second chapter discusses the powers of directors. Directors' duties to the company are examined in chapters 3, 4, 5, and 6. The fair dealing rules (i.e., the no-conflict rule and the no-profit rule) and the statutory as well as the common law role in relaxing them are examined in both chapter 3 and 4. The fifth chapter is concerned with directors' duty of honesty and good faith. The duty of skill and care is examined in chapter 6. Directors' duty to individual shareholders is the subject of chapter 7. In chapter 8 directors' duties to the creditors of their company are highlighted. Litigation and the protection of minority shareholders have been examined in chapter 9. The thesis ends with a summary and conclusions.

The power to manage a company is usually vested in the board of directors. A director's primary duty is owed to his company. However, in some exceptional cases a director may owe duties to the company's shareholders and its creditors. It is submitted that the fair dealing rules as applied in the U.K. are inflexible. The courts, however, have shown their willingness to relax them. The test of the duty to act bona fide is mainly subjective. The test of the proper purpose is mainly objective. Directors' duties of skill and care are mainly governed by the common law rules. The test applied to the duty of care and skill is mainly subjective. Since a director's breach of duty may harm the minority shareholders, the common law as well as the legislation tried to provide minority shareholders with the necessary protection.
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CHAPTER 1

INTRODUCTION

I have chosen this topic for two reasons. First, the importance of the position of directors in the company. A company consists, basically, of two main organs. One is the shareholders in general meeting; the other is the board of directors. The board of directors which is elected by the general meeting is usually entrusted with the management of the company. So, to a large extent directors are considered the agents of the company; because the company, being an artificial entity, can only act through human agents. The considerable tract of legal rules governing directors' powers, duties and liabilities constitutes, in my personal view, a cornerstone of company law. The second reason is the depth and the width of the issue of directors' powers, duties and liabilities. Being from Jordan, a country whose company law, particularly in relation to limited liability companies, was derived from the British Companies Act 1907, examining this wide issue is not without merits. While British company law has gone through different stages of development and been subjected to a variety of amendments up to the Companies Act 1989, Jordanian company law has failed, apart from some minor amendments, to accompany its predecessor.
Thus, it is to my advantage in examining a subject which covers a wide area of company law to be aware of the development of the British company law.

In this thesis the powers, duties and liabilities of directors will be explored. In addition to their duties and liabilities to their companies, directors' duties and liabilities to the shareholders and creditors of their companies will also be examined. The substantive rules of the Companies Acts and related legislation and the principles of common law in respect of this issue are to be analysed. Where appropriate, the law of some Commonwealth countries will be referred to. In the next chapter of this thesis, the powers of directors will be discussed. Great importance, however, will be attached to the power to sue in the name of the company in case of a receivership, the power to delegate functions, and the power to bind the company. The third chapter is concerned with the directors' fiduciary duties, in particular, the fair dealing rules. The no-conflict rule and the no-profit rule are to be examined. Examples of situations of conflict of interests are to be explored. Great significance, however, will be attached to the use of corporate information, insider dealing and exploiting corporate opportunities. In the fourth chapter, it will be shown that the fair dealing rules as applied in the United Kingdom are fairly inflexible. In addition, it will be shown that because
of that inflexibility which is not always appropriate,
the common law and the legislation have played a major
role in relaxing the fair dealing rules. Further, it
will be shown that the courts have also tried to relax
the rigidity of those rules. The analysis and the
examination of directors' fiduciary duties will extend
to occupy the fifth chapter of this thesis. There, the
fiduciary duty of honesty and good faith will be
discussed. In chapter six, the problematical duty of
skill and care which is owed by directors to their
companies will be tackled. The development of the law
of negligence and its effect, if any, on directors'
duties of skill and care will be explored.
Not only to their companies do directors owe duties but
also to the shareholders and creditors of their
companies. Thus, the examination of directors' duties
and liabilities will extend horizontally to both chapter
seven and chapter eight. Chapter seven is taken up to
directors' duties to individual shareholders. There,
the duties of directors to individual shareholders at
the common law will be examined. Further, some selected
statutory duties owed by directors to shareholders are
to be discussed. Chapter eight is concerned with
directors' duties to the creditors of their companies.
The statutory and the judicial protection of creditors
will be examined in the necessary detail. Great
significance will be attached to both fraudulent and
wrongful trading as being sources of directors' liability to creditors. In addition, it will be shown that the courts have made an attempt to protect the interests of creditors even in the absence of statutory provisions. Further, concurrent liability of directors in some selected issues, will be examined. Chapter nine is concerned with the various forms of litigation by means of which the duties and liabilities of directors can be enforced. The rule in Foss v. Harbottle and the exceptions to it will be examined in detail. Great importance will be attached to the proceedings which may be initiated by minority shareholders who allege that the affairs of their company have been conducted in a manner unfairly prejudicial to their interests. The winding up of a company on the "just and equitable ground" as being a manner to protect minority shareholders will be discussed. In chapter ten, a summary and conclusions will be laid down in general terms. Thus, it should be noted that the conclusions in chapter ten do not reflect every single idea or personal view expressed in the main body of this thesis. Finally, I am obliged to admit that the work done in this thesis is not comprehensive, and cannot be made so in a couple of hundred pages.
CHAPTER 2

DIRECTORS' POWERS

2.1. Introduction

In this chapter two main issues are to be examined. First, the division of powers between the company in general meeting and the board of directors. The importance of this issue stems from the fact that the directors are, usually, appointed for the purpose of conducting the company's affairs\(^1\). They derive their powers from those of the company. In other words, their powers are derived from the shareholders in general meeting. Since the shareholders in general meeting constitute an effective organ of the company, it is important to know how the powers are divided between them and the board of directors. It is also important to know the extent to which the shareholders are excluded from the management of their company's affairs, and the extent to which they can intervene in the management. Second, the specific powers of directors. It should be noticed that only some of those powers, which are felt to be important, will be examined in detail.
2.2. DIVISION OF POWERS BETWEEN THE SHAREHOLDERS IN GENERAL MEETING AND THE BOARD OF DIRECTORS.

Until at least the end of the nineteenth century, the courts were inclined to examine the relationship between the general meeting and the board of directors as one existing between a principal and agents. Thus, company law in its early stages had been influenced by notions derived from the law of partnership. Considering directors as agents of a company, produced the result that the general meeting had complete control over the acts of the directors in relation to the conduct of the company's affairs. The first case, apart from Foss v. Harbottle, dealing with the relationship between the general meeting and the board of directors was Isle of Wight Railway Co. v. Tahourdin. In that case, the required number of shareholders requisitioned a meeting, inter alia, to appoint a committee to reorganise the management of the company. The directors wanted to restrain the holding of the meeting. They applied to the court for an injunction for this purpose. The Court of Appeal rejected that application. Cotton L.J. said:

It is a very strong thing indeed to prevent shareholders from holding a meeting of the company, when such a meeting is the only way in which they can interfere, if the majority of them think that the course taken by directors, in a matter intra vires of the directors, is not for the benefit of the company.
His Lordship also observed that if a shareholder complains of the conduct of directors while they are acting within their powers, then the court says to him,

if you want to alter the management of the affairs of the company go to a general meeting, and if they agree with you they will pass a resolution obliging the directors to alter their course of proceeding.

Those observations led to the assumption that the general meeting could direct and control the board of directors in relation to the management of the company.

The issue of the division of powers between the general meeting and the board of directors was clarified and settled by the decision of the Court of Appeal in the case of Automatic Self-Cleansing Filter Syndicate Co. Ltd. v. Cuninghame. In that case, article 96 of the company's articles of association vested in the directors the power to manage the business of the company including the power to sell any property of the company on such terms and conditions as they might think proper. At a general meeting, the shareholders passed an ordinary resolution instructing the directors to sell the company's undertaking to a particular company. The directors refused to carry out the sale. The court of Appeal relied on the true construction of the articles and held that the power to sell was vested in the
directors alone, and the shareholders were not entitled, by passing an ordinary resolution, to instruct the directors as to the management of the company. Cozens-Hardy L.J. observed that the articles constituted a contract between the members of the company; by which they had agreed that the "directors and the directors alone shall manage"(10). His Lordship challenged the view that by analogy to partnerships, the general meeting of shareholders can direct the directors of the company. His Lordship pointed out that even in the case of a partnership, the partners may not direct the managing partner as to the management of the partnership. His Lordship said:

. . . if you once get clear of the view that the directors are mere agents of the company, I cannot see anything in principle to justify the contention that the directors are bound to comply with the votes or the resolutions of a simple majority at an ordinary meeting of the shareholders(11).

The Cuninghame case(12) was followed by the case of Gramophone and Typewriter Ltd. v. Stanley(13) in which the Court of Appeal delivered a decision similar to that of the Cuninghame case. It is worth noting, however, that in the Stanley case Buckley L.J. had changed his view which was expressed in his book in 1897(14). His Lordship said:

The directors are not servants to obey directions given by the shareholders as individuals; they are not agents appointed by and bound to serve the shareholders as their principals. They are persons who may by the regulations be entrusted with the control of
the business, and if so entrusted they can be dispossessed from that control only by the statutory majority which can alter the articles. Directors are not, I think, bound to comply with the directions even of all the corporators acting as individuals(15). The decision of the Court of Appeal, in the Stanley case, as it was clear from the judgment of Buckley L.J. (quoted above), made it clear that neither ordinary nor extraordinary resolution of the general meeting could bind the directors to follow the instructions or the directions of the shareholders, unless the shareholders in general meeting were empowered by the articles to do so. This, however, does not mean that the shareholders in general meeting cannot remove the directors who do not act as the shareholders desire(16). The directors can be removed from office by an ordinary resolution even before the expiration of their period of office. The shareholders in general meeting can also alter the articles of the company, so as to limit the powers of directors, or to give the company, in general meeting, a supervisory power over the directors. However, a company's articles can only be altered by a special resolution(17). The decision of the court in the Stanley case has been described(18) as the first clear formulation of the principles governing the relationship between the company in general meeting and the board of directors(19).
The principles governing the relationship between the general meeting and the board were further considered in Quin & Axtens v. Salmon (20), and Shaw & Sons (Salford) Ltd. v. Shaw (21). In both cases the court gave a similar decision to that in the Cuninghame (22) case and the Stanley (23) case. That is, where the articles, clearly, give the board of directors the power to manage the company's business, then, the shareholders in general meeting have no control over the board in relation to the management of the company. In Shaw & Sons (Salford) Ltd. v. Shaw (24), the court held that the resolution taken by the shareholders in general meeting disapproving the commencement of an action by the directors was a nullity. Greer L.J. said:

A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain other powers may be reserved for the shareholders in general meeting. If powers of management are vested in directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders (25).

At this stage, it could be concluded that the courts had relied upon the true construction of the articles of association to find out the relationship between the
board and the shareholders in general meeting. This attitude seems to be the correct one since there is nothing in the law preventing a company from giving or taking away from the shareholders in general meeting a supervisory power over the board of directors(25).

Consequently, if the shareholders are empowered to give directions to the board in relation to the management of the company, then, a resolution instructing the directors or giving them directions will not be held void. That is because the articles constitute a binding contract between the members of the company(27). So, the law leaves the distribution of powers between the two main organs of the company to the articles of association. This is, of course, with the exception of some powers which are, expressly, given by the law to the shareholders in general meeting and can only be exercised by them(28). Because the division of powers is a contractual issue, the company is free to adopt whatever form of articles it desires. The form of management articles, normally, adopted by companies is that found in art. 70 of the 1985 Table A. Art. 70 provides:

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 the directors who may exercise all the powers of the company. No alteration of the memorandum or articles and no such direction shall invalidate any prior act of the directors which would have been valid if that
alteration had not been made or that direction had not been given.

In respect of art. 70, it is worth noting that:

First, the first sentence of the article allows a company in general meeting to direct the board of directors on how to act. However, this can only be done by a special resolution. This permission reminds us of art. 80, of the 1948 Table A, which referred to "regulations . . . prescribed by the company" rather than " . . . directions given by special resolution". Many commentators argued that, according to the wording of art. 80 and particularly the word "regulation", a company could give directions to the board, even by passing an ordinary resolution, so long as the management function was vested in the board in general terms. However, in both the Gramophone case, and the Stanley case, it was held that the word "regulation" indicated that only by way of a special resolution, could the general meeting have control over the board. Further discussion of the meaning of the word "regulation" is no longer necessary since art. 70 of the 1985 Table A makes it clear that a special resolution is needed for the purpose of directing the board on how to manage the company's business.

Second, the second sentence of art. 70 makes it clear that neither alteration of the articles or the
memorandum nor the directions of the shareholders in general meeting can have any retrospective effect on previous acts of directors\(^{(34)}\). Similarly, the removal of directors from office must have no retrospective effect on their previous acts. In other words, the exercise by the general body of the shareholders of their powers under art. 70 affects only future acts of directors. However, it would seem that proposed acts can be affected by the exercise of the powers given by art. 70.

It remains to examine the extent to which the shareholders in general meeting can intervene in the management of the company. This issue will be examined in brief since it does not directly relate to the powers of directors.

The legislation as well as the case law empowers, in some situations, the shareholders in general meeting to intervene in the management of the company. In other words, the shareholders in general meeting may have control of the company by virtue of the statutory provisions or of the case law.

2.2.1. The Statutory Powers of the Shareholders in General Meeting.

It is clear from art. 70 of the 1985 Table A that the directors' powers to manage the company are subject to
the provisions of the Companies Act 1985. So, the Companies Act 1985 reserves some powers which can only be exercised by the shareholders in general meeting. Similarly, the Insolvency Act 1986 reserves some powers to this organ of the company. Examples of those powers are the following:

a) the power to approve of compensation to directors for loss of office\(^{(35)}\);

b) the power to approve of substantial property transactions involving directors or connected persons\(^{(36)}\);

c) the power to alter the share capital\(^{(37)}\);

d) the power to allot relevant securities\(^{(38)}\). This power cannot be exercised by directors without being authorised to do so by the company in general meeting or by the company's articles\(^{(39)}\);

e) the power to authorise the market purchase by the company of its own shares\(^{(40)}\);

f) the power to approve of funds to directors to meet expenditure on company business\(^{(41)}\);

g) the power to approve of directors contracts of employment for periods in excess of 5 years which make no term for extinction by notice or provide for such extinction only in specified circumstances\(^{(42)}\);

h) the power to consider the necessary steps to deal with a serious loss of capital of a public company\(^{(43)}\);
i) the power to approve of terms of an agreement made by a public company to acquire non-cash assets from a certain member during the initial period\(^ {44}\);

j) the power to sanction the variation of class rights in some circumstances. An extraordinary resolution is required here\(^ {45}\);

k) the power to resolve, by an extraordinary resolution, to wind up the company voluntarily when it cannot continue its business because of its liabilities\(^ {46}\);

l) the power to authorise the liquidator, in cases of members' voluntary winding up to pay a class of creditors in full or to make a compromise over any of the company's debts\(^ {47}\).

It should be noticed that the powers rehearsed (above) are mere examples of those, given by the statutes, to the company in general meeting.

2.2.2. Reversion of Powers to the Company in General Meeting.

In some situations, directors' powers revert to the company and can be exercised by it in general meeting. Examples of these situations are where a deadlock exists between the directors and where there are no directors.

a) Deadlock situations.

In Barron v. Potter\(^ {48}\), the company had two directors.
They were given the power to appoint additional directors. They failed to do so because of the refusal of one of them to attend any board meeting. The court held that the company in general meeting could exercise such power. Warrington J. said:

If directors having certain powers are unable or unwilling to exercise them - are in fact a non-existent body for the purpose - there must be some power in the company to do itself that which under other circumstances would be otherwise done. The directors in the present case being unwilling to appoint additional directors under the power conferred on them by the articles, in my opinion, the company in general meeting has power to make the appointment.49

b) Where there are no directors.

In Alexander Ward & Co. Ltd. v. Samyang Navigation Co. Ltd.50, the directors were given a general power, by the articles, to manage the company. The shareholders in general meeting wanted to institute legal proceedings on the company's behalf because there were no directors. The House of Lords held that they could. Lord Kilbrandon said:

I am not at all convinced that, the management of a company having been confided to the directors, and the instructing of actions at law being an act of management, then, if the company has for the time no directors, it cannot during that time take step to recover its debts. I think the [relevant article] probably means no more than this, that the directors, and no one else, are responsible for the management of the company, except in the matters specifically allotted to the company in general meeting. This is a term of the contract between the shareholders and the company. But it does not mean that no act of management, such as instructing the company's solicitor, can validly be performed without
the personal and explicit authority of the directors themselves(51).

Similarly, it was held that the company in general meeting could exercise the powers of the directors in cases where an effective quorum could not be obtained(52). It was also held that if the directors failed to bring an action on behalf of the company, then, the shareholders in general meeting could sue or authorise someone to sue on behalf of the company(53).

c) Ratification.
If directors exceed their powers or exercise those powers for improper purpose, the company can, in general meeting, ratify their acts so long as the ratification does not amount to a fraud on the minority(54).

2.3. Specific Powers of Directors.

It has already been mentioned that directors derive their powers, generally, from the company's articles. However, some specific powers have been recognised by the law as being exercisable by directors. Examples of these powers are the following:

1) the power to sue in the name of the company(55);
2) the power to bind the company(56);
3) the power to appoint additional directors(57);
4) the power to borrow and to give securities for such borrowing(58);
5) the power to compromise(59);
6) the power to convene meetings(60);
7) the power to delegate their powers(61);
8) the power to grant pensions to staff(62);
9) the power to forfeit shares(63);
10) the power to issue shares and debentures(64);
11) the power to make calls(65);
12) the power to issue negotiable instruments(66);
13) the power to petition in bankruptcy(67); and,
14) the power to reject a transfer of shares(68).

It has already been declared that only some of those powers (which in one's opinion are very important) will be examined in detail.

2.3.1. Power to Sue in the Name of the Company.

If a company's articles confer the power to initiate litigation in the company's name on the board of directors, then, the decision whether or not to litigate must be taken by the board(70). If the board brings an action in the name of the company, the shareholders in general meeting cannot order the board to abandon litigation by passing an ordinary resolution. If, however, the articles of association give the
shareholders in general meeting the right to give directions or instructions to the board on how to manage the company, the shareholders can ask the board, by passing a special resolution, to abandon actions brought by the board in the name of the company. If the board decides not to bring an action in the name of the company, the shareholders, in general meeting, can, by passing an ordinary resolution, override the board’s decision and appoint someone to litigate in the name of the company. This is so even if the shareholders are not empowered to give directions to the board\(^ {71} \).

In the case of liquidation, directors’ powers including the power to litigate in the name of the company, cease on the appointment of a liquidator\(^ {72} \). This result is justified by the purpose lying behind appointing a liquidator. A liquidator is appointed with the object of terminating the existence of the company and winding it up\(^ {73} \).

In the case of an administration order, the administrator has, during the period for which the administration order is in force, a general power to manage the "affairs, business and property of the company"\(^ {74} \); those powers include the "power to bring or defend any action or other legal proceedings in the name and on behalf of the company"\(^ {75} \). Unlike liquidation, it would appear that the directors' powers do not cease on the appointment of the administrator, but the exercise of
those powers becomes subject to the administrator's consent. That is, the administrator's status overrides that of the directors. If the exercise, by directors, of a particular power interferes with the powers of the administrator, that power cannot be exercised except with the consent of the administrator. S.14(4) of the Insolvency Act 1986 provides:

Any power conferred on the company or its officers, whether by this Act or the Companies Act or by the memorandum or articles of association, which could be exercised in such a way as to interfere with the exercise by the administrator of his powers is not exercisable except with the consent of the administrator, which may be given either generally or in relation to particular cases.

Thus, directors cannot initiate litigation in the company's name without the consent of the administrator. This result is justified by the fact that an administrator is appointed with the object of reviving the company. He is obliged to take care of the interests of the company including the interests of its creditors(76). Thus, it is for the benefit of the company as a whole not to allow directors to interfere with the exercise, by the administrator, of his powers. Because directors are not allowed to act on behalf of the company without the consent of the administrator, the Insolvency Act 1986 gives creditors and members of a company the right to petition (to the court for an order, at any time when an administration order is in force) on the ground-
a) that the company's affairs, business and property are being or have been managed by the administrator in a manner which is unfairly prejudicial to the interests of its creditors or members generally, or of some part of its creditors or members (including at least [the petitioner], or
b) that any actual or proposed act or omission of the administrator is or would be so prejudicial.

So, if the administrator fails to act and prevents directors from acting on behalf of the company, then, it is the administrator not the directors who is to be blamed if the company suffers loss.

The situation might be different in the case of receivership. First of all it should be noticed that S.42(2) and S.55(1) and (2) of the Insolvency Act 1986, make it clear that the powers of a receiver apply only to the assets which are subject to the charge. Consequently, in respect of assets which are not within the scope of the charge, the directors retain the power to act on behalf of the company. The difficulty arises in relation to the exercise of powers by directors in respect of the property subject to a floating charge. Does the appointment of a receiver supersede the powers of directors to the effect that they cannot raise an action in the name and on behalf of the company, in relation to the rights (whether property or undertaking) which are subject to the charge, without his consent?. Do directors need the consent of the court if the receiver who has failed to bring the action is
the one who has been appointed by the court?. Who is to be blamed if the interests of creditors (other than those who have been granted a floating charge over the company's assets) have been jeopardised?. It is appreciated that all the questions stated above revolve around one substantial point which is the existence of the directors' powers in case of receivership. Before giving any answer to those questions, it would seem necessary to draw a distinction between the aim of appointing a receiver on the one hand and that of appointing a liquidator and of appointing an administrator on the other hand. It has already been mentioned that the aim of appointing the liquidator is the winding up of a company and the termination of its existence. It has also been mentioned that the aim of appointing the administrator is the reviving of the company and the protection of its interests including the interests of its creditors. A receiver is, usually, appointed to protect a company's rights which are within the scope of a fixed or a floating charge. Thus, the receiver is concerned with the interests of the debenture holder or the creditor who has appointed him(81). It would appear that even if a receiver is appointed by the court, he remains interested in the protection of the interests of those who applied to the court to appoint him. So, the fact that the receiver who is appointed by the court is an officer of the
court\(^{(83)}\) and, thus, not an agent of any debenture holder\(^{(83)}\), does not mean that the receiver is concerned with the protection of the interests of the company as a whole. Similarly, the fact that a receiver enjoys many of the administrator's powers does not mean that the aim of appointing him is the furtherance of the company's interests. Again, a receiver who is appointed by the court is an officer of the court\(^{(84)}\), whereas the receiver who is appointed by a debenture holder is an agent of the company\(^{(85)}\), unless it is agreed as between the company and the appointor of the receiver that the receiver is to be deemed the agent of the appointor. However, whether the receiver is the agent of the company or of the appointor or an officer of the court, his main task is to serve the interests of the debenture holder. It was held that the receiver who is appointed by the court "supersedes the company which becomes incapable of making contracts on its behalf"\(^{(86)}\).

However, as it has already been mentioned, the receiver "supersedes" the company's powers and the authority of its directors insofar as the rights subject to the charge are concerned\(^{(87)}\). Now, does the appointment of the receiver supersede all the directors' powers to the effect that they cannot sue in the name and on behalf of the company without his consent? The importance of this issue stems from the fact that directors are bound to serve the interests of their company including the
interests of its creditors. It seems that if the receiver who fails to bring an action is the one who is appointed by the court, the directors cannot bring the action on behalf of the company without the consent of the court. This view is reached by analogy to the court's decision in Viola v. Anglo American Cold Storage Co. where it was held that the receiver who was appointed by the court could not sue or be sued without the consent of the court. Thus, since the receiver himself, in this case, cannot sue without leave of the court, it would appear arguable that the directors cannot sue instead of him without the consent of the court.

The difficulty, however, arises in cases where the receiver is appointed by a debenture holder. The leading case is Newhart Developments Ltd. v. Co-operative Commercial Bank Ltd. In that case the plaintiffs and the debenture holder (the bank) were engaged in a joint venture involving property development. The bank were to provide money for the venture. Things had not gone well and the venture ran into difficulties. Consequently, the bank had refused to provide further money and exercised their power to appoint a receiver of the plaintiffs' company. The directors brought an action, in the company's name, against the bank for breach of contract. The receiver sought to have the action set aside on the ground that
it was brought without his consent. The Court of Appeal held that the appointment of the receiver did not prevent the directors from exercising their power to sue so long as their act did not jeopardise the property subject to the charge. Shaw L.J. contrasted a receiver with the liquidator and said that there is no provision in the statute which provides that the functions of directors cease on the appointment of a receiver. The statute gives certain powers to the receiver to enable him to perform his duties to the debenture holder; but those powers do not
divest the directors of the company of their power, as the governing body of the company, of instituting proceedings in a situation where so doing does not in any way impinge prejudicially upon the position of the debenture holders by threatening or imperilling the assets which are subject to the charge.[91]

Shaw L.J. added that if the receiver failed to raise an action in the name of the company to vindicate rights which fall within the scope of the charge, "it would be incumbent"[92] on the directors to raise it so long as the exercise of such power did not harm the charge holders in their capacity as such. That is because directors owe a duty to further the interests of their company and of its creditors (other than the debenture holder) who have rights and expectations regardless of the receivership. "The receiver is entitled to ignore the claims of anybody outside the debenture holders.
Not so the company; not so, therefore, the directors of the company"(93). The facts of the Scottish case of Imperial Hotel (Aberdeen) Ltd. v. Vaux Breweries Ltd(94) were similar to those of the Newhart case. A different decision, however, was reached by the Outer House of the Court of Session. In that case it was held that it was not competent for the directors to raise an action on behalf of the company in connection with the property which was within the scope of a floating charge. The Lord Ordinary (Grieve) stated:

I am quite satisfied that the terms of the Act of 1972(95) do not empower the directors of a company, whose assets are the subject of a floating charge in connection with which a receiver has been appointed, to deal in any way with assets of theirs which are the subject of such a charge during the currency of the receivership. In particular it is not competent for the directors to raise actions in connection with such property"(96).

The uncompromising decision of Lord Grieve, which subordinates all other interests to those of the debenture holder, may not stand for long in Scotland. The Lord Ordinary, in Shanks v. Central Regional Council(97), observed that it could not be held that the directors of a company were not entitled in any circumstances to deal in any way, including the bringing of an action, with assets which were the subject of a floating charge; that while the decision of the Imperial case was applicable to most situations, it did not mean that an action brought by the directors of a company in
receivership was "inherently incompetent or necessarily a fundamental nullity"(98). Lord Weir said:

The [Companies (Floating Charges and Receivers) (Scotland) Act 1972 does not provide that the powers of a company to raise proceedings cease upon the appointment of the receiver and a study of these provisions does not lead me to conclude that Parliament intended by implication that these powers should cease(99).

It could be deduced from the observations of Lord Weir (quoted above) that the Scottish courts are willing to bring the Scots law in line with its English counterpart in relation to the powers of directors during the currency of the receivership.

It is submitted that the decision of the Court of Appeal in the Newhart case(100) and the observations of Lord Weir in the Shanks case(101), illustrate the correct approach. If a receiver failed to bring an action in relation to rights which are the subject of a floating charge, the directors should be allowed to bring the action on behalf of the company, without the consent of the receiver, so long as this action would not harm the interests of the charge holder qua charge holder. It follows that the directors are those who are to be blamed if they fail to raise an action in the name and on behalf of the company in these circumstances. If the directors failed to raise the action, then, the shareholders should have the right, by passing an
ordinary resolution, to appoint someone to act on behalf of the company (102).

It remains to say that if directors are allowed to raise an action in relation to the assets which are the subject of the charge, there can be no reason why they should not be entitled to indemnification (for the costs they properly incurred) out of the company's assets (which are not the subject of the charge). But, if the action fails, who will bear the costs of litigation in cases where the charge cover all the assets and undertaking of the company both present and future?. This type of charge was found in the Newhart case (103). In that case, the company was to be indemnified in respect of the costs of the action. Consequently, it was held that the right of action against the debenture holder would not in any way jeopardise the interests of the debenture holder in the assets which were the subject of the charge (104). But, what if the company is not to be indemnified in respect of the costs of the action?. If the directors' action in the name of the company is to be allowed, then, it will, definitely, affect the interests of the debenture holder in his capacity as such. It will adversely affect those interests if it has been a failure. On the other hand, if the action is not to be allowed, then, the interests of the company and those of the unsecured creditors will be left without protection. These situations have been
dealt with recently in Tudor Grange Holdings Ltd. and others v. Citibank NA and another (105). In that case C and his family controlled two groups of companies. They embarked on an expansion programme which led to a complex system of loans. The loans were to be provided by banks and a floating charge was granted over all the assets of the companies to secure their debts. The companies' project did not prosper and they defaulted in repaying the interest on the loans. The banks appointed an administrative receiver of the companies. Without the receiver's consent, pursuant to resolutions passed by the board of directors of each of the companies, C and the companies brought an action against the banks claiming damages for misrepresentation (105). The banks counterclaimed for repayment of principal and interest of various loans; and applied to strike out the plaintiffs' claim contending that the plaintiffs had no locus standi to bring the proceedings. Browne-Wilkinson V-C held that the directors had no power to bring the proceedings. He based his decision on the ground that:

[W]hen the directors of the plaintiff companies decided to start proceedings in the name of the company they were starting proceedings which could directly impinge on the property subject to the receiver's powers in that they held no indemnity against the liability of the companies' assets to satisfy a hostile order for costs made against the companies . . . [T]he receiver's position was prejudiced by the decision taken (107).
However, in the Tudor case\(^\text{(108)}\), the directors offered to provide an indemnity, within 28 days, against all liability of the companies in costs to the defendants to the sum of £200,000. This offer led the judge not to strike out their action\(^\text{(109)}\).

It is plain that the decision of the Tudor case is a clear application of the decision of the Court of Appeal in the Newhart case\(^\text{(110)}\). According to the decision in both cases, directors have no locus standi to start proceedings in the name and on behalf of the company where the proceedings impinge on the assets subject to the charge. The proceedings directly impinge on those assets if the company is not to be indemnified against liabilities it may incur, to satisfy a hostile order for costs made against it. In this case the receiver's consent is essential if the directors wish to sue in the name of the company. If the receiver refuses to sanction the commencement of proceedings made by the directors, then, the directors themselves will sustain the costs of those proceedings with no right of indemnity out of the company's assets. If following the refusal of the receiver, the directors decided not to commence any proceedings in the name of the company, it would seem that, the directors would not be blamed or sued for a breach of duty. It is not reasonable to blame them in such a case because it is unfair to ask
them to protect the interests of the company and those of its creditors at their own expense.

If the company is to be indemnified in respect of the costs of an action, then directors can bring the action in its name without the consent of the receiver who fails to act.

However, despite the fact that Browne-Wilkison V-C in the Tudor case followed the decision of the Newhart case, he criticised it by stating:

I have substantial doubts whether the Newhart case was correctly decided in any event. That may have to be looked at again in the future. The decision seems to ignore the difficulty which arises if two different sets of people, the directors and the receivers, who may have widely different views and interests, both have power to bring proceedings on the same cause of action. The position is exacerbated where, . . . , the persons who have been sued by the directors bring a counterclaim against the company. Who is to have the conduct of that counter claim which directly attacks the property of the company? Further, the Court of Appeal in the Newhart case does not seem to have had its attention drawn to the fact that the embarrassment of the receiver in deciding whether or not to sue can be met by an application to the court for directions as to what course should be taken, an application now envisaged in S.35 of the Insolvency Act 1986(111).

Again, it is submitted that the decision of the Newhart case is a correct and reasonable one. However, to avoid multiplicity of actions (i.e., to avoid the case of bringing proceedings on the same cause of action by two different sets of people, directors and the receiver(112)), it is suggested that directors must have
first made a real attempt to obtain the receiver's cooperation. If the receiver refuses to bring the action on behalf of the company (probably because the defender is his appointer), directors must have the power to sue in the name and on behalf of the company to protect its interests including the interests of the creditors other than the holder of the charge. It is also suggested that if the defender makes a counterclaim against the company which may attack the property under the charge, the directors can exercise the power to defend the action in the name of the company. But, they must have first made a real attempt to obtain the receiver's cooperation. If the receiver insists on not defending the action (probably because the one who made the counterclaim was his appointer), the directors must not be prevented from defending the action in the name and on behalf of the company. It is to be emphasised, however, that the suggestions made (above) are subject to the rule that the exercise of the power to sue or the power to defend an action must not harm the assets falling within the scope of the charge.
2.3.2. Power to Delegate.

The power to manage a company is usually vested in the board of directors. But it is neither feasible nor customary for the directors to run the company's affairs in the sense that they themselves conduct its daily operations\(^{(115)}\). Directors' duties are of an "intermittent nature to be performed at periodical board meetings"\(^{(116)}\). Thus, directors are not expected to devote their whole time to their company's affairs. In practice, and particularly in large companies, directors do not enter into or supervise every single transaction on behalf of the company\(^{(117)}\). It follows that it is necessary for the board of directors, in some situations, to delegate some of its powers to others.

A company is an artificial entity. It acts through its directors. The directors derive their powers, mainly, from the company's articles. To some extent, directors may be considered as agents of the company\(^{(118)}\). The law of agency principle "delegatus non potest delegare" applies to them\(^{(119)}\). Thus, they cannot delegate the powers vested in them without the authority of the company's members or the company's articles. The articles, normally, allow the board of directors to delegate powers to individual directors or committees or sub-committees of the board\(^{(120)}\). Delegation of powers by the board is usually revocable\(^{(121)}\). Proper
delegation to a committee of the board may in some cases exonerate the directors who are not on the committee(122).

Power to delegate: Test of validity

Since directors are subjected to the norm "delegatus non potest delegare"(123), their power to delegate is, usually, strictly construed depending on the articles of association(124). In the absence of an express authorisation to delegate, it was held, that directors could not delegate their discretionary powers to others(125). But, like ordinary agents, directors can delegate those functions which belong to the management of the ordinary commercial business"(126) of the company, without the need for an express authorisation. In other words, the non-discretionary functions (i.e. which do not involve an exercise of judgment and discretion) can be delegated without an express authorisation.

A company is free to adopt whatever form of articles it desires. An example of a management article, which deals with the issue of delegation of powers, and which is usually adopted by companies, is found in art.72 of the 1985 Table A(127). The article provides:

The directors may delegate any of their powers to any committee consisting of one or more directors. They may also delegate to any managing director or any director holding any
other executive office such of their powers as they consider desirable to be exercised by him. Any such delegation may be made subject to any conditions the directors may impose, and either collaterally with or to the exclusion of their own powers and may be revoked or altered. Subject to any such conditions, the proceedings of a committee with two or more members shall be governed by the articles regulating the proceedings of directors so far as they are capable of applying.

If a company has adopted art.72, then it is competent for its directors to delegate their powers to a committee of one(128) or more directors or to a managing director.

Since the validity of delegation depends upon the true construction of the articles, the difficulty of distinguishing between delegable and non-delegable functions (i.e. non-discretionary and discretionary functions) may hardly arise. If it is found that the articles do not authorise the delegation of a particular power, the delegates will have no authority to exercise that particular power. In Guinness plc v. Saunders(129), a committee of directors was formed to conduct a take-over bid. Following the successful completion of the bid, the committee authorised special payment to one of its members (for advice and services in relation to the bid) despite the fact that it had no authority to authorise those payments. Such payment could only be authorised by the board of directors. The House of Lords held that because the committee had no
power to authorise those payments, the payments were reclaimable from the director concerned.

Again, because the validity of delegation depends on the true construction of the articles, the companies in the U.K. are accustomed to state clearly, in their articles, the extent to which the powers of directors may be delegated. The strictness with which the articles and the service contracts are construed is well illustrated by the case of Holdsworth (Harold) & Co. (Wakefield) Ltd. v. Caddies. In that case, the articles of the company empowered the directors to delegate any of their powers to a managing director. C was appointed a managing director for five years under a service agreement with the company. The agreement provides:

[C] shall be and he is hereby appointed a managing director of the company and as such managing director he shall perform the duties and exercise the powers in relation to the business of the company and the business (howsoever carried on) of its existing subsidiary companies at the date hereof which may from time to time be assigned to or vested in him by the board of directors of the company.

The service agreement also provided that C should devote all his time and attention to his functions and should obey the orders of the board. Following a dispute between the board and C, the board resolved that C should confine his attention to a particular subsidiary company. C brought an action against the company for breach of contract. His action was dismissed on the
ground that neither the Act nor the service agreement could on their true construction be said to prevent the company from limiting his functions to a particular subsidiary company. The service agreement provided that C should perform such functions as may be assigned to him by the board from time to time. Consequently, the House of Lords held, the limiting of his duties, by the board, was entirely consistent with the terms of the agreement. It is clear from the decision of the House of Lords in the Caddies case(132), that the true construction of the articles is the touchstone against which the court examines the validity of a particular delegation of power. Similarly, the court will rely on the true and strict construction of a service contract to find out whether the board is entitled to limit or abrogate the powers of the managing director.

Delegation of a particular power

If a particular power is expressly vested in the board of directors, then, the board cannot delegate that power to others in reliance on an authority to delegate given to it in general terms. In the Howard's case(133), the power to allot or to distribute unsubscribed shares was, under the articles, vested in the directors, three of who constituted a quorum. A resolution was passed by the directors providing that "the shares remaining
undistributed, shall be allotted according to the discretion of the manager and the two private directors"(134). Accordingly, the shares were allotted by the manager and the two directors. The court held that the allotment was invalid on the ground that the delegation by the directors was unwarranted as they had no authority to delegate that particular power which was expressly vested in them by the articles. Similarly, in the Cartmell's case(135), the power to buy shares from any shareholder on behalf of the company out of its own funds was expressly given to the board of directors. The directors were also given the power to appoint a general manager. The general manager exercised the power to buy shares from the shareholders on behalf of the company and out of its funds. The court held that,

"a mere power to appoint a general manager would not authorise the directors to transfer to him the power to purchase shares where that power is by the articles given to the directors themselves"(136).

But, what if the articles authorise directors to delegate all or any of their powers?. Can the directors, in this case, delegate a particular power which is by the articles expressly given to them?. The answer to this question is yes. For example, in Re Taurine Company(137), the articles of the company empowered the directors to delegate all or any of their powers to others. The articles, however, provided:

A transfer of a registered share, except a fully paid up share, shall not be made without
the approval of the board, who shall have an absolute discretion as to accepting or rejecting the transfer.

The power to approve the transfers was delegated by the board to a one director committee. The court held that the delegation was properly made. The decision was based on the ground that the articles empowered the directors to delegate any or all of the powers vested in them. There was no reason to say that the power to approve of a transfer of shares was excepted. Accordingly, it is submitted that, if the articles empower the directors to delegate all or any of their powers, then, it is competent to them to delegate any particular power even if it is, by the articles, expressly vested in them.

Directors' power to delegate to the exclusion of their own powers.

It is competent to a company to adopt an article authorising the board of directors to delegate its powers (to a committee consisting of one or more directors, or to a managing director or any director holding any executive office) to the exclusion of its own powers. This is clear from the wording of art. 72 of the 1985 Table A which provides:

The directors may delegate any of their powers... Any such delegation may be made... to the exclusion of their own powers...
If a company adopts art. 72, then, it is submitted, the directors can divest themselves of their own powers and escape any responsibility for the proper discharge of the power so delegated. It is also submitted that, if the directors delegate any of their powers to the exclusion of their own powers, they must not be allowed to supervise the exercise of that power or to give directions to the delegates on how to exercise that power. In other words, the directors should not be allowed to interfere with the delegates' exercise of the power so delegated, unless they reserve to themselves the right to interfere. Art. 72 contains the words "... and may be revoked or altered". Despite those words, it is submitted that, the directors must not be allowed to revoke the delegation, so long as a service agreement is in existence, unless they reserve for themselves the right to do so. Otherwise, directors may be held liable for a breach of the service contract entered into with the delegates. In addition, it would seem that the phrase "to the exclusion of their own powers" will have a defective meaning if the directors are allowed to revoke the delegation. This phrase should be interpreted to mean that the power to revoke the delegation is also excluded unless, as already mentioned, the right to revoke is expressly reserved for the directors by the service agreement (i.e. the agreement which is entered into with the
delegates in pursuance of an article similar to art.72)(140).
It is submitted that the directors' power to delegate any power, to the exclusion of their own powers, must not amount to an assignment of office (which can only be authorised by a special resolution of the general meeting)(141). Directors' power to delegate to the exclusion of their powers will not amount to an assignment of office so long as the delegation: (1) is made in respect of some, but not all, of the powers of directors, and/or (2) is made for a specified period of time.

Directors' liability for delegates

The liability in question is, mainly, governed by the rules of agency. Thus, one intends not to discuss this issue in detail since this chapter deals mainly with the powers of directors rather than their liability. It may not be out of place, however, to refer here to the case of Re City Equitable Fire Insurance(142). In that case Romer J. said:

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(143).
A director is justified in trusting delegates and can rely on them where the circumstances of the delegation give him no ground for suspicion. Thus, a director who delegates a particular function to others and reserves for himself the right to supervise the performance of that function cannot allege and should not be allowed to maintain that he did not know what was going on. However, reliance on delegates cannot constitute a defence in a director's hand unless it is a reasonable one.

Proper delegation to a committee of the board may in some circumstances exonerate the directors who are not on the committee. In *Land Credit Co. of Ireland v. Lord Fermoy*¹⁴⁵, some powers were delegated to a sub-committee of the board. The sub-committee used the company's funds to buy the company's shares for the purpose of keeping up their price. This operation was cloaked by the sub-committee under the veil of loans which were disclosed to the full board but the purpose of which was concealed. It was held that the sub-committee had breached its duty by concealing the objectionable nature of the loans. Consequently, the sub-committee was made liable to repay those loans. However, the director who was not on the sub-committee was exonerated.

It seems that in cases where the directors delegate some of their powers to the exclusion of their own powers,
they can escape liability for the proper discharge of the matters so delegated. No responsibility or blame could be attached to them so long as they reserved no right for themselves to supervise the exercise of the delegated powers.

Delegation of powers and third parties

It should be noticed that this issue will be discussed only under the Companies Act 1985 as amended by the Companies Act 1989. The new S.35A (S.108 CA 1989) provides:

(1) In favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company's constitution.

It seems that this section has almost completely removed the need to rely on the rules of agency. According to the new S.35A (1) (quoted above), a person who deals with a company in good faith is protected whatever the validity of the delegation. In other words, even if the directors have no authority to delegate a particular power to others, the exercise of that power by the delegates will be considered valid insofar as a bona fide third party is concerned. Good faith on the part of a third party dealing with the company is presumed unless the contrary is proved.
Further, the mere knowledge, that directors are not allowed to delegate a particular power under the company's constitution, does not amount to mala fides on the part of the third party\(^{(150)}\). Furthermore, third parties are not bound to enquire as to "any limitation on the powers of the board of directors to bind the company or authorise others to do so"\(^{(151)}\).

The position of a third party has also been strengthened by the abolition of the constructive notice doctrine for almost all purposes. The new S.711A (S.142 CA 1989) provides:

\[(1) A \text{ person shall not be taken to have notice of any matter merely because of its being disclosed in any document kept by the registrar of companies (and thus available for inspection) or made available by the company for inspection)}^{(152)}\].

2.3.3. Power to Issue Shares and Debentures.

S.80 CA 1985 provides:

\[(1) \text{ The directors of a company shall not exercise any power of the company to allot relevant securities, unless they are, in accordance with this section [or section 80A], authorised to do so by-}
\]

(a) the company in general meeting; or

(b) the company's articles.

Accordingly, directors may only allot shares if empowered to do so by the shareholders in general meeting or by the company's articles of association. The authority of directors to allot shares under S.80 may be general or specific\(^{(153)}\), but this authority may
not last for more than 5 years\(^{(154)}\). The maximum amount of securities which may be allotted must be stated in the authority; the authority must state the date on which it expires\(^{(155)}\). The authority may be renewed for a further period not exceeding 5 years\(^{(156)}\). However, the new S.80A\(^{(157)}\) gives private companies the right to elect that the provisions of S.80A will apply instead of S.80(4) and (5). The new S.80A (2) allows a private company to give the authority to allot shares for an indefinite period.

Directors must exercise the power to allot shares for a proper purpose\(^{(158)}\).

A company's articles may empower the directors to issue debentures. There is no provision preventing a company from issuing debentures at a discount\(^{(159)}\).

### 2.3.4. Power to Make Calls and Forfeiture.

Subject to any limitation in a company's memorandum, directors may make calls upon the members in respect of any moneys unpaid on their shares. A call, however, may be revoked before receipt by the company of any payment and may be postponed\(^{(160)}\). A call can be made at any time; but it is possible for a company to determine that any portion of its shares (which has not been already called up) is not to be called up except on the winding up of the company. A special resolution is, however,
required in this case\(^{161}\). The unpaid money on a member's shares is a debt owed by him to the company\(^{162}\). In England, the period within which an action can be brought for payment of those moneys is 12 years\(^{163}\). In Scotland, the period within which a call can be enforced is 20 years\(^{164}\).

The power of the directors to make calls on shares must be exercised \textit{bona fide} in the best interest of the company\(^{165}\). Accordingly, they are not entitled to exercise this power for the purpose of giving themselves an advantage over other shareholders\(^{166}\). They are, for example, not entitled to make calls on all the members of the company except themselves without the approval of the other members\(^{167}\).

A company's articles may empower directors to forfeit shares\(^{168}\). Forfeiture of shares can, however, only be made for non-payment of a call or an instalment\(^{169}\). Directors must exercise the power to forfeit shares in good faith and in the best interest of the company. Directors, for example, must not exercise this power for the purpose of relieving shareholders from liability\(^{170}\).

2.3.5. Power to Reject a Transfer of Shares.

Directors may reject the transfer of shares if they are empowered by the articles to do so\(^{171}\). In the absence
of restrictions in a company's articles on transfer of shares, a shareholder can, by virtue of the statute, transfer his shares to any transferee. This is so provided that the transferor, in good faith, divests himself of any benefit or interests in the shares. If there are no restrictions on transfer in the articles, directors cannot refuse to register the transferred shares to the transferee. These matters are well illustrated by Buckley L.J. in Lindlar's case^{172}. His Lordship said:

[The Companies Acts provide] that the shares in a company under these Acts shall be capable of being transferred in manner provided by regulations of the company. The regulations of the company may impose fetters upon the right of transfer. In the absence of restrictions in the articles the shareholder has by virtue of the statute the right to transfer his shares without the consent of any body to any transferee, even though he be a man of straw, provided it is a bona fide transaction in the sense that it is an out-and-out disposal of the property without retaining any interest in the shares - that the transferor bona fide divests himself of all benefit. . . In the absence of restrictions it is competent to a transferor, notwithstanding that the company is in extremis to compel registration of a transfer to a transferee notwithstanding that the latter is a person not competent to meet the unpaid liability upon the shares. Even if the transfer be executed for the express purpose of relieving the transferor from liability, the directors cannot upon that ground refused to register it unless there is in the articles some provision so enabling them^{173}.

Restrictions on transfer of shares can only be made by private companies. In the case of a public company, transfer of shares must, normally, be free from
restrictions if a stock exchange quotation is to be obtained. If a company's articles give the directors an absolute and unlimited discretion (when exercising the power to refuse a transfer) with no obligation on them to give reasons for refusing a transfer, then, they are not obliged to reveal the reason for the refusal\(^{(174)}\). In this case, the court would not interfere with the exercise of, such a power unless it is shown that the directors were not acting bona fide in the best interest of the company as whole\(^{(175)}\). It is to be noticed that *bona fides* is presumed unless the contrary is proved\(^{(176)}\).

If the articles empower the directors to refuse to register a transfer on certain grounds, the directors can be questioned as to the grounds on which they have refused registration. The directors, here, owe a duty to the company to exercise such a power for the purpose for which it is conferred. If the directors give reasons for their refusal to transfer shares, the court can decide whether the given reasons are sufficient to justify the refusal. In *Re Bede SS. Co. Ltd.*\(^{(177)}\), the articles entitled directors to refuse a transfer of shares if "in their opinion it is contrary to the interests of the company that the proposed transferee should be a member thereof". The directors exercised that power and refused to register a transfer of single shares on the ground that a transfer of single shares to
outsiders (with no interest in, or knowledge of shipping) was contrary to the interests of the company. The court held that that reason was not enough to justify the refusal. Refusal should be based on grounds personal to the transferee as was stated in the articles. The law deals with directors' power to refuse a transfer has been summarised by Vinelott J. in Tett v. Phoenix Property & Investment Co. Ltd. (178). The Judge said:

[T]he court will not interfere with the exercise by directors of a discretion not to register a transfer if their decision was one which a reasonable board of directors could bona fide believe to be in the interests of the company. If the discretion is an unfettered one and not limited to specific grounds of refusal the court will not compel the directors to give their reasons for their refusal. If their decision was one which a reasonable board could consider to be in the interests of the company then the court presumes that they acted bona fide and had good grounds for their decision. However, if the directors once give their reasons the court can consider how far those reasons did justify their decision (179).

If a company's articles provide that a member may not sell his shares without first offering them to existing members, directors are under a duty to refuse to register a transfer to an outsider if the transferee has breached the articles by not offering the shares to existing members first (180). If directors refuse to register a transfer, the company must send a notice of refusal to the transferee "within 2 months after the date on which the transfer was
lodged" for registration (181). If the company fails to send notice of refusal to the transferee within the specified period, "the company and every officer of it who is in default is liable to a fine and, for continued contravention [of S.183 (5)], to a daily default fine" (182).

Directors' decision to register a transfer must be taken within a reasonable time after the transfer has been submitted. The power to refuse registration must be affirmatively exercised by the board of directors (183); silence is not sufficient since the transferee has a prima facie right to be registered unless refused (184). In the light of S.183(5) a reasonable time within which the board of directors can refuse registration of a transfer is prima facie two months (185).

2.3.6. Power to Bind the Company.

In general, after the incorporation of a company, the company is bound by the transactions entered into by its directors on its behalf. The question of directors' power to bind the company leads one to examine the position of directors in relation to both pre-incorporation and ultra vires transactions.
1) **Pre-incorporation transactions** (186).

Before the formation of a company, any transaction entered into by persons purporting to act on its behalf will not bind the company. Such a transaction cannot be enforced (187) or ratified by the company after incorporation (188). Before incorporation, a company has no capacity to enter into any transaction, and consequently, no person can enter into a transaction on behalf of a non-existent principal (189). The effect of such a transaction is that it binds the person who enters into it. In *Kelner v. Baxter* (190), before the incorporation of the company, the promoters signed a contract "on behalf of" the proposed company for the purchase of a quantity of wine. The company was formed and the wine was handed over to it and consumed. However, before payment was made the company went into liquidation. The court held that the promoters were personally liable to pay for the wine, and no ratification could release them from liability.

At the common law, there was a distinction between the position of a person who acted as an agent and that of a person who was purporting to authenticate the signature of the company. The former was held to be personally liable (191), whereas the latter was not (192). In *Newborne v. Sensolid (Great Britain) Ltd.* (193), a quantity of tinned ham was sold to S Ltd. by a company
which was not in existence at the time of the contract. The contract was "We have this day sold to you . . . (Signed) Leopold Newborne (London) Ltd". S Ltd. refused to take delivery because the market price of the ham was fallen. It was held that Leopold Newborne (London) Ltd. could not enforce the contract because it was made before its incorporation. Leopold Newborne (the promoter) was also held not to be able to enforce the contract because the case was not one of an agent undertaking to do certain things himself as agent for another, rather it was a case in which a company purported to sell. So, the contract was held to be "a complete nullity".

The distinction between signature of a person acting as agent and a signature authenticating that of the company has been abolished by the enactment of S.36(4) of the Companies Act 1985 (194). S.36(4) has been replaced by, what is now, the new S.36(c) (195). The section provides:

(1) A contract which purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as an agent for it, and he is personally liable on the contract accordingly (196).

Thus, in Phonogram v. Lane (197), before the formation of the company, Lane signed a contract "for and on behalf of Fragile Management Ltd.". Under the contract he
received an advance payment of £6,000 which was repayable if a recording contract was not entered into within one month. The company was never formed and no recording contract was made. The lender sued for the return of the £6,000. The Court of Appeal held Lane personally liable for the return of the money despite the fact that at common law Lane's signature could be regarded as mere authentication of the company's signature (198).

What is important in this context is that a person (who holds himself out as occupying the position of a director, and who enters into a transaction on behalf of a company before incorporation) binds himself, not the company, to that transaction. His liability is presumed unless there is an agreement to the contrary (199). Consequently, he can escape personal liability by inserting an exclusion clause in the agreement with the other party to the transaction. To avoid personal liability, only a clear exclusion of personal liability would amount to an agreement to the contrary (200).

2) Ultra vires transactions.

The question of the ultra vires transactions will be examined only as far as the directors' power to bind the company is concerned. However, it might be desirable to
discuss, in brief, the history of the ultra vires doctrine.

In the past, it was to the advantage of a person who was about to deal with a company to have regard to the following matters:

1) that the company has the capacity to enter into the sort of transaction in question;
2) that the company has the power to enter into that kind of transaction; and
3) that the company's officer with whom he deals has the power or the authority to involve the company into that transaction.

The first and the second matters deal with the capacity and the power of a company. Prior to the enactment of the new S.35 of the Companies Act 1985, a company's capacity is limited by its memorandum. S.2 of the Companies Act 1985 requires a company to state its objects. So, any act beyond those objects was considered to be beyond the capacity of the company. Any act beyond the capacity of the company was deemed to be ultra vires and, consequently, void and not ratifiable. An ultra vires act could not be ratified even by a unanimous vote of the shareholders.

Further, "an ultra vires agreement cannot become intra vires by reasons of estoppel, lapse of time, . . . acquiescence or delay".

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A company's objects were distinguished, in the past, from a company's powers. A company could not exercise any of its powers otherwise than for the purposes of its objects. In General Auction Estate & Monetary Co. v. Smith (204), the company had borrowed money. The court was faced with the question whether the company had a power to borrow and, if so, whether in this particular case the money was borrowed for the purposes of its objects. The court held that the company in question had the power to borrow money and the money were borrowed for the purposes of its stated objects. Had the company, in that case, had no power to borrow money, the borrowing would have been beyond its capacity and consequently ultra vires.

The courts tried to lessen the rigidity of the ultra vires doctrine in several ways. Firstly, it had been held that matters incidental or conducive to the attainment of the main objects of a company could be undertaken by the company (205). Secondly, the main object rule was defeated by the decision of the House of Lords in Cotman v. Brougham (206), where it was held that it was competent to a company to declare at the end of its objects clause that each and every clause should be regarded as a separate and independent object of the company. Thirdly, in Bell Houses Ltd v. City Wall Properties Ltd (207), the court held valid a clause which permitted a company to engage in any business which was
regarded by the directors as for the benefit of the company. The decision in that case, in effect, defeated the policy behind having an object clause. Fourthly, the courts moved toward disregarding any distinction between objects and powers. Objects and powers were treated as one and the same. A wide construction was also given to every word deployed in the objects clause\(^{(208)}\). Fifthly, in *Rolled Steel Products Ltd. v. British Steel Corporation\(^{(209)}\)*, the Court of Appeal rejected the view that a company could not exercise any of its powers otherwise than for the purpose of its objects. The court held that if a company had a particular power in its objects clause then it would have the capacity to exercise that power for any legal purpose notwithstanding its objects.

The Companies Acts have also made an attempt to lessen the effects of the ultra vires rule. Firstly, S.9 of the Companies Act 1985 allows a company to alter its objects by a special resolution\(^{(210)}\). Thus, a company is allowed to alter its objects clause so as to expand its activities as it thinks proper. Prior to the enactment of the Companies Act 1989, an alteration of the articles could only be made for a specified purpose. Nowadays, the new S.4 of the companies Act 1985\(^{(211)}\) allows a company to alter its objects clause by a special resolution at any time and for any purpose. Secondly, the new S.3A of the Companies Act 1985\(^{(212)}\)
allows a company to state that its object is "to carry on business as a general commercial company". This section has, in fact, great impact on the scope of application of the ultra vires doctrine. That is because, it allows a company "to carry on any trade or business whatsoever"(213), and to "do all such things as are incidental or conductive to the carrying on of any trade or business"(214). If a company drafts its objects clause in the manner described by the new S.3A, the ultra vires doctrine may operate only in the field of corporate gifts and gratuitous transactions(215).

Thirdly, S.35 of the Companies Act 1985(216) protected a limited class of person dealing with a company from the devastating effects of the ultra vires doctrine. It provided:

(1) In favour of a person dealing with a company in good faith, any transaction decided on by the directors is deemed to be one which it is within the capacity of the company to enter into, and the power of the directors to bind the company is deemed to be free of any limitation under the memorandum or articles.

S.35 had been widely criticised as being one which added a complicated face to the ultra vires doctrine(217). S.35 has been replaced by the new S.35(218) which effectively abolishes the ultra vires doctrine insofar as a third party dealing with a company in good faith is concerned. On the other hand, the new S.35 reserves the internal effects of the doctrine. The new S.35 provides:
(1) The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company's memorandum.

Accordingly, a company's capacity is not limited by its memorandum\(^\text{219}\).

It has already been mentioned that care should be taken to ensure that the company officer, with whom he deals, has the power to bind the company to the transaction in question. If a director has the authority to bind the company to a particular transaction, then, the third party is well protected. In other words, the company cannot avoid that transaction.

A company may try to avoid a transaction by arguing that it has been entered into, on its behalf, by a person who is not a director; or by the board in excess of its authority; or by an individual director without proper delegation. In the past, a third party could rely on the rules of agency to enforce such a transaction against the company\(^\text{220}\). Nowadays, a third party can rely on the new S.35A instead of the rules of agency to enforce a transaction against the company. New S.35A removes the need to rely on the rules of agency in almost all cases. The section refers to the "power of the board of directors to bind the company, or authorise others to do so". It provides:
In favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or authorise others to do so, shall be deemed to be free of any limitation under the company's constitution.

Thus, so long as a third party is dealing with the company in good faith (and he is presumed to do so unless the contrary is proved) a transaction entered into with the company is binding on it, regardless of any limitations, under its constitution, on the power of the board of directors to bind it. In other words, the board's excess of power, abuse of power and defective delegation are no longer effective defences in the hand of a company to invalidate a particular transaction so long as those breaches arise from limitations under the company's constitution.

The phrase "any limitation under the company's constitution" has been given a very wide meaning by the new S.35A (3). The section provides:

[L]imitations on directors' powers under the company's constitution include limitations deriving:
(a) from a resolution of the company in general meeting or a meeting of any class of shareholders, or
(b) from any agreement between the members of the company or any class of shareholders.

Thus, the word "limitation" is not limited to those found in the company's memorandum or articles of association.

The mere knowledge that a particular act is beyond the directors' powers under the articles does not amount to
a *mala fides* on the part of a third party\(^{(224)}\). The new S.711A of the Companies Act 1985\(^{(225)}\) abolishes the doctrine of constructive notice for almost all purposes. So, a person cannot be taken to have notice of any matter merely because it is "disclosed in any document kept by the registrar of companies (and thus available for inspection) or made available by the company for inspection"\(^{(226)}\). The position of a third party has been further strengthened by the new S.35B which provides that a person dealing with a company is not bound to enquire as to any limitation on the power of the directors to bind the company or to authorise others to do so\(^{(227)}\).

To sum up: any limitation on the power of the board to bind the company or to authorise others to do so is of no effect so long as the other party to the transaction is dealing with the company in good faith. It follows that a company would not be able to avoid a transaction simply on the ground that the directors had exceeded or abused the powers vested in them by its constitution. This rule, however, has been subjected to a very important exception: An act of a company is voidable at the instance of the company where the other party to the act is the company's director or directors or any director of its holding company or any of their associates\(^{(228)}\). The reason behind this exception is to prevent directors from using new S.35A as a vehicle for
fraud by misusing their powers in order to bind the company to a transaction from which they are to benefit(229). However, this restriction does not affect transactions in which bona fide third parties are involved. Those transactions remain valid and binding on the company insofar as the third parties are concerned(230).

2.4. Excess of Power, Abuse of Power and Ratification.

It has already been mentioned that directors derive their powers, mainly, from the articles of association. They are required to exercise the powers vested in them bona fide in the best interest of the company(231). They are also required not to usurp powers which they never have (e.g. powers which are vested, by the articles, in the general meeting of the shareholders)(232).

Where directors exercise their powers for purposes other than those for which they are conferred, it can be said that they are abusing their powers. But where they usurp a power which they never have, it can be said that they are exceeding their powers(233).

Directors' abuse of power can be ratified by the company in general meeting so long as they have acted bona fide in what they believe to be in the interest of the company(234). However, any ratification which is
tantamount to fraud on the minority cannot be allowed. An abuse of power can be ratified by an ordinary resolution. In Bamford v. Bamford, the directors issued shares in exercise of a power vested in them by the company's articles. It was alleged that the purpose for which the shares were issued (which was the defeating of a take-over bid) was improper. However, the company ratified the directors' act by an ordinary resolution. The Court of Appeal held that such ratification would be effective. Harman L.J. said:

The only question is whether the allotment, having been made, as one must assume, in bad faith, is voidable and can be avoided at the instance of the company - at their instance only and of no one else, because the wrong, if wrong it be, is a wrong done to the company. . . . the company which had the right to recall the allotment, has also the right to approve of it and forgive it . . .

Similarly, excess of power can be ratified by the company by way of ordinary resolution. In Grant v. United Kingdom Switchback Railways, the articles of the company disqualified any director from voting at a board meeting in respect of any contract in which he was interested. The directors decided to sell the company's undertaking to another company despite the fact that they were the promoters of the purchasing company. The Court of Appeal held that despite the fact that the directors had exceeded their powers, their act could be ratified by an ordinary resolution of the general
meeting. The argument that such ratification amounted to an alteration of the articles (which could only be done by a special resolution) was rejected by the court. The court distinguished between the case where a company ratified an unauthorised act and the case where the company gave the directors a power to do things in the future which were not permitted by the articles. The former was held to be ratification and could be effected by ordinary resolution, whereas the latter was held to be an alteration of the articles which could only be effected by special resolution. Cotton L.J. approached that distinction and put it in this way:

"The ratifying of a particular contract which had been entered into by the directors without authority, and so making it an act of the company, is quite a different thing from altering the articles. To give the directors power to do things in future which the articles did not authorise them to do would be an alteration of the articles, but it is no alteration of the articles to ratify a contract which has been made without authority"(240).

But, what if the directors do an unauthorised act which can only be done by a special majority of the shareholders in general meeting. Can the company ratify such an act by an ordinary resolution? The answer to this question seems to be no. A special resolution may be needed to ratify such an act.

Excess of power and abuse of power can be regarded as a breach of duty(240). It is as yet unclear whether ratification will relieve directors from liability for
the breach or merely cure the irregularity in the
transaction\(^{(242)}\). In *Multinational Gas and
Petrochemical Co. Ltd. v. Multinational Gas and
Petrochemical Services Ltd.*\(^{(243)}\), May L.J., in his
dissenting judgment, was of the opinion that
ratification would not deprive the company of its right
to sue the directors in breach of duty in respect of the
alleged negligence. It would seem that this view has
found some support in the new S.35(3) of the Companies
Act 1985\(^{(244)}\). The section provides that a company can,
by passing a special resolution, ratify an act which
would previously have been regarded as being beyond its
capacity. But a resolution ratifying such act "shall
not affect any liability incurred by the directors or
any other person; relief from any such liability must be
agreed to separately by special resolution"\(^{(245)}\). Thus,
while ratification "cures" the breach of duty, it does
not relieve the directors from liability incurred by
virtue of the directors exceeding their powers. For an
effective relief from liability a separate special
resolution is required. This distinction, it is
agreed\(^{(246)}\), should be recognised by the courts. It
should be recognised generally and not only in relation
to *ultra vires* transactions. In other words, if a
company ratifies an act done by the directors in excess
of their powers (but *intra vires* the company) such
ratification must not affect the directors' liability which is incurred as a result of the excess of power.
FOOTNOTES

1) See Impey and Montague, Running a Limited Company, [1990].
3) [1842] 2 Hare 461.
4) [1883] 25 Ch.D. 320 (CA).
5) The Scottish term "interdict".
6) [1883] 25 Ch.D. 320 (CA) at p.329.
7) [1883] 25 Ch.D. 320 (CA) at pp.330-1.
8) See Buckley, The Law and Practice under the Companies Acts 1862-1893, 7th ed, [1897], at p.53. Buckley had no longer held this view when sitting in the Court of Appeal in 1908: see his Lordship's judgment in Gramophone and Typewriter Ltd. v. Stanley [1908] 2 K.B. 89 at pp.105-6. The old view had been illustrated by the wording of S.90 of the Companies Clauses Consolidation Act 1845 which provides: "The directors shall have the management and superintendence of the affairs of the company, and they may lawfully exercise all the powers of the company, except as to such matters as are directed by this or the special Act to be transacted by a general meeting of the company; but all the powers so to be exercised shall be exercised in accordance with and subject to the provisions of this and the special Act; and the exercise of all such powers shall be subject also to the control and regulation of any general meeting specially convened for the purpose, but not so as to render invalid any act done by the directors prior to any resolution passed by such general meeting" (emphasis added).
9) [1906] 2 Ch. 34.
10) [1906] 2 Ch. 34 at p.44.
11) [1906] 2 Ch. 34 at p.45; Tahourdin's case [1883] 25 Ch. 320 was distinguished on the ground that S.90 of the Companies Clauses Consolidation Act contained words which were not to be found in the Companies Act 1862.
12) [1906] 2 Ch. 34.
13) [1906] 2 K.B. 89.
14) Buckley, The Law and Practice under the Companies Acts 1862-1893, 7th ed, [1897], at p.530 where he said that a company in general meeting had a power to direct and control the board of directors as to the management of the company's affairs.
15) [1908] 2 K.B. 89 at pp.105-6.
16) Buckley L.J. said that the shareholders could, by a special resolution, remove the directors from office: [1908] 2 K.B. 89 at p.106.; However, S.303
CA 1985 (S.184 CA 1948) entitles a company to remove the director by ordinary resolution. Bourne has correctly argued that S.303 may not always be effective; a director may escape from the rigour of that section and thus defeat any attempt to dismiss him in cases where he holds a majority of shares either personally or with his supporters: Bourne, "Removal of Directors" [1992] B.L.R. 5.

17) S.9 CA 1985.


19) However, see Neville J. in Marshall's Valve Gear Co. Ltd. v. Manning, Wardle & Co. Ltd. [1909] 1 Ch. 267 where he took a view which was different from that taken by the Court of Appeal in the Stanley case and the Cuninghame case. However, the Marshall's Valve Gear case was one dealing with the initiation of an action in the company's name which the directors failed to proceed. The court held that the decision of the majority shareholders to bring the action without the directors' consent was valid and could not be set aside.

20) [1909] A.C. 442 (HL).

21) [1935] 2 K.B. 113 (CA).

22) [1906] 2 Ch. 34 (CA).

23) [1908] 2 K.B. 89 (CA).

24) [1935] 2 K.B. 113 (CA); see also Scott v. Scott [1943] 1 All E.R. 582.

25) [1935] 2 K.B. 113 (CA) at p.134.


27) See per Cozens L.J. in Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame [1906] 2 Ch. 34 at p.44.

28) Examples of these powers will be examined later.


30) See Marshall's Valve Gear Co. Ltd. v. Manning, Wardle & Co. Ltd. [1909] 1 Ch. 267 where Neville J. distinguished between powers which are the subject of express reference on the one hand and powers which are given in general terms. Powers are given in general terms where the articles contain a clause empowering the board to manage the company's affairs generally. If the powers were given in general terms, then, the court said, the members would have
control over the board even by way of ordinary resolutions.

31) [1906] 2 Ch. 34.
32) [1908] 2 K.B. 89.
33) However, it was argued that those cases where decided on the basis of the particular articles involved and were decided before the existence of art.80 of the 1948 Table A: Goldberg, "Article 80 of Table A of the Companies Act 1948", [1970] 33 M.L.R. 177; Sullivan, "The Relationship between the Board of Directors and the General Meeting in Limited Companies", [1977] 93 L.Q.R. 569; see also Mackenzie, "Who Control the Company?— Interpretation of Table A", [1983] 4 Co. Law. 99.
35) S.312 and 313 (1) CA 1985.
36) S.320 (1) CA 1985.
37) S.121 (4) CA 1985.
38) S.80 (2) CA 1985.
39) S.80 (1) CA 1985.
40) S.166 (1) CA 1985.
41) S.337 CA 1985.
42) S. 319 (1) and (3) CA 1985.
43) S.142 (1) CA 1985.
44) S.104 (1) and (4)(c) CA 1985.
45) S.125 (2) and (3) CA 1985.
46) S.84 (1)(c) of the Insolvency Act 1986.
48) [1914] Ch. 896.
49) [1914] Ch. 895 at p.903. Cases involving deadlock must be distinguished from those in which the board is able to act but is held up by the opposition of a faction which has a power of veto; see Quin & Axtens Ltd. v. Salmond [1909] AC 442 (HL). For more details about that case see Chapter No. 9.
50) [1975] 1 W.L.R. 673 (HL).
51) [1975] 1 W.L.R. 673 (HL) at p.682-3.
52) Foster v. Foster [1916] 1 Ch. 532.
54) This issue will be examined later in this chapter.
56) See for example new S. 35 CA 1985.
57) Foster v. Foster [1916] 1 Ch. 532; see also art.78 of the 1985 Table A.
58) Gibbs & West's case [1870] LR 10 Eq. 312.
60) See art.37 of the 1985 Table A.
61) See art.72 of the 1985 Table A.
63) See art.19 of the 1985 Table A.
64) Howard Smith v. Ampol Petroleum [1974] AC 821; For restrictions on this power see S.80(4) CA 1985.
65) See art.12 of the 1985 Table A.
68) See arts.24 and 25 of the 1985 Table A.
70) John Shaw & Sons (Stanford) Ltd v. Shaw [1935] 2 K.B. 113; these issues have been discussed earlier in this chapter.
72) See S.144(1) of the Insolvency Act 1986 in relation to a compulsory liquidation. In relation to a voluntary wind up see S.103 of the Insolvency Act 1986 which provides: “On the appointment of a liquidator, all the powers of the directors cease, except so far as the liquidation committee (or, if there is no such committee, the creditors) sanction their continuance”.
73) Charlesworth and Morse Company Law, 14th ed, [1991].
74) S.8(2) of the Insolvency Act 1986.
75) Insolvency Act 1986, Sch.1, para.5, and Sch.2 para.5 (Powers of a Scottish receiver).
76) See Chapter No. 8. The courts, in some cases, gave the phrase “a company’s interests” a wide interpretation so as to include the interests of creditors.
77) S.27(1) (a) and (b) of the Insolvency Act 1986.
78) This section deals with the receivership in England and Wales. For details about receiverships see, generally, Samwell, Corporate Receiverships, [1981].
79) This section deals with the receivership in Scotland.
80) See Campbell, "Powers of Directors and Receivers" [1979] N.L.J. 261; Greene and Fletcher, The Law and Practice of Receivership in Scotland [1987], at p.31. The receiver derives his powers, mainly, from the instrument creating the charge. He has powers similar to those given to an administrator by Sch.1 and 2 of the Insolvency Act. If there is a conflict between the powers of the receiver given by the instrument creating the charge and those given by Sch.1, the former are to prevail: S.42(1) of the Insolvency Act 1986 (England and Wales) and S.55(1) and (2) of the same Act (Scotland).
81) A receiver’s duty “is to protect the interests of the mortgagee or debenture holders, as the case may be”: per Shaw L.J. in Newhart Developments Ltd. v.
Co-operative Commercial Bank Ltd. [1978] 2 Q.B. 814 at p.819; "A receiver's primary duty is to the security holder": per Lord Grieve in Imperial Hotel (Aberdeen) Ltd. v. Vaux Breweries Ltd. [1978] S.L.T. 113 at p.116; "The primary duty of the receiver is to the debenture holders and not to the company": per Jenkins L.J. in Re Johnson & Co. (Builders) Ltd. [1955] Ch. 34 at p.661.


87) S.42(2) & S.55(1) and (2) of the Insolvency Act 1986.

88) Directors' duties to the company and the creditors will be discussed later in this thesis.


95) The Companies (Floating Charges and Receivers) (Scotland) Act 1972.

96) [1978] S.L.T. 113 at p.116. It is argued that the report of the Newhart case was not available at the time of Imperial Hotel case and had that report been available the Scottish case might have been appealed: Campbell, "Powers of Directors and Receivers" [1979] N.L.J. 261.


100) [1978] Q.B. 814.
104) [1978] Q.B. 814, see Shaw L.J..
106) The plaintiff companies alleged that they entered into certain commitments in reliance on representations made by the defendant banks as to the banks' preparedness to fund the companies' project through to completion.
107) [1991] 4 All E.R. 1 at p.11.
109) Browne-Wilkinson V-C said: "Given the possibility of such an indemnity now being forthcoming, if the case is otherwise appropriate to go on, I would not strike out ... but wait to see whether this £200,000 was available and the terms offered at that stage" [1991] 4 All E.R. 1 at p.11.
113) See per Browne-Wilkinson V-C in the Tudor case where criticise the Newhart case in relation to this point: [1991] 4 All E.R. 1 at p.10.
118) See, for example, Selborne L.J. in Great Eastern Rly. Co. v. Turner [1872] L.R. 8 Ch. 149 at p.152.
120) See art.102 of the 1948 Table A and art.72 of the 1985 Table A.
121) Manton v. Brighton Corporation [1951] 2 All E.R. 101; see also art.72 of the 1985 Table A which revocation is possible.
122) Land Credit Co. of Ireland v. Lord Fermoy [1870] LR 5 Ch. App. 763; see also Re City Equitable Fire Insurance Co. Ltd [1925] 1 Ch. 407 at p.429 per Romer J..


125) Shirlaw v. Southern Foundries (1926) Ltd., and Federated Foundries Ltd [1939] 2 All E.R. 113. In that case Greene M.R (at p.117) described a managing director as "a director to whom the board, being empowered to do so by the articles of association, delegated its powers of management, or some of them". If directors are empowered by the articles to appoint a managing director to exercise powers or to perform duties as they may determine, the only powers which can be delegated to such manager "are those which belong to the management of the ordinary commercial business of the company", and not the power to purchase shares which is expressly given, by the articles, to the directors themselves: [1939] 2 All E.R. 113 at p.117.


127) Originally art.102 of the 1948 Table A.

128) In Re Taurine Co.[1884] 25 Ch.D. 118 at p.132 Cotton L.J. said that "committee" means "a person or persons to whom powers are committed which would otherwise be exercised by another body".


130) [1955] 1 W.L.R. 352 (HL).

131) [1955] 1 W.L.R. 352 (HL) at p.355.

132) [1955] 1 W.L.R. 352 (HL).

133) [1866] 1 Ch. App. 561.

134) [1866] 1 Ch. App. 561 at p.562..

135) [1874] 9 Ch. App. 691.


137) [1884] 25 Ch.D. 118 (CA).


139) This argument can be supported by the description of the office of managing director given by Greene M.R. in the case of Shirlaw v. Southern Foundries (1926) Ltd., and Federated Foundries Ltd [1939] 2 All E.R. 113 at p.118 where he said that a managing director is "a director to whom the board, being empowered to do so by the articles of association,
delegates its powers of management, or some of them, and this delegation is usually, if not invariably made subject to the overriding authority of the board". It could be concluded from that statement that if the delegation was not made subject to the overriding authority of the board, then, the delegation to the exclusion of the directors' powers would be free from interference by the directors; see Gower, Principles of Modern Company Law, 4th ed, [1979], ; Cf. Pennington, Partnership and Company Law, [1962], at p.184 where he said: "The powers of the delegates are revocable by the board at any time . . . "; and Manton v. Brighton Corporation [1951] 2 All E.R. 101 where the court held that delegation was revocable even if it has been made for a specified period of time.

To the contrary, Goel argued that: "As a rule, the delegated powers are always subject to resumption by the delegating authority", and the words 'to the exclusion of their own powers' "could be taken to suggest that the managing director may be free from any interference of the directors in the exercise of the powers vested exclusively in him in the sense that so long as the same are not revoked, withdrawn, altered or varied expressly by the board's resolution, they are not subjected to the instruction or the approval of the board": Goel, "Delegation of Directors' Powers and Duties" [1969] 18 I.C.L.Q. 152 at p.168. It is also argued that if directors agree to divest themselves of the right to revoke the delegation, their conduct may infringe "the rights of the minority, who are entitled . . . to say that they are entitled to have the whole business [of the company] managed by the governing directors and no body else": per Neville J. in Horn v. Henry Faulder and Co. Ltd [1908] 99 L.T. 524.

141) S.308 CA 1985.
142) [1925] 1 Ch. 407. For a full discussion of that case see Chapter NO. 6.
143) [1925] 1 Ch. 407 at p.429.
145) [1870] L.R. 5 Ch. App. 763.
146) For more details, see Chapter No. 6.
147) For More details about new S.35 see Chapter No. 9.
148) The rules of agency were applied in Freeman & Lockyer v. Buckhurst Park Properties [1964] 2 Q.B. 480. In that case a director had assumed powers of management with the company's approval. However, he had never been appointed managing director. He entered into a contract with architects. In an action brought by the architects, the company denied liability to pay the plaintiff's fees. The
court held that because entering into such a contract was within the scope of the authority of a managing director of a property company, and because the articles of the company empowered the directors to appoint a managing director; and because the directors allowed the one who entered into a contract with the architects to act as a managing director, the company was bound to the contract. The court also pointed out that the plaintiffs were not obliged to enquire as to whether the one who entered into the contract with them was properly appointed.

149) New S. 35A (2)(c).
150) New S. 35A (2)(b).
151) New S. 35B.
152) For more details see Chapter No. 9.
153) S. 80(3) CA 1985.
154) S. 80(4) CA 1985.
155) S. 80(4) CA 1985.
156) S. 80(5) CA 1985.
157) S. 115(1) CA 1989.
158) For more details see Chapter No. 5.
160) See art. 12 of the 1985 Table A.
161) S. 120 CA 1985.
162) S. 14(2) CA 1985.
165) See Chapter No. 5.
166) Alexander v. Automatic Telephone Co. [1900] 2 Ch. 56 (CA).
167) Alexander v. Automatic Telephone Co. [1900] 2 Ch. 56 (CA).
168) Art. 19 of the 1985 Table A.
169) S. 143(3) (d) CA 1985 and art. 19 of the 1985 Table A.
171) See art. 24 of the 1985 Table A.
172) [1910] 1 Ch. 312 (CA).
173) [1910] 1 Ch. 312 (CA) at p. 316; see also per Lord Kincairney (Ordinary) in the Scottish case of Stewart v. James Keiller & Sons Ltd [1902] 4 F. 657 at p. 667.
175) Re Smith & Fawcett Ltd [1942] Ch. 304 (CA); Stewart v. James Keiller & Sons Ltd [1902] 4 F. 657. If the directors have an absolute discretion to refuse a transfer of shares (they are entitled to refuse the transfer even on the ground that the transferee is a stranger) so long as they are acting bona fide in the best interests of the company:
Charles Forte Investments Ltd. v. Amanda [1964] Ch. 240. Challenging a refusal to transfer shares in such a case will be difficult because this requires an allegation that the directors have not acted bona fide which is difficult to prove: Hannigan, "Share Transfer Problems in the Private Company" [1990] 11 Co. Law. 170.


[1917] 1 Ch. 123 (CA).


[1984] B.C.L.C. 599 at page 621. The applied test here is objective. It seems difficult to bring Vinelott J.'s decision in line with the subjective test laid down by Lord Greene MR. in Re Smith & Fawcett Ltd. [1948] Ch. 304 at p.306; see Chapter No. 5.


S.183(5) CA 1985.

S.183(6) CA 1985.


Re Hackney Pavilion Ltd [1924] 1 Ch. 276.


See Harman J. in Rover International Ltd. v. Cannon
193) [1954] 1 Q.B. 45.
194) S.9(2) of the European Communities Act 1972.
195) This section is inserted by the Companies Act 1989, S.130(4).
196) S.36C (2) provides that Subsection 1 applies—
(a) to the making of a deed under the law of England and Wales, and
(b) to the undertaking of an obligation under the law of Scotland as it applies to the making of a contract.
198) The Court of Appeal in that case considered the effects of the old S.36(4) which was identical to new S.36(c).
199) See new S.36(c) CA 1985.
203) Per Russell J. in York Corporation v. Henry Letham & Sons Ltd. [1924] 1 Ch. 557 at p.573.
204) [1891] 3 Ch. 432.
206) [1918] AC 514.
207) [1966] 2 Q.B. 656.
210) S.10 CA 1948; see also S.4 CA 1985.
211) This section is substituted by S.110 CA 1989.
212) S.110 CA 1989.
213) New S.3A (a) CA 1985.
214) New S.3A (b) CA 1985.
215) However, new S.35 CA 1985 (S.108 CA 1989) abolishes the ultra vires doctrine as far as a bona fide third party is concerned. This means that a company can effectively make a gift to a third party: see new S.35A (2)(a) which defines the words "deals with" as follows: "a person 'deals with' a company if he a party to any transaction or other act to which the company is a party". The giving
of gifts, it is submitted, is included in the meaning of the word "act".

216) Originally S.9(1) of the European Communities Act 1972.


220) For the application of the rules of agency see Royal British Bank v. Turquand [1856] 6 E & B 327 where it was stated that a person dealing with a company in good faith was entitled to assume that there had been due compliance with all matters of internal management and procedure required by the company's articles (i.e. that the acts of the company had been properly and duly performed), and that that person was not required to enquire into the internal management of the company; see also Diplock L.J. in Freeman & Lockyer v. Buckhurst Park Properties Ltd. [1964] 2 Q.B. 480 (CA) at p.506 where his Lordship stated that a contract entered into on behalf of a company by an agent who had no actual authority to do so could be enforced against the company by fulfilling four conditions. It must be shown:

(1) that a representation that the agent had authority to enter on behalf of the company into a contract of the kind sought to be enforced was made to the contractor;
(2) that such representation was made by a person or persons who had 'actual' authority to manage the business of the company either generally or in respect of those matters to which the contract relates;
(3) that he (the contractor) was induced by such representation to enter into the contract, that is, that he, in fact, relied upon it; and
(4) that under its memorandum or articles of association the company was not deprived of the capacity to enter into a contract of the kind sought to be enforced or to delegate authority to enter into a contract of that kind to the agent.


222) Sealy, Guide to the Companies Act 1989, [1989], Ernst & Young, London, at pp.96-7; Goldenberg, Guide to Company Law, 3rd ed, [1990], at p.45; see Stephenson who argues that a third party would not be protected if aware that the directors were acting in breach of their fiduciary duty as well as beyond their powers: Stephenson, "Ultra Vires and Agency Under the New Law" [1990] 134 S.J. 304; Griffin, "Directors' Authority" [1991] 5 Co. Law. 98; see also Doran, who argues that the ultra vires doctrine operates in respect of breaches not arising from limitations under the company's constitution: Doran, "Transactions at an Under Value and the Maintenance of Capital Principle" [1991] 12 Co. Law. 169.

223) See Chapter No. 9.
224) S.35A (2)(b).
225) S.142 CA 1989.
227) See Chapter No. 9.
231) See Lord Greene M.R. in Re Smith and Fawcett Ltd.
[1942] Ch 304; [1942] 1 All E.R. 542 (CA); see also Chapter No. 5.
234) See for example Hogg v. Cramphorn Ltd [1967] Ch. 254; Bamford v. Bamford [1970] Ch. 212 (CA); see Chapter No. 5.
235) Alexander v. Automatic Telephone Co. [1900] 2 Ch. 56 (CA); see Chapter No. 9. In Australia, it was held that a company was not entitled to ratify an abuse of power committed by the directors where this was capable of prejudicing the interests of creditors at a time when the company was insolvent: Kinsela v. Russell Kinsela Pty Ltd. [1986] 10 A.C.L.R. 395; Fox and Bowen argue that shareholders must not be allowed to ratify a director's act, even by a unanimous vote, when that act amounts to misfeasance for the purposes of S.212 of the Insolvency Act 1986 so as to prejudice creditors: Fox and Bowen, The Law of Private Companies [1991], at p.117; see Chapter No. 8.
236) [1970] Ch. 212 (CA).
237) [1970] Ch. 212 (CA) at p.238.
239) [1888] 40 Ch. D. 135 (CA).
240) [1889] 40 Ch. D. 135 (CA) at p.138.
241) Professor Gower argues that excess of power "hardly seems to be a breach of the fiduciary duty of good faith", Gower, Principles of Modern Company Law, 4th ed. [1979], at pp.580-1. However, it would seem that an act exercised by directors in excess of their powers constitutes a breach of a statutory duty. That is because new S.35(3) CA 1985 requires directors to observe any limitations on their powers flowing from the company's memorandum.
242) Many commentators have argued that ratification can effectively "cure" the breach of duty and "absolves" the directors from liability: Gore-Browne, Gore-Browne on Companies, 44th ed. [1986], para. 27.21.1; Pennington, Pennington Company Law, 5th ed. [1985], at p.737; For a full discussion of this issue see Partridge, "Ratification and the Release of Directors from Personal Liability" [1987] 46 C.L.J. 122; see Chapter No. 9.
243) [1983] Ch. 258.
244) S.108 CA 1989.
245) New S.35(3).
CHAPTER 3

DIRECTORS' FIDUCIARY DUTIES: THE FAIR DEALING RULES.

3.1. Introduction

It is well established that a fiduciary is not allowed to put himself in a position in which his personal interest may conflict with his duty to his principal, or in a position in which "his judgment is likely to be biased" (1). This principle finds its origins in trust cases. The leading case in this context is Keech v. Stanford (2), in which a lessor refused to renew the lease to the infant beneficiary whereupon the trustee renewed for himself. The court laid down the rigid rule that a trustee is not allowed to take the lease for himself even if the lessor refuses to renew it to the beneficiary. Lord Chancellor King observed (3):

I must consider this as a trust for the infant; for I very well see, if a trustee on the refusal to renew, might have a lease to himself, few trust estates would be renewed to cestui que; though I do not say there is a fraud in this case, yet he should rather have let it run out, than to have had the lease to himself. This may seem hard, that the trustee is the only person of all mankind who might not have the lease, but it is very proper that the rule should be strictly pursued, and not in the least relaxed; for it is very obvious what would be the consequence of letting trustees have the lease, on refusal to renew to cestui que use.
In Charitable Corporation v. Sutton(4), the Committeemen who managed the corporation, which was created by a royal charter were accused of breach of trust. Lord Chancellor Hardwick said that the Committeemen are agents to those who employed them in this trust . . . [and] by accepting of a trust of this sort, a person is obliged to execute it with fidelity . . . "(5). The language of trusts and agency was used to hold a fiduciary liable to account(6). Liability was imposed by analogy with trust and agency principles in Attorney General v. Wilson(7). In that case the governing body of the corporation fraudulently alienated certain parts of its property. A suit was brought in the name of the corporation against the wrongdoers. The defendants argued that the acts complained of were acts of the corporation and a cestui que trust cannot complain of a breach of trust to which he was a party. This argument was rejected by Lord Cottenham L.C.. His Lordship said:

The true way of viewing this is to consider the members of the governing body of the corporation as its agents bound to exercise its functions for the purposes for which they were given, and to protect its interests and its property; and if such agents exercise these functions for the purpose of injuring its interests and alienating its property . . . the corporation may complain, and may have redress against such members and agents as are authors of the wrong"(5).

The inflexible rules are not restricted to cases in which a fiduciary deals directly with his principal or with his principal's property. These rules have, in
fact, a wide scope of application. A fiduciary, for example, is not allowed to use his position to appropriate for himself benefits or advantages which he ought to have acquired for his principal(9).

In Hamilton v. Wright(10), Lord Brougham stated:

There cannot be a greater mistake than to suppose, as seem to have been done below, that a trustee is only prevented from doing things which bring an actual loss upon the estate under his administration. It is quite enough that the thing which he does has a tendency to injure the trust; a tendency to interfere with his duty . . . Nor is it only on account of the conflict between his interest and his duty to the trust that such transactions are forbidden. The knowledge which he acquires as trustee is of itself a sufficient ground for disqualification, and of requiring that such knowledge shall not be capable of being used for his own benefit to injure the trust "(11).

The inflexibility of the rules has been emphasised by Lord Herschell in Bray v. Ford(12), where his lordship said:

It is an inflexible rule . . . 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 . . . It has, therefore, been deemed expedient to lay down this positive rule".

The inflexible rules which are applied to trustees have also been applied to companies' directors because they too are in a fiduciary position. In Aberdeen Rly Co v. Blaikie Bros(13), a director was a member of a partnership with which his company, the pursuer, entered into a contract. On a claim by the company against the
director, the court held that the company was entitled to set aside that contract. Lord Cranworth L.C said that a company could only act by an agent and this agent owed fiduciary duties to the company. He is obliged to discharge these duties on behalf of, and in the best interest of, the company.

And it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interest of those who he is bound to protect"(14).

Similarly, in Imperial Mercantile Credit Association v. Coleman(15), the court held that a company's director was not allowed to obtain any benefit from a contract entered into by the company and which required the approval of the board of which he was a member. Likewise in Cook v. Deeks(16), the directors of company A formed another company B and deflected a contract in which company A was interested to company B which they owned personally. The court held that the directors must maintain that contract with company A since the contract belonged to it(17). In Regal (Hastings) Ltd v. Gulliver(18) the company decided to acquire two cinemas, in addition to the one which it already had. A subsidiary company had been formed for this purpose. The old company, i.e, Regal, could not take up more than 2000 shares in the subsidiary company. The
directors took up the other 3000 shares for themselves. Ultimately the directors sold the two companies' shares to outsiders and made personal profit. The purchasers of Regal brought an action against the former directors to account for the profit made. The court held the defendants liable to account on the grounds that they obtained those shares "by reason and only by reason of the fact that they were directors of Regal and in the course of the execution of that office...". (19).

It is to be concluded that an inflexible rule which prohibits conflicting situations and disallows the making of a profit out of a directorial position, has been created (20). This rule can be described as a prophylactic rule against transactions in which a director has an interest conflicting with that of the company.

3.2. THE NO CONFLICT RULE AND THE NO PROFIT RULE.

It may not be out of place to recall here Lord Herschell's observations which were made in Bray v. Ford (21) (quoted above).
The question here is this: Is his Lordship stating two separate rules or a single rule in two different ways? Is he stating a wide basic rule from which a derivative rule stems? If he states a basic rule and a derivative one, which one is the basic rule and which one is the derivative? (22)

To answer these questions, it seems necessary to examine the existing case law. In Aberdeen Town Council v. Aberdeen University (23), the judges did not refer to the no-conflict rule. The liability was imposed on the trustees by applying the no-profit rule independently. The facts of that case were as follows: the council was the trustee of certain lands. It was acting through an agent. The trustees bought the lands and then acquired certain fishing rights which could be granted by the Crown to the owner only. It did not appear that the trustees were under a duty to acquire the fishing rights for the beneficiaries. The House of Lords held that both the land and the fisheries were to be held for the original beneficiaries and a trustee could not hold for his own benefit any benefit obtained as a result of his being a trustee. Thus, since there was no duty to acquire fishing rights for the beneficiaries the no-conflict rule could not arise. The no-profit rule achieved a great importance in this case. Similarly, in Re Lewis (24), the no-profit rule only was applied. In that case the defendant had been employed as a
salesman by a partnership, in which his father was a partner. In 1905 the father died and the defendant became a partner by virtue of being a trustee of his father's will. The defendant also continued to act as a salesman for the partnership and in 1909 he entered into an agreement with the partnership. The beneficiaries claimed that he was liable to account to the trust for his salaries. Warrington J. disregarded the no-conflict rule and applied the no-profit rule only. He held that the defendant had not received his salaries as a result of being a trustee or a partner, and thus he was not liable to account. It is said that the court could have reached the opposite result if it applied the no-conflict rule. The personal interest of the defendant in getting the highest possible salary conflicted with his duty to the trust which was to consider only the interest of that trust.

In Regal (Hastings) Ltd v. Gulliver, the defendants argued that they owed no duty to Regal to acquire the shares to it and it would have been a breach of duty to do so in the light of Regal's financial inability. In other words, it was argued that the no-conflict rule could not be applied. Four of the judges relied exclusively on the no-profit rule. Lord Russell of Killowen made it clear that "The liability arises from the mere fact of a profit having ... been made."
Thus, it is plain that the no-profit rule only was applied in the Regal case. Lord Wright put it in this way:

... if a person in a fiduciary relationship makes a secret profit out of the relationship, the court will not inquire whether the other person is damnified or has lost a profit which otherwise he would have got. The fact is in itself a fundamental breach of the fiduciary relationship. 

The House of Lords also held the defendants liable to account, depending on the no-profit rule only, in Brown v. I.R.C. In that case it was held that a solicitor could not retain for himself the interest on his trust accounts. Lord Reid and Lord Upjohn stated that the rule which was applied was that a trustee was not allowed to make a profit out of his trust.

To sum up: even if there is no-conflict between a director's interest and his duty to the company (probably because no duty is owed in a particular instance), liability may be imposed upon a director if he makes a profit out of his directorial position.

The courts, on the other hand, relied on the no-conflict rule alone in some cases. For example, in Wright v. Morgan, a testator devised certain lands to trustees and gave one of them, Harry, who was also a beneficiary, the option to buy the lands if the trustees decided to sell. Douglas, who was a trustee, bought Harry's beneficial interest and his "option". When the trustees
decided to sell, the lands were offered to and bought by Douglas. Some of the beneficiaries claimed that the sale should be set aside. The Privy Council held that Douglas had placed himself in a conflicting position by taking an assignment of and exercising the "option". The decision of the Privy Council, therefore, based only on the rule that "equity will not allow a person who is in a position of trust to carry out a transaction, where there is a conflict between his duty and his interest". However, in some other cases, both the no-conflict and the no-profit rules were taken into account. That is, the courts relied upon the two rules to hold the defender liable. In some cases, the relation between the two rules was unclear. For example, in Re Macadam, two trustees were given the power to appoint directors. They appointed themselves. The court held that they were accountable to the trust for the salaries they received. Cohen J. referred to the two rules in his judgment as follows:

I think that the root of the matter really is: Did [ the defendant ] acquire the position in respect of which he drew the remuneration by virtue of his position as a trustee?

It is clear from the above statement that the judge referred to the no-profit rule. He described it as the root of the matter. On the other hand, later in his judgment, Cohen J. referred to the no-conflict rule. He said:
. . . the opportunity to receive that remuneration was gained as a result of a discretion vested in the trustees, and they had put themselves in a position where their interest and duty conflict(37).

It is said(38) that Cohen J. in his judgment brought the no-profit rule to the level of equality with the no-conflict rule. However, since Cohen J. described the no-profit rule as the "root of the matter", it would appear that he was considering it as the basic rule. But, there was nothing in Cohen J.'s statement to indicate that the no-conflict rule was the derivative one. Thus, the relation between the two rule was unclear in that case.

In Boardman v. Phipps(39), a trust consisted, partially, of shares in Laster and Harris Ltd. Mr Boardman, the solicitor of the trust and Mr Phipps, a beneficiary under the trust attended a company meeting. Accordingly, they thought that buying the outstanding shares in the company would improve the position of the trust. However, the trustees were unable to buy these shares and in fact they had no legal power to do so. Mr Boardman was purporting to act for the trust and gained valuable and confidential information about the company. Ultimately Mr Boardman and Mr Phipps bought most of the outstanding shares in their own right. Some of the beneficiaries under the trust claimed that the shares
should be held for the trust and the defendants should be made accountable for the profit so derived.

At first instance, Wilberforce J. applied the no-profit rule. He held that "trustees or agents shall not retain a profit made in the course of or by means of their office"(40). The Court of Appeal affirmed the decision of Wilberforce J.. However, Lord Denning indicated that liability can also be imposed by applying the no-conflict rule. He pointed out that Mr Boardman had placed himself in a position where there was a conflict between his duty to advise an application to the court [by the trustees] and his interest to acquire the shares himself . . ."(41). Mr Boardman's advice would be influenced by his personal interest if he was consulted by the trustees. He would be unable to give an unprejudiced advice as to how they should act. Thus, in Lord Denning's decision the no-profit rule appears as separate and distinct from the no-conflict rule(42).

The House of Lords upheld the decision by a majority of three to two. Lord Guest relied solely on the no-profit rule. Lord Cohen relied on both the no-conflict and the no-profit rules as grounds for his decision. Lord Hodson opened his judgment with an approval of the no-profit rule and ended it on a conflict basis, saying that there was a possibility of conflict and that possibility was enough to bring the rule into operation or to warrant the court's intervention.
Of the two dissenting judgments, Viscount Dilhorne recognised both the no-profit rule and the no-conflict rule. But he held that none of them applied to the case. He pointed out that the trust indicated that it was not interested in acquiring the shares. Thus, there was no possibility of Boardman being asked to advise the trust on the purchase of the shares. Accordingly, there was no evidence of conflict of interest and duty. He also pointed out that the knowledge acquired by Mr Boardman and Mr Phipps was not trust property, nor did their saying that they represented the trust amounted to a use of fiduciary position.

Lord Upjohn, in his dissenting judgment, said:

The relevant rule for the decision of this case is the fundamental rule of equity 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 trustee must not place himself in a position where his duty and interest may conflict(43).

It is clear that Lord Upjohn recognised the two rules. On the one hand the no-profit rule which was described by his Lordship as "the fundamental rule of equity" and on the other hand the no-conflict rule. His Lordship considered the no-profit rule as part of the wider rule which is the no-conflict rule. Thus, he determined the relationship between the two rules. The no-conflict rule is the basic one while the no-profit rule is a derivative from it.
However, in the light of the Phipps case\textsuperscript{(44)}, and that of the Regal case\textsuperscript{(45)}, it is argued\textsuperscript{(46)} that the law, in the U.K. recognises two rules applied to fiduciaries including directors, i.e, the no-profit rule and the no-conflict rule. The two rules are certainly not rigidly separated in most of the judicial pronouncements. This is perhaps because they represent two perspectives on the same problem which is generally described by the no-conflict rule as a catch-all. However, it is quite possible for a profit to be made without there being a conflict of interest and vice versa\textsuperscript{(47)}. And it is quite possible, in some cases, that the application of one will impose liability while the application of the other will not\textsuperscript{(48)}. It is submitted that, in fact, there is a continuum between two extremes characterised by the two rules and that often both questions are merely different sides of the same coin.

**The Advantages of the rigid Application of the Fair Dealing Rules**

In favour of a rigid application of the rules it has been argued:

i) By rigid application of the rules, the question of preferring the director's personal interest over that of the company will not arise\textsuperscript{(49)}. That is, because of their clear cut prohibition of conflict of interest the
rules remove any doubt surrounding the directors' motives.

ii) Rigid application of the rules will save time and money because the court will not be required to examine the fairness of the transaction\(^{50}\).

iii) The rigid application of the rules is the most effective way to resist temptation. That is, since directors and businessmen, generally, measure their success by what they gain personally, not by what their companies gain, the absence of the rigid rules may tempt them to breach their fiduciary duties by exploiting their positions to gain personal profit\(^{51}\). A rigid application of the rules will help to keep directors single-mindedly devoted to their companies\(^{52}\).

iv) Norris J. in *Peso Silver Mines Ltd v. Cropper*\(^{53}\), argued that the complexities of modern business require a rigid application of the rules because any relaxation of them would allow today's complexities to become a cloak for fraud. Ordinary people's confidence in their dealing with companies could be weakened by any relaxation of these rigid rules. People are assured of having some protection against directors' improper acts if the rigid rules apply. Applying these rules will also remind directors of their fiduciary duties and, hopefully, mean that they will avoid breaching them. Norris J. also argued that a rigid application of the rules will not harm directors. They can escape
liability by making a full disclosure to the company in general meeting and seeking its approval.

v) Finally, the common law rigid rules have an obvious advantage which is the ease with which they can be applied(54).

3.3. SITUATIONS OF CONFLICT OF INTEREST

3.3.1. Directors' interests in contracts

The general rule at common law is that a director may not have a direct or indirect interest in a contract with his company unless permitted by the company's articles or by the company in general meeting(55). The reason behind such an embargo is to avoid the possibility of conflict between a director's personal interest and his duty to the company. The most famous case in which the no-conflict rule has been applied is Aberdeen Rly Co. v. Blaikie Bros(56). In that case, a director was a member of a partnership with which his company, the pursuer, entered into a contract. On a claim by the company against the director, the court held that the company was entitled to set aside that contract. Lord Cranworth L.C said that a company can only act by an agent, and this agent owes a fiduciary duties to the company. He is obliged to discharge these
duties on behalf and in the best interest of the company,

and it is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements 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" (57).

Similarly, the court, in Imperial Mercantile Credit Association v. Coleman (58), held that a company's director was not allowed to obtain any benefit from a contract entered into by the company, and which required the approval of the board of which he was a member.

This is the general rule at Common Law. This rule applies to situations in which a director has a direct as well as an indirect interest in transactions with his company (59).

Applying the above rule makes a director's contract with the company voidable at the instance of the company, and makes the interested director liable to account for the profit made (60). A director may also be interested as a member of another company in a contract made between that company and the company of which he is a director. In such a case he is liable to disclose his interest to the board of directors. If he fails to do that he will be liable to a fine (61). In addition such a contract is voidable at the instance of his company unless the other company,
of which he is a member, is unaware of the director's interest when the contract is entered into.\(^{(62)}\)

3.3.2. The use of a company's property.

By using a company's property, a director may place himself in a conflicting position. He may make a profit out of that use. Thus, like a trustee, a director is liable to account to his company for a profit made out of using its assets unless he makes a full disclosure to the company and obtains the shareholders' approval in general meeting. The use by a director of a company's assets for his own benefit is a clear breach of fiduciary duties. A director in such a situation will be made liable as a constructive trustee.\(^{(63)}\)

In Menier v. Hooper's Telegraph Works\(^{(64)}\), the defendants, who had a majority of shares in the company, had made an arrangement by which they had dealt with matters affecting the whole company. They had dealt with them in consideration of their obtaining for themselves certain advantages. The minority of the shareholders brought an action alleging that the majority shareholders had divided the assets of the company among themselves. The court found that the case was within the scope of the "fraud on the minority" exception to the rule in Foss v. Harbottle\(^{(65)}\), and held
that the defendants were not allowed to sell the company's assets and keep the consideration for themselves.

Purchasing assets from the company or selling assets to it by directors are situations in which a conflict of interest may arise. Moreover, a conflict of interests may arise if these transactions are entered into by companies in which the directors have an interest. In respect of such transactions, the shareholders' approval must be sought before the transaction is entered into(66).

The Companies Act 1985 deals with this issue. S.320(67) requires a director to obtain the shareholders' approval to enter into transactions which relate to the assets of the company(68). Shadow directors are also caught by this section(69). Non-compliance with S.320(1) makes the contract or the arrangement voidable at the instance of the company(70). It makes a director liable to account for any gain which he has made directly or indirectly out of the arrangement in question(71). A director may also be held liable to indemnify the company for any loss resulting from that arrangement even if the company does not exercise its right to avoid the transaction(72). However, the company will be unable to avoid an arrangement if restoration is impossible or if it has been indemnified for the resulting loss(73). Similarly, the company
cannot invalidate the transaction if a third party acquired rights bona fide by that transaction(74), or if the arrangement, is within a reasonable period, affirmed by the company in general meeting(75). However, a director can escape liability if he shows that he took all reasonable steps to secure the company's compliance with S.320(76). In any case, no liability can be imposed on a director who authorised the prohibited transaction if he shows that at the time the transaction was entered into, he did not know the relevant circumstances constituting the contravention(77). These provisions are intended to make a balance between the rights of the innocent parties and the company's right to avoid(78).

Exceptions to the rule stated in S.320(1)

(1) Small amounts
S.320(2)(79) provides that an approval is not required if the requisite value of the non-cash assets, at the time the arrangement is entered into, is less than £100,000 or 10% of the company's assets value. The amount should be less than £2,000 if the criterion used is the 10% of the company's assets value in order to ignore the approval requirement. The company's net assets value is determined by reference to its last annual accounts. If no accounts have been prepared and
laid under Part VII of the Companies Act 1985, the "amount of the company's called up share capital"(80).

(2) Transactions between the holding company and its subsidiaries.
Since there are no outside shareholders in a wholly owned subsidiary who need protection, S.321(2)(a) permits a holding company to acquire a non-cash asset from its wholly owned subsidiaries and vice versa. It also permits a wholly owned subsidiary of a holding company to acquire such assets from another wholly owned subsidiary of that same holding company(81).

(3) Winding up.
Shareholders will have little interest in the disposal of the company's assets if the company is being wound up(82). Therefore, S.321(2)(b) does not require an approval if the arrangement is entered into by a company which is being wound up(83).
However, since shareholders will retain an interest in the disposal of their company's assets, an approval is required in cases of voluntary winding up by the company's members(84).

(4) Acquisition by a member
S. 321(3) provides that no approval is required if the arrangement is entered into by a member in his capacity as a member. This subsection applies to the acquisition of a non-cash asset by a member from the company, but not the acquisition by the company from a member(85).

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3.3.3. Remuneration.

Remuneration is another field in which a possibility of conflict of interests may arise. It is in a director's self-interest to bargain for the highest remuneration obtainable. But it is in the best interests of the company to pay the lowest remuneration for directors or officers in general. And since directors are under a duty to act in the best interests of the company, a conflict of interests may arise. Under Art. 82/Table A 1985(86), remunerations of directors are to be determined by way of ordinary resolution of the general meeting(87). Directors are not prohibited from voting on remunerations or compensation schemes in the company's general meeting and starting from this point a conflict of interests and duty may arise(88). The problem becomes more serious in cases where directors have the control over the majority votes in the general meeting. It would seem not easy to avoid the conflict of interest in such a case. However, a derivative action may be brought against the directors in such a case if the compensations obtained by them are unfair or if the resolution regarding these compensations is unduly passed(89).
3.3.4. Loans from a company.

A loan from a company is another field from which a conflict of interests may stem. This issue is the subject of S.330 (2)(a) of the Companies Act 1985 which prohibits a company from making loans to its directors or the directors of its holding company(90). Loans to directors of the subsidiary companies are not affected by this section unless they are also directors of the holding company(91). If the directors of the subsidiary company are themselves the directors of the holding company, then, loans to them are subject to this section because those directors may have the control over the subsidiary company. A relevant company(92) is not allowed to make a loan to a person connected with its directors(93). However, private companies, which are not relevant companies, are not prohibited from making loans to "connected persons"(94).

Exceptions to the rule that prohibits the making of loans to directors

(1) Loans of small amounts
S.334 CA 1985 provides that a company is not prohibited "from making a loan to [its directors or to directors of] its holding company if the aggregate of the relevant amounts does not exceed £5,000"(95). By
using the aggregate of the relevant amounts as a formula, the Legislature attempts to avoid the possibility of circumventing the Legislation by dividing a transaction into a number of smaller transactions(96).

(2) "Inter-company loans in same group"(97). A relevant company(98) which is a member of a group of companies is not prohibited from making a loan to another member of that group(99). Moreover, making a loan by a subsidiary company to its holding company is not prohibited by the Act(100). It is to be noted that while making a loan by a company to its holding company is allowed according to S.336(a), it is not allowed to be made to the directors of the holding company(101).

(3) Money-lending companies

S.338(2) CA 1985 defines "money lending company" as "a company whose ordinary business includes the making of loans or quasi-loans, or the giving of guarantees in connection with loans or quasi-loans ". Such kind of companies is not prohibited from making a loan to any person(102) including directors provided that the loan must be made "in the ordinary course of the company's business"(103), and its amount must not be greater, and its terms must not be more favourable than, those which it is reasonable to expect the company would have offered to a person of "the same financial standing but unconnected with the company"(104). S.338(4) does not allow a relevant company to enter into a transaction if
the aggregate of the relevant amounts exceeds £100,000.

3.3.5. Quasi-loans.

Quasi-loans are another field in which a conflict of interests may arise. A relevant company is prohibited from making a quasi-loan to its directors. It is said that this prohibition would cover the provision by the company of a credit card to its directors who will be given the authority to use it on the basis that the company will pay instead of him initially and the users will reimburse the company latter. However, this prohibition does not apply to private companies which are not relevant companies. A relevant company is also prohibited from making quasi-loans to the directors of its holding company or to persons connected with those directors.

Exceptions to the rule that prohibits quasi-loans to directors

(1) Small amounts

Making a quasi-loan to a director of the company or a director of its holding company is not prohibited if

   (a) the quasi-loan contains a term requiring a director or a person on his behalf to reimburse the creditor his expenditure within 2 months of its being incurred; and
(b) the aggregate of the amount of that quasi-loan and of the amount outstanding under each relevant quasi-loan does not exceed £5,000"(110).

However, it would seem that the exception provided by S.332 does not cover the making of a quasi-loan by a relevant company to persons connected with its director or the directors of its holding company.

(2) Inter company quasi-loans in same group.
S.333(a) permits a relevant company which is a member of a group of companies to make a quasi-loan to another member of that group. S.336(a) permits such a company to make a quasi-loan to its holding company.

(3) Money-lending companies
S.338(1)(a) allows money-lending companies to make a quasi-loan to any person if that quasi-loan satisfies certain conditions. The conditions imposed on making quasi-loans are identical to those imposed on making loans(111). Those conditions are: 1) A quasi-loan must be made in the ordinary course of the company's business; and 2) the amount of the quasi-loan is not greater, and its terms are not more favourable than those which it is reasonable to expect that company to have offered to a person of the same financial standing but unconnected with the company(112).
The aggregate of the relevant amount, in relation to a relevant company must not exceed £100,000\(^{(113)}\). However, there is no limit if the relevant company is a recognised bank\(^{(114)}\).

3.3.6. Credit transactions.

A relevant company\(^{(115)}\) is not allowed to enter into a credit transaction as creditor for its directors or a director of its holding company, or a person so connected\(^{(116)}\). Private companies which are not relevant companies are not prohibited from entering into such transactions. A credit transaction has been defined by S.331(7) CA 1985 as follows:

A credit transaction is a transaction under which one party ('the creditor')—
(a) supplies any goods or sells any land under a hire-purchase agreement or a conditional sale agreement;
(b) leases or hires any land or goods in return for periodical payments;
(c) otherwise disposes of land or supplies goods or services on the understanding that payment (whether in a lump sum or instalments or by way of periodical payments or otherwise) is to be deferred".

Again, by entering into such a transaction a director places himself in a conflict of interest situation and accordingly he is liable to disgorge any profit so derived.
Exceptions to the rule prohibiting a company from entering into credit transactions

(1) Small amounts
S.335(1) CA 1985 allows a company to enter into a credit transaction if the aggregate of the relevant amounts does not exceed £10,000\(^\text{(117)}\).

(2) Inter-company credit transactions in the same group
S.336(6) allows a company to enter into a credit transaction as creditor for its holding company.

(3) "Ordinary course of business"\(^\text{(118)}\)
Similar to that exception to loans, a company may enter into a credit transaction if it is in the ordinary course of business; and that the value of it is not greater, and its terms are no more favourable, than those which it is reasonable to expect the company to have offered to a person of the same financial standing but unconnected with the company\(^\text{(119)}\).

3.3.7. Back to back transactions, assignment, guarantees and expenditures incurred for the company's purposes.

(1) Back to back transactions
S.330(7) provides:

A company shall not take part in any arrangement whereby—
(a) another person enters into a transaction which, if it had been entered into by the company, would have contravened any of subsections (2), (3), (4) or (6) [of this section]; and
(b) that other person, in pursuance of the arrangement, has obtained or is to obtain any benefit from the company or its holding company or a subsidiary of the company or its holding company".

Thus, a transaction by which a company agrees to make loans to the directors of another company in return for a loan or loans to its own directors from that other company is caught by S.330(7) and accordingly is prohibited. S.330(7) also catches an arrangement by which a director of a company obtains a loan from a bank on favourable terms in return for the company's business(120).

It is clear that s.330(7) is designed to prevent any device to circumvent subsection (2), (3), (4) and (6) of section 330 of the Companies Act 1985 .

(2) Assignment to the company

S.330(6) CA 1985 provides:

A company shall not arrange for the assignment to it, or the assumption by it, of any rights, obligations or liabilities under a transaction which, if it had been entered into by the company, would have contravened subsection (2), (3) or (4) . . . "(121).

This prohibition is restricted to transactions prohibited by S.330(2), (3), and (4) only(122). An example of the assignment is the case in which a company buys the right to repayment of a loan which is made by a third party to a director of the company.
(3) Guarantees

Since a company is prohibited from entering into some transactions, such as loans, quasi-loans etc, with its directors, it is also prohibited from giving a guarantee or providing security in respect of that prohibited transaction\(^\text{[123]}\). Moreover, despite the fact that a company is permitted to enter into loans or quasi-loans under some special conditions, it cannot give a guarantee or provide a security in respect of such transactions "which presumably therefore remain prohibited"\(^\text{[124]}\). However, one cannot see the wisdom of prohibiting a company from giving guarantees or providing securities in respect of transactions which the company is allowed to enter into under some special conditions. It would seem that there is no clear reason justifying this restriction.

(4) Expenditures incurred for a company's purposes

S. 337 CA 1985 provides:

"(1) A company is not prohibited by S.330 from doing anything to provide a director with funds to meet expenditures incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company".

Thus, a company may give its director a bridging loan to enable him to perform his duties towards the company.
But this assistance cannot be provided by the company unless one of the following conditions is satisfied:
i) The assistance is done with the prior approval of the company in general meeting(125), or
ii) it is done on condition that, "if the approval of the company is not so given at or before the next annual general meeting, the loan is to be repaid, or any other liability arising under any such transaction discharged, within 6 months from the conclusion of that meeting . .
(126).
However, a relevant company is not allowed to enter into any transaction if the aggregate of the relevant amounts exceeds £20,000 even if one of the above two conditions is satisfied(127).

3.3.8. Competing with the company.

Competing with the company is another situation which may give rise to a conflict between a director's interests and his duty to his company. Competing with a company can be done by two ways: i) Direct competition between a director and his company; and, ii) Common directorship.
A fiduciary is not allowed to compete with his beneficiaries without their consent. This norm is found in the law of partnership(128). It is surprising to find that this rule does not apply to directors of a
company. For example, in London & Mashonaland Exploration Co v. New Mashonaland Exploration (129), it was held that a director was not prohibited from acting as a director of a rival company (130).

It has been argued that "this view is becoming increasingly impossible to support" (131). It was held that because of the duty of fidelity which stems from the relationship of master and servant, the servant was not allowed to engage in a work competing with that of his master even in his spare time (132). Since the duty of fidelity, imposes upon the servants, includes lesser obligations than those imposed by the duty of good faith owed by directors (133), why should a director not be prevented from competing with his company? (134). However, the existing case law in the U.K. does not consider competing with the company as a breach of fiduciary duty by directors. The company cannot, accordingly, obtain an interdict to restrain its director from doing so. In respect of this point, a director's fiduciary obligations are narrower than those of a partner who is obliged to account to his fellow partners for a profit made out of carrying on or being interested in a rival business (135). Lord Blanesburgh in Bell v. Lever Bros. (136), expressed the view that a director could join the board of a rival company. To this view Lord Denning gave his reply in Scottish
Cooperative Wholesale Society Ltd v. Meyer (137). His Lordship said:

This may have been so at that time. But it is at risk now of an application under S.210 [CA 1948, S.459 CA 1985] if he subordinates the interests of the one company to those of the other”.

However, the permission to compete with the company is not an absolute or an unlimited one. This permission or immunity "extends merely to having interest in directing a rival company" (138). Furthermore, such an immunity can be abandoned by inserting a term in the director's service contract which prohibits a director from engaging in any other business without the consent of his company. For example, in Thomas Marshall (Exporters) Ltd v. Guinle (139), the court held that the defendant director (who competed with his company by serving in a rival company) was in breach of his duty of fidelity and good faith and in breach of the terms of his service contract (140).

It is to be noted that a director is not allowed to use his company's assets, good will, customer lists or trade secrets for the benefit of the rival company. And he is accountable for a profit made out of using these assets (141).

In addition, in Hivac Ltd v. Park Royal Scientific Investments Ltd (142), it was held that a director was restrained from using skills, which his original company
invested resources in providing him with, for the benefit of a rival company.

3.3.9. The use of corporate information.

A director is not allowed to use information which has been generated by his company for his own benefit. If he does so, he will be liable to account for a profit made to the company and to compensate the company for any loss suffered by it. Thus, a director's duty in relation to information belonging to his company is to use it for the benefit of the company only. The use of the corporate information by a director for his personal benefit places him in a state of conflict between his duty to the company and his personal interests; a state which is prohibited under the Common Law as well as under the Statute.

The information in this context should be confidential and unpublished in order to hold its user liable to account. Thus, the liability to account may be based on the ground that the information was given to the director confidentially, i.e., in a way prohibiting him from using it except for the benefit of the company. This information should also be obtained by a director while carrying out his functions as a director or "in consequence of being a director", in order to hold that director liable to account.
Liability may be imposed on a director even if he uses this information after his resignation from the company provided that "while a director he had that use in contemplation in circumstances liable to give rise to a conflict of interest"(146).

Liability was imposed on a director for misuse of corporate information in Industrial Development Consultants Ltd v. Cooley(147). In that case, the defendant director (Cooley) was employed by the plaintiff (the company) to secure a contract to build a depot for the Eastern Gas Board. The Gas Board was unwilling to enter into that contract with the plaintiff. The defendant was invited, as an individual, by the Gas Board, to work on the project. He obtained his resignation from the plaintiff company by misrepresenting that he was ill. Ultimately, he accepted the post with the Gas Board. On a claim against him by the company, the court held that he had allowed his interests to conflict with his duty to the company. He was held liable to account for the benefit he gained. Roskill J. said:

> Information which came to [Cooley] while he was managing director and which was of concern to the plaintiffs and relevant to the plaintiffs to know, was information which it was his duty to pass on to the plaintiffs"(148).

It is clear that Roskill J. based his judgment on the ground that Cooley had obtained information which was of
concern to the company and relevant to it to know, and deployed this information for his own personal advantage\(^{(149)}\). However, the decision in the Cooley case can be based on the ground that the defendant had exploited a corporate opportunity. But Roskill J. chose the misuse of information as a ground for his judgment because there was a little chance for the company to secure that opportunity due to the Gas Board's unwillingness to deal with it. Roskill J. said:

> It is unlikely that [the company] would have got [the opportunity] for [itself] had the defendant complied with his duty to [it]" but "if the defendant is not required to account he will have made a large profit as a result of having deliberately put himself into a position in which his duty to the [company] who was employing him and his personal interest conflict\(^{(150)}\).

**Information as property**

If a director misuses information generated by the company, can it be said that he misuses the company's property? There was a debate over this question in *Boardman v. Phipps\(^{(151)}\).* In that case the solicitor to the trust obtained information in respect of the potential development of the activities of the company in which the trust held shares. The solicitor was held liable to account for the profit made as a result of using this information. At the trial Wilberforce J. said:

> This [information] ( so far as the expression can be used ) [is] essentially the property of the trust\(^{(152)}\).
In the Court of Appeal, Lord Denning M.R, said:

Likewise with information or knowledge which [the defendant] has been employed by his principal to collect or discover, or which he has otherwise acquired, for the use of his principal, then again if turns it to his own use, so as to make a profit by means of it for himself, he is accountable... for such information or knowledge is the property of his principal, just as much as an invention is(153).

Similarly, in the House of Lords, Viscount Dilhorne, Lord Hodson and Lord Guest, agreed that information obtained by an agent while acting for the principal could be regarded as property belonging to the principal. This understanding was affirmed by Lord Cohen but his Lordship expressed the issue somewhat differently. His Lordship said:

Information is, of course, not property in the strict sense of that word and... it does not necessarily follow that because an agent acquires information and opportunity while acting in a fiduciary capacity he is accountable to his principals for any profit that comes his way as the result of the use he makes of that information and opportunity. His liability to account must depend on the facts of the case"(154).

From the judgments quoted above, it is to be concluded that as a general rule the judges considered information as property.

In his dissenting judgment Lord Upjohn agreed that information is a property but only in a limited cases or under certain conditions. His Lordship said:

In general, information is not a property at all. It is normally open to all who have eyes
to read and ears to hear. The true test is to determine in what circumstances the information has been acquired"(155).

His Lordship continued:

The real rule, is in my view, that knowledge learnt by a trustee in the course of his duties as such is not in the least property of the trust and in general may be used by him for his own benefit . . . unless it is confidential information which is given to him (1) in circumstances which, regardless of his position as a trustee, would make it a breach of confidence for him to communicate to anyone for it has been given to him expressly or impliedly as confidential, or (2) in a fiduciary capacity, and its use would place him in a position where his duty and his interest might possibly conflict"(156).

Thus, Lord Upjohn does not consider information as property as a general rule. In his view, information is property only under conditions stated in his judgment. Moreover, his Lordship qualified the second exceptional case (i.e. where information was obtained in a fiduciary capacity and its use would place the fiduciary in a situation of conflict of interest) by the condition that the use of the information should be capable of injuring the trust. In his Lordship’s words he said:

"... you have to look and see whether the knowledge acquired was capable of being used for his [i.e., a trustee] own benefit to injure the trust"(157).

To sum up, a director who uses information belonging to the company, or information which is relevant and important to the company to know, may be held liable to account for a profit made out of that use and to
compensate the company for any loss suffered by it. Such a liability can be based on the rule that prohibits the making of a secret profit. Liability may also be based on the ground that the defendant has been given this information confidentially, and the use of it amounts to a breach of confidence\(^{(153)}\). Liability may also be based on the ground that information is a property belonging to the company\(^{(151)}\). Finally, liability may be based on the wider equitable rule that a fiduciary must not place himself in a position in which his duty to his principal conflicts with his personal interests\(^{(160)}\).

It is said\(^{(161)}\) that since the essential point is that a fiduciary must not be allowed to make a personal profit out of his fiduciary position, any debate over whether information is a property or not tends to obscure that essential point and does not offer any new solution or rule. One is inclined to support this view because the real question is whether A who is a director uses his fiduciary position to make a personal profit or places himself in a conflicting situation or not. Accordingly, whether the information obtained by a fiduciary is property or not, if the use of it places that fiduciary in a situation of conflict of interest, he must be made liable to account for the profit made out of that use.
Confidentiality

Where there is a service contract between a company and its director, this contract, normally, contains an express provision prohibiting the director from using or disclosing confidential information belonging to the company for purposes other than those of the company\(^{(162)}\). Such a prohibition is effective even after the termination of the employment. In the absence of such a contract or in the absence of such a provision a director is under an implied duty not to disclose such information or to use it for his own benefit in the course of his employment. He is also not allowed to use or to disclose trade secrets even after the termination of his employment\(^{(163)}\). Thus, in *Faccenda Chicken Ltd v. Fowler*\(^{(164)}\), it was held that information of a highly confidential nature could never be disclosed by an employee during his employment or even after his resignation. A second class of information was also identified by the court. That class was information which must be dealt with as confidential due to either its obvious confidential nature or to the fact that the employee was informed that it is a confidential information. An employee can be prevented from using or disclosing information of the second class during the course of his employment by his employer. But an employer cannot stop his employee using or disclosing this class of information after the termination of his
employment unless there is an express provision in the employee's service contract giving the employer the right to prevent the employee from doing so. If the information lost its confidential nature and became open to the public, a company would be unable to protect this information by preventing its employee from using it. No action for a breach of confidence can be brought against the user of this information (165).

If a company proves that a specific category of information is confidential and that using or disclosing this information will cause harm to it, the company will be able to restrain its director from using that information for his own benefit (166).

It is argued (167) that the question of confidentiality, in the conflict of interests context, is irrelevant. A director is bound to use the information, whether confidential or not, for the benefit of his company if he obtains it while acting as a director provided that this information relates, or may possibly relate to the company's affairs. The use of such information by a director for his own benefit or to achieve his personal goals makes him liable to account for a profit made out of that use. "It is the use that is made of the information that comes to a director in his capacity as such that matters, whether it is confidential or not" (168). Having regard to the general rule that a director may not place himself in a position in which
his duty to the company conflicts with his own interests, and may not make a profit out of his directorial position, one is inclined to agree with the above argument. But, even where there is no conflict, a director who uses or discloses confidential information (in breach of express or implied prohibition in the contract of employment) acts in breach of confidence. Confidentiality in such a case, seems to be, the nucleus of the matter. Similarly, in the case where the information is confidential in its nature, a director may not use it for his own benefit and he is bound to give the opportunity of making use of it to the company (169), even in the absence of any possibility of conflict of interests (170). The court may issue an interdict against the one to whom information is confidentially communicated to prevent him from making use of it for improper or unauthorised purpose (171). A third party who is aware of the confidential nature of the information which he has received from the person to whom this information has been confidentially communicated by the plaintiff may be prevented by an interdict from making use of such information (172).
3.3.10. Insider Dealing: The use of confidential information to deal in a company's securities.

A profit can be made by dealing in a company's securities. This is called "insider dealing". Thus, insider dealing can be defined as dealing in a company's securities, options or debentures, by the use or misuse, of "unpublished price sensitive information", belonging to the company. The statute prohibits insider dealing. However, the existence or the absence of a fiduciary duty is irrelevant to the issue in question.

History of insider dealing

Before the enactment of the Companies Act 1980, insider dealing was governed by such rules as the no-conflict rule and the no-profit rule. In addition, before 1980 there were Self-Regulatory Organisations which regulated insider dealing such as the Council for the Stock Exchange and the Panel on Take-overs and mergers. But those were not enough to restrain insider dealing because in most cases the company was not the one who sustained loss by insider dealing. The real losers are the investors; so, the company has no motive to sue the dealers in its securities. Part V of the Companies Act 1980 contained provisions prohibiting the use of unpublished price sensitive information by an insider in...
relation to a company's securities. Since 1980 insider dealing has been considered as a criminal offence rather than a breach of fiduciary duty. Insider dealing is punishable by criminal penalties only. Seven years imprisonment is the maximum for a conviction on indictment according to SS.49(1), 171(b) of the Criminal Justice Act 1988. The maximum limit of sentence for a summary conviction is six months. But the court has the option to impose a fine in lieu of or in addition to an imprisonment sentence.

The provisions prohibiting insider dealing have been adopted by the Insider Dealing Act 1985 as amended by the Financial Services Act 1986. Insider dealing in England and Wales is to be prosecuted "by, or with the consent of, the Secretary of State or the Director of Public Prosecutions"(181). In Scotland, Proceedings for an offence of insider dealing are under the control of the Lord Advocate.

According to S.1(1) of the Insider Dealing Act 1985 the prohibition under this Act applies only to individuals(182). Thus, the prohibition cannot be applied to companies or corporate bodies such as local authorities(183). However, a company cannot be used as a shield behind which insider dealing is to be committed by directors. That is, a device by which a director, for example, deals in his company's securities through
another company formed for this purpose is caught by the embargo against insider dealing.

Classes of insiders

Insiders can be divided into two classes:

(1) Primary insiders: a primary insider is any person who possesses "price sensitive information" and deals either "in the securities of a company with which he is 'connected', or in the securities of some other company, with which he is connected with is about to transact or not, whichever is the case"(184). Connection with a company may arise in one of two ways:

i) an individual who deals in the company's securities is a director of the company or of a related company;

ii) an individual who deals in the company's securities is an officer (other than a director) or an employee who occupies a position, in a company or a related company, which might reasonably be expected to give him access to unpublished price sensitive information about the securities of the company or the related company, and which he would reasonably be expected not to disclose except for the proper performance of his function(185).

In other words a dealer could be an officer or an employee (other than a director) who is able, due to his position, to obtain such information about the securities of his company.
Secondary insiders (Tippees): A tippee is an outsider who deals either in the securities of a company by the use of a "price sensitive information" which he "knowingly obtained"(185), from a connected person or, in the securities of any other company with which "the informant's company is contemplating a transaction"(187). However, to hold a tippee liable, the pursuer must prove the following(188):

i) that the tippee knows that the informant is a connected person; and

ii) that he knows or reasonably believes that the information being offered arises by virtue of the connection of the informant with the company; and

iii) that he knows or reasonably believes that because of the informant's position, it would be reasonable to expect him not to disclose the information "except for the proper performance of the functions attaching to that position"(189).

So, it is quite difficult to prosecute a tippee due to the necessity of satisfying the above three requirements. Thus, in R v. Kettle & Thorneywor(190), it was held that no offence was committed because the prosecution was unable to adduce an evidence showing that the defendant knew that this information was confidential(191).
Inside information

Information must satisfy the following conditions in order to hold the dealer liable:

i) It must be held by virtue of the connection with the company\(^{(192)}\). Thus, a director who acquires information from an outsider (unless the outsider is a connected person, i.e., prohibited from using it to deal in the company's securities) is not prohibited from using it to deal in the company's securities\(^{(193)}\).

ii) It is information that it would be reasonable to expect a person so connected, not to disclose except for the proper performance of his function\(^{(194)}\). This condition imposes an objective test on the insider. A director who discloses information to a third party which it is not proper for him to disclose, is liable under the legal provisions governing insider dealing.

iii) The information must be unpublished and price-sensitive\(^{(195)}\). The phrase "unpublished price-sensitive information" has been defined in section 10 of the Insider Dealing Act 1985 as:

"... information which—
(a) relates to specific matters relating or of concern (directly or indirectly) to that company, that is to say, is not of a general nature relating or of concern to that company, and
(b) is not generally known to those persons who are accustomed or would be likely to deal in those securities but which would if it were generally known to them be likely materially to affect the price of those securities".
Information must be of a specific nature but not of a general nature in relation to specific matters. Thus, the problem that arises here is how to distinguish between specific and general information (196).

Depending on another element of the above definition, it is said that the difference between those two kinds of information is as between "day-to-day knowledge" and knowledge which will shift or affect the price of the securities if it is revealed to the market(197). Accordingly, information will be of a specific nature if it affects the market price. If revealing information does not affect the market price of the securities it will possess the quality of being "general". Consequently, using information which can be described as "specific" in purchasing or selling a company's securities amounts to an offence or illegal act. It is also argued that information is "general" if it can be "obtained from an examination of the company's continuous records"(198). Knowledge of sale of a particular subsidiary can be described as specific information(199).

If information is generally known to persons who are accustomed or would be likely to deal in securities, it will not be a specific information. Thus, to hold the dealer in securities liable for using information, this information must not be known to persons who are willing to deal in the securities. Finally, information must
affect the market price of the securities. Information about the change of investment policy of a certain company which indicates that it is going to move from a general to a specialist investment trust has been held to be a price sensitive information(200).

iv) In case of related company, information must relate "to any transaction (actual or contemplated) involving both the first and the other company, or involving one of them and securities of the other, or to the fact that any such transaction is no longer contemplated"(201). It is to be noted that the liability for insider dealing is not a strict one. The reason is that a primary insider must know that the information which he possesses is "unpublished price sensitive information". A secondary insider must knowingly obtain this information in order to hold him liable for using it. Insider dealing is a criminal offence and the knowledge of wrongfulness of the act is an essential element in every offence(202).

I respect of a sub-tippee, it is said that he "is probably outside the present scope of judicial interpretation of the Rule"(203). However, it could be argued that sub-tippees are caught by S.1(3)(a) of the Insider Dealing Act 1985. This section provides that it is to be applied to an individual where "he has information which he knowingly obtained (directly or
indirectly) from another individual . . . ". It would seem that the word "indirectly" can be construed to embrace situations in which an individual obtains information from another individual who acquires this information from an insider. That is, situations in which a sub-tippee is involved or in which he is the defender.

Insider dealing has been recognised as unfair and damaging to the investors' confidence in the integrity of the share market. To create a successful market, an equal access of information for all potential investors is necessary. In the absence of such an equality in the market, that market will be seen as unfair and this will have a devastating effect on investors' confidence(204).

The unfairness of insider dealing stems from the fact that the one who possesses confidential information takes no risk(205). Such a person does not compete with other investors on equal terms(206). In other words, insider dealing legislation is necessary to prevent insiders from "stealing a march on the market by reason of their possession of information which other market actors did not have, and more importantly, could not get"(207). On the other hand, proscribing insider dealing has been criticised by many commentators who would allow insider dealing. It has been argued that:

(1) due to the inadequacy of the existing provisions for compensations, such as salaries, bonus and special bonus
for innovations, insider dealing is the best incentive compensation device for entrepreneurs (208). (2) Insider dealing is the best force to direct the market prices in the correct way toward levels which reflect the value of the secret or confidential and unpublished information (209). (3) In terms of market efficiency insider dealing may sustain confidence in the share market because insiders can be seen as "leading indicators" in the market. The initiative of those "leading indicators" will be followed by the other market actors. In addition, the great performance of insiders which is represented by their huge gain will lead the other actors in the market to respond to the insiders' investment activities (210).

In fact, those who are supporting the view of proscribing insider dealing stressing the need for a timely disclosure of information to the market. That is, information should be released by the company to the market at the earliest opportunity "because only then will the traded price of the stocks reflect the true facts" (211).

Sanctions imposed on insider dealers

The law imposes criminal sanctions against insider dealing. The sanctions are imprisonment and/or criminal fines. There is a debate over whether a criminal penalty is a proper one to deter insider dealing.
practices. It is argued\(^{212}\) that despite the fact that criminal sanctions are commendable; they are misdirected. In practice, criminal penalties against insider dealing fail to achieve their goals of deterrence and, in fact, these penalties have led to unjust results. In support of the above argument it is said\(^{213}\) that the main problem which faces the authorities is the burden of proof. In criminal cases a high standard of proof is required. The authorities must prove that there is a link between the insider and the information that he used\(^{214}\). To prove such a link the authorities stated that the only way is to have the testimony of persons who are involved in the scheme. However, despite the fact that it is possible to identify the persons who are involved, it is difficult, in practice, to prove that critical link\(^{215}\).

Criminal sanctions have little deterrent effect. Insiders can deal in securities without any fear of detection. This result stems from the difficulty in enforcing criminal penalties\(^{216}\). If in many cases criminal penalties are unenforceable, then an insider will have little reason to refrain from dealing in securities no matter how harsh the penalty\(^{217}\).

A criminal sanctions system imposed on insider traders may give rise to unfair results\(^{218}\). Thus, it is an unfair system because while it is possible to prosecute opportunists, the system fails to detect and punish the
more sophisticated rings of criminals due to the difficulties in proving the link between the trader and the information(219).

Because of those criticisms, it is argued(220) that a civil penalty system is more convenient to police insider trading effectively. A civil penalty system is more effective because it will eliminate the problem presented by the criminal burden of proof(221). By eliminating the problem of burden of proof a wide range of traders who deal in companies' securities can be prosecuted. Consequently, a civil penalty system is also a fair one. It is also argued(222) that if the legislators believe that insider dealing is an economic crime, then a fine as an economic penalty is the most convenient one. Imprisonment has a harsh impact on a trader's life especially if he has a family and owes a huge sum of money to other persons(223). Despite the fact that a civil penalty system may reduce the criminal burden of proof, one is of the view that a criminal penalty system is more effective to deter insider dealing. (1) The imprisonment penalty, it would seem, is very effective deterrent. An insider, hopefully, will think a lot about such a harsh penalty before deciding to deal in securities. An insider may think about the devastating effects of this penalty on his personal life, his family and his reputation. And consequently, he, hopefully, will abandon the idea of
carrying out such a crime\(^{(224)}\). (2) In the opinion of those who ask for the application of civil penalties only, fines are the most appropriate penalties\(^{(225)}\). But one sees that fines are criminal penalties which require the application of criminal law. Civil penalties can be represented by holding the wrongdoer liable for damages. Those damages must be given to the injured party. (3) Since insider dealing is capable of damaging the confidence of the public in the fairness of the share market, and because the losers are not the companies but the investors, and because individuals have no cause of action against insider traders for losses they sustained, it is submitted that a criminal penalty system is more convenient than the civil one. Since it is not easy to recognise the injured parties in insider dealing cases to distribute civil remedies amongst them if a civil penalty system is to be applied, a criminal penalty system remains more effective and more reasonable. It is also submitted that the difficulties in prosecuting insider dealers, due to the high standard of proof required by the present law, do not justify using a civil penalty system instead of a criminal one. Finally, it may not be out of place to refer to the EEC Directive on insider dealing which should be implemented by Member States by the 1st of June 1992. The Directive has ignored the requirement of confidentiality which is
found in S.1(1) (b) of the Insider Dealing Act 1985.

Art.1(1) of the Directive provides:

'Inside information' shall mean information which has not been made public of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities which, if it were made public would be likely to have a significant effect on the price of the transferable security or securities in question.

Thus, information for the purposes of insider dealing under the Directive must be precise, non-public and price-sensitive. Confidentiality of the information will be irrelevant.

The Directive also expand the class of person who may be caught by its provisions. Art.2(1) states three sets of relationships out of which a person can possess inside information. It provides:

Each Member State shall prohibit any person who:
- by virtue of his membership of the administrative management or supervisory bodies of the issuer,
- by virtue of his holding in the capital of the issuer, or
- because he has access to such information by virtue of the exercise of his employment, profession or duties, possesses inside information from taking advantage of that information with full knowledge of the facts by acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which the information relates.

The third set of relationships needs not be a relationship with a company. Any person possesses inside information "by virtue of the exercise of his
employment, profession or duties" may be held liable if he deals with transferable securities.

Art. 4 of the Directive provides a definition for secondary insiders. Secondary insider according to Art. 4 embraces any person,

who with full knowledge of the facts possesses inside information the direct or indirect of which could not be other than a person referred to in Article 2(226).
3.3.11. Exploiting corporate opportunities.

Corporate opportunity has been considered as a corporate asset which is not available to be appropriated by directors\(^{(227)}\). In *Cook v. Deeks\(^{(228)}\)*, the directors of company A formed another company B and deflected a contract in which company A was interested to company B which they owned personally. The court held that the directors must maintain the contract with company A since the contract belonged to it. The court added that the contract had come to the directors in their capacity as directors of company A and by virtue of their position.

A director, who exploits a corporate opportunity belonging to his company or in which his company is interested, violates his fiduciary duty that he owes to his company. A director in such a case places himself in a position in which his duty to the company conflicts with his personal interests. A director may make a profit by exploiting a corporate opportunity and thus he is also caught by the no-profit rule and must account to the company for a profit made. In *Regal (Hastings) Ltd v. Gulliver\(^{(229)}\)*, the House of Lords held that the former directors of Regal were accountable for the profit made on the ground that they obtained these shares "by reason and only by reason of the fact that they were directors of Regal and in the course of
execution of that office . . . "(230). The House of Lords made it clear that liability would be imposed on directors once it was established

(i) that what the directors did was so related to the affairs of the company that it can properly be said to have been done in the course of their management and in utilisation of their opportunities and special knowledge as directors; and (ii) that what they did resulted in a profit to themselves" (231).

The directors of Regal had exploited a corporate opportunity and made a personal profit. The corporate opportunity which the company had been deprived of was that of the purchase of all the shares in the subsidiary company (232). The House of Lords rejected the defence that the company was unable to take up the opportunity due to financial difficulties. However, holding a director liable to account for a profit made, regardless of the fact that the company is unable to finance that opportunity, extends only to cases in which the opportunity relates to the company's affairs. In addition, the exploitation should amount to a breach of duty of loyalty and honesty owed by a director to his company (233). Thus, in cases where the opportunity does not relate to the company's activities and the company is unable to exploit it, a director must be held free to exploit it for his own benefit (234).

In Industrial Development Consultant Ltd v. Cooley (235), the court held that the defendant had allowed his
interests to conflict with his duty to the company because he exploited an opportunity that belonged to the company. Consequently, the court held him liable to account for the benefits he gained\(^{236}\). Similarly, in Canadian Aero Services Ltd v. O'Malley\(^{237}\), the inflexible rules were applied. The court held that the defendant had breached his fiduciary duty by diverting a corporate opportunity for his own benefit\(^{238}\).

Some cases dealing with the corporate opportunity have been presented. It has been shown that the no-conflict rule and the no-profit rule had been rigidly applied in those cases. One must, now, examine the tests of corporate opportunity.

**Corporate opportunity doctrine.**

The question in this context is: What is the corporate opportunity which is not available to be exploited by directors? An answer to this question requires an examination of the corporate opportunity tests. However, it is argued\(^{239}\) that there is no necessity to develop a corporate opportunity doctrine to deal with cases that fall within the scope of the no-profit rule such as the *Deeks* case\(^{240}\) and the *Regal* case\(^{241}\).

The reason is that those cases are governed by the no-profit rule itself. But the necessity for a corporate opportunity doctrine arises in cases in which a director exploits an opportunity which relates to the company's
activities while the knowledge about that opportunity acquired by the director in his capacity as an individual\(^\text{(242)}\). A clear example of this situation is the Cooley case\(^\text{(243)}\), where the defendant received the information about the opportunity in his private capacity, rather than in his capacity as a director. It would also seem that a corporate opportunity doctrine is necessary to deal with cases in which a fiduciary has not used his company's assets to develop a specific opportunity. The reason is that the one who uses his company's assets is liable under the rule that prohibiting the appropriation of the principal's property.

Brudney and Clark\(^\text{(244)}\) argue that a corporate opportunity doctrine is required for three reasons: (1) That a corporate opportunity as against fiduciaries, is considered as a corporate assets. Since a corporate fiduciary, such as a director, is prohibited from usurping corporate assets, he is also not allowed to exploit a corporate opportunity without the consent of his company; (2) that a corporate opportunity doctrine prohibiting a fiduciary from exploiting an opportunity belonging to his company reduces the cost of individually contracting for a fiduciary's loyalty; and, (3) that investors in companies will be harmed if a fiduciary is permitted to appropriate a corporate opportunity for his own benefit.
In general, a corporate opportunity doctrine is needed to protect companies' interests and the interests of shareholders or investors. It is also needed to eliminate the costs of contracting with fiduciaries for their loyalty. Finally, such a doctrine is necessary to embrace cases that fall beyond the scope of the established common law rules such as the no-conflict rule and the no-profit rule.

1) The capacity test or the capacity approach

In the Regal case(245), Lord Russell of Killowen said that the directors were liable to account for the profit made because they acquired the opportunity in their capacity as directors and in the course of the execution of their office(246). It is clear that his Lordship laid emphasis on the issue of capacity. Thus, a corporate opportunity, according to the capacity test is the one the exploiting of which by a director in his capacity as a director, exposes him to liability to account for the profit made. However, it would seem very clear that this definition is a defective one because it does not concentrate on the nature of the opportunity but on the position occupied by or the capacity of its exploiter.

The capacity test has also been applied by Roskill J. in Industrial Development Consultants v. Cooley(247). The judge said that at the time the defendant received the
information about the contract with the Gas Board, he had only one capacity which was as a managing director. This information was important and of concern to the company. The defendant's duty as a director was to pass on this information to the company because of the fiduciary relationship between him and the company[248]. By this judgment Roskill J. rejected two defences: First, that the defendant received the information about the opportunity in his private capacity. Second, that there was no fiduciary duty imposed upon the defendant to pass on this information to the company. Thus, Roskill J.'s decision seems a clear application of the inflexible rule that proscribing a fiduciary from using his position to make a personal profit. But the judge laid emphasis on two important points: First, the importance of the information to the company. The judge said that the information was important and of concern to the company. Accordingly, it would seem that this decision takes the issue far beyond the capacity test to the interest and necessity test. And in fact, the interest test can avoid the judge the difficulties of determining the capacity of the defendant when he acquired the information about the opportunity. Second, the duty of the defendant to pass on information to the company. It is argued[249] that this issue cannot be a ground for a liability judgment unless the defender makes a personal profit. That is, a failure, on the
part of the defender, to pass on information to the company cannot stand alone as a ground for a liability judgment. It is also argued\(^{(250)}\) that the ambit of the fiduciary duties will be extended in a dramatic way if a director is held liable for a breach of fiduciary duties simply because he has failed to pass on information to his company regardless of the absence or the presence of a profit element. Imposing liability on a director for failure to pass on information to his company, regardless of the absence of a profit element, means imposing an affirmative duty on him. That is, a duty to act or to advance the interest of his company so long as the company is interested in that information, and notwithstanding that the director has obtained the information in his private capacity. The fiduciary duties are negative in nature, i.e., they have only become operative once the director begins to act\(^{(251)}\). Because of this nature one is not happy to see directors under a very wide range of fiduciary duties including an affirmative duty to pass on information (which has been obtained in a private capacity and in the absence of a profit element) to their companies. The shortcomings of a theory imposing such a duty are seen in the difficulties which the courts will be faced with when they move to decide the measure of recovery, especially in cases where the company has suffered no loss\(^{(252)}\). In addition, imposing an affirmative duty on directors
may expose them to liability in cases of common directorships which is permissible under the current British Law. Suppose that A who is a director of B company and C company acquired information in his capacity as an individual. Can he disclose this information to either B or C without the risk of having to account to the other? Thus, imposing an affirmative duty on directors to pass on information to their companies (even if the information was obtained by them in their private capacity) may bear dramatic consequences on them\(^\text{253}\). However, in the Cooley case\(^\text{254}\), the court held that the defendant placed himself in a conflicting situation. This is despite the fact that the defendant was invited (by the Gas Board, to work in the project) in his private capacity. So, one finds no justification for Roskill J.'s holding that at the time the defendant received the information, he had only one capacity which was of a managing director. In fact, it seems that there was no necessity to discuss the issue of capacity in the Cooley case. The defendant was employed by his company to secure for it a contract to build a depot for the Gas Board. The defendant accordingly was under a specific duty to persuade the Gas Board to enter into that contract with the plaintiff company. By taking that contract to himself the defendant placed himself in a position in which his personal interest conflicts with his duty to the
company. Thus, in one's opinion a business opportunity should not be exploited by a director in cases where that director is under a specific duty to act in respect of a specific issue as a representative of the company. In the presence of such a specific duty an uncompromising rigid rule should be applied, and a director should not be allowed to use whatever defence to justify his exploitation of his company's opportunity for his own benefit.

The capacity test has been criticised by many judges and commentators. In Canadian Aero Services Ltd v. O'Malley(255), Laskin J. noted that several factors should be taken into account in cases involving corporate opportunity. These factors include the nature and the ripeness of the opportunity, the office held by the director and the relationship between him and the opportunity, the amount of knowledge obtained by him about the opportunity and the circumstances in which that knowledge had been obtained. Laskin J. was not satisfied with the capacity test because of its inflexibility. He also said that this test "straitjackets" the development of the law in this field.

Weinrib(256) has criticised the capacity test on two grounds: (1) it "encourages counsel to attempt to bifurcate a single personality into different personae"(257), and (2) it ignores the crucial point
which is the existence of a fiduciary obligation and the scope of the discretion that can be exercised by directors. This crucial point is more important than the capacity of the profiteer because "once the former is determined so that the contract of the supposed fiduciary either falls within it or stands outside it, the latter becomes superfluous" (258). The capacity test presupposes the existence of the fiduciary obligation and asks whether this obligation has been violated or not. Weinrib argues that the test should ask whether there is a fiduciary obligation or not rather than presupposing its existence (259).

Professor Beck (260) has tried to explain the meaning of the statement given by Lord Russell in the Regal case which is read as follows: "in the course of the execution of that office" (261). He said that "Lord Russell's judgment cannot be read to require participation in company business as essential for a finding that the director profited by reason of his fiduciary position" (262). He argues that the capacity test is a narrow one and it becomes narrower if it requires evidence that the defendant made profit while he was carrying out a corporate business (263). A director is a fiduciary, and if his principal's interests are in need of protection, he should further these interest. Thus, Beck argues that whenever the interests of the company are in need for protection, the
director should further these interests. If he failed to do so, the court should make him liable to account for a profit made. The fact that a defender made profit out of exploiting an opportunity the information about which was obtained in a private capacity should be held irrelevant (264).

2) The dualistic test i.e., the combination of the capacity test and the nature of the opportunity element

The court in Island Export Finance Ltd v. Umunna (265), adopted a bipartite test. That is, a combination of the capacity test and the nature of the opportunity itself (266). Umunna, the defendant director of the plaintiff company obtained, for a company he owned, two orders from the Cameroon postal authorities after he had resigned from the plaintiff company. The plaintiff company alleged that he breached his fiduciary duty and made improper use of its confidential information. The company sought to make him liable to account for the profits derived from those two orders. Hutchinson J. held that Umunna was not liable to account on the grounds that:

(a) The hope of obtaining further orders . . . could not in any realistic sense be said to be a maturing business opportunity. (b) Neither when Mr Umunna resigned nor when he succeeded in obtaining the [orders] was the plaintiff actively pursuing the matter. (c) It cannot, in any true sense, be said that , at the time he resigned, Mr Umunna had in contemplation
the exploration of the Cameroons postal box business. . . It cannot possibly be said that his resignation was prompted or influenced by a wish to acquire for himself the opportunity sought by the company" (267).

Thus, it is clear that the judge employed the capacity test when he held that the defendant was not motivated by the desire to exploit the opportunity at the time he resigned. The judge also had taken the nature and the ripeness of the opportunity into his account. This is clear from his speech when he said that the opportunity was not "a maturing business opportunity" (268).
FOOTNOTES

1) Gower, *Principles of Modern Company Law*, 4th ed, [1979], p.583. See generally, Loose, *The Company Director, his Functions, Powers and Duties*, 5th ed, [1982]; MacCann, "Directors' Fiduciary Duties" [1991] 9 I.L.T. 80. It is said that "interest" is usually taken by courts to mean "financial interest": Farrer's *Company Law*, 2nd ed, [1988]); see also Finn, *Fiduciary Obligations* [1977], p.203. A director may have a direct interest in a transaction if he has a financial interest in that transaction. Thus, a direct interest may arise if the interested director is himself the contracting party: see Barnard J. "Curbing Management Conflicts of Interest- The Search for an Effective Deterrent", [1988] 40, Rutgers. L. Rev. 369 , p.382. An indirect interest arises if a transaction involves, for example, another entity in which the director has a material financial interest: Barnard J. "Curbing Management Conflicts of Interest- The search for an Effective Deterrent" [1988] 40 Rutgers. L. Rev. ,369, pp.382. It was held that a director of a parent company was not placing himself in a conflicting situation when he accepted to be appointed to the board of the subsidiary: Bell v. Lever Bros Ltd [1932] AC 161, pp.195-6 (HL). But he is obliged to consider the interests of the subsidiary company as a distinct obligation and he must not subordinate those interests to the requirement of the group: see Mitchell Ph. *Insider Dealing and Directors duties*, 2nd ed, 1989.

2) [1726], Sel, Cas. T. King 61, 25 E.R. 223.
3) [1726], Sel, Cas. T. King 61, 25 E.R. 223.
4) [1742], 2 Atk 400, 26 E.R. 642.
5) [1742], 2 Atk 400, 26 E.R. 642 at p.644-5. See also Benson v. Heathorn [1842] 1 Y. & C.C.C. 326, 62 E.R. 909, in which a director of a joint stock company, who had sold his own property to the company when he was under a duty to buy for it, was held liable to account. In that case, the Vice-Chancellor said: "It is mainly this danger, the danger of the commission of fraud in a manner and under circumstances which, in the great majority of instances, must preclude detection, that in the case of trustees and all parties whose character and responsibilities are similar (for there is no magic in the world), includes the court (not only for the sake of justice in the individual case, but for the protection of the public generally, and with a view to assert and vindicate the obligation of plain and direct dealing between man and man in all cases, but especially in those when one man is trusted by another), to adhere strictly to the rule that no
profit shall be made by a person so circumstanced": at pp.916-7.
7) [1840] Cr. & Ph. 1, 41 E.R. 389.
8) [1840] Cr. & Ph. 1, 41 E.R. 389 at pp.396-7.
10) [1842], 9 CL. & Fin. 110, 8 E.R. 357.
11) [1842], 9 CL. & Fin. 110 at p.123.
12) [1896] A.C. 44.
13) [1854] 1 Macq 461.
14) [1854] 1 Macq 461 at p.471.
15) [1871] L.R. 6 Ch. App. 558, see particularly Lord Hatherley L.C.
16) [1916] 1 A.C. 554 (P.C).
18) [1967] 2 A.C. 134.
19) [1967] 2 A.C. 134 at p.147 per Lord Russell of Killowen. The inflexible rule was also applied to companies' directors in many cases; see for example Industrial Development Consultants Ltd v. Cooley [1972] 1 W.L.R. 443; Canadian Aero Services Ltd v. O'Malley [1973] 40 D.L.R. (3d) 371 (Supreme Court of Canada 1972) and Phipps v. Boardman [1967] 2 A.C. 134. It is agreed that if directors offered the new shares to the shareholders of their company or to the public and no one took them, they would not be liable to account for a profit made out of buying and reselling these shares provided that they had not treated their own applications in a preferential way. See Pennington R. Company Law , 4th ed, [1979] at p.534; Cf per Lord Chancellor King in Keech v. Stanford [1786] Sel. Cas. T. King 61, 25 E.R. 223 (quoted above).
20) However, it is to be noted that a director who made profit incidentally as a consequence of exercising his power for proper purpose and in the best interest of the company, would not be made accountable for that profit (see Hirsche v. Simms [1894] A.C. 654).
22) For an excellent discussion of these questions see, McClean A. "The Theoretical Basis of the Trustee's Duty of Loyalty" [1969] 7 Alta. L. Rev. 218.
23) [1877] 2 App. Cas. 544 (HL).
24) [1910] 103 L.T. 495 (Ch.D).
26) [1942] 1 All E.R. 378 (HL).
27) [1942] 1 All E.R. 378 (HL), see per Lord Macmillan at p.391, per Lord Wright at p.393 and per Lord Porter at p.394.
28) [1942] 1 All E.R. 378 (HL), at p.386.
29) [1942] 1 All E.R. 378 (HL), at p.392.
30) [1965] A.C. 244 (HL).
31) [1965] A.C. 244 (HL) at p.256 per Lord Reid at p.265.
32) A secret profit can be made by a director in several ways. For example, a director may make profit by dealing in his company's securities. A secret commission received by a director in return for preferring a particular supplier was held to be a secret profit for which the director was held liable to account: Boston Deep Sea Fishing and Ice Co. v. Ansell [1888] 39 Ch.D. 339, 59 Lt 345, CA. Receiving a sum of money by a director from the buyer in order to procure the shareholders' consent to sell their shares was held to be a secret profit: see General Exchange Bank v. Horner [1870] LR 9 Eq 480, 39 LJ. Ch. 393. A director may also be made liable to account for a bribe received even if the company sustained no loss: Lister & Co. v. Stubbs [18901 45 Ch.D. 1; see also Reading v. Attorney-General [1948] 2 K.B. 268, affd. in C.A [1949] 2 K.B. 232; H.L [1951] A.C. 507.
33) [1926] A.C. 788.
34) [1926] A.C. 788 at p.797.
35) [1946] Ch. 73 (Ch. D); see also Re Gee [1948] Ch. 284 (Ch. D), particularly see per Harman J. at p.294.
36) [1946] Ch. 73 (Ch. D) at p.82.
37) [1946] Ch. 73 (Ch. D).
39) [1967] 2 A.C. 46 (HL).
41) [1965] Ch. 992 at p.1020.
43) [1967] 2 A.C. 46 at p.123.
44) [1967] 2 A.C. 46 (HL).
45) [1942] 1 All E.R. 378 (HL).
49) Brudney V. "The Independent Director—Heavenly City or Potemkin Village?" [1982] 95 Harv. L. Rev 597; see also Farrar's Company Law, 2nd ed, [1988].

50) Brudney V. "The Independent Director—Heavenly City or Potemkin Village?" [1982] 95 Harv. L. Rev 597.

51) Prentice D. "The Corporate Opportunity Doctrine" [1974] 73 M.L.R., 464; Dr. Prentice says: "the decision in [the Canadian Aero Services Ltd. v. O'Malley [1973] 40 D.L.R (3d) 371 (S.C.C) in which the inflexible rules had been applied] provides a secure doctrinal basis for a new variant of the Old Wildean aphorism that we can resist every thing but temptation". He also added that "on a policy basis [the decision in that case] is to be commended. Equity's uncompromising attitude has much to recommend it when dealing with errant directors".


56) [1854] 1 Macq 461.

57) [1854] 1 Macq 461 at p.471.

58) [1871] L.R. 6 Ch. App. 558, particularly see Lord Hatherley L.C.

59) Gower L. Principles of Modern Company Law, 4th ed, [1979], p.584. A director may be said to have an indirect interest, for example, if his spouse is the contracting party. In general, it is said that a director has an indirect interest if any member of his/her immediate family is the contracting party. Spouses, parents, children are examples of the members of the immediate family: Bernard J. "Curbing Management Conflict of Interest—The search for an Effective Deterrent", [1988] 40 Rutgers. L. Rev 369 at p.384.

60) A director can escape liability by making a full disclosure of his interest in contracts and the nature of that interest to the company in general meeting. It is also the duty of a director to disclose his interest in contracts and the nature of that interest to the board of directors: S.317(1) CA 1985.


64) [1874] 9 Ch. App. 350.

65) [1843] 2 Hare. 461.

66) See the White Paper, "The Conduct of Company
Directors" (Cmd 7037), para 16.

67) It provides: (1) With the exceptions provided by the section next following, a company shall not enter into an arrangement—
(a) whereby a director of the company or its holding company, or a person connected with such a director, acquires or is to acquire one or more non-cash assets of the requisite value from the company; or
(b) Whereby the company acquires or is to acquire one or more non-cash assets of the requisite value from such a director or a person so connected, unless the arrangement is first approved by a resolution of the company in general meeting and, if the director or connected person is a director of its holding company or a person connected with such a director, by a resolution in general meeting of the holding company.

68) The word "arrangement" in S.320(1) covers transactions by which the company's property transferred to a third party and subsequently to a director or connected person: see Farrar's Company Law, 2nd ed, [1988].

69) S.320(3) CA 1985. This section provides:
"For purposes of this section and section 321 and 322, a shadow director is treated as a director".

70) S.320(1) CA 1985.
71) S.322(3)(a) CA 1985.
72) S.322(4) CA 1985.
73) S.322(2)(a) CA 1985.
74) S.322(2)(b).
75) S.322(2)(c) CA 1985.
76) S.322(5) CA 1985.
77) S.322(6) CA 1985.
79) S.320(2) provides:
"For this purpose a non-cash asset is of the requisite value if at the time the arrangement in question is entered into, its value is less than £2,000 but (subject to that) exceeds £100,000 or 10 per cent of the company's asset value, that is—
(a) except in a case falling within paragraph (b) below, the value of the company's net assets determined by reference to the accounts prepared and laid down under Part VII in respect of the last preceding financial year in respect of which such accounts were so laid; and
(b) where no accounts have been so prepared and laid before that time, the amount of the company's called-up share capital.
It should be noted that the figures in square brackets substituted by Companies (Fair Dealing by Directors) (increase in Financial Limits) Order 1990, SI 1990, No 1393. Previously the figures were £1,000, £50,000.
80) S.320(2)(a) and (b).

81) S.321(2) provides:
"Section 320(1) does not apply to an arrangement for the acquisition of a non-cash asset—
(a) if the asset is to be acquired by a holding company from any of its wholly-owned subsidiaries or from a holding company by any of its wholly-owned subsidiaries, or by one wholly-owned subsidiary of a holding company from another wholly-owned subsidiary of the same holding company."

82) See Farrar's Company Law, 2nd ed, [1988], p.356

83) S.321(2)(b) provides:
"if the arrangement is entered into by a company which is being wound up, unless the winding up is a members' voluntary winding up".


85) S.321(3) provides:
"Section 320(1)(e) does not apply to an arrangement whereby a person is to acquire an asset from a company of which he is a member, if the arrangement is made with that person in his character as a member".

86) This Article provides:
"The directors shall be entitled to such remuneration as the company may by ordinary resolution determine and, unless the resolution provides otherwise, the remuneration shall be deemed to accrue from day to day".


88) Similarly, a state of conflict may arise in respect of cases in which indemnifying directors for travelling, hotel, and other expenses incurred by them in connection with the discharge of their duties: see Art.83 of Table A 1985 which gives directors the right to be paid out of the company's funds for those expenses.


90) S.330 provides:
"(2) A company shall not—
(a) make a loan to a director of the company or of its holding company.

91) Farrar's Company Law, 2nd ed, [1988].

92) S.331(6) CA 1985 defines "relevant company" as follows:
"Relevant company" means a company which—
(a) is a public company, or
(b) is a subsidiary of a public company, or
is a subsidiary of a company which has as another subsidiary a public company, or
(d) has a subsidiary which is a public company.

S.346(2) CA 1985 defines the phrase "connected person" as follows:
"A person is connected with a director of a company if, but only if he (not being himself a director of it) is-
(a) that director's spouse, child or step-child; or
(b) except where the context otherwise requires, a body corporate with which the director is associated; or
(c) a person acting in his capacity as trustee of any trust the beneficiaries of which include-
   (i) the director, his spouse or any children or step-children of his, or
   (ii) a body corporate with which he is associated, or of a trust whose terms confer a power on the trustees that may be exercised for the benefit of the director, his spouse or any children or step-children of his, or any such body corporate; or
(d) a person acting in his capacity as partner of that director or of any person who, by virtue of paragraph (a), (b) or (c) of this subsection is connected with that director; or
(e) a Scottish firm in which-
   (i) that director is a partner,
   (ii) a partner is a person who, by virtue of paragraph (a), (b) or (c) above, is connected with that director or
   (iii) a person is a Scottish firm in which that director is a partner or in which there is a partner who, by virtue of paragraph (a), (b) or (c) above, is connected with that director.


S.339 defines the "relevant amount" as follows:
"(2) Subject as follows, the relevant amounts in relation to a proposed transaction or arrangement are-
(a) the value of the proposed transaction or arrangement,
(b) the value of any existing arrangement which-
   (i) falls within subsection (6) or (7) of section 330, and (ii) also falls within subsection (3) of this section, and (iii) was entered into by virtue of the relevant exception by the company or by a subsidiary of the company or, where the proposed transaction or arrangement is to be made for a director of its holding company or a person connected with such a director, by that holding company or of its subsidiaries;
(c) the amount outstanding under any other transaction.
(i) falling within subsection (3) below, and
(ii) made by virtue of the relevant exception, and
(iii) made by the company or by a subsidiary of the company or, where the proposed transaction or any arrangement is to be made for a director of its holding company or a person connected with such a director, by that holding company or any of its subsidiaries.

(3) A transaction falls within this subsection if it was made-
(a) for the director for whom the proposed transaction or arrangement is to be made, or for any person connected with that director; or
(b) where the proposed transaction or arrangement is to be made for a person connected with a director of a company, for that director or any person connected with him;

and an arrangement also falls within this subsection if it relates to a transaction which does so.

Subsection (6) of section 330 provides:
"A company shall not arrange for the assignment to it, or the assumption by it, of any rights, obligations or liabilities under a transaction which, if it had been entered into by the company, would have contravened subsection (2), (3) or (4); but for the purpose of section 330 to 347 the transaction is to be treated as having been entered into on the date of the arrangement.

Subsection (7) of section 330 provides:
"A company shall not take part in any arrangement whereby— (a) another person enters into a transaction which, if it had been entered into by the company, would contravened any of subsection (2), (3), (4) or (6); and (b) that other person, in pursuance of the arrangement, has obtained or is to obtain any benefit from the company or its holding company or a subsidiary of the company or its holding company.

It should be noted that the figure in this context substituted by CA 1989, S.138 (b). Previously the figure was £2,500.

97) S.333 CA 1985.
98) See the definition of "relevant company" in S.331(6) CA 1985.
99) S.333(a) CA 1985.
100) See S.336(a) which provides:
"The following transactions are excepted from the prohibitions of section 330—
(a) a loan or a quasi-loan by a company to its holding company, . . . ".

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102) S.338(1)(a) CA 1985.
103) S.338(3)(a) CA 1985.
104) S.338(3)(b) CA 1985. This section provides:
"(b) the amount of the loan or quasi-loan, or the amount guaranteed, is not greater, and the terms of the loan, quasi-loan or guarantee are not more favourable, in the case of the person to whom the loan or quasi-loan is made or in respect of whom the guarantee is entered into, than that or those which it is reasonable to expect that company to have offered to or in respect of a person of the same financial standing but unconnected with the company".

105) Figure substituted by CA 1989, S.138 (c). Previously the figure was £50,000.
106) S.331(3) defines a quasi-loan as follows:
"A quasi-loan is a transaction under which one party (the creditor) agrees to pay, or pays otherwise than in pursuance of an agreement, a sum for another (the borrower) or agrees to reimburse, or reimburse otherwise than in pursuance of an agreement, expenditure incurred by another party for another (the borrower)—
(a) on terms that the borrower (or a person on his behalf) will reimburse the creditor; or
(b) in circumstances giving rise to a liability on the borrower to reimburse the creditor".

108) There is nothing in S.330(a) to indicate that private companies which are not relevant companies are prohibited from making quasi-loans to their directors.
109) S.330(3)(a) and (b) CA 1985.
110) S.332(1)(a) and (b) CA 1985. Figure in square brackets substituted by CA 1989, S.138 (a). Previously the figure was £1,000.
111) S.338(3)(a) and (b) CA 1985.
112) S.338(3)(b) CA 1985.
113) S.338(4) CA 1985. Figure substituted by CA 1989, S.138 (c). Previously the figure was £50,000.
114) S.338(4) CA 1985.
115) See the definition of the “relevant company” in S.331(6) CA 1985.
116) S.330(4) CA 1985
117) S.335(1) CA 1985 provides: "section 330(4) does not prohibit a company from entering into a transaction for a person if the aggregate of the relevant amounts does not exceed £10,000]. Figure in square brackets substituted by Companies (Fair Dealing by Directors) (Increase in Financial Limits) Order 1990, SI 1990 No 1393. Previously the figure was £5,000.
119) S.335(2)(a) CA 1985.
120) See comments on this section in Morse G. Companies Consolidation Legislation 1987 at p.288.
121) S.330(2) prohibits making loans by the company and prohibits entering into guarantee or providing any security in connection with a loan. S.330(3) prohibits the making of quasi-loans by the company to its directors. S.330(4) prohibits entering into a credit transaction.
123) See S.330(2)(b), (3)(c) and (4)(b) CA 1985.
125) S.337(3)(a) CA 1985.
126) S.337(3)(b) CA 1985.
127) S.337(3)(b) CA 1985. Figure in square brackets substituted by Companies (Fair Dealing by Directors) (Increase in Financial Limits) Order 1990, SI 1990 No. 1393. Previously the figure was £10,000.
129) [1891] W.N. 165.
131) Gower L. Principles of Modern Company Law, [1979], p.599.
132) Hivac Ltd v. Park Royal Scientific Instruments Ltd [1946] Ch. 169 (CA).
134) Gower L. Principles of Modern Company Law, [1979], p.600.
137) [1959] A.C. 324.
138) Pennington R. Directors' Personal Liability, [1987], p.51. But a director can compete personally and directly with his company after his resignation from his office provided that he is not using any information belonging to the company or any of its opportunities and provided that there is no agreement to the contrary. A director in such a case will not be in breach of his duties. See Gower L. Principles of Modern Company Law, 4th ed, [1979], p.601. See also Jacobs L. "Business Ethics and the Law: Obligations of Corporate Executives" [1973] 28 Bus. Law. 1063, p.1081.
140) It is difficult to conclude from this judgment that there is a rule prohibiting a director from serving in a rival company because of the intervention of an express agreement between the parties precluding
a director from serving, without the consent of his company, in a rival company and because of the fact that the defendant director had diverted the company's business to himself. See Gower L. Principles of Modern Company Law, [1979], p.600. A director's service contract with his company may implicitly require him to devote his time and his effort to his company's business. So, if a director engages in a rival business he may be sued for breach of contract. And this allows the company to obtain damages against that director. However, the company cannot recover a profit made by its director in this case because he is not in breach of his fiduciary duty but in breach of a service contract: see Whitwood Chemical Co. Ltd v. Hardman [1891] 2 Ch. 416.


142) [1946] Ch. 169.


145) Pennington R. Director's Personal Liability [1987], p.53.

146) Gower L. Principles of Modern Company Law [1979], p.595; see Cl 44(3)(b) of the 1978 Bill.


149) This judgment raises the question as whether there is an affirmative duty on a director to pass on information which he has obtained from a third party to his company.

150) [1972] 1 W.L.R. 443 at p.453.

151) [1967] 2 A.C. 46.

152) [1964] 2 All E.R. 187 (Ch. D) p.204.

153) [1965] Ch. 992 (CA) at pp.1018-1019.

154) [1967] 2 A.C. 46 at pp.102-103.

155) [1967] 2 A.C. 46 at p.127.


157) [1967] 2 A.C. 46 at p.129.


161) Beck S. "The Saga of Peso Silver Mines: Corporate
169) However, while it is possible to imagine situations in which a director discloses confidential information without being in a conflict of interest situation or even without making a personal profit; it is difficult to imagine situations in which he makes use of that information for his own benefit without placing himself in a conflicting situation or without being a subject to the no-profit rule. Thus, using confidential information by a director to obtain a personal profit makes him liable to account for the profit made or to compensate the company for a loss it has suffered consequently.
175) S.1 of the Insider Dealing Act 1985 provides: "Subject to section 3, an individual who is, or at any time in the preceding 6 months has been, knowingly connected with a company shall not deal on a recognised stock exchange in securities of that company if he has information which— (a) he holds by virtue of being connected with the company, (b) it would be reasonable to expect a person so connected, and in the position by virtue of which he is so connected, not to disclose except for the proper performance of the functions attaching to that position, and
(c) he knows is unpublished price sensitive information in relation to those securities.


182) S.1(1) of the Insider Dealing Act 1985 provides: "... an individual who is, ...".


186) S.1(3) of the Insider Dealing Act 1985. This section provides: "The next subsection applies where-

(a) an individual has information which he knowingly obtained (directly or indirectly) from another individual who - (i) is connected with a particular company, or was at any time in the 6 months preceding the obtaining of information so connected, and (ii) the former individual knows or has reasonable cause to believe held the information by virtue of being so connected, and

(b) the former individual knows or has reasonable cause to believe that, because of the latter's connection and position, it would be reasonable to expect him not to disclose the information except for the proper performance of the functions attaching to that position".

The word "obtain" had been considered in Attorney-General's Reference [1989] 1 All E.R. 321, in which Lord Lowry stated that the definition of the word "obtain" can be satisfied not only by an active receipt but also by a passive receipt of information. So the court held that the decisive element is the dealing, while the obtaining on its own is of no impact. Accordingly, proving that the information was obtained by the defender without exerting any effort was not a defence.

188) See those conditions in S.1(3) of the Insider Dealing Act 1985.
189) S.1(3)(b).
191) The facts of that case were as follows: Two employees of a firm obtained information from a stockbroking firm connected with Blockleys Plc. They were led to believe that a third party was acquiring substantial amounts of Blockleys shares. Consequently, they bought shares with a hope to seeing the price rise on a takeover.
195) S.1(1)(c) and 1(2)(c) of the Insider Dealing Act 1985.
197) This description was given by the Government in Parliamentary debate on the 1980 Act; see Mitchell Ph. Insider Dealing and Directors' Duties, 2nd ed, [1989], p.235.
201) S.1(2)(d).
204) See Ashe T. "Insider Dealing" [1990] 11 Co. Law, 127; see also Sealy L. Cases and Materials in Company Law, 2nd ed, [1989]; see the Singapore case Public Prosecutor v. Allan Ng Poh Meng, referred to by Ashe T. (Ibid) at p. 127. In that case Errol Foenander SDJ emphasised that one of the reasons for legislation against insider dealing is to protect corporate confidences, to prevent insiders from gaining an advantage out of information which is not theirs. The Judge equated dealing in companies securities by the use of information which the dealers possess as stealing this information.
207) Ashe T. "Insider Dealing!" [1990] 11 Co. Law. 127, quoted from the judgment of Errol Foenander SDJ in
the Singapore case Public Prosecutor v. Allan Ng Poh Meng, referred to in the same article.

208) See Manne H. Insider Trading and the Stock Market [1966]. However this view has been criticised as to the extent to which the beneficiaries of insider dealing are actually entrepreneurs. Insider dealing may reduce directors' incentives to perform well and may produce a fluctuation in the market value of their companies' shares rather than maximising the present value of those shares. See those criticisms in Posner R. and Scott K. Economics of Corporation Law and Securities Regulations [1980], p. 153-154.

209) See Manne H. Insider Trading and the Stock Market [1966]. Manne also argued that insider's gain is not made at the expense of anyone and criticised the view that insider dealing is unfair as hypocritical and self-righteous. However, it is argued that a rapid disclosure of an important information would serve the same result even more effectively: see this criticism in Posner R. and Scott K. Economics of Corporation Law and Securities Regulations [1980].

210) This view was concluded by a study in 1985 entitled 'Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence' (Referred to by Ashe T. "Insider Dealing" [1990] 11 Co. Law., 128.


217) Gower L. Gower's Report, referred to by Naylor J. "The Use of Criminal Sanctions by the U.K and the U.S Authorities for Insider Trading: How can the


219) Ibid.

220) Ibid.


224) This view has been supported by some writers. For example, Coffee J. argued that imprisonment is the most effective deterrent no matter who is involved in insider dealing, i.e., no matter whether this has an impact on the dealer's life or not and notwithstanding that his imprisonment may affect his creditors: Coffee J. "Corporate Punishment: A Non-Chicago View of the Enforcement of Criminal Sanctions" [1980] 17 Am. Crim. L. Rev 419.


227) A director is prohibited from exploiting an opportunity to the development of which the company's asset has been used. The term 'asset' includes 'hard' assets like cash, facilities and contracts. It also includes 'soft' assets like good will, working time and corporate information": Brudney V. and Clark R. "A New Look at Corporate Opportunities" [1980-1981] 94, Harv. L. Rev. 998 at p.1006-7.

228) [1916] 1 A.C. 554 (PC).

229) [1967] 2 A.C. 134.

230) [1967] 2 A.C. 134 at p.147 per Lord Russell of
Killowen.


232) However, professor Gower argued that the directors of Regal did not steal a corporate opportunity from their company because the company was unable to purchase all the subsidiary's shares due to lack of funds: Gower, Principles of Modern Company Law, 4th ed, [1979], at p.593.

233) This is clear from Lord MacMillan's speech in the Regal case [1967] 2 A.C. 134 at p.153.

234) However, it will be shown in chapter 4 that even if the opportunity is ultra vires the company a director may not be allowed to exploit it.


236) [1972] 1 W.L.R. 443; [1972] 2 All E.R. 162, see per Roskill J. However, even if Mr Cooley had not committed a fraud he would have been accountable for the profit he made on the ground that he had placed himself in a position of conflict of interests.


238) [1973] 40 D.L.R (3d) 371, see per Laskin J.


245) [1967] 2 A.C. 134.

246) [1967] 2 A.C. 134, at p.147.


248) [1972] 2 All E.R. 162 at pp.173-174, per Roskill J.


250) Ibid.


252) Prentice D. "Directors' Fiduciary Duty, the Corporate Opportunity Doctrine" [1972] 50 Can. Bar. Rev p.623. However, Dr. Prentice sees some attraction in a theory imposing an affirmative duty on directors to further the interests of their companies. He said " The law should more clearly recognise that there are affirmative duties on the director to further the interest of his company. No doubt, this only come about by extensive legislative intervention, but until such takes place we should make the best use of the tools at
our disposal": Prentice D. "Regal (Hastings) v. Gulliver— The Canadian Experience" [1967] M.L.R. 540 at p.455. Dr. Prentice says that imposing an affirmative duty on a director has some advantages such as (1) it will put an end to a practice of a person holding more than one directorship at least where the companies are in the same line of business. (2) It will prevent a director from competing with his company: Prentice D. (Ibid).

253) Prof. Beck is inclined to support the view that a director should be subjected to an affirmative duty to advance their companies' interest a head of their own interest. The reason is that directors are fiduciaries and they should further their principals' interests if these interest call for protection: Beck S. "The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered" [1971] 49 Can. Bar. Rev. 80 at p.107.

254) [1972] 2 All E.R. 162.


261) [1967] 2 A.C. 134 at p.147 per Lord Russell of Killowen.


263) He criticised the decision of the Supreme Court of Canada in Peso Silver Mines Ltd v. Cropper [1966] 58 D.L.R (2d) 1 (S.C.C) in which the court adopted a narrow interpretation of the phrase "in the course of the execution of that office" which was given by Lord Russell in the Regal case [1967] 2 A.C. 134 at p.147. The court took the view that this phrase required the showing that a director, to be held liable, must actually engage in carrying out a corporate transaction when he makes a personal profit.


266) see Farrar's Company Law , 2nd ed, [1988].

267) [1986] B.C.L.C. 460 at p.482 per Hutchinson J.

268) [1986] B.C.L.C. 460 at p.482 per Hutchinson J.
CHAPTER 4

THE INFLEXIBILITY AND THE RELAXATION OF THE FAIR DEALING RULES.

4.1. Introduction

Both the no-conflict and the no-profit rules, as applied in the United Kingdom are rigid ones. Their rigidity can be realised by examining the courts' attitude towards the various defences which have been raised by defender fiduciaries in many cases. In this chapter it will be shown that the common law and the legislation have tried to relax the inflexibility of the fair dealing rules. The judicial tendency to relax the fair dealing rules will be examined in detail.

4.2. Features of the Inflexibility.

4.2.1. Bases of liability: The mere possibility of conflict and the mere fact that a profit has been made.

In many cases, the judicial intervention was justified on the ground that there was a possibility of conflict of interest and/or that a profit had been made.

In Aberdeen Railway Company v. Blaikie Bros(1), Lord Cranworth L.C held that the defender director was not
allowed to contract with himself on behalf of the company or with a firm in which he was a partner. This is because in such a case a director places himself in a conflicting situation. His Lordship said that a company can only act by agents. These agents have duties of a fiduciary nature which they are obliged to discharge towards their principals. His Lordship stated:

"It is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements 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." 

Thus, in that case, the mere possibility of conflict was sufficient to guarantee the intervention of the court. It was sufficient to hold the defender liable and to set aside the contract. So, there was no necessity to prove the existence of an actual conflict. The mere fact that a profit had been made was enough to justify the application of the rigid rules in some cases. For example, in Parker v. Mckenna, the directors of the bank were entrusted with the duty of selling shares. They bought some of those shares for themselves and made profit by re-selling them. The court held that they had to account for the profit made. The Lord Chancellor said:

"The court will not inquire, and is not in a position to ascertain, whether the bank has or has not lost by the acts of the directors. All that the court has to do is to examine whether a profit has been made by an agent,"
without the knowledge of his principal, in the course of and execution of his agency\(^4\).

Similarly, in *Regal (Hastings) v. Gulliver\(^5\)*, Lord Russell stated that the defendants were liable "if, while standing in a fiduciary relationship to Regal they have by reason and in the course of that fiduciary relationship made a profit"\(^6\). His Lordship emphasised that "The liability arises from the mere fact of a profit having, in the stated circumstances, been made"\(^7\).

So, whenever a director made a profit out of his position, he might be held liable to account for it even if there was no conflict of interest and duty.

4.2.2. No remunerations for a trustee's care and troubles.

The strictness of the rules was also emphasised by Lord Talbot L.C in *Robinson v. Pett\(^8\)*. In that case his Lordship refused to allow an allowance to the defendant for his care and the work done for the trust estate. His Lordship said:

> It is an established rule that a trustee, executor, or administrator, shall have no allowance for his care and trouble: the reason of which seems to be, for that on those pretences, if allowed, the trust estate might be loaded, and rendered of little value\(^9\).

It is clear that the rigid rules were applied strictly in that case. The refusal to allow an allowance to the
defendant for his care and trouble is one of the features of the inflexibility.

4.2.3. Bona fides is no defence.

In many cases(10), directors had tried to defend themselves by claiming that they were acting bona fide in the best interests of their companies. In Ex parte Lacey(11), Lord Eldon said that the courts were unable to examine the bona fides of the parties. Similarly, in the Regal(12) case, Lord Russell said that "The profiteer, however honest and well-intentioned, cannot escape the risk of being called upon to account"(13).

In Phipps v. Boardman(14), it was held that the defendants had put themselves in a special fiduciary position. This position enabled them to buy the shares and consequently they made a personal profit. The defendants were made liable to account for the profit made and it was irrelevant that they had acted honestly and in a manner beneficial to the trust(15). So, the courts contended that they were incapable of determining questions of bona fides(16).

In sum, a fiduciary, whether a director or an officer, cannot escape liability by showing that he was acting in good faith when he made a personal profit. The rejection of such a defence represents one of the features of the rigidity of the fair dealing rules.
4.2.4. Company's financial inability is no defence.

Applying the inflexible rules deprives directors from usurping corporate opportunities for their own benefit on the plea of company's financial inability. The company in the Regal case\(^{(17)}\), was unable to finance the transaction. The directors tried to use this fact as a defence. This defence has been rejected by the House of Lords. Lord Russell said that the liability to account for a profit made, "in no way depends on . . . consideration as whether the profit would or should otherwise have gone to the plaintiff . . ."\(^{(18)}\). His Lordship rejected this defence by analogy to the decision in Keech v. Stanford\(^{(19)}\), in which the lessor refused to renew the lease to the infant where upon the trustee renewed for himself. The court laid down the inflexible rule that the trustee might not have the lease, but must hold it on trust for the infant regardless of the facts that the lessor had refused to renew it to the infant and that the trustee had acted in good faith. It is argued that the company is entitled to its directors' individual loyalty. Thus, a director may not exploit a corporate opportunity even if his company is financially unable to exploit it because "the company is entitled to freedom from competition by those charged by the promotion of its interest"\(^{(20)}\).
In the Canadian case Weber Feeds Ltd v. Weber(21), the court held that the company's financial inability was irrelevant and did not have any bearing on the question of breach of fiduciary duty.

The reason behind articulating such a rigid rule which deprives a director from depending on his company's financial inability as a defence is a prophylactic one. That is, it is intended to remove all kinds of temptation. Swan J., in Irving Trust Co. v. Deutsch(22), put it in this way:

The defendants' argument that fiduciary principles can have no application where the corporation is unable to undertake the venture is not convincing. If directors are permitted to justify their conduct on such a theory there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation since, if it does not meet the obligations, an opportunity of profit will be open to them personally(23).

Dr. Prentice(24) has agreed with Swan J. and said that if the company's financial inability is accepted as a defence, directors will be tempted to refrain from exerting their best effort on behalf of the company as this would afford them an opportunity to gain profit which might be at the company's expense. It is also argued(25) that a rule of uncompromising rigidity denying the defence of financial inability is based upon public policy rather than upon the resulting harm to the company. It is thought that public policy can be served effectively when temptation is removed. Clark(26)
argues that some types of allegations are "implausible". If a director believes that a specific business opportunity is lucrative, why does he not "convince a bank or other investor of this fact in order to obtain financing for the corporation to take it?" (27). Allowing the defence of financial inability reduces the directors' incentive to solve corporate financing and other problems (28). It has been argued (29) that a director is required to make a genuine effort to enable the company to acquire any profitable opportunity. However, a director's duty may not be extended to lending personal funds. But it is said (30) that he is required, at least, to repay any debts owed to the company before making any attempt to exploit the opportunity for his own benefit. The fact that the defendant owed the company a large sum of money in the Irving case (31), was one of the most important reasons which led the court to reject the defence of financial inability (32).

4.2.5. Third party's unwillingness to deal with the company is no defence.

If a third party is unwilling to deal with the company, can a director take the opportunity himself? The rigid application of the fair dealing rules deprives a director from exploiting a corporate opportunity in such
a case. In *Keech v. Stanford*\(^{(33)}\), the court held the trustee liable because he had taken the lease for himself despite the fact that the lessor had refused to renew that lease to the infant beneficiary. Similarly, in *Industrial Development Consultants Ltd v. Cooley*\(^{(34)}\), the unwillingness of the Gas Board to deal with the company had not been accepted as a defence available to the defendant. However, Roskill J. recognised the anomalous consequences of this decision and said that the plaintiffs will gain a benefit "which . . . it is unlikely they would have got for themselves had the defendant complied with his duty to them"\(^{(35)}\). But the judge pointed out that it was the defendant's duty to persuade the Gas Board to contract with the plaintiff company. The judge said:

> It is a curious position under which he whose duty it would have been to seek to persuade them to change their minds should now say that the plaintiff suffered no loss because, he would never have succeeded in persuading them to change their mind\(^{(36)}\). 

Dr. Prentice argues\(^{(37)}\) that there is a sound policy reason for rejecting such a defence. That reason is to stop any temptation which may lead directors to refrain from exerting their best effort to further their companies' interests.

Rajak\(^{(38)}\) said that Roskill J., in the *Cooley* case, adopted the view that there was a fiduciary relationship between the defendant and the company. That
relationship stems from the relationship between a director and his company.

In Abbey Glen Property Corp. v. Stumborg\(^{(39)}\), directors of company A approached company B on behalf of company A to join the latter company in a venture to acquire and develop land in a specific area. Company B expressed its unwillingness to deal with company A. But it was willing to deal with the directors of company A. Directors of company A formed a new company owned by them which, eventually, took the intended land. Company A alleged that its directors had breached their fiduciary duties. The court held that the defendants were liable in spite of the refusal of company B to deal with the plaintiff company.

It is said\(^{(40)}\) that it is undesirable to consider the unwillingness of the third party as an affirmative defence due to the difficulties of verification of unwillingness. Allowing such a defence may also encourage directors to induce the unwillingness. However, an absolute rejection of such a kind of defence seems unreasonable.

4.2.6. The ultra vires transactions.

No conflict of interest and duty will arise in cases where it is illegal for a company to take a specific opportunity. Accordingly, a director can exploit that
opportunity without the risk of being held accountable for a profit which he may make. A director is not required to seek the approval of the company to take such an opportunity. Similarly, where the inability of the company to take an opportunity resulting from its insolvency, it seems that a director is not precluded from taking advantage of that opportunity. But the situation is different in cases where the opportunity is ultra vires the company. In such cases it is said that a conflict of interest and duty may exist if a director exploits an ultra vires opportunity. So, a director cannot defend himself by claiming that the opportunity which he has exploited is ultra vires the company. The reason lying behind this embargo is that the objects clause of a company can be amended so as to enable the company to take any profitable opportunity. Rejecting the defence of ultra vires represents another feature of the rigidity of the fair dealing rules. Such a rejection should not be commended since many opportunities will go unexploited because of the difficulties in amending a company's objects clause in a short period of time. However, since the ultra vires doctrine, in relation to bona fide third parties, has been abolished in the United Kingdom, an argument that it should be a defence is no longer worthwhile. New S.35 of the Companies Act 1985 provides that a company's capacity is not limited by its memorandum.
Thus, a company, now, has the capacity to take advantage of any fruitful opportunity\(^{44}\).

4.2.7. Exploiting an opportunity by a director after his resignation from his office.

In *Industrial Development Consultants v. Cooley*\(^{45}\), the defendant director pleaded that he entered into the contract with the third party after his resignation from his office of directorship. The court rejected this defence on the ground that the opportunity came to the defendant's knowledge while he was occupying a director's position. Furthermore, it was found that the resignation of the defendant in that case was prompted by the desire to obtain for himself the contract with the third party. In the Canadian case *Canadian Aero Services Ltd. v. O'Malley*\(^{46}\), the same defence was pleaded by the defendants. It was found that the plaintiff company had devoted itself for that opportunity which was captured by former directors. Thus, Laskin J. rejected this defence and said that a director is qualified from usurping for himself . . . a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation is fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company; or where it was his position with the company rather than a fresh initiative that
led him to the opportunity which he later acquired(47).

On the other hand, in Island Export Finance Ltd. v. Umunna(48), the court found that the resignation was not prompted by the desire to acquire the opportunity. Hutchison J. said that exploiting the opportunity by the defendant director

was certainly not his motive for resignation, and it cannot possibly be said that his resignation was prompted or influenced by a wish to acquire for himself the opportunity sought by the company(49).

Thus, the court accepted the defence that the exploitation was achieved after the resignation. However, it should be noted that the special facts of each case are crucial while the time of exploitation is less important. In other words, rejecting or accepting a defence of such a kind depends on the circumstances of each case. The intention of the defender and the motives that led to resignation are decisive and very important. Thus, an absolute rejection of the defence of resignation without making an inquiry into the motives of the defenders would be unwise and would constitute another feature of the rigid application of the fair dealing rules.
4.2.8. Change in shareholders and unjustified enrichment as defences

The original shareholders at the time of the breach may leave the company and new shareholders may replace them at the time of the action against the directors. The question here is this: Does this change form a defence in the hands of the directors against the company's allegation?. Can it be said that the new shareholders will have gained a windfall profit if recovery has been allowed ?. In the Regal case, it could be argued that the new directors and/or the new shareholders had gained a windfall profit (i.e. they had been unjustly enriched by holding the previous directors liable to account for the profit made). Professor Gower describes their action as "unmeritorious". Lord Porter said that the recovery in the Regal case resulted in the new shareholders obtaining an "unexpected windfall". But his Lordship concluded that that fact was immaterial and the inflexible rule must be applied. Professor Pennington said that the real losers, in the Regal case, were the previous shareholders while the new shareholders had, in fact, lost nothing. Therefore, the unfairness of the House of Lords' judgment lies in the fact that the new shareholders are themselves the persons who have bought the defendants' shares in the subsidiary company. The profit which had been made by
the previous directors was provided by the new purchasers. When those purchasers acquired the shares and the control of Regal, "they knew of, and must therefore have implicitly assented to, the profit which the directors had made"(54).

However, the directors were held liable to account in the Regal case. Their liability had not been affected by the change in the shareholders.

In Abbey Glen Property Corp v. Stumborg(55), the company alleged that its directors had breached their fiduciary duties regarding certain land transactions. The defendant directors tried to defend themselves by claiming that the shareholders at the time of the alleged breach had left the company and new shareholders had replaced them at the time of the action. The majority of the Appellate Division held that the change in the shareholders was irrelevant. The right to an accounting was an asset to the company. Clement J. put it in this way:

A change in shareholders in itself cannot diminish the rigour of the obligation to account to the company which remains unchanged in its character of a corporate entity(56).

The minority of the Appellate Division held that the new shareholders would be unjustly enriched by receipt of a benefit for which they had not bargained. Clement J. reacted against the minority's judgment and said that if the principle of the unjust enrichment had been applied
in the way suggested by the minority of the court's members

then in logic the consequences would vary with the proportion of the new shareholders in the company. If . . . one half were new shareholders, the defence would be half way successful, the company would receive an accounting for only one-half of its equitable interest, and the fiduciary would keep the rest. The remedy of restitution would fail in part or in whole, as it would here if the defence were to succeed. With the failure of the remedy the principle itself is compromised(57).

Thus, the application of the rigid rules gives rise to an unjust enrichment aspect (58). The application of the corporate entity doctrine has enabled new shareholders to acquire an unexpected windfall. It is the company who will recover the profit according to the corporate entity doctrine. The benefit which will be obtained by the new shareholders, as a result of recovery, will be obtained indirectly. That is, by having the value of their shares increased. However, rejecting the defence of change in shareholders seems to be another feature of the rigid application of the fair dealing rules.

4.2.9. No injury sustained by the company is no defence.

A company may sustain no loss as a result of the directors' gain. This fact was rejected by courts as a defence in the hands of directors. In Parker v.
McKenna(59), the directors of a bank, who were entrusted with the duty of selling shares, bought some of those shares themselves. They then sold those shares and made profit. The Lord Chancellor stated that:

The court will not inquire, and is not in a position to ascertain whether the bank has or has not lost by the acts of the directors(60).

It is clear from his Lordship's statement that injury to the principal is irrelevant. A very clear decision in respect of this particular point was submitted by James L.J in the same case(61). His Lordship said:

It appears to me very important, that we should concur in laying down again and again the general principle that in this court no agent in the course of his agency, ... , can be allowed to make any profit without the knowledge and consent of his principal; that that rule is an inflexible rule, and must be applied inexorably by this court, which is not entitled, in my judgment, to receive evidence ... as to whether the principal did or did not suffer any injury in fact by reason of the dealing of the agent; for the safety of mankind requires that no agent shall be able to put his principal to such an inquiry as that(62).

This decision confirmed all the strictness of the fair dealing rules. The fact that the principal suffered no loss was entirely irrelevant according to that decision. In Regal (Hastings) v. Gulliver(63), Lord Russell rejected the defendants' argument that the company had suffered no loss(64). Similarly, this defence was rejected by the court in Keech v. Stanford(65) and in Canadian Aero Services Ltd v. O'Malley(66). So, the fact that the defender director had made profit was the
heart of the matter while injury to the trust had no bearing on the question of liability. It would seem that this holding represents one of the rigid features of the application of the fair dealing rules.

4.2.10. The fact that the exploited opportunity is not identical to the one offered to the company may not be a defence.

In Canadian Aero Services Ltd. v. O'Malley(67), the directors had devoted effort and planning in respect of a particular corporate opportunity as representatives of the plaintiff company (Canaero). Subsequently, they deflected that opportunity to another company (Terra) which they owned personally. The allegation against them was that they breached their fiduciary duties. The directors had unsuccessfully tried to defend themselves by showing that the opportunity which was exploited by Terra was not identical to that in which Canaero was interested. This defence was rejected by Laskin J. as irrelevant. The judge said:

I do not regard it as necessary to look for substantial resemblances. Their presence would be a factor to be considered on the issue of breach of fiduciary duty but they are not a sine qua non. [The opportunity which was exploited by Terra was one] in line with [Canaero]'s general pursuits . . . .(68).

It seems that unless there is a substantial difference between the exploited opportunity and the opportunity
offered to the company, the courts will not accept a defence based on such a ground.

4.2.11. The bona fide rejection of an opportunity by the board of directors as a defence.

The board of directors may bona fide reject an opportunity on behalf of the company. Does such a rejection constitute an effective defence in the hands of the directors who exploited the rejected opportunity? Unfortunately, such a defence was rejected by the courts. Such a rejection confirms the strict application of the fair dealing rules.

In the Regal case, for example, the directors' good faith had not been accepted as a defence. Accordingly, a director cannot take a corporate opportunity for himself even if it has been rejected by the company. This is so unless the company allows him to exploit that opportunity(69).

On the contrary, this defence had been accepted by the court in the Canadian case Peso-Silver Mines Ltd v. Cropper(70). In this case the board of directors, bona fide, rejected the opportunity which was offered to the company. The rejection was upon two grounds: First, that the company was in a difficult financial situation. Second, that the company had enough land. After it had been rejected by the company, the opportunity was
exploited by three of the directors. The court had not held them liable to account for the profit made because: (1) they were acting bona fide in the interest of the company when they rejected the opportunity on its behalf; (2) after it had been rejected by the company, the opportunity ceased to be a corporate one and, consequently, it was open to be taken by the directors. This decision has been widely criticised. First, it is said that it requires the court to determine bona fides which is difficult to determine; second, this decision was in clear contradiction with the finding in the Regal case, in which the court held that the issue of bona fides had no bearing on the question of liability; third, the directors who exploited the opportunity in question were themselves those who rejected it on behalf of the company. They might be tempted, to reject that opportunity on behalf of the company by the desire to exploit it themselves; fourth, allowing directors to exploit an opportunity which had been rejected by their company may tempt them not to exercise their best effort to further their company's interests; fifth, even if the opportunity has ceased to be a corporate one as a result of the board's rejection of it, a conflict of interest and duty may exist if that opportunity has been exploited by directors. Consequently, such an exploitation justifies a rigid application of the no-conflict rule.
The criticisms of the decision in the *Peso* case(75), confirmed all the strictness of the fair dealing rules. Norris J.'s dissenting judgment in the *Peso* case(76), asked for the fair dealing rules to be applied rigidly. He said that the defendants had acquired the information about the opportunity in the course of the execution of their duties as directors and consequently they should be made liable to account for the profit made.

However, one is inclined to agree with Professor Gower who expressed his view over this issue. He said that it is difficult to say that there is a conflict of interest and duty in cases where it is impossible for the company to avail itself of the opportunity, and where the directors are not in a position to compete with the company(77). In the *Peso* case it was found that it was impossible for the company to avail itself of the offered opportunity. In the *Regal* case(78), the opportunity had not been rejected by the board of directors. In fact, Regal was willing to take up that opportunity, but it could not do that due to lack of funds. So, it seems that the House of Lords realised the fact that it was possible for the company to avail itself of the opportunity had the directors tried to raise its funds(79).
4.3. THE RELAXATION OF THE FAIR DEALING RULES

4.3.1. The Common Law and the Statutory role in relaxing the Fair Dealing Rules.

The disadvantages of the fair dealing rules

(1) Where a director is the sole source of a particular transaction, preventing him from dealing with the company may deprive the company of a worthwhile transaction.\(^80\).

(2) In terms of cost and time, dealing with an insider may cost the company less than dealing with an outsider. The reason is that, the insider is, usually, a well known person to the company and it is easy to contact him. Negotiation with an outsider, certainly, needs more time than negotiation with an insider.\(^81\).

(3) A director is, usually, appointed to develop relationships between his company and other companies. Thus, it is highly likely that he may have a contact with the other companies due to his position as such, and the possibility of conflict arises from the outset.\(^82\).

The rigid application of the fair dealing rules may be regarded as unworkable in real business life and against the best interests of companies. Because of these reasons and because of those disadvantages the
rules have been relaxed in two ways: (i) Shareholders' approval and ratification(83); (ii) Waiver.

4.3.1.1. Ratification

A director who has an interest in a contract with his company must make a full disclosure of that interest and its nature to the company in general meeting. If the company approves that contract a director will not be in breach of his fiduciary duties. It is argued(84) that the effects of the approval are that it cures directors' breach of duty and releases them from liability. These effects were confirmed by the decision in Regal (Hastings) Ltd v. Gulliver(85). Lord Russell said:

[The defendants] could, had they wished, have protected themselves by a resolution . . . of Regal shareholders in general meeting. In default of such approval liability to account must remain(86).

The direct result of ratification is the prevention of the minority shareholders from suing the wrongdoers unless they can bring their action within one of the exceptions to the rules in Foss v. Harbottle(87). Shareholders' consent can be obtained in advance, i.e., before a director's act takes place. This is the so called "approval"(88). On the other hand, the consent can be given in form of ratification after the occurrence of the breach. However, ratification is ineffective in cases where a director's act amounts to a
fraud on the minority(89). Thus, a difficult question arises in this context which is: How to distinguish between ratifiable and non-ratifiable breaches?(90). Do shareholders have the power to approve or to ratify an act which gives away assets belonging to the company?. It is well established that any act deprives a company from any part of its assets could not be approved or ratified by shareholders. In Cook v. Deeks(91), the directors appropriated to themselves a contract belonged to the company. The court held that this act was not ratifiable. In Menier v. Hopper's Telegraph Works(92), the directors obtained for themselves the benefit of a contract in which their company was interested. The court held that the shareholders had no power to ratify such an act. In Park v. Daily News(93), the court restrained the directors from distributing the proceeds of a sold asset, which was belonging to the company, among its employees. It held that this act was ultra vires the company and could not be ratified(94). According to the cases mentioned above, it could be said that the appropriation of a company's assets cannot be approved or ratified by the shareholders. The reason behind this embargo seems to be to protect the minority shareholders. Thus, it is submitted that if shareholders unanimously approve the directors' action, directors will not be held accountable. This is, of
course, unless the directors' action is capable of injuring the rights of the company's creditors.

Lord Russell, in the *Regal* case, said that the directors could have escaped liability by seeking an approval from the majority shareholders. In that case the directors bought shares in the subsidiary company and sold them. Can it be said that those shares belonging in equity to the company? Professor Beck argues that if the directors "had not sold the shares, they would have been constructive trustees of them for the company and would have been required to transfer them to it." If it was correct that the directors in the *Regal* case would be constructive trustees for the shares, a contradiction between Lord Russell's dicta and the courts' decisions, which made the appropriation of the company's assets non-ratifiable, would arise. But, it is agreed that the directors in the *Regal* case owe no duty to acquire the shares for the company. This view had been expressed by Lord Macmillan, Lord Wright and Lord Porter, in the *Regal* case itself. The judges relied solely on the no-profit rule in holding the directors liable to account for the profit made. They did not rely on the no-conflict rule because the directors owed no duty to the company to acquire the shares for it. In the absence of such a duty one could say that the shares did not belong to the company (i.e. they were not part of the company's
property). Consequently, the directors had not misappropriated a company's assets to themselves (101). Thus, it seems that the decision given by Lord Russell is a correct one. That is, directors of Regal company were able to escape liability by obtaining the majority shareholders' approval. Is it possible to draw a distinction between ratifiable and non-ratifiable acts on the basis of good faith? The directors' act in the Regal case was held to be ratifiable (102), while their act was held to be not ratifiable in Cook v. Deeks (103). The directors in the former case were acting bona fide while in the latter they were acting malum fide. Depending on the above two cases it is said (104) that it is possible to distinguish between ratifiable and non-ratifiable breaches on the basis of good faith. However, the distinction on such a basis is not without difficulties due to the courts' reluctance to investigate the defendants' bona fides (105). Despite the fact that the courts in some cases decided that injury to the trust was irrelevant (106), to the question of accountability, one is of the opinion that a distinction between ratifiable and non-ratifiable breaches can be made depending on whether the company sustains loss or not (107). Shareholders should be given the power to approve or to ratify the directors' act if the company sustained no harm. If the directors' act
exposes the company to loss such an act should not be ratified. However, this approach is wide enough to embrace cases in which directors' act amounts to a fraud on the minority and accordingly such an act, it is submitted, cannot be ratifiable. The advantages of this approach are that: (1) It avoids for us the difficulties of judging bona fides. (2) It exempts us from entering into a discussion over whether information is a property or not in cases of corporate opportunity.

Ratification can be made, in many cases, by ordinary resolution of the general meeting. Can an interested director uses his vote qua shareholder to ratify his breach of duty? One finds no obligatory rule in Britain depriving an interested director from voting in such a case\(^{108}\). However, some sort of indication can be found in the case law. The directors in Hogg \(v\). Cramphorn\(^{109}\), were ordered not to vote the shares they had improperly issued to themselves, while in North West Transportation \(v\). Beatty\(^{110}\), the director was allowed to use his vote qua shareholder to ratify a contract with his company in which he was interested. Sir Richard Bagally said:

\[\text{[Every]}\text{ shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject matter opposed to or different from the general or particular interests of the company}^{111}.\]
However, it is suggested that interested directors should not be allowed to use their votes to ratify or to approve their own acts. Such a prohibition provides effective measures to protect minority shareholders, particularly, in cases where interested directors control the majority vote in the general meeting. The decision in *Cook v. Deeks* (112), may guarantee the fairness of a transaction to some extent, even if interested directors are allowed to vote. But in cases that involve the use of corporate information that decision may fail to protect the minority shareholders. The reason is that it is not clear whether information is property or not (113). If information is not property, using it may not invoke the decision in *Cook v. Deeks* (114). It is to be noted that according to the new S.322A (1) of the Companies Act 1985 (115), if a director enters into a transaction with his company, in excess of any limitation on his powers under the company's constitution, the transaction will be voidable at the instance of the company. In addition, whether or not the transaction is avoided, the director concerned is liable:

a) to account to the company for any gain which he has made directly or indirectly by the transaction, and
b) to indemnify the company for any loss or damage resulting from the transaction (116).

It is clear from the wording of the section (quoted above) that ratifying such a transaction does not
release the director from the liability to account for the profit he has made or to indemnify the company for the loss it has suffered as a result of that transaction. If the transaction (to which a director is a party) is ultra vires the company, then, it can only be ratified by a special resolution. The quorum at the meeting may cause difficulty if interested directors are prevented from using their vote at the general meeting to approve their acts. Suppose that there are only three shareholders, two of them are interested in a transaction with the company, and the quorum is two. The quorum in such a case will never exist if the interested directors / shareholders are not to be counted for the quorum purposes. A solution for this problem can be found in Art.97 of Table A 1985 which provides:

Where proposals are under consideration concerning the appointment of two or more directors to offices or employment with the company or any body corporate in which the company is interested the proposals may be divided and considered in relation to each director separately and (provided he is not for another reason precluded from voting) each of the directors concerned shall be entitled to vote and be counted in the quorum in respect of each resolution except that concerning his own appointment.

One finds no reason depriving us from applying this solution to cases which involve corporate opportunities. An interested director A should be allowed to use his vote to ratify an act done by another interested
director B. But B himself should be deprived from using his vote to ratify his own act. This solution, it is to be noted, can be applied provided that there is no fraud on the minority.

4.3.1.2. Waiver

A company can waive, in advance, the rules protecting it, such as the no-conflict rule and the no-profit rule. Waiver allows directors to retain the profit made by them out of their position without making a full disclosure to the company in general meeting. The company can achieve this purpose by adopting an exclusion clause in its articles of association. Art.85 of Table A(111) contains an exclusion clause which is available to be adopted by companies to relieve their directors, to some extent, from liability. Art.85 reads as follows:

Subject to the provisions of the Act, and provided that he has disclosed to the directors the nature and the extent of any material interest of his, a director notwithstanding his office—
(a) may be a party to, or otherwise interested in, any transaction or arrangement with the company or in which the company is otherwise interested;
(b) may be a director or other officer of, or employed by, or a party to any transaction or arrangement with, or otherwise interested in, any body corporate promoted by the company or in which the company is otherwise interested; and
(c) shall not, by reason of his office, be accountable to the company for any benefit which he derives from any such office or
employment or from any such transaction or arrangement or from any interest in any such body corporate and no such transaction or arrangement shall be liable to be avoided on the ground of any such interest or benefit.

Thus, Art.85 allows a director to contract with his company or to have an interest in a contract with it without being accountable for any profit or benefit so derived. But, since the waiver by the company is against the shareholders' interest(119), Art.85 itself and S.317 CA 1985 require an interested director to disclose his interest to the board of directors. S.317 cannot be abrogated by the articles of association. Thus, in the absence of the company's approval, a director cannot, for example, enter into a contract with his company unless two conditions are satisfied: (1) That his company's articles contain an exclusion clause similar to that in Art.85, and (2) that he has disclosed his interest to the board of directors according to S.317(120). A disclosure to a committee of the board was held to be ineffective(121).

The Purpose of S.317

S.317 provides:

(1) It is the duty of a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company.
(9) Nothing in this section prejudices the operation of any rule of law restricting directors of a company from having an interest in contract with the company.
It seems that the purpose of this section is, only, to impose a statutory duty on directors to disclose their interest in a contract with their companies to the board of directors. Failure to do so exposes an interested director to a fine\(^{(122)}\). It is agreed\(^{(123)}\) that, such a failure brings the common law principle that prohibits a director from having an interest in a contract with his company into operation\(^{(124)}\). This is so, notwithstanding that the company's articles contain an exclusion clause. In other words, failure to disclose an interest to the board according to S.317 (as well as according to Art.85 if adopted by a company) makes a director's contract with the company voidable at the instance of the company but not void, and any profits made are recoverable. On the other hand, compliance with S.317 does not make the contract valid unless the company's articles of association contain an exclusion clause similar to that in Art.85. In the absence of an exclusion clause the company has the right, at Common Law, to rescind the contract even if the interested director has complied with S.317\(^{(125)}\). Thus, S.317 is not intended to relax the inflexibility of the fair dealing rules. This is clear from the wording of SS.317(9) which provides that S.317 does not prejudice any rule of law restricting directors from having an interest in contracts with their companies.
The extent and the aims of disclosure

An interested director must disclose the nature of his interest and the extent of the benefit which he will make as a result of the contract with the company (126). However, S.317 requires an interested director to disclose only the nature of his personal interest in the contract or arrangement. Thus, a director is not required to disclose matters affecting his fiduciary position such as wrongful conduct (127). Nor he is required to disclose all activities which are irrelevant to his personal interest in contract (128), or all the material facts (129).

The extent of disclosure is, in fact, limited to some extent by SS.317(3) which provides that a general notice given by the interested director to the board of directors that:

a) he is a member of a specified company . . . and is to be regarded as interested in any contract which may . . . be made with that company . . .; or
b) he is to be regarded as interested in any contract which may after the date of the notice be made with a specific person who is connected with him . . ., is deemed a sufficient declaration of interest in relation to any such interest.

The purposes of disclosure are that it gives a company's creditors the opportunity to inspect documents required to be public, such as register of members, directors and
secretaries or filed with the registrar (e.g. annual return, directors' report and memorandum and articles of association). It also gives directors or other officers the chance to escape liability for a breach of fiduciary duties, and to retain the profit or the benefits they may gain from contracting with their companies.

**Art. 85 of Table A v. S.310 of the Companies Act 1985:**

**Unclear relationship**

Art. 85 includes an exclusion clause. It is said that the purpose of this Article is to limit the effects of the decision of the House of Lords in *Regal (Hastings) v. Gulliver*, which is deemed to be a harsh decision on directors.

The relationship between Art. 85 and S.310, is unclear. S.310 makes void:

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 ... from, or indemnifying him against, any liability which by virtue of any rule of 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.

Gore-Browne argues that S.310 relates to liability arising from a breach of duty, i.e., to the consequences of a breach of fiduciary duty. Thus, it makes void any provision exempting a director from liability for a
breach of duty, but it permits the modification or the abrogation of that duty. Accordingly no conflict between S.310 and Art.85 may arise. Gore-Browne qualified his view by saying that the articles or any provision in a director's service contract cannot exempt a director from any duty based on a mandatory rule of statute or general law(137). Professor Gower(138) shares the same view with Gore-Browne, but he imposes a different qualification on that view. He says that a company's articles or a director's service contract cannot relieve him of his duty to act in good faith or of his duty of skill and care, nor can it exempt him from liability for a breach of these duties. Such breaches are banned by S.310. In Gower's opinion a company's articles can modify a director's scope of duty; but subject to the general principle that no clause can protect directors against the consequences of their own fraud(139). Thus, a company's articles may, for example, allow a director who is acting in good faith to retain the profit made by him even if he places himself in a position where his duty and his interest conflict. But in order to consider the articles valid, Gower says, they should be very similar to Art.85. Birds(140) has argued that the duties which are imposed on directors by the general law cannot be excluded by the articles by virtue of S.310. A director's duty to use his power for proper purpose can be excluded by the
articles because this duty does not stem from the general law but from the articles themselves. He added that it is possible to modify directors' duties by a company's articles by requiring them to disclose their interest to the board of directors instead of making such a disclosure to the shareholders in general meeting. In such a case, directors are exempted from liability to account for a profit made by them. However, Birds concluded that the Articles of Table A including Art.85 are valid because of their appearance in a statute. That is, in his view Art.85 is valid as an exception to the general prohibition imposed by S.310.

Professor Pennington argues that a company's articles and a director's service contract cannot exempt a director from his fiduciary duties and the duty of skill and care which are imposed on him by law. The duties imposed by the general law can be increased by articles but cannot be diminished. Accordingly, in Pennington's opinion, S.310 prevails in case of contradiction with the company's articles.

Baker argues that S.310 makes void any clause in a company's articles exonerating a director from liability for a breach of duty. It does not also prevent liability from arising even if the duty is excluded by the articles of association. In other words, even if a company's articles adopted Art.85, a director would be
liable if he breached his duties. Baker also argues that S.310 does not make void an article which replaces a director’s duty to disclose his interest to the company in general meeting with a duty to disclose that interest to the board of directors provided that “the exclusion of the general equitable principle is made conditionally upon compliance with the duty to disclose the interest to the board” (144).

Finally, it has been said that “the general consensus appears to be that Art.85 is permissible as it is designed to prevent the no-conflict duty arising and does not relieve an individual from liability for breach of that duty” (145).

It is clear from the wording of S. 310 that it is very wide. It covers both exoneration and indemnification cases. Thus, in Viscount of the Royal Court of Jersey v. Shelton (146), it was held that an article exonerating a director from liability or indemnifying him out of the company’s fund would violate S.310 despite its validity under the Jersey law. It also seems that S.310 is wide enough to cover articles which are intended to exempt directors from liability for breach of duties of skill and care or to indemnify them out of the company’s fund in relation to that breach (147).

However, it could be argued that there is no conflict between Art.85 of Table A and S.310. The following reasons can be adduced to support this argument:
Art.85 starts with the words "Subject to the provisions of the Act ...". These words can be understood as proscribing any application of Art.85 in contradiction to any provision in the Act including S.310(148). Since Art.85 is made subject to the provisions of the Act, adopting it by a company's articles does not mean that a director is exempted from liability for a breach of duty because such exemption goes against the explicit prohibition imposed by s.310.

(2) Art.85 has a specified scope of application. It only permits a director to be a party to a transaction or otherwise to be interested in any transaction or arrangement with the company or in which the company is interested or to be a director or a party to any transaction or arrangement or otherwise interested in, "any body corporate promoted by the company or in which the company is otherwise interested"(149). Despite this specified scope Art.85 operates only, to a limited extent, i.e. in cases where there is no breach of duty. It cannot be said that whenever a director enters into a transaction or arrangement with his company or has an interest in his company's transaction with a third party, he is in breach of his duties. In cases where the contract is fair, if the company, for example, buys assets from its director at the current market price, no conflict of duty and interest may arise. Accordingly there will be no breach of a duty in the part of the
director(150). But if a director, for example, breaches his duty by entering into a contract with his company, Art.85 does not operate because its operation will be against S.310 which Art.85 is made subject to and consequently void(151).

(3) Shareholders, in general meeting, can ratify a director's contract with the company or the contract in which a director has an interest. Adopting Art.85 means that the shareholders delegate their power to ratify such a contract to the board of directors. Art.85 states that "... provided that he has disclosed to the directors the nature and the extent of any material interest of his ...". Thus, if a director discloses his interest to the board of directors in the manner specified in Art.85, then any profit he might make in such a fashion is no longer secret. But this exemption is qualified, as mentioned above, by a clear condition that the director's act must not amount to a breach of duty which will invoke S.310(152).

One is drawn to conclude, from the above discussion of Art.85 and S.310, that Art.85 represents a statutory tendency to relax the rigid application of the fair dealing rules. A director can enter into a transaction with his company and keep the profit made if his company's articles of association adopt Art.85 provided that a full disclosure of the nature and the extent of
his interest has been made to the board of directors and that no violation of S.310 has been committed.
There was a debate over whether S.310 rendered void policies of professional indemnity insurance effected by a company on behalf of its directors. The position was unclear until the enactment of the Companies Act 1989. The new S.310(3) (a) of the Companies Act 1985 provides that a company is entitled to purchase or to maintain for any officer insurance against liability arises under S.310(1). S.310(3) (b) entitles a company to indemnify any officer against any liability incurred by him as a result of being a successful defendant in civil or criminal proceedings or a successful petitioner for relief under S.144 or S.727 of the Companies Act 1985. The section, however, does not make directors' liability insurance policies valid for all purposes. Some liabilities cannot be insured against because to allow insurance in relation to them would be contrary to public policy. Thus, for example, no valid insurance can be made against liabilities which arise from, tortious acts which involve dishonesty or a crime, wrongful trading and criminal fines.
Finally, the Companies Act 1985 has intervened to relax the inflexibility of the fair dealing rules by giving the court a discretionary power to relieve directors from liability for a breach of duty in certain cases. S.727 provides:
(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 that 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 . . . he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that the court may relieve him either wholly or partly, from his liability on such terms as it thinks fit.

It is clear from the wording of S.727 that the defender must establish that he has acted honestly and reasonably and, that having regard to all the circumstances, he "ought fairly to be excused". Gore-Browne states that while it is possible to prove the first two conditions, it is not easy at all to prove the third one which is an issue for the discretion of the court in each case\(^1\)\(^5\)\(^5\). Gore-Browne has also stated that S.727 does not apply to a director's duties to the company under legislation other than the Companies Acts\(^1\)\(^5\)\(^6\). A director cannot plead S.727 as a defence against a claim of wrongful trading\(^1\)\(^5\)\(^7\), nor can he claim relief under it where he is in a possession of the company's assets as constructive trustee\(^1\)\(^5\)\(^8\). However, the section was applied in many cases. For example, a director who acted \textit{bona fide} and sought a legal advice to the effect that the transaction was \textit{ultra vires} was relieved of liability incurred as a result of carrying out that transaction\(^1\)\(^5\)\(^9\).
4.3.2. The Judicial Tendency to Relax the Inflexibility of the Fair Dealing Rules.

The case law has played a noteworthy role in relaxing the fair dealing rules. It will be shown that there is a strong tendency to relax those rules.

4.3.2.1. Allowing remuneration for care and work done by a defender director.

The policy of granting remuneration to defendants was accepted by Fox L.J. in O'Sullivan v. Management Agency and Music Ltd(160), where his Lordship said that it would be "unduly severe" to apply "a hard and fast rule that the beneficiary can demand the whole profit without an allowance for the work without which it could not have been created"(161). Similarly, in Phipps v. Boardman(162), the defendants were allowed remuneration for the work done. Thus, the Phipps case, despite the fact that the majority of the court had held that confidential information belonged to the trust and so the liability was imposed on the defendants, represents the starting point of a way to relax the inflexible fair dealing rules(163).
4.3.2.2. The interpretation of the phrase "possibly may conflict"

An important indicator of the desirability of relaxing the fair dealing rules appears in Lord Upjohn's dissenting judgment in Phipps v. Boardman\(^{(164)}\). His Lordship examined the meaning of the phrase "possibly may conflict", which appeared in Lord Cranworth's judgment in the Blaikie case\(^{(165)}\), and said:

> In my view it means that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict; not that you could imagine some situations arising which might, in some conceivable possibility in events not contemplated as a real sensible possibility by any reasonable person result in a conflict\(^{(166)}\).

His Lordship was inclined to lessen the rigidity of the no-conflict rule by requiring a proof of the existence of a "real sensible possibility of conflict". Therefore, the mere possibility of conflict of interests was not enough in his Lordship's opinion, to hold the defendant liable to account for the profit made\(^{(167)}\).

4.3.2.3. The issue of bone fides

Despite the fact that the courts have decided, in many cases, that the question of bone fides is irrelevant and has no bearing on the question of liability for breach
of fiduciary duty\textsuperscript{(168)}, it has been given some attention in many cases. For example in \textit{Holder v. Holder}\textsuperscript{(169)}, Danckwerts L.J. rejected Lord Eldon's reasoning in the \textit{Ex parte Lacey} case\textsuperscript{(170)}, that the fair dealing rules should be applied rigidly due to the impossibility to prove \textit{bona fides}, i.e. to ascertain whether the trustee is acting in good faith or not. Danckwerts L.J. said that the Chancery judges are daily engaged in determining the knowledge and the intentions of the parties.

In the \textit{Regal} case\textsuperscript{(171)} itself, the finding of \textit{bona fides} by the trial judges was not overturned\textsuperscript{(172)}; in the \textit{Phipps} case\textsuperscript{(173)}, the finding of \textit{bona fides} had not been disturbed\textsuperscript{(174)}.

It could also be concluded from Lord Roskill's speech in \textit{Industrial Development Consultants Ltd v. Cooley}\textsuperscript{(175)}, that his Lordship was willing to take into account the question of \textit{bona fides}. He applied the inflexible rules and said

\begin{quote}
I have less reluctance in reaching that conclusion . . . since I know that what happened was enabled to happen because a release was obtained . . . by the dishonest and untrue misrepresentations . . . \textsuperscript{(175)}.
\end{quote}

In \textit{Cook v. Deeks}\textsuperscript{(177)}, the absence of good faith on the part of the defendants had led the court to hold that their act was not ratifiable.

The issue of \textit{bona fides} should be taken into account at least in cases of granting remunerations or rewards for
the work done. In both the *Phipps* case(178) and the *O'Sullivan* case(179), there is an approach which invites the courts to consider the justice of the case including the parties’ *bona fides*. That is, there is an invitation not to apply the fair dealing rules in their rigidity. This approach is clear in some other cases, such as the *Canadian Aero Services Ltd v. O'Malley*(180), and *Island Export Finance Ltd v. Umunna*(181), where the judges laid emphasis on the issue of the defendants’ motives and intentions which led them to resign from their office as directors. In the *O'Malley* case(182), Laskin J. noted that it was not appropriate to apply the no-conflict and the accountability principles in the *Regal* case in their rigidity as they were applied to trustees(183). The judge sees the the *Phipps* case(184) and the *Cooley* case(185), as involving "an updating of the equitable principle whose roots lie in . . . loyalty, good faith and avoidance of a conflict of duty and self-interest"(186). Thus, it would seem that Laskin J. would have favoured a flexible application of the fair dealing rules. And he considered the issue of *bona fides* as an important factor to deal with the question of liability(187).
4.3.2.4. The *bona fide* rejection of an opportunity

The accepted rule now is that a director can exploit an opportunity for himself if the company has considered it and *bona fide* decided not to take it\(^{188}\)). Thus, in *Peso Silver Mines Ltd v. Cropper*\(^{189}\), the board of directors *bona fide* rejected an opportunity on behalf of the company. After that they took the opportunity themselves. The company alleged that its directors had breached their fiduciary duties and should account for the profit made. The court held that the directors were not liable because they were acting *bona fide* in the interest of the company when they rejected the opportunity\(^{190}\). Thus, contrary to the finding in the *Regal* case\(^{191}\), a *bona fide* rejection by the company opened the opportunity to be taken by the directors. Consequently, no-conflict of interest and duty may arise in such a case\(^{192}\). This decision represents a clear judicial tendency to relax the rigid application of the fair dealing rules. A similar decision is found in the Australian case *Queensland Mines Ltd. v. Hudson*\(^{193}\), where the Privy Council held that the defendant had fully discussed the situation with the board who resolved not to take the opportunity and so, he was not liable to account for the profit derived from a personal exploitation of the opportunity.
However, Brudney and Clark (194), suggest that different types of rules should be applied depending on the type of the company in question. In respect of public companies, strict rules should be applied. Full time executives should be prevented from exploiting any active business opportunity (i.e. any business opportunity in respect of which a director is required or entitled to participate in making a decision). On the other hand a passive business opportunity can be taken by a full time executive. A passive investment of savings "may be defined as one the making of which does not require or entitle the investor to participate in decision making with respect to operations of the entity in which investment is made" (195). An outside director is prohibited only from taking an opportunity by the use of the company's resources including its information (196). Strict rules or categorical rules should be applied to public companies due to the convenient managerial compensation plans and their widely scattered shareholders. And shareholders of public companies are more like the beneficiaries of trusts who effectively delegate full decision making power over operating matters to directors (197). In addition, strict rules are more convenient to govern cases which involve public companies because the duties of those companies' directors, normally, require them to devote most of their time to further their companies'
interests. Furthermore public companies' business is wide enough to embrace any new opportunity(198). In relation to private companies, shareholders have the greater ability to select managers and to discuss or negotiate special arrangements with each other. The fields of the private companies' business are not wide enough to absorb a wide range of new opportunities. Because of the those facts and because of the frequent inadequacy of compensation plans, private companies, it has been suggested(199), should be free to reconcile this problem between the parties as a matter of contract.

A liberal approach, has been suggested by Wolfson(200), indicating that there is no need to find any rule to govern the issue of corporate opportunity. Wrongdoers will be identified in the market and will be removed by the shareholders. They will be identified in the market because the value of their companies' shares will be adversely affected by their improper acts.

4.3.2.5. Injury to the company and unjust enrichment.

In both Parker v. Mckenna(201) and Regal (Hastings) v. Gulliver(202), the court held that injury to the principal is irrelevant to the question of liability for a breach of directors' fiduciary duties(203). However, it is argued(204) that the objects of the inflexible
rules are twofold: (1) The prevention of unjust enrichment; and (2) the prevention of the mere possibility of conflict of interests. It is justifiable to apply the rigid rules in cases where the defender had acted dishonestly even if he has not enriched himself at the expense of his company. But it is not easy to justify such an application in cases where the defender has acted in good faith and honestly in the best interest of the company, and has not been enriched at its expense. Applying the rigid rules in such a case will result in a "rigorous equity"(205), and a variance between the two objects of the fair dealing rules will exist(206).

Indeed, the question of injury to the principal and the issue of unjust enrichment have been given some regard by many judges and commentators. Professor Gower has described the plaintiffs' action in the Regal case as "unmeritorious"(207), because the purchasers of Regal company who agreed to pay the price of the shares had gained an "undeserved windfall"(208) by recovering the profit made by the former directors(209).

The minority of the Appellate division in Abbey Glen Property Corp. v. Stumborg(210) held that the new shareholders would be unjustly enriched by receipt of a benefit for which they had not bargained(211). They were not shareholders at the time the breach occurred, so, they sustained no loss.
Lord Upjohn in the Phipps case held that there was no "real sensible possibility" of conflict because of the fact that the defendants had not been unjustly enriched at the expense of the trust\(^{(212)}\). Jones\(^{(213)}\) argues that the fiduciary duty of the defendant in the Phipps case\(^{(214)}\), had ended when they failed to persuade the shareholders to appoint one of them a director in the company. Thus, the decision in that case can be justified only on the ground that the policy of the cases required that both Mr. Boardman and Mr. Phipps (the defendants) should be made accountable. This policy, Jones argues, is questionable for two reasons: (1) Temptation is always available in trust cases. So, why should not the defendant be given a chance to prove that they resisted temptation?; and (2) there is a strong public interest in finding trustees, and it is in the interest of the public to be fair with them\(^{(215)}\).

Lord Brougham in Hamilton v. Wright\(^{(216)}\) pointed out that injury to the trust is the basis of the rule, and the act must have at least a tendency to do so\(^{(217)}\). In Heyting v. Dupont\(^{(218)}\), the court held that the defendants were not accountable. One of the grounds on which the decision was based was that the company had sustained no loss.

It is plain from the above discussion that there is a real tendency to relax the inflexible rules by requiring a proof that the company had suffered loss. It would
seem that there is a desire to deny recovery in cases where the pursuer might gain an unexpected windfall.

4.3.2.6. Financial inability of the company

In Heyting v. Dupont\(^{(219)}\), the company was unable to exploit a specific opportunity due to lack of funds. Each one of the two directors formed a company to exploit that opportunity. Cross-actions were brought by the two directors in their capacity as shareholders on behalf of the company to restrain each other from exploiting that opportunity. The court held that no director can be sued by the company for the profit made as a result of exploiting the business opportunity. One of the reasons for such a holding was that the company was financially unable to exploit the offered opportunity.

It is clear that the decision in that case is inconsistent with that in the Regal case\(^{(220)}\). It represents a plain deviation from the policy of applying the fair dealing rules rigidly.

It has been argued\(^{(221)}\) that financial inability should not be accepted as a defence against allegations of breach of fiduciary duty because a director can obtain a loan for the company to enable it to finance the offered opportunity. Against this argument it can be said that obtaining a loan for the company may put it in future
troubles. A company may not be able to repay that loan and the due interest in future. So, such a loan may lead the company to insolvency. Moreover, a director may expose himself to liability if he obtains a loan for the company in circumstances in which the company is unable to repay that loan. In cases where the constitution of the company imposes a debt limit, a director will be liable to compensate the company for any loss suffered if he exceeds or violates that limit. In addition it is not always easy for a director to obtain loans for his company. He may not find a lender in cases where the company is in failing circumstances. And directors are under no duty to lend money to their companies in order to enable those companies to exploit new opportunities.

An argument, which says that it is easy for directors to claim the appearance of their companies' financial inability, seems unsatisfactory. It is agreed that it is not satisfactory because the courts, in many cases, have accepted the bona fide rejection of an opportunity as a defence despite the fact that it is easy for directors to induce the rejection by deciding that a specific opportunity is not sound or appropriate. Professor Beck argues that the best approach for the courts to take is to require a director to show that he took every reasonable step to enable the company to take the opportunity including a showing of reasonable effort.
to raise the necessary funds. If a director proved those facts he should be allowed to exploit the opportunity himself. Rivers(225) argues, and it is submitted that this is the best approach, that if financial inability is clearly established, it should be accepted as a defence in the hands of directors. This approach seems to be a reasonable and a practicable one(226).

4.3.2.7. Third party's unwillingness to deal with the company

A further indication of the judicial tendency to relax the fair dealing rules is the acceptance of the refusal of the third party or his unwillingness to deal with the company as a defence.

It is argued(227) that there was a critical difference between the Regal case(228) and the Peso case(229) on the one hand and the Cooley case(230) on the other hand. That difference lies in the fact that in the former two cases the plaintiff company was the party in the position to accept or to refuse the available opportunity. In the Cooley case(231) the third party was the one who was in the position to accept or to refuse the dealing with the plaintiff company. This difference, it is argued, should be taken into account by the court. Rajak(232) is inclined to say that the
unwillingness of the third party to deal with the company might be capable of rebutting the presumption that there is a fiduciary relationship between the defender and the pursuer. He also said that the decision in Keech v. Stanford\(^{233}\), in which the court refused to accept the lessor's refusal to deal with the infant as a defence, is questionable because that decision does not form an "absolute" or an "inflexible" rule\(^{234}\). However, since the defendant, in the Cooley case\(^{235}\), was acting in bad faith, Rajak concluded that the court's decision has been correctly given. The reason is that it is not reasonable to allow Mr. Cooley to enjoy the fruit of his dishonesty. It would seem that if the refusal of the third party or his unwillingness to deal with the company has been clearly proven and that the defender has played no role in inducing unwillingness, the offered opportunity will have ceased to be a corporate one. Consequently, it should be open to be exploited by a director. By allowing a director to take an opportunity under those conditions, the society as a whole will get the benefit since such an opportunity will not go unexploited. In addition, the company will lose nothing\(^{236}\).
FOOTNOTES

1) [1854] 1 Macq. 461.
2) Ibid at pp. 471-472.
3) [1874] L.R. 10 Ch. App. 97.
4) Ibid at p. 118.
5) [1942] 1 All E.R. 378 (HL).
6) [1942] 1 All E.R. 378 (HL) at p. 385.
7) [1942] 1 All E.R. 378 (HL) at p. 386.
12) [1967] 2 A.C. 134.
14) [1967] 2 A.C. 47 (HL).
16) See per Lord Wright in the Regal case [1967] 2 A.C. 134 at p. 154; See also per Lord Russell in the same case at p. 145 citing the speech delivered by Lord Eldon L.C. in Ex Parte James [1803] 8 ves. 337 at p. 34.
20) Note, "Fiduciary Duty of Officers and Directors not to Compete with the Corporation", [1941] 54 Harv. L. Rev. 1191 at p. 1199.
22) 73 F. 2d, 121 [2d, Cir. 1934].
28) Brudney V. and Clark R. "A New Look at Corporate
31) 73 F. 2d, 121 [2d. Cir 1934].
33) 73 F. 2d, 121. [2d. Cir 1934].
35) [1972] 2 All E.R. 162 at p.175.
43) See the new S.35 CA 1985 (S.108 CA 1989).
44) However, a company's members can restrain the doing of an ultra vires act: see new S.35(2); see Chapter No. 9.
45) [1972] 2 All E.R. 162.
49) [1986] B.C.L.C. 460 at p.482.
50) [1967] 2 A.C. 134.
53) He argued that it would be more just and more fair to allow the old shareholders who suffered loss as a result of the director's breach of duty, to recover a pro rata share of the profit made in proportion to their individual holdings; but since the directors owe no duty to them, individually, under the present law, they cannot recover any share of the profit: Pennington R. Company Law, 4th ed, [1979] at p.538. Dr. Prentice agrees with Professor Pennington, but said that a pro rata recovery may be faced with difficulties in cases involving public companies. Those difficulties stem from the fact that public companies may have a large number of shareholders. And because of this fact, the benefit which an individual shareholder expects to recover may be


56) Ibid at p.63-64; see also per Lord Porter in Regal (Hastings) v. Gulliver [1967] 2 A.C. 134 at p.157 where he said: "The company and its shareholders are separate entities . . . [and] the principle that a person occupying a fiduciary relationship shall not make a profit must be applied".


63) [1967] 2 A.C. 134.

64) [1967] 2 A.C. 134 at p.144.


70) [1966] 58 D.L.R. (2d) 1.


72) See per Lord Russell in the Regal case, ibid, at p.145.


75) [1966] 58 D.L.R. (2d) 1.

76) [1966] 58 D.L.R. (2d) 1.


78) [1967] 2 A.C. 134.

79) However, imposing a duty on directors, to raise their companies' funds, will expose them to a severe
liability. This issue will be discussed later in this chapter.

80) Brudney V. "The Independent Director- Heavenly City or Potemkin Village ?" [1982] 95 Harv. L. Rev. p.597; see also Farrar's Company Law, 2nd ed, [1988].


82) Farrar's Company Law, 2nd ed, [1988].

83) The concept "ratification" has variously been used as synonym to "adoption": see North-West Transportation Co. Ltd. v. Beatty [1887] 12 App. Cas. 589 at pp.593-4. In some other cases it had been used as synonym to "confirmation": see Prudential Assurance Co. Ltd. v. Newman Industries Ltd (No.2) [1981] Ch. 257. That concept was used as synonym to "approval" in the case of Foss v. Harbottle [1843] 2 Hare 461.

84) Palmer's Company Law, vol (1), para 64-25; see also Bamford v. Bamford [1970] Ch. 122; Gore-Browne on Companies, 44th ed, [1986], para. 27.21.1. Gore-Browne states: "It is clear that some, but not all, breaches of duty can be 'cured' through the director's conduct being disclosed to the general meeting and ratified thereat by the passing of an ordinary resolution . . . . The cases have expressly established some types of breach to be ratifiable: these are failure to disclosed an interest in contract to which the company is a party, obtaining a secret profit in circumstances not involving any misappropriation or misapplication of company property, breach of the duties of skill and care, using power to call in initial payments on shares so as to suit personal interests and using a power of allotment for improper purposes": see also Pennington, Company Law, 5th ed, [1985] at p.737; Professor Gower appears to accept that the Regal case has established the rule that "prima facie . . . the company could ratify what [the directors] had done and enable them to retain the profit": Gower, Principles of Modern Company Law, 4th ed, [1979] at pp.618 and 620. Partridge argues that the effect of ratification is not the same in all cases. In cases where a director's breach of duty gives rise to the right of rescission, it is appropriate to speak of the ratification as binding on the company. Whereas in cases where the breach gives rise to a personal liability for the directors, the ratification will not affect the director's liability to account for a profit made by him or to compensate the company for the loss suffered by it: Partridge, "Ratification and the Release of Directors from Personal

85) [1967] 2 A.C. 134.
86) [1967] 2 A.C. 134 at p.150.
87) [1843] 2 Hare 261. This rule and the exceptions to it will be discussed in detail in Chapter 9.

91) [1916] 1 A.C. 554.
93) [1962] Ch. 927.
94) See also Canada Safeway Ltd v. Thompson [1951] 3 D.L.R. 295.
95) [1967] 2 A.C. 134 at p.150.
98) [1942] 1 All E.R. 378 at p.391.
99) [1942] 1 All E.R. 378 at p.393.
100) [1942] 1 All E.R. 378 at p.394.
102) Beck S. "The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered" [1971] 49 Can. Bar. Rev 80. However, it is argued that the directors in the Regal case had used information that came to them in their capacity as directors; and in the light of the decision in the Phipps case, such an
information might be considered as property belonging to the company. Accordingly, the use of this information cannot be ratified: see Gower L. The Principles of Modern Company Law, 3rd ed, [1969]. This is unless the company sustains no harm.

103) [1916] 1 A.C. 554.
105) See Regal (Hastings) V. Gulliver [1967] 2 A.C.134, particularly see per Lord Russell and per Lord Wright. Ex Parte Lacey [1802] 6 Ves. 625 see per Lord Eldon at p.626. Lord Wright, for example, said that it was difficult and dangerous to investigate bona fides.

108) According to Art.94 of the 1985 Table A, an interested director cannot vote on a resolution allowing him to retain the benefit of his breach of duty. But the company's articles may allow the interested director to vote. Article 94 of Table A is not an obligatory one. It provides that: "Save as otherwise provided by the articles, a director shall not vote ... on any resolution concerning a matter in which he has, directly or indirectly, an interest ...".
109) [1966] 3 All E.R 420 (Ch).
110) [1887], 12 App. Cas. 589 (P.C).
112) [1916] 1 A.C. 554.
113) Some judges do not regard information as property; see the debate over this issue in the Phipps case [1967] 2 A.C 47 (HL). See Chapter No. 3.
114) [1910] 1 A.C. 554. Beck argues that a director who acts in good faith has nothing to fear from the votes of his fellow disinterested shareholders. Prohibiting an interested director from using his vote in such a case is merely an application of the rule that "no man should be seen to be a judge in his own cause": Beck S. "The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered" [1971] 49 Can. Bar. Rev 80 at p.119.
116) New S.322A (3)(a) and (b).
Law. 35, p.42; Rivers E. "Financial Inability as a Defence under the Corporate Opportunity Doctrine" [1951] 29 Kentucky L. J. 229. If a company adopts Art.94 of Table A 1985, interested directors will be prevented from using their votes and, generally, must not be counted for quorum purposes: see Mitchell Ph. Insider Dealing and Directors' Duties, 2nd ed, [1989]; see also Re Cleadon Trust Ltd [1939] Ch 286, [1938] 4 ALL. E.R. 518, CA.

118) See The Companies (Table A-F) Regulations 1985.
119) Palmer's Company Law, vol (1), [1987].
120) Of course, a director can enter into a contract with his company if he obtains the approval of the shareholders. However, he is still under the statutory duty to disclose his interest to the board of directors according to S.317: see Rayan Ch. Company Directors, Liabilities, Rights and Duties, 2nd ed, [1987] at p.127. Some exceptions to the policy of relaxation have been recognised. Those exceptions are (1) Loans and related transactions (SS.330 (2)(a) (CA 1985). (2) Quasi-loans (SS.331(3) (CA 1985). (3) Credit transactions (SS.331(7) (CA 1985). (4) Related transactions (SS.330(7) (CA 1985). Those matters have been examined in chapter 3; for a good discussion of those exceptions, see Farrar's Company Law, 2nd ed, [1988] at pp.347-353; see also Mayson, French and Rayan Company Law [1988-1989].

122) See SS.317(7).
124) See McCann, "Directors Fiduciary Duties" [1991] 9 I.L.T. 80; see per Lord Denning M.R. in the Hely Hutchinson v. Brayhead Ltd [1967] 3 All E.R. 98 where his Lordship said: "[the defendant] failed to comply with S.199 of the Companies Act 1948 [CA 1985. S.317] . . . It seems that when a director fails to disclose his interest, the effect is the same as non-disclosure in contracts uberrimae fidei, or non-disclosure by a promoter who sells to the company's property in which he is interested . . . Non-disclosure does not render the contract void or a nullity. It renders the contract voidable at the instance of the company and makes the director accountable for any secret profit which he has made" (Ibid at p.103). Also, in the Court of Appeal in Guinness Plc v. Saunders [1988] B.C.L.C. 607, Fox L.J supports Lord Denning's opinion (quoted above). His Lordship said that a company may relax the Common Law rules by special
provisions in its articles. " The purpose of S. 317(1) is not to destroy the power to relax [the Common Law rules] by the articles, but to impose a binding safeguard on that power . . . [the exclusion clauses] must be read in the light of S. 317(1) to which [they are] always subject, . . . [the defendant] plainly acted in breach of duty in failing to disclose his interest in the agreement to a meeting of directors" : [1988] B.C.L.C 607 at p.612. Then, his Lordship referred to and accepted the view expressed by Lord Denning M.R. in respect of the consequences of a non-compliance with S.317 CA 1985). Fox L.J. said: "It seems to me that consistently with [ Lord Denning's view] S.317(1) must be regarded as imposing a duty which has consequences in civil law in addition to the penalty of a fine": [1988] B.C.L.C. G07 at p.613. Thus, in his Lordship's opinion a breach of S.317 exposes a director to a fine in addition to making his contract voidable at the instance of the company. The advantage of this view is that it prevents an interested director, who is prompted by his own personal benefit not to disclose his interest in accordance with S.317, from retaining the profit made even if his company's articles, unconditionally, exclude the Common Law principles. However, it is argued that a director who fails to make a proper disclosure of his interest because of his intention to gain a personal profit is caught by the general rule which prohibits a director from making profit out of his directorial position: see Baker C. "Disclosure of Directors' Interests in Contracts" [1975] J.B.L. 181. Despite the fact that S.317 is silent in respect of any civil consequences (i.e. it does not, expressly, entail a civil consequences) it could be argued that failure to comply with it renders the contract voidable, for the following reasons: (1) Many statutory provisions have been construed by the courts to have civil consequences although such consequences have not been expressly stated: see for example Smith v. Mawhood [1845] 14 M. & W. 452 ; see Baker C. "Disclosure of Directors' Interests in Contracts" [1975] J.B.L. 181. (2) S.317 is an obligatory one and cannot be abrogated by the company's articles. So, even if a company's articles contain an unconditional exclusion clause, a director must disclose his interest in contracts to the board according to S.317. Failure to do so, results in a breach of duty and makes the contract voidable and the profit made recoverable.

But Baker argues that S.199(1) CA 1948 (S.317 CA 1985) has a limited effect. Its effect is limited to imposing a fine on the director who fails to
comply with it. And that this section does not of itself entail civil consequences, i.e., an invalidating effect. Thus, whether a director's contract is voidable depends or not depends upon the provisions of a company's articles. If a company's articles exclude the general equitable principle which prohibits a director from having an interest in contracts with the company, the contract is valid even if that director does not comply with the requirement of disclosure under S.317: Baker, "Disclosure of Directors' Interests in Contracts" [1975] J.B.L. 181. This view, in fact, finds some support in the Court of Appeal's decision in Hely-Hutchinson v. Brayhead Ltd [1968] 1 Q.B. 549. In that case Lord Pearson said (at p.594): "It is not contended that section 199 [S.317 CA 1985] in itself avoids the contract. The section merely creates a statutory duty of disclosure and imposes a fine for non-compliance; but it has to be read in conjunction with [the company's articles]"; see also Professor Pennington who argues that failure to disclose interest according to section 317 exposes a director to a fine without giving the company the right to rescind the contract simply because the director has not complied with section 317: Pennington R. Directors' Personal Liability, [1987] at p.79; See Nock R. "When Is a Director not a Director?" [1967] 30 M.L.R. 705.

125) However, if it is too late to rescind a director's contract with the company, the contract will be fully enforceable against the company. But the director is still liable to account for the profit made: see Hely Hutchinson v. Brayhead [1968] 1 Q.B. 549 (CA).

126) See Imperial Mercantile Credit Asscn v. Coleman [1873] L.R. 6 (HL). 189; Gray v. New Augartia Procupine Mines [1952] 3 D.L.R. 1 (P.C); see Gower L. Principles of Modern Company Law, 4th ed, [1979]; "The disclosure must be such that the other director or directors can see what his interest is and how far it goes": Movitex Ltd v. Bulfield [1988] B.C.L.C. 104 per Vinelott J. at p.121.


129) Gower L. Principles of Modern Company law, 4th ed, [1979].

130) Mitchell Ph. Insider Dealing and Directors' Duties, 2nd ed, [1989].

131) Mitchell Ph. Insider Dealing and Directors' Duties, 2nd ed, [1989].

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133) [1967] 2 A.C. 134.

134) S.310 (S. 205 of The Companies Act 1948) was introduced as a result of the recommendation that made by Green Committee which was intended to prohibit the relief of officers from breach of duty (Cmd. 2657), paras 46 and 47. Prior to S.317 (S.205 CA 1948), a company's articles could exempt the director from liability except for breaches which were "Fraudulent": see Re City Equitable Fine Insurance Co. [1925] Ch. 407; see also Gower L. Principles of Modern Company law, 4th ed, [1979].

135) See Palmer's Company Law, vol (1), [1979].


137) This view has been criticised by Baker C. in his article "Disclosure of Directors' Interests in Contracts" [1975] J.B.L. 181. He said that the qualification imposed by Gore-Browne on his own view is not satisfactory, and it destroys the view itself. That is because it is difficult to see whence the duties can be derived other than from "statute or the general law". He also added that if Gore-Browne intended to distinguish between mandatory and non-mandatory rules of law, he did not state the nature of the distinction. Vine110 J. criticised this view as it fails to give effect to the words "for exempting" which are found in S.205 (CA 1948, S.310 CA 1985); and leads to the unreasonable result that an article could modify or abrogate the duty of skill and care and so relieve a director from liability which would otherwise arise; this result is in conflict with the purpose of that section: Movitex Ltd v. Bulfield and others [1988] B.C.L.C. 104 at pp.117-118.


139) See Re Brazilian Rubber Plantations and Estates Ltd [1911] 1 Ch. 425, 440.


141) "It may be that S.310 permits the draftsmen to introduce only alternative ways of satisfying fiduciary duties, i.e, by disclosure to the board rather to the company in general meeting" Palmer's Company Law, vol (1), [1987], at p.960.

142) Pennington R. Directors' Personal Liability, [1987].

144) Ibid at p. 194.

145) Farrar's Company Law, 2nd ed, at p. 346. It is to be noted that this interpretation has been accepted by Vinelott J. in Movitex Ltd v. Bulfield and Others, [1988] B.C.L.C 104. Vinelott J. referred to and accepted the view which was expressed by Megarry V-C in Tito v. Waddell (No. 2), [1977] 3 All E.R. 129 at pp. 247-248. Megarry V-C's view indicates that the over-riding principle of equity is that the court will intervene to set aside any transaction entered into by a director if that director places himself in a position in which his duty conflicts with his personal interests. The court will intervene without inquiring into whether there is a breach of duty or not. This principle of equity can be abrogated or modified by the company's articles. "In doing so [the articles] do not exempt a director from or from the consequences of a breach of duty owed to the company": Movitex v. Bulfield, [1988] B.C.L.C 104 at p. 120, per Vinelott J.. According to this analysis there is no contradiction between S.310 CA 1985 and Art. 85 of Table A.

146) [1986] 1 W.L.R. 985.

147) Instone argues that the Greene Committee suggested the predecessor of S.310, i.e., S.205 (CA 1948), to prevent only indemnification of officers out of their companies' funds: Instone R. "The Modification of Directors Duties—Letter to Editor" [1981] J.B.L. 171. This argument, in one's opinion is unacceptable since it ignores the words "for exempting" which are included in S.310.

148) "When a provision is a statute 'subject to' another provision requiring something to be done, the first provision is conditional upon the provision referred to" (Massey - Harris Co. v. Strasburg, [1941] 4 D.L.R. 620 at p. 622 per Macdonald J.A., referred to by Saunders J. Words and Phrases Legally Defined, 3rd ed, vol (4): R-Z [1990], at p. 244). "Subject to" means "Liable, subordinate, subservient, inferior, obedient to; governed or affected by; provided that; provided; answerable for" (Homan v. Employers Reinsurance Corp., 345 MO. 650. 136 S.W. 2d 289, 302, referred to by Black H. Black's Law Dictionary, 5th ed, [1979].

149) Art. 85(b) of Table A.

150) See Pennington R. Directors' Personal Liability, [1987].

151) It is to be noted that if the company's articles do not include an exclusion clause similar to that in Art. 85, the company has the right, at the common law, to rescind the contract with the director whether that contract is fair or unfair one. This
right has been given to the company to avoid any possibility of conflict of interest and duty: see Aberdeen Rly. Co. v. Blaikie Bros [1854] 1 Macq, 461 (HL).

However, it seems that embodying the phrase "provided that he has disclosed to the directors the nature and the extent of any material interest of his" in Art.85, is supererogatory because this condition is included in S.317 CA 1985: and that section is an obligatory one, i.e., it cannot be abrogated by a company's articles of association.


Re Claridge's Patent Asphaltes Co. Ltd. [1921] 1 Ch. 543; see also Re Duomatic Ltd. [1969] 2 Ch. 365.

[1985] 3 All E.R. 351.

Ibid at p.372.

[1967] 2 A.C. 47.

Cf. Robinson v. Pett, [1734], 3 P. Wms. 249; 24 E.R. 1049 (L.C) where Lord Talbot L.C refused to allow an allowance to the defendant for the work done by him in favour of the trust estate.

[1967] 2 A.C. 47.


Cf. Keech v. Stanford, [1726], Sel. Cas. T. King 61; Robison v. Pett, [1734], 3 P. Wms. 249 and Aberdeen Rly. Co. v. Blaikie Bros, [1854] 1 Macq 461, in which the mere possibility of conflict was held to be enough to make the defendants accountable for the profit made.


[1967] 2 A.C. 134, see per Lord Russell at p.144; Lord Macmillan at p.151; and per Lord Porter at p.158.

[1967] 2 A.C. 47.

[1967] 2 A.C. 47, see per Lord Cohen at p.104; Lord Hudson at p.112; and per Lord Guest at p.115.

176) [1972] 2 All E.R. 162 at p.176. Dr. Prentice argues that even if Cooley was acting in good faith, he would be liable to account for the benefit that he gained because the question of bona fides does have no bearing on the existence of the breach of duty. However, the presence or the absence of good faith may affect the form of relief but does not move the existence of the breach of duty: see Prentice D. "Directors' Fiduciary Duties, the Corporate Opportunity Doctrine" [1972] 50 Can. Bar. Rev., 623 at p.636.

177) [1916] 1 A.C. 554 (P.C).
178) [1967] 2 A.C. 47.
179) [1985] 3 All E.R. 351.
184) [1967] 2 A.C. 47.
185) [1972] 2 All E.R. 162.
187) Jones argues that unless fiduciaries have acted in bad faith or have been unjustly enriched they should not be made liable to account for the profit made by them: Jones G. "Unjust Enrichment and the Fiduciary's Duty of Loyalty" [1968] L.Q.R. 472.
190) Cartwright J. in the Peso case, ibid, referred to Lord Greene's hypothesis in the Regal case [1967] 2 A.C. 134 in the Court of Appal, and said that the facts of the Peso case are identical with those of the hypothetical case given by Lord Greene. Lord Greene M.R said that it is far beyond a director's or an agent's duty to hold him liable to account if he exploits an opportunity after it has been considered and bona fide rejected by its board of directors. So, Cartwright J. held that the defendants in the Peso case were not liable to account for the profit made.
191) [1967] 2 A.C. 134.
192) See per Bull J. in the Peso case [1966] 58 D.L.R. (2d) 117. It is said that there was a difference between the Regal case and the Peso case which had led to a different judgment in the latter. The difference is that the company in the Peso case was continuously receiving offers of properties. Once one of those offers rejected the directors could...
take it to themselves. In the Regal case the
offered opportunity was wanted, but could not be
obtained by the plaintiff due to lack of funds. Similarly, in Keech v. Stanford [LC 1726] Sel. Cas. T. King. 61, 25 E.R 223, 2 Eq Ab. 741, 22 E.R 629, the infant could not obtain the lease due to the lessor's refusal to renew it to him: See Beck S. "The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered" [1971] 49 Can. Bar. Rev 80. However, the board of directors in the Peso case decided that the company had enough land. This was one of the reasons which had led the board of directors to reject the offered opportunity on behalf of the company. So, it could be argued that that fact in itself distinguishes the Peso case from the Regal case.

pp.1002-1003.
198) Ibid at pp.1033-1004.
199) Ibid; see also Clark R. Corporate Law [1986].
Farrar says that this approach is the most appropriate one to solve the problem of corporate opportunity: Farrar's Company Law, 2d ed, [1988] at p.363.
200) [1980] 34 Miami. L. Rev. 959, referred to by
Farrar's Company Law, ibid.
201) [1874] L.R. 10 Ch. App. 97.
202) [1967] 2 A.C. 134.
203) Parker v. Mckenna [1874] L.R 10 Ch. App. 97, particularly see the Lord Chancellor at p.118 and
206) However, Jones, ibid, noted that in some cases, for policy reasons, the court may find it absolutely necessary to hold a fiduciary liable to account even if he has acted in good faith and has not been enriched at the expense of his company. Public policy may require the removal of all temptation and the extinguishment of all possibility of profit. But such a decision should be taken after giving careful regard to the facts of the case, the
relevant policy consideration, the nature of the fiduciary's responsibilities and whether holding the honest man liable will teach the others a good lesson or not.


208) Gower L. Principles of Modern Company Law, 4th ed [1979].

209) See per Lord Porter in the Regal case [1967] 2 A.C. 134 at p.157, where he was disturbed by the fact that allowing recovery in such a case will result in a windfall gain for the new shareholders. But his Lordship concluded that despite the fact that the new shareholders obtained an unexpected windfall "[t]he company and its shareholders are separate entities...[and] the principle that a person occupying a fiduciary relationship shall not make a profit by reason thereof is of such vital importance that the possible consequence in the present case is in fact as it is in law an immaterial consideration".


213) Ibid.

214) [1967] 2 A.C. 47.


216) [1842] 9 C 1, and F 111 at p.124, 8 E.R. 357.

217) Those remarks has been referred to by Lord Guest in the Phipps case [1967] 2 A.C. 47 at p.115.


219) [1964] 1 W.L.R. 843; [1964] 2 All E.R. 273, in that case each one of the two shareholders of the company formed his own company to exploit the opportunity which the original company failed to exploit due to lack of funds. Cross- actions were brought by the two shareholders (directors) on behalf of the company to restrain each other from exploiting that opportunity.

220) [1967] 2 A.C. 134.

221) Clark R. Corporate Law [1986].


226) Rivers said that the basis of the inflexible rules is to be found in the unfairness of a fiduciary exploiting an opportunity or taking an advantage when the interest of his company justly calls for protection. Thus, any rule adopted should achieve two objects: (1) It should encourage legitimate business transactions; and (2) it should produce justice to all parties. Those two objects will not be violated by allowing a director to exploit the opportunity which his company is financially unable to exploit: Rivers E. "Financial Inability as a Defence under the Corporate Opportunity Doctrine" [1951] 29 Ky. L. J. 229.


228) [1967] 2 A.C. 134.

229) [1966] 58 D.L.R. (2d) 117.

230) [1972] 2 All E.R. 162.

231) [1972] 2 All E.R. 162.


234) Rajak H. "Fiduciary Duty of a Managing Director" [1972] 35 M.L.R. 655. Rajak said that the rule in Keech v. Stanford must bow to the consent of the company. Rajak says that the relationship between Cooley and his company was an employee-employer one because Cooley was the managing director of the company. Such a relationship should be governed by a contract. That is, Cooley's liability should be made on a contractual basis: see Boulting v. A.C.T.T. [1963] 2 Q.B. 606, particularly see Lord Upjohn's judgment, for the proposition that a managing director may be an employee of the company and the relationship between him and the company is an employee-employer one.

If the court adopted the view that the relationship between Cooley and the company is one of employee-employer, liability would not be attached to Cooley. Cooley would not be liable, Rajak said, because, assuming that the information is a property, the circumstances in which the information about the...
contract with the Gas Board coupled with the Gas Board's refusal to deal with the plaintiff company, could hardly be said to confer on the information the status of being the plaintiff's property. In addition the argument adduced by the plaintiff which provided that the defendant had used the company's car and its time was dismissed by the learned judge as "fiddling". Rajak argues that, the company's property and time in the Cooley case is irrelevant. The defendant was able to gain the contract with the Gas Board even if he did not use the company's car and time. The situation in the Cooley case is different from that in Reading v. Attorney-General [1951] A.C. 507, in which the defendant used his military uniform in order to obtain the gain. So, the use of the property of the employer (His Majesty's Army) in that case, was relevant to the question of liability and thus, liability was imposed on the defendant to account for the bribe that he obtained.

235) [1972] 2 All E.R. 162.

236) However, in respect of the Cooley case, one sees that the defendant was under a specific duty which was to obtain the contract with the Gas Board to the plaintiff company. So, he should be deprived from taking that contract for his own benefit.
CHAPTER 5

DIRECTORS' DUTY OF HONESTY AND GOOD FAITH

5.1. Introduction

The primary fiduciary duty of a company director is that of honesty and good faith in the exercise of the powers vested in him by the company's constitution. Those powers must be exercised only for the purposes for which they are conferred. Thus, a director may not use his power to achieve any collateral, improper or unauthorised purpose. In this context, a distinction could be made between actions which constitute an abuse of power and those which are ultra vires the director. A director may be said to have abused his powers if he has exercised those powers for purposes other than those for which they were conferred, i.e., for improper purposes. But a director's act is ultra vires if he has usurped a power which he never had. That is, where he exercises a power not given to him by the company's articles of association or its memorandum. The above two actions can be tested objectively because they are concerned with objective matters. That is, the court will look at the scope of the directors' powers and the scope of the purposes for which those powers are conferred. If it
found that the directors were acting beyond the scope of their powers, it would hold that their actions were ultra vires. If it found that they were acting beyond the scope of the purposes for which their powers were conferred, it would hold that they had abused their powers. So, the intention of the directors or their motives has no bearing on the question of the directors’ duty not to abuse their powers or their duty not to exceed their powers. It is, however, submitted that it is not easy at all for the courts to define in advance the scope of the proper purposes. This issue will be examined later.

The rule that requires a director to act bona fide in the best interests of the company is concerned with the intention of the director. That is, this rule is concerned with what is going on in the directors’ minds, i.e., with their motives.

A director’s duty to exercise his powers for proper purposes has sometimes been dealt with as an alternative to the duty to act in good faith, while at other times it has been regarded as something separate from it(3).
5.2. Director's Duty to Act Bona Fide in the Interest of the Company.

In Re Smith & Fawcett Ltd.(4), Lord Greene MR. laid down the principle that directors are bound to exercise the powers conferred upon them

"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".

It is worthwhile considering the facts of that important case. Article 10 of the company's articles of association provided that: "The directors may at any time in their absolute and uncontrolled discretion refuse to register any transfer of shares". The issued capital of that company consisted of 8002 ordinary shares. There were only two shareholders, who were also the directors of the company. Each of the two shareholders held 4001 shares. After the death of one of the shareholders/directors, his son, as his executor, applied to have the testator's shares registered in his name. The other shareholder/director refused to register all the testator's shares in the son's name. But he offered to register 2001 shares in the name of the executor and to buy 2000 at a fixed price. The executor applied to the court to have all of his father's shares registered in his name. Lord Greene MR said that article 10 gave the directors an absolute...
power to refuse to register any transfer of shares: a point which was clear from the wording of article 10 itself. And apart from the implicit limitation, which is imposed by law, that a fiduciary power must be exercised bona fide in the interest of the company, there is nothing in "principle or in authority" to impose a limitation on the directors' power in the present case. Thus, his Lordship found that the defendant had acted bona fide in the interest of the company and that there was nothing to show that this power had been exercised in a contrary manner. The plaintiff claimed that the defendant had not exercised his power, under article 10 not bona fide in the interest of the company but for a collateral purpose; which was to preserve his dominating position in the company. Lord Greene MR said that in the absence of evidence which might support this claim, the affidavit evidence was unsatisfactory evidence of the motives of directors in exercising their powers. Accordingly he dismissed the plaintiff's appeal. The principle articulated by Lord Greene MR was described by Berger J. in Teck Corporation Ltd. v. Millar(5) as follows:

The law says that the directors of a company, in exercising their powers, must act bona fide in what they consider to be the best interest of the company . . . But their purpose must be one countenanced by the law. They cannot exercise their power for an extraneous purpose(6).
In Re W & M Roith Ltd.\(^7\), the director, who had no pension arrangement with the company, fell ill. The company altered its memorandum specifically in order to take power to pay a widow's pension. Ultimately, the director entered into a service agreement with it in order to provide a generous pension for his widow in the event of his death. The court found that the director had not entered the agreement bona fide in the interests of the company. So, he was in breach of a director's fiduciary duty. The court, however, held that the agreement was ultra vires and, consequently, not binding on the company. In Re Welfab Engineers\(^8\), it was held that the directors who sold the company as a going concern, when it was in financial difficulties, would not be in breach of their fiduciary duties if they failed to gain a higher price by breaking up the business. They were not in breach of their duties because they were acting honestly and in good faith.

The principle laid down by Lord Greene MR. consists of several factors which give rise to several questions which need to be answered. First, how to test 'bona fides'? Second, what is the meaning of the phrase 'in the interests of the company'? Third, what is the meaning of the words 'collateral purpose'?.
5.2.1. Tests of bona fides

i) The subjective test.

It is clear from the wording of Lord Greene MR. in Re Smith & Fawcett Ltd.\(^9\), that the adopted test is a subjective one\(^10\). So, if the directors exercised a specific power, under a belief that this act was in the best interests of the company, the court would not consider their act as a breach of duty merely because, in its own opinion, this particular act was not in the interests of the company\(^11\).

The court will not exercise a supervisory role over directors' decisions. Lord Wilberforce said in Howard Smith Ltd. v. Ampol Petroleum Ltd\(^12\):

There is no appeal on merits from management decisions to courts of law; nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.

Similarly, Latham CJ. said in Richard Brady Franks Ltd. v. Price\(^13\): "It is not for a court to determine whether or not the action of the directors was wise"

The onus of proving subjective bad faith is on the pursuer. So, if the articles failed to define the scope of the directors' discretion in exercising their powers, it will be very difficult for the plaintiff to prove \textit{mala fides} on the part of the directors\(^14\). Subject to the articles of association, the court will insist that it is the directors themselves (and not some delegate),

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who should decide how the powers conferred upon them are best used in the best interests of the company\(^{(15)}\). The subjective test deals with the intentions and the motives of the directors. That is, it deals with what is going on in the minds of the directors. It is submitted that, because the intentions and the motives of the directors exist deep inside them as human beings, they cannot be examined easily. Because of the difficulty in examining the intentions and the motives, directors may escape liability despite their *mala fides*. Consequently, the effectiveness of the rule, which imposes (on directors) a duty to act *bona fide* in the best interests of the company may be reduced\(^{(16)}\).

ii) The objective test.

Despite the subjective nature of the issue of *bona fides*, the court can still interfere if no reasonable director could possibly have decided that a particular exercise of power was in the best interests of the company\(^{(17)}\). In such a case the court is applying an objective test\(^{(18)}\), i.e., the reasonableness test. But one believes that applying an objective test to the directors' duty of good faith is not an easy task. The reason is that directorship is not a profession\(^{(19)}\). It does not require the one who wants to undertake the functions of a director to obtain an advanced education or a special training. A director might be a lawyer, an
architect, or a farmer . . . etc. So, who is the reasonable director?. Is he the reasonable lawyer, or the reasonable architect or the reasonable farmer . . . etc ?.

It is submitted, however, that the main test of directors' bona fides is the subjective test. The reason is that the issue of bona fides is, as mentioned above, of a subjective nature which cannot be, usually, tested objectively. The role of the objective test in this field is a complementary one. That is , the objective test operates only in cases where the directors' act is as odd as to justify its application. In other words, in cases where no reasonable director could possibly have considered the act done as in the best interests of the company.

iii) The test of fairness.

Where there are different classes of shareholders, the courts have said that it is not easy to apply the test of acting in the interests of the company. Bona fides in such a case can be tested by examining whether the directors have acted with equal fairness between the competing interests of the different classes of shareholders. In the Australian case Mills v. Mills(20), the defendant director was an ordinary shareholder in the company. He procured a resolution of the board under which accumulated profits were
distributed among the shareholders by way of fully-paid bonus shares. As a result, the ordinary shareholders gained enhanced voting powers against the existing preference shareholders. The good faith of the board was not challenged in this case, but questions were raised about the position of the director who gained personally from the transaction. The court held that the director was not in breach of his fiduciary duties.

Latham CJ. said(21):

Where there are preference and ordinary shares a particular decision may be of such a character that it must necessarily affect adversely the interests of one class of shareholders and benefit the interests of another class. In such a case it is difficult to apply the test of acting in the interests of the company. The question which arises is sometimes not the question of the interests of the company at all, but a question of what is fair as between different classes of shareholders. . . . A director who holds one or both classes of such shares is not, in my opinion, required by the law to live in an unrealistic region of detached altruism and to act in a vague mood of ideal abstraction from obvious facts which must be present to the mind of any honest and intelligent man when he exercises his powers as a director.

If directors are acting bona fide in the interests of the company, they "are not chargeable with dolus malus or breach of trust merely because in promoting the interest of the company they were also promoting their own"(22).

In sum, as between different classes of shareholders, a director must act fairly, while towards the company a
director must act bona fide in the interests of the company.

5.2.2. The phrase: "in the interests of the company".

It would seem that this phrase is not a clear one. That is, it may not have the same meaning in all cases which deal with directors' duties. However, it should be emphasised that the general rule is that fiduciary duties of a company's director are owed to the company alone and not to any other person or persons. But, the law has recognised some exceptions to that rule. The first exception is that a director may, in some situations, owe fiduciary duties to shareholders as individuals(23). A director must have regard to the interest of the company's employees. This is clear from the wording of S.309 CA 1985. S.309(1) provides:

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, it would seem that the director's duty to the company will prevail in case of conflict with his duty to the company's employees. That is because the director's duty is owed to the company and to the company alone. On the other hand, it would seem that S.309(1) is unable to provide an effective statutory rule to protect the interests of the company's
employees. The reason is that S.309(2) emphasises the general rule that a director's duty is owed to the company alone. S.309(2) provides:

Accordingly, the duty imposed by this section on the directors of a company is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors.

Because the directors' duty, imposed by S.309(1), is owed to the company, and a breach of that duty constitutes a wrong done to the company, the rule in Foss v. Harbottle(24) will come into play and the enforcement of the directors' duty will be at the discretion of the company. If the company, represented by the majority shareholders, fails to proceed, a shareholder, in general, will be unable to bring a derivative action. A shareholder, however, can bring a derivative action if he proves that the wrongdoers are: (1) in control of the company and consequently, prevent it from suing in its own name and, (2) that the wrongdoers' act falls within the scope of the "fraud on the minority" exception to the rule in Foss v Harbottle(25). An employee, of course, has no locus standi to bring such an action.

Going back to the phrase "in the interests of the company", this phrase is capable of bearing several meanings. That is, it may refer to several things or
it can be interpreted in several ways. One shall present those interpretations in order to reach a satisfactory definition for that phrase.

1) The phrase in question may refer to the interests of the corporate body as a separate entity. In Charterbridge Corp. Ltd. V. Lloyds Bank Ltd. (26), it was alleged that the legal charge given by Castleford Co. to the defendant bank as a security for the due performance of its obligations under a guarantee, was ultra vires, because its directors had not bona fide intended to further its interests. The argument that the directors did not give separate consideration to the benefit of Castleford Co. was rejected by Pennycuick J. as an unduly narrow test because the directors' act might be beneficial to the company. The judge also rejected the argument, that it was sufficient that the directors of Castleford Co. looked to the benefit of the group as a whole, because the directors of a particular company were not allowed to sacrifice the interests of that company for the benefit of the group (27). Since each company in the group is a separate entity it is very likely that each company has separate creditors. The proper approach, in the absence of actual distinct consideration, the judge said,

must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that
the transactions were for the benefit of the company(28).

ii) The phrase "in the interest of the company" or "for the benefit of the company as a whole"(29) may refer to the shareholders as a general body. In Greenhalgh v. Arderne Cinemas Ltd.(30), the company's articles gave pre-emptive rights to existing members to buy the shares of any member who wished to sell. The managing director procured the passing of a special resolution, allowing him to sell to an outsider; which in effect negatived the pre-emptive rights of the existing members. One of the members sought a declaration that the resolution was void as a fraud on the minority. The court refused to give the declaration. Evershed MR. said that the question in this case was whether the resolution had been passed bona fide in the interest of the company as a whole or not. He then gave a definition of the phrase "in the interest of the company as a whole". He said:

[It] does not mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body(31).

Defining the "interests of the company" by reference to the interests of its members, is used by S.309(1) CA 1985 which requires a director to consider the interests of the company's members.
iii) It is said that the phrase in question may refer not only to the interests of the present members but also to the interests of future members\(^{(32)}\). In the Savoy case\(^{(33)}\), Council for the company said that directors "should balance a long-term [interests of the company] against short-term interests of present members". It has been said\(^{(34)}\) that Megarry J. took a similar view in Gaiman v. National Association for Mental Health\(^{(35)}\). In that case article 7 of the articles of association of the Mental Health Association provided that: "A member . . shall forthwith cease to be a member:- (B) if he is requested by resolution of the council to resign . . ". The council requested the resignation of 302 members. Eight of them brought an action against the council. One of the contentions was that the council had been in breach of its fiduciary duty to the association and, in not considering the interests of the members who had been requested to resign, had abused its powers. The court held that the council had exercised its powers in the bona fide belief that its action was in the association's best interests. Megarry J. said that the power given by article 7 was a direct power to deprive a member of his membership. The purpose for which this power was given was to further the interests of the association. The association is an artificial legal entity, said Megarry J., and it is not
easy to determine its interests without paying attention
to the interests of its members. Megarry J. added:

The interests of some particular section or
sections of the company cannot be equated with
those of the company, and I would accept the
interests of both present and future members
of the company, as a whole, as being a helpful
expression of a human equivalent. It would seem that the judge accepted the view that the
company's interests includes the interests of the future
members. He described the interests of both the present
and the future members, as a whole, as being "a helpful
expression of a human equivalent" to the interest of the
association as an artificial legal entity.

In Dawson International plc. v. Coats Patons plc., Lord Cullen said that there appeared to be no reason why
S.309 CA 1985 should not be deemed to require a director
to have regard to the interests of both present and
future members.

With respect, I am not satisfied with the view that the
phrase "in the interest of the company as a whole"
requires directors to take into account the interests of
the future members of the company unless the interests
of the future members means the future interests of the
company as a going concern. The reasons are that: (1)
The general rule is that director's duties are owed to
the company and to the company alone. A director must
have regard to the interests of the company. The
interests of the company, it is submitted, include the
interests of the current members(38). Directors must not ignore the interests of the present members and act on the basis of what is in the interest of the company as a corporate entity(39). And, indeed, it is not easy to determine what is in the best interests of the company without paying due regard to the interests of the current members of the company because a company is an artificial legal entity(40). This, however, does not mean that directors must comply with the directions of the shareholders or must act in accordance with the desires of the shareholders as individuals(41). It would seem that the word "members" includes only the present members and cannot be expanded to embrace future members. A future member of a company is unknown. He "may be, almost literally, anyone in the world"(42). Thus, his interests are unspecified. So, how can a director take into account such interests? Future members, are members of the community as a whole, and it is submitted, that a director owes no fiduciary duty to further the interests of the community. (2) The view that a director must have regard to the interests of the company's future members is, it is agreed(43), incapable of applying in the case of non-profit-making companies. The reason is that, it is submitted, the interests of the future members means and should only mean the interests of the company as a going concern. In the case of profit-making companies the interests of the
current members, as investors, coincides, in fact, with the long-term interests of the company. But in the case of a non-profit making company, both the present and the future members have no financial interests. Thus, what might be in the interests of the company might not be the same in relation to the members. In other words, the interests of the members is not always identical to the interests of the company. Megarry J.'s decision in the Gaiman case, however, went, directly, against this view because the association in that case was a non-profit making one. The judge accepted that the interests of the company includes the interests of both the present and the future members. (3) A future member, for example a potential investor, has no locus standi to sue a director who fails to consider the interests of the future members. He cannot bring a derivative action on behalf of the company, nor can he bring a personal action against the directors on the ground that his personal rights have been infringed. So, in the absence of statutory means to enforce the directors' duty towards future members, it will be futile to argue that companies' directors owe a duty to consider the interests of future members. (4) The subject of the Gaiman case(44) was not the directors' duty to consider the interests of future members. The question in that case was whether the council had been in breach of its fiduciary duty in not considering the
interests of the present members who had been requested by the council to resign. So, the issue of the interests of future members was irrelevant to the substance of that case. It would seem that Megarry J.'s remarks, in relation to that issue, were obiter. (5) There are no decisions which support the view that a company's interests include the interests of future members. An analogy to auditors can be drawn in this context. In Caparo Industries plc v. Dickman and others (45), the court held that, due to the lack of proximity between the auditors and potential investors, the former owed no duty of care to the latter. The facts of Caparo case were simple. An auditor's report on the company's accounts was inaccurate. In reliance on the audited accounts, the plaintiffs, who were shareholders in the company, made a successful take-over bid for the company. They sustained loss. They alleged that the auditors had been negligent in auditing the accounts. The Majority of the Court of Appeal held that the auditors owed a duty of care to the present shareholders, due to the presence of both the foreseeability and the proximity elements between the auditors and the shareholders. But, it held that no duty of care was owed by the auditors to potential investors on the grounds that: (1) There was no sufficient proximity between the two parties, and, (2) it would not be just and reasonable to impose a duty on
the auditor to non-shareholding investors. The court gave this decision despite the fact that it was reasonably foreseeable that potential investors might rely on the auditor's report in considering whether and how to deal in the company's shares. In the House of Lords, it was held that in certifying a company's accounts for the purpose of the Companies Act 1985, an auditor owed no duty of care to a potential investor, whether or not he was already a shareholder of the company. The House of Lords held that foreseeability, no matter how high, that a potential investor might rely on the audited accounts did not suffice to found a duty of care, since there was no sufficient relationship of proximity between an auditor and a potential investor(46). If the potential investor is an identified person, the situation might be different. In Morgan Cruible v. Hill Samuel Bank(47), the plaintiff, who was an identified take-over bidder, alleged that the directors, among others, were negligent when they gave an inaccurate pre-bid financial statements and profit forecast of their company and were aware that he (the plaintiff) would rely on that forecast. At the trial the judge held that the directors owed no duty of care to a known take-over bidder to ensure that the pre-bid financial statements and profit forecast were accurate, because these documents were prepared for the purpose of advising the shareholders of the target company.
whether to accept the bid and not for the guidance of the bidder and, accordingly, there did not exist sufficient proximity between the directors and the take-over bidder to give rise to a duty of care. The plaintiff appealed. The Court of Appeal held that if the take-over bidder is an identified person and the defendant directors intended him to rely on the pre-bid financial statements and profit forecast for the purpose of deciding whether to make an increased bid, and the take-over bidder did so rely on those statements and the profit forecast, a relationship of proximity between the two parties would exist. This relationship would be sufficient to give rise to a duty of care.

It would seem that the position of directors vis-à-vis future members of the company, is similar to that of auditors. So, the same rule should be applied to directors. That is, directors owe no duties to future members, and consequently, they are not required to consider the interests of future members because of the absence of a sufficient relationship of proximity between directors and potential investors.

The interests of the shareholders or the members include, of course, the interests of the directors if they themselves are shareholders. So, the law does not require directors to take into account the interests of the shareholders and to ignore their own interests as
shareholders. This situation has been dealt with in the Australian case Mills v. Mills(49).

In relation to the meaning of the phrase "in the interests of the company as a whole", two questions remain to be answered: (1) Does a director of a company, which is a member of a group of companies, owe a duty to consider the interests of the group?. (2) Does the phrase include the interests of the company's creditors, consumers or even the interests of the community as a whole?.

As regards the first question, it is submitted that the primary duty of a director is to consider the interests of the company of which he is a director. In Charterbridge Corpn. v. Lloyds Bank Ltd.(50), Pennycuick J. remarked, obiter, that a director must not be led by the interests of the group as a whole if this might harm the interests of the company of which he is a director.

It would seem that, since each company in the group might have separate creditors, this approach is a sound one. That is, creditors of the subsidiary company might not be themselves the creditors of the parent company. Thus, sacrificing the interests of the subsidiary company, for the benefit of the parent company, may harm the interests of the former's creditors. However, Pennycuick J. said that a director will not be in breach of duty to his company if he considers the interests of the group in a case in which such a consideration has no
negative effect on the interests of his own company. Similarly, in Pergamon Press Ltd. v. Maxwell(51), the same judge held that it was not the duty of the directors of the subsidiary company to consider the interests of the holding company at the expense of the subsidiary. This decision, in fact, confirms the general rule that a director's duty is owed to the company and not to any section of the members(52).

In respect of the second question, it is agreed that a director must pay regard to the interests of the company's creditors(53). This view can be supported by Pennycuick J.'s judgement in the Charterbridge case(54), when he remarked, obiter, that a director of the the company, which is a member of a group of companies, must not be guided by the interests of the group if this might be detrimental to the interests of the company of which he is a director, particularly where the company has separate creditors(55).

There are some writers who argue that directors' duties must be expanded to embrace a duty to have regard to the interests of society. This argument is based on the ground that companies occupy a pre-eminent position in the economy of the community and, consequently, they are required to act for the public good(56).

On the other hand, it is said(57) that the interests of consumers and those of the community as a whole are legally irrelevant. In the Savoy case, Sir Milner
Holland, the inspector who was appointed by the Board of Trade to investigate the affairs of the Savoy Hotel Limited and the Berkeley Hotel Company Limited, stated that the interests of the nation "would not seem to me to form part of a true legal definition of the interests of the company" (58). It has also been said (59) that the notion of companies' social responsibilities has found little favour with legislators anywhere in western countries. Despite the fact that one is satisfied with the view that no interests outside those of the current members of the company and those of the creditors can be legitimately considered by the directors, the directors may find it in the interests of the company as a going concern to have regard to the interests of the consumers of the company's product and to those of the community as a whole.

A company's articles may exonerate a director from his duty not to place himself in a situation in which his interests conflict with his duty to the company. A clear example is where the articles allow a director to contract with his company. This exoneration does not extend to the director's duty of good faith. That is, a director will remain subject to the rule that he must act in the best interests of the company (60). In addition, a director who fails to exercise his powers bona fide in the best interests of the company cannot
plead the consent of the general meeting as a defence to an action for breach of duty(61).

5.3. Directors' Duty To Exercise Their Powers For proper Purposes

The exercise of power by a director, bona fide, in the interests of the company, does not prevent the court from intervening if that power is exercised for an improper purpose. Thus, a director, in addition to his duty to act bona fide in the interests of the company, must exercise his powers for the purposes for which those powers are conferred. If it is found that the powers are exercised for an improper purpose, the transaction may be set aside; notwithstanding the directors' honest belief that they were acting in the interests of the company(62).

5.3.1. One duty or two?

The question which may arise in this context is whether the director's duty to act for proper purposes constitutes a distinct one from the duty to act bona fide in the interests of the company?. Buckley J. held in Hogg v. Cramphorn Ltd(63), that the statement of Lord Greene MR in Re Smith & Fawcett Ltd.(64), quoted above, indicates that company's
directors are under two duties: (1) The duty to act bona fide in the interests of the company and, (2) the duty to act for a proper purpose. So, in that case, Buckley J. said that even if the directors acted in good faith in what they considered the best interests of the company, it was not permissible for them to issue shares in order to defeat an attempt to secure control of the company, or to remain in office.

To the contrary, Berger J. in Teck Corporation Ltd v. Millar(65), said that if the directors honestly believed that they were acting in the interests of the company and there were reasonable grounds for that belief, the purpose for which they acted would not be improper. Thus, Berger J. stressed that the only test against which the directors' acts must be examined is the subjective test(66). This view, fortunately, has been rejected by Lord Wilberforce in Howard Smith Ltd v. Ampol Petroleum Ltd(67). His Lordship emphasised that good faith is not enough and the purpose for which the directors act must be objectively proper. It is submitted that both the subjective and the objective elements should be considered. That is, a director must act in good faith and for the proper purpose. Paying regard only to the subjective element may lead to an undesired result. This result has been noted by Plowman J. in Parke v. Daily News Ltd(68). He said that bona fides cannot be the sole test, otherwise you might have
a mad person conducting the business of the company, and giving away its money or property with both hands in a perfectly bona fide but completely irrational manner. On the other hand, consideration of only the objective element requires one to ignore, completely, the business judgment rule: a dangerous qualification of the directors' discretion. And it is well known that directors are aware of their companies' interests more than any one else. Thus, a subjective element should also be taken into account in dealing with directors' performance of their duties and the exercise of their powers. While it is not easy to apply an objective test in relation to bona fides (because bona fides is of a subjective nature) the objective nature of the proper purpose requirement facilitates the application of the objective test. And, in fact, due to the objective nature of the proper purpose issue, the application of the objective test would seem convenient.

5.3.2. The Proper Purpose Doctrine

It has already been mentioned that a director must exercise his powers to achieve the purposes for which those powers are conferred. If he exercises his power for improper purpose (i.e., for purposes which are outside the objects of his company as stated in the company's memorandum or in its articles of association)
the court may intervene. In Re Cameron's Coalbrook Steam Coal, & Swansea & Lougher Rly. Co. (69), Turner LJ. said (70):

... in the exercise of the powers given to them ... [the directors] must, as I conceive, keep within the proper limits. Powers given to them for one purpose cannot, in my opinion, be used by them for another and different purpose. To permit such proceedings on the part of directors of companies would be to sanction not the use but the abuse of their powers. It would be to give effect and validity to an illegal exercise of a legal power.

Again, a director is bound to exercise the powers given to him for the purposes for which these powers are conferred. It is not, however, possible to determine or to enumerate the proper purposes. In other words it is not possible to lay down, in advance, the limits beyond which directors are prohibited from exercising their powers. Lord Wilberforce referred to this issue in Howard Smith Ltd v. Ampol Petroleum Ltd. (71), and said:

To define in advance exact limits beyond which directors must not pass is, in their Lordships' view, impossible. This clearly cannot be done by enumeration, since the variety of situations facing directors of different types of company in different situations cannot be anticipated.

5.3.3. The Proper and Improper Purposes

Since it is not possible to draw a line beyond which a director's act can be described as for improper purpose, the duty of the court is to examine the special
circumstances of each case. So, in each case the court will probe the directors' motives and the particular purpose which the directors intend to achieve by exercising their powers. Directors' powers can be exercised to achieve one or more proper purpose. Thus, the defining, by the court, of a single proper purpose, for which the power may be exercised and describing all other purposes as improper is not the sound approach.

In Howard Smith Ltd. v. Ampol Petroleum Ltd.\(^{(72)}\), the court concluded that it is:

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too narrow an approach to say that the only valid purpose for which shares may be issued is to raise capital for the company.
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The soundest approach has been expressed by Lord Wilberforce in the same case\(^{(73)}\). His Lordship said:

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In their Lordships' opinion it is necessary to start with a consideration of the power whose exercise is in question, in this case a power to issue shares. Having ascertained, on a fair view, the nature of this power, and having defined as can best be done in the light of modern conditions the, or some, limits within which it may be exercised, it is then necessary for the court, if a particular exercise of it is challenged, to examine the substantial purpose for which it was exercised, and to reach a conclusion whether that purpose was proper or not. In doing so it will necessarily give credit to the bona fide opinion of the directors, if such is found to exist, and will respect their judgment as to matters of management; having done this, the ultimate conclusion has to be as to the side of the fairly broad line on which the case falls.
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5.3.4. Mixed Purposes

Directors may exercise their powers to achieve more than one purpose. It is quite possible to find that some of those purposes are proper while other purposes are improper. In such a case the court may not set aside the directors' exercise of power if it finds that the substantial purpose is a proper one. In other words, it will uphold the exercise of power, even if an incidental purpose has been achieved, providing that the proper purpose is the substantial or primary purpose. If, for example, the substantial purpose is a proper one, directors' act will not be invalidated simply because they personally obtain some incidental benefit. In McCannie (London) Ltd. v. Cook & Watts Ltd., the court held that if the substantial purpose for which the power was exercised was improper, then the directors' decision would not be saved by the fact that a subsidiary proper purpose was also achieved. However, it is said that it is impossible for the court to distinguish between the substantial and the insubstantial purposes. Accordingly, it is argued that in cases of "mixed motives", the exercise of power should be invalidated by any improper purpose, whether that purpose is is primary, i.e. substantial, or secondary. This view has been supported by the argument that a director who exercised his powers to achieve any
purpose not contemplated by the company's memorandum or the articles of association, would be in breach of his fiduciary duties, irrespective of whether the purpose was a substantial or an insubstantial purpose. This approach, it is submitted, is an inflexible one and so undesirable. It is agreed that this approach "gives little credit to the judiciary's ability to weigh up the case before them"(79). In addition, it is unreasonable to set aside the directors' exercise of power wherever it is found that that exercise has achieved some incidental purposes, which might be of little significance in comparison with the benefit obtained by the company as a result of that exercise. There was an attempt made by Viscount Finlay J. in Hindle v. John Cotton Ltd(80), to lay down a test by which the substantial purpose can be examined. He said:

Where the question is one of abuse of powers, the state of mind of those who acted, and the motive on which they acted, are all important and you may go into the question of what their intention was, collecting from the surrounding circumstances all the material which genuinely throw light upon that question of the state of mind of the directors so as to show whether they were honestly acting in discharge of their powers in the interests of the company or were acting from some bye-motive, possibly of personal advantage, or for any other reason(81).

However, it would appear that the High Court of Australia has preferred a narrower approach in Whitehouse v. Carlton Hotel Pty Ltd(82). The majority of the court said:
In this court, the preponderant view has tended to be that the allotment will be invalidated only if the impermissible purpose or combination of impermissible purposes can be seen to have been dominant... The cases in which that view has been indicated have not, however, required a determination of the question whether the impermissible purpose must be the substantial object or moving cause or whether it may suffice to invalidate the allotment that it be one of a number of such objects or causes. As a matter of logic and principle, the preferable view would seem to be that, regardless of whether the impermissible purpose was the dominant one or but one of a number of significantly contributing causes, the allotment will be invalidated if the impermissible purpose was causative in the sense that, but for its presence, 'the power would not have been exercised'.

5.3.5. The Proper Purpose Doctrine and share allotment

The proper purpose doctrine plays a major role in the field of share allotments. Generally, directors have the power to allot shares. This power, is in fact, restricted by S.80(1) CA 1985. The section provides that the directors are not allowed to exercise the power to allot shares unless they are authorised to do so by the company in general meeting or by the articles of association. So, if directors are not authorised to allot shares by the company's articles they have to seek an authorisation by the company in general meeting to allot shares. However, the power to allot shares must be exercised for proper purposes. Economic, social, and political considerations may be taken into account by directors to decide whether an allotment of shares
should be made or not. Berger J. in Teck Corporation Ltd. v. Millar, stated that directors are entitled to consider the reputation, policies, and the experience of those who are willing to take over the company. Berger J. also said:

... the directors ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interests if the company is taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorised as improper.

Purpose of Issuing Shares

In the early cases the purpose of issuing shares was only to raise the company's capital when it was required. So, the courts held that to issue shares for any other purpose would be invalid. In Punt v. Symons & Co. Ltd, the directors had issued new shares to five additional members in order to secure the passing of a special resolution. Byrne J. said that the primary purpose for which the power to issue shares might be exercised was to raise the capital. The judge found that in the present case this power was not bona fide exercised to achieve that purpose or to benefit the company. On the contrary he was satisfied that the directors used that power to secure the necessary statutory majority for passing a special resolution. Accordingly, he held that their exercise of power could
not be allowed to stand. Similarly, in Piercy v. Mills & Co. Ltd\(^{(89)}\), the court held that issuing shares for the purpose of depriving the existing majority shareholders of their voting control was invalid.

If the purpose is found to be improper, the bona fides of directors will not validate their acts. In Hogg v. Cramphorn Ltd\(^{(90)}\), the directors had issued shares with special voting rights to the trustees in order to upset a particular take-over bid. The court found that the directors were acting in good faith but the purpose which they achieved was improper. Buckley J. said:

\[
\text{[The directors']} \text{ primary purpose was to ensure the control of the company by [them] and those whom they could confidently regard as their supporters}^{(91)}.\]

Allocation of shares will be invalid if its purpose is to destroy an existing majority. In Howard Smith v. Ampol Petroleum Ltd\(^{(92)}\), A Co. and S Co. made two rival bids for M Co. M's board of directors rejected A's bid. A Co. and B Co. who held the majority shares in M Co. proposed to reject all offers for their shares. M's directors preferred S Co.'s bid and so they issued a large number of shares to S Co. which had the effect of displacing the A/B Co. controlling holding. The learned judge found that the directors had intended to destroy the existing majority. The Privy Council upheld that judgment and held that such exercise of power by the
directors was a misuse of fiduciary powers and should be set aside(93).

In addition it was held that issuing shares by directors for the purpose of benefiting themselves financially is invalid(94). However, this does not mean that in the absence of any element of self interest the issue of shares is valid. The Privy Council in the Howard Smith case(95) stated:

Self interest is only one, though no doubt the commonest instance of improper motive; and, before one can say that a fiduciary power has been exercised for the purpose for which it was conferred, a wider investigation may have to be made(96).

However, the principle which states that the power to issue shares must be exercised only for the purpose of raising a company's capital, has been correctly criticised in many cases. For example, in the Howard Smith case(97), Lord Wilberforce said:

It was too narrow an approach to say that the only valid purpose for which shares may be issued is to raise capital for the company. The discretion is not in terms limited in this way; the law should not impose such a limitation on directors' powers(98).

In some Commonwealth cases, the courts upheld the directors' exercise of power to issue shares although their purpose was not to raise capital for the company. In Harlowe's Nominees Pty Ltd v. Woodside Oil Co. (99), an issue of shares which was intended to secure the financial stability of the company was held to be valid despite the fact that it had the effect of defeating an
attempt to secure control of the company. In Teck Corp. Ltd v. Miller(100), the directors allotted shares to a single allottee to enable the company to enter into the best possible contract which the directors bona fide considered as beneficial to the company. The court upheld the directors' act despite the fact that it had the effect of changing a take-over bidder's majority holding into a minority(101).

As is mentioned above, where there is more than one purpose the court will examine the substantial or the primary purpose. If it finds that the primary purpose is legitimate, the directors' action will not be invalidated even if an additional subsidiary purpose has been achieved.

If it is found that the directors exercise their power to issue shares for improper purpose, can the company ratify their action in general meeting? According to the decisions in Hogg v. Cramphorn Ltd. (102), and Bamford v. Bamford(103), the company is entitled to ratify such an action by an ordinary resolution in general meeting. This, of course, will prevent the minority shareholders from bringing a derivative suit on behalf of the company against the directors. But, if the directors' action amounts to a fraud on the minority(104), an action in respect of which can be brought by the minority shareholders against the directors.
FOOTNOTES

1) See Re Smith & Fawcett Ltd [1942] Ch. 304 at 306 Per Lord Greene. The company's articles of association is the instrument which creates the powers of directors. The directors' powers are given to achieve specific aims. Thus, directors must exercise their powers to achieve the intended aims. If they exercise their powers to achieve objects beyond the scope of the purposes for which those powers are given, this exercise of power can be considered as for an improper or for a collateral or an unauthorised purpose. For example, the directors who exercise the power to issue shares for the purpose of defeating a take-over bid and thus maintaining the board and their allies in control, were held liable for the breach of their fiduciary duty which was to act in the interest of the company and not for an improper purpose: Hogg v. Cramphorn [1967] Ch. 254.

Directors are also not entitled to exercise the power to issue shares for the purpose of destroying an existing majority or to prevent it from its voting control: Piercy v. Mills & Co Ltd [1920] 1 Ch. 77.

2) Professor Gower said that while the former case amounts to a breach of fiduciary duty, the latter "hardly seems to be a breach of the fiduciary duty of good faith". See Gower L. Principles of Modern Company Law, 4th ed, 1979, pp.580-81.


4) [1942] Ch. 304 at 306.


7) [1967] 1 All E.R. 427.

8) [1990] B.C.C. 600, see Hoffmann J.

9) [1942] Ch. 304.

10) It has been said that the subjective test of bona fides entrenches the directors discretionary powers to an unacceptable degree. If the articles of association are drafted widely enough, the result will be that the directors will obtain an uncontrolled and an absolute discretion: See Farrar's Company Law, 2nd ed, [1988]. However, it would seem that the subjective test is a fair one. The guide of the director under this test is his conscience. It is his conscience that directs him to consider a specific transaction as being in the interests of the company or not. However, because this test deals with the intentions or the consciences of directors which exist deep inside them as human beings, it could be argued that it does not form an absolutely accurate formula.

16) Parsons R. "The Director's Duty of Good Faith", [1965-7] 5 Mel. Univ. L. R. 395. However, it is said that "Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational": per Bowen LJ. in Hutton v. West Cork Railway Co., [1883] 23 Ch. D. 654 at p.671. However, "where the self-interest of the directors is involved, they will not be permitted to assert that their action was bona fide thought to be, or was, in the interest of the company": per Lord Wilberforce in Howard Smith Ltd. v. Ampol Petroleum Ltd. [1974] A.C. 821 at p.834; see Lee Panavision Ltd. v. Lee Lighting Ltd. [1991] The Times, 25 June; see generally, Fox, "Contrasting the Powers of Directors" [1991] 12 Co. Law. Dig. 153.
18) However, Professor Gower said that it may be argued that a directorship is a "recognised office of profit": Principles of Modern Company Law, 4th ed, [1979], at p.603.
19) [1938] 60 C.L.R. 150.
20) [1938] 60 C.L.R. 150 at p.164.
22) For example, the case where a director has been appointed by a shareholder or shareholders to act as agent on their behalf in respect of a specific transaction. Directors' duties to individual shareholders will be discussed in Chapter 7.


28) C 1970 3 Ch 62 at p.74. But see Walker v. Wimborne [1976] 50 A.L.J.R. 446 where Mason J. said that the argument that the group may derive a benefit from the transaction tends to obscure the fundamental principles that each company in the group constitutes a separate legal entity and it is the duty of the directors of each company to consult its interests alone.

29) Per Lindley MR. in Allen v. Gold Reefs of West Africa Ltd. [1900] 1 Ch. 656, CA.

30) [1951] Ch. 286.

31) [1951] Ch. 286 at p.291. Professor Sealy said that Lord Evershed MR's view was undoubtedly both correct and sound. But he said that the better view was to say that the phrase "in the interest of the company" could mean different things in different contexts. In some situations, the shareholders may find it in the best interests of the company to focus on its interests as a commercial entity: Sealy L. "Bona fides" and 'Proper Purposes' in Corporate Decisions", [1989] 15 Monash L. R. 265.

32) Second Savoy Hotel Investigation, Report of the Inspector [1954] H.M.S.O at p.16. This case never reached the courts. In that case Sir Milner Holland was appointed to investigate the affairs of the Savoy Hotel Ltd. and the Berkeley Hotel Company Ltd. The directors of Savoy Hotel Ltd., in that case, attempted to prevent Berkeley Hotel Co. Ltd. from controlling the company so as to frustrate a particular take-over bid.


35) [1971] Ch. 317.


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37) [1988] 4 B.C.C. 305.
38) See per Evershed Mr. in Greenhalgh v. Ardenes Cinema Ltd. [1951] Ch. 286 at p.291; see also S.309 CA 1985.
51) See per Buckley LJ. in Gramophone & Typewriter Ltd. v. Stanley, [1909] 1 Ch. 311 at p.319; per Lord Wilberforce in Howard Smith Ltd. v. Ampol Petroleum Ltd., [1974] A.C. 821, at p. 837. In that case Lord Wilberforce said: "Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders, and indeed that the majority of the shareholders cannot control them in the exercise of these powers while they remain in office . . . ".
44) [1971] Ch. 317.
45) [1989] 1 All E.R. 798.
46) see the decision of the House of Lords in Caparo Industries plc v. Dickman [1990] 1 All E.R. 568, [1990] 2 A.C. 605; see Chapter No. 6.
47) [1990] 1 All E.R. 148.
48) See Chapter No. 6 and Chapter No. 7.
49) [1938] 60 C.L.R. 150 (Aust. H. C). This case has been discussed earlier in this chapter.
50) [1970] Ch. 62.
51) [1970] I W.L.R. 1167.
52) The holding company, at that case, held 70 per cent. of the shares of the subsidiary. See Palmer's Company Law, vol. (1), [1987].
54) [1970] Ch. 62.
55) Directors' duties and liabilities to a company's creditors will be examined in Chapter No. 8.
56) For more detail about this argument and similar arguments see Dodd, "For Whom Are Corporate Managers Trustees?" [1932], 45 Harv. L. Rev. 1145; see also Berle, "For Whom Corporate Managers Are Trustees", [1932] 45 Harv. L. Rev. 1365.
60) See Parsons R. "The Director's Duty of Good Faith", 

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64) [1942] Ch. 304, CA.


66) Berger J.'s view has been supported by some commentators. See for example Sealy L., "Company-Directors' Powers: Proper Motive but Improper Purpose", [1967] C.L.J. 33, who argues that only the subjective element should be regarded. On the contrary, there are some who argue that only the objective element should be regarded. Franzi N., for example, argues that the decision to issue shares should only be examined objectively. The directors' beliefs should be ignored as irrelevant, because of the difficulties of proving or establishing malafide. See Franzi N. "The Subjective and Objective Elements of a Company Board's Power to Issue Shares", [1975-6] 10 Mel. Univ. L. R. p.392.

67) [1974] A.C. 821, FC; see also Exco Corporation Ltd v. Nova Scotia Savings & Loan Co. [1987] 78 N.Sr (2d) 91, in which the court, despite the directors' bona fides, held that the exercise of power for an improper purpose was invalid. This view has been accepted by Goulding J. in Mutual Life Insurance Co. of New York v. The Rank Organisation Ltd, [1985] BCLC 11. For more details about the contradiction between Teck and Haward Smith see Bennun M. "Directors Powers To Issue Shares: Two Contrasting Decisions", [1975] 24 I.C.L.Q. p.359.

68) [1962] Ch. 927.


70) [1854] 5 De G M & G 284, at p.298. See also Rolled Steel Products (Holdings) Ltd v. British Steel Corp. [1986] Ch. 246.


See Nagurli Ltd v. McCann, [1953] 90 C.L.R. 425 at 440; see also Mills v. Mills, [1938] 60 C.L.R 150. In Howard Smith Ltd v. Ampol Petroleum Ltd, [1974] A.C. 821, Lord Wilberforce referred to the "substantial purpose" as an important point to probe the directors' motives where they are motivated by more than one purpose. His Lordship indicated that regard is to be had to their primary purpose in deciding whether the court will intervene.

The Privy Council in Howard Smith v. Ampol Petroleum Ltd, [1974] 1 All E.R. 1126 approvingly quoted this test (see this at p.1133.

It is to be noted that the proper purpose doctrine applies to the exercise by directors of all their powers and not only to the allotment of shares. So, this doctrine applies for example to the power to expel a company's member: Gaiman v. National Asso. for Mental Health, [1971] Ch. 317, [1970] 2 All E.R. 362. It also applies to the power to refuse to register a transfer of shares: Re Smith & Fawcett Ltd., [1942] Ch. 304, [1942] 1 All E.R. 542, (CA).


[1903] 2 Ch. 506.

[1920] 1 Ch. 77.

[1966] 3 All E.R. 420. (Chancery Division).

[1966] 3 All E.R. 420 at p.427; see also Ashburton Oil NL v. Alpha Minerals NL, [1971] 123 C.L.R. 614, (High Court of Australia); cf: Teck Corp. Ltd. v. Millar, [1972] 33 D.L.R. 288 where it was held that directors were entitled to frustrate a take-over bid so long as they were acting in good faith. For more detail about the contradiction between the Hogg case and the Teck case see Sarre D. "Director's Powers and the Proper Purposes", [1974] J.B.L. 85; see also Bennun M. "Directors' Powers to Issue Shares: Two Conflicting Decisions", [1975] 24 I.C.L.Q. 359.


See Ngurli Ltd v. McCann, [1953] 90 C.L.R. 425 (High
Court of Australia).

95) [1974] 1 All E.R. 1126.
96) [1974] 1 All E.R. 1126 at p.1133.
97) [1974] 1 All E.R. 1126.
98) [1974] 1 All E.R. 1126 at p.1133. However, even in some old cases the judges indicated that raising capital may not be the only purpose for the allotment of shares. For example in Punt v. Symons & Co. Ltd, [1903] 2 Ch. 506, Byrne J. said that "there may be occasions when the directors may fairly and properly issue shares . . . for other reasons" (at p.516). So, shares can be issued to defeat a corporate looter, or to foster the company's business connections: see Farrar's Company Law, 2nd ed, [1988], p.335.
99) [1968] 121 C.L.R. 983.
102) [1967] Ch. 254.
103) [1970] Ch. 212.
CHAPTER 6

DIRECTORS' DUTIES OF SKILL AND CARE

6.1. Introduction

Directors owe fiduciary duties to their companies. They may also owe their companies a duty of care and skill at common law. The test of determining the existence and scope of the duty of care has gone through different stages of development over a short period of time. This chapter is divided into two main parts: (I) The development of the law of negligence until Caparo Industries plc v. Dickman(1). (II) Directors' duties of skill and care and the effects of the development of the law of negligence on those duties.


6.2.1. The Position Before and After Donoghue v. Stevenson(2)

Before 1932 there was no general rule defining the relationships between pursuers and defenders, that give rise to a duty of care. In other words, there was no general rule upon which the courts might rely in
order to determine the existence of a duty of care in all circumstances\(^3\). In giving their decisions, on a case before them, the courts relied on recognisable categories of situations as guides to the existence of a duty of care. This approach can be called the "duty-situation"\(^4\) approach, according to which, a duty of care could be held to exist "only where the case [could] be referred to some particular species which ha[d] been examined and classified"\(^5\).

The leading case of Donoghue v. Stevenson\(^6\), represented a milestone in the field of negligence law. The majority of the House of Lords swept away the "duty-situation" approach, and moved towards establishing a single general principle against which the existence of a duty of care could be tested. The majority of Lords emphasised the impossibility of cataloguing the relationships between pursuers and defenders in which a duty of care might arise\(^7\). The most important judgment in the Donoghue case, is Lord Atkin's. His Lordship laid down the first single general principle, in the history of the law of negligence, in Britain, in relation to the existence of a duty of care. The object of this principle, which is known as the "neighbourhood" or "foreseeability" principle, is to determine the existence and the scope of a duty of care in a given case without testing it in the light of previously
decided cases. Lord Atkin explained this novel principle as follows:

You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who then, in law, is my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question.

Although the "neighbourhood" principle was widely applied to cases of physical damage, it was not free from criticisms. It was considered as being inadequate to determine, solely, the existence of a duty of care in cases involving non-physical injuries (e.g., where the loss suffered was pure economic loss). The courts were, in fact, willing to restrict the "neighbourhood" principle by introducing the so-called "public policy" or "public interest" or the "demands of society". The purpose of introducing those elements is to limit the scope of liability or to negate the liability altogether. Policy factors had been clearly expressed by Lord Morris in Dorset Yacht Co. Ltd v. Home Office. His Lordship said:

I doubt whether it is necessary to say, in cases where the court is asked whether in a particular situation a duty existed, that the court is called on to make a decision as to policy. Policy need not be invoked where reason and good sense will at once point the way. If the test whether in some particular situation a duty of care arises may in some cases have to be whether it is fair and reasonable that it should so arise the court must shrink from being the arbiter.
Likewise, Lord Keith, in Peabody Donation Fund v. Sir L. Parkinson & Co.(13), said that for a duty of care to arise it must be "fair and reasonable" to impose the duty on the defendant in a case before the court.

The most important and comprehensive attempt to state a test for a duty of care was reached by Lord Wilberforce in Anns v. Merton London Borough Council(14). His Lordship introduced a single general test to determine the existence and scope of a duty of care in all circumstances and made an explicit reference to policy considerations. His Lordship said:

"... in order to establish that a duty of care arises in a particular situation, it is not necessary to bring the facts of that situation within those of previous situations in which a duty of care has been held to exist. Rather the question has to be approached in two stages. First one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage, there is a sufficient relationship of proximity or neighbourhood such that, in the reasonable contemplation of former, carelessness on his part may be likely to cause damage to the latter, in which case a prima facie duty of care arises. Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed or the damages to which a breach of it may give rise(15)."

The Privy Council remarked, in Yuen Kun-Yeu v. Att.-Gen. of Hong Kong(16), that the first stage of Lord Wilberforce's test conceals two separate elements: "foreseeability of the harm" and "a close and direct
relationship of proximity" between the parties(17). Lord Wilberforce's test was a flexible one. It had been applied to many cases and the courts relied upon its flexibility to determine new areas of liability(18).

The decision in the Anns case represented another development in the field of the law of negligence. It imposed liability in cases of, and allowed damages for, a pure economic loss(19). It is to be noted, however, that many judges have taken a hostile attitude towards the idea of imposing liability in cases of pure economic loss; but more so towards articulating a single general rule to determine the existence and scope of a duty of care.

More significantly, the House of Lords "have emphasised the inability of any single general principle to provide a practical test which can be applied to every situation to determine whether a duty of care is owed and, if so, what is its scope"(20).

Thus, for example, in Yuen Kun-Yeu v. Att.-Gen. of Hong Kong(21), Lord Keith remarked:

\[\ldots\] their Lordships consider that for the future it should be recognised that the two-stage test in Anns is not to be regarded as in all circumstances a suitable guide to the existence of a duty of care(22).

Also, in Hill v. Chief Constable of West Yorkshire(23), Lord Keith, again, gave a clear signal that the courts were willing to move away from any single general principle of liability and return to a "Categories-
based" or a "duty-situation" approach. His Lordship advocated that foreseeability is not, in itself, capable of creating a sufficient relationship of proximity. His Lordship added that in order to establish the relationship of proximity, "some further ingredient is invariably needed . . . and all the circumstances of the case must be carefully considered and analysed in order to ascertain whether such an ingredient is present. The nature of the ingredient will be found to vary in a number of different categories of decided cases(24).

Similarly, in Sutherland Shire Council v. Heyman(25), Brennan J. said:

"It is preferable in my view, that the law should develop novel categories of negligence incrementally and by analogy with established categories, rather than by a massive extension of a prime facia duty of care restrained only by indefinable 'considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed'(26)."

6.2.2. The Position After the Caparo(27) case

More recently, the House of Lords in Caparo Industries plc v. Dickman(28), adopted the old approach (i.e. the "duty-situation" approach), thus, abandoning the modern approach, which examines the existence of a duty of care against a single general principle of liability. The facts of the Caparo case were as follows: The auditors carried out an audit which they were required to prepare within the terms of S.236 and S.237 CA 1985. The plaintiffs made a successful take-over bid for the company in question. They relied on the auditors'
report which turned out to be inaccurate and misleading. The plaintiffs brought an action against the auditors alleging that they had made the bid in reliance on the auditors' misleading reports and, consequently, they suffered financial loss. The majority of the Court of Appeal made a distinction between the position of the current shareholders who bought additional shares in the company and that of non-shareholder potential investors. It held that the auditors owed a duty of care to the former class but not to the latter. The House of Lords rejected this distinction and held that in this particular case the auditors owed no duty of care to either the present shareholders or potential investors. The House stated that: (1) Foreseeability, no matter how high, that a potential investor might rely on the audited account, is not enough to found a duty of care. That is because of lack of proximity between the parties. (2) A sufficient relationship of proximity between the parties, in cases involving economic loss caused by negligent statement or negligent advice, exists if:

(a) the advisee or the recipient of the statement is an identified person; (b) the purpose, for which the advice is given or for which the statement is made, is a known one. In other words, the advisor is aware of the purpose of the advice; (c) the advisor or the giver of the statement is aware (actually or inferentially) that
the advisee or the recipient of the statement is going to rely on the advice or the statement given; and, (d) the advisee or the recipient of the statement relied on and acted upon the advice or the given statement to his detriment (30).

In the Caparo case, the House of Lords held that the auditors owed no duty of care to the plaintiffs. The House based its decision on the ground that the purpose of making an audit in that case was not to assist shareholders in their role as investors, but to enable them to exercise their class rights in general meetings. One may argue, however, that the decision of the Caparo case is not entirely correct. If the auditors prepared a profit forecast, why should not, at least, the current shareholders be entitled to rely on it to make further investments in the company?. This argument seems more convincing in cases of rights issues. If a company issued a prospectus inviting its shareholders to subscribe for shares by way of a rights issue, why should not the shareholders be entitled to rely on that prospectus in order to buy further shares (31)?.

Accordingly, one is of the opinion that accountants "must have appreciated that accounts which [they] prepared might be used for a variety of purposes in connection with the business of the company" (32). In other words, while it is correct to say that the purpose of the audited accounts is to enable the shareholders to
exercise their class rights in general meetings, it is not correct to say that it is the sole purpose. Subscription for shares is an important element for the continuity of the companies' life. In order to prompt individuals to buy shares, it is important for a company to tell them something about its financial status. Audited accounts and the profit forecast are means by which individuals can be prompted to subscribe for shares. If the individuals know nothing about a particular company, how can they have the motive to invest their money by buying shares in that company? So, it would seem that the individuals, whether existing or potential shareholders, should be entitled to rely on the audited accounts and the profit forecast. In addition, the Companies Acts require that annual reports be sent to preference shareholders although they, generally, have no voting rights\(^{33}\). This fact emphasises that the annual reports and the audited accounts might be used for a variety of purposes and not only for the purpose of enabling shareholders to exercise their class rights in general meetings. In cases of negligent accounts, however, directors could escape liability if they placed reasonable reliance on the expertise of the accountants and there were no grounds for suspicion as to the accuracy of those accounts\(^{34}\).
What is to be emphasised in the Caparo case is the attitude of the House of Lords towards the idea of creating a single general principle to test the existence and scope of a duty of care in all circumstances. The House took a hostile stand against this idea. Their Lordships' rejection of any single principle to determine the existence of a duty of care, represents the adoption of the old approach (i.e., the "duty-situation" approach). In his speech in the Caparo case, Lord Bridge said:

I think the law has now moved in the direction of attaching greater significance to the more traditional categorisation of distinct and recognisable situations as guides to the existence, the scope and the limits of the varied duties of care which the law imposes(35).

The House of Lords, however, affirmed the general elements of a duty of care which apply in all circumstances. That is, foreseeability of harm, proximity and whether it is "fair, just and reasonable" to impose the duty(36). But the House, emphasised the concealing nature of concepts like "proximity" and "fairness". Lord Bridge said:

... the concepts of proximity and fairness ... are not susceptible of any such precise definition as would be necessary to give them utility as practical tests, but amount in effect to little more than convenient labels to attach to the features of different specific situations which, on a detailed examination of all the circumstances, the law recognises pragmatically as giving rise to a duty of care of a given scope(37).
The effect of the decision in Caparo on future litigation is as yet unclear. It is argued\(^{(38)}\), however, that the adoption of the "duty-situation" approach "may have brought less, not greater, certainty to the law"\(^{(39)}\). One is inclined to agree with this view for the following reasons: (1) The flexibility of a single general principle of liability gives the courts a wide discretion. "Policy considerations" and "just, fair and reasonable" are concepts capable of relaxing the general principle and giving it a flexible nature. (2) Establishing a single general principle of liability is a practical approach. The courts can apply this principle to determine the existence of a duty of care and its scope in a given case without bringing its facts within "those of previous situations in which a duty of care has been held to exist"\(^{(40)}\). (3) In the long term, cataloguing the situations in which a duty of care may arise is a difficult task and an impractical idea. The courts may find themselves, in the future, faced with a long list of duty-situations or categories of negligence. (4) The "duty-situation" approach conceals a self-destructive nature. This approach is, mainly, based on the argument that the existence of a duty of care in a given situation could not be justified unless it had been declared as such in a previous occasion. The absurd result is that the first case which was decided in the field of negligence law, and in which a
duty of care was held to exist, must be wrongly decided. That is because it was decided without precedent (41). In Murphy v. Brentwood District Council (42), their Lordships emphasised that any case without precedent is tantamount to "judicial legislation" and is liable to be overruled at any time. This judgment, in fact, creates great uncertainty in the law of negligence. Any case, according to this judgment, which declares the existence of a duty of care in any new situation, can be overruled at any moment, by a subsequent judgment. (5) It would seem that the "duty-situation" approach restricts the courts' discretion. If the facts of a case, before the court, have to be brought within those of previously decided cases, the court will not be able to go beyond the borders of those previous cases. In other words, the courts will not be able to justify any new extension of negligence beyond the scope of the previously decided cases.

In the post Caparo decision, Al-Nakib Investments (Jersey) Ltd. & Another v. Longcroft and Others (43), the court took a restrictive approach towards the liability of company's directors to potential investors. In that case, the defendants were directors of M. Ltd., which was a subsidiary of C. plc. The latter issued a prospectus inviting its shareholders to invest in M. Ltd by way of a rights issue. The plaintiffs took advantage of the rights issue and bought shares in M. Ltd.. The
plaintiffs alleged that a number of statements in the prospectus were untrue and misleading. They claimed damages for negligence. The defendants argued that they owed no duty of care to the plaintiffs in relation to the purchase of shares in the market. The court accepted this argument and based its decision on the ground that the purpose for which the prospectus was issued was to encourage subscription to the rights issue; purchase of shares in the market was not the "particular transaction" for which the prospectus was issued. Mervyn Davies J. 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(44).

The decision of the court in that case is a clear application of the decision of the House of Lords in the Caparo case. The court emphasised the purpose of the directors' act as a crucial matter.

To the contrary, a less restrictive approach was taken by the Court of Appeal in Morgan Crucible Co. plc. v. Hill Samuel and Co. Ltd(45). In that case, the plaintiff company MC announced a take-over bid for another company FCE. Before declaring the bid the chairman of MC asked the chairman of FCE to confirm FCE's profit forecast for the year to January 1986. The chairman of FCE did not reply. Thus, MC relied on an unconfirmed profit forecast and made its first bid. Two
days after the announcement of the bid, the chairman of FCE sent to the shareholders the first of a series of circulars. All of these circulars were comparing the profit record of MC unfavourably with that of FCE and recommending that the offer be refused. Later on, FCE issued another circular which contained a very favourable profit forecast together with a statement made by the accountants confirming that the forecast had been compiled in accordance with FCE's stated accounting policies. The forecast was also coupled with a statement from a bank indicating that it had been made after due and careful inquiry. MC relied on this forecast and increased its bid. The new bid was accepted by FCE's shareholders. MC claimed that the accounting policies adopted in the pre-bid financial statements and the profit forecast were negligently prepared and were misleading and grossly overstated the profits of FCE. It also claimed that FCE was worthless at the time the bid was made and had it known this fact it would never have made the bid. MC claimed damages in negligence from the defendants. The accountants of FCE and its directors were among the defendants. At the trial, Hoffman J. saw the case as indistinguishable from the Caparo case. He attached great importance to the City Code on Take-overs and Mergers. The judge referred to some of the Code's rules and said that it was clear from those rules that the purpose of the profit forecast
and the statements made by the defendants was to advise shareholders whether to accept the bid or not. Their purpose was not to assist MC in its role as a bidder or an investor. Accordingly, Hoffman J. held that the defendants owed no duty of care to the plaintiffs. The Court of Appeal took a less restrictive approach. It took the view that since (1) the defendants intended the plaintiffs to rely on the pre-bid financial statements and the profit forecast for the purpose of deciding whether to make an increased bid; and, (2) the plaintiffs did so rely on those statements and the profit forecast and increased their bid, it was plainly arguable that there was, as between the plaintiffs and the defendants, a sufficient relationship of proximity to create a duty of care. The court, however, did not hold that the defendants owed a duty of care to the plaintiffs. It only decided that the plaintiffs' claim was not bound to fail. The Court of Appeal made it clear that a duty of care could be negated if it was found that it would not be just and reasonable to impose it on the defendants. What is important in the decision of the Court of Appeal in the Morgan case, is the flexible approach taken by the court in relation to the "purpose" requirement. Slade L.J. stated that the City Code would require further analysis at the trial. His Lordship added that the court assumes that the Code does not "explicitly envisage that persons concerned in
preparing [companies' reports, accounts and profit forecasts] will owe a duty of care to potential or actual bidders"(47). Thus, the Court of Appeal did not assume that the Code contemplated purposes such as the assistance of bidders. Rather, it attached great significance to the intention of the defendants when they made the statements and the profit forecast. The defendants were identified bidders. So, the court stated that "on the assumed facts the defendants intended that the defence documents should be relied on for the specific"(48) purpose of deciding "whether or not to make an increased bid"(49). Slade L.J remarked that the inducement of the plaintiffs to increase their bid was "one of the purposes of the defence documents and the representations contained therein"(50).

It is worth noting that in the Morgan case, neither the judge at the trial nor the Court of Appeal gave any attention to the fact that the chairman of the target company recommended that the first bid be refused. The impact of that recommendation was not discussed by Hoffman J. at the trial or even by the Court of Appeal. It might be argued, however, that this recommendation was no more than a manoeuvre made by the chairman of the target company to induce the plaintiffs to make an increased bid. But what would be the position if the shareholders of the target company refused the first bid? It could be argued that, had the first offer been
refused by the shareholders of the target company, this refusal would have formed an effective defence in favour of the defendants. In one's opinion, such refusal was capable of extinguishing that offer. Consequently, it would seem that after the extinction of that offer the plaintiff could not be, correctly, described as an actual or an identified bidder. The bidder, in such a case, becomes a potential bidder to whom the defendants owe no duty of care according to the House of Lords decision in the Caparo case\(^5\).

The law of negligence has been subjected to another development. The House of Lords, in Murphy v. Brentwood District council\(^52\), overruled the decision of Anns v. Merton Borough Council\(^53\). In the Murphy case, the House held that, when carrying out its statutory functions, a local authority was not liable in negligence for the cost of remedying defects in a building resulting from the failure of the local authority to ensure that the building was erected in conformity with the applicable standards prescribed by the building regulations or bye laws unless the loss suffered was coupled with a physical damage. So according to the decision of the Murphy case, a pure economic loss is irrecoverable. It is not, however, the subject of this chapter to discuss the impact of the Murphy case in detail. Suffice to say, that there is ground for dissatisfaction with the decision of the
House of Lords in that case. The reason is that, economic interests deserve and need protection as much as personal or physical interests.

6.3. Directors' Duties of Care and Skill and the Effects of the Developments of the Law of Negligence on these duties

Generally speaking, a breach of duty of care might arise from gross negligence, ordinary negligence or even from inactivity. In discharging his duties a director must act honestly; "but he must also exercise some degree of both skill and diligence"(54). In the past, it had been laid down that the degree of negligence, needed to impose liability on a company's director, was said to be "culpable" or "gross negligence"(55). The reason for this have been said to be historical(56). Directors were, mainly, part-time officers. They did not posses any special skills. Those considerations were taken into account by the courts in many cases(57). Consequently, the courts found it unreasonable to impose upon those amateur directors an onerous standards of care and skill. Professor Farrar(58) has said that the courts' reluctance to investigate the internal management of the company and to assess the managerial skills of an individual director was another reason for not imposing an onerous standard of skill upon
directors. While it is correct to say that shareholders, who appointed amateur directors, must bear the risk that this argument ignores the negative effects of corporate collapse on creditors, employees, and society as a whole. The courts, however, found a great difficulty in drawing a line between "gross" negligence and the mere "negligence". In Re Brazilian Rubber Plantations and Estates Ltd., Neville J. pointed out that such a distinction could not be made without determining the extent of the duty which it was alleged to have been neglected. In Re City Equitable Fire Insurance Co. Ltd., Romer J. confessed that he found some difficulty in understanding the difference between those two types of negligence, except in so far as those expressions were used for the purpose of distinguishing between two kinds of duties owed in two separate situations. In Wilson v. Brett, Baron Rolfe J. said: "... I could see no difference between negligence and gross negligence - that it was the same thing, with the addition of a vituperative epithet." In the Scottish case of Hunter v. Hanley, the Lord President stated:

In relation, however, to professional negligence, I regard the phrase "gross negligence" only as indicating so marked a departure from the normal standard of conduct of a professional man as to infer a lack of that ordinary care which a man of ordinary skill would display.
Thus, the Lord President saw no distinction between "gross negligence" and "negligence". It should be noted, however, that the theory, which distinguished between "gross negligence" and ordinary negligence, and which emanated from Roman Law, has been abandoned. It would seem, however, that the distinction between the ordinary negligence and gross negligence lies in the degree of diligence shown by a director rather than in the type of the duty omitted or breached. That is, a negligence can be described as "gross" if it may not be committed even by a highly negligent person. Whereas, an ordinary negligence is that which may not be committed by an ordinary man of ordinary skills. There is also a third degree of negligence which is the vapid negligence, and which may not be committed by a prudent man(68).

In relation to directors' duty of care and skill and the standard of skill, the most important case is Re City Equitable Fire Insurance Co. Ltd(59). In this case, Romer J. deduced from the early cases three general propositions(70). These propositions form principles to govern directors' duty of care and skill. The first proposition deals with the standard of skill applied to directors. The second one deals with the degree of diligence required from a director. Whereas the third proposition has been laid down to govern cases involving directors' delegation of functions.
The first proposition provides:

A director need not 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(71).

The proposition makes it clear that directors are not liable for "honest mistakes" of judgment(72), and the applicable test is a subjective one(73). So, a director's knowledge, skills and experience will be taken into account, and they are in fact crucial elements. Those considerations confer on the test a subjective nature. The test is not objective because, it is submitted that, directorship is not a profession; directors do not form an "homogeneous category"(74). Thus, the concept of "reasonable director" cannot be applied, or more precisely, is not to be found. However, Professor Gower argues that the test laid down by Romer J. "is partly objective (the standard of the reasonable man), and partly subjective (the reasonable man is deemed to have the knowledge and experience of the particular individual)"(75). With respect, it would seem that the test is purely subjective since the degree of skill is judged depending upon the personal knowledge and experience of the defender rather than the knowledge and experience of a reasonable man carrying out the same functions. A test consists of two elements (i.e. subjective and objective) is found in S.214 of the Insolvency Act 1986(76).
It has been suggested that in the presence of a service contract between a director and his company, an implied term requiring him to show reasonable skill and care, "objectively assessed", is likely to be read into that contract.

A clear application of the first proposition is found even before the Re City Equitable Fire case. It is found in Re Brazilian Rubber Plantations and Estates Ltd. In that case, the directors of a rubber company were in complete ignorance of the rubber industry. Despite this fact, they were held not liable in negligence for losses resulting from rubber speculations. If a director, however, possesses some experience and knowledge, he is obliged to give the company the advantage of his knowledge. But, if he is a professional and appointed by the company in his capacity as such, then, he must exercise the skill and care which are reasonably be expected from a competent member of that profession.

The second proposition deals, as mentioned before, with the degree of diligence required from a director. Romer J. said:

A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.
The implication of this proposition is that a director's non-attendance at general meetings cannot form a sufficient ground for holding him liable for losses suffered by the company as a result of that non-attendance. That is because a director is not required to give continuous attention to his company's business. A director is, however, obliged to attend board meetings "whenever, in the circumstances, he is reasonably able to do so" (80). Another implication of Romer J.'s second proposition is that a director who failed to prevent other directors making unwise or even fraudulent appropriation of the company's assets, should not be held liable merely because his failure resulted from his absence at board meetings (81). In Re Cardiff Savings Bank, Marquis of Bute's case (82), the president of the Bank attended only one board meeting in 38 years. Despite that, he escaped liability for losses resulting from irregularities in the bank's operations. The court observed that the omission to attend board meetings was not the same as the neglect or omission of duties which ought to have been performed at any such meeting. In the Re City Equitable Insurance case, the court attached no blame to one of the directors who was living in Aberdeen and who found it difficult to attend board meetings in London. In some other cases, however, the courts had adopted a tougher stand towards inactive
directors. For example, in *Re Charitable Corp. Sutton* (83), only five out of some 50 committee men were actively involved in the running of the company in question. Those active directors caused the company to lose a large sum of money. The remaining 45 committee men were held guilty of gross negligence, because their inactivity enabled the other five to cause the company financial losses.

One is, however, prompted to say that, in addition to the company's interests, there are some other interests which deserve protection, namely, the interests of a company's creditors and employees. Those interests can be better served by asking directors to attend board meetings and to give a reasonable attention to their companies' affairs. So, it is agreed with Byrne J. that a director who accepts a directorship must understand that this is a position involving "duties which cannot be shirked by leaving everything to others" (84). More recently, in *Winkworth v. Edward Baron Development Co. Ltd.* (85), the House of Lords indicated its lack of sympathy for directors who plead ignorance of their duties and fail to exercise the powers vested in them where their failure caused the creditors to sustain loss. Nowadays, under S.6 of the Company Directors Disqualification Act 1986, the court may consider the inactivity of a director of an insolvent company, a ground sufficient for disqualifying him (86). In the
presence of a service contract between a director and his company, the former may not be able to avail himself of the "relaxed regime advocated by the earlier cases"(87). Such a contract may explicitly or implicitly require the director to give his exclusive attention to his company's business(88).

The third proposition deals, as mentioned above, with directors' delegation of functions. Romer J. said:

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(89).

The functions of directors, particularly in large companies, are numerous. They may not be able to carry out all those functions themselves, either because of lack of time or lack of skill. Thus, they are entitled to delegate some of those functions to others(90). It follows that they are entitled to rely on others and to trust them(91). However, reliance on delegates cannot form a defence in a director's hand unless it is a reasonable one(92). Delegation of functions may be made to a committee of the board. It may also be made to experts. Proper delegation to a committee of the board may in some circumstances exonerate the directors who are not on the committee. Thus, in Land Credit Co. of Ireland v. Lord Fermoy(93), a director who properly relied on the sub-committee of the board was held not
liable for the committee’s breach of duty. In that case, the sub-committee of the board used the funds of the company to buy the company’s shares in order to keep up their price. This operation was cloaked by the sub-committee under the veil of loans which were disclosed to the full board but their purpose was concealed. The sub-committee breached its duty by concealing the objectionable nature of the loans. The court found the sub-committee liable to repay these loans. Whereas, the director who was not on the sub-committee was exonerated.

The exoneration of directors, in relation to delegation of functions, is not free from qualifications. A director is justified in trusting his co-directors and other officers and can rely on them only where the circumstances of the delegations give him no ground for suspicion. Thus, a director who delegates a specific function to others, but then keeps an eye on its performance, cannot allege and will not be allowed to maintain that he did not know what was going on. In the absence of any ground for suspicion a director who delegates some of his functions to others is not required to supervise them. Otherwise, the delegation of functions, as an operation, becomes meaningless. Thus, in Huckerby v. Elliott, a director of a gaming club was held not negligent in failure to check whether the club had the proper licence.
when the task of obtaining the licence had been delegated to someone else. Likewise, if a board of directors appointed an auditor and had no grounds for suspecting anything wrong, the board would not be liable in damages for the auditors' negligence\(^\text{93}\). While directors are entitled to rely on others in relation to the delegated functions, they are not entitled to pay no attention to all documents placed before them\(^\text{99}\). They are required to exercise a reasonable amount of care in relation to documents placed before them. Romer J. in the Re City Equitable Fire case\(^\text{100}\), suggested that directors should have a complete list of their company's assets before declaring dividends. They ought not to be guided by the chairman's assurances and the auditors' belief as to the value of the company's assets. In relation to cheques, Romer J. suggested\(^\text{101}\) that before signing a cheque a director should satisfy himself that the board had authorised the signature of that cheque, or should subsequently obtain a board's resolution confirming the signature. However, as to the substance of a cheque, Romer J. suggested\(^\text{102}\) that a director before whom a cheque was placed for signature could trust the assurances of relevant officers as to the purpose for which the payment was required and as to whether the payment was, subsequently, applied for that purpose. Signing a blank cheque is, of course, a clear negligence\(^\text{103}\).
To sum up: at common law, directors' duty of care and skill is judged subjectively. Directors are not required to give "continuous attention" to their companies' business; and they are entitled to rely on delegates provided that such reliance is reasonable and that there is no ground of suspicion as to the honesty and the competence of these delegates.

As previously mentioned, the law of negligence has been subjected to radical changes in recent years. Those developments, indeed, affect auditors' and accountants' liability. Their duties of care and skill have been increased by the courts' "more rigorous enforcement of their obligations"(104) in contract as well as in tort. However, the House of Lords in the Caparo case tried to limit the scope of auditors' duties. So far, one can see that those developments do not affect the general rules applied to directors' duties of care and skill. Yet, the enforcement of directors' duties remains a major problem. A director's duty of care and skill is owed to the company. So, a breach of that duty will be a wrong done to the company. Consequently, "the proper plaintiff in an action in respect of a wrong alleged to be done to the company . . . is prima facie the company . . . itself"(105). The company may decide not to sue the directors. In this case, the shareholders will not be able to sue the directors on behalf of the company unless they bring themselves within one of the
exceptions to the rule stated above. It should be noticed that a breach of duty of care can be ratified by an ordinary resolution of the general meeting. In Pavlides v. Jensen, the directors sold an asset of the company at an undervalue. A minority shareholder initiated an action against them alleging that they breached their duty of skill and care. The court held that the directors' act was ratifiable by an ordinary resolution of the general meeting. However, in addition to the duty of care owed to the company, directors owe, in some circumstances, a duty of care to shareholders as individuals.
Footnotes

2) [1932] A.C. 562.
3) See per Lord Atkin in Donoghue v. Stevenson [1932] A.C. 562 at p.579 when his lordship said: "The courts are concerned with the particular relations which come before them in actual litigation, and it is sufficient to say whether the duty exists in those circumstances. The result is that the courts have been engaged upon an elaborate classification of duties" which take account of the particular relations between the parties.
5) [1932] A.C. 562, at p.580 per Lord Atkin.
7) [1932] A.C. 562, see per Lord Thankerton at p.603.
8) [1932] A.C. 562 at p.580. Lord Atkin, however, was cautious when he laid down his principle. His caution can be realised from his own speech in the same case. His Lordship said:
   To seek a complete logical definition of general principle probably go beyond the function of the judge, for the more general definition the more likely it is to omit essentials or to introduce non-essentials: at p.580.
12) [1970] 2 A.L.R. 294 at pp.307-8; see also Lord Reid in the same case at p.297-8; for more detail about the willingness of the judges to limit the scope of the "neighbourhood" principle by introducing "policy" considerations elements, see Symmons C., "The Duty of Care in Negligence: Recently Expressed Policy Elements (Part I)", [1971] 34 M.L.R. 394 and (Part II) [1971] 34 M.L.R 528.
17) The Privy Council deduced this critical point from
Lord Atkin's judgment in the Donoghue case. Lord Atkin said:

"Who, then, in law, is my neighbour? The answer seems to be - persons who are so closely and directly affected by my act ... 


So, in their Lordships' opinion, in the Yuen case, foreseeability and a mere proximity are insufficient to give rise to a duty of care. The relationship of proximity between the parties must be "a close and direct" one.


19) Anns has been overruled by the decision of the House of Lords in Murphy v. Brentwood District Council [1990] 2 All E.R. 908.


22) [1987] 2 All E.R. 705 at p.712.


29) This was a deduction from the decision of Hedley Byrne & Co. Ltd v. Heller & Partners Ltd. [1964] A.C. 465.

30) Lord Bridge said that these requirements are neither conclusive nor exclusive: see Lord Bridge in the Caparo case [1990] 1 W.L.R 359 at p.384.

31) See Al-Nakib Investments (Jersey) Ltd. and Another v. Longcroft and others [1990] 3 All E.R. 321, where the court held that the defendant directors owed no duty of care to the plaintiffs (who took advantage of the rights issue and bought shares in the company) because the purpose for which the prospectus was issued was to encourage subscription to the rights issue; but not to encourage purchase of shares in the market.


34) See the proposition laid down by Romer J. in Re City

36) See per Lord Bridge in the Caparo case [1990] 2 W.L.R. 359 at p.365.
37) [1990] 2 W.L.R. 359 at p.365.
42) [1990] 2 All E.R. 908.
43) [1990] 3 All E.R. 321.
44) [1990] 3 All E.R. 321 at p.326.
48) [1991] 1 All E.R. 148 at p.160 per Slade L.J.
49) [1991] 1 All E.R. 148 at p.159 per Slade L.J.
50) [1991] 1 All E.R. 148 at p.159. Slade L.J. said that the Morgan case could be distinguished from the Caparo case on the ground that in the former, some of the representations were made after the plaintiffs as a bidder had emerged, whereas in the latter all the representations were made "before an identified bidder had emerged": see per Slade L.J. [1991] 1 All E.R. 148 at p.154.
51) Following a telephone call with the legal adviser of Hill Samuel Bank, it was confirmed that this case was settled out of court.
52) [1990] 2 All E.R. 908.
55) See, for example, Turquand v. Marshall [1869] 4 Ch. App. 376; Overend, Gurney & Co. v. Gibb [1872] LR 5 (HL) 480 at p.494-5; Re National Bank of Wales Ltd. [1899] 2 Ch. 629 at p.671 (CA); and Re Brazilian Rubber Plantations and Estates Ltd. [1911] 1 Ch. 425.
56) Farrar’s Company Law, 2nd ed, [1988].
57) For example, see Turquand v. Marshall [1869] 4 Ch. App. 376; Overend, Gurney & Co. v. Gibb [1872] LR 5 (HL) 480 at p.494-5; Re National Bank of Wales Ltd. [1899] 2 Ch. 629 at p.671 (CA); and Re Brazilian Rubber Plantations and Estates Ltd. [1911] 1 Ch. 425.
58) See Farrar’s Company Law, 2nd ed, [1988].
60) Farrar’s Company Law, 2nd ed, [1988].
61) The Parliament has, recently, given attention to this issue in passing The Company Directors Disqualification Act 1986 and The Insolvency Act 1986.

62) [1911] 1 Ch. 425.

63) [1925] 1 Ch. 407.

64) [1843] 11 M. & W. 113.

65) [1843] 11 M. & W. 113 at p.115

66) [1843] 11 M. & W. 113 at p.115

67) [1925] 1 Ch. 407.

68) It is also not easy to draw a line between those degrees of negligence according to this view.

69) [1925] 1 Ch. 407. In that case, as a result of the managing director's deliberate fraud there was a shortage in the company's funds. The managing director had been convicted and sentenced. Whereas a number of directors, who where acting honestly, were held not liable in negligence for the losses resulting from the managing director's fraud.

70) see generally, Gore-Browne on Companies, 44th ed, [1986]; see also MacCann, "Directors' Duties of Care, Skill and Diligence" [1991] 9 I.L.T. 56.

71) [1925] 1 Ch. 407 at p.428. The standard of skill required from a director had been put in a clear words by Lindley M.R. in Lagunas Nitrate Co. v. Lagunas Syndicate [1899] 2 Ch. 392 at p.434. He said:

If directors act within their powers, if they act with such care as is reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company.


73) See Gore-Browne on Companies, 44th ed, [1986], para. 27.19.1; Farrar's Company Law, 3rd ed, [1991], at p.397; See also Sealy who said that a pure objective test cannot be applied on directors' duties of care and skill; a subjective element is necessary and cannot be ignored: Sealy, "Reforming the Law on Directors' Duties" [1991] 12 Co. Law. 175.


76) It should be noted that S.214 (4) of the Insolvency Act 1986, sets a standard of skill involving subjective and objective elements. This section applies only if the company has gone into insolvent liquidation. Thus, it will not affect the conduct
of company's directors while the company is a going concern. It should be noted that this section have dealt with wrongful trading. It provides:

"... 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 would 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 that director has"; See Chapter No. 8.

In Dorchester Finance Co. Ltd. v. Stebbing [1989] B.C.L.C. 498, the court accepted a distinction between the duty to exhibit a degree of skill and the duty to take care. A subjective test was applied to the former, whereas an objective test was applied to the latter. This was clear from the judgment of Foster J. where he said: "(a) A director is required to exhibit in performance of his duties such a degree of skill as may reasonably be expected from a person with his knowledge and experience. (b) A director is required to take in the performance of his duties such care as an ordinary man might be expected to take on his own behalf": [1989] B.C.L.C. 498 at p.501.

78) [1911] 1 Ch. 425.
80) [1925] 1 Ch. 407 at p.429 per Romer J.
81) See Re Montrotier Asphalte Co. [1876] 3 LT 716; Re Forest of Dean Coal Mining Co. [1878] 10 Ch. D. 450 at p.452; Huckerby v. Elliott [1970] 1 All E.R. 189; see also Re Cardiff Savings Bank, The Marquis of Bute's case [1892] 2 Ch. 100.
82) [1892] " Ch. 100.
83) [1742] 2 Atk. 400.
84) Per Byrne J. in Dricebier v. Wood [1899] 1 Ch. 393 at p.406; see also Dorchester Finance Co. Ltd v. Stebbing (unreported but summarised in [1980] 1 Co. Law. 38, where Foster J. held that it was unreasonable for directors not to attend board meetings.
86) S.6 (1) of the Company Directors Disqualification
Act 1986 provides:
The court shall make a disqualification order against a person in any case where, on an application under this section, it is satisfied—
(a) that he is or has been a director of a company which has at any time become insolvent (whether while he was a director or subsequently), and
(b) that his conduct as a director of that company (either taken alone or taken together with his conduct as a director of any other company or companies) makes him unfit to be concerned in the management of a company.

87) Farrar's Company Law, 2nd ed, [1988].
88) Farrar said that Romer J.'s second proposition must be re-considered in the light of the Insolvency Act 1985. An inactive director may find it difficult to persuade the court that he took every step with the view of minimising the potential loss to the company's creditors: See S.214 (3) of the Insolvency Act 1986; see Farrar's Company Law, 2nd ed, [1988], at p.341.
90) See Chapter No. 2.
91) This is for the simple reason that "[business] cannot be carried on upon principles of distrust": Re National Bank of Wales [1899] 2 Ch. 629 at p.673 (CA).
93) [1870] LR 5 Ch. App. 763.
94) See per Romer J. in Re City Equitable Fire Insurance Co. Ltd [1925] 1 Ch. 407 at p.429. For example a director, who knows or has a good reason to suspect that a delegate is not honest or competent, is not entitled to rely on that delegate's assurances or statements. He has to verify and to check the soundness of the work done.
96) See Dovey v. Cory [1901] AC 477 at p.493 (HL). In this case, it was held that a director was under no duty to verify auditors' calculations: see also Re City Equitable Fire Insurance Co. Ltd [1925] 1 Ch. 407 at p.430.
97) [1970] 1 All E.R. 189.
100) [1925] Ch. 407 at p.471-2 (CA).
101) **Re City Equitable Fire Insurance Co. Ltd** [1925] 1 Ch. 407 at pp.459-60.

102) **Re City Equitable Fire Insurance Co. Ltd** [1925] 1 Ch. 407 at pp.452-3.


104) **Pennington R. Directors' Personal Liability** [1987] at p.91.


106) There are four exceptions to the rule in **Foss v. Harbottle** [1843] 2 Hare 461. It is not the subject of this chapter to discuss these exceptions: see Chapter 9.

107) [1956] Ch. 565.

CHAPTER 7

DIRECTORS' DUTIES TO SHAREHOLDERS

7.1. Introduction

The relationship between directors and their companies is a fiduciary one. This relationship gives rise to some fiduciary duties. These duties are owed to their companies as separate legal entities. Thus, generally speaking, directors owe no fiduciary duty to individual shareholders. Even if the directors act in a way which causes the company to incur a legal liability, they owe no duty to the shareholders. Examples of this, are the situations where the directors cause the company to breach a contract entered into by it; or where they cause it to harm the rights of the shareholders by refusing to allow them to vote at a general meeting. In these situations, the general rule is that the directors are not responsible to the shareholders. In some exceptional cases, however, directors may owe fiduciary duties as well as a duty of care to shareholders in common law. Those exceptional cases are where there is an agency relationship between the directors and the shareholders, where the directors give an advice to the shareholders, and where the company has the family character and the directors occupy a dominant position.
over the company and its shareholders. In addition to their duties in common law directors owe some duties to the shareholders under the legislation.

7.2. The general rule of immunity from liability

The general rule, as stated above, is that directors are immune from liability to individual shareholders. This rule has been applied in several cases. It has, for example, been decided that the directors having granted an option for a shareholder to buy further shares in the company, were under no liability to satisfy the option by transferring some of their shares to the option holder if all the shares had been issued(2).

Similarly, it has been held that a director of a subsidiary company, having obtained compensation from the holding company for leaving his office, without disclosing to the holding company that he was not entitled to obtain compensation because he breached some of his duties to the subsidiary, was not liable to return that compensation(3). In Lindgren v. L and P Estates Co. Ltd(4), the Court of Appeal held that the directors of a subsidiary company were not liable to compensate the parent company for the loss in the value of the shares it held in the subsidiary which resulted from allowing, negligently or wilfully, the subsidiary's money or assets to be misappropriated. This is, of
course, a clear application of the "proper plaintiff" rule(5). The proper plaintiff in that case was the subsidiary company. So, the holding company as a shareholder in the subsidiary company, was not entitled to recover any loss suffered by it as a result of the directors' breach of duty to the subsidiary company.

In Percival v. Wright(6), which may be regarded as the most important case in this context, the shareholders approached the directors and offered to sell their shares in the company to them, i.e., to the directors. The directors agreed to buy the shares at a fair price. They did not disclose that they were negotiating a take-over offer from an outsider to buy shares at a higher price. The directors bought the shareholders' shares and sold those shares as well as all the company's shares to the outsider who launched the take-over offer. As a result the directors made some profit. The shareholders who had sold their shares to the directors brought an action against the directors in order to rescind their contract with them and to seize the opportunity of selling their shares to the outsider who offered a higher price. Alternatively, the shareholders claimed that the directors should be made accountable for the profit made as a result of re-selling the shares to the outsider. The shareholders made it clear that their claims were based on the ground that the directors had failed to disclose the fact that they were
negotiating a take-over offer from an outsider to buy all the company’s shares. The court held that the directors owed no duty of disclosure to the shareholders who offered to sell their shares to the directors. Consequently, the directors could not be made liable to account for the profit made and the contract between the directors and the selling shareholders could not be rescinded. In this case the shareholders did not allege that the directors had made any misrepresentation in relation to the company’s financial position or to the value of the shares. They did not also allege that the directors had exercised undue influence over them to induce them to sell their shares. If the shareholders alleged that there was a misrepresentation on the part of the directors, the court’s decision would probably be in favour of the selling shareholders. Swinfen-Eady J. said that:

"[T]here is no question of unfair dealing in this case. The directors did not approach the shareholders with the view of obtaining their shares. The shareholders approached the directors and named the price at which they were desirous of selling(7)."

Percival v. Wright has been widely criticised. The Cohen Committee(8) and the Jenkins’ Committee(9) both criticised it and recommended the enactment of legislation to overrule the decision in that case. Lord Wilberforce said "The decision [i.e. the decision in Percival v. Wright] was no doubt good traditional..."
equity but when generalised, as it has been, was surely bad economics . . . "(10). In Coleman v. Myers(11) the plaintiff's counsel argued that Percival v. Wright was no longer accepted as one establishing a decisive rule in the field of directors' duties. Counsel for the plaintiff also pointed out that no Commonwealth court had expressly approved the decision in Percival v. Wright. Mahon J., in Coleman v. Myers(12) said that the decision in Allen v. Hyatt(13) "appears to be the only decision of coercive authority which in terms adverts to the decision of Percival v. Wright but does not go so far, as I read it, as to affirm or approve that decision". The judge also said(14):

I reach the unhesitating conclusion that the decision in Percival v. Wright, directly opposed as it is to prevailing notions of correct commercial practice, and being in my view wrongly decided, ought no longer to be followed in any impeached transaction where a director dealt with identified shareholders".

In Mahon J's opinion, the directors' duty to disclose arises only in cases where the parties are identified. If the parties are not identified it is not possible to prove that directors are capable of compliance with the duty of disclosure. In his own words Mahon J. said(15):

The liability of the director cannot be enforced in the absence of proof that he was capable in the specified transaction of compliance with the duty of disclosure".

Professor Gower has described the judgment in Percival v. Wright as "a calamitous decision"(16). Professor
Loss said that the decision in Percival v. Wright is "a monument to the ability of lawyers to hypnotise themselves with their own creations"(17). It is also said(18) that the decision in Percival v. Wright is in conflict with both commercial morality and the rule which prohibits directors from making a secret profit by using the property or the confidential information of the company. However, it is also argued(19) that this case is distinguishable on its facts. In this case the shareholders themselves approached the directors and named the price at which they wished to sell their shares. The directors themselves did not approach the shareholders to buy their shares with the intention of gaining personal profit by hiding the fact that they were negotiating a take-over offer. If the directors themselves were to approach shareholders then it might be argued that the court would decide in favour of the plaintiff shareholders. It is submitted, however, that in the absence of misrepresentation or unfair dealing in general, the court would not change its attitude even if the directors themselves were to approach the shareholders. The reason is that in such a case the directors approach the shareholders in their capacity as buyers, and it is open to the shareholders to accept or to reject the directors' offer. In the presence of an unfair dealing on the part of directors, the directors will be liable to the shareholders. This can be
understood from Swinfen Eady J.'s decision in Percival v. Wright itself (quoted above).

The court had dealt with a misrepresentation case in Walsham v. Stainton\(^{(20)}\). In that case the confidential agents of the partnership conspired together to obtain for themselves the shares of the plaintiff, who was a partner, at an undervalue. They executed this conspiracy by keeping the accounts of the partnership fraudulently, so as to conceal from the plaintiff the true value of the shares. The plaintiff sold his shares at an undervalue. Lord Justice Turner held that the defendants were liable for the real value of the shares\(^{(21)}\).

In relation to Percival v. Wright, the only allegation, in the absence of a misrepresentation, against the directors would be that they breached their fiduciary duties. And, in that case, the court found that there was no fiduciary relationship between the directors and the shareholders\(^{(22)}\).

However, in favour of the decision in Percival v. Wright it has been argued\(^{(23)}\) that no Commonwealth court has ventured to say that that case has been wrongly decided. In deed, despite the criticisms made by the Cohen Committee and the Jenkins Committee in respect of the case in question, the legislature in Britain did not intervene to abolish the rule laid down by that case. In addition, in favour of that decision it could be
argued that in some cases disclosing some information about a potential take-over bid might not be in the best interest of the company.

The reason for directors' general immunity from liability towards shareholders is the result of the relationship between the directors and their companies. A relationship which, in fact, exists between two parties. On the one hand the directors and on the other hand the company as a separate legal entity distinct from its members. This legal personality has its own budget, resources, rights, duties, and creditors. It also has the ability to sue and to be sued. So, despite the fact that it is the shareholders who will suffer economically in consequence of the directors' breach of duties to their companies, the directors are under no duty to them as a general rule. However, it should be understood that this general rule extends only to directors' conduct while acting on behalf of the company, i.e., in their capacity as directors.

In the case of partnerships, one has to make a distinction between the English Law and the Scots Law. The English Law does not recognise partnerships as legal entities distinct from the members composing them. This attitude has been evinced by S.4(1) of the Partnership Act 1890. This section provides that:

> Persons who have entered into partnership with one another are for the purpose of this Act called collectively a firm, and the name under
which their business is carried on is called the firm name.

This section defines "firm" as meaning the members or the partners who compose the firm. Thus, the English Law maintains its inflexible position of denying a partnership a separate legal personality. The view of the English Law, however, is not free from criticisms. Lindley(27) has considered the non-recognition of the personality of the firm as a defect in the English Law. Accordingly, he criticised the Partnership Act 1890 as one which failed to bring the English Law into line with Scots Law in relation to this issue. Miller(28) states that "[the] view of the English Law is in conflict with the realities of the commercial life"(29).

The nature of partnerships in Scotland is different from that in England. The Scots Law recognises partnerships as separate legal entities. This position has been evinced by S.4(2) of the Partnership Act 1890. The section provides that:

In Scotland a firm is a legal person distinct from the partners of whom it is composed, but an individual partner may be charged on a decree or diligence directed against the firm, and on payment of the debt is entitled to relief pro rata from the firm and its other partners.

This section recognises the distinguishing features of Scottish firms. The nature of the legal personality of partnerships in Scotland, however, is different from that of incorporated companies. S.4(2) of the
Partnership Act 1890 made it clear that an individual partner may be held liable for the partnership's debts. On the other hand, a partner who has paid a debt on behalf of the partnership is entitled to "relief pro rata from the [partnership] and its other partners". While those qualifications do not destroy the legal personality of partnerships in Scotland, they give that personality a special nature different from that of incorporated companies. The liability of shareholders in the incorporated companies, for example, is limited to their shareholdings in these companies.

Going back to the main issue, to whom a managing partner's duty is owed in a partnership: in England, since partnerships have no separate legal personalities, fiduciary duties of the partners are owed to each other. So, an outsider's offer to purchase the partnership's shares must be disclosed by the directors to the other partners. Accordingly, it would seem that had Percival v. Wright dealt with a partnership, the defendants would have been held liable for the failure to disclose information, to the partners, about the outsider's take-over offer. On the other hand, in Scotland, a partnership has a separate legal personality. So, a managing partner's duties are owed primarily to this legal entity. Accordingly, if Percival v. Wright had dealt with a Scottish
partnership, the court's decision, it would seem, would not have been different.

The general rule of immunity from liability to shareholders, was affirmed by Dillon LJ. in Multinational Gas & Petrochemical Co. v. Multinational Gas & Petrochemical Services Ltd(33). His Lordship said:

The directors . . . stand in a fiduciary relationship to the company . . . and they owe fiduciary duties to the company though not . . . to individual shareholders.

In some exceptional cases, however, directors may owe duties to the shareholders at common law as well as under the legislation. In their relationship with shareholders, directors may find themselves subjected to the rules which govern the agency relationship, contracts or even the rules of delict. In addition, directors may find themselves liable to the shareholders under the legislation. The duties which directors may owe to the shareholders can be fiduciary duties as well as a duty of care and skill. Those exceptional cases to the general rule of immunity from liability will be discussed next.
7.3. Exceptions to the general rule of immunity from Liability: Directors' Duties to Individual Shareholders.

7.3.1. Exceptions at the Common Law.

7.3.1.1 Directors as agents of the shareholders.

Directors may be considered as agents of the shareholders and, consequently, a fiduciary relationship may exist between them. A director may become the agent of a shareholder or a group of shareholders in several ways. For example, a director might be appointed by a shareholder to act as his proxy to represent him at general meetings and vote on his behalf. The director, as a proxy, is the representative of the shareholder who appointed him and, consequently, the law of agency is applied to their relationship. A director might be appointed by a shareholder or a group of shareholders to sell their shares in the company. In such a case, the shareholders are relying upon the appointed director's skills, knowledge and bargaining power. Again, the rules of the law of agency are applied to this case. Thus, if it is found that a director is acting as agent on behalf of a shareholder, or a group of shareholders, then he will owe fiduciary duties to the shareholders, who appointed him, similar to those owed by an agent to his principal under the law.
of agency. As an agent, a director must not exceed the powers given to him by his principal. He must act in good faith and exercise reasonable care in performing his duties. He must further the interests of his principal and not allow his own interests to conflict with his principal's. In addition, he must not gain profit out of his position without the consent of the principal.

In Allen v. Hyatt (35), the directors obtained options from the shareholders to buy their shares in the company through representations that this would facilitate a potential amalgamation with another company. The directors exercised the options and sold the shares to the amalgamating company. The price at which the directors exercised the options was lower than the price paid by the amalgamating company. Consequently, they made a handsome profit. The court held that the directors were the agents of the shareholders when they took the options from them, and so were liable to the shareholders (i.e. their principals) to account for the profit made. Viscount Haldane L.C. said (36):

"The [plaintiff shareholders] appeared to have been under the impression that the directors of a company were entitled under all circumstances to act as though they owed no duty to individual shareholders. No doubt the duty of the directors was primarily one to the company itself. It might be that in circumstances such as those of Percival v. Wright they could deal at arm's length with a shareholder. But the facts in the present case were widely different from those in Percival v. Wright, and their Lordships..."
thought that the directors must here be taken to have held themselves out to the individual shareholders as acting for them in the same footing as they were acting for the company itself, that was, as agents . . . .

It has been said(37) that the decision in Percival v. Wright was too generous to directors. It places the directors under no liability to shareholders in general. However, despite the fact that the decision in Allen v. Hyatt has invaded that generosity, it is said(38) that it has a limited scope of application because it is based on the particular way in which the defendant directors choose to carry out their fraud.

The fact that the appointed director must further the interests of his appointor or appointors does not, however, mean that he is allowed to ignore the interests of the company of which he is a director. Thus, the appointed director must not agree to subordinate the interests of the company to the interests of the shareholder or shareholders who appointed him(39).

7.3.1.2. Directors' duty to give an accurate advice to shareholders.

In relation to all forms of negligence liability, including liability for negligent statements, the test of the existence of a duty of care has been subjected to radical developments, over a short period of time(40). In brief, before 1932 there was no general principle.
upon which the courts could rely to determine the existence of a duty of care in all circumstances. The courts had no choice but to rely on traditional categorisation of recognisable situations as guides to the existence of a duty of care and the scope of that duty. In other words, the courts were relying upon the existing precedents. In 1932 Lord Atkin in the case of Donoghue v. Stevenson\(^1\)\(^4\)\(^1\)\), laid down the famous "neighbourhood or foreseeability" principle. That general principle had been the subject of many developments. The most comprehensive attempt to formulate a general principle was achieved by Lord Wilberforce in Anns v. London Borough of Merton\(^4\)\(^2\)\). His Lordship laid down a test of two stages. "Neighbourhood" or "proximity" and "foreseeability" are the main elements of the first stage of the test. The second stage deals with policy considerations which may negate the duty of care or limit its scope. In latter cases, the courts added a new element, to this test, which was whether it is "fair, just and reasonable" to impose a duty of care on the defender in any given case. Over the years, the general principle test of liability, has been criticised as being an impractical test\(^4\)\(^3\)\). The terms "proximity" and "fairness" have been attacked as being no more than "labels" to attach to specific situations which "the law recognises pragmatically as giving rise to a duty of care"\(^4\)\(^4\)\). Most recently, in Caparo Industries plc v.
Dickman(45), the House of Lords abandoned the general principle test of liability and preferred the traditional categorisation of recognisable situations as guides to the existence of a duty of care and the scope of that duty. In addition, the decision in the Anns case has, recently, been overruled by the decision of the House of Lords in Murphy v. Brentwood District Council(46). In the latter the House held that, when carrying out its statutory functions of exercising control over building operations, a local authority owed no duty of care to owners or occupiers who suffered economic loss as a result of repairing structural defect in their property. Thus, the Anns case which allowed recovery for pure economic loss has been overruled.

In relation to liability for negligent statements or negligent advice the leading case is Hedley Byrne & Co. Ltd v. Heller & Partners Ltd(47). Before this case there had been no case allowing recovery in negligence for economic loss caused by negligent statements(48). In that case the House of Lords held that, in the absence of an express disclaimer of responsibility, the bank, who gave information about one of its customers' creditworthiness to a firm of advertising agents, owed a duty of care to the advertising agents to insure that the information it gave was sound. The House of Lords based its decision on the existence of a "voluntary assumption of responsibility"(49) on the part of the
defendant which gave rise to a "special relationship" between the defendant and the plaintiff. Reliance was a crucial factor in that case. The House stated that a "special relationship" between the defendant and the plaintiff might exist if the defendant knew or ought to have known that the plaintiff would rely on the given statement\(^{(50)}\). Most recently, the House of Lords, in *Caparo Industries plc v. Dickman*\(^{(51)}\), accepted and affirmed the decision of the *Hedley Byrne* case. The *Caparo* case was concerned with the liability of the auditors of a public company to potential investors. From the decision in the *Hedley Byrne* case, the House of Lords, in the *Caparo* case, deduced the following grounds which are necessary for a duty of care to arise: (1) The statement or the advice was given to a known person; (2) It was given to achieve a specific purpose; (3) the maker of the statement or the advisor was aware of that purpose; (4) the maker of the statement or the advisor aware, "actually or inferentially"\(^{(52)}\), that the advisee or the recipient of the statement would rely on it; and (5) the recipient or the advisee had, actually, relied on the statement or the advice and "acted upon to his detriment"\(^{(53)}\). The absence of any of those grounds is capable of preventing liability from arising\(^{(54)}\). But, does the existence of all these grounds necessarily mean that liability will arise? The answer is found in Lord
Oliver's speech in the Caparo case itself. His Lordship said:

That is not, of course, to suggest that these conditions are either conclusive or exclusive, but merely that the actual decision in the case does not warrant any broader propositions\(^\text{55}\). 

His Lordship also said:

... in a swiftly developing field of law, there can be no necessary assumption that those features which have served in one case to create the relationship between the plaintiff and the defendant on which liability depends will necessarily be determinative of liability in the different circumstances of another case\(^\text{56}\).

His Lordship meant that the decision, in the Caparo case, left an open door to further conditions in the future. In one's opinion, new conditions or "propositions" can be divided into two types: (1) General conditions which are applied to all cases in all circumstances (e.g., the foreseeability of the harm); and (2) special conditions which stem from the special circumstances of a given case (e.g. the purpose of making a report under S.236 and S.237 CA 1985). Special conditions are applicable only to the case from which they stem. Developing any general condition will necessarily limit the scope of the duty of care. Whereas the effect of any special condition is confined to the case from which that condition stems. Thus, the special conditions of a particular case, while able to prevent liability from arising in that case, are unable
to do the same in other cases. In other words these conditions amount to no more than considerations which "ought to negative, or to reduce or limit the scope of the duty or the class of persons to whom it is owed or the damages to which a breach of it may give rise"\(^{(57)}\). Thus, one can conclude that if Lord Oliver’s statement (quoted above) means that the door is open to further general conditions or propositions, then the law is moving toward narrowing the range of the duty of care in relation to negligent misstatement and negligent advice.

Going back to the main issue: directors’ duty of care to shareholders. If directors advise the shareholders to accept the wrong take-over bid, will they be held liable to the shareholders? Before giving an answer to this question, one should examine the issue of whether, for a duty of care to arise, the advisor must be professional (i.e. possesses the skill and knowledge to give an advice of the sort given). In Mutual Life & Citizens’ Assurance Co. Ltd v. Evatt\(^{(58)}\), the majority of the Privy Council held that for a duty of care to arise under the Hedley Byrne rule, the one who gives the advice must be either a professional, i.e. specialised in giving business advice of that kind or has held himself out as a skilled or competent to give an advice of the kind given\(^{(59)}\). It is said\(^{(60)}\) that the only possible exception to this rule is where the adviser or the giver of the information has a financial interest in
the information he is giving. In their dissenting judgment, Lord Reid and Lord Morris, stated that, for a duty of care to arise, it is unnecessary for the advisor to be an expert or specialist in the matter on which he gave the advice. They said:

We can see no ground for the distinction that a specially skilled man must exercise care but a less skilled man need not do so(61).

An unskilled advisor, in their opinion, owe a duty to take reasonable care before giving the advice. A skilled advisor must conform to the standard of skill and competence which is generally shown by persons who carry on the business of giving an advice of the sort given. Thus an unskilled advisor cannot escape liability by saying that he does not possess the necessary skill and knowledge. Accordingly, their Lordships said:

We are unable to accept the argument that a duty to take care is the same as a duty to conform to a particular standard of skill(62).

For a duty of care to arise, however, the advisee must act reasonably in seeking the advice. A reasonable man will not seek a legal advice, for example, from a butcher. The liability will not arise in this case, not because the butcher has no skill to give a legal advice, but because the advisee has not acted reasonably in seeking the advice. In addition, the one who seeks an advice must make it clear to the advisor that he is going to rely on it in relation to a certain matter(63).
Finally, the advisee must follow the advisor's directions. If he failed and, consequently, suffered loss, the advisor would not be blamed.

It is to be noted, however, that the decision in the Mutual Life case is not binding on the British courts. So, it has only a persuasive force in Britain(64). Accordingly, it is agreed(65) that the courts in Britain may not release an advisor from a duty of care merely because he is not a professional or expert in giving advice of the kind given. Here, suppose that a director of a company advised the shareholders to accept a certain take-over bid and to reject a rival one; the shareholders relied on that advice and accepted that bid which turned out not to be the best one. Will the directors be held liable in this case?. The answer seems to be yes. The directors in such a case owe a duty of care to the shareholders. It is to be noted that Rule 3 of the Code on Take-overs and Mergers (The Code)(66), requires the board of an offeree company to obtain "competent independent" advice on any take-over offer. Rule 25 imposes a positive duty on the board of an offeree company to advise the shareholders of its views on the offer. It also requires the board to make known to the shareholders the substance of the advice given to it by its independent advisers. General principle 5 of the Code, requires that the advice must
be given with the highest standards of truth and accuracy (67).

It remains to examine the question of casual advice. Casual advice cannot give rise to a duty of care (68). An advice can be regarded as a casual one, if it has been given in a social context or, generally, in circumstances which make it clear to a reasonable enquirer that the giver of the advice does not intend to bind himself by it. In the Mutual life case, Lord Reid and Lord Morris stated:

... no duty beyond the duty to give an honest answer can arise when advice is given casually or in a social context, and the reason is that it would be quite unreasonable to impose any greater duty on the advisor (69).

The duty of care discussed above is the common law duty of care. The courts, however, went beyond that and held that in the presence of a relationship of dependency and confidence between the adviser and the recipient of the advice, the former may owe a fiduciary duty of care to the latter. A breach of this fiduciary duty of care was held to be an adequate ground for rescinding the contract entered into by the adviser and the recipient of the advice. In Lloyds Bank Ltd v. Bundy (70) it was held that because the bank's officials had failed to give an advice to the guarantor as to the possible consequences of the bank's customer defaulting, the guarantor was entitled to rescind the guarantee which he gave to secure a bank's loan made to that customer. The
courts emphasised that the guarantor should be advised to seek an independent advice before entering into the transaction. The bank officials failed to give that advice and so the guarantor was entitled to rescind the transaction. The duty which had been breached by the bank officials was a fiduciary duty of care stemming from the relationship of dependency and confidence which existed between the guarantor in the one hand and the bank and its officials in the other hand. It is said that the court in such a situation might be entitled to order compensation for the loss suffered by the plaintiff, and to compel the defendant to account for any profit made by him.

The common law duty of care as well as the fiduciary duty of care can be applied to companies' directors when giving advice to the shareholders. A director's inaccurate advice may cause the shareholder a direct or an indirect loss. A direct loss may be caused if a director advises the shareholder to sell or to purchase shares at an under or over value. An indirect loss may be caused to a shareholder if a director advises the shareholder to approve the company's decision to sell or to purchase shares at an under or over value. The company's shares, in the latter case, will loose value in the market and consequently, the shareholders will be adversely affected by that loss. The rule in Foss v. Harbottle(72), however, remains an obstacle to
shareholders' actions against directors when the loss is classified as an indirect one(73). So, the damages available to shareholders are limited to the loss sustained directly by them. In other words, they are not entitled to recover damages "merely because the company in which [they are] interested has suffered damages"(74). The proper plaintiff in that case is the company itself. Shares are merely rights of participation in a company. Thus it is logical that a personal action cannot be allowed in cases where the loss suffered by a shareholder is merely a reflection of the loss suffered by the company through the diminution of the value of its shares(75). If the company recovers its loss, the shares will return to their former value(76). It is said(77) that going beyond these limits might permit double recovery and may destroy the rule in Foss v. Harbottle(78). In addition, going beyond those limits may subvert the rule which provides that the company is a separate legal entity(79). It is said(80) that if a share is considered as a piece of personal property, a shareholder will be entitled to bring a personal action against those who cause injury to that property.

Where there are two rival bids, directors must not act recklessly in deciding between these two bids. In Heron International Ltd v. Lord Grade(81), it was alleged that the directors had, by selling their own shares, forced
the shareholders to accept a particular bid which was not the best at the time. The court held that there was no negligence on the part of the directors. They were right to consider that, at the time, the rival bid was unrealistic. The Court of Appeal, however, stated that had the directors been found negligent, they would have been held, financially, liable for the failure to decide between the two rival bids.

When giving shareholders advice, whether to accept or to reject a take-over offer for their shares, directors are under a duty to act in good faith. This fiduciary duty is owed directly to shareholders. In Gething v. Kilner,[82] Brightman J. said that where a take-over bid had been made, the directors of the offeree company were under a duty to act honestly and not to mislead the shareholders. Similarly, in Prudential Assurance Co. Ltd v. Newman Industries Ltd (No. 2)[83], the court held that the directors were under a duty to act in good faith when giving shareholders advice whether to approve a scheme for the purchase of a large block of assets from another company.

7.3.1.3. Duties resulting from the special characters of a company and the dominative position of directors.

In some circumstances, the court may hold the directors liable towards the shareholders depending on the nature
of the company. In the New Zealand case of Coleman v. Myers(84), Mr Myers, the chairman's son, indicated to his father that he was not ready to undertake the job of chief executive unless he had a sizeable stake in the company. The company's shares were held by various members of three generations of the Myers family. So, the company was effectively a family business. With the assistance of his father, Mr Myers contracted to buy two large blocks of shares in the company, on condition that he did not have to pay the price of those shares for six months. During this period, he used the control given to him by holding these shares and intended to compel the company to sell valuable buildings and to lend him the cash obtained thereby. He intended to use the cash to pay for the shares which he bought from the company. Following an attack on him by the other shareholders, he formed another company and launched a full-scale takeover bid in order to buy the shares of the minority shareholders compulsorily. He fixed the price at which he offered to buy the shares. He and his father, the second defendant, recommended that the shareholders should accept the offer. Mr Myers had successfully carried out his plan and made profit out of the sale of the company's buildings which produced more money than was necessary to buy the shares at the price that had been agreed. The minority shareholders, whose holdings were compulsorily purchased, brought an action against
Mr. Myers and his father. The minority alleged that the defendants had committed a fraud, and breached their fiduciary duty as well as their duty of care and skill. With respect to the second allegation, i.e., the breach of the fiduciary duty, the court rejected the approach which says that directors will never owe fiduciary duties to shareholders. The court accepted that directors can owe fiduciary duties to shareholders even in the absence of an agency relationships. The court emphasised that these fiduciary duties do not stem solely from the director–shareholder relationship. Some other factors may give rise to these fiduciary duties. In determining these factors Woodhouse J. said (85):

[The] standard of conduct required from a director in relation to dealings with a shareholder will differ depending upon all the surrounding circumstances and the nature of the responsibility which in a real and practical sense the director has assumed towards the shareholder. In the one case there may be a need to provide an explicit warning and a great deal of information concerning the proposed transaction. In another there may be no need to speak at all. There will be intermediate situations. It is, however, an area of the law where the courts can and should find some practical means of giving effect to sensible and fair principles of commercial morality in the cases that come before them; and while it may not be possible to lay down any general test as to when the fiduciary duty will arise for a company director or to prescribe the exact conduct which will always discharge it when it does, there are nevertheless some factors that will usually have an influence upon a decision one way or another. They include, I think, dependence upon information and advice, the existence of a relationship of confidence, the
significance of some particular transaction for the parties and, of course, the extent of any positive action taken by or on behalf of the director or directors to promote it.

Woodhouse J. indicated that factors which gave rise to directors' fiduciary duties were not limited and could not be enumerated. The judge gave as examples of those factors: a relationship of confidence between the parties; reliance by the plaintiff on the defendant's skill and knowledge; and the significance of some transactions for the parties. These are all among the factors which may give rise to fiduciary duties. In his judgment Cooke J. emphasised the importance of the family character of the company, the position of the directors, their high degree of inside knowledge and the way in which they carried out their plans as factors had participated in giving rise to the directors' fiduciary duties in the Coleman case. Cooke J. said:

[The] facts giving rise to the [fiduciary] duty are the family character of this company; the positions of father and son in the company and the family; their high degree of inside knowledge; and the way in which they went about the take-over and the persuasion of shareholders.

Indeed, the considerations which were taken into account in the Coleman case were very similar to those in Ebrahimi v. Westbourne Galleries Ltd. The effect of the decision in the latter case, however, does not extend beyond cases where the company is to be wound up. It does not extend to govern the relationship between
directors and shareholders when the company remains a going concern. It is agreed\(^{(88)}\) that any such extension may develop directors' fiduciary duties, in Britain, along the lines of the Coleman case. This is because to follow the decision in the Coleman case means to create a rule capable of governing directors—shareholders relationship while the company is a going concern\(^{(89)}\).

7.3.2. Directors' Duties to Shareholders under the legislation

In relation to directors' statutory duties to shareholders, only two main and important duties will be discussed. Namely, directors' duties in relation to prospectuses and the compensation for loss of office. So, it is to be noted that directors' duties to shareholders under the statutes are not confined to these two issues.

7.3.2.1. Liability for Untrue or Misleading Statements in a Prospectus\(^{(90)}\).

In Derry v. Peek\(^{(91)}\), the House of Lords held that the directors were not liable, in the absence of fraud, for negligent, untrue, statements in a prospectus. This decision was overruled by the decision of Hedley Byrne & Co. Ltd v. Heller & Partners Ltd\(^{(92)}\), where it was held
that persons could be held liable for negligent statements where there was a sufficient degree of proximity between them and the person who suffered loss as a result of that statement.

In relation to directors' duties for the falsity of a statement in a prospectus, however, the Directors' Liability Act 1890 reversed the decision of *Derry v. Peek* (93). The Directors' Liability Act 1890 contained provisions which laid down directors' liability for untrue statements in prospectuses. Those provisions are now contained in the Companies Act 1985 (94) as well as in the Financial Services Act 1986.

The Companies Act 1985 imposes some statutory duties on directors toward individual shareholders. One important duty is to issue accurate prospectuses. A director may be held liable to compensate shareholders for the loss they suffer as a result of untrue statements in prospectuses. Thus, the law gives the subscribers the right to seek compensation from directors who are responsible for issuing prospectuses which cause loss to them. This is covered by S.67(1) CA 1985. The section provides:

> Where a prospectus invites persons to subscribe for a company's shares or debentures, compensation is payable to all those who subscribe for any shares or debentures on the faith of the prospectus for loss or damage which they may have sustained by reason of any untrue statement included in it.
It is clear from the wording of this section that
directors' liability may arise only if the prospectus
includes untrue statements. In other words, this
section does not extend to cover cases of omission from
prospectuses. The provisions which dealing with directors' duties in
relation to prospectuses are now contained, as mentioned
above, in the Financial Services Act 1986. S.166
FSA 1986 provides that:

. . . the person or persons responsible for a
prospectus or supplementary prospectus shall
be liable to pay compensation to any person
who has acquired the securities to which the
prospectus relates and suffered loss in
respect of them as a result of any untrue or
misleading statement in the prospectus or the
omission from it of any matter required to be
included by section 163 or 164 . . . .

Under the section stated above, the company itself can
be responsible for untrue statement in a prospectus and
accordingly can be made liable to pay compensation to
the injured party. A director is also among those
who are responsible for a prospectus.

S.166 extends to cover omissions from a prospectus of
any matter required to be included by the statute. In
addition to their liability under this section,
directors can also be sued for a breach of a statutory
duty if they omit to include the necessary information
in a prospectus as required by the statute. The pursuer
needs not prove that he relied on the statement
contained in the prospectus. He needs only to prove
that he has suffered loss as a result of the falsity of the statement.

How can a director escape liability? The statutory defences

The liability of a director for untrue or misleading statement in a prospectus or the omission from it is not an absolute. He can escape liability by relying on one or more of the defences set out in the Financial Services Act 1986(100).

It is said(101), that those defences reduce the liability of directors to "at most one for negligence". So, a director can escape liability by proving that the statement in prospectuses were not made negligently.

S.167(1) FSA 1986 enumerates those defences. According to that section a director can escape liability:

(1) If he satisfies the court that he reasonably believed that the statement was true and not misleading or that the matter whose omission caused the loss to the plaintiff was properly omitted, and

(a) that he continued in that belief until the time when the securities were acquired; or (b) that they were acquired before it was reasonably practicable to bring a correction to the attention of persons likely to acquire the securities in question; or (c) that before the securities were acquired he had taken all such steps as it was reasonable for him to have taken to secure that a correction was forthwith brought to the attention of those persons; or (d) that the securities were acquired after such a lapse of time that he
ought in the circumstances to be reasonably excused(102).

(2) If he satisfies the court that, at the time when the prospectus was delivered for registration, he believed on reasonable grounds that the expert, who authorised the statement was competent to make or to authorise the statement and had consented to the inclusion of that statement(103).

(3) If he satisfies the court that a timely correction was made before the securities were acquired or that the fact that the expert was not competent was "published in a manner calculated to bring it to the attention of persons likely to acquire the securities in question"(104), or that he took all reasonable steps to "secure such publication and reasonably believed that it had taken place before the securities were acquired"(105).

(4) If he satisfies the court that the untrue statement arises from the accurate and fair reproduction of a public official statement or document(106).

(5) If he satisfies the court that the person who suffered loss was aware of the falsity of the statement(107).

Thus, directors' liability in respect of prospectuses is not an absolute. A wide range of defences is available to directors to escape liability for untrue or misleading statements in prospectuses.
The measure of compensation

If the pursuer proves the falsity of the statement in a prospectus and the loss he has suffered, he will be entitled for compensation from those who are responsible for that statement. This is, of course, unless the defender has managed to escape liability by relying on one or more of the available defences. If a director is the only person who is responsible for the falsity of a statement in a prospectus, the pursuer subscriber cannot rescind the contract because the director is not the other contracting party. So, the measure of compensation is the delict measure. It is not the contract measure. The measure of compensation, accordingly, is the difference between the price paid by the pursuer subscriber to the company and the real value of the shares at the date they were issued to him.

In addition the pursuer may be granted compensation for any consequential loss.

7.3.2.2. Loss of Office Compensation

A company, according to S.312 CA 1985, is prohibited from making any payment to a director by way of compensation for loss of office in the absence of the company's approval. A similar prohibition is contained in S.313 CA 1985. This section provides that
if "in connection with the transfer of the whole or any part of the undertaking or property of the company", any payment is made to a director by way of compensation for loss of office or in connection with his retirement from office, it must be disclosed to and approved by the company in general meeting. In the absence of an approval, in relation to S.312 and S.313, the amount received by the director must be held in trust for the company. The shareholders' approval is required in such situations because of the position of directors. It is in the shareholders' interests to know what might change the directors' attitude. The payment of compensation for directors might, of course, affect their attitude toward the company and its shareholders.

A company may become a target of a take-over bid. The bidder may offer compensation to directors who will lose their office. This compensation must be disclosed to and approved by the selling shareholders. If the selling shareholders refuse to approve it, the directors who received the compensation must hold it in trust for the selling shareholders. A director's liability toward individual shareholders, in relation to compensation for loss of office, can be attached to him only if:

(a) an offer made to the general body of shareholders; or (b) an offer made by or on behalf of some other body corporate with a view to the company becoming its subsidiary or the subsidiary of its holding company; or (c) an offer made by or on behalf of an individual
with a view to his obtaining the right to exercise or control the exercise of not less than one-third of the voting power at any general meeting of the company; or (d) any other offer which is conditional on acceptance to a given extent(113).

It is the director's duty to disclose the proposed compensation to the selling shareholders. If he fails to do so he will be liable to a fine(114). Compliance with the duty of disclosure, however, does not mean that the director who received the compensation is entitled to keep it for himself. He must seek the approval of the selling shareholders.

The selling shareholders who sell their shares to the offeror for a cash consideration are those who will become the beneficiaries of the statutory trust. The shareholders who exchange in the target company for new shares in the offeror company are not entitled to receive a fraction of the amount which is paid to the directors as compensation for loss of office(115). In S.312 and S.313 CA 1985, the recipient of the payment must hold it in trust for the company. In S.314A CA 1985, this payment must be held in trust for the selling shareholders. The reason is that if the company is made the beneficiary of the statutory trust under S.314, then the selling shareholders will have no remedy, i.e., they will obtain no fraction out of the amount paid to directors. They will have no remedy because they are no longer shareholders in the company. Thus, S.314 is
designed to protect the interests of the selling shareholders. To achieve this purpose the section provides, in clear words, that the amount of money received by the directors shall be held "in trust for persons who have sold their shares as a result of the offer made". In addition, to achieve the purpose of protecting the selling shareholders, S.316(2) CA 1985 provides that if the price to be paid to a director, who will lose his office, for his shares in the company is in "excess of the price which could at the time have been obtained by other holders of the like shares"(116), the excess will be deemed as a payment made by way of compensation for loss of office or in connection with his retirement from office(117). This section is, in fact, providing an effective way to prevent such an attempt to circumvent S.314 and S.315.

A proposed compensation and a contractual compensation

Compensation for loss of office, which is unlawful in the absence of the shareholders' approval, does not extend to the contractual compensation payment which the company is, perhaps, bound to pay to its managing director(118). It would seem that the phrase "the proposed payment" in S.314 CA 1985 is confined only to a proposed payment to a director qua director. That is, it does not extend to embrace the payment which the
company is bound to make to its managing director under the service contract.

A director and a managing director

In the Scottish case of Anderson v. James Sutherland (Peterhead) Ltd and others(119), Lord President Normand said(120):

... the managing director has two functions and two capacities. Qua managing director he is a party to a contract with the company, and this contract is a contract of employment ... it is a contract of service and not a contract of services.

So, the managing director is usually a party to a contract of employment with the company. This is not the case in relation to a director qua director. Lord Jenkins(121) accepted that the positions of director and managing director formed "two distinct offices"(122).

In the Australian case of Lincoln Mills (Aust) Ltd v. Gough(123), G was the director of L company and the managing director of that company. Under the agreement of employment, L would pay G a lump sum if the agreement with G as a managing director was terminated in certain circumstances. The agreement was terminated and L paid the agreed lump sum, but later claimed that G held it in trust for L. The court held that G held two offices: a director and a managing director. The compensation he received, the court said, was for an uncompleted term as
managing director, and was a lawful payment to him under the statute. Hudson J. said:

[The payment] was not made with the intent or object of compensating [E] for loss of his office as a director or as a consideration for his retirement therefrom. It was a payment which the plaintiff company made and was liable to make to [E] in the events that had happened on the termination of his office as a managing director. If it is properly described as a compensation for loss of office... then it was for loss of... the office of managing director and not that of a director.

In the New Zealand case of Taupo Totara Timber Co. Ltd v. Rowe, R was the director and the managing director of T. As a managing director R had entered into a service contract with T. To encourage R to stay in the company as a managing director his service contract with the company contained special provisions regarding resignation and compensation. One of those provisions provides that T company will pay R a lump sum if it terminates his service contract or if R resigns after a successful take-over bid. Following a take-over of T by another company, R resigned. The question was whether the proposed payment was lawful or not. The Privy Council held that R was holding two offices in the company; on the one hand the office of a director; on the other hand the office of a managing director. As a managing director, R had a service contract with the company. So, he was one of the company's employees. He was entitled to have the benefits of that contract...
including the agreed compensation for loss of office of a managing director. The Privy Council held that the payment made by the company was lawful and not in contravention of the relevant statute (126).
FOOTNOTES

1) See Percival v. Wright [1902] 2 Ch. 421, where the court held that the directors were not trustees for the shareholders; and their duty was primarily one to the company; see S.309(2) CA 1985 which provides: "Accordingly, the duty imposed by this section on the directors of a company is owed by them to the company (and to the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors". One can conclude from this section that the general rule is that directors owe their duties to nobody but their company; see Pennington R. Directors' Personal Liability, [1987].

3) Bell v. Lever Bros. Ltd [1932] A.C. 161. However, it would seem that the director in this case should be made liable to account for the money that he obtained on the ground of the unjust enrichment.

4) [1968] Ch. 572.
5) The "proper plaintiff" rule springs from the recognition, by the law, of the company as a separate legal personality: see Wedderburn, "Shareholders' Rights and the Rule in Foss v. Harbottle" [1957] C.L.J. 194. The sense of this rule is that "the proper plaintiff in an action in respect of a wrong alleged to be done to a company ... is prima facie the company ...": per Jenkins L.J. in Edwards v. Halliwell [1950] 2 All E.R. 1064 at p.1066. This rule was, in fact, originally, laid down by the decision in Foss v. Harbottle [1843] 2 Hare 461. In this case the court laid down another rule which provides that the court must not interfere with the internal management of companies acting within their legitimate powers; see Chapter No. 9.

6) [1902] 2 Ch. 421.
7) [1902] 2 Ch. 421 at pp.426-7.
8) See the 'Report of the Committee on Company Law Amendment', (Cmd 6659), paras. 86-87.
10) See the comments made by Lord Wilberforce in "Law and Economics" [1966] J.B.L. 301, 307,
13) [1914] 30 T.L.R. 444.
17) See Loss, "The Fiduciary Concept as Applied to
18) This argument had been presented by the counsel for the plaintiff in Coleman v. Myers [1977] 2 N.Z.L.R. 225, referred to by Mahon J at p. 266.
20) [1863] 1 De G J and S M 678.
21) But Professor Pennington said that non-disclosure of material facts cannot be a ground for rescinding a contract unless one of the contracting parties owes a fiduciary duty of disclosure to the other or a duty to account for a secret or an unauthorised profit to that other party: Pennington, Directors' Personal Liability, [1987]. However, non-disclosure can be a ground for rescinding a contract of insurance or guarantee. It is submitted that the directors in Percival v. Wright owed their fiduciary duties to the company and to the company alone. And in the absence of any misrepresentation to the shareholders or any undue influence on the part of the directors, they were under no duty to the shareholders and should not be made liable to account for any profit made. Accordingly, it is submitted that Percival v. Wright was correctly decided. Non-disclosure of information about a take-over offer could not be a ground for holding the directors liable in that case simply because disclosure might not be at the best interests of the company. And it would seem unreasonable to compel directors to disclose information which might affect the price of their companies' shares whenever a shareholder chooses to sell his shares to the directors.
22) See Pennington R. Directors' Personal Liability, [1987].
24) Pennington R., Directors' Personal Liability, [1987].
25) In relation to the law of partnerships see, generally, Banks, Lindley and Banks on Partnerships, 16th ed, [1990].
26) "[In England] the firm has no existence separate from the units of which it is at any time composed" (Clark F. A Treatise on the Law of Partnership and Joint Stock Companies, According to the Law of Scotland [1860], vol (1) at p.31; see per Farwell J. in Sadler v. Whiteman [1910] 1 K.B. 868 at p.869 where he said: "In English law . . . the firm name is a mere expression, not a legal entity . . . . It
is not correct to say that a firm carries on business; the members of a firm carry on business"; see Lindley on the Law of Partnership (Scamell E., ed.), 15th ed., [1984]; see also Pollock F. A Digest of the Law of Partnership, 2nd ed., [1880].


29) Miller also stated that the pressure of the commercial life has led the English law to relax its position: Miller J. The Law of Partnership in Scotland [1973]. The attitude of the English law has been relaxed by allowing a partnership to sue and to be sued in its own name: see Lindley on the Law of Partnership, 15th ed., [1984].

30) Miller J. The Law of Partnership in Scotland [1973] at p.16; Hamphill (see Hamphill P. "The Personality of the Partnership in Scotland" [1984] J.R 208) argues that "the [legal personality of a partnership] . . . is a fifth wheel to the law of partnership". So, he means that the legal personality is an unnecessary characteristic for partnerships. In his opinion partnerships in Scotland have legal personality without substance. He supports his argument as follows: (1) It is "implausible" to claim that the Scottish concept of the persona of the firm can be traced back to the Roman law (at pp.217-220); (2) it cannot be confirmed that this concept is of continental origin (at pp.222-224); (3) partnerships have no "perpetual succession". The absence of this characteristic is "at least a piece of evidence against the legal personality of the firm" (at p.240); (4) the fact that the partners are liable for the debt of the partnership is capable of undermining the concept of the legal personality of the partnership: Cf Miller J. The Law of Partnership in Scotland [1973] at p.16. Miller argues that the legal personality of the partnership cannot be undermined by the fact that the partners are liable for the debt of the partnership; See also Gretton, "Who Owns Partnership Property", [1987] J.R 163. Gretton argues that the partnership in England has the substance of the legal personality without the name. Whereas a partnership in Scotland has the name and the substance of the legal personality. In this context, one is inclined to say that the legal personality of a partnership, as it is understood in Scotland, is of a special nature. This personality cannot be considered as perfect, since the partners can be held liable, in their own money, for the debts of the partnership. The main reason for creating the concept of the legal personality is, as
far as one can understand it, to allow a group of persons to trade under the name of that personality without exposing themselves to an unlimited liability for the debts of that personality. On the other hand, however, one cannot venture to say that the legal personality of the partnership in Scotland is of no substance. Similar to the incorporated companies, partnerships in Scotland can sue and be sued in their own names; the partnership as a legal personality is the person who carry on the business; and the partnerships in Scotland have their own budgets. It should be noted that those are mere examples of the features of the legal personality of the partnership in Scotland. To conclude, one is inclined to say that the best description, for the legal personality of a partnership in Scotland, is that it is a personality of a special nature.

31) The special nature of the legal personality of a partnership in Scotland reminds us of the concept of "quasi-persona". Clark says: "The distinctive or central feature of the Scottish partnership is that it constitutes a quasi-persona, of which the members are agents and sureties": Clark F. A Treatise on the Law of Partnership and Joint Stock Companies, According to the Law of Scotland [1866], vol (1) at p.31).

32) Law v. Law [1905] 1 Ch. 140.

34) See Allen v. Hyatt [1914] 30 T.L.R. 444 where the Privy Council found that the directors had held themselves out to the individual shareholders as acting for them as agents when they took the options to purchase their shares. Accordingly, the Privy Council held that the defendant directors were trustees of the profit made, out of reselling the shares, for the benefit of the plaintiff shareholders.

35) [1914] 30 T.L.R. 444; see also Briess v. Woolley [1954] A.C. 333, where an agency relationship had been held to exist when the shareholders appointed the managing director to negotiate the sale of their shares.

38) See Mayson S., French D. and Rayan C. Company Law, [1988-89].
40) Those developments has been dealt with in detail in Chapter No. 6.
45) [1990] 2 W.L.R. 358.
46) [1990] 2 All E.R. 908 (HL).
49) A "voluntary assumption of responsibility" has been considered to be untrue ground of liability: see per Lord Griffiths in Smith v. Eric S. Bush [1989] 2 W.L.R. 790 at p.813. His Lordship said: "The phrase assumption of responsibility" can only have any real meaning if it is understood as referring to the circumstances in which the law will deem the maker of the statement to have assumed responsibility to the person who acts upon the advice".
50) "Reliance" solely was held to be insufficient ground for a duty of care to arise. The recipient of the statement who relied upon it, and the purpose for which the statement was acquired must be in the defendant's contemplation. To hold the giver of the statement or the advisor to be under a duty of care to any person who may choose to rely upon it and to achieve any purpose, amounts to subjecting him to "liability in an indeterminate amount for an indeterminate time to an indeterminate class": per Cardozo C.L. in Ultramesares Corporation to v. Touche [1931] 174 N.E. 441 at p.444. Cardozo C.L.'s opinion has been accepted in Caparo Industries plc. v. Dickman [1990] 2 W.L.R. 358: see for example per Lord Bridge at p.368.
52) [1990] 2 W.L.R. 358 at p.384 per Lord Oliver.
53) [1990] 2 W.L.R. 358 at p.384 per Lord Oliver.
54) [1990] 2 W.L.R. 358 ,see per Lord Oliver; see Morris, "The Liability of Professional Advisers: Caparo and After" [1991] J.B.L. 36.
56) [1990] 2 W.L.R. 359 at p.381.
58) [1971] 1 All E.R. 150.
said that the directors were not in business of giving advice on investments nor had they held themselves out to the shareholders as skilled or competent to give a reliable advice. Accordingly, he held that the directors owed no duty of care to the shareholders on the basis of the Hedley Byrne principle.


61) [1971] 1 All E.R. 150 at p.163.
62) [1971] 1 All E.R. 150 at p.163.
63) [1971] 1 All E.R. 150 at p.162.

64) Indeed, the decision in Mutual Life was rejected in two British cases. See Esso Petroleum Co. Ltd v. Mardon [1976] 2 All. E.R 5; Howard Marine & Dredging Co. Ltd v. A Odgen & Sons (Excavations) Ltd [1978] 2 All E.R 1134 where the court in both cases refused to follow the "skill" principle and preferred the more flexible approach of the minority of the Privy Council in the Mutual Life case.


66) This Rule and the other Rules mentioned in this chapter set out in January 1988 edition of the Code as amended in October 1988, April and August 1989 and January 1990. The Code is issued by the Panel on Take-over and Mergers. Its object is to ensure fair and equal treatment of all shareholders in cases of take-overs. It is also concerned with the way in which take-overs are conducted so as to enable the shareholders of the offeree company to have an opportunity to consider any take-over offer. The Code, however, is neither a statute, nor it has the force of law. "It has, however, been acknowledged by both the government and other regulatory authorities that those who seek to take advantage of the facilities of the securities markets in the United Kingdom should conduct themselves in matters relating to take-overs in accordance with [the Code]": Gore-Browne on Companies, 44th ed, vol 2, [1986], para. 29.2.3.

67) For a comprehensive details see Gore-Browne on Companies, 44th ed, vol 2, [1986].
69) [1971] 1 All E.R. 150 at p.162; see also per Lord Diplock, in the same case, at p.158.
71) Pennington R. Directors' Personal Liability, [1987], at p.160.
72) [1843] 67 E.R. 1891.
75) This was one of the three grounds on which the court of Appeal in Prudential Assurance Co. v. Newman Industries (No. 2) [1982] 1 All E.R. 356, gave its decision in favour of the defendant directors.
78) [1843] 2 Hare 461.
79) In relation to the allotment of shares, however, it has been argued that shareholders have standing to sue directors who allot shares for improper purpose. Such allotment, it is argued, cannot be a wrong to the company as a corporate entity because "[the company is not particularly concerned with who its shareholders are.]: per Hoffman J. in Re a Company (No. 005136 of 1986) [1987] B.C.L.C. 82 at p.84. This argument has been opposed by the decision in the Australian case Kolback Services Ltd v. Epoch Mining NL [1987] 11 A.C.L.R. 630, (New South Wales). In the latter case, the court said that allotting shares for improper purpose is a wrong to the company as a separate person, and the members have no standing to sue the directors or to prevent a proposed allotment.
81) [1983] B.C.L.C. 244.
83) [1982] 1 All E.R. 345.
89) S.459 CA 1985 contains, however, a rule which governs to some extent directors' shareholders relationships: see Chapter No. 9.
91) [1889] 14 App Cas 337, (HL).
95) see Pennington R. Directors' Personal Liability.

97) See S.168(1)(a) FSA 1986 which provides that the persons responsible for a prospectus are: "(a) the issuer of the securities to which the prospectus or supplementary prospectus relates".


102) See S.167(1)(a-d).

103) S.167(2). In addition, a director who wants to rely on this defence has to prove, at least, one of four issues which are contained in S.167(2)(a-d). These issues are identical to those which are contained in S.167(1)(a-d).

104) S.167(3)(a).

105) S.167(3)(b).

106) S.167(4).

107) S.167(5).

108) It is to be noticed that when one talks about false statements, one means also misleading statements and cases of omission from them.


110) See Farrar's Company Law, 2nd ed, [1988].


112) S.315(2) CA 1985.

113) S.314(1) CA 1985.

114) S.314(2) and (3) CA 1985.


116) S.316(2)(a).

117) See also S.316(2)(b) which tries to prevent any attempt to circumvent S.314 and S.315 by giving directors a valuable consideration instead of money.


121) See Goodwin v. Brewster (HM Inspector of Taxes), [1951] 32 TC 80 (CA) p.84 at p.96.

122) See also the Australian case Lincoln Mills (Aust) Ltd v. Gough, [1964] VR 193 at pp.197-8, per Hudson J.

123) [1964] VR 193.


125) [1977] 3 All E.R. 123.

126) The relevant section in relation to this case was S.191 of the New Zealand Companies Act 1955; see Markson H. "Loss of Office Compensation" [1978] 128.
N.L.J 925. Markson says that there is a practical need for and it is desirable to ensure that any term, about loss of office compensation, is clearly expressed and that it does not go against the statute.
CHAPTER 8

Directors' Duties to Creditors

8.1. Introduction

Directors are under a duty to exercise their powers for the purposes for which they were conferred and bona fide in the interests of the company\(^1\). This duty is not owed to "individual members of [the] company, but only to the company itself, . . . "\(^2\). This principle indicates that, in general, though there are important exceptions to be discussed later, directors owe no duties to company's creditors, nor they are liable for its debts to creditors with whom they deal on the company's behalf. Thus, directors were held not to be liable, at common law, for the company's debts, even if they knew that the company was insolvent at the time the debts were incurred\(^3\). Moreover, the fact that the directors' negligent conduct or breach of fiduciary duty to the company has caused the company to breach its contractual obligations, does not make the directors liable to the company's creditors or to the other contracting party who has suffered loss as a result of the company's breach of obligation\(^4\). Directors are also not liable for wrongs or torts committed by the company so long as they have not personally participated
in the commission of the tort or authorised its commission\(^5\). The reason for this general immunity from liability stems from the distinct legal personality of the company\(^6\). Since the company has a separate legal personality, then it is the only one who is responsible for the fulfilment of its obligations or the payment of its debts. However, in some exceptional cases directors may be held to owe duties to creditors regardless of the general rule of immunity which is stated above. The principles of agency, the statutes and the courts have tried to provide creditors with some sort of protection against the directors' actions. So, this chapter will discuss the available methods of protecting company's creditors. It is divided into two main parts. (I) The statutory protection of creditors. (II) The judicial protection of creditors. A great significance, however, will be attached to the second part. One must declare that directors' duties to third parties, under the principles of agency, will not be examined in this chapter. That is because the rules of agency are well established and one felt that it is unnecessary to discuss those rules here\(^7\).

8.2. The Statutory Protection of Creditors.

The statutes contain several provisions aiming to protect creditors of the company. This issue can be
divided into two parts: (1) fraudulent and wrongful trading; (2) directors' concurrent liability. In these cases, directors may incur personal liability to creditors under the statute. In the former, a director may be compelled by the court to contribute to the company's assets. In the latter, the director may become concurrently liable, with the company, for the payment of its debts for the benefit of the creditors.

8.2.1. Fraudulent and wrongful trading.

8.2.1.1. Fraudulent trading.

Fraudulent trading is governed by S.213 of the Insolvency Act 1986. The section provides:

(1) If in the course of the winding up a 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) 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 proper.

To hold a director liable under this section, the company must be in the course of being wound up; the director has knowingly engaged in carrying on the company's business for the purpose of defrauding creditors or for any fraudulent purpose. These are the
key elements of S.213. Because fraudulent trading is a criminal offence under S.458 CA 1985, a high standard of proof of fraud is required in order to obtain an order imposing personal liability on the defender. A standard which is equal to that required for criminal conviction. For example, it must be proved that the defender director is actually aware of his company's inability to pay its debts, when he acts on its behalf, and that he intends to defraud the creditors or to achieve any fraudulent purpose. Here, it would seem that an inferential knowledge of the company's inability to pay its debts, is not enough to make a director liable under S.213. This is clear from the judgment of Maugham J. in Re Patrick and Lyon, where he said that the words "defraud" and "fraudulent purpose" connote "real dishonesty involving, according to current notions of fair trading among commercial men at the present day, real moral blame."

S.213 has been designed to punish persons who deliberately and knowingly set out to defraud creditors. The words "fraud" and "fraudulent", in this context, must be distinguished from the word "fraud" in the context of the minority protection. In the latter, the word "fraud" was given a wide interpretation. Thus, it is said that "fraud on the minority" can be held to exist if it is proved that the action of the majority shareholders confers some benefit on them. Consequently, a majority's
negligence can constitute fraud on the minority provided that that negligence confers some benefit on the majority. Likewise "fraud on the minority" can be held to exist if it is shown that the majority has abused its powers, for example, by injuring one class of shareholders to the benefit of another(14). Therefore, in relation to the meaning of "fraud" in the context of "the minority protection", lack of honesty is not a necessary element for the existence of fraud. Otherwise, owing to the difficulty of proving dishonesty, it would not always be possible to hear the groaning of the minority shareholders who suffer under the rigidity of the majority rule(15). One feels that a wide interpretation of the word "fraud" while suitable and desirable in the context of "minority protection", is inappropriate in the context of "fraudulent trading". The reason lying behind this conclusion is the fundamental point that fraudulent trading is a criminal offence, while a fraud on the minority is not. Fraudulent trading is a criminal offence which deserves a criminal penalty. Thus, a strict interpretation of the word "fraud" is more appropriate. Consequently, dishonesty must remain a crucial element to prove fraudulent trading. Thus, in order to make a director liable under S.213, it is not sufficient to prove that he is guilty of negligent mismanagement. In addition, the mere omission by a director cannot constitute a
breach of that section. That is because the expression "parties to" involves some positive step(16).

Despite the difficulty of proving "actual dishonesty" it has been held that this requirement can be satisfied if it is proved that the director caused the company to incur additional liabilities at a time when it was clear to him that the company would never be able to pay its creditors. Similarly, the requirement of "actual dishonesty" can be satisfied if it is proved that the director has obtained credit for the company when he knew that "there is no reason for thinking that the company is able to meet all its liabilities as they fall due"(17). It is not necessary, however, for the purpose of making a director liable under S.213 to prove that all creditors have been defrauded. Thus, in Re Gerald Cooper Chemicals Ltd(18), it was held that a single transaction which was carried out to defraud a single creditor could constitute a violation of the fraudulent trading provision.

The expression "carrying on business" was held not to be necessarily synonymous with actively carrying on trade(19). Thus, "the collection of assets acquired in the course of business and the distribution of the proceeds of these assets in discharge of business liabilities"(20), can constitute a carrying on of business. However, in Re Sarflax Ltd.(21) it was held that where the only allegation against the company or
its officers was that they preferred one or more creditors over others, this could not constitute fraud within the meaning of S.213.

The court has been given a discretionary power to make the defender liable to contribute to the company's assets as it thinks proper. The Insolvency Act 1986 puts neither maximum nor minimum limit on the liability to contribute to the company's assets in cases of fraudulent trading. It follows that it is not necessary to bear in mind how many debts incurred by the company during the period of fraudulent trading nor whether certain creditors were misled(22). It is said(23), however, that (when deciding the amount of contribution to the company's assets) the court will take into account the decrease in the company's assets and the increase in its liabilities resulting from fraudulent trading. It should be noticed that under S.213(2) the contribution ordered to be made must be made to the company's assets. Thus, the money recovered will be available for all creditors and not paid to particular creditors(24). S.215(4) gives the court the power to direct that the whole or any part of the debt owed by the company to the person who is found guilty of fraudulent trading and any interest thereon "shall rank in priority after all other debts owed by the company and after any interest on those debts"(25). Furthermore, imposing a criminal liability on a director
who is found guilty of fraudulent trading does not exonerate him from the civil liability to contribute to the company's assets\(^1\). Finally, for the purposes of S.450 CA 1985, fraudulent trading can be prosecuted even if the company is not in the course of being wound up. In other words, the criminal offence is not linked to a winding up\(^2\). Whereas the "course of winding up" requirement is still intact in relation to the civil liability.

8.2.1.2. Wrongful Trading.

The Cork Committee\(^3\), suggested the wrongful trading provision under which civil personal liability could exist without proof of dishonesty\(^4\) and without requiring the high standard of proof which is required for criminal convictions. The wrongful trading is now governed by S.214 of the Insolvency Act 1986. The reason behind the enactment of the wrongful trading provision is to govern cases in which directors have carried on of business recklessly and can escape liability owing to the difficulty of establishing a case of fraudulent trading against them. So, it would seem appropriate to draw a distinction between fraudulent trading and wrongful trading at this stage. First, in fraudulent trading a personal liability may be imposed upon any person who is a party to the carrying on of the
company's business\(^{30}\). Whereas in wrongful trading only the directors and shadow directors\(^{31}\) are caught by its provisions. In relation to shadow directors, they cannot be made responsible for wrongful trading unless the directors are accustomed to act in accordance with their instructions\(^{32}\). Second, in fraudulent trading, the onus of proving the intention to defraud creditors is on the liquidator. Whereas in wrongful trading, directors who wish to escape liability bear the onus of proving that they have taken every step to minimise the potential loss to the company's creditors.

It follows that while it is necessary to prove actual dishonesty in order to establish a case of fraudulent trading, proving dishonesty is unnecessary to establish a case of wrongful trading. Thus, mere negligence is sufficient for the purposes of the wrongful trading provisions\(^{33}\). Third, while fraudulent trading is a criminal offence\(^{34}\), wrongful trading is not. The similarities, however, between fraudulent trading and wrongful trading lie in two matters: first, the liquidator is the one who can make an application to the court in relation to both types of trading; second, in both fraudulent and wrongful trading, the defender may be held personally liable to contribute to the company's assets as the court thinks proper.

According to section 214 the court may declare that a person, who is or has been a director or shadow director
of a company, is liable to contribute to the company's assets as it thinks proper 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.

S.214 was applied in Re Purpoint. In that case a car, which was not needed for the purposes of the company, was bought by the director on behalf of the company. It was also bought in a time when the company was in parlous state. The court held the director liable to contribute to the company's assets. The court based its decision on the ground that he should have realised that the company could not avoid insolvent liquidation; and that he would be liable to contribute to the company's assets in an amount equal to the loss suffered by the company (as a result of the continuation of trading after its being unable to pay its trade debts).

Since the court's jurisdiction under S.214 is meant to be "compensatory rather than penal", then when holding directors liable to contribute, the court may have regard to the extent of the loss caused to the company's creditors by the directors' conduct.
A director, however, can escape liability if he satisfies the court that, after he realised the likelihood of insolvent liquidation, he took every step, he ought to have taken with a view to minimising the potential loss to the company's creditors\(^{(38)}\). In relation to this particular point, one does not agree with the view that the liquidator must prove, in addition to the requirement found in S.214(2), that the defender director took insufficient steps in the circumstances to minimise the potential loss to the company's creditors\(^{(39)}\). It would seem that S.214 is very clear. If the liquidator satisfies the court as to the requirements of that section, the court may declare that the defender is liable to contribute to the company's assets. It is then for the defender to prove, if he wishes to avoid liability, that he has taken every step with the view to minimising the loss to creditors. S.214 has tried to increase the possibility of pursuing directors who are involved in wrongful trading by introducing an objective element to the standard of care required from a director. Thus, the section leads to a substantial increase in claims by liquidators against directors of insolvent companies\(^{(40)}\). To decide whether a director ought to have concluded that an insolvent liquidation was unavoidable, the court must apply the test which is laid down in S.214(4). According to that section the conclusions which a director
"ought to reach and the steps which he ought to take are those which would 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 that director has.

It is clear from the wording of S.214(4) (a) and (b) that the directors' conclusions are subjected to a test consisting of two elements. First, an objective element which is found in S.214(4) (a) (i.e. a reasonable man of a reasonable general knowledge, skill and experience carrying out the same functions); and, second, a subjective element which is found in S.214(4) (b) (i.e. the personal knowledge, skill and experience which the defender has)(41).

Finally, it should be noted that since the recovery is corporate under both S.213 and S.214, neither of those two provisions violates the principle that all creditors participate pari passu in bankrupt estate(42).

8.2.2. Concurrent Liability of Directors.

The Companies Act 1985 contains some provisions under which a director may be held concurrently liable, with the company, to the creditors, for the debts or the contractual obligations of the company. Examples of those situations are to be discussed next.
8.2.2.1. A director's Liability as a sole member of the company.

S.24 CA 1985 provides that if a company carries on business with only one member for more than six months, the sole member is liable jointly and severally with the company for the payment of the company's debts contracted by the company after the six months have expired and during the time that he remains the sole member of the company and is aware of that fact. Directors are caught by this section and, in fact, it is the most likely that the sole member of a company is a director. The purpose of this section is to ensure that a company always has a minimum membership of two as required by the legislation in order to carry on its business. However, the liability of the sole member, under this section, is confined to the debts resulting from contracts entered into by the company after the period defined by the statute. So, if the company incurred debts by the operation of law such as taxes, the sole member will not be made liable for those debts. It should be noticed, however, that the Twelfth Directive of the EEC makes possible the creation of a one man company. The Directive applies to private limited companies only. That Directive should have been implemented on the 1st of January 1992. However, it has
not been implemented by the United Kingdom so far. Professor Murray(43) argues that it is the duty of the national courts to construe national law in the light of Twelfth Directive even although the national legislature has failed to implement it into state legislation. An important and direct result of implementing this directive will be the abolition of the rule that a winding up order is justified where the number of the members of the company is reduced below two(44).

8.2.2.2. Directors' liability in connection with negotiable instruments.

S.349(4) CA 1985 provides that a person who signs or authorises the signature of a bill of exchange, promissory note, cheque or order for money or goods in which the company's name is not mentioned as required by the statute(45), commits an offence punishable by a fine, and he is further personally liable to the holder for the amount of instrument unless it is duly paid by the company. Accordingly, it was held that the name of the company was not stated in full if part of it was contracted by an "etc"(46). Similarly, it was held that the name of a limited company was not stated in full as required by the statute if the word "limited" had been omitted(47). However, S.27(1) CA 1985 treated the contractions "ltd" or "plc" as equivalent to the
expressions "limited" and "public limited company". The contraction "Co." was also accepted as equivalent to the word "company"(48). It should be noted that, under S.349(4), the defender cannot escape liability by pleading that the payee is aware of the fact that the company's name was misspelled in the instrument(49). Directors are caught by S.349(4). If a director is found liable under this section, his liability will be concurrent with that of the company. The purpose of this section is to ensure that the company's acceptance of liability for the negotiable instruments or for orders for money or goods is made clear by a statement of its full name.

8.2.2.3. Liability of Disqualified Directors to creditors.

The court may disqualify a director, in the future, from acting as a director or in any other capacity in relation to the company's business if (1) he is convicted of criminal offence in relation to the company(50) or, (2) he has been persistently in default in relation to the provisions of the companies legislation requiring any return, account or other document to be filled with, delivered or sent, or notice of any matter to be given to the Registrar of Companies(51) or, (3) he is found guilty of fraud in
relation to the company or responsible for fraudulent trading\(^{(52)}\) or, (4) he is found unfit to be a director\(^{(53)}\). In addition, a person who is an undischarged bankrupt is automatically disqualified from acting as a director of a company until he obtains his discharge in bankruptcy, unless the court gives him leave to act as such\(^{(54)}\). The period of disqualification is to be fixed by the court. The Court of Appeal in Re Sevenoaks Stationers (Retail)\(^{(55)}\), gave guidance on the periods of disqualification to be imposed. It stated that a period over 10 years should be imposed in particularly serious cases such as a second disqualification. The period of 2-5 years applied to cases which were not very serious. Whereas a period of 6-10 years applied to serious cases which did not merit being labelled particularly serious\(^{(56)}\). With respect, this classification would seem artificial and vague because it is not easy to draw a clear cut distinction between "serious cases" and the so called "particularly serious cases". In general, however, the Company Directors Disqualification Act 1986 provides that the maximum period of disqualification is 15 years except in the case of persistent breaches of companies legislation where the maximum period of disqualification is 5 years\(^{(57)}\). An application of the provisions dealing with disqualification orders is found in many cases. For example, in Re Civica Investments Ltd\(^{(58)}\). A
was the sole director of a number of companies. He had made a large number of defaults in relation to the provisions of the companies legislation. He had been convicted in respect of 59 defaults involving failure to file accounts and annual returns. Nourse J. held that it would be improper not to impose any period of disqualification on the defendant having regard to the huge number of defaults he had made. The judge, however, limited the disqualification period to only one year (59). If a director defied the disqualification order and acted in violation of it without leave of the court, he would be made personally liable for the debts and liabilities incurred by the company during the time he was involved in its management while disqualified (60). Where a disqualified director is held to be personally liable for the debts of the company, he is jointly and severally liable in respect of those debts, with the company, to creditors and others who have claims against the company (61). Professor Pennington (62) argues that such a director can be made liable for the company's debts incurred during the time he was involved in the management while disqualified even if these debts were incurred by operation of law. It would seem that the only justification for this extension of liability lies in the fact that violating a disqualification order constitutes a criminal offence (63) and thus, the object of the provisions

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dealing with disqualification orders is penal rather than compensatory. Finally, the court has no power to exonerate someone who acts in contravention of a disqualification order, from personal responsibility for the debts incurred by the company while he was involved in its management. S.727(1) CA 1985 which gives the court the power to exonerate directors or officers from liability if they are acting bona fide and in a reasonable way, has no application in relation to a personal liability incurred under the provisions dealing with disqualification orders(64). It should be noted that the above situations are not the only ones in which a director may become concurrently liable for the company's debts. A director of a public company, for example, may incur concurrent liability if his company commences business before obtaining its "trading certificate"(65). It must be noticed that the expression "trading certificate" is not synonymous with the expression "certificate of incorporation". The former certificate is required to be obtained by public companies only. This certificate is a conclusive evidence that the company is entitled to do business and exercise any borrowing powers. Without this certificate, a public company shall not do business or exercise any borrowing powers, unless it is re-registered as a private company. The private companies are not required to obtain such certificate. So, they
can do business immediately after obtaining the certificate of incorporation which is necessary for both private and public companies.

If a public company X entered into a contract with Y before obtaining its "trading certificate", Y can enforce X to discharge its obligations under that contract. If X fails to do so, then its directors will be jointly and severally liable to indemnify Y for any loss he suffers as a result of X's failure to discharge its contractual obligations. The contract between X and Y, described above, cannot be considered as a pre-incorporation contract. That is because the "trading certificate" is completely different one from the certificate of incorporation. However, under S.117(7) CA 1985, this contract amounts to a criminal offence punishable by a fine. Similarly, a director may become responsible for the company's debts, concurrently with the company, if he guarantees those debts which the company has failed to pay. The creditor in this case is entitled to resort to the company or the surety, or both of them, to recover the debt or the damages suffered by him as a result of the company's breach of obligations.
8.3. The Judicial Protection of Creditors.

The statutory protection of creditors has been already examined. It remains only to discover if the courts have extended directors' duties to creditors, and whether creditors are, truly, in need for this extension. Despite the statutory protection available to creditors, and the agency principles which offer some protection to them it would seem that the courts are willing to protect creditors particularly in cases where the company is on the verge of collapsing. There is, however, a debate over whether the debt market is able to protect creditors. Professor Posner(67), an exponent of the idea that the debt market can protect creditors, laid down a theory which provides that interest rates accurately reflect the risk in the most efficient manner(68). In his opinion, most creditors advance loans in cases where different interest rates or prices are charged for incremental levels of risk. The interest rate charged on a loan represents a payment, in advance, for the rental of the capital as well as for the risk that the borrower may fail to repay that loan(69). Consequently, Professor Posner reached the view that because an increase in risk will be matched by an increase in the interest rate, the lender will be relatively unconcerned with the outcome of the venture. That is because the borrower himself will bear the cost.
of exploiting the loan in risky ventures. Professor Posner pointed out that the lender has to investigate the credit-worthiness of his customers, before giving loans or supplying goods, in order to know the level of risk. Therefore, he acknowledged that the calculation of the risk depends to some extent on the honesty of the borrower. He reached a final conclusion that in the absence of misrepresentation, on the part of the borrower, of facts important to the calculation of the risk, the lenders are well protected and will not be harmed(70). Professor Posner, however, admitted that his theory does not work in two main cases: (1) where the costs of obtaining sufficient information about the risk are disproportionate to the value of or the amount of the transaction(71), and (2) it does not work in cases of involuntary creditors such as tort creditors(72) and the tax collectors at all level of government(73). On the other hand, Landers(74) pointed out that the debt market is unable to provide adequate protection to creditors. In some situations, Landers argues, the interest rate falls below the level of risk undertaken, and consequently, the borrower will be able to externalise the cost of the debt. That is, the cost of the debt can be, to some extent, shifted to the lender. Landers argues(75) that many creditors choose not to investigate the credit-worthiness of their customers because they cannot afford it. And even if
they can and do investigate, they usually do not increase prices of goods or interest rates on loans to match the expected risk. Landers added that even if creditors choose to investigate the credit-worthiness of their customers, it is quite possible that the customers may not provide the creditors with full information about the nature of the venture, their financial position and their ability to achieve completion of that venture. In addition, fixed prices for goods is a common phenomenon. This pricing system does not reflect the actual risk of supplying to those whose credit-worthiness has not been investigated by the supplier. Trade creditors were accustomed to make some investigation about the credit-worthiness of their customers. They, however, tend to rely on borrowers' history of regular payment. A history of regular payment does not necessarily reflect the actual risk of giving loans, particularly in cases of parent-subsidiary companies. In these cases, it is quite possible that those regular payments have been made by the assistance of the parent company to the subsidiary company where the latter is the borrower. In the above situations, the interest rate will not be able to reflect the real risks. Consequently, the borrower will be able to externalise the cost of the loan, i.e. to shift it to the lender. Landers also argues that the interest rate reflects the predictable risks only. That
is, it reflects the risks which are known at the time the loan is made. Thus, any increase in the risk after that date will effectively lower the interest rate. An unpredictable risk is found, for example, in cases involving parent-subsidiary companies and veil piercing is ordered. In these cases, there is a risk that creditors of one of these companies will reach the assets of the other one. Creditors of the borrower, in these cases, cannot estimate this risk in advance, and thus the interest rate will not be able to reflect this type of risk. Consequently, the new unpredictable cost will be shifted to the lender. Professor Posner's reply was that creditors could protect themselves against unpredictable costs, such as the cost of exploiting the loan in risky ventures, by restrictive covenants. McDaniel, who is a critic of the debt market restraints argues that these covenants are not very common and are an inappropriate response for trade creditors.

In support of his argument that the market can provide creditors with the necessary protection, Professor Posner said that, in cases involving a multi-unit corporate enterprise, creditors can be protected by operating individual units as individual "profit centres" rather than as components of a single enterprise. Consequently, the creditors of one unit will not be exposed to the enterprise dangers. In
return, Landers(81) argues that this approach is inaccurate because separate corporate units are usually formed either to advance a business need of investors or to take advantage of the skills developed in one line of activity. In other words, most multi-unit corporate enterprises involve interrelated business. In addition, many corporate managers do not, in fact, aim toward maximum profitability of each individual corporate unit. The debate over the efficiency of the market to protect creditors is, however, far from over. It could be concluded that the market can, to some extent, protect creditors in cases where it is clear that the company will continue in its business. If the company can continue in trade or has the intention to continue in it, the market can restrain directors' conduct provided that full information is given about the venture and the financial position of the borrower. This was, in fact, the conclusion reached by Professor Posner where he said that in the absence of misrepresentation, on the part of the borrower, of facts important to the calculation of the risk, the lenders are well protected and will not be harmed(82). Landers' argument that, in practice, many creditors choose not to investigate their customers credit-worthiness or that they choose not to increase interest rates, does not seem able to undermine Posner's theory. Posner's theory does not apply to creditors who do not take the necessary steps to protect themselves.
Professor Posner assumes that creditors will investigate carefully. However, what seems to be a weak point in Posner's theory is the remarkable exceptions to it. Professor Posner acknowledges that his theory does not work where the costs of obtaining information about the risk are disproportionate to the amount of the venture. Similarly, he recognises that his theory does not work in cases involving involuntary creditors. Nor does it work in cases where the company is tending to insolvency. These exceptions, in fact, limit the scope of the application of Posner's theory. The last exception leads us to a very important point which is the protection of creditors in cases where the company is insolvent or threatened with insolvency. In this case the borrower does not care about the lender's confidence. A lender's confidence represents a long term interests for the borrower. These interests exist only when the company expects to continue in trade. Thus, a company that need money from time to time has an incentive to avoid causing losses on creditors. If it happened that a company caused harm to its creditors, it would definitely lose their confidence. In addition, new creditors will demand additional interest as compensation for the expected risk of suffering the same fate as the old creditors(83). On the other hand, what is important for a company faced with financial difficulties is the avoidance of insolvency. Therefore,
the directors will not hesitate in exploiting loans in any risky ventures so long as there is a gleam of hope that the company will avoid insolvency. In other words, it is rational for a company to make a venture which is "riskier but alone offers the possibility, albeit remote, of a bonanza pay off that will prevent insolvency"(84). In this case, i.e. the case of insolvency, the potentiality for creditors-shareholders conflict exists because creditors have prior but limited claims on the company’s assets while the shareholders have limited liability for the company’s debts and unlimited claims on the rest of its assets(85). In case of insolvency, shareholders’ investments are already lost, and because their liability is limited, it makes sense to use loans in what may be a futile rescue attempt(86). Thus, the onset of a company’s insolvency may motivate the company to harm its creditors by shifting the cost of loans from the shareholders to the creditors. Consequently, it would seem that creditors are in need for protection at this stage of a company’s life. A judicial protection for creditors’ interests can be also justified on the ground that the company’s failure to repay its debts may lead its creditors to insolvency. And it is quite possible that the insolvency of one creditor may lead to a series of insolvencies amongst other creditors. This at the end will adversely affect the interests of the society as a
whole. Creditors deserve protection, as much as the shareholders do, because they play a major role in financing companies with the needed capital. Fischel\(^{(87)}\), argues that there is no difference between the position of shareholders and that of creditors. Both provide companies with needed capital in exchange for an expected rate of return generated by cash flows from the companies' assets. The issue of creditors' protection leads some writers to take, as it seems, some extreme views. It is argued\(^{(88)}\), for example, that shareholders are no more the owner of the company than are the debentureholders, other creditors and employees. Similarly, Baysinger and Butler\(^{(89)}\) referred to shareholders as risk bearers rather than owners of the company. The critics of the debt market restraints concluded that since the market is unable to provide the creditors with the necessary protection, particularly in cases where the company is tending to insolvency, there must be some other means to protect them. Since the statutes do not provide the creditors with that protection, then it is to the courts to offer them some judicial protection. Some writers, however, argue, on grounds other than the market restraints, that creditors do not need judicial protection. For example, Professor Sealy\(^{(90)}\) argues that the establishing of duties owed directly by directors to creditors is "unnecessary". The reasons are as follows: (1) to give remedies to some
creditors in an insolvency which are denied to others will undermine the fundamental principle that all creditors participate pari passu in bankrupt estate;

(2) that the novel "wrongful trading" provision of the Insolvency Act 1986, section 214 provides a protection to creditors on a statutory footing. This section makes any judicial rule, established to protect creditors, unnecessary. Furthermore, to recognise a duty owed by directors to individual creditors is to create a problem of double recovery and a multiplicity of suits if both the company and individual creditors are allowed to sue directors. The courts in the United Kingdom have recognised that creditors' interests need special attention where the company is insolvent or on the edge of insolvency. They realised that directors in these situations may take actions capable of causing harm to the creditors' interests. Thus, directors may owe some duties to creditors in these situations. This will be discussed next.

**Directors' duties to creditors on and before insolvency.**

There is a difference between saying that directors owe fiduciary duties to creditors and that they are bound to consider the interests of creditors. The former statement implies that creditors can enforce these
duties themselves. The latter indicates that the director's duty to consider the creditors' interests is a duty owed to the company and is, consequently, enforceable by the company alone. In other words, in the latter case, the company's interests are extended so as to embrace that of its creditors. Before considering the relevant case law, one should give examples of managerial actions which may be prejudicial to the creditors' interests. Creditors' interests can be prejudiced not only by managerial actions but also by managerial inaction. The directors of the company may, after the loan has been made, reduce the "pool of assets" from which the company can repay a loan. This can be achieved by distributing the company's resources by means of excessive dividends, or by selling its assets at an undervalue, or by granting securities over those assets. The interests of the creditors can also be harmed if the company's directors, after the making of the loan, cause the company to incur additional liabilities, for example, by taking new loans. The new loans or debts may compete with the original ones for the security. This action might cause greater damage to the interests of the old lenders where the new loans were obtained at a higher interest rate and were used for a very risky ventures. A venture is risky if it has low possibility of success but a big profit if
If the venture succeeds, shareholders will collect most of the gain. The market value of the company will increase, but most of the increase will go to shareholders. But if the venture fails, the market value of the company will decrease, and the lenders will be those who will sustain most of the loss. If these actions lead the company to insolvency, the creditors may not find enough assets to recover their money. In these situations, it is the directors' positive conduct which cause harm to the interests of the creditors. Directors' inaction may prejudice the creditors if, for example, the directors fail to exploit the opportunity for which the loan has been advanced.

The question which arises at this stage is when and how to protect creditors. In their attempt to protect creditors, the courts have avoided novelty and relied instead upon the existing rules which govern directors' actions. In other words, the courts do not create new rules establishing duties owed by directors to creditors. They have adopted and expanded the existing rules so as to make them capable of protecting creditors' interests.

Before considering the relevant authorities, it is useful to rehearse the established rules that govern the conduct of the directors. The board of directors is vested with wide powers in order to run the company's
business. These powers are largely free of shareholders interference\(^{104}\). The scope of those powers is, however, limited by some obligations imposed upon directors. First, directors are under a duty to exercise their powers for the purposes for which they were conferred\(^{105}\). They are also obliged to act in good faith in what they consider as in the best interests of the company\(^{106}\). Second, Directors are under a duty not to make a secret profit and/or to place themselves in a position where their personal interests conflict with their duty to the company\(^{107}\). Third, directors are required to exercise due care and skill in the management of the company's affairs\(^{108}\). These are the most important rules governing directors' conduct. It is the first rule which is relevant to the question of the protection of creditors. That is, directors must exercise their powers bona fide in the best interests of the company. The courts have relied on this rule in their attempts to extend directors' duties to creditors. In many cases the courts have considered the creditors' interests as being embodied in the interests of the company. To clarify this issue, one should examine the relevant authorities. The first judicial attempt, to establish that the board of directors must consider the interests of the creditors, is found in the comments of Mason J. in the Australian case Walker v. Wimborne\(^{109}\). This case had

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dealt with a claim of misfeasance arising out of shifting of funds between companies in a group. Mason J. said:

In this respect it should be emphasised that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interest of creditors will have adverse consequences for the company as well as for them. The creditor of a company . . . must look at that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.(110).

It is to be noted that there is nothing in the comments of Mason J. to suggest that the duty to consider the interests of creditors is owed directly to the creditors themselves. He did not say that directors owe duties to creditors, merely that, while performing their duties to the company, the directors must have regard to the creditors' interests.

Thus, the duty to take account of the creditors' interests is owed to the company and is, consequently, enforceable by the company alone. The judgement of Mason J. found some support in the remarks of Cooke J. in the New Zealand case Nicholson v. Permakraft (NZ) Ltd.((111)). In that case, a new company was formed, with identical shareholders, to purchase the original company's shares. The proceeds of the sale were distributed to the shareholders by way of capital dividend. The effect of this conduct was to reduce the
pool of the available assets within reach of creditors. The Court of Appeal held that the board of directors was acting within its powers and in the best interest of the company. The liquidator's claim that the board had breached its duty was rejected by the court. Cooke J., however, made some important remarks. He said:

The duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors.(112)

So, neither Mason J. nor Cooke J. said that directors owe a duty directly to creditors. In their comments both judges confirmed the old rule that directors' duties are owed to the company. The rule which finds its origins in the case of Foss v. Harbottle(113) and its line of cases. In support of this rule, Dillon L.J. stated

The directors indeed stand in a fiduciary relationship to the company, ... they owe fiduciary duties to the company though not to the creditors, present or future . . .(114).

However, the dictum of Lord Templeman in Winkworth v. Edward Baron Development Co. Ltd.(115) goes against that rule. It suggests that directors owe a direct duty to creditors. His Lordship said:

But 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 confided to its directors. A
duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors(116).

The dictum of Lord Templeman has been referred to with apparent approval in the New Zealand decision of Hilton International v. Hilton(117). In that case Tipping J. held that the directors owe a duty, when declaring a dividend, "not only to the company but also to its creditors . . ., both present and future"(118). It should be noted that the idea of imposing a direct duty upon directors to creditors is beset with some problems. First, it, as mentioned above, goes against the old and the well established rule that directors owe their duties to the company alone. Second, if it is accepted that the aim of the creation of companies is to achieve a maximum profit, and the function of the directors is to pursue that maximisation, then a direct duty owed by the directors to the creditors will disrupt this function(119). Directors will not be entirely free to fulfil their duty of maximising shareholders utility(120). That is because they will be under the creditors' control. The creditors are interested in the assets of the company and look to it for payment. They will not allow the directors to use the company's assets in a risky venture. Thus, it is submitted that where the company is solvent, directors' duties are owed to it.
and enforceable by it alone. The creditors' interests do not emerge as an important matter distinct from the company's interest. A confirmation of this is found in Brady v. Brady\(^{(121)}\), where Nourse L.J. said:

> . . . where the assets are enormous and the debts minimal, it is reasonable to suppose that the interests of creditors ought not to count for very much\(^{(122)}\). 

The creditors' interests, which must be taken into account by the directors in cases where the company is solvent, emerge as part of or are included in the company's interests. The position may differ in cases where the company is insolvent\(^{(123)}\). While the interest of the company is the collective interest of its shareholders where the company is solvent, the interest of the company could be regarded as the creditors' interest where the company is insolvent. So, the question here is whether insolvency is a crucial element or not. This point has been clarified by Nourse L.J. in Brady v. Brady\(^{(124)}\) where he said:

> Where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of the existing creditors alone\(^{(125)}\).

Thus, if the company is insolvent, the shareholders and the directors are no longer able to deal freely with its assets. This point has been emphasised by Street C.J. in Kinsella v. Russell Kinsella pty Ltd\(^{(126)}\), where he identified the rationale behind directors' duty to consider the interests of creditors. His Honour said:
In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company . . . where a company is insolvent the interests of creditors intrude . . . It is in a practical sense their assets and not the shareholders assets that . . . are under the management of the directors\(^\text{127}\).

The statement of Street C.J. was quoted with approval by Dillon L.J. in the British case of West Mercia Safetyware Ltd v. Dodd\(^\text{128}\). In that case, West Mercia Ltd. was a wholly-owned subsidiary of Dodd and Co. Ltd. (Dodd). D was the director of both companies. Both companies banked with the same bank. Dodd's overdraft at the bank was guaranteed personally by D. In May 1984 West Mercia Ltd. owed Dodd about £30,000. At that time both companies were in financial difficulties. On 21 May D transferred £4,000 from the account of West Mercia Ltd. to Dodd's account. In June both companies went into liquidation. The liquidator of West Mercia Ltd. alleged that D was guilty of misfeasance and breach of trust. Accordingly, he asked the court to order D to repay the £4,000 transferred from West Mercia Ltd. to Dodd. At the trial, the judge held that although D had acted improperly, he didn't misapply West Mercia's assets. The transfer of £4,000 was repayment in part of a debt owed by West Mercia Ltd. to Dodd. The liquidator appealed. The Court of Appeal allowed his appeal and held that D had breached his duty. D was ordered to repay the £4,000 with interest. The court's decision
was based on the ground that West Mercia Ltd. was known to D to be insolvent when he caused the £4,000 to be transferred from its account to Dodd's account. The court emphasised that once a company was insolvent, the creditors' interests overrode those of the shareholders. That was because the company's assets belonged in a real sense to the creditors, and these assets were the only source for the satisfaction of their debts. Thus, D had, in fact, disregarded the interests of the creditors of the insolvent company when he transferred the £4,000. A direct result of the decision in West Mercia is the restriction of the shareholders' right to ratify directors' breach of duty. The West Mercia case clearly stated that where a company is insolvent, the creditors' interests override, the shareholders' interests in the company cease to exist and thus the shareholders should be prevented from ratifying the directors' breach of duty (129).

Thus it would seem that insolvency or even "doubtful solvency" is a crucial element in relation to creditors' interests. Thus, if the company is insolvent of "doubtfully solvent", the creditors' interest arises as an issue which deserves protection. While it is clear from the case law, which dealt with directors duties to creditors, that directors owe a duty to consider the interests of the creditors particularly where the company is on the verge of insolvency, the content of
that duty is as yet unclear. In Nicholson v. Permakraft (NZ) Ltd(130), Cooke J. indicated that directors were not required to give creditors' interests a sort of positive consideration. In taking account of the creditors' interests directors must consider "whether what they do will prejudice their company's practical ability to discharge promptly debts"(131). Likewise in Winkworth v. Edward Baron Development Co. Ltd.(132), Lord Templeman felt that the directors owe a duty to ensure that the company's property was not "dissipated or exploited for the benefit of the directors themselves to the prejudice of creditors"(133). Similarly, in Re Welfab Engineers Ltd.(134), Hoffmann J. held that the directors' duty extends only to avoiding action that would cause damage to creditors' interests. The above cases share the view that directors are not under duties similar to those of a liquidator in relation to creditors' interests. This view cannot be affected by the fact that the company is insolvent or near insolvency. So, according to this view directors are under a negative or proscriptive duty to creditors. They are only bound to avoid actions which may prejudice the interests of creditors.

To the contrary, in Brady v. Brady(135), Nourse L.J. pointed out that the board was bound to act in the interests of the company. However, his Lordship said that "where the company is insolvent, or even doubtfully
solvent, the interests of the company are . . . the interests of the existing creditors alone"(136). So, in his Lordship's opinion, the creditors are the beneficiaries if the company is "insolvent or doubtfully solvent". In such a case directors must actively further the interests of the creditors because the basic fiduciary obligation(137) requires fiduciaries to take positive actions in furtherance of the beneficiaries' interests. A similar view is also apparent in Kinsella v. Russell Kinsella pty Ltd(138) where Street C.J. said that "where a company is insolvent the interests of creditors intrude . . . It is their assets . . . that are under the management of the directors"(139). Thus, there is a division within the authorities in relation to the content of directors' duty to creditors. Regarding the company's assets as belonging to creditors in cases where the company is insolvent, is the only view that gives weight to the idea of imposing a positive duty on directors to further the interests of creditors. That is because, as mentioned above, fiduciaries must take positive actions to further the interests of the beneficiaries who are, in cases involving insolvent companies, the creditors alone. It follows that directors must serve the interests of creditors alone(140); and that directors may be held liable if they further the interests of non-creditors, such as the interests of the employees, notwithstanding
that their conduct has no damaging effect on the interests of the creditors\(^{(141)}\). It has been, however, argued\(^{(142)}\) that the division amongst the authorities is more apparent than real. Creditors' interests in most cases can be served by a prescriptive duty for two reasons: (1) The now fashionable "enterprise"\(^{(143)}\) view of the company requires directors to consider the interests of various groups who are interested in the company. The shareholders, the creditors and the employees are examples of those groups. During the lifetime of the company, however, the interests of one group may deserve greater consideration than the others'. While it is correct to say that the interests of creditors deserve greater consideration than the other interests in case of insolvency, this does not mean that directors are entitled to ignore the interests of other groups. So, directors can satisfy the creditors' claims simply by avoiding prejudicial conducts\(^{(144)}\). (2) Creditors can be exposed to a real risk if the directors transfer the wealth form creditors to shareholders by causing the company to incur additional liabilities or by withdrawing its assets. It follows that the interest rate charged upon the loan becomes inadequate. In this case creditors can be better served and protected by prohibiting directors from externalising the cost of the debt\(^{(145)}\). That is, the creditors' interests can be adequately served by a
proscriptive duty. In cases where the interest rate reflect the real risk, creditors will not be concerned by the inability of the company to repay the loan because the interest rate charged upon the loan represents a payment, in advance, for the rental of the capital as well as for the risk of the borrower failing to return it(146).

To conclude, the case law indicates that where the company is insolvent or near insolvency, the creditors' interests are in need for protection. Where the company is solvent, the directors owe no duty to creditors to keep the company's capital intact(147). That is because creditors interests are not impaired sufficiently to justify judicial restraints on the company's self-interested actions(148). The creditors have no locus standi to sue the directors for their mismanagement. The rule in Foss v. Harbottle(149) remains an obstacle in the creditors' way to sue directors. They cannot also bring a derivative action on behalf of the company since none of the exceptions to the rule in Foss v. Harbottle applies to their claims. So, it is only when the company goes into liquidation that the creditors' claim can be heard. However, the creditors may not succeed in their claims against directors whose actions lead the company to insolvency. That is because the bona fides of directors is judged subjectively(150). So, even if the directors appreciated that their actions may lead
the company to insolvency, the court might hold that they were acting bona fide in the interests of the company. It is, however, argued\(^1\) that creditors' interests need more protection than is afforded by the subjective test. An objective test may be demanded in cases where the directors' actions threaten the existence of the company\(^2\). However, whatever the test is, the rule in *Foss v. Harbottle* will operate to prevent creditors from suing directors as long as the company is solvent.

It remains to say that if it is accepted that directors' duties to consider the interests of creditors are owed to the company, the recovery will be corporate. That is, the company is the one who will receive the damages. There is, in fact, a merit for considering that directors' duties are owed to the company rather than to individual creditors. This merit lies in the fact that the principle of *pari passu* distribution to the creditors of the company will not be undermined.
Footnotes


2) Jenkins Committee, (Cmnd, 1749), [1962], para. 89; Percival v. Wright [1902] 2 Ch. 421; see also Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd [1983] Ch. 258 at p.288 where Dillon L.J. stated that: "The directors indeed stand in a fiduciary relationship to the company, ... they owe fiduciary duties to the company though not to the creditors,...".

3) Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd [1983] Ch. 258


6) See Pennington R. Directors' Personal Liability, [1987].

7) It is enough to note that there are two main headings under which a director may become liable to the creditors under the agency principles. These are: (1) contract made by directors personally; see for example Bridges and Salmon Ltd. v. The Swan (owner) [1968] 1 Lloyds Rep. 5; Kettle v. Dunster & Wakefield [1927] 138 L.T. 156; Dutton v. Marsh [1871] LR 6 QB 361; Penkivil v. Connell [1850] 5 Exch 381; see also Elliott v. Bax-Irons 1925 2 K.B. 301; (2) Breach of warranty of authority: see, for example, Royal British Bank v. Turquand [1855] 5 E & B 248; Cherry & McDougall v. Colonial Bank of Australasia [1869] LR 3; see also Hely-Hutchinson v. Brayhead Ltd., [1968] 1 Q.B. 549. See generally Pennington R. Directors' Personal Liability [1987]; see also Ryan C., Company Directors, Liabilities, Rights and Duties, 2nd ed, [1987].

8) S.458 CA 1985 (S.332 CA 1948). It is to be noted that under S.458 CA 1985, fraudulent trading is a criminal offence and can be prosecuted even if the company has not been in the course of winding up.


10) [1933] Ch 786. at p.790.

11) See also Re Augustus Barnett & Son Ltd. [1986] B.C.L.C. 170 where the need to show dishonesty was stressed; see also R. v. Cox & Hedges [1982] 75 Crim. App. R. 291. For the purposes of S.213 of the

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Insolvency Act 1986, intent to defraud creditors could not be inferred where the company was simply unable to pay its debts as they fell due: Re EB Tractors Ltd. [1987] P.C.C. 313 see Murray J.


15) See Chapter No. 9.

16) See Boyle and Birds' Company Law, 2nd ed, [1987].


18) [1978] 1 Ch. 262.

19) Re Sarflax Ltd. [1979] Ch. 592.

20) Re Sarflax Ltd. [1979] Ch. 592, at p.599 per Oliver J.

21) [1979] Ch. 592.

22) See per Maugham J. in Re William C. Leitch Brothers Ltd. [1932] 2 Ch. 71.


24) Prior to the enactment of S.213(2), the court had a discretionary power to order payment to particular creditors: see Re Cyom Distributors Ltd [1967] Ch. 889.

25) This section, i.e, S.215(4) applies to both fraudulent and wrongful trading.

26) S.215(5) of the IA 1986.

27) See Charlesworth & Morse Company Law, 14th ed, [1991].

28) Cmnd 8558, Ch 44.


30) S.213(2) of the IA 1986.

31) S.214(2)(c) and S.214(7).

32) See S.741(2) CA 1985. This section added that: "... a person is not deemed a shadow director by reason only that the directors act on advice giving by him in a professional capacity". Section 741(3) provides that: "... a body corporate is not to be treated as a shadow director of any of its subsidiary companies by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions". 

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34) S.458 CA 1985.
35) S.214(2). For the purposes of operating the section a company goes into insolvent liquidation at a time when its assets are insufficient to pay its debts and other liabilities: S.214 (6). The valuation of assets in order to establish a case of wrongful trading is not an easy task: for details see Goode, "Wrongful Trading and the Balance Sheet Test of Insolvency", [1989] J.B.L. 436. The principle of limited liability has been significantly eroded by the creation of S.214 which makes directors personally liable for the company's debts where it continues to trade at the expense of its creditors: Prentice, "Creditors Interests and Directors Duties" [1990] 10 O.J.L.S 265.
38) S.214(3). Directors are responsible to be aware of their company's financial position. If they recognise that insolvency cannot be avoided, then, they have to do their utmost to minimise the debts of the company: Swaden, "Wrongful Trading – The Directors' Responsibilities and Auditors' Position" [1989] 93 Acct. Rec. 33.
39) See this view in Charlesworth and Morse Company Law, 14th ed, [1991] at p.418; see Farrar's Company Law, 2nd ed, [1988], in support for the view that the liquidator is not required to prove that the defender director took insufficient steps to minimise the potential loss to creditors.
41) In construing those provisions see Knox J. in Re Produce Marketing Ltd [1989] 3 All E.R. 1; see generally Rajak, "Companies Directors - the End of an Era?" [1989] 139 N.L.J. 1458; Rajak, "Companies Directors – the End of an Era", [1989] 139 N.L.J. 1374; see also Doyle, "Everything to Lose – Trading While Insolvent" [1991] 135 S.J. 1110. The deployment of a subjective element is a departure from the structures of the Cork Committee. The Committee wanted the test for wrongful trading to be purley 'objective' and the standard of skill and care to be applied should be 'that of the ordinary, reasonable man': Gillespie, "Wrongful Trading: Policy and Practice" [1989] 4 J.B.L. 259; for the potential impact of the deployment of an objective element on directors' duty of care see Dine,
Whether the money recovered under S.214 are caught by a floating charge is as yet unclear. Knox J. in Re Produce Marketing Consortium Ltd said that the court should exercise its jurisdiction "in a way which will benefit unsecured creditors": [1989] BCLC 520 at p.554. In Re Yagerphone Ltd [1935] Ch. 392, it was held that the money recovered from a creditor on the basis that it was paid out as a fraudulent preference was not subject to a floating charge because, at the time of crystalization, that money was not part of the company's property. The argument that the money could constitute a "contingent interest" was rejected by the court: [1935] Ch. 392 at p.396. On the other hand it was held that the money recovered by a liquidator in misfeasance proceedings were caught by a floating charge over the company's property because the right to recover the money in this case was one which inhered in the company at the time the directors breached their duty: Re Asiatic Electric Co. Pty Ltd. [1970] 92 WN (NSW) 361. For more details about this issue, see Prentice D. 'Creditor's Interests and Director's Duties', [1990] O.J.L.S. 265.


See S.122(1)(e) of the Insolvency Act 1986. To accommodate the Twelfth Directive the following amendments have to be made to the existing law: (1) S.1 of the Companies Act 1985 must be amended to allow private limited companies to be formed with just one member. (2) S.24 of the Companies Act 1985 must be amended so as to make it ineffective in respect of private companies. (3) The quorum for private companies meetings will be one for companies with one member. (4) A winding up of a private company on the ground that the membership has fallen to one will no longer be possible: see Bourne, "Company Law Update" [1992] B.L.R. 81.

See S.349(1) CA 1985.


British Airways Board v. Parish [1979] 2 Lloyds Rep. 361; see Scottish & Newcastle Breweries Ltd. v. Blair & others [1967] S.L.T. 72, where the name of the company inserted in the bill of exchange was not the correct name. In that case the signatories were held personally liable to the pursuers as holders of that bill. See Blum v. OCP Repartition SA [1988] B.C.L.C. 170 in which the director who signed the
promissory note was held personally liable for the plaintiff as a holder of the promissory note on which the name of the company had not been accurately stated. See also Rafsanjan Pistachio Producers Co-operation v. Reiss [1990] B.C.L.C. 352, where a director signed cheques on behalf of the company, but failed to put the company’s name on them. The cheques were dishonoured and the recipient (of the cheques) called the director personally to make payment according to S.349(4) of the Companies Act 1985. The director sought rectification of the cheques. The court dismissed the application for rectification. Potter J. observed that even if rectification was possible, it would not relieve the defendant from personal liability (i.e. it would not deprive the recipient of the cheques of the benefit of a statutory liability imposed upon the signatory of the cheques): for details see Fox, "Section 349(4) - No Relief by Rectification" [1991] 12 Co. Law. Dig. 33.


50) S.2 of the CDDA 1986.

51) S.3 of the CDDA 1986.

52) S.4 of the CDDA 1986.


54) S.11(1) CDDA 1986; see Re Chadmore [1990] B.C.L.C. 673 which deals with the application for leave to act as a director of another company.


56) See also Re T. & D. Services (Timber Preservation and Damp Proofing Contractors) [1990] B.C.C. 592 where Vinelott J. disqualified the defendant who was the director of four companies, all of which had become insolvent, on the ground of unfitness. Vinelott J. said that there was on the part of the defendant a serious want of probity.

57) See S.3(5) of the CDDA 1986.

58) [1983] B.C.L.C.

59) See also Re Arctic Engineering Ltd (No 2) [1986] B.C.L.C. 253. The defendant in that case was not a director but a liquidator. It should be noted that the age of a person (who is going to be disqualified from being a director or being involved in the promotion or formation or management of a company)
may be taken into account in determining the period of disqualification: see Re Melcast (Wolverhampton) [1991] B.C.L.C. 288.

60) S.15 CDDA 1986.
61) S.15(2) CDDA 1986.
62) Pennington R. Directors' Personal Liability [1987].
63) S.13 CDDA 1986.
65) S.117(8) CA 1935.
66) See Duncan Fox & Co. v. North and South Wales Bank Ltd [1880] 6 App. Cas. 7; Industries Co. v. Papadopulos [1980] 2 All E.R. 29, in which it was held that if the creditor or the other party to the contract terminates the contract because the company has breached one of contract's terms, the surety will, nevertheless, remain liable towards the creditor or the other party for breaches of contract committed by the company before the contract has been terminated.
See McDaniel M., "Bondholders and Corporate Governance" [1986] 41 Bus. Law. 413 at p.419. The direct result of those actions is an increase in the ratio of debt to equity and a decline in the market value of the debentures which will cause a decline in the market value of the company: see Mendelson, "The Threat of Corporate Debt", [1984] 6 J. Comp. Bus & Capital Market L. 149.


Re Smith Fawcett Ltd. [1942] Ch. 304, CA, particularly see Lord Greene MR at p.306; see Gower, Principles of Modern Company Law, 4th ed, [1979] at p.580; see Chapter No. 5.

Re Smith Fawcett Ltd, [1942] Ch. 304, particularly see Lord Greene MR at p.306; see also Howard Smith Ltd v. Ampol Petroleum Ltd. [1974] A.C. 821.

See Chapter No. 3.

Re City Equitable Fire Insurance Co. Ltd [1925] 1 Ch. 407 particularly see Romer J. at p.427; see Chapter 6.


[1843] 2 Hare 461.


120) See Grantham R., "The Judicial Extension of
Directors' Duties to Corporate Creditors", [1991]
J.B.L. 1; see Sealy L., "Directors' Duties - An
Professor Sealy criticised the dicta of Lord
Templeman and said that if it prevailed over the
early decisions, "the limited liability company
would never have got off the ground".


122) [1988] 4 B.C.C. 30 at p.33; see Hawke N.
"Creditors' Interest in Solvent and Insolvent
Companies" [1989] J.B.L. 54; Cf Ring v. Sutton
[1980] 5 A.C.L.R 546, where the Court of Appeal of
New South Wales held that directors must have
regard to the interests of creditors even when the
company was clearly solvent.

123) For details see Farrar J. and Fletcher I., "The
Obligation of a Company's Directors to its
Creditors Before Liquidation", [1985] J.B.L. 413;
Grantham R., "The Judicial Extension of Directors'
Duties to Corporate Creditors", [1991] J.B.L. 1 at
p.13; Sappideen R., "Fiduciary Obligations to
Hawke N., "Creditors' Interests in Solvent and
Insolvent Companies", [1989] J.B.L. 54; Finch V.,
"Directors' Duties Towards Creditors", [1989] 10
Co. Law. 23; see also Giugni P., and Rayan J.
"Company Directors' Spheres of Responsibility:


125) [1987] 3 B.C.C. 535 at p.552. If a company is
insolvent the directors owe a fiduciary duty to the
company to consider the interests of the creditors.
A breach of this duty cannot be ratified by the
shareholders: Petkovic, "Directors' Duties and the
Intrusion of Creditors' Interests" [1989] 4
J.I.B.L. 166.


129) See Hoffmann J. in Aveling Barford Ltd. v. Perion
Ltd. & Others [1989] 5 B.C.C. where he held that a
transaction entered by a company could still be set
aside, even if it had been unanimously ratified by
the shareholders, where the creditors had been
deprived of assets twelve months before
receivership. Depriving the creditors of assets
(e.g., gratuitous desposition of assets) when the
company is insolvent is illegal as being a fraud on
creditors, and, thus, cannot be ratified even by a
unanimous shareholder consent: MacCann,
"Directors' Duties: To Whom are they Owed?" [1991] 9
I.L.T. 30; Burke, "Shareholders Ratification of
Directors' Actions" [1990] 140 N.L.J. 240; see also

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132) [1987] 1 All E.R. 114.
133) [1987] 1 All E.R. 114 at p.118.
135) [1987] 3 B.C.C. 535.
136) [1987] 3 B.C.C. 535 at p.552.

141) See Finn P.D. The Fiduciary Principle , in Youdan (ed), Equity, Fiduciaries and Trusts , p.27, when he noted, a "fiduciary's conduct may be condemned notwithstanding that it has no adverse effect at all on the interests of the beneficiary: a disloyal tendency is enough".

147) Re Horsley & Weight Ltd [1982] 3 All E.R. 1045 at p. 1055 CA.
148) It is said, however, that directors or the controlling shareholders can inflict losses on creditors long before the company's insolvency. These losses represented by the fall in the market value of the bonds: see McDaniel M., "Bondholders and Corporate Governance" [1986] 41 Bus. Law. 413 at p.446.
149) [1843] 2 Hare 461.
150) Re Smith & Fawcett Ltd [1942] Ch 304, particularly see Lord Greene MR at p.306.
CHAPTER 9

Litigation and Protection of Minority Shareholders

9.1. Introduction

There are three main judicial means by which the court can enforce directors' duties on an application made to it. First, the court may issue an interdict(1) to prevent a director from committing a breach of duty. Alternatively, if the legislation provides a special remedy for a certain type of default, the court will apply it. For example, under S.185(1) and (7) CA 1985, the court may order the directors to issue a new share certificate to a transferee of shares. Secondly, the court may order the director who is in default to pay damages to the company or the creditor or the shareholder whose rights have been infringed. The court may also order restitution. That is to say, the court may order a director to restore the assets of the company which were misappropriated by him, or to account to the company for any secret profit improperly obtained by him. Thirdly, the court may declare that a certain transaction made by the director is invalid if, for example, it violates a statutory rule.

This chapter is divided into two main parts. (1) Litigation by a company. (2) Litigation by shareholders
and creditors. Greater significance, however, will be attached to litigation initiated by shareholders; particularly, in relation to protection of the minority shareholders.

9.2. Litigation by a company

Directors' duties to their companies stem either from their service contracts or legislation or the common law. These duties can be enforced by the court on an application made to it by the company itself and in its own name. The nature of the relief sought by the company depends on the nature of the duty alleged to be broken by directors. Common law remedies can be sought in relation to directors' breach of fiduciary duties. The company may obtain an interdict to restrain the wrongdoer director from breaching his duties. If the breach is of a continuing nature, an interdict may be obtained to stop the director from committing it. For example, the court may issue an interdict to prevent a director from directing the company's profits to his own account. If restoration is possible, the company may bring an action against the defender director to compel him to restore its property and the proceeds of that property which are misappropriated by him. Similarly, the court may order a director to account to the company for any profit he obtains from exploiting
any corporate opportunity\(^5\). Constructive trust notion has been applied to cases involve persons who are "under a fiduciary duty arising from a relationship other than an express trust"\(^6\). Since directors stand in a fiduciary position, the court may hold them liable as constructive trustees in relation to the company's property which is held by them\(^7\). In addition, if a director uses his company's property for his personal purposes and makes profit, he may be held liable to account for the profit he has made. That is because he stands in a fiduciary position to the company\(^8\). He will also be held liable to account for bribes or commissions received by him while acting as a director. Directors owe a duty to disclose their personal interests in contracts with the company. If they fail to do so, the company may rescind such contracts. In Hely - Hutchinson v. Brayhead Ltd.\(^9\), Lord Denning MR said:

> It seems to me that when a director fails to disclose his interest, the effect is the same as non-disclosure in contracts uberrimae fidei, or non-disclosure by a promoter who sells to the company property in which he is interested . . . Non-disclosure does not render the contract valid or a nullity. It renders the contract voidable at the instance of the company and makes the director accountable for any secret profit which he has made\(^10\).

Breach of a fiduciary duty is also a justifiable ground for dismissal. In Maintenance Co. Ltd. v. Dormer\(^11\), the managing director and his family dealt in the
company's property without the consent of the shareholders in general meeting. The company dismissed him from office. The Employment Appeals Tribunal (EAT) held that the dismissal of that director was fair. The EAT based its decision on the ground that a director is in a similar position to that of a trustee and, being in a fiduciary relationship, he is prohibited from placing himself in a position where his personal interest and the interest of the company conflict.

Awarding damages is the appropriate remedy for a breach of common law duties. Accordingly, a company may claim damages from the defender director for the loss suffered by it as a result of a breach of duty even if the defender has made no corresponding gain. If, for example, a director performed his duties negligently and caused the company to suffer loss, he might be sued in damages for that breach.

If there is a contract of service between a director and his company, the company may claim damages for the loss it suffered as a result of the director's breach of his contractual obligations.

In relation to directors' statutory duties, the legislation, usually, specifies the remedy which can be sought by the company where a director breaches those duties. S.313(2) of the Companies Act 1985, for example, provides that the director who has received unlawful compensation for loss of office must hold it in
trust for the company. In this case the company can bring an action to recover the amount of compensation which is unlawfully paid to the director. Similarly, S.80 CA 1985 prohibits directors from allotting relevant securities unless they are authorised to do so by the company in general meeting or by the articles of association. If, however, the statutes do not specify the appropriate remedy, the company is not prevented from claiming damages for past defaults or obtaining an interdict to compel directors to comply with their statutory obligations in the future.

Power to litigate in the company's name is usually vested in the board of directors. So, the shareholders cannot, by passing an ordinary resolution, require the board of directors to depart from litigation initiated by the board in the company's name, unless the articles of association give them the right to instruct the board as to the exercise of its powers including the power to litigate. However, the shareholders can, by passing an ordinary resolution, decide that the company will sue regardless of the board's opposition. This is so even where the shareholders have no power under the articles to give instructions to the board of directors. In this case, the general meeting may choose the persons who will exercise the right to litigate in the company's name. It is noteworthy that no individual shareholder, or group of
shareholders, can bring an action in the company's name without the consent of the shareholders in general meeting. Any proceedings in the name of the company brought by an individual shareholder without the consent of the majority shareholders in general meeting is liable to be struck out by the court on an application made by the defender(17). It is, however, possible for the board of directors to adopt those proceedings. In this case the proceedings will be regarded as properly brought in the company's name(18). If the company goes into liquidation, these proceedings may be adopted by the liquidator(19). If the company goes into liquidation, the liquidator is the one who has the power to litigate in the company's name. He also has the power to authorise anyone to initiate the action in the company's name. If the liquidation is ordered by the court, the liquidator must obtain the court's consent or that of the liquidation committee to sue the directors or others in the company's name(20). The court, however, will not give guidance as to whether the liquidator should bring an action against directors. This matter is left to the liquidator's discretion(21). In cases where a receiver is appointed, the receiver has the power to sue the directors in the company's name for a breach of their duties(22). But where the receiver is appointed by the court, he has to obtain the court's
consent to bring an action against directors in the company's name(23).

9.3. Litigation by Shareholders and Creditors

9.3.1. The enforcement of directors' personal liabilities to shareholders and creditors.

Directors may incur personal liability to individual shareholders(24) or to creditors(25). Directors' duties to these two groups can be enforced by personal claims initiated by the shareholders or the creditors whose rights have been infringed by the directors' breach of duties. It should be noticed that in an action against a director, the director must be named as defender and the shareholder or the creditor must be named as pursuer. So, in a personal claim against a director, the company's name does not appear as defender in cases where the director is solely liable(25). In cases where the company and its directors are concurrently liable, the company's name may appear as defender in addition to that of the director or the directors unless the pursuer chooses to sue the directors without first suing the company. It is noteworthy, however, that in some cases special terms can be found compelling the pursuer to sue the company first. An example of these terms can be
found in cases involving guarantee of a company's debts by directors\(^{(27)}\).

The recovery in personal claims is not corporate. So, for example, a recovery in relation to false statements in a prospectus or in relation to an inaccurate advice given to a shareholder can be obtained by the pursuer shareholder not by the company.

Directors' liability to contribute to the company's assets in cases of fraudulent and wrongful trading cannot be enforced by creditors\(^{(28)}\). The fact that the creditors are those who will benefit from such contribution does not give them the right to sue directors for fraudulent or wrongful trading. Directors' liability in this case can only be enforced by the court on an application made by the liquidator.

The recovery, here, is corporate and will benefit the company's creditors collectively\(^{(29)}\).

9.3.2. The enforcement of directors' liabilities to the company by shareholders.

Since the company is a separate legal persona capable of suing and being sued, the duties owed to it can be enforced by it alone and in its own name. This in essence is the rule in Foss v. Harbottle\(^{(30)}\). Normally, the power to sue in the company's name is vested in the board of directors. The general meeting, as is already

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mentioned, can pass an ordinary resolution to litigate in the company's name regardless of the opposition of the board. But it is perfectly possible that the directors may form the majority of the shareholders: in other words, the directors control the majority of votes. In this case, the directors can breach their duties to the company and escape liability unless the minority shareholders are allowed to sue them on behalf of the company. According to the rule in *Foss v. Harbottle* the minority shareholders cannot sue on behalf of the company because they do not represent it and they have no power to sue in its name. Thus, if this rule is strictly applied, the minority shareholders remain at the mercy of the majority. Since rigid application of this rule may be both unreasonable and unfair, the courts have established several exceptions to it. Some of those exceptions are intended to allow minority shareholders to litigate on the company's behalf in order to enforce its rights. Such an action is called a derivative action. It is derivative in the sense the minority derives the right to sue from that of the company. On the other hand, some exceptions to the rule allow a minority shareholder, who has suffered personal loss in addition to the harm to the company, to bring a representative action on behalf of himself and all the other shareholders who have suffered similar harm. Additionally, he may raise a personal action if only his
personal rights have been infringed. We will first examine the rule and then the exceptions to it. Since the exceptions to the rule in Foss v. Harbottle represent the common law protection of the minority shareholders, they and the rule itself will be examined under the heading of "common law protection of the minority shareholders". Later in this chapter, statutory protection of minority shareholders will be discussed.

9.4. The Common law protection of the minority shareholders.

9.4.1. The rule in Foss v. Harbottle(31).

It is a basic principle of company law that minority shareholders have no title to sue for wrongs done to the company. This principle is known as the rule in Foss v. Harbottle. In that case, two shareholders brought an action against the company's directors alleging that the latter had misapplied and wasted the company's property. The court held that the plaintiffs were not entitled to sue on behalf of the company and that the right to sue was confined to the company alone.

The basic rule was clearly expressed by Jenkins L.J. in the case of Edward v. Halliwell(32). His Lordship said:

The rule in Foss v. Harbottle . . . comes to no more than this. First, the only proper
plaintiff in an action in respect of a wrong alleged to be done to a company . . . is prima facie the company . . . itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company . . . and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company . . . is in favour of what has been done, then cedit quaestio(33).

What is central to the rule is that the minority shareholders cannot sue the directors whenever a breach of directors' duties is ratifiable. In an application of this rule it has been established that a mere breach of directors' fiduciary duty owed to the company is ratifiable and therefore cannot be a subject of a minority shareholders' action(34). For example, it was held that directors' acts which exceeded their powers were ratifiable by the majority shareholders and hence could not be the subject of a minority shareholders' action(35). The rule was also applied in the Scottish case of Rixon v. Edinburgh Northern Tramways Co.(36). In this case Lord Kinnear (Ordinary) said:

... although the transaction complained of was beyond the powers of the directors, it was competent for the shareholders to sanction it, and therefore that a single shareholder, or a minority, had no title to sue(37).

Despite the negative effect of the rule on the minority shareholders, it has several advantages. Firstly, it prevents multiple actions. "If each shareholder were permitted to sue, the company might be harassed by a
succession of actions started and discontinued by innumerable plaintiffs' \textsuperscript{(38)}. Secondly, it prevents fruitless actions. If the wrong done to the company is ratifiable, then, it is futile to have litigation about it without the consent of the shareholders in general meeting\textsuperscript{(39)}. Thirdly, it secures the principle of majority rule and emphasises the fact that the company is a separate legal persona distinct from its members\textsuperscript{(40)}.

9.4.2. Exceptions to the rule in Foss v. Harbottle.

As it has already been mentioned, some of the exceptions to the rule have been designed to allow a minority shareholder to bring a derivative action to enforce the company's rights. It has also been mentioned that a minority shareholder, in this action, derives the right to sue from that of the company. Thus, if the company has no right to sue, then no derivative action will have been allowed\textsuperscript{(41)}.

It is to be noticed that a derivative action is unknown in Scotland. Thus, a minority shareholder would require to sue the wrongdoer directors in his own name\textsuperscript{(42)}. However, it has been argued\textsuperscript{(43)} that an action to enforce the company's rights in Scotland, is subject to some preconditions which are similar to those imposed on derivative actions. These conditions are: (1) the
alleged wrong must not be ratifiable. If it is ratifiable, the complaint must be brought to the directors' attention or to that of the shareholders in general meeting before raising an action(44); (2) the wrongdoers must be in control of the company and have the power to prevent the company from suing in its own name(45). In any case, S.461(2)(c) CA 1985(46) empowers the court to "authorise civil proceedings to be brought in the name of and on behalf of the company". This section applies to Scotland. So, it is agreed(47) that a derivative action has been introduced into Scotland by virtue of that section(48).

In derivative actions, the company must be joined as a nominal defender together with the wrongdoers. The reason lying behind this policy is to prevent the company suing again in its own name, on the same facts, in cases where the action was a failure. In other words, to bind the company by the court's judgement(49). In addition, if the action succeeds, the only way for the company to benefit from it, is by joining it as a party to the action(50).

The recognised exceptions to the rule in Foss v. Harbottle are the following: (1) where the wrong complained of is an illegal or ultra vires transaction; (2) where the matter is one which can be validly done or sanctioned, not by a simple majority, but only by some special majority; (3) where the individual rights of the
pursuer as a shareholder have been infringed; and (4) where the majority is committing a fraud on the minority\(^{(51)}\).

(1) where the wrong complained of is an illegal or ultra vires transaction.

It is well established that illegal acts cannot be ratified. Thus, a minority shareholder can bring a personal action against the company and its directors to restrain them from entering into an illegal transaction\(^{(52)}\). If the pursuer failed in his personal action he would bear the costs of litigation. Therefore, it is to his advantage to bring a derivative action instead of a personal action. A minority shareholder is entitled to bring a derivative action against directors to restrain them from doing illegal acts on behalf of the company\(^{(53)}\). In derivative actions the pursuer can apply to the court for an order that he be indemnified out of the company's funds. However, if the majority of independent\(^{(54)}\) shareholders resolves not to sue directors to compel them to pay damages for the loss suffered by the company as a result of an illegal act, the resolution will bind the minority provided that it has been made in good faith and for the benefit of the company\(^{(55)}\). This means that a minority shareholder is in a better position to prevent
prospective illegal acts while it is not in good position to obtain damages for the company once the illegal act has been committed. In Smith v. Croft (No. 2)(56), a derivative action was brought by the minority shareholders to compel the directors to repay money illegally spent as contravening S.151 CA 1985. In that case the defendants controlled 65% of the shares. The plaintiffs held about 12%. The rest of the shares were held by another company (Wren). Wren had made it clear that it opposed the plaintiff's action.

Wren's opposition as a majority independent shareholder was regarded by Knox J. as a sufficient reason for disallowing the minority's action. The judge said:

Ultimately the question which has to be answered in order to determine whether the rule in Foss v. Harbottle applies to prevent a minority shareholder seeking relief as plaintiff for the benefit of the company is 'Is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?'. If it is an expression of the corporate will of the company by an appropriate independent organ that is preventing the plaintiff from prosecuting the action he is not improperly but properly prevented and so the answer to the question is 'No'. The appropriate independent organ will vary according to the constitution of the company concerned and the identity of the defendants who will in most cases be disqualified from participating by voting in expressing the corporate will. Finally, on this aspect of the matter I remain unconvinced that a just result is achieved by a single minority shareholder having the right to involve a company in an action for recovery of compensation for the company if all the other minority shareholders are for disinterested reasons satisfied that the proceedings will be productive of more harm than good(57).
The judge continued:

"There is no sufficient evidence that in relation to the present question whether these proceedings should continue Wren Trust has reached its conclusion on any grounds other than reasons genuinely thought to advance the company's interests." (§§)

Thus, in striking out the plaintiffs' action in this case, Knox J. regarded the decision of the majority of independent shareholders as conclusive. However, the court in this case retains a discretion to override the decision of the majority of independent shareholders (§§).

The minority's actions in relation to illegal acts has been discussed. It remains to examine these actions regarding ultra vires acts.

Prior to the Companies Act 1985 (S.35, originally S.9 of the European Communities Act 1972) (§§), an ultra vires transaction was void. It followed that an ultra vires transaction would not be ratified and, therefore, could not be enforced either by the company or by a third party (§§). S.35(1) CA 1985 provides that an ultra vires transaction is valid vis à vis third parties who are dealing with the company in good faith. S.35(2) provides that third parties are "not bound to enquire as to the capacity of the company to enter into [a transaction] or as to any such limitation on the powers of the directors, and [are] presumed to have acted in good faith unless the contrary is proved". However, a
proposed ultra vires transaction can be challenged and restrained by any member of the company. It can be inferred from the wording of section 35 that an ultra vires transaction with a third party who does not act in good faith is void and, therefore, cannot be ratified. The section was widely criticised and has been replaced by what are now new S.35A and S.35B (S.108 CA 1989).

S.2 CA 1985 provides that the memorandum of any company must state the objects of the company. This section has not been changed or amended by the Companies Act 1989. A company is however, allowed to do things which are reasonably incidental to its objects.

Despite S.2 of the 1985 Act, the new S.35 (S. 108 CA 1989) states that a company's capacity is not limited by its memorandum. So, even if the company details its objects, its capacity is not limited to these objects. The direct consequence of this section is that the ultra vires doctrine has been abolished as far as a bona fide third party is concerned. This is clear from the wording of the new S.35(1) which provides:

The validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of any thing in the company’s memorandum.

Unlike the old S.35 CA 1985, the new S.35(1) is not subject to any condition. There is no reference, for example, to "transactions decided on by directors".
Thus, third parties are protected even if the act has been done by one director or by an officer. Moreover, the new S.35(1) refers to acts rather than transactions. It follows that this section covers gifts as well as commercial contracts(64).

The position of third parties is strengthened by S.142 CA 1989 (the new S.711A) which abolishes the doctrine of constructive notice for all purposes except the case where a person takes a charge over a company's property. This person is deemed to "have notice of any matter requiring registration and disclosed on the register at the time the charge is created"(65).

While the new S.35 provides that a company's capacity is not limited by its memorandum, it does not remove the limitation on directors' powers under the memorandum.

So, to protect third parties, new S.35A removes any limitation on the powers of directors or others under the company's constitution as far as bona fide third parties are concerned.

New S.35A (2)(c) provides that good faith on the part of a third party is presumed unless the contrary is proved. Most important is the new S.35A (2)(b) which goes further to state that:

[A] person shall not be regarded as acting in bad faith by reason only of his knowing that an act is beyond the powers of the directors under the company's constitution(66).
The legislature has not been fully satisfied with the provisions discussed above as a statutory shield to protect third parties. So, the new §35B has been enacted. The section makes it clear that "a party to a transaction with the company is not bound to enquire as to whether it is permitted by the company's memorandum or as to any limitation on the powers" of the directors to bind the company. It would appear that apart from being defective, new §35B is entirely unnecessary. First, it is defective in that it refers to "transactions" rather than acts. So, it does not go with the new §35 which refers to "acts" rather "transactions"(67). The question which arises here is whether a gift is included in the meaning of the word "transaction" or not. Secondly, it is unnecessary because: (1) by virtue of the new §35, a company's capacity is free from any limitation; (2) by virtue of new §35A, directors' powers are free from any limitation under the company's constitution in favour of a bona fide third party; and (3) by virtue of the new §711A (S.142 CA 1989), the doctrine of constructive notice has been abolished for all purposes except in cases where a person takes a charge over a company's property.

The original purpose of the ultra vires doctrine was the protection of both investors and creditors(68). If a company drafted its objects clause clearly, then
investors would know exactly what kind of business they were going to invest their money in. Creditors of the company will also be aware of the company's business and the ultra vires doctrine will guarantee that the company will not act beyond its objects clause. The ultra vires doctrine was criticised as being unable to achieve these purposes. Thus, Parliament has been led to limit the effects of that doctrine in the Companies Act 1985(69), and to abolish it insofar as a bona fide third party is concerned, by the new S.35 (S.108 CA 1989)(70). Moreover, under the new S.35 an ultra vires act is ratifiable and no longer void.

It has already been mentioned that the protection of third parties, who are dealing with the company in good faith, is now guaranteed by the new S.35. To preserve some sort of balance between the interests of third parties and those of the members of the company, the 1989 Act retains the ultra vires rule as between the company and its members.

While an ultra vires act is valid in favour of third parties dealing with the company in good faith, the right of an individual shareholder to restrain the company from doing an ultra vires act is preserved by the new S.35(2) and 35A (4). The members' right to seek an interdict to prevent an ultra vires act is not subject to the rule in Foss v. Harbottle. A member's right to prevent an ultra vires act is, however, not
absolute. It is subject to several restrictions. First, a member cannot bring proceedings to restrain the doing of such act if the company is required to carry it out in "fulfilment of a legal obligation arising from a previous act of the company"(71). Thus, if a company is legally bound to carry out an ultra vires act in pursuance of a previous obligation, the members cannot bring proceedings to restrain the doing of that act. Second, since an ultra vires act is valid and binding on the company vis a vis bona fide third parties by virtue of the new S.35 (1), then a completed ultra vires act cannot be challenged or restrained by a company's members unless the third party is dealing with the company in bad faith. It follows that, so long as a third party is dealing with the company in good faith, the members can only bring proceedings to restrain a proposed ultra vires act. Third, the members' right to restrain an ultra vires act is restricted by the new S.35(3) which allows the company to ratify ultra vires acts by special resolutions. It follows that if the company ratifies a proposed ultra vires act involving a bona fide third party, or a proposed or a completed ultra vires act which involving a malafide third party, no shareholder can bring proceedings to restrain the doing of such an act(72).

What remains to a company's members is to sue directors who may incur liability as a result of involving the
company in ultra vires acts. Again, the 1989 Act restricts the members' right to sue directors by allowing the company to relieve directors of any liability incurred as a result of an ultra vires act. A separate and special resolution is, however, needed for an effective relief(73).

Owing to the restrictions mentioned above, it would appear that the 1989 Act does not provide the shareholders with protection equivalent to that available to third parties. If, however, an ultra vires act and/or relief of directors from liability have been sanctioned by an ordinary resolution rather than by a special one, the members can prevent that act and can sue directors for liabilities incurred by them as a result of that act. It is submitted that this will bring the matter within the scope of another exception to the rule in Foss v. Harbottle. That is, the "special majority" exception to the rule which will be discussed next. Alternatively, the aggrieved members may petition under S.459 of the 1985 Act or S.122(1) (g) of the Insolvency Act 1986(74).

(2) Where the matter is one which can be validly done or sanctioned, not by a simple majority, but only by some special majority.
In Edwards v. Halliwell(75), Jenkins L.J. considered that any act which according to the articles of association ought to be done by special majority fell outside the rule in Foss v. Harbottle; otherwise, a company which, by its directors, had broken its own regulations by doing something without a special resolution which could only be done validly by a special resolution, could assert that it alone was the proper plaintiff in any consequent action, and the effect would be to allow a company acting in breach of its articles to do de facto by ordinary resolution that which according to its own regulations could only be done by special resolution(76).

Thus, if a particular act was sanctioned by a simple majority in contravention of the articles (which required that that act could only be sanctioned by a special resolution), it would be competent to a minority shareholder to bring a derivative action to restrain the doing of that act. In other words, the rule in Foss v. Harbottle does not apply to this case(77).

The reason for the creation of this exception is that the articles constitute a contract between the company and its members. This is clear from the wording of S.14 CA 1985(78) which provides:

(1) Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles.

In Quin and Axtens Ltd v. Salmon(79), the articles provided that certain transactions could not be entered
into without the consent of both managing directors. One of the directors dissented; but subsequently a simple majority of shareholders tried to authorise the transaction without that director’s consent. It was held that the dissenting director had the right, in an action brought on behalf of himself and all other shareholders except the defendants, to obtain an injunction restraining the company from authorising that transaction which was inconsistent with the articles. The plaintiff in that case brought a representative action in his capacity as a member. The company’s attempt to authorise that transaction was held to be an attempt to "alter the terms of the contract between the parties by a simple resolution instead of by a special resolution"(80). So, the plaintiff’s action in this case was meant to compel the company to observe the contract under the articles(81).

In this context, was there a conflict between Salmon’s case(82) and the case of Hickman v. Kent or Romney Marsh Sheep Breeders’ Association(83)? In Hickman’s case, Astbury J. laid down a rule which provided that "outsider"-rights can never be enforced by reliance upon the articles(84). The plaintiff in Salmon’s case was one of the directors. In his capacity as a director he was an outsider. Since his action was tantamount to an indirect enforcement of "outsider"-rights vested in him, there was an apparent clash between this case and
the rule in Hickman's case. But it is agreed(85) that since the plaintiff in Salmon's case brought the action in his capacity as a member qua member, his action would be regarded as one intended to compel the company to comply with the terms of the contract under the articles. This is so, even although the effect of his action is, in fact, an indirect enforcement of his rights as an outsider.

If it is correct that the articles constitute a contract between the company and its members; and that the members can compel the company to observe the terms of that contract(86), then it would seem that there is a conflict between this conclusion and some earlier cases based on the rule in Foss v. Harbottle. For example, in MacDougall v. Gardiner(87), James L.J. expressed the view that a member did not have the right to complain of "irregularities" even if they are inconsistent with the articles. The above conclusion also clashes with cases such as Grant v. United Kingdom Switchback Railway Co.(88) and Irvine v. Union Bank of Australia(89), where the court permitted the ratification, by the majority shareholders in general meeting, of conduct in breach of the articles. However, such ratification can be justified on the ground that it deals with some minimal internal irregularities and does not amount to alteration of the terms of the contract under the articles(90). It is submitted that if the company's
attempt to ratify an action, by a simple majority, amounts to a real attempt to alter the terms of the contract under the company's articles, then a clear conflict with Salmon's case exists. So, to avoid this conflict, a majority of shareholders must not be allowed to ratify, what in substance, is an alteration of the articles, or a breach amounting to a "complete transformation of the company - a fundamental alteration of policy"(91). However, it is further submitted that it is not easy to draw a clear distinction between acts which constitute actual alteration of the articles and those which do not. This matter should be left to the court to be judged on the specific facts of each case.

The scope of the "special majority" exception to the rule in Foss v. Harbottle has been widely curtailed by new S.35A (S.108 CA 1989)(92). The section provides that in favour of a bona fide third party, the powers of directors to bind the company "shall be deemed to be free of any limitation under the company's constitution". The word "constitution" includes the memorandum of the company and its articles of association. And for the purposes of new S.35A, the company's constitution includes the company's resolutions in general meetings and any agreement between the company's members(93). Thus, even if the articles require a special majority to sanction a specific act, if a bona fide third party is concerned,
and the act with him has been concluded, a member of the company cannot restrict the doing of that act. The members, however, can sue directors who incurred liability as a result of that act unless the company relieves the directors of liability by a special resolution(94).

(3) Where the individual rights of the plaintiff as a shareholder have been infringed.

First of all, it should be noted that this matter cannot be considered as a true exception to the rule in Foss v. Harbottle, simply because the rule deals with wrongs done to the company rather than wrongs done to the members of the company. This, indeed, is the reason that the action, in respect of this matter, is a personal rather than a derivative one. Alternatively, a representative action can be brought in cases where the rights of more than one member have been infringed.

Members' personal rights stem from the articles of association, or from legislation, or from contracts of employment(95). A contract of employment may, in some cases, incorporate the articles of association as terms of agreement(96). A company, according to S.9 of the 1985 Act, is entitled to alter its articles. Contracts of employment cannot restrain the company's right to alter the articles. However, the company may incur a
liability for breach of contract if it alters its articles in cases where the articles have been incorporated as terms of agreement in a contract of employment(97).

The articles of association of a company give rise to some personal rights which are of great importance. Examples of these rights are a shareholder's right to vote and to have his vote recorded(98); the right to prevent irregular alterations in rates of contribution to the trade union(99); a shareholder's right to have shares offered to him(100); the right to prevent directors holding office in breach of the articles(101); the right to enforce a declared dividend as a legal debt(102) and, the right to prevent alterations in the articles which would constitute a "fraud" on the minority shareholder(s)(103). In these cases the court held that a shareholder was entitled to bring a personal action to enforce these rights against the company, namely, to obtain an interdict restraining the company from doing acts which would infringe his personal rights. It is argued(104) that a shareholder may not be able to obtain a money judgment against his company, while he is a shareholder, except in cases of a declared dividend which has become a debt due to him.

To enforce his personal rights, which spring from the articles, a member must sue in his capacity as a member. Thus, in Quin and Axtens Ltd v. Salmon(105), the
director's action against the company to compel it to observe the terms of the articles was allowed because he was suing in his capacity as a member. "Outsider"-rights can never be enforced by reliance upon the articles of association(106). Thus, had the plaintiff, in Salmon's case, sued in his capacity as a director, his action would have not been allowed. So long as the plaintiff sues in his capacity as a member, it is of no effect that the action tantamount to an enforcement of "outsider"-rights vested in him as a director.

There is a debate over whether a member has the right to have all the articles observed. Wedderburn argues that a shareholder has the right to have all the articles observed "subject only to those matters of 'internal management' on which the courts have seen fit to displace his contractual rights in favour of the majority rule"(107). Beck(108) argues that a personal action is justified wherever the directors breach their fiduciary duties. Farrar(109) argues that membership rights which stem from the articles are limited. Farrar relies on some cases in which a member's action was disallowed. For example, it was held that a member did not have the right to have a poll taken(110); a member did not have the right to have directors retire in accordance with the articles(111); nor did he have the right not to have the value of his shares reduced by the wrongdoing of the directors where that wrongdoing had
caused loss to the company and his loss as, a shareholder, was only consequential to that of the company\(^{(112)}\). If the loss suffered by the shareholder is consequential to that suffered by the company, no personal action will lie. To found a personal action, a shareholder’s loss must be separate from that of the company\(^{(113)}\).

The answer to the question of how to determine the extent of the membership rights is as yet unclear. One is, however, inclined to accept Wedderburn’s argument since it finds some support in the wording of S.14 of the Companies Act 1985. The section provides that the company and the members are bound by the memorandum and the articles, and that the memorandum and the articles contain covenants on the part of each member to observe “all the provisions of the memorandum and of the articles”. Since all the members are bound by the memorandum and the articles, it would seem that, as a general rule, each member has the right to have all the articles observed. The generality of the section is, however, subjected to the provisions of the Companies Act. For example, a company can alter its articles by a special resolution. Thus, when accepting to become a member of a company a person agrees to a contract alterable by the company at any moment.

Finally, it is noteworthy that the more we extend the scope of the membership rights, the more we restrict the
scope of application of the rule in Foss v. Harbottle* (114).

(4) Where the majority is committing a fraud on the minority.

In respect of this matter, the action is a derivative one brought by a minority shareholder on behalf of the company. In order to found a derivative action based on the "fraud on the minority" exception, in England, the plaintiff must establish two elements: (I) a "fraud on the minority", and (II) wrongdoer control. The situation in Scotland is slightly different. It is not sufficient for the pursuer to plead that the majority has the power to outvote him. The pursuer must have first made a clear attempt to obtain the majority's co-operation (115). This means that, in Scotland, the minority shareholder who wishes to sue the wrongdoers for a fraud alleged to be committed by the latter, must prove that it has made a definite attempt to obtain the majority's co-operation prior to establishing fraud and wrongdoer control.

(I) Fraud on the minority.

The word "fraud" in this context does not mean deceit in the criminal sense (116). It is not, however, confined
to fraud at common law. It has been given a wider interpretation in many recent cases. In Daniels v. Daniels(117), the directors authorised the sale of the company land to one of them at an undervalue. A minority shareholder brought an action to set aside the sale. The directors argued that the action should not be allowed since fraud had not been alleged. Templeman J. rejected this argument and said:

... a minority shareholder who has no other remedy may sue where directors use their powers, intentionally or unintentionally, fraudulently or negligently in a manner which benefits them at the expense of the company(118).

The essence of the decision in this case is that the minority shareholders can bring a derivative action whenever the directors use their powers in a manner which benefits them and the majority at the expense of the company. The Daniels case was distinguished, by Templeman J., from Pavlides v. Jensen(119), on the ground that the sale in the latter was to a third party and thus the directors had not benefited by their 'negligence' at the expense of the company. It is correctly argued(120) that Templeman J.'s decision is signalling the demise of the rule in Foss v. Harbottle. That is because the decision has widened the scope of non-ratifiable conducts and consequently limited the scope of application of that rule.
In Estmanco (Kilner House) Ltd v. Greater London Council it was decided that the majority's abuse of power could amount to a fraud on the minority. In that case the majority had attempted to defeat the purpose for which the company was formed. The facts of the case were as follows: the Greater London Council (the GLC) when under Conservative control decided to sell a block of 60 flats. The company (Estmanco) was formed in accordance with an agreement with the GLC to manage the flats on a non-profit making basis after all 60 flats were sold. Each of the purchasers was to have one share in the company, but would have no voting power until all 60 flats were sold. Prior to the completion of the sale of all the flats, the voting shares would be vested in the GLC. After the completion of the sale the purchasers would carry votes and the GLC would withdraw. Control of the GLC passed to Labour after only 12 flats had been sold. The GLC decided that the flats should be let rather than sold. The 12 purchasers had been approached by the GLC to give up the flats in return for damages. Estmanco voted to discontinue proceedings against the GLC for breach of the agreement existed between them. One of the purchasers brought an action in Estmanco's name to obtain an injunction preventing the GLC from carrying out its scheme. The GLC argued that it was acting bona fide in the interest of the company and there was no fraud on the minority. The
court held that a voteless shareholder who had an expectancy of becoming qualified to vote in the future was within the exception of fraud on the minority. The plaintiff was granted an injunction to enforce the terms of the agreement against the GLC. Megarry V-C said that it may be in the best interest of the company to deprive the minority of some of their rights, but this does not give the majority an absolute right to do this. Megarry V-C added:

No right of a shareholder to vote in his own selfish interests or to ignore the interests of the company entitles him with impunity to injure his voteless fellow shareholders by depriving the company of a cause of action and by stultifying the purpose for which the company was formed(122).

He also said:

... I feel little doubt that the Council has used its voting power not in order to promote the best interests of the company but in order to bring advantage to itself and disadvantage to the minority(123).

It is to be concluded that the word "fraud" has been given its widest sense. The effect of this wide interpretation is, in fact, the extension of the scope of application of the "fraud on the minority" exception, and consequently, the contraction of the scope of application of the rule in Foss v. Harbottle. This, definitely, signals the courts' willingness to provide the minority shareholders with as much protection as possible.
Wrongdoer Control.

In addition to establishing fraud on the minority, a pursuer who wishes to bring his case within the "fraud on the minority" exception must establish wrongdoer control which prevents the company suing in its own name(124). Wrongdoer control exists where the wrongdoers control the majority of the votes, or where the majority has ratified conduct which constitutes a fraud on the minority(125). Control in this context means de jure control, i.e., an actual voting control. However, in Prudential Assurance Co. Ltd v. Newman Industries Ltd (No.2)(126), Vinelott J. was prepared to recognise de facto control as sufficient to allow a minority shareholder to bring a derivative action. That is, a derivative action should be permitted wherever the wrongdoer, though not holding the majority of the shares, was shown to be able "by any means of manipulation" of his position in the company, to ensure that the majority shareholders would not allow a claim to be brought in relation to the alleged wrong(127). However, the Court of Appeal in that case expressed no opinion on this point. If Vinelott, J's view is accepted by the courts, then, it will have a great impact on the rule in Foss v. Harbottle. The judge's view aims to widen the ambit of the fraud on the minority exception and, consequently, the scope of application of the rule will be narrowed.
On the other hand the fraud on the minority exception has been narrowed by the decision of Knox J. in Smith v. Croft (No. 2) (128), where he held that if a disinterested majority of the independent shareholders do not wish to sue, then no action can be brought even if the defendants are in control. So, contrary to the signals we inferred from the decisions in Daniels v. Daniels (129) and Estmanco (Kilner House) Ltd v. Greater London Council (130), Knox J.'s judgment shows a clear willingness to keep the minority shareholders out of the court (131).

Cases in which a fraud on the minority was held to exist are numerous. Examples of these cases will be discussed next.

1) Expropriation of a company's property.

In Cook v. Deeks (132), the directors took a contract, which the company was actively pursuing, in their own name. Subsequently, at a general meeting, they used their vote to pass a resolution declaring that the company had no interest in that contract. The Privy Council held that the resolution was a misuse of voting powers and was a fraud on the minority and therefore ineffective. In other words it was held that the directors' conduct was not ratifiable and the directors were made liable to account for the profit they made out
of that contract. The directors' conduct in that case amounted to an appropriation of the company's assets\(^{133}\). Reconciling this case with *Regal (Hastings) v. Gulliver*\(^{134}\) may not be easy. In the *Regal* case the directors made a personal profit out of exploiting a corporate opportunity which their company was financially unable to exploit. The House of Lords held that the directors were liable to account for the profit so derived. However, the House of Lords decided that their conduct was ratifiable. Thus there is an apparent clash between these two cases. It is said\(^{135}\) that the two cases can be reconciled on the basis that the *Regal* case was one involving incidental profit making by bona fide directors, while the conduct of the directors in *Cook v. Deeks* constituted an actual misappropriation of the company's assets\(^{136}\). In other words, the directors in the *Regal* case was acting bona fide in the interests of the company when they made a personal profit, whereas in *Cook v. Deeks* they deprived the company of a contract in which it was interested and appropriated that contract for themselves. However, Professor Sealy\(^{137}\) noted that it is difficult to say why the impropriety in the *Regal* case was ratifiable while that in *Cook v. Deeks* was not, unless the fact that the profit in the *Regal* case was made incidentally was regarded as a crucial finding.
2) An issue of shares designed to cause harm to the minority.

In Clemens v. Clemens Bros. Ltd(138), the plaintiff held 45% of the issued shares and her aunt, who was one of the directors, held 55% of the shares. The aunt's shares were used at the general meeting to secure the passing of resolutions to issue further shares to directors and trustees. As a result, the plaintiff's holding was reduced to about 24.5% of the issued shares. This deprived the plaintiff of her power to block special or extraordinary resolutions. The court set aside the resolutions on the ground that they were oppressive to the plaintiff because they were designed (i) to ensure that the plaintiff could never get control of the company, and (ii) to deprive the plaintiff of her right to defeat special resolutions(139).

3) An act done to defeat the purpose for which the company was formed

In Estmanco (Kilner House) Ltd v. Greater London Council(140), the court held that the decision of the company to discontinue proceedings for breach of contract, against the GLC, amounted to a fraud on the minority. Megarry V-C said:

No right of a shareholder to vote in his own selfish interests or to ignore the interests
of the company entitles him with impunity to injure his voteless fellow shareholders by depriving the company of a cause of action and by stultifying the purpose for which the company was formed.  

4) A negligent act which benefits the majority at the expense of the company.

While it is possible for the minority shareholders to bring a derivative action in cases of directors' breach of fiduciary duties, it has been held that no derivative action can be brought against directors for failure to exercise their powers with proper skill and care. In other words, mere negligence on the part of the controlling directors or shareholders, is not sufficient to ground a derivative action. Mere negligence on the part of controlling directors or shareholders does not amount to a fraud on the minority. In Pavilides v. Jensen, the assets of the company were sold to a third party at an undervalue. The court held that the directors' conduct was ratifiable and there was no fraud on the minority. On the other hand in Daniels v. Daniels, the sale of the company's assets to one of the directors at an undervalue was held not to be ratifiable. The court based its decision on the ground that since the directors' conduct benefited them at the expense of the company then there was a fraud on the minority. Consequently, the derivative action was allowed. It
could be inferred from the previous two cases that, while mere negligence does not justify a derivative action, self-serving negligence does. It is agreed that the probable explanation of this case lies in the fact that a director is prohibited from making personal profit out of his directorial position. In other words, since it is a breach of a fiduciary duty for a director to gain personal profit from the exercise of his functions, the cause of action in the Daniels case is, in fact, not the directors' negligence but the retention of a windfall profit resulting from negligent exercise of directors' powers. So, it would seem correct to say that the decision of the Daniels case reflects a well known category of non-ratifiable conduct which is the misappropriation of a company's assets.

9.5. The Statutory Protection of minority shareholders.

The Companies Act 1985 as well as the Insolvency Act 1986 contains some provisions intended to protect minority shareholders against the misconduct of directors or that of the controlling shareholders. Two situations only will be examined under this heading, namely, the unfair prejudicial conduct under S.459 CA 1985 and the winding up of a company on the "just and equitable" ground under S.122(1) (g) IA 1986.

Because a "just and equitable" winding up under S.122(1) (g) IA 1986(149) is, usually, inappropriate, S.459 CA 1985 has been enacted to provide an alternative remedy for a minority shareholder(150).

The roots of S.459 were found in S.210 CA 1948. S.210 provides:

(1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) may make an application to the court by petition for an order under this section.
(2) If on any such petition the court is of the opinion (a) that the company's affairs are being conducted as aforesaid and (b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the fact would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up.

S.210 was widely criticised. First, a remedy under this section will not be available unless the facts of the case justify the making of a winding up order on the "just and equitable" ground. Second, a single and completed action cannot form an oppression under the section. There must be a continuing wrong to justify the making of a winding up order(151). Third, the concept of oppression was narrowly construed by the courts(152). Finally, it was held that under S.210 a member must complain in his capacity as a "member qua
member" (153). Those requirements restricted the section and reduced its efficiency as a remedy for minority shareholders. Therefore, during the lifetime of the section only two applications for relief from oppressive conduct were accepted (154).

The defects suffered by S.210 had led Parliament to reform the remedy. SS.459-461 of the Companies Act 1985 (155) replace S.210. They avoid many of their predecessor's defects. S.459 provides:

(1) 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 some part of the members (including at least himself) or any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

It is clear from the wording of S.459 that the rule, that the conduct complained of could only be challenged where it consisted of a continuous course of conduct which continued up to the date of the petition, was abolished (156). The section also replaces the concept "oppression" by the expression "unfairly prejudicial". In addition, there is no longer requirement that the facts of the case must justify the making of a winding up order. S.459 maintains the judicial requirement that a member can only bring a petition in his capacity as a "member qua member" (157). It is to be noticed that the Companies Act 1989 has replaced the phrase "unfairly
prejudicial to the interests of some part of the members" in S.459(1) by the phrase "unfairly prejudicial to the interests of its members generally or of some part of its members"(158). The effect of this amendment is the abolition of the judicially created restriction of the scope of the remedy available in S.459 and its predecessor S.210 CA 1948. That is, the abolition of the rule that a member has no cause of action where the conduct complained of has affected all the members of the company(159).

S.459 will now be analysed since some words or terms in it need special attention.

1) The term "member".

It is to be noticed that neither the old S.210 nor the new S.459 used the term "minority". Instead, the term "member" has been deployed. It is not, however, easy to imagine a majority shareholder petitioning under this section. So, it seems that this section is designed to protect the minority shareholders. The direct result of using the term "member" is, of course, the exclusion of creditors. Thus, a creditor has no cause of action or has no locus standi to petition to the court under S.459(160). As previously mentioned, S.459 fails to abolish, in clear words, the rule which the judiciary had developed in the old S.210, that a member could only bring a petition under the section in his capacity as a
"member qua member"(161). Thus, a member whose interests have been prejudiced in his capacity as a director or as an employee, but not as a member, cannot bring a petition under S.459.

2) The term "interests".

There is no statutory guidance as to the meaning of the word "interests". It is also unlikely that the articles or the memorandum of a company provides a definition for this word(162). Thus, the courts may look beyond the legal entity of the company to examine the existence of these interests. In Ebrahimi v. Westbourne Galleries(163), Lord Wilberforce said:

There is room in company law for recognition of the fact that behind [the legal entity of a limited company] or amongst it, there are individuals with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.

Lord Wilberforce's approach is not confined to a winding up cases. It is applicable to cases of unfair prejudice too(164). Similarly, in Postage & Denby (Agencies) Ltd(165), Hoffmann J. noted:

Section 459 enables the court to give full effect to the terms and understanding upon which the members of the company became associated, but not to rewrite them.

Hoffmann J.'s remarks are a clear indication of the court's willingness to override the "qua member" requirement. In small private companies and in "quasi-
partnerships" a member's expectations are wide. A member may, for example, expect to take part in the management of the company or to be employed by it in return for salaries. If such a member is excluded from the management of a company which is formed on the basis of management participation, can this member bring a petition under S.459 ? In this case the member's interests were prejudiced in his capacity as a director or as an employee rather than as a member. In Re a Company(166), Vinelott J. said that he thought it is unlikely that such a member was precluded from bringing a petition under S.459 even though the exclusion from management would not strictly affect his rights as a member. In Re a Company(167), Hoffmann J. said that if the exclusion from management amounts to exclusion from a "legitimate expectation" then it will be unfairly prejudicial conduct(168). Similarly, in Re Ringtower Holdings Plc(169), Peter Gibson J. accepted that if participation in the management formed a legitimate expectation then the exclusion from it could found an unfair prejudice petition(170).

It could be concluded that the courts are willing to give the word "interests" a wide interpretation so as to embrace "legitimate expectations". Thus the word "interests" is not limited to strict legal rights under the company's constitution(171). It is submitted that this interpretation is capable of overriding the "qua
member" requirement at least in respect of private companies where employment and management participation are, usually, "legitimate expectations". However, if the court finds that management participation is not a "legitimate expectation" S.459 will not apply. In other words, the special circumstances of each case will determine the existence of a member's interests and whether prejudicing these interests may entitle him to bring a petition under S.459.

3) The term "unfairly prejudicial".

The conduct complained of must be both unfair and prejudicial. The case law provides some guidance as to the scope of this term. The conduct complained of may be past, present or future(172).

The judgment of Slade J.(173), which was cited with approval by Nourse J. in Re R.A. Noble (Clothing) Ltd(174), gave some indication as to the meaning of the term "unfairly prejudicial". The judgment reads as follows:

Without prejudice to the generality of the wording of [S.459], which may cover many other situations, a member of a company will be able to bring himself within the section if he can show that the value of his shareholding in the company has been seriously diminished or at least seriously jeopardised by reason of a course of conduct on the part of those persons who have had de facto control of the company, which is unfair to the member concerned. The test of unfairness must, . . ., be an objective, not a subjective one. In other
words, it is not necessary for the petitioner to show that persons who have had de fact control of the company have acted as they did in conscious knowledge that this was unfair to the petitioner or that they were acting in bad faith; the test . . . is whether a reasonable bystander observing the consequences of their conduct would regard it as having unfairly prejudiced the petitioner's interests.

Thus, the test of what constitutes unfair prejudice is an objective. Consequently, 'bad faith' and lack of fair dealing by those in control are irrelevant(175). A case of unfair prejudice might be established even if the defender was acting in good faith. As far as directors' fiduciary duties are concerned, a breach of a fiduciary duty may assist in establishing unfair prejudice. According to the judgment (quoted above), de facto control by those against whom unfairly prejudicial conduct is alleged is sufficient. In other words, de jure control is not a crucial element for a petition under S.459. This, indeed, constitutes a judicial attempt to circumvent the limitations of the "fraud on the minority" exception to the rule in Foss v. Harbottle. In three cases(176), Hoffmann J. regarded allegations of breach of fiduciary duties as capable of establishing unfair prejudice. Thus, a misappropriation of a company's assets by a majority shareholder is capable of establishing unfair prejudice to the minority shareholders(177). The fact that misappropriation of a company's assets entitles minority shareholders to bring a derivative action, does not prevent it from
bringing a petition under S.459(178). When making a statement supporting one of two rival take-over bids, directors owe a duty not to mislead shareholders. A breach of this duty is capable of establishing unfair prejudice(179). In Re a Company(180), the directors fraudulently induced the petitioners to sell their shares in the company. Hoffmann J. refused to strike out the petition on the ground that the conduct complained of constituted a wrong to the petitioners as defrauded sellers of their shares and as wrongfully dismissed managing director (as regard to one petitioner) of that company(181).

The payment of excessive remuneration to directors to the detriment of a company's members would be unfairly prejudicial to the interests of those members who were not directors(182). It is, however, difficult to prove that the remuneration paid to directors was excessive. The courts are inclined not to interfere with matters which require the commercial judgement of the board. Therefore, the test of excessive remuneration would seem subjective. If the board has, in good faith and genuinely, exercised the power to pay remuneration, the court will not determine whether the remuneration paid were reasonable(183). However, failure to pay adequate dividends coupled with excessive remuneration may found unfair prejudice(184).
In *Malaga Investments Ltd* (Petitioners), the petitioner requisitioned a general meeting to make resolutions to replace three non-elected directors whose appointment was previously rejected by the shareholders in general meeting. The board wrongly obtained a "freezing order" on the shares of the protesting minority shareholders under S.216 CA 1985, so preventing the protesting shareholders from voting on the resolutions. The court held that the board's conduct was capable of establishing unfair prejudice.

It is to be noticed that the conduct complained of must be that of the company represented by the board of directors or the controlling shareholders. S.459 does not apply where the conduct complained of is that of a director in his personal capacity. That is because such conduct cannot be one on behalf of the company. If a director, for example, stole cash from the company's safe, his conduct could not be described as on behalf of the company. It seems that it will make no difference if that director has abused his directorial position to effect or to facilitate the theft.

In relation to the directors' duty of skill and care, the question whether a petition can be brought for breach of that duty under S.459 is as yet unclear. Directors' breach of duty of skill and care may cause a real harm to the company's affairs and consequently the value of the members' interests will be harmed. The
wording of S.459 is, however, encouraging. A petition under the section can be brought in relation to "any actual or proposed act or omission of the company including an act or omission on its behalf", where this "is or would be so prejudicial". Thus, it would appear that directors' negligence which was found to be unfairly prejudicial to the interests of the members should be governed by the section(188).

4) Court orders

If the court is satisfied that a petition under S.459 is well founded, it may make such order as it thinks proper for giving relief in respect of the matters complained of(189).

S.461(1) gives the court an unlimited discretion to make a proper order. S.461(2), however, enumerates five possible orders which the court may make.

1) An order regulating the company's affairs in the future(190).

An example of this type of order is that made by the court in Re H.R. Harmer Ltd(191). In that case the court ordered that the 80 year old founder director who had managed the company in a tyrannical and autocratic way, ignoring the articles and the board's wishes,
should be made a president of the company with no
inghts, duties or powers. The court also ordered that
the company should contract for his services as a
consultant for life. In addition the old director was
ordered not to interfere in the company's management
unless he was asked by the board to do so. Under this
heading the court may also order that the capital should
be reduced, or a director should be removed or
appointed, or the articles should be altered(192).

ii) An order to restrain the doing or continuing of an
act or omission(193).

An example of this type of order is that made in Whyte,
Petitioner(194), where the court issued an injunction
restraining a company from passing a resolution removing
a director and replacing him with another(195).

iii) An order authorising civil proceedings to be
brought in the name and on behalf of the company by such
person or persons and on such terms as the court may
direct(196).

S.461(2)(c) is intended to circumvent the difficulties
of bringing a derivative suit under any of the
exceptions to the rule in Foss v. Harbottle. If the
court authorised civil proceedings a minority
shareholder can sue a director on behalf of the company even if he cannot bring his action within one of the exceptions to that rule.

iv) An order providing for the purchase of the shares of any member by other members or by the company (197).

An example of this type of remedy is that made in Scottish Co-operative Wholesale Society v. Meyer (198). In that case, the petitioners were minority shareholders in a subsidiary company formed by Scottish Co-operative Wholesale Society. The board of directors of the subsidiary company consisted of five directors three of whom were nominees of Scottish Co-operative Wholesale Society and the petitioners were the other two directors. The subsidiary was dependent on Scottish Co-operative Wholesale Society for its supplies. A dispute between the petitioners and Scottish Co-operative Wholesale Society had led the latter to adopt a policy of deliberately ruining the subsidiary by cutting off its supplies. The nominee directors supported that policy. As a result the value of the petitioners' holdings was reduced from £6 a share to nothing. The court found that there was an oppression on the minority and consequently Scottish Co-operative Wholesale Society was ordered to buy the petitioners' shares for £3.15s a share. The value of the petitioners' shares was
assessed on the basis of what a fair price would have been if the oppressive conduct had not occurred (199).

Most recently, in *Holt v. Holt* (200), the Privy Council held that the applicable test to share valuation was the price at which a hypothetical "willing but not anxious vendor would sell [his shares] and a willing but not anxious purchaser would buy [them]" (201).

5) The conduct of the petitioning shareholder.

The power of the court to give relief under S. 459 is equitable in character (202). Thus, the one who wishes to bring a petition under S. 459 must come before the court with "clean hands" (203). A petitioner's motive is of importance in deciding whether a relief is to be given. In *Re Bellador Silk Ltd* (204), the petition was held to deserve dismissal because the petitioner's motive was to put pressure on the company to compel it to pay a debt it owed him. Similarly, in *Re R.A. Noble & Son* (205), Nourse J. refused to grant a petition under S. 459 on the ground that the management exclusion had not been unfair since it was partly due to the petitioner's disinterest. Instead, the Judge made a winding up order on the "just and equitable ground".

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9.5.2. Protection of Minority Shareholders under S.122(1)(g) of the Insolvency Act 1986.

S.122(1) (g) empowers the court to order that a company be wound up where it is "just and equitable" to do so. The section provides:

(1) A company may be wound up by the court if:
   (g) the court is of the opinion that it is just and equitable that the company should be wound up.

An application for a winding up can be made by the company, or the directors, or by any creditor or creditors or by any contributory. A contributory is defined as a "person liable to contribute to the assets of the company in the event of its being wound up". A contributory cannot bring a winding up petition unless either (a) the number of the members is reduced below two, or (b) the shares were originally allotted to him or have been held by him and registered in his name for at least 6 months during the 18 months before the commencement of the winding up, or have devolved on him through the death of a former holder.

A partly paid-up shareholder is a contributory since he is liable to contribute to the company's assets in the event of its being wound up. Thus, he is qualified to present a winding up petition. A fully paid-up member cannot be a contributory. However, if he establishes that he has a tangible interest in the winding up he is
qualified to bring a petition for a winding up order\(^{(210)}\). Establishing that the petitioner had only a purely private advantage in the winding up was held to insufficient\(^{(211)}\). The "tangible interests" requirement is purely judicial\(^{(212)}\). It goes against the substance of S.125 of the Insolvency Act 1986, which provides that "the court shall not refuse to make a winding up order on the ground only that . . . the company has no assets". However, the purpose of establishing the "tangible interests" requirement is the avoidance of \textit{mala fide} petitions which are intended to destroy the company. It is submitted that while it is correct that a fully paid-up member will not be harmed financially by the continuation of his company because his liability is limited; the "tangible interests" requirement is arbitrary. The term "interest" should not be limited to cases of "tangible" or financial interests. A member of a good reputation may have an interest in the winding up of his insolvent company. It is quite possible that his being a member in an insolvent company may injure his reputation. So, why should not he be able to bring a petition for the winding of this company?\(^{(213)}\).

A petitioner for a winding up order on the "just and equitable" ground must come before the court with "clean hands". If the breakdown of a company's business was a result of the petitioner's misconduct, the court would not make a winding up order\(^{(214)}\). If the conduct
complained of was sanctioned by the petitioner prior to the bringing of the petition, again the court would not make a winding up order. Similarly, if the petition was intended only to put pressure on the company and not to obtain a relief, the court would not make an order for the winding up of the company.

The availability of an alternative remedy, such as that under S.459 CA 1985 does not deprive the court of making a winding up order. However, according to S.125 of the Insolvency Act 1986, if the court is of the opinion that the petitioner is acting unreasonably in not pursuing the available alternative remedy, it may strike out his petition for a winding up. In Re a Company the petitioner was offered to sell his shares at a fair value to be determined by an independent expert. The petitioner refused the offer. The court found that his refusal was unreasonable and, therefore, his petition for the winding up of the company was struck out.

The attempt to categorise the grounds, on which a winding up order may be granted on the "just and equitable" ground, has been criticised by Lord Wilberforce in the leading case of Ebrahimi v. Westbourne Galleries Ltd. In that case Lord Wilberforce pointed out that the words contained in S.122(1)(g) were general and should not be restricted or limited to a specific number of instances. However, one will examine some situations, as examples, in which the
court made a winding up order on the "just and equitable" ground.

i) Loss of substratum

If the main purpose for which a company was formed has been fulfilled or achieved or its achievement has become impossible, the court may order the winding up of it on an application made by a petitioner (219).

ii) Deadlock situations.

If there is a deadlock in the management of the company's business because the directors cannot agree on important matters, a winding up may be ordered. An example of this situation is found in the case of Re Yenidje Tobacco Co. Ltd. (220). In that case a company was formed by two shareholders. They were also the directors of the company. The relation between them had totally broken down. They failed to agree on many vital matters such as the appointment of senior employees. They refused to talk to one another and all the communications between them were through a third party. The court held that the winding up was justifiable. It is said (221) that "deadlock" may not be accepted as a ground for a winding up of a company which is not a "quasi-partnership". That is because, in such a
company, the general meeting would be able to exercise its residual powers to resolve any deadlock.

iii) Collapse of mutual trust and confidence.

If a company is in essence a partnership and the basis of mutual trust and confidence has been broken, the court may order the winding up of it. An example of this situation is found in the leading case of Ebrahimi v. Westbourne Galleries Ltd (222). In that case, E and N had been business partners since 1945. In 1958 a private company was formed. The shares of the company were divided equally between them. Each one held 500 shares out of 1000. They were also the directors of the company. Shortly afterwards N's son, G, joined the business. E and N each transferred 100 shares to G. The company was prosperous and made a good profit. E, N and G were accustomed to distribute the profit amongst them as directors' remuneration. Following a disagreement between E and N, a general meeting was called and E was removed from the board by N and G. E petitioned for an order that the company be wound up on the "just and equitable" ground. The House of Lords ordered that the company should be wound up. The House of Lords based its decision on the ground that when E and N formed the company, it was clear that the character of the association or the basic nature of
their personal business relationship would remain the same. That is, E expected to continue in taking part in the management of the company and to receive profits distributed as a director's remuneration. In this case, N and G were, in fact, acting within the limits of their powers. This fact did not prevent the House of Lords from ordering that the company be wound up. Some equitable considerations may come into play to further a member's rights which are not defined by the articles. An example of these considerations is the mutual confidence between the members. Lord Wilberforce suggested that in order to make a winding up order on the "just and equitable" ground, the court should find out whether one or more of the following factors exists:

(i) an association formed or continued on the basis of a personal relationship involving mutual confidence . . .; (ii) an agreement, or understanding, that all, or some (for there may be sleeping members) of the shareholders shall participate in the conduct of the business; (iii) restrictions upon the transfer of members' interests in the company . . . (223).

iv) Lack of probity.

If there is a justifiable lack of confidence in the conduct and management of a company's affairs, the court may order that the company must be wound up. In Loch v. John Blackwood(224), in order to keep the petitioners ignorant as to the value of the company, so that they could acquire the petitioners' shares at an undervalue,
the directors failed to submit accounts or recommend dividends and even failed to call meetings. The Privy Council ordered that the company be wound up. Lord Shaw said:

It is undoubtedly true that at the foundation of applications for winding up on the 'just and equitable rule' there must lie a justifiable lack of confidence . . . grounded on conduct of the the directors . . . in regard to the company's business . . . . [W]henever the lack of confidence is rested on a lack of probity in the conduct of the company's affairs, then the former is justified by the latter and it is, under the statute, just and equitable that the company be wound up (225).

Finally, the importance of S.122(1)(g) has been reduced by the enactment of S.459 which provides a petitioner with an alternative remedy. The outcome of a petition under S.459 is more satisfactory and more favourable than that under S.122(1)(g). It is more satisfactory because of the wide range of remedies available for the petitioner in comparison with the sole and undesirable outcome of a petition under S.122(1)(g). In addition, the winding up of a company may not benefit the petitioner since the break-up value of the company's assets may be small (226). Suffice here to imagine the undesirable effects of applying S.122(1)(g) on the existence of a prosperous company, its employees and the society as a whole. Therefore, it is suggested that S.122 (1)(g) should not be applied whenever an alternative remedy is available.
Footnotes

1) The English term "injunction".

2) A contract of employment may, for example, impose an obligation on the director to devote all his time to the company's business.

3) See, for example, S. 330 CA 1985 which prohibits a company from entering into a credit transaction with its directors.

4) For example, directors' duty of skill and care and the duty not make a secret profit out of their directorial position; see Chapter No. 3.

5) Regal (Hastings) v. Gulliver [1942] 1 All E.R. 378; see also Industrial Development Consultant Ltd v. Cooley [1972] 1 All E.R. 152; see Chapter No. 3.

6) Wilson and Duncan, Trust, Trustees and Executors, [1975], at p.79.

7) Boardman v. Phipps [1967] 2 A.C. 46. The defendants in that case were the solicitor of the trust and one of the beneficiaries. However, it would seem that its decision is applicable to directors.


12) Similarly, see S.143(1) and (3), S.151(1), S.84(1) and S.85(2) CA 1985.

13) See Rayan, Company Directors, Liabilities, Rights and Duties [1987]; see also Pennington R. Directors' Personal Liability [1987].


20) S.105(3), S.107(1) of the IA 1986 and Sch. 4, para 4.
22) S.42(1) of the Insolvency Act 1986 and Sch. 1, para 5.
24) See Chapter No. 7.
25) See Chapter No. 8.
26) See Chapter No. 8.
27) See Wright v. Simpson [1802] 6 Ves 714, particularly see Lord Eldon at p.734.
28) S.122(1)(g) of the Insolvency Act 1986.
29) S.27 of the IA 1986 entitles a creditor or a member of a company to apply to the court by petition on the ground that the company's business, affairs and property are being or have been managed by the administrator in a manner which is unfairly prejudicial to the interests of its creditors or its members generally or some part of its creditors or members. This section is confined to cases where an administration order is in force. Under S.459 CA 1985 the members only can petition to the court. Creditors are not entitled to petition under this section. A creditor, however, can apply to the court for a winding up order on the "just and equitable" ground under S.122(1)(g) of the Insolvency Act 1986. Both S.459 and S.122(1)(g) will be examined later in this chapter.
30) [1843] 1 Hare 461.
31) [1843] 2 Hare 461. For a comprehensive discussion, see Wedderburn K. "Shareholders' Rights and the Rule in Foss v. Harbottle" [1957] C.L.J. 194; and for a brief discussion of that rule see Hornby, Introduction to Company Law, 5th ed, [1975].
32) [1950] 2 All E.R. 1064 at p.1066.
33) The rule in Foss v. Harbottle consists of two principles. Those principles had been described by Street J. in Hawkesbury Development Co. Ltd. v. Landmark Finance Pty. Ltd [1970] 92 W.N. (N.S.W) 199 as (1) the proper plaintiff principle, and (2) the internal management principle.
35) Grant v. U.K. Switchback Railways [1888] 40 Ch. 135 (CA); see also Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd. [1983] Ch. 258 (CA), cf. the dissenting judgment of May L.J. in the same case.
36) [1889] 16 R. 653.
37) [1889] 16 R. 653 at p.656; see also Lee v. Crawford [1890] 17 R. 1094 where the action was brought against the directors for payment to the company of funds alleged to have been illegally lent to officials of the company.

38) Gower, Principles of Modern Company Law, 4th ed, [1979] at p.656; see also James L.J. in Gray v. Lewis [1873] 8 Ch. App. 1035 at p.1051. It is said that there is another advantage for the rule. It prevents the company being subjected to expensive and long litigations to no ultimate purpose if an independent majority decide not to sue: see Prudential Assurance Co. Ltd v. Newman Industries (No.2) Ltd. [1982] Ch. 204 (CA); see also Smith v. Croft (No.3) [1987] B.C.L.C. 355.

42) Charlesworth and Morse, Company Law. 14th ed, [1991].

46) S.75(4)(c) CA 1980.

50) See Pennington, Directors' Personal Liabilities [1987].

51) It was assumed in some cases that there may be a fifth exception to the rule in Foss v. Harbottle represented by the justice of the case. That is, the rule has no application where the justice of the case so required: see Heyting v. Dupont [1963] 3 All E.R.; Edward v. Halliwell [1950] All E.R. 1064, (CA); Russell v. Wakefield Waterworks Co. [1875] LR 20 Eq 474. This exception was accepted by Vinelott J. in Prudential Assurance Co. Ltd v. Newman Industries Ltd (No.2), [1980] 2 All E.R. 841 at p.877. However, The Court of Appeal in this case
rejected this exception as being an impractical test.

52) See, for example, Simpson v. Westminster Palace Hotel Co. [1860] HL Cas. 712.


54) An independent shareholder is that who is independent from the wrongdoers and who makes up the majority of the minority shareholders.


56) [1988] Ch. 114.

57) [1988] Ch. 114 at p.184-185.

58) [1988] Ch. 114 at p.189.

59) See per Knox J. [1988] Ch 114 at p.186, where he said: "The court should not substitute its own opinion but can, in my view should, assess whether the decision making process is vitiated by being or being likely to be directed to an improper purpose"; Cf. the Court of Appeal's comments in Prudential Assurance v. Newman Industries (No.2) [1981] Ch. 257, which indicated that the view of the independent shareholders were always important. It is argued, however, that it is difficult to conceive of circumstances where the court may override the decision of the majority of independent shareholders: Hollington, Minority Shareholders' Rights [1990]. It should be noted that the question of the majority of the independent shareholders is one of fact in each case.

60) S.35 CA 1985 finds its origins in S.9(1) of the European Communities Act 1972. The section is originally an implementation of the art.9 of the First Directive of the EEC.


62) There is no room to rehearse those criticisms in this chapter.


64) See new S.35A(1) (a) which provides:
"a person "deals with" a company if he is a party to any transaction or other act to which the company is a party"; see Poole, "The Abolition of the Ultra vires Doctrine and Agency Problems" [1991] 12 Co. Law. 43.

65) S.103 CA 1989 (S.416). Thus, according to new S.711A the doctrine of constructive trust applies only where a person is under some other duty to make
reasonable enquires and has failed to do so: see Tucker, "Companies Act 1989 — Where Are We Now", 135 S.J. 773.

66) It is said that bad faith exists in cases, for example, where a third party assists the directors in the abuse of their powers or is a party to fraud: see Abbott, Company Law, 4th ed, [1990]. It should be noted that the limitations on directors' powers which are removed by new S.35A are those which stem from the company's constitution including the limitations flow from the resolutions of the company in general meetings, or a meeting of any class of shareholders or from any agreement between the members of the company or of any class of shareholders: see new S.35A(3) (a) and (b).

67) S.9 of the Age of Legal Capacity (Scotland) Act 1991 provides: "'transaction' means a transaction having legal effect, and includes— (a) any unilateral transaction".

68) For a full discussion, see the Consultative Document of the DTI, Reform of the Ultra Vires Rule, [1986], Report by Dr. Prentice D.

69) S.35, originally S.9 of the European Communities Act 1972.


71) New S.35(2).


73) New S.35(3).

74) These sections will be discussed later in this chapter.

75) [1950] 2 All E.R. 1064.

76) [1950] 2 All E.R. 1064 at p.1067.

77) See Baillie v. Oriental Telephone Co. Ltd [1915] 1 Ch. 503 (CA), in which a company was successfully restrained from acting on a special resolution of which inadequate notice had been given.

78) S.20 CA 1948.

79) [1909] 1 Ch. 311; aff'd. [1909] A.C. 441.

80) Farwell L.J. in Quin and Axtens Ltd v. Salmon [1909]
It is to be noted, however, that the contract referred to by S.14 is subject to S.9 CA 1985, which allows a company to alter its articles by a special resolution.


Quin and Axtens Ltd v. Salmon [1909] 1 Ch. 311


This section has been discussed in detail under the previous exception to the rule in Foss v. Harbottle.

See the first exception to the rule in Foss v. Harbottle discussed above.


See Re T. N. Farrer Ltd [1937] Ch. 352.


Pender v. Lushington [1877] 6 Ch. d. 70, particularly see per Jessel M.R. at p.81, where he held that these rights were enforceable.


Catesby v. Burnett [1916] 2 Ch. 325.


Hickman v. Kent or Romney Marsh Sheep Breeders' Association [1915] 1 Ch. 881 at p.900, per Astbury J.


Farrar's Company Law. 2nd ed, [1988].
112) Prudential Assurance Co. Ltd v. Newman Industries Ltd. (No.2) [1982] Ch. 204 at p.223. However, such conduct may found a derivative action since the company has suffered loss.
113) Prudential Assurance Co. Ltd v. Newman Industries Ltd. (No.2) [1982] Ch. 204
114) This is only and only if the "special majority" issue constitutes a real exception to the rule. It is, however, submitted that it does not. This matter is simply outside the scope of application of the rule, and what is outside the scope of application of a certain rule cannot be described as an exception to it.
115) See per Lord Kylilachy (Ordinary) in Lee v. Cramford [1896] 17 R. 1094; see also Brown v. Stewart [1898] 1 F. 316. It is to be noted that a derivative action is not known in Scotland. This matter has already been discussed earlier in this chapter.
118) [1978] Ch. 406 at p.414.
119) [1956] Ch. 565.
121) [1982] 1 All E.R. 437.
122) [1982] 1 All E.R. 437 at p.448.
123) [1982] 1 All E.R. 437 at p.447.
125) Russell v. Wakefield Waterworks Co. [1875] LR 20 Eq 474 at p.482 per Jesse M.R.
126) [1980] 2 All E.R. 841.
127) [1980] 2 All E.R. 841 at p.875 per Vinelott J.
130) [1982] 1 All E.R. 437.
131) Farrar's Company Law, 2nd ed, [1938], at p.389.
134) [1967] 2 A.C. 134.
135) See Farrar's Company Law, 2nd ed, [1988].
139) Cf Greenhalgh v. Arderne Cinemas Ltd [1951] Ch. 286, in which the alteration of the articles was designed to allow the majority shareholder to transfer his shares to non-members, while compelling the minority shareholder to offer his shares to the majority shareholder first. It was held that that alteration was not a fraud on the minority on the ground that an "individual hypothetical member" regardless of whether he held the majority or the minority of the shares would benefit since there would be less restrictions on the right to sell his shares. It is submitted that this decision was not satisfactory because the minority right to sell remained restricted while that of the majority was free of any limitations. The purpose of the alteration of the articles in the Greenhalgh case was improper because the alteration was primarily meant or designed to injure other members of the company. And a fraud on the minority may exist where the majority exercises its powers for an improper corporate purpose: see Gower, Principles of Modern Company Law, 4th ed, [1979].

140) [1982] 1 All E.R. 437.

141) [1982] 1 All E.R. 437 at p.448.

142) See Cook v. Deeks [1916] 1 A.C. 554 (PC); Piercy v. Mills & Co. Ltd [1920] 1 Ch. 77, in which the court invalidated an allotment of shares made by directors to themselves and their nominees in order to maintain their control of the votes in general meetings; Hogg v. Cramphorn Ltd. [1967] Ch. 254, in which the suit was brought in relation to directors' action which was intended to defeat a take-over bid; see also Heward Smith Ltd v. Ampol (Petroleum) [1974] A.C. 821, a case was concerned with directors' decision to favour one of two competing take-over bidders.


144) [1956] Ch. 565.


146) Pennington, Directors' Personal Liability, [1987].


149) This section will be examined later in this chapter.

150) Gore-Browne on Companies, 44th ed, supp. 4, [1986].

151) See Meyer v. Scottish Textile & Manufacturing Co. Ltd. [1954] S.L.T. 237 where it was pointed out that S.210 was confined to a continuing state of affairs and was not enacted to give compensation.
for wrongs which ceased to continue; see Bourne, "The Minority Remedy In S.75, Companies Act 1980 - Peashooter or Blunder bus?" 5 B.L.R. 263; see also Bastin, "Minority Protection: A Plea for Reform" [1977] 127 N.L.J. 230.

152) See Lord Simonds in Meyer v. Scottish Co-operative Wholesale Society [1959] A.C. 324 at p.342 where his Lordship said that oppression means "burdensome, harsh and wrongful"; see also Lord Keith in Elder v. Elder Ltd [1952] S.C. 49 at p.60, where his Lordship said that the word oppression denotes "an element of lack of probity and fair dealing".


155) S.75 CA 1980.

156) This rule has been developed by the courts after the enactment of S.210; see Meyer v. Scottish Textile & Manufacturing Co. Ltd. [1954] S.L.T. 237; see also Re Jermyn Street Turkish Baths Ltd. [1970] 3 All E.R. 57.


158) CA 1989, S.145, Sch. 19, para 11. See generally Fox, "Conduct Unfairly Prejudicial to Some Member(s) or to Members Generally", [1990] 11 Co. Law. Dig. 153; see also Griffiths, "Private Companies and the Companies Act 1989" [1991] 135 S.J. 1215. It is said that the latest amendment to S.459 of the Companies Act 1985 introduced by S.145 of the companies Act 1989, is unlikely to represent a major advance for the efficacy of the section; it is difficult to see how the court can apply a wide discretion to remedy unfair prejudice to a shareholder's interests and still require him to sue qua member; to make S.459 effective, it should be amended so as to permit a shareholder to present a petition where it would be "just and equitable" for the court to grant relief: Bouchier, "Companies Act 1989 - Yet Another Attempt to Remedy Unfair Prejudice" [1991] J.B.L. 132.

159) See Re Carrington Viyella plc [1983] 1 W.L.R. 1068 at p.1074, where he said that no petition under S.459 could be based upon conduct that has equal effect on all shareholders.

160) A person who is not a member of the company but to whom the shares in the company have been
transferred or transmitted by operation of law, may bring a petition under S.459(1): S.459(2). This includes the personal representatives of a deceased member and trustees in bankruptcy. The Secretary of State may also do so following an investigation: S.460.

161) See, for example, Elder v. Elder Ltd. [1952] S.C. 49. This requirement was one of the main reasons for the failure of S.210 as a remedy: see Hannigan, "S.459 of the Companies Act 1985- a Code of Conduct for the Quasi- Partnership?". [1988] L.M.C.L.Q. 60. This requirement may also cause practical difficulties, specially in respect to small private companies, where it is difficult to distinguish between the rights of a member in his capacity as a member and as a director: Bastin, "Minority Protection: A Plea for Reform" [1977] 127 N.L.J. 230; In Re a Company [1983] 2 All E.R. 35 Lord Grantchester Q.C. emphasised that prejudice had to be suffered by a member "qua member".


169) [1989] 5 B.C.C. 82.

170) See also Re R.A. Noble & Sons (Clothing) ltd [1983] B.C.L.C. 273 where Nourse J. accepted that the exclusion from management participation could found an unfairly prejudicial petition, even though the value of the petitioner's shareholding would not have been seriously diminished.

171) The word "interests" is wider than the word "rights". A member can present a petition under S.459 even where his rights as a member have not been jeopardised: per Peter Gibson J. in Re Sam Weller & Sons Ltd. [1989] 5 B.C.C. 810 at p.814.

172) See, for example, Re Kenyon Swansea ltd. [1987] 3 B.C.C. 259.

173) Re Bovey Hotel (Ventures) ltd (unreported) 31 July 1981.


175) Per Peter Gibson J. in Re Sam Weller & Sons Ltd. [1989] 5 B.C.C. 810 at p.814.


183) Re Halt Garages, ltd. [1982] 3 All E.R. 1016; see also Smith v. Croft [1986] 2 B.C.C. 99, where Walton J. rejected the plaintiff's allegation that the directors' salaries were excessive. The judge also warned that in some areas of business, remunerations were justifiable though far in excess of what could be earned in other professions.
184) See Re Sam Weller & Sons ltd. [1989] 5 B.C.C. 810, particularly see per Peter Gibson J.
185) [1987] 3 B.C.C. 569.
186) An unreasonable delay in holding an extraordinary general meeting requisitioned by a shareholder was held to be capable of establishing unfair prejudice to the interests of that shareholder: see McGuinness & Another [1988] 4 B.C.C. 161. For a satisfactory discussion of this issue, see Fox, "Unfairly Prejudicial Conduct by Delaying Meetings" [1988] 132 S.J. 1261; Failure to hold either annual general meeting or to prepare account was held to be unfairly prejudicial to the interests of all members of the company: Re Exp. Broadhurst [1990] B.C.L.C. 384, particularly see Harman J.
187) S.459(1) itself.
189) S.461(1).
190) 461(2) (a).
191) [1958] 3 All E.R. 689.
192) See Farrar's Company law, 2nd ed, [1988].
193) S.461(2) (b).
195) See also Re a Company [1985] B.C.L.C. 80, where the court restrained a proposed allotment of shares which would have diluted the petitioner's holding in the company; McGuinness v. Bremner plc [1988] S.L.T. 891, where the court restrained the company from issuing further shares.
196) S.461(2) (c).
197) S.461(2) (d).
198) [1959] A.C. 324, (HL), (SC).
199) Per Lord Denning in Scottish Co-operative Wholesale Society v. Meyer [1959] A.C. 324 at p.343. A proper valuation of shares is one of the most difficult issues in an unfair prejudice situations. The valuer must have regard to a variety of factors, such as the nature of the business, the value of the company's assets and the profits of the company. The valuer will need to know the
date upon which the shares are to be valued and the basis of valuation. The court, however, has a discretion in determining what is a fair price in all circumstances: see Re London School of Electronics [1986] Ch. 211; Re Bird Precision Bellows ltd. [1986] Ch. 658, at p.669. In determining what may form a fair price, the court will have regard to the value of the shares at a date prior to the occurrence of the unfair prejudicial conduct: Re O.C. (Transport) Services ltd [1984] B.C.L.C. 251; Re a Company [1987] B.C.L.C. 552. For a satisfactory discussion of this issue see Hollington, Minority Shareholders' Rights [1990] at pp.79-80; Farrar's Company Law, 2nd ed, [1988] at pp. 406-7; see also Jacobs, "Unfair Prejudicial Conduct in Company Management" [1988-1989] 8 Lit. 297.

200) [1990] 1 W.L.R. 1250 (PC).

201) [1990] 1 W.L.R. 1250 (PC) at p.1252 per Lord Templeman. That test was, in fact, deduced from the decision of Hatrick v. Commissioner of Inland Revenue [1963] N.Z.L.R. 541.

202) Pennington, Directors' Personal Liability [1987].

203) Cf. Gore-Browne on Companies, 44th ed, [1986] para 28.15, [1989], where it is argued that the "clean hands" principle does not apply to a petition under S.459.

204) [1965] 1 All E.R. 667.


206) S.124 of the IA 1986.

207) S.79(1) IA 1986.

208) S.124(2) (a). It is to be noted that the Twelfth Directive of the EEC makes possible the creation of a one man company. Implementing this Directive will abolish the ground that a winding up order may be made if the number of members is reduced below two. See Chapter No. 8.

209) S.124(2) (b) of the IA 1986.

210) Re Rica Gold Washing Co. [1879] 1 Ch. D. 36 (CA); see also Re Chesterfield Catering Co. ltd [1976] All E.R. 294 at p.299, where Oliver J. suggested that tangible interests was not confined or limited to surplus assets but could cover potential liabilities of a shareholder.


216) Re a Company [1983] B.C.L.C. 492; However, in
Hujnovich v. Vujnovich [1990] B.C.L.C. 227 (PC), it was held that although the minority shareholder had been partly responsible for the breakdown of the relationship between the parties, he would not be prevented from the right to obtain a winding up order on the just and equitable grounds. This decision, it is submitted, should not be commended.

219) See Re Bleriot Manufacturing Air Craft Co. Ltd. [1916] 32 T.L.R. 253; Re German Date Coffee Co. [1882] 20 Ch. D. 169 (CA); see also Re Haven Gold Mining Co. [1882] 20 Ch. D. 151 (CA).
220) [1916] 2 Ch. 426.
224) [1924] A.C. 783 (PC).
225) [1924] A.C. 783 at p.788.
CHAPTER 10

SUMMARY AND CONCLUSIONS

The board of directors is the organ through which a company, usually, conducts its business. The law leaves the distribution of powers between the two main organs of the company (i.e. the board of directors and the shareholders in general meeting) to the articles of association. Therefore, the true construction of the articles is the real touchstone against which the division of powers between the board of directors and the general meeting is defined. It is well established that where the power to manage the company's affairs is, by the articles, clearly vested in the board of directors, the general meeting will have no control over the board in relation to the management of the affairs of the company. However, if the articles give the shareholders in general meeting a supervisory power over the board in relation to the management of the company's business, then, the directors are bound to follow the instructions of the general meeting.

If a company adopts Art. 70 of the 1985 Table A, then, the shareholders in general meeting can instruct the board on how to manage the company's business. However, for binding instructions a special resolution is required.
Directors are, usually, vested with the power to litigate in the name and on behalf of the company. If the assets of the company are subject to a floating charge and a receiver is appointed, it is submitted that, the directors can sue in the name of the company even without the receiver's consent, provided that the exercise of the power to sue must not harm the interests of the charge holder in his capacity as such. To avoid multiplicity of actions (i.e. to avoid the case of bringing proceedings on the same cause of actions by two different sets of people, the directors and the receivers) it is suggested that the directors must have made a real attempt to obtain the receiver's co-operation. If the receiver refuses to bring an action in the name and on behalf of the company, directors must have the power to sue in order to protect the interests of the company including the interests of its creditors. This suggestion extends to cases involving defending actions on behalf of the company.

A company's articles, normally, allow the board of directors to delegate some of its powers to others. It is submitted that where the articles empower the directors to delegate all of their powers, then, it is competent to them to delegate any power without exception even if a particular power is expressly vested in them. It is also submitted that if directors delegate a particular power to the exclusion of their
own powers, they must not be allowed to interfere with the exercise of that particular power by the delegates, unless the directors reserve to themselves the right to interfere. Similarly, unless the directors reserve to themselves the right to revoke the delegation of a particular power, they must not be allowed to revoke it so long as the service contract is in existence. However, delegation of powers must not amount to an assignment of office. An assignment of office can only be authorised by a special resolution of the general meeting.

In general, after the incorporation of a company, the company is bound by the transactions entered into by its directors on its behalf. According to new S.35A CA 1985, the board's excess of power, abuse of power and defective delegation are no longer effective defences in the hand of a company to invalidate a particular transaction (so long as those breaches arise from limitations under the company's constitution and the third party deals with the company in good faith). To strengthen the position of a bona fide third party, new S.711A CA 1985 abolishes the doctrine of constructive notice for almost all purposes.

Abuse of powers and excess of powers by directors are ratifiable so long as there is no fraud on minority shareholders. It is submitted that ratification "cures" the irregularity in a transaction but does not relieve
Directors' primary duty is owed to the company itself as a separate legal persona and not to individual shareholders. A director is not allowed to place himself in a position where his personal interests and his duty to the company may conflict. Consequently, he is not allowed to enter into transactions with the company unless permitted by the articles of association or a due disclosure is made. He is not allowed to make a secret profit out of his directorial position or to take a bribe. Further, he is prohibited from diverting to himself business opportunities belonging to the company. Those rules, it is submitted, are inflexible. The legislation as well as the courts have realised the rigidity of those rules and show their willingness to relax them.

A director owes a duty to the company not to act in a manner which is illegal or ultra vires. An illegal act is void and cannot be ratified. In the past, an ultra vires act was held to be void and could not be ratified. Nowadays, the new S.35 CA 1985 makes it possible for a company to ratify an ultra vires act. However, it is now well established that an ultra vires act is binding on the company insofar as a bona fide third party is concerned. But, a director is still liable in damages.
for any loss suffered by the company as a result of involving it in an ultra vires act. Relieving a director from liability in this case is possible but only by way of a special resolution. Directors must exercise their powers "bona fide, in what they consider not what the court may consider to be in the best interests of the company". The test of bona fide is mainly subjective. It is submitted that the interests of the company include the interests of its creditors, but not those of future members. In addition to their duty to act bona fide in the interests of the company, directors must exercise their powers for the purposes for which they were conferred. The applicable test, here, is mainly objective.

Directors' duty of skill and care is mainly governed by the common law. Since directorship is not a profession and directors do not form a homogeneous group, the standard of care imposed on directors is purely subjective. However, the provisions of the wrongful trading introduced an objective element to the standard of care required from directors. The reason behind introducing the objective element is to protect the interests of the creditors in cases where the company is insolvent. In cases where the company is insolvent and continues in trade, it continues at the expense of creditors. Thus, a higher standard of care with an objective element is required from directors in such a
case. It is submitted, however, that the deployment of an objective standard of care is confined to cases where the company is insolvent and should not be extend to apply to directors' duty of care in cases where the company is solvent.

In relation to shareholders, the general rule is that directors are immune from liability to individual shareholders. In some circumstances, however, directors may owe duties to individual shareholders. If there is an agency relationship between a director and a shareholder, fiduciary duties owed by that director to that shareholder may arise. Those duties are governed by he rules of agency. Thus, a director who can be considered as an agent to a shareholder must not exceed the powers vested in him; he must act in good faith and must exercise reasonable care in performing his duties; he must further the interests of his principal and must not place himself in a position where his interests conflict with those of his principal.

In deciding between two rival bids, directors owe a duty to give an accurate advice to individual shareholders. Further, directors' duties to shareholders may stem from the family nature of the company and the dominant position of the directors over it.

Directors' duties to shareholders may stem from the legislation. For example, under S.166 FSA 1986 directors are obliged to issue accurate prospectuses.
Consequently, a director may be held liable to compensate shareholders for the loss suffered as a result of untrue or misleading statements in prospectuses. In addition, under some conditions contained in S.314 and S.315, a compensation for loss of office obtained by a director must be held by him in trust for individual shareholders.

In addition to their duties to the company and the shareholders, directors owe a duty to consider the interests of the creditors of their company. When a company is insolvent or threatened with insolvency, directors owe a fiduciary duty to the company to consider the interests of its creditors. A breach of that duty cannot be ratified by the shareholders in general meeting because, it is submitted that, when the company is insolvent or threatened with insolvency, the interests of the creditors are to prevail over those of the general body of shareholders. However, since the duty is owed to the company and not to individual creditors, an action in respect of such a duty can only be brought by the company (normally through a liquidator). It follows that individual creditors must not be allowed to sue directors for the alleged breach of duty. Otherwise a problem of double recovery and a multiplicity of suits will arise.

The legislation offers a protection to a company's creditors through section 213 and 214 of the Insolvency
Act 1986. That is, through the provisions which are governing both fraudulent and wrongful trading. Under both S.213 and 214 the recovery is corporate. Thus, neither of those two provisions violates the principle that all creditors participate pari passu in the bankrupt estate. Finally, a director may in some situations be held concurrently liable for his company's debts. For example, a concurrent liability is imposed by the Companies Act 1985 on a director if he is the sole member of the company or if he acts while disqualified. In addition, a director is liable to the holder of a negotiable instrument for its amount if it is signed by the director without stating the company's name on it as required by the legislation.

According to the rule in Foss v. Harbottle, directors' duties to the company can be enforced by the company alone. In some exceptional cases, however, a derivative action can be brought by a minority shareholder on behalf of the company to enforce a duty owed to the company. In some other cases a personal action can be brought by a minority shareholder to enforce a duty owed to that shareholder. Those exceptions are known as the exceptions to the rule in Foss v. Harbottle. In addition to the protection offered to minority shareholders at the common law (which is represented by the exceptions to the rule in Foss v. Harbottle) the legislation offers them effective measures of
protection. Under S.459 CA 1985, proceedings may be initiated by minority shareholders who allege that the affairs of their company are being or have been conducted in a manner unfairly prejudicial to their interests. S.459 avoids many defects suffered by its predecessor S. 210 CA 1948. However, the section fails to abolish the judicially created rule that a member can only bring a petition under it in his capacity as a "member qua member". It is submitted that such a failure limits the effectiveness of the section as one created to protect the interests of minority shareholders. However, the courts are willing to give the word "interests" its widest interpretation so as to include the "legitimate expectations" of members. So, it is submitted that such a wide interpretation is capable of overriding the "qua member" requirement at least in respect of private companies where employment and management participation are, usually, "legitimate expectations". Another way of protection is offered to minority shareholders by S.122 (1)(g) of the Insolvency Act 1986. The section entitles the court to wind up a company on the "just and equitable" ground. The section contains a deadly weapon to protect minority shareholders. It should be noted that the availability of an alternative remedy, such as the one offered by S.459 CA 1985, does not, in general, deprive the court of applying S.122 (1)(g) to restore justice. It is
submitted that the outcome of a petition under S.459 CA 1985 is more satisfactory and more favourable than that under S.122 (1)(g). A wide range of remedies available for the petitioner under S.459 in comparison with the sole and undesirable outcome of applying S.122 (1)(g). The winding up of a company may not benefit the petitioner since the break-up value of the company's assets may be small. In addition, suffice to imagine the undesirable effects of applying S.122 (1)(g) on the existence of a prosperous company, its employees and the society as a whole. Therefore, it is suggested that an order for the winding up of a company should not be made whenever some other alternative remedy to restore justice is available.
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