Corporate finance and management issues in company law

Section C: Corporate management I

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Chapter 2: The management of the company

Introduction

In this chapter we will consider the relationship between the board of directors and the general meeting.

We will also outline the various categories of directors and how they are appointed and removed.

Finally, we will consider the liability of directors found 'unfit' to hold office under the Company Directors Disqualification Act 1986 (CDDA 1986). This deals with the disqualification of 'unfit' directors. We will conclude by examining their liability for abusing the privilege of limited liability under the Insolvency Act 1986.

Essential reading

Gower and Davies, Chs. 14: 'The board', 9: 'Statutory exceptions to limited liability' and 10: 'Disqualification of directors'.

Dignam and Lowry, Ch. 13: 'Corporate management'.

Sealy and Worthington, Ch. 5: 'The board of directors as an organ of the company'.

Cases

Automatic Self-Cleansing Filter Syndicate Co Ltd v *Cunninghame* [1906] 2 Ch 34.

John Shaw & Sons (Salford) Ltd v *Shaw* [1935] 2 KB 113.

Barron v *Potter* [1914] 1 Ch 895.

Secretary of State for Trade and Industry v *Tjolle* [1998] BCC 282.

Re Kaytech International plc [1999] BCC 390.

Yukong Line Ltd of Korea v *Rendsburg Investments Corpn of Liberia (No. 2)* [1998] BCC 870.

Re Hydrodan (Corby) Ltd [1994] BCC 161.

Unisoft Group Ltd (No. 2) [1993] BCLC 532.

Bushell v *Faith* [1970] AC 1099.

Re Cannonquest, Official Receiver v *Hannan* [1997] BCC 644.

Re Sevenoaks Stationers (Retail) Ltd [1991] Ch 164.

Re Polly Peck International plc (No. 2) [1994] 1 BCLC 574.

Re Grayan Building Services Ltd [1995] Ch 241.

Re Lo-Line Electric Motors Ltd [1988] Ch 477.

Morphitis v *Bernasconi* [2003] 2 WLR 1521.

Learning outcomes

By the end of this chapter and the relevant readings you should be able to:

define the term 'director'

discuss the role of the board of directors and its relationship with the general meeting

describe the various types of director

explain the process for awarding remuneration

describe how the general meeting can remove a director from the board

explain how directors can be disqualified from holding office

discuss:

- the liability of directors for fraudulent and wrongful trading
- the misfeasance procedure available to liquidators
- the avoidance of floating charges.

2.1 Defining the term 'director'

A company is an artificial legal entity. As such, it must operate through its human organs. The management of the company is vested in the board of directors who are expected to act on a collective basis, although the articles may, and in large companies generally do, provide for delegation of powers to smaller committees of the board and individual directors.

It should be borne in mind that in small private companies the same individuals may fulfil a number of roles within the business as directors, workers and shareholders.

In large companies, however, there is generally a clear division between the board and shareholders.

The Companies Act 2006 does not define the term 'director' beyond stating in s.250 that the term 'includes any person occupying the position of director, by whatever name called.'

Thus, whatever title the articles of association adopt to describe the members of the company's board (e.g. 'governors'), the law will nevertheless view them as directors. Section 154 lays down the minimum number of directors that companies must have:

two for public companies

one for private companies.

2.2 The position of the board of directors

The CA 2006 does not attribute specific roles to company directors. The Act is also silent with respect to the structure and form of corporate management, leaving such matters to the company's constitution.

Although it is now accepted that in the modern company the board enjoys a position of management autonomy, this has not always been the case. During the nineteenth century directors were viewed as largely symbolic appointments; executive power was vested in the general meeting. A company in a general meeting had constitutional supremacy – the board of directors was viewed as its agent and had to act in accordance with its decisions.

However, this changed dramatically from the early part of the twentieth century with the emergence of the professional director. Shareholding became more dispersed and directors began to be appointed on the basis of particular skills and managerial competence rather than social standing. Articles of association were drafted to give boardrooms greater independence.

Consequently, the judicial response was that the board should **not** be viewed as the agent or servant of the general meeting.

In *Automatic Self-Cleansing Filter Syndicate Co Ltd* v *Cunninghame* [1906] 2 Ch 34 (Sealy and Worthington, p.176) the question for the Court of Appeal was whether the directors were bound to give effect to an ordinary resolution of the general meeting requiring them to sell the company's undertaking to a new company incorporated for the purpose. The company's articles of association provided that 'the management of the business and the control of the company' was in the hands of its directors.

Collins MR, having reviewed the relevant article, explained that:

> [I]t is not competent for the majority of the shareholders at an ordinary meeting to affect or alter the mandate originally given to the directors by the articles of association…the mandate which must be obeyed is not that of the majority – it is that of the whole entity made up of all the shareholders.

A further illustration is to be found in *Quin & Axtens Ltd* v *Salmon* [1909] AC 442 (Sealy and Worthington, p.178), where Lord Loreburn LJ, having reviewed the company's articles of association, observed:

> The bargain made between the shareholders is contained in…the articles of association, and it amounts for the purpose in hand to this, that the directors should manage the business; and the company, therefore, are not to manage the business unless there is provision to that effect.

See also:

Gramophone and Typewriter Ltd v *Stanley* [1908] 2 KB 89 (Sealy and Worthington, p.42).

John Shaw & Sons (Salford) Ltd v *Shaw* [1935] 2 KB 113 (Sealy and Worthington, p.179).

The draft model articles of association confer on the board virtual managerial autonomy. For example Table A, article 70 provides that:

> Subject to the provisions of the Act, the memorandum and the articles and to any directions given by special resolution, the business of the company shall be managed by the directors who may exercise all the powers of the company.

The power of the general meeting is limited to certain matters, such as the right to alter the articles (s.21), share capital (ss.617 and 641) and delegate authority to allot shares (ss.549 and 551).

If shareholders disapprove of a director they can remove him from office by ordinary resolution (see s.168, below).

Where the board of directors is deadlocked so that it is incapable of managing the company, executive power will revert to the general meeting. See *Barron* v *Potter* [1914] 1 Ch 895 (Sealy and Worthington, p.180), where the two directors had argued and were not on speaking terms.

Activity 2.1

Read *Barron* v *Potter* [1914] 1 Ch 895 (Sealy and Worthington, p.180).

Write brief answers (of not more than 500 words each) to the questions in Sealy and Worthington, p.181.

No feedback available.

Summary

Directors are not mere delegates or agents of the general meeting, but are under a duty to act bona fide in the interests of the company as a whole. We will discuss this in more detail in Chapter 3 of this Study Guide.

Table A, Article 70 confers extensive managerial powers on directors, who can thus pursue a course of action different from that prescribed by a bare majority of shareholders.

However, the general meeting can remove a director by ordinary resolution (s.168 CA 2006).

Activity 2.2

Read *Gramophone and Typewriter Ltd* v *Stanley* [1908] 2 KB 89 (Sealy and Worthington, p.42).

Can a controlling shareholder dictate how directors should act?

Feedback: see page 30.

2.3 Appointment of directors

Subject to certain statutory provisions, the appointment of directors is left to the articles of association. Section 9(4)(c) of the CA 2006 requires that the documents filed with the Registrar of Companies as part of the application for registration must include a statement of proposed officers, and s. 16(6) provides that the persons named in that statement are, on the company's incorporation, deemed to be its first directors and secretary.

We have seen above that s.154 stipulates the minimum number of directors for companies. Section 160 goes on to provide that for public companies the appointment of directors shall be voted on individually. Beyond these particular statutory provisions, the CA

2006 is silent on boardroom appointments, leaving the issue to the articles of association.

Although first directors are appointed in accordance with ss.9 and 16, their successors are elected by the shareholders in a general meeting. For example, Table A, Article 73 provides that at the first annual general meeting (AGM):

- all the directors shall retire from office
- at every subsequent AGM one-third of the directors who are subject to retirement by rotation[1] shall retire from office.

[1] Or, if less than three or a multiple of three, the number nearest to one-third.

If there is only one director who is subject to retirement by rotation, he shall retire. It should be noted that in small private owner-managed companies, the articles will often provide for the permanent appointment of directors.

Summary

Sections 154–67 of the CA 2006 govern the appointment and registration of directors. The principal requirements for appointment are:

- Every private company is to have at least one director, and every public company at least two (s.154).
- The minimum age for a director to be appointed is (as in Scotland) 16 (s.157).
- The appointment of a director of a public company is to be voted on individually, unless there is unanimous consent to a block resolution (s.160).
- The acts of a person acting as a director are valid notwithstanding that it is afterwards discovered that there was a defect in his appointment, that he was disqualified from holding office, that he has ceased to hold office, or that he was not entitled to vote on the matter in question (s.161, replacing s.285 of the CA 1985). See the construction given to this provision in *Morris* v *Kanssen* [1946] AC 459, Lord Simonds.

2.4 Categories of directors

There is a clear division of roles between executive and non-executive directors. It should also be noted that because the law imposes strict duties on directors (discussed in Chapter 3), the courts will nevertheless treat persons who act as directors, while not being formally appointed as such, as being subject to these duties. In this way the law prevents avoidance of the onerous obligations that the office of director carries.

2.4.1 Executive and non-executive directors

Executive directors are full-time officers who generally have a service contract with the company. The articles will normally provide for the appointment of a managing director, sometimes called a chief executive, who has overall responsibility for the running of the company (Table A, Article 72).

Non-executive directors are normally appointed to the boards of larger companies to act as monitors of the executive management. Typically, they are part-time appointments.

2.4.2 De facto directors

A **de facto director** is one who has not been formally appointed, but has nevertheless acted as a director: *Re Kaytech International plc* [1999] BCC 390 CA. The issue of whether or not an individual is a de facto director generally arises in relation to disqualification orders under the Company Directors Disqualification Act 1986 (CDDA).

The courts have formulated guidelines for determining the issue. In *Re Richborough Furniture Ltd* [1996] BCC 155, Lloyd J stated that emphasis should be given to the functions performed by the individual concerned. See also *Secretary for State for Trade and Industry* v *Jones* [1999] BCC 336.

In *Secretary of State for Trade and Industry v Tjolle* [1998] BCC 282 Jacob J stated that the essential test is whether the person in question was 'part of the corporate governing structure'. This was approved by the Court of Appeal in *Re Kaytech International plc*.

In *Secretary of State for Trade and Industry v Hollier* [2006] EWHC 1804 (Ch,), Etherton J, having made the point that no one can simultaneously be a de facto and shadow director, went on to state that although various tests have been laid down for determining who may be a de facto director, there is no single touchstone. The key test is whether someone is part of the governing structure of a company in that he participates in, or is entitled to participate in, collective decisions on corporate policy and strategy and its implementation.

2.4.3 Shadow directors

In order to evade the duties which directors are subject to, a shareholder might avoid a formal appointment but still direct the board's decision-making. In this case, the shareholder may be classified as a 'shadow director' and will be subject to the statutory and common law obligations of directors: see *Yukong Line Ltd of Korea* v *Rendsburg Investments Corpn of Liberia (No. 2)* [1998] BCC 870.

For example, s.214 of the Insolvency Act 1986 (discussed further below) provides that a shadow director may be liable to contribute to the company's assets if it goes into insolvent liquidation and it is proved that at some time before the liquidation he knew, or ought to have known, that there was no reasonable prospect of avoiding insolvent liquidation.

Section 251(1) of the CA 2006 defines a shadow director as 'a person in accordance with whose directions or instructions the directors are accustomed to act' (see also s.22(5) CDDA 1986).

Those who provide professional advice are expressly excluded, but a professional person may be held to be a shadow director if his conduct amounts to effectively controlling the company's affairs: *Re Tasbian Ltd (No. 3)* [1993] BCLC 297.

In *Re Hydrodam (Corby) Ltd* [1994] BCC 161, Millett J considered the definition contained in s.251(1). He took the view that in determining whether or not an individual is a shadow director, four factors are relevant:

- The *de jure* and *de facto* directors of the company are identifiable.
- The person in question directed those directors on how to act in relation to the company's affairs, or was one of the persons who did.
- The directors did act in accordance with his instructions.
- They were accustomed so to act.

Millet J explained that a pattern of behaviour must be shown 'in which the board did not exercise any discretion or judgment of its own but acted in accordance with the directions of others.'

However, merely controlling one director is not sufficient; a shadow director must exercise control over the whole board, or at least a governing majority of it.

See *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 and *Re Unisoft Group Ltd (No. 2)* [1993] BCLC 532.

Activity 2.3

Read *Secretary of Trade for Trade and Industry* v *Deverell* [2001] Ch 340.

What was the court's approach to the determination of whether or not the respondent was a shadow director?

Feedback: see page 30.

2.5 Directors' remuneration

As with trustees, a director is not entitled as of right to be paid for his services unless the articles of association or a service contract between him and the company provide otherwise: *Re George Newman & Co* [1895] 1 Ch 674. Table A, Article 82 provides that the directors shall be entitled to such remuneration as the company may, by ordinary resolution, determine.

A formal resolution is not required if all the members entitled to vote on the matter give their informal assent: *Re Duomatic Ltd* [1969] 2 Ch 365.

Generally:

- The power to decide executive directors' remuneration is delegated to the board (see Table A, Article 84) or a sub-committee of the board.
- The scope of its power depends upon the proper construction of the articles.

Where the board has power to set its own remuneration, issues of transparency and accountability obviously arise. The temptation for directors to vote themselves 'fat cat' (i.e. extravagant) awards has generated much debate over the past 20 years or so.

It should be noted that the DTI has published a number of proposals for reinforcing the accountability of directors to shareholders over boardroom pay awards. See the DTI consultative documents *Directors' Remuneration* (URN 99/923) (London: DTI, 1999) and (URN 01/1400) (London: DTI, 2001).

A significant proposal was that there should be a mandatory requirement for the company's annual report to contain:

- a statement of remuneration policy
- details of the remuneration of each director.

This was implemented for all quoted companies for financial years ending on or after 31 December 2002 by statutory instrument (the Directors' Remuneration Report Regulations 2002, SI 2002/1986). This came into force on 1 August 2002 and has now been incorporated into the CA 2006, ss.420–422.

The remuneration report must be approved by the board of directors and signed on behalf of the board by a director or secretary of the company (s.422(1)). Where a directors' remuneration report is approved but does not comply with the statutory requirements, every director of the company who knew of its non-compliance, or was reckless as to whether it complied, and failed to take reasonable steps to secure compliance or to prevent the report from being approved, commits an offence punishable by fine (s.422). Section 439 goes on to provide that prior to the accounts meeting, a quoted company must give to those members entitled to receive it notice of its intention to move an ordinary resolution approving the directors' remuneration report for the financial year. Failure to comply with this requirement is an offence punishable by fine (s.440).

Activity 2.4

Read *Guinness plc* v *Saunders* [1990] 2 AC 663 (Sealy and Worthington, p.249).

- What were the material terms of the company's articles of association?
- Why did the House of Lords order Mr Ward to repay the company the £5.2m awarded him by way of remuneration?

Feedback: see page 31.

2.6 Removal of directors

Section 168 CA 2006 provides that a company may, by ordinary resolution, remove a director before the expiration of his period of office. This can be done notwithstanding anything in any agreement between him and the company.

Special notice must be given of the resolution, that is, at least 28 days' notice must be given before the meeting at which the resolution is to be moved (ss.168 and 312).

The director concerned is entitled to address the meeting at which it is proposed to remove him (s.169(2)). He may also require the company to circulate to the shareholders his representations in writing (providing they are of a reasonable length), unless the court is satisfied that this right is being abused to secure needless publicity for defamatory matter (s.169(3)).

Although the power contained in s.168 cannot be removed by the articles, it is possible for a director to entrench himself by including in the articles a clause entitling him to weighted voting in the event of a resolution to remove him.

In *Bushell* v *Faith* [1970] AC 1099 (Sealy and Worthington, p.256) the articles provided that, on a resolution to remove a particular director, his shares would carry the right to three votes per share. This meant that he was able to outvote the other shareholders who held 200 votes between them. In other words, the ordinary resolution could be blocked by him. The House of Lords approved the clause.

Lord Upjohn reasoned that: 'Parliament has never sought to fetter the right of the company to issue a share with such rights or restrictions as it may think fit.'

He went on to state that in framing s.303, all that Parliament was seeking to do was to make an ordinary resolution sufficient to remove a director and concluded: 'Had Parliament desired to go further and enact that every share entitled to vote should be deprived of its special rights under the articles it should have said so in plain terms by making the vote on a poll one vote one share.'

Nowadays, however, although weighted clauses are commonly encountered in private companies of a quasi-partnership nature, they are expressly prohibited by the Listing Rules of the London Stock Exchange.

2.7 Disqualification of directors

The Company Directors Disqualification Act 1986 seeks to protect the general public against abuses of the corporate form. The effect of a disqualification order is that a person shall not, without the leave of the court:

> be a director of a company, or a liquidator or administrator of a company, or be a receiver or manager of a company's property or, in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company, for a specified period beginning with the date of the order.
> (Section 1(1)).

A disqualified person cannot, therefore, act in any of the alternative capacities listed. For example, a disqualified director cannot participate in the promotion of a new company during the disqualification period: *Re Cannonquest, Official Receiver* v *Hannan* [1997] BCC 644. Nor can he be 'concerned' or 'take part in' the management of a company by virtue of acting in some other capacity, such as a management consultant: *R* v *Campbell* [1984] BCLC 83.

2.7.1 Discretionary orders

The 1986 Act draws a distinction between discretionary orders of the court and mandatory disqualification for unfitness.

Persons convicted of an offence

Section 2 provides that the court may, in its discretion, issue a disqualification order against a person convicted of an indictable offence (whether on indictment or summarily) in connection with the promotion, formation, management, liquidation or striking off of a company, or with the receivership or management of a company's property.

The offence does not have to relate to the actual management of the company, provided it was committed in 'connection' with its management. The maximum period of disqualification is:

- five years where the order is made by a court of summary jurisdiction
- 15 years in any other case (s.2(3)).

Persistent breaches of the companies legislation

The court may disqualify a director where it appears that he has been **persistently in default** in complying with statutory requirements relating to any of the following concerning the Registrar:

- any return, account or other document to be filed with, delivered or sent
- notice of any matter to be given (s.3(1)).

Persistent default will be presumed by showing that in the five years ending with the date of the application, the person in question has been convicted (whether or not on the same occasion) of three or more defaults (s.3(2)).

Section 5 goes on to provide that a disqualification order for persistent default can be made by a magistrates' court (in England and Wales) at the same time as a person is convicted of an offence relating to the filing of returns, etc.

Fraud

The court may make a disqualification order against a person if, in the course of the winding-up of a company, it appears that he:

- has been guilty of an offence for which he is liable (whether he has been convicted or not) under s.458 of the Companies Act (fraudulent trading)
- has otherwise been guilty, while an officer or liquidator of the company or receiver or manager of its property, of any fraud in relation to the company or any breach of his duty as such officer, liquidator, receiver or manager (s.4).

The maximum period for disqualification is 15 years (s.4(3)). Where a person has been found liable under ss.213 or 214 of the Insolvency Act 1986 (respectively the fraudulent trading and wrongful trading provisions, see below) the CDDA gives the court discretion to disqualify such person for a period of up to 10 years.

Disqualification after investigation of the company

Section 8 provides that if it appears to the Secretary of State from a report following a DTI investigation that it is expedient in the public interest that a disqualification order should be made against any person who is, or has been, a director or shadow director of any company, the Secretary of State may apply to the court for a disqualification order. The court can disqualify such a person for up to 15 years if it is satisfied that his conduct in relation to the company makes him unfit to be concerned in the management of a company.

This power has been used where, following a DTI investigation, it was apparent that a director had abused his power to allot shares in order to retain control of the company: *Re Looe Fish Ltd* [1993] BCC 348.

2.7.2 Mandatory disqualification orders for unfitness

Section 6(1) of the CDDA 1986 provides that the court shall make a disqualification order against a person in any case where it is satisfied that he is or has been a director of a company which has at any time – whether while he was a director or subsequently – become insolvent and 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.

The minimum period of disqualification is two years and the maximum period is 15 years (s.6(4)). In contrast with the other grounds for disqualification noted above, s.6 is restricted to directors or shadow directors, including de facto directors.

The policy underlying s.6 was explained by Dillon LJ in *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164 (Sealy and Worthington, p.266) as being to 'to protect the public, and in particular potential creditors of companies, from losing money through companies becoming insolvent when the directors of those companies are people unfit to be concerned in the management of a company.'

An insolvent company is defined as including a company which goes into liquidation at a time when its assets are insufficient to meet the payment of its debts, liabilities and liquidation expenses (s.6(2)).

An application under s.6 must be brought by the Secretary of State[2] if it appears to him that it is expedient in the public interest that a disqualification order should be made against any person (s.7(1)).

[2] Or, if the company is in compulsory liquidation, by the Official Receiver.

The meaning of 'unfitness'

Section 6 provides that the court must be satisfied that the director's conduct 'makes him unfit to be concerned in the management of a company.' This has been construed as meaning unfit to manage companies **generally**, rather than unfit to manage a particular company or type of company.

See:

Re Polly Peck International plc (No. 2) [1994] 1 BCLC 574

Re Grayan Building Services Ltd [1995] Ch 241.

In determining whether a person's conduct renders him unfit to be a director, s.9 CDDA 1986 directs the court to take into account the matters listed in Schedule 1, although those matters are not exhaustive. The list is divided into those matters which are generally applicable and those which are applicable only where the company has become insolvent.

The first category comprises:

misfeasance or breach of any fiduciary or other duty by the director (para. 1)

the degree of the director's culpability in concluding a transaction which is liable to be set aside as a fraud on the creditors (paras. 2 and 3)

the extent of the director's responsibility for any failure by the company to comply with the numerous accounting and publicity requirements of the CA 2006 (paras. 4 and 5).

Those matters to which regard is to be had when the company is insolvent are listed in Part II of Schedule 1. They include:

the extent of the director's responsibility for the causes of the company becoming insolvent (para. 6)

the extent of the director's responsibility for any failure by the company to supply any goods or services which have been paid for, in whole or in part (para. 7).

In *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 Sir Nicholas Browne-Wilkinson VC said that while ordinary commercial misjudgment is not in itself sufficient to establish unfitness, certain conduct would be sufficient to justify disqualification. Examples of such conduct include conduct:

which displays 'a lack of commercial probity'

which is grossly negligent

which displays 'total incompetence'.

See also:

Re Dawson Print Group Ltd [1987] BCLC 601

Secretary of State for Trade and Industry v *Ettinger, Re Swift 736 Ltd* [1993] BCLC 896.

An interesting recent decision is *Secretary of State for Trade and Industry v Swan (No. 2)* [2005] EWHC 2479, in which Etherton J subjected the responsibilities of a non-executive director, against whom an application for disqualification under s.6 had been brought, to detailed consideration. N, a senior non-executive director and deputy chairman of the board and chairman of the audit and remuneration committees of Finelist plc, together with S, the company's CEO, were disqualified for three and four years respectively. N's reaction upon being informed by a whistle-blower of financial irregularities ('cheque kiting') going on within the group was held to be entirely inappropriate. He failed to investigate the allegations properly, nor did he bring them to the attention of his fellow non-executive directors or to the auditors. The judge held that N's conduct fell below the level of competence to be expected of a director in his position and he was therefore 'unfit' to be concerned in the management of a company.

Activity 2.5

Read *Secretary of State for Trade and Industry* v *TC Stephenson* [2000] 2 BCLC 614.

What allegations were made against the director by the Secretary of State? What was the decision of the court?

Feedback: see page 31.

Summary

The courts will look for abuses of the privilege of limited liability as evidenced by capricious disregard of creditors' interests or culpable commercial behaviour amounting to gross negligence.

Non-executive directors who lack corporate financial experience may rely on the advice and assurances provided by the company's accountants, although they should be vigilant and raise objections whenever they have concerns about the financial operation of the company.

2.7.3 Disqualification undertakings

The Insolvency Act 2000 amends the CDDA 1986 by introducing a procedure whereby in the circumstances specified in ss.7 and 8 of the 1986 Act, the Secretary of State may accept a disqualification undertaking by any person that, for a period specified in the undertaking, the person will not be a director of a company, or act as a receiver, 'or in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company unless (in each case) he has the leave of the court' (s.6(2) of the 2000 Act, inserting s.1A into the CDDA 1986).

In determining whether to accept a disqualification undertaking by any person, the Secretary of State may take account of matters other than criminal convictions, notwithstanding that the person may be criminally liable in respect of those matters.

It is further provided that if it appears to the Secretary of State that the conditions mentioned in s.6(1) are satisfied with respect to any person who has offered to give him a disqualification undertaking, he may accept the undertaking if it appears to him that it is expedient in the public interest that he should do so (instead of applying, or proceeding with an application, for a disqualification order) (s.6(3) of the 2000 Act, inserting s.7(2A) into the CDDA).

Section 8 of the CDDA 1986 is amended so that where it appears to the Secretary of State from the report of a DTI investigation that, in the case of a person who has offered to give him a disqualification undertaking:

> the conduct of the person in relation to a company of which the person is or has been a director or shadow director makes him unfit to be concerned in the management of a company and
>
> it is expedient in the public interest that he should accept the undertaking (instead of applying, or proceeding with an application for a disqualification order)

he may accept the undertaking (s.6(4) of the 2000 Act, inserting s.8(2A) into the CDDA).

Section 8A of the CDDA 1986 provides that the court may, on the application of a person who is subject to a disqualification undertaking, reduce the period for which the undertaking is to be in force or provide for it to cease to be in force (s.6(5) of the 2000 Act).

These reforms are designed to save court time so that in the specified circumstances, disqualification can be achieved administratively without the need to obtain a court order.

2.8 Fraudulent trading

A director will not be able to hide behind the corporate veil – that is, will not be protected by the principle that the company is legally distinct from its members – and avoid personal liability for the company's debts where he has used the company for fraudulent trading (or for wrongful trading; see below).

2.8.1 Civil and criminal liability

Civil liability for fraudulent trading is imposed by s.213 of the 1986 Act. This provides that if in the course of the winding-up of 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 court, on the application of the liquidator, may declare that any persons who were knowingly parties to the carrying on of the business in that manner are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

Criminal liability for fraudulent trading is imposed by s.993 CA 2006, the wording of which is virtually identical to s.213. A person who uses a company for fraudulent trading is liable to be prosecuted whether or not the company is being wound up, and on conviction is liable to a fine, imprisonment or both.

The meaning of 'fraud'

The meaning of **fraud** for the purposes of s.213 has been defined as requiring 'real dishonesty involving, according to current notions of fair trading among commercial men at the present day, real moral blame': *Re Patrick and Lyon* [1933] Ch 786, Maugham J.

Continuing to trade while the company is insolvent is not sufficient to establish liability. In *Morphitis* v *Bernasconi* [2003] 2 WLR 1521 the Court of Appeal, while accepting that fraudulent trading can occur even though only one creditor has been defrauded, nevertheless stressed that to find fraud there must be clear evidence of fraudulent intent on the part of the directors in carrying on the business of the company. Liability did not arise under s.213 just because it might appear to the court that any creditor of the company had been defrauded.

Actual dishonesty must be proved: *Welham* v *DPP* [1961] AC 103. However, allowing a company to trade knowing that it is unable to meet all of its debts as they fall due may amount to sufficient evidence of dishonest intent: *R* v *Grantham* [1984] QB 675.

The difficulty of establishing fraud is illustrated by *Re Augustus Barnett & Son Ltd* (1986) 2 BCC 98, 904. An off-licence chain was the wholly-owned subsidiary of a Spanish company. The off-licences traded at a loss for some time but the parent company repeatedly issued statements that it would support its subsidiary. Such statements had been made via 'comfort letters' to the subsidiary's auditors and were published in its accounts for three successive years.

When eventually the parent company withdrew its support and allowed the subsidiary to go into liquidation, it was alleged that the parent company was guilty of fraudulent trading. It was held that

the facts did not disclose the requisite intent to defraud the creditors. Indeed, they were consistent with the parent company having an honest intent, at the time it made the statements, to support its subsidiary. The fact that it later changed its mind did not prove that its original intent was fraudulent.

On the other hand, a clear example of fraudulent intent appears from the facts of *Re William C Leitch Brothers Ltd* [1932] 2 Ch 71, in which the liquidator sought declarations that the director of the company had been knowingly a party to carrying on the business of the company with intent to defraud its creditors and he was therefore personally liable for all the company's debts.

The company had owed around £6,500 for goods on 1 March 1930 and it lacked the means to pay off these debts. Subsequently, the director ordered goods worth £6,000. These became subject to a charge contained in a debenture held by him. He also lent sums of money to the company after this date which were paid off in part by the company. Later, he appointed a receiver on the ground that the company had defaulted on interest payments.

The company's account with the Midland Bank was overdrawn by around £800. He had guaranteed this sum and had deposited title deeds with the bank. Between April and June 1930 £684 of the overdraft was paid off. It also emerged that the goods which the director had ordered were greatly in excess of the company's requirements.

In holding the director liable, Maugham J observed:

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

Similarly, in *Re Gerald Cooper Chemicals Ltd* [1978] Ch 262 it was held that accepting advance payment for the supply of goods from one creditor where the directors knew that there was no prospect of the goods being supplied and the payment returned amounted to fraud committed in the course of carrying on business. See also *Morris* v *State Bank of India* [2003] EWHC 1868 (Ch), in which Patten J stated that knowledge included 'blind-eye' knowledge (i.e. deliberately shutting one's eye to the obvious).

The 'parties' to the carrying on of the business

The term **parties to the carrying on of the business** contained in s.213 is expansive in effect so that any person who takes a positive step in the fraudulent trading can be liable. Contrast s.214 below, the scope of which is limited to directors and shadow directors.

In *Re Maidstone Building Provisions Ltd* [1971] 1 WLR 1085 it was held that the failure of a company secretary to advise the directors that the company is insolvent is not sufficient to render him a party to the carrying on of the business in a fraudulent manner. As Pennycuick VC defined 'parties' as those who participate in, take part or concur in fraudulent trading, it thus involves some 'positive steps.'

But it has been held that a creditor who knowingly accepts money fraudulently obtained by the company is a party to the carrying on of the business in a fraudulent manner: *Re Gerald Cooper Chemicals Ltd*.

The nature of the liability

The extent of liability under s.213 is subject to the court's discretion. In *Re William C Leitch Brothers Ltd* Maughan J noted that s.213 carries a punitive element and a director may therefore be ordered to pay more under the section than is actually owed to the creditors who have been defrauded.

See *Re a company (No. 001418 of 1988)* [1991] BCLC 197, in which the director was ordered to pay an additional sum of £25,000 by way of punitive element.

However, in determining the issue of liability Chadwick LJ in *Morphitis* v *Bernasconi* observed that:

> The power under section 213(2) is to order that persons knowingly party to the carrying on of the company's business with intent to defraud make 'such contributions (if any) to the company's assets' as the court thinks proper. There must, as it seems to me, be some nexus between (i) the loss which has been caused to the company's creditors generally by the carrying on of the business in the manner which gives rise to the exercise of the power and (ii) the contribution which those knowingly party to the carrying on of the business in that manner should be ordered to make to the assets in which the company's creditors will share in the liquidation. An obvious case for contribution would be where the carrying on of the business with fraudulent intent had led to the misapplication, or misappropriation, of the company's assets. In such a case the appropriate order might be that those knowingly party to such misapplication or misappropriation contribute an amount equal to the value of assets misapplied or misappropriated. Another obvious case would be where the carrying on of the business with fraudulent intent had led to claims against the company by those defrauded. In such a case the appropriate order might be that those knowingly party to the conduct which had given rise to those claims in the liquidation contribute an amount equal to the amount by which the existence of those claims would otherwise diminish the assets available for distribution to creditors generally; that is to say an amount equal to the amount which has to be applied out of the assets available for distribution to satisfy those claims.

Further, notwithstanding *Re William C Leitch Brothers Ltd* and *Re a company (No. 001418 of 1988)*, it is noteworthy that the Court of Appeal doubted whether in civil proceedings under s.213 it had the power to include a punitive element, given that such power is contained in s.993 CA 2006. In this regard Chadwick LJ stated:

> I am not persuaded that there is power to include a punitive element in the amount of any contribution which, in the exercise of the power conferred by section 213(2) of the 1986 Act, a person should be declared liable to make to the assets of the company. As I have said, I think that the principle on which that power should be exercised is that the contribution to the assets in which the company's creditors will share in the liquidation should reflect (and compensate for) the loss which has been caused to those creditors by the carrying on of the business in the manner which gives rise to

> the exercise of the power. Punishment of those who have been party to the carrying on of the business in a manner of which the court disapproves – beyond what is inherent in requiring them to make contribution to the assets of a company with limited liability which they could not otherwise be required to make – seems to me foreign to that principle.

Such contributions ordered by the court to be paid to the liquidator are held on trust for the unsecured creditors. They do not, therefore, become subject to the winding-up expenses or to the priority of a floating charge: *Re Floor Fourteen Ltd* [2001] BCLC 392; *Re MC Bacon Ltd* [1990] BCLC 607.

Summary

A director will be liable for the company's debts where he was **knowingly** party to a company's fraudulent trading.

Fraudulent trading occurs where a director allows a company to continue trading **knowing** that:

- it cannot pay its debts
- there is no reasonable prospect that it will be able to pay them.

To establish liability there must be some nexus between:

- the loss which has been caused to the company's creditors generally by the carrying on of the business in the manner which gives rise to the exercise of the power
- the contribution which those **knowingly** party to the carrying on of the business in that manner should be ordered to make to the assets in which the company's creditors will share in the liquidation.

2.9 Wrongful trading

It has been seen that s.213 requires proof of dishonest intent so that directors who carry on business recklessly do not fall within its scope. To address this loophole, and following the recommendations of the Cork Committee (Cork Committee Report, Cmnd 8558, Ch. 44), s.214 of the Insolvency Act 1986 introduced the concept of 'wrongful trading'.

Like fraudulent trading, s.214 only applies where the company is in liquidation. It provides that a liquidator of a company in insolvent liquidation can apply to the court to have a person who is or has been a director of the company declared personally liable to make such contribution (if any) to the company's assets as the court thinks proper for the benefit of the unsecured creditors.

2.9.1 Director

The term director for the purposes of s.214 encompasses 'shadow directors' and de facto directors: *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180. In *Secretary of Trade for Trade and Industry* v *Deverell* [2000] 2 BCLC 133 the Court of Appeal held that the definition of a 'shadow director' for the purposes of s.22(5) CDDA 1986 included anyone, other than professional advisers, with real influence in the corporate affairs of the company.

On the facts, both respondents were described as consultants but the company's board were accustomed to act in accordance with their directions and 'suggestions'. They were therefore shadow directors.

Where a director has died, the liquidator can maintain the claim against his estate: *Re Sherbourne Associates Ltd* [1995] BCC 40. The liquidator must prove that the director in question allowed the company to continue to trade, at some time before the commencement of its winding-up, when he knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. An **awareness** that creditors are exerting pressure for payment or refusing to make further deliveries will be sufficient: *Re DKG Contractors Ltd* [1990] BCC 903.

2.9.2 Culpability

In determining whether a director ought to have concluded that an insolvent liquidation was **unavoidable**, s.214(4) 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 reasonable 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.

The first reported case under s.214 was *Re Produce Marketing Consortium Ltd* [1989] BCLC 520 (Sealy and Worthington, p.671), in which two directors were each held liable to contribute £75,000 to the company's assets. Knox J held that the time at which they ought to have realised that the company's liquidation was unavoidable was the latest possible date on which the annual accounts for that year ought to have been delivered. The fact that the directors had not seen them was irrelevant and in any case they had acquiesced in the delay of their delivery.

Construing s.214(4), Knox J took the view that its objective and subjective elements required each director to be judged on the facts actually known to them but also according to those facts which **should have been known** had the accounts been duly delivered as required by the Companies Act.

Accepting counsel's submission that there was a requirement to have regard to the functions being carried out by the particular director in relation to the company in question, which would involve having regard to the particular company and its business, Knox J stated:

> It follows that the general knowledge, skill and experience postulated will be much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures.

> Nevertheless, certain minimum standards are to be assumed to be attained. Notably there is an obligation laid on companies to cause accounting records to be kept which are such as to disclose with reasonable accuracy at any time the financial position of the company at that time: see the Companies Act [2006, ss.386 and 387].

Knox J concluded that the knowledge to be imputed to directors in testing whether or not they knew or ought to have realised that there was no reasonable prospect of the company avoiding insolvent liquidation is not limited to the documentary material available at the given time. This, he thought, was evident from the wording of s.214(4), which refers to those facts 'which he ought to ascertain, a word which does not appear in sub-section 2(b).'

Accordingly, the following should be included:

- the factual information available to the directors
- what with 'reasonable diligence and an appropriate level of general knowledge, skill and experience, was ascertainable.'

It should be noted that it is no defence for directors of a small, family-run incorporated business that they lacked the basic financial and accounting knowledge necessary to fulfil their obligations: *Re DKG Contractors Ltd*.

Further, in *Re Continental Assurance Co of London plc* [2001] All ER (D) 229 (Apr), ChD, in which a small insurance company collapsed leaving large losses which came to the board's attention the year before, Park J stated that the **standard of skill** expected under s.214(4) was that of the intelligent layman:

> [The directors]…would need to have knowledge of what the basic accounting principles for an insurance company were…They would be expected to be able to look at the company's accounts and, with the guidance which they could reasonably expect to be available from the finance director and the auditors, to understand them…What I do not accept is that they could have been expected to show the sort of intricate appreciation of recondite accounting details possessed by a specialist in the field.

Nor is it a defence that the director did not play an active part in the management of the company. In *Re Brian D Pierson (Contractors) Ltd* [2001] 1 BCLC 275 Hazel Williamson QC, sitting as a deputy High Court judge, observed: '[o]ne cannot be a "sleeping director"; the function of "directing" on its own requires some consideration of the company's affairs to be exercised.'

2.9.3 Defence

Directors may be able to avoid liability if the conditions set out in s.214(3) are satisfied, namely, that if after the time when they first knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid going into insolvent liquidation, they took every step with a view to minimising the potential loss to the company's creditors.

A decision to carry on business may, in the circumstances, be an acceptable course of action to follow, but the court will take a dim view if this involves increasing the company's indebtedness. See *Re Brian D Pierson Ltd* and *Rubin* v *Gunner* [2004] EWHC 316 (Ch), where the directors had continued paying themselves remuneration

right up until the time when the company went into liquidation; compare *Butts Park Ventures (Coventry) Ltd* v *Bryant Homes Central Ltd* [2004] BCC 207.

On the other hand, realising the company's assets at a reasonable price in order to begin the process of discharging the company's debts may bring the directors within s.214(3).

Resigning from the board and seeking opportunities elsewhere will not be an acceptable course of action: *Re Purpoint Ltd* [1991] BCLC 491. The best course of action for the purposes of s.214(3) is probably to seek professional advice at the earliest opportunity possible, especially since liability for wrongful trading can lead to disqualification.

However, the absence of warnings from advisers will not relieve directors from their responsibility to review the company's position critically: *Re Brian D Pierson (Contractors) Ltd*. Relief under s.1157 is not available in wrongful trading proceedings, since the provision carries its own defence: *Re Produce Marketing Consortium Ltd*.

2.9.4 Liability

For the purposes of an order under s.214 whereby a director will be required to contribute to the company's assets, the court will assess the sum payable by reference to the amount by which the company's assets were reduced by the conduct in question.

Where the company has kept inadequate records, the court at its discretion may determine the period of wrongful trading: *Re Purpoint Ltd*. Interest will be payable from the date of the winding-up: *Re Produce Marketing Consortium Ltd (No. 2)* (1989).

It is now settled that a liquidator who proposes to bring proceedings for wrongful trading against directors has no automatic right to have the costs paid as a liquidation expense: *Re Oasis Merchandising Services Ltd* [1997] 1 BCLC 689; *Re Floor Fourteen Ltd, Lewis* v *IRC* [2001] 2 BCLC 392, CA. From a practical perspective, this clearly undermines the provision's potential as a deterrent against directorial abuses of the corporate form.

Activity 2.6

Read Sealy and Worthington, section on 'Directors disqualification orders', pp.264–72. What factors will the court take into account when deciding to make a disqualification order?

No feedback available.

2.10 Misfeasance proceedings

In a winding-up, typically it will be the liquidator, not the company, who will bring an action against the directors for any breaches of duty committed by them. Section 212 of the IA 1986 provides that, if in the course of the winding-up it appears that an **officer of the company**[3] has misapplied or retained or become accountable for any money or other property of the company, or has been guilty of any misfeasance or breach of any fiduciary duty or other duty in relation to the company, the court may, on the application of the Official Receiver, the liquidator or any creditor or contributory,

[3] A term that encompasses a director, secretary or manager or, *inter alia,* a promoter or liquidator of a company.

examine the conduct in question and compel the person to repay or restore or account for the money or property, or to contribute such sum to the company's assets by way of compensation as the court thinks just.

Section 212 is a procedural rule which enables property or compensation to be recovered in a winding-up. It covers breaches of fiduciary duty and the common law duties of care and skill.

2.11 Avoidance of floating charges

Section 245 of the Insolvency Act 1986 invalidates a floating charge created within 12 months (termed 'the relevant time') prior to the onset of insolvency, unless it was created in consideration for money paid, or goods or services supplied, at the same time as or subsequent to the creation of the charge. The 'relevant time' is extended to two years where the charge is created in favour of a connected person.

However, s.245(4) provides that a floating charge created in favour of a non-connected person within the 'relevant time' (i.e. 12 months) will not be invalidated if the company was able to pay its debts at the time the charge was created and did not become unable to do so as result of creating the charge.

It should be noted that this provision does not extend to charges created in favour of **connected persons**. The term 'connected person' is defined by s.249 as meaning:

- a director or shadow director of the company
- an associate of a director or shadow director of the company
- an associate of the company.

The object of s.245 is to prevent an unsecured creditor obtaining a floating charge to secure his existing loan at the expense of other unsecured creditors.

We look at floating charges, and avoidance of them, in more detail in Section B of this course.

Reminder of learning outcomes

By this stage you should be able to:

- define the term 'director'
- discuss the role of the board of directors and its relationship with the general meeting
- describe the various types of director
- explain the process for awarding remuneration
- describe how the general meeting can remove a director from the board
- explain how directors can be disqualified from holding office
- discuss:
  - the liability of directors for fraudulent and wrongful trading
  - the misfeasance procedure available to liquidators
  - the avoidance of floating charges.

Useful further reading

Axworthy, C.S. 'Corporate directors – who needs them?' [1988] *MLR* 273.

Bradley, C. 'Enterprise and entrepreneurship: the impact of director disqualification' [2001] *JCLS* 53.

Cooke, T.E. and A. Hicks 'Wrongful trading – predicting insolvency' [1993] *JBL* 338.

Finch, V. 'Disqualification of directors: a plea for competence' [1990] *MLR* 385.

Hicks, A. 'Disqualification of directors – 40 years on' [1988] *JBL* 27.

MacKenzie, J. 'Who controls the company? The interpretation of Table A' [1983] *Co Law* 99.

Milman, D. 'Personal liability and disqualification of company directors: something old, something new' [1992] *NILQ* 1.

Prentice, D. 'Corporate personality, limited liability and the protection of creditors' in Grantham, R. and C. Rickett (eds) *Corporate Personality in the Twentieth Century.* (Oxford: Hart Publishing, 1998).

Riley, C.A. [1994] 'Controlling corporate management: UK and US initiatives' [1994] *LS* 244.

Simmons, M. 'Wrongful trading' [2001] *Insolv Intell* 12.

Sullivan, G.R. 'The relationship between the Board of Directors and the general meeting in limited companies' [1977] *LQR* 569.

Feedback to activities

Activity 2.2 *Buckley LJ explained that a person who holds all of the shares in a company is not entitled to control its business. Directors are not the servants of shareholders. Therefore they are not bound to obey their directions given as individuals. Nor are directors the agents of shareholders bound to follow orders given by their principals.*

Where the articles of association entrust directors with control of the company, such control can only be removed by amending the articles in accordance with the statutory procedure laid down in s.21 CA 2006. This requires a special resolution.

Activity 2.3 *After reviewing the case law, Morritt LJ reversed the trial judge's finding that the respondents were not shadow directors within the statutory definition. He then laid down five propositions:*

> *The definition of a shadow director is not to be too narrowly construed given that the purpose of the CDDA 1986 is to protect the public.*
>
> *Although the purpose of the legislation is to identify those, other than professional advisers, with real influence in the corporate affairs of the company, it is not necessary that such influence should be exercised over the whole field of its corporate activities.*
>
> *Whether any particular communication (by words or conduct) from the alleged shadow director is to be classified as a direction or instruction must be objectively ascertained by the court in the light of all the evidence.*
>
> *Non-professional advice may come within the statutory description: the proviso excepting advice given in a professional capacity assumes that advice generally is or may be included. The concepts of 'direction' and 'instruction' do not exclude the concept of 'advice' because all three share*

> *the common feature of 'guidance'. The critical factor is whether the person has real influence over the company's affairs.*
>
> *Although it is sufficient to show that in the face of 'directions or instructions' from the alleged shadow director the properly appointed directors or some of them cast themselves in a subservient role or surrendered their respective discretions, this is not necessary in all cases. Such a requirement would be to put a gloss on the statutory requirement that the board are 'accustomed to act' 'in accordance with such directions or instructions'.*

Activity 2.4 *(a) Article 90 provided that the board would fix the annual remuneration of the directors subject to the proviso that, without the consent of the general meeting, such remuneration would not exceed £100,000. Article 91 went on to confer on the board the power to grant special remuneration, in addition to ordinary remuneration, to any director who served on any committee or gave special attention to the business of the company.*

(b) Mr Ward was a member of a committee set up by Guinness's board of directors to guide the company through a takeover bid it had made for another company, Distillers. He had been paid a fee of £5.2m for his services, which had been agreed by the committee.

Lord Templeman, construing the language of the articles of association, found that they did not confer on the committee the power to pay remuneration to one of its own members. He said:

> *Article 91 draws a contrast between the board and a committee of the board. The board is expressly authorised to grant special remuneration to any director who serves on any committee. It cannot have been intended that any committee should be able to grant special remuneration to any director, whether a member of the committee or not.*

Activity 2.5 *H was a non-executive director of the company and signatory to the company's cheque account. The company's accounts, which H looked to when assessing the company's financial position, were prepared by professional accountants.*

The company went into liquidation and the Secretary of State applied for an order under s.6 on the basis that H had caused the company to operate a policy of not paying Crown moneys and had failed to keep himself properly informed of the company's financial position.

The grounds of the application were that beginning in June 1995 the company had ceased making National Insurance and PAYE payments. Also, the fact that the company was in arrears of VAT was apparent in the management accounts for February and April 1995.

It was alleged by the Secretary of State that H either knew the payments were not being made or ought to have realised they were not being paid because he had not been requested to sign any cheques in respect of such payments.

Further, H had signed a number of cheques to pay another director's son's school fees, thereby allowing that director to breach his fiduciary duties by misusing company funds for his own personal use. H had questioned the propriety of these payments but had been assured by the accountants that they would be treated as part of that director's remuneration and would be properly reflected in the accounts as such. Notwithstanding the accountant's advice, H had refused to sign additional cheques for school fees and he had reported these payments to the board.

The Secretary of State's allegation that H had failed to keep himself properly informed of the company's financial health was rejected. Merely being a signatory to the company's cheques was not sufficient to make the director personally

responsible for any policy of not paying Crown monies. H was entitled to rely on the assurances of the accountant that the finances of the company were being properly managed.

The court held, taking H's lack of experience in operating corporate finances together with his non-executive status, that he was entitled to rely on the accountants to prepare the accounts and their assurances that the finances were being properly run.

A cheque signatory is not a finance director and is therefore not expected to possess such expertise. With respect to the cheques for school fees, H had acted on the advice of the accountant and he had also reported the payments to the board.