exercise of their powers in a particular manner, even though the contract taken as a whole is manifestly for the benefit of the company. Such a rule could well prevent companies from entering into contracts which were commercially beneficial to them.

The true rule was stated by the High Court of Australia in *Thorby v Goldberg* (1964) 112 CLR 597. … [Kitto J dealt with the argument that any fetter on a director's exercise of discretion is void for illegality in the following terms, at pp 605–606:]

> 'The argument for illegality postulates that since the discretionary powers of directors are fiduciary, in the sense that every exercise of them is required to be in good faith for the benefit of the company as a whole, an agreement is contrary to the policy of the law and void if thereby the directors of a company purport to fetter their discretions in advance … There may be more answers than one to the argument, but I content myself with one. There are many kinds of transactions in which the proper time for the exercise of the directors' discretion is the time of the negotiation of a contract, and not the time at which the contract is to be performed. A sale of land is a familiar example. Where all the members of a company desire to enter as a group into a transaction such as that in the present case, the transaction being one which requires action by the board of directors for its effectuation, it seems to me that the proper time for the directors to decide whether their proposed action will be in the interests of the company as a whole is the time when the transaction is being entered into, and not the time when their action under it is required. If at the former time they are bona fide of opinion that it is in the interests of the company that the transaction should be entered into and carried into effect, I see no reason in law why they should not bind themselves to do whatever under the transaction is to be done by the board. In my opinion the defendants' contention that the agreement is void for illegality should be rejected.'

… In the present case the undertakings given by the directors were part of the contractual arrangements made on 28 January 1990 which conferred substantial benefits on the company. In those circumstances it cannot be said that the directors improperly fettered the future exercise of their discretion, nor is there any scope for the implication of any such term as is suggested by the plaintiffs.

(p. 352) … We were referred to two English cases at first instance where in each the court held that an undertaking by directors to use their best endeavours to ensure that their shareholders should approve a particular deal by the company (in one case a purchase, in the other a sale) was unenforceable. The cases are*Rackham v Peek Foods Ltd* [1990] BCLC 895 and *John Crowther Group plc v Carpets International plc* [1990] BCLC 460. In neither case was *Thorby v Goldberg*cited. It may be that these decisions can be justified on their particular facts, but they should not be read as laying down a general proposition that directors can never bind themselves as to the future exercise of their fiduciary powers. If they could be so read then they would be wrong.

➢ Note

The position of nominee directors is particularly difficult in this context. The nominator clearly expects its appointed director to look after its interests, and yet the director's duties are expressly owed to the whole *company*, not to the specific nominator. In *Scottish Co-operative Wholesale Society Ltd v Meyer* **[13.24]**, the difficult and special position of a 'nominee director' is discussed in detail.[36] That case confirms the view that a nominated director must *not* put the principal's (ie the nominator's) interest above those of the company, and indicates that members of the company may be able to invoke CA 2006 s 994 if this happens.

But in Australia and New Zealand there are cases which suggest that this may be too narrow a view. The whole object of having a director appointed to represent a special interest may have been the furtherance of

some ulterior corporate good, and in such circumstances it may be justifiable to put that interest first. Thus in *Levin v Clark* [1962] NSWR 686, directors nominated to the board to represent the interests of a secured creditor were held not to be in breach of any fiduciary duties to the company when they acted to enforce the security: the company, by accepting the credit on the terms in question, had waived its right to have the unqualified loyalty of those directors.

Again, in *Berlei Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150 at 165–166, Mahon J (without deciding the point) adverted to the possibility that the normal fiduciary duties might be modified where a company had been set up as a joint venture between two or more participants on the understanding that each of them would be separately represented on its board by nominee directors.

But in the UK this approach remains unacceptable. See, for example, a recent case where the joint venture nature of a company was held not to abrogate the duties each director owed to it: *Gwembe Valley Development Co Ltd v Koshy (No 3)* **[7.37]**.

➢ Questions

1. If a company's constitution provides for the election of employee representatives to the board, is there a case for adopting the reasoning in *Levin v Clark* ?

2. Directors sometimes confer upon a 'management company' all their powers of management, pursuant to a 'management agreement' (eg *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22, CA). Does such an arrangement infringe the principle of 'independent judgement'? To be effective, must such an arrangement have the shareholders' approval? Would such approval make any difference (eg if new shareholders joined the company)?

3. If this sort of 'management company' arrangement is put in place, what, if any, duties would the directors continue to owe to the company? Consider the following excerpt from the **(p. 353)** recent judgment of *Weavering Macro Fixed Income Fund Ltd (In Liquidation) v Peterson* FSD 113 of 2010 (Grand Court of the Cayman Islands):

> 10 Directors have a duty to exercise an independent judgment … In the context of open ended investment funds, investment management, administration and accounting funds are invariably delegated to contracted professional service providers, but the exercise by the directors of their power of delegation in this way does not absolve them from the duty to supervise the delegated functions. This means that they must do more than react to whatever problems may be brought to their attention by the other professional service providers. They must apply their minds and exercise an independent judgment, in the ordinary course of business, in respect of all the matters falling within the scope of their supervisory responsibilities … They are not entitled to assume the posture of automatons, as these Directors did, by signing whatever documents are put in front of them by the investment manager without making enquiry or applying their minds to the matter in issue, on the assumption that the other service providers have all performed their respective roles (actual or perceived) and therefore do not need to be supervised in any way whatsoever.

Duty to exercise reasonable care, skill and diligence: CA 2006 s 174

Historically, it was widely asserted in the UK that the common law did not require directors to exhibit a greater degree of skill than may reasonably be expected from a person with their knowledge and experience (a subjective test).[37] This test allowed inherently poor directors to escape liability for company losses, even when most reasonable people would have regarded their decisions as negligent. In the absence of legislative intervention, the courts had to act to raise standards. Their approach was to suggest that the common law standard was not so low as often suggested, and indeed that it mirrored the tests laid down in IA 1986 s 214, which includes both an objective and a subjective assessment of a director's conduct (see Hoffmann LJ leading this move in, eg, *Re D'Jan*

of London Ltd **[7.20]**). The current law, in CA 2006 s 174, is modelled on this IA 1986 section. It provides that a director owes a duty to the company to exercise the same standard of care, skill and diligence that would be exercised by a reasonably diligent person with:

(i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as the director in relation to that company (*an objective test*); and
(ii) the general knowledge, skill and experience that the director actually has (*a subjective test*).

The CA 2006 provision thus codified the approach increasingly found in the more recent case law, and marked an end to the subjective test identified from *Re City Equitable Fire Insurance Co Ltd* **[7.19]**. The statutory approach adopts as the minimum standard that objectively expected of a person in the directors' position; that standard may then be raised by the subjective element of the test if the particular director has any special knowledge, skill and experience.

The Act does not indicate whether this duty is to be modelled (as per s 170(3) and (4)) on the common law or the equitable duty of care (if there is a difference between the two[38]), but **(p. 354)** it is expressly not fiduciary (see CA 2006 s 178). The duty is owed to the company (s 170), not to the members. Members, for example, have no right to expect a reasonable standard of general management from the company's managing director: management quality is one of the normal risks of investing (*Re Elgindata Ltd* [1991] BCLC 959).

As well as liability to the company, breach of this duty may show unfitness to be concerned in the management of the company and so lead to disqualification under the Company Directors Disqualification Act 1986 s 6 (see 'Directors' disqualification', pp 294ff).

The old subjective test

The extent of the duty of care and skill and assessment of its breach.

[7.19] Re City Equitable Fire Insurance Co Ltd [1925] Ch 407 (Chancery Division)

The company had lost £1,200,000 (a fantastic amount at the time), owing partly to the failure of certain investments but mainly to the frauds of the chairman of directors, Bevan, 'a daring and unprincipled scoundrel'. In this action the liquidator sought to make the other directors liable for the losses on the ground of negligence.[39] The action failed because of a provision in the articles which exempted the directors from liability apart from losses caused by 'their own wilful neglect or default'.[40] The decision of Romer J remains important as a summary of the old 'subjective-only' duties of care and skill. It also indicates some of the potential problems in applying an objective test, and defining the outlook of a 'reasonable director'.

> ROMER J: It has sometimes been said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship to the company, the statement is true enough. But if the statement is meant to be an indication by way of analogy of what those duties are, it appears to me to be wholly misleading. I can see but little resemblance between the duties of a director and the duties of a trustee of a will or of a marriage settlement. It is indeed impossible to describe the duty of directors in general terms, whether by way of analogy or otherwise. The position of a director of a company carrying on a small retail business is very different from that of a director of a railway company. The duties of a bank director may differ widely from those of an insurance director, and the duties of a director of one insurance company may differ from those of a director of another. In one company, for instance, matters may normally be attended to by the manager or other members of the staff that in another company are attended to by the directors themselves. The larger the business carried on by the company the more numerous, and the more important, the matters that must of necessity be left to the managers, the accountants and the rest of the staff. The manner in which the work of the company is to be distributed between the board of directors and the staff is in truth a business matter to be decided on business lines …
>
> In order, therefore, to ascertain the duties that a person appointed to the board of an established company undertakes to perform, it is necessary to consider not only the nature of the company's business, but also the manner in which the work of the company is in fact distributed between the directors and the other

officials of the company, provided always that this distribution is a reasonable one in the circumstances, and is not inconsistent with any express provisions of the articles of association. In discharging the duties of his position thus ascertained a director must, of course, **(p. 355)** act honestly; but he must also exercise some degree of both skill and diligence. To the question of what is the particular degree of skill and diligence required of him, the authorities do not, I think, give any very clear answer. It has been laid down that so long as a director acts honestly he cannot be made responsible in damages unless guilty of gross or culpable negligence in a business sense. But as pointed out by Neville J in *Re Brazilian Rubber Plantations and Estates Ltd*,[41] one cannot say whether a man has been guilty of negligence, gross or otherwise, unless one can determine what is the extent of the duty which he is alleged to have neglected … The care that he is bound to take has been described by Neville J … as 'reasonable care' to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf …

There are, in addition, one or two other general propositions that seem to be warranted by the reported cases: (1) 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. [But contrast CA 2006 s 174.] A director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or of a physician … It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment. (2) A director is not bound to give continuous attention to the affairs of his company … [Romer J continued in words seemingly applicable only to non-executive directors, and even then requiring less of them than would now be expected.] (3) 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

… [again, continuing in words that reflect perhaps more lenient views of the oversight that would now be seen as necessary.]

➢ Questions

1. *Does* Romer J apply a subjective test in this case, or an objective one? The orthodox view is that it is the former, but see A Hicks, 'Directors' Liability for Management Errors' (1994) 110 LQR 390 and A Walters, 'Directors' Duties: The Impact of CDDA 1986' (2000) 21 *Company Lawyer* 110.

2. Would a subjective duty alone work satisfactorily? See C Riley, 'The Case for an Onerous but Subjective Duty of Care' (1999) 63 MLR 697.

The subjective/objective test

A simple common law illustration of the issues: standards of care and skill, breach, damages and potential relief from liability granted either by the members (ratification) or by the court (CA 2006 s 1157).

[7.20] Re D'Jan of London Ltd [1994] 1 BCLC 561 (Chancery Division)

The facts appear from the judgment.

HOFFMANN LJ (sitting as a judge of the Chancery Division): This is a summons under s 212 of the Insolvency Act 1986 by a liquidator against a former officer of the company. … The liquidator alleges [and Hoffmann LJ subsequently agreed] that the respondent Mr D'Jan was negligent in completing and signing a proposal form [which contained material errors] for fire insurance with Guardian Royal Exchange Assurance plc. As a result, the insurers repudiated liability for a fire at the company's premises in Cornwall which had destroyed stock said to be worth some £174,000. The company **(p. 356)** is insolvent, having a deficiency

as regards unsecured creditors of about £500,000. The liquidator therefore brings these proceedings for the benefit of the unsecured creditors …

[D'Jan trusted his insurance broker to complete the form correctly.] Nevertheless I think that in failing even to read the form, Mr D'Jan was negligent. Mr Russen [counsel for D'Jan] said that the standard of care which directors owe to their companies is not very exacting and signing forms without reading them is something a busy director might reasonably do. I accept that in real life, this often happens. But that does not mean that it is not negligent. People often take risks in circumstances in which it was not necessary or reasonable to do so. If the risk materialises, they may have to pay a penalty. I do not say that a director must always read the whole of every document which he signs. If he signs an agreement running to 60 pages of turgid legal prose on the assurance of his solicitor that it accurately reflects the board's instructions, he may well be excused from reading it all himself. But this was an extremely simple document asking a few questions which Mr D'Jan was the best person to answer. By signing the form, he accepted that he was the person who should take responsibility for its contents. In my view, the duty of care owed by a director at common law is accurately stated in s 214(4) of the Insolvency Act 1986. [He then set out the subjective and objective limbs, now largely replicated in CA 2006 s 174, which is itself noted earlier] …

Both on the objective test and, having seen Mr D'Jan, on the subjective test, I think that he did not show reasonable diligence when he signed the form. He was therefore in breach of his duty to the company.

Mr Russen said that nevertheless the company could not complain of the breach of duty because it is a principle of company law that an act authorised by all the shareholders is in law the act of the company: see *Multinational Gas and Petrochemical Co v Multinational Gas and Petrochemical Services Ltd* **[7.39]**. Mr D'Jan held 99 of the 100 issued ordinary shares and Mrs D'Jan held the other. Mr D'Jan must be taken to have authorised the wrong answer in the proposal because he signed it himself. As for Mrs D'Jan, she had never been known to object to anything which her husband did in the management of the company. If she had known about the way he signed the form and it was too late to put the matter right the chances are that she would also have approved. She could hardly have brought a derivative action to sue her husband for negligence because he could have procured the passing of a resolution absolving himself from liability.

The difficulty is that unlike the *Multinational* case, in which the action alleged to be negligent was specifically mandated by the shareholders, neither Mr nor Mrs D'Jan gave any thought to the way in which the proposal had been filled in. Mr D'Jan did not realise that he had given a wrong answer until the insurance company repudiated. By that time the company was in liquidation. In my judgment the *Multinational* principle requires that the shareholders should have, whether formally or informally, mandated or ratified the act in question. It is not enough that they probably would have ratified if they had known or thought about it before the liquidation removed their power to do so.[42]

It follows that Mr D'Jan is in principle liable to compensate the company for his breach of duty. But s 727 of the Companies Act 1985 [equivalent to CA 2006 s 1157] gives the court a discretionary power to relieve a director wholly or in part from liability for breaches of duty, including negligence, if the court considers that he acted honestly and reasonably and ought fairly to be excused. It may seem odd that a person found to have been guilty of negligence, which involves failing to take reasonable care, can ever satisfy a court that he acted reasonably. Nevertheless, the section clearly contemplates that he may do so and it follows that conduct may be reasonable for the purposes of s 727 despite amounting to lack of reasonable care at common law.

In my judgment, although Mr D'Jan's 99% holding of shares is not sufficient to sustain a *Multinational* defence, it is relevant to the exercise of the discretion under s 727. It may be reasonable **(p. 357)** to take a risk in relation to your own money which would be unreasonable in relation to someone else's. And although for the purposes of the law of negligence the company is a separate entity [to] which Mr D'Jan owes a duty of care which cannot vary according to the number of shares he owns, I think that the economic realities of the case can be taken into account in exercising the discretion under s 727. His breach of duty in failing to read the form before signing was not gross. It was the kind of thing which could happen to any busy man, although, as I have said, this is not enough to excuse it. But I think it is also

relevant that in 1986, with the company solvent and indeed prosperous, the only persons whose interests he was foreseeably putting at risk by not reading the form were himself and his wife. Mr D'Jan certainly acted honestly. For the purposes of s 727 I think he acted reasonably and I think he ought fairly to be excused for some, though not all, of the liability which he would otherwise have incurred.

[His Lordship accordingly gave judgment against D'Jan for an amount limited to the sum which he remained entitled to claim as an unsecured creditor of the company.]

➢ Questions

1. Why was this case not brought under IA 1986 s 214? (Look closely at the conditions that must be met for the liquidator to bring such a claim.)

2. *Could* the company have authorised the breach before the event (however unlikely that scenario)? *Could* the shareholders have ratified the breach afterwards? See*Kinsela v Russell Kinsela Pty Ltd* **[7.08]**, *Daniels v Daniels* [1978] Ch 406 and *Pavlides v Jensen* [1956] Ch 565. Also see CA 2006 ss 180 and 239 for the current provisions.

3. Was the application of CA 1985 s 727 (CA 2006 s 1157) sensible in the circumstances?

'Reasonable' directors: keeping informed and delegating responsibilities

How do the courts decide on the qualities of a 'reasonable director'? The problem here is that companies range from the very large to the very small, and that even within the same company the roles of different directors may vary considerably: some may be highly qualified and bring wide commercial experience to their post, and work for the company full time for a substantial salary; while others may serve as non-executive directors and be required only to attend monthly or quarterly board meetings. Yet others may be appointed to bring expertise of a technical nature—as engineers or scientists, for instance—without any background in business. And, of course, the law allows those who form a small family company or a one person company to appoint themselves directors regardless of their abilities and circumstances. The subjective standards brought to the role will certainly be different, but so too are the objective standards of a 'reasonable director' in the circumstances. So it is not altogether surprising that the search for an objective standard has proven, and likely will continue to prove, elusive. The following details provide further elaboration.

➢ Notes

1. Re-read *Re Barings plc (No 5)* **[6.12]** and *Re Landhurst Leasing plc* **[6.13]** (both disqualification proceedings).

2. Similar developments in directors' duties of care have taken place in Australia. In *Daniels v Anderson* (1995) 16 ACSR 607, NSWCA (commonly known as the *AWA*case), the court signalled what was then a new approach, and made a number of emphatic statements: that it is no longer appropriate to judge directors' conduct by the subjective tests applied in the older cases; that (by analogy with cases under the Australian insolvent trading legislation) ignorance should not be regarded as a defence to proceedings brought against directors; and **(p. 358)** that more is required of directors than supine indifference.[43] It was alleged (by the auditors) that the chief executive and several non-executive directors of AWA were liable in negligence for their failure to prevent the massive foreign exchange trading losses caused by one of their employees. In the event, only the chief executive was held to have acted negligently. The same duty of care was owed by both types of director but, in the circumstances, the non-executive directors were entitled to assume (contrary to the fact) that they had been given a comprehensive account of the company's problems, especially given their publicly expressed concerns and frequent requests for detailed information and considered action. AWA's chief executive, on the other hand, was

deemed to have acted negligently: knowing nothing himself about foreign exchange trading, he had delegated the function to someone relatively inexperienced and had allowed this person to operate without ensuring that appropriate management controls were in place; the obvious problems this was likely to cause were compounded because this was a novel venture for AWA and so its managers lacked experience in the area; moreover, when the problems eventually came to light, the chief executive failed to obtain all the information necessary to take remedial action, failed to delegate the rescue operation to someone sufficiently experienced and failed to give the entire matter the degree of personal attention, energy and detailed supervision that its obvious seriousness demanded in order to achieve a successful resolution. One practical consequence of application of an objective test is that directors are increasingly focused on ensuring that management systems, processes and procedures are adequately developed, documented and applied—and that their application is assured by systematic measurement, reporting and audit processes.

3. Directors cannot escape liability for negligence simply by avoiding undertaking any activities in their director's role. In *Dorchester Finance Co Ltd v Stebbing* (1977), reported [1989] BCLC 498, a money-lending company had three directors, Stebbing, Parsons and Hamilton. Stebbing worked full time for the company; the other two paid very little attention to it and visited its premises only rarely. They signed blank cheques at Stebbing's request, and he used these to make loans that were illegal and accordingly irrecoverable. No board meetings were held. All three directors were held liable to make good the company's losses. Foster J laid some stress on the fact that the two non-executive directors were experienced in accountancy; but it appears that this was not crucial to his decision. He said:

> For a chartered accountant and an experienced accountant to put forward the proposition that a non-executive director has no duties to perform I find quite alarming. It would be an argument which, if put forward by a director with no accountancy experience, would involve total disregard of many sections of the Companies Act 1948 … The signing of blank cheques by Hamilton and Parsons was in my judgment negligent, as it allowed Stebbing to do as he pleased. Apart from that, they not only failed to exhibit the necessary skill and care in the performance of their duties as directors, but also failed to perform any duty at all as directors of Dorchester. In the Companies Act 1948 the duties of a director whether executive or not are the same.

4. For the suggestion that directors have a duty to take positive action and keep themselves informed, see *Re Barings plc (No 5)* **[6.12]** (a disqualification case), and its references to *Re Westmid Packing Services Ltd* [1998] 2 All ER 124. More recently, see *Lexi Holdings plc (In Administration) v Luqman* [2009] EWCA Civ 117, [2009] BCC 716, CA, where the court held two sisters liable as directors for the consequences of failing to exercise active oversight of the company's affairs which would have ended their brother's dishonest dealings. He, as managing director, had stolen almost £60 million that banks had lent the company for use **(p. 359)** in its business. Because of their negligence, the sisters were held liable (jointly with their brother) for the stolen money. Similarly, see *Weavering Capital (UK) Ltd (In Liquidation) v Peterson* [2012] EWHC 1480 (Ch) affd [2013] EWCA Civ 71,[44] where the court held both the husband (the only active director) and his wife (also a director) liable for losses resulting from a fraudulent scheme involving swap agreements and misrepresentations to investors. The wife's argument that she had only a 'confined area of responsibility' was rejected. The court held that her conduct fell short of what was expected of a reasonable director of a hedge fund management company in her position, with her experience, actual knowledge and intelligence, and she simply failed to acquire a sufficient knowledge of the business to discharge such duties [173]–[174]. *Should* it be possible to be a director, but one who does not participate in the company's governance?[45]

5. For the extent to which directors can, without being negligent, rely on other officials and employees, see: *Re Barings plc (No 5)* **[6.12]** (a disqualification case).

6. In deciding whether a director's acts fall short in discharging his duty to exercise due care, skill and diligence, courts may seek evidence of best or normal practice in the business in which the company operates, especially if the breach of duty concerns the precise way in which the business is run: *Abbey Forwarding Ltd (In Liquidation) v Hone* [2010] EWHC 2029 (Ch) (finding then that the directors were not liable); *ASIC v Rich* [2003] NSWSC 85

(where the judge referred to the Higgs Review, noted at ‘Separation of the roles of chairman and managing director’, p 264).

7. By way of exception, note CA 2006 s 463, which exempts directors from liability for negligent misstatements in or omissions from the directors’ report and remuneration report, imposing liability only on the basis of knowledge or recklessness.

[7.21] Australian Securities and Investments Commission v Healey [2011] FCA 717 (Federal Court of Australia)

The case concerned the collapse of the Centro group, and the allegation of negligence related to a failure by the directors to disclose in annual reports sums amounting to almost $4 billion in short-term liabilities.

MIDDLETON J:

8. … The directors are intelligent, experienced and conscientious people. There has been no suggestion that each director did not honestly carry out his responsibilities as a director. However, … the directors failed to take all reasonable steps required of them, and acted in the performance of their duties as directors without exercising the degree of care and diligence the law requires of them …

10. This proceeding is not about a mere technical oversight. The information not disclosed was a matter of significance to the assessment of the risks facing [two companies in the group]. Giving that information to shareholders and, for a listed company, the market, is one of the fundamental purposes of the requirements of the Act that financial statements and reports must be prepared and published …

11. The significant matters not disclosed were well known to the directors, or if not well known to them, were matters that should have been well known to them.

(p. 360) 12. In the light of the significance of the matters that they knew, they could not have, nor should they have, certified the truth and fairness of the financial statements, and published the annual reports in the absence of the disclosure of those significant matters. If they had understood and applied their minds to the financial statements and recognised the importance of their task, each director would have questioned each of the matters not disclosed. Each director, in reviewing financial statements, needed to enquire further into the matters revealed by those statements.

13. The central question in the proceeding has been whether directors of substantial publicly listed entities are required to apply their own minds to, and carry out a careful review of, the proposed financial statements and the proposed directors’ report, to determine that the information they contain is consistent with the director’s knowledge of the company’s affairs, and that they do not omit material matters known to them or material matters that should be known to them.

14. A director is an essential component of corporate governance. Each director is placed at the apex of the structure of direction and management of a company. The higher the office that is held by a person, the greater the responsibility that falls upon him or her. The role of a director is significant as their actions may have a profound effect on the community, and not just shareholders, employees and creditors.

15. This proceeding involves taking responsibility for documents effectively signed-off by, approved, or adopted by the directors. What is required is that such documents, before they are adopted by the directors, be read, understood and focused upon by each director with the knowledge each director has or should have by virtue of his or her position as a director. I do not consider this requirement overburdens a director, or as argued before me, would cause the boardrooms of Australia to empty overnight. Directors are generally well remunerated and hold positions of prestige, and the office of director will continue to attract competent, diligence and intelligent people.

16. The case law indicates that there is a core, irreducible requirement of directors to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor.

There is a responsibility to read, understand and focus upon the contents of those reports which the law imposes a responsibility upon each director to approve or adopt.

17. All directors must carefully read and understand financial statements before they form the opinions which are to be expressed in the declaration required by s 295(4). Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company's financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director. These include the following: a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged; a director should keep informed about the activities of the corporation; whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies; a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements; a director, whilst not an auditor, should still have a questioning mind.

18. A board should be established which enjoys the varied wisdom, experience and expertise of persons drawn from different commercial backgrounds. Even so, a director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience or expertise. A director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise.

…

20. Nothing I decide in this case should indicate that directors are required to have infinite knowledge or ability. Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her. Such a **(p. 361)** responsibility arises in this proceeding in adopting and approving the financial statements. Because of their nature and importance, the directors must understand and focus upon the content of financial statements, and if necessary, make further enquiries if matters revealed in these financial statements call for such enquiries.

21. No less is required by the objective duty of skill, competence and diligence in the understanding of the financial statements that are to be disclosed to the public as adopted and approved by the directors.

Proving causative loss in negligence cases

The problems of proof of breach are noted previously. The cases against directors are also hampered by problems in proving a causative loss. Typically, the facts are similar to those of *City Equitable* **[7.19]**: a rogue, reasonably trusted by all, at the centre of the action, his frauds deceiving even the auditors; and a board of directors, many of them non-executive, meeting only at intervals and justifiably delegating many functions to committees or subordinate officers. On such facts, it is sometimes virtually impossible to hold that the acts (or, more likely, the omissions) of those directors who were not directly involved in the wrongdoing were the *cause* of the company's loss.

For example, in *Cohen v Selby* [2001] 1 BCLC 176, CA, a father-and-son jewellery company was run by the father, who was a *de facto* director only, not formally appointed. His son, a student, was a director, but took no part in the company's affairs. Uninsured jewellery worth £395,000 was stolen while the father travelled with it. The father was held fully liable for the loss. The son escaped personal liability for negligence because it was considered not unreasonable for him to have trusted his father, an experienced businessman, and also because there was insufficient causal link between his conduct and the company's loss (although he was nevertheless disqualified (in separate proceedings) for three years). Similarly, see *Re Denham & Co* (1883) 25 Ch D 752, where the director had asked questions about potential fraud, but had been given so much information that he was none the wiser for his investigations. And for a quite different ground for preventing recovery by the company from its directors, re-

read *Safeway Stores Ltd v Twigger* **[3.33]**.

These difficulties perhaps explain why the law on directors' negligence is now being driven not by these breach of duty cases, but primarily by the cases on director disqualification (with some input also from cases under CA 2006 s 994 and its predecessors (unfairly prejudicial conduct) and IA 1986 s 214 (wrongful trading)).

Duty to avoid conflicts of interest: CA 2006 s 175

This section is the first of three general sections, appearing in succession, that address the true fiduciary duties of loyalty owed by directors to their companies (also see CA 2006 Pt 10, Ch 4 on specific transactions between directors and the company and Pt 14 on political donations and expenditure).[46] The section imposes a duty to avoid situations where there is a conflict between the director's interests and those of the company, and in particular not to exploit any property, information or opportunity (presumably only where such property, information or opportunity 'belongs' to the company—see the following discussion).

(p. 362) This section replaces the equitable *no conflict rule* (of which the *no profit rule* forms a key part), although *only* as it applies to conflicts of interest arising from the director's dealings with third parties (s 175(3)). CA 2006 separates these third party dealings from situations involving bribes and secret commissions ('third party benefits'—CA 2006 s 176), and from the conflicts that inevitably exist in transactions between directors and their own companies (CA 2006 ss 177 and 182).

The remedies available for breach of this duty have not been codified, but are the same as if the corresponding equitable principle applied (CA 2006 s 178, see 'General issues', pp 413ff).

Before considering the wording of this duty as codified under s 175, it is useful to begin with an understanding of the orthodox position prior to the CA 2006 codification, and, in particular, to gain some appreciation of the difference (if any, often) between the *no conflict rule* and the *no profit rule*.

Illustrations of the rules

This area of directors' duties has probably generated more case law than any of the others. What follows is an illustrative selection. The cases that pre-date CA 2006 not only apply the equitable concepts of the no conflict and no profit rules; they also apply the equitable rules on authorisation and ratification. These have been profoundly affected by CA 2006, so care is needed in using the cases even as persuasive authorities. On the other hand, s 178 preserves the common law and equitable rules as to remedies, so here these cases remain applicable.

Orthodox statements of the no conflict rule

Two early judicial statements of the no conflict rule are invariably cited, even in modern cases:

(i) Lord Cranworth LC, in *Aberdeen Rly Co v Blaikie Bros* (there is a longer extract at **[7.34]**):

> … it is a rule of universal application that no one having such duties [fiduciary duties as an agent] 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.

(ii) Lord Herschell in *Bray v Ford*:[47]

> It is an inflexible rule of the court of equity that a person in a fiduciary position, such as the plaintiff's, 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 does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a

fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule. But I am satisfied that it might be departed from in many cases, without any breach of morality, without any wrong being inflicted, and without any consciousness of wrong-doing. Indeed, it is obvious that it might sometimes be to the advantage of the beneficiaries that their trustee should act for them professionally rather than a stranger, even though the trustee were paid for his services.

(p. 363) Application of the rules

Taking corporate opportunities for personal benefit—constructive trust remedies.

[7.22] Cook v Deeks [1916] 1 AC 554 (Privy Council)

Three of the four directors of the Toronto Construction Company (Deeks, Deeks and Hinds—the three defendants) resolved to break their business relations with the fourth director, Cook (the plaintiff). The company had built up considerable goodwill with the Canadian Pacific Railway Company as a result of the satisfactory performance of a series of construction contracts, each of which had been negotiated with the railway company's representative by one of the defendants. The last of these contracts, the Shore Line contract, was negotiated in the same way, but when the arrangements were completed, the defendants took the contract in their own names and not that of the company. Cook claimed that the company was entitled to the benefit of the contract, and that a shareholders' resolution (which the defendants had carried by their own votes) purporting to confirm (ie ratify) that the company claimed no interest in the contract was ineffective. The Privy Council upheld both contentions, reversing the decisions of the courts in Ontario in favour of the defendants.

The opinion of their Lordships was delivered by LORD BUCKMASTER, who stated the facts, and continued: Two questions of law arise out of this long history of fact. The first is whether, apart altogether from the subsequent resolutions, the company would have been at liberty to claim from the three defendants the benefit of the contract which they had obtained from the Canadian Pacific Railway Company; and the second, which only arises if the first be answered in the affirmative, whether in such event the majority of the shareholders of the company constituted by the three defendants could ratify and approve of what was done and thereby release all claim against the directors.

It is the latter question to which the Appellate Division of the Supreme Court of Ontario have given most consideration, but the former needs to be carefully examined in order to ascertain the circumstances upon which the latter question depends.

It cannot be properly answered by considering the abstract relationship of directors and companies; the real matter for determination is what, in the special circumstances of this case, was the relationship that existed between Messrs Deeks and Hinds and the company that they controlled. Now it appears plain that the entire management of the company, so far as obtaining and executing contracts in the east was concerned, was in their hands, and indeed, it was in part this fact which was one of the causes of their disagreement with the plaintiff. The way they used this position is perfectly plain. They accelerated the work on the expiring contract of the company in order to stand well with the Canadian Pacific Railway when the next contract should be offered, and although Mr McLean [Manager of the Toronto Construction Co] was told that the acceleration was to enable the company to get the new contract, yet they never allowed the company to have any chances whatever of acquiring the benefit, and avoided letting their co-director have any knowledge of the matter. Their Lordships think that the statement of the trial judge upon this point is well founded when he said that 'it is hard to resist the inference that Mr Hinds was careful to avoid anything which would waken Mr Cook from his fancied security', and again, that 'the sole and only object on the part of the defendants was to get rid of a business associate whom they deemed, and I think rightly deemed, unsatisfactory from a business standpoint'. In other words, they intentionally concealed all circumstances relating to their negotiations until a point had been reached when the whole arrangement had been concluded in their own favour and there was no longer any real chance that there could be any interference with their plans. This means that while entrusted with the conduct of the affairs of the company they