Bills Committee on Companies Bill

Follow-up actions for the meeting held on 2 December 2011 in relation to Part 10 of the Companies Bill

Purpose

This paper sets out the Administration's response to the issues raised by Members at the Bills Committee meeting on 2 December 2011 relating to Part 10 (Directors and Company Secretaries) of the Companies Bill ("CB").

Administration's response

Clause 449 (Direction requiring company to appoint director)

2. Taking into account the concern about the consistency in the drafting of sub-clauses (3) and (4), we would consider amending subclause (4) by replacing "contravenes" in the English text with "fails to comply with" and "違反" in the Chinese text with "沒有遵從".

Clauses 449 (Direction requiring company to appoint director) and 467 (Direction requiring company to appoint company secretary)

3. There was a suggestion that we should follow the approach in the United Kingdom ("UK") by setting out in the CB the period for complying with Registrar of Companies ("Registrar")'s directions given under clauses 449 and 467. Having considered sections 156(2) and 272(2) of the UK Companies Act 2006 ("UKCA 2006"), we would introduce Committee Stage Amendments ("CSAs") to set out the period for complying with the Registrar's instruction (not less than one month or more than three months after the date on which the Registrar's direction is given).

Clause 452 (Validity of acts of director)

4. There were queries on the effect of clause 452, how it would interact with clauses 112 and 114 and relevant provisions in comparable jurisdictions. The required supplementary information is set out in the note at **Annex A**.

Clauses 453 (Resolution to remove director) and 454 (Director's right to protest against removal)

5. Members were concerned that there were no provisions on the consequence of non-compliance with the requirements under clauses 453 and 454. In particular, members suggested that there should be provisions on the consequences of non-compliance with the requirements for the company to send the director's representations to members or to read out the representations at the meeting under clause 454(3) and (4).

6. Clauses 453 and 454 are provisions on the procedural requirements for the passing of an ordinary resolution at a general meeting to remove a director. For most of the requirements, the common law rules and equitable principles and also the relevant provisions under Part 12 of the CB as regards the validity of a resolution would apply in case of non-compliance. For example, on the issue of insufficient notice, a transaction of business which has not been sufficiently notified or which is substantially different from that notified is invalid. If the notice is misleading, the court will restrain the holding of the meeting, or restrain the directors from acting on resolutions passed on insufficient notice, until confirmed by the company at a meeting properly notified.[1] If special notice of a resolution as required by clause 453(4) is not given pursuant to clause 568(1) (under Part 12), the resolution is not effective. Further, clause 568(2) to (4) also applies to the special notice required by clause 453(4). A failure to comply with clause 568(2) to (4) or other provisions on resolutions at meetings as stipulated in clause 552(1) (under Part 12) may make a resolution invalid.

7. Regarding the specific requirements under clause 454(3) and (4) for the company to send the director's representations to members or to read out the representation at the meeting, in view of Members' concern, we will introduce CSAs to add provisions in respect of the validity of the resolution.

Clause 454(5) (Director's right to protest against removal)

8. Members sought clarification on what would constitute an abuse under clause 454(5) and asked if the wording should be consistent with other provisions on "abuse" (e.g. clauses 306(8) and 633(7)). In this regard, the word "abuse" is to be interpreted in accordance with its ordinary meaning. The dictionary meaning of "abuse" includes "make a bad or wrong use" of

[1] Paragraph 637 of Halsbury's Laws of England, 5th Edition, Volume 14(2009).

something. In the corporate law context, notions of abuse of power apply in relation to exercise of both directors' powers and the powers of majority shareholders. Here, there is abuse if the powers are exercised beyond the purposes for which they were conferred. Similar ideas are arguably relevant in relation to clause 454. The right to make representations enables directors to set out a case for why they should not be removed from office. There could be abuse if the right to make representations is used for extraneous purposes. The wording used in the equivalent section in the Companies Ordinance ("CO") (section 157B(4)) — rights abused to secure needless publicity for defamatory matter — provides on example of abuse.

9. For case law on "abuse", reference could be made to the case of *Jarvis plc & Ors v PricewaterhouseCoopers (a firm)* [2001] BCC 670 regarding a company's allegation against its auditors that they were using a statement of circumstances for circulation to members or creditors of the company to secure needless publicity for defamatory matter. With reference to the judgment, it may be interpreted that there is an abuse of the rights to circulate an auditors' statement of circumstances or a director's representations if the statement or representations is or are given in bad faith or in pursuit of any private or collateral interest.[2] Reference could also be made to the cases on abuse of the process of the court. It is an abuse of the process of the court if the process is not used bona fide or properly. These principles are arguably applicable, by analogy, to an abuse of rights given under statutory provisions. The categories of conduct that render the exercise or an assertion of rights an abuse are not closed but depend on all the relevant circumstances.

10. The provision in clause 454(5) is different from the provision on "abuse" in clauses 306(8), 633(7) and other similar provisions on inspection of a company's registers. In respect of the latter provisions, the court has decided in an earlier case that section 98(4) of the CO (which is in similar terms as clauses 306(8) and 633(7)) gives the court a discretion in whether to order an inspection in the event of refusal to inspect. It is therefore not necessary to specifically provide for the court's discretion to refuse inspection on the ground of abuse in clauses with similar provisions as in section 98(4) of the CO.

<u>Clause 454(6) (Director's right to protest against removal)</u>

11. There was a query on why the Court might order the director to pay costs for an application under clause 454(5) even if the director is not a party to the application. In this regard, the intention of clause 454(6) is to allow the

[2] *Jarvis*, paragraph 14 at page 676.

court on an application under clause 454(5), where the court is satisfied that the rights of the director being removed to have copies of his representations sent to members or to have his representations read out at the meeting are being abused, to order the director to pay the company's costs of the application, even where the director is not a party to the application. Section 52A(2) of the High Court Ordinance (Cap 4) provides that the Court of Appeal or the Court of First Instance may, in accordance with rules of court, make an order awarding costs against a person who is not a party to the relevant proceedings, if the Court of Appeal or the Court of First Instance, as the case may be, is satisfied that it is in the interests of justice to do so.

12. However, there are safeguards for the interests of the non-party concerned. Order 62 rule 6A of The Rules of the High Court (Cap 4A) provides that the Court in considering whether to exercise its power under section 52A or 52B of the High Court Ordinance to make a costs order in favour of or against a person who is not a party to the relevant proceedings, may order that the person must be joined as a party to the proceedings for the purposes of costs only and must be given a reasonable opportunity to attend a hearing at which the Court shall consider the matter further.

Clauses 455(5) (Resignation of director) and 468(5) (Resignation of company secretary)

13. There was a suggestion that clauses 455(5) and 468(5) should not override the articles of companies. On this, it is noted that clauses 455 and 468 largely restate section 157D of the CO, which was enacted in 1984 pursuant to the recommendation of the Second Report of The Companies Law Revision Committee of 1973. There does not seem to have been major problems thus far concerning the application of section 157D. Subject to Members' views, we do not propose to change the status quo.

Clause 456(2) (Duty to exercise reasonable care, skill and diligence)

14. Members asked for clarification on the meaning of clause 456(2) and relevant case law. There was also a concern about the objective test under clause 456(2)(a) given that there was no qualification requirement for directors.

15. A Note on clause 456(2) that clarifies the meaning of clause 456(2)(a) and (b) by reference to case law is at **Annex B**. The dual objective / subjective test for director's duty of care has been well established in comparable common law jurisdictions including the UK, Australia and Singapore. The director's

duty of care is a common law duty, owed by a director to his company in the performance of his functions and the exercise of powers of a director. The duty arises from the circumstances that a director assumes responsibility for a company's property and affairs. The dual objective / subjective test enables the court to ask what it would be reasonable to expect the director to have done both by reference to the responsibilities that he undertook, and by reference to his own knowledge and skills. A director, upon assuming the position as a director, is subject to various responsibilities and duties to the company. Therefore, the absence of a specific qualification requirement should not affect the application of the objective test.

Clause 456(4) (Duty to exercise reasonable care, skill and diligence)

16. Members sought clarification on the effect of clause 456(4), including whether the common law rules and equitable principles in relation to directors' fiduciary duty would be replaced by the clause, and whether acts taken place before the commencement date of the CB would continue to be governed by the existing common law.

17. Clause 456(4) is modelled on section 170(3) of the CA 2006. It is clear that only the common law rules and equitable principles as regards the duty of a director to exercise reasonable care, skill and diligence, but not the fiduciary duties, are replaced by the duty specified in clause 456(1).

18. Clause 456 takes effect on the commencement of the clause and applies to directors' breaches of duty of care, skill and diligence that occur on or after the commencement. The common law rules and equitable principles as regards the duty of a director to exercise reasonable care, skill and diligence apply to breaches that occur before the commencement of clause 456.

Clause 464 (Ratification of conduct by director involving negligence)

19. There were questions on whether clause 464(1) would change the current law and whether a breach of trust by a director could be ratified. In this regard, clause 464 follows section 239 of the UKCA 2006. The intention of the clause is to set out express provisions in respect of the following –

(a) any decision by a company to ratify misconduct by a director must be taken by resolution of the members of the company (clause 464(2)); and

(b) the decision / resolution must be made / passed without reliance on the votes in favour by the director in question or persons connected with him (clause 464(3)).

20. Other than these two requirements, it is not the intention of the clause to change the law on ratification of acts of directors. Under the common law, a beneficiary can release a trustee from liabilities for breach of trust since the trustee's duties are owed to the beneficiary: e.g. *Wright v Vanderplank* (1865) 5 De G M & G 233; 44 ER 340.

21. The provision in clause 464(7)(b) is intended to preserve the existing company law principles which may prevent the company (acting through the shareholders in general meeting) from effectively ratifying breaches of duties (including a breach of trust) by directors in particular circumstances. For example, majority shareholders cannot effectively ratify a breach where to do so amounts to a fraud on the company (or fraud on the minority): see *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1981] Ch 257. Ratification by majority shareholders will not be effective where the breach involves misappropriation of the company's property: *Cook v Deeks* [1916] 1 AC 554.

Section 83(4) of Schedule 10 (Requirement to have at least one director who is natural person)

22. In response to Bills Committee’s query, it is confirmed that “The company” in section 83(4) means the company as stated in section 83(3). We would consider if it is necessary to introduce a CSA to clarify the intention.

Financial Services and the Treasury Bureau
Companies Registry
24 February 2012

Annex A

Note on Clause 452 of the Companies Bill

Background

1. Clause 452 (validity of acts of director) of the Companies Bill ("CB") restates with modification section 157 of the Companies Ordinance (Cap 32) ("CO") which was first enacted as section 75 of the Companies Ordinance 1911. In the UK, similar provisions on validity of acts of director appeared as early as section 99 in the Companies Clauses Consolidation Act 1845 and as model articles in the Companies Acts of the UK in the 19th century.

2. Section 161 of the Companies Act 2006 ("CA 2006") is the corresponding provision of clause 452. The wording of an earlier version of section 161[1] of the CA 2006 had been interpreted narrowly so as to apply only when there is a procedural defect in the appointment, not when there has been no appointment at all, or where a director had vacated office but continued to act.[2] Section 161 of the CA 2006 is explicitly more expansive, and, for example, covers acts of directors who have vacated office and of under-age directors notwithstanding their appointment is void. Nevertheless, there must still, at some stage, have been a purported appointment of the person of the role of director.[3] It was also considered that the principle of a person seeking to rely on a validation provision should have acted in good faith as established in earlier cases continues to apply to section 161 of the CA 2006 as the material words in the new section are identical, even though the provision itself is silent on the issue.[4]

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[1] Section 285 of the Companies Act 1985 of the UK provided that "The acts of a director or manager are valid notwithstanding any defect that may afterwards be discovered in his appointment or qualification; and this provision is not excluded by section 292(2) (void resolution to appoint)".

[2] Morris v Kanssen [1946] AC 459, at 471 and 472.

[3] See commentary in paragraph 8.2003 of Palmer's Company Law.

[4] See commentary in paragraph 8.2004 of Palmer's Company Law.

Cases on provision on validity of acts of director

3. In *Mahony v East Holyford Mining Co*[5], a bank had honoured a company's cheques, signed by two of three named directors, after having received from the company's secretary a letter with copy of a board resolution on giving cheque signing powers to the three directors and the signatures of the directors. Neither the "secretary" nor "directors' had been properly appointed. The bank successfully resisted the claim. The doctrine in *Royal British Bank v Turquand* (commonly known as the indoor management rule) was approved and applied by the court which held that provided nothing appeared which was contrary to the company's articles, the bank was entitled to assume that the directors had been properly appointed.[6] The court also referred to the validity clause in the company's articles[7] and stated that independently of any general law upon the subject, it appeared that the validity clause covered any defect in the appointment of the directors in the case.[8]

4. In *Dawson v African Consolidated Land and Trading Company*[9], it was held that a clause in the company's articles which validates acts of directors despite disqualification or defect in appointment did not operate only as between the company and outsiders but also as

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5 (1875) LR 7 HL 869. The shareholders of the company through the company's official liquidator brought an action to recover from the bank the amount of the cheques on the ground that there had been no sufficient authority for the payments on the cheques since there was no evidence that the persons who signed the cheques had been duly appointed as directors.

6 *Turquand* (1856) 119 ER 886. In *Mahony* (at p. 900), Lord Penzance quoted the judgment of Chief Justice Jervis in *Turquand* that they "are bound to read the statute and the deed of settlement; but they are not bound to do more, and the party here, on reading the deed of settlement, would find not a prohibition from borrowing, but a permission to do so on certain conditions.".

7 A clause in the company's articles provided that all acts by the board of directors be valid despite defect in the appointment of the directors or their disqualification.

8 *Mahony* (1875) LR 7 HL 869 at 887, 897 and 903.

9 [1898] 1 Ch 6. Directors of the company passed a resolution for a call. Shareholders applied for injunction against the call on the ground that there was no duly constituted board of directors when the call was made as there were irregularities relating to appointment and disqualification of the directors and argued that the article on validity of act of director only applied between the company and outsiders, not between the company and its members.

between the company and its members as the article itself did not make such a distinction, and the article was sufficient to cover such irregularities as alleged, and that the call made by the board of directors was valid. The shareholders were prevented from setting up irregularities as a defence to actions for calls.

5. In *Channel Colliers Trust Ltd v Dover*[10], there was dispute on whether the appointment of two directors who did not hold the required qualification shares at the time of their appointment was valid and whether the allotment to them of the qualification shares purported to be made by them and another director in a board meeting was valid. The directors sought to rely on a statutory provision which validated acts of directors despite defects in appointment or disqualification.[11] The Court of Appeal held that the irregular allotment by the directors of the qualification shares was an act done by de facto directors, which was validated by the statutory provision, the test being whether the directors in making the allotment had acted bona fide, which was not disputed in the case.[12] Therefore, a person who seeks to rely on the validation provisions must have acted in good faith. The court also reaffirmed the decision in the case of *Dawson* and stated that the statutory validation provision was not limited to dealings between the company and outsiders, but that it applied also to dealings between the company and persons in the company.

6. Clause 452 is to be interpreted with reference to case law to validate the acts of a person acting as a director despite a defect in his appointment (paragraph (a) of clause 452(1)) or other irregularities (paragraphs (b) to (d) of clause 452(1)), provided that the person who seeks to rely on the validation provision has acted in good faith. The provision applies even if the director's appointment is void. It

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[10] [1914] 2 Ch 506.

[11] Section 99 of the Companies Clauses Consolidation Act 1845 of the UK.

[12] As per Lord Cozens-Hardy M.R. at 511 and 512. The directors concerned were acting in perfect good faith as they were not aware of the invalidity of the appointment by reason of the want of qualification and they honestly believed that it was sufficient if contemporaneously with their appointment they obtained the qualifying shares.

is the act of an improperly or invalidly appointed director that is validated, not the appointment itself. A resolution which is duly signed by a director who is not properly appointed may be validated by the provision.

***Turquand's* rule**

7. The *Turquand's* rule was previously explained in the Annex to the Paper dated 28 October 2011 on follow-up actions for the meeting on 11 October 2011. In *Turquand*, it was held that persons dealing with the company were bound to make themselves acquainted with the statute and the deed of settlement of the company, but they were not bound to do more; a person, on reading the deed of settlement, would find, not a prohibition against borrowing, but a permission to borrow on certain conditions, and, learning that the authority might be made complete by a resolution, he would have a right to infer the fact of a resolution authorising that which on the face of the document appeared to be legitimately done; and, therefore, the company was liable whether or not the resolution had been passed. *Turquand's* rule will not apply where the third party has been put on enquiry or has actual knowledge of the irregularity in the conferral of authority.

8. *Turquand's* rule applies in respect of the authority of agents generally, and not merely of directors to bind the company on whose behalf they purport to contract. As set out in paragraph 3 above, the rule was approved and applied in the case of *Mahony* which related to acts done by directors who were not properly appointed and where the court stated that the validation provision in the company's articles could be applied independently of any general law upon the subject. Therefore, we consider that clause 452 can be relied upon as an alternative to the common law indoor management rule in *Turquand* if the situation falls within any of the specific circumstances set out in paragraphs (a) to (d) of clause 452(1). Yet although particular actual scenarios can come within the scope of both clause 452 and *Turquand's* rule, the two are concerned with different aspects of questions of validity. Clause

452 focuses on defects in appointment/qualifications of directors while *Turquand's* rule focuses on defects or irregularities in the conferral of authority on directors (or other agents).

Clauses 112 to 114 of the CB

9. The analysis of clauses 112 to 114 of the CB and their relationship with the *Turquand's* rule was set out in the aforesaid follow-up Paper dated 28 October 2011.

10. Clause 112(1) provides that "*subject to section 114, in favour of a person dealing with a company in good faith, the power of the company's directors to bind the company, or authorize others to do so, is to be regarded as free of any limitation under any relevant documents*[13] *of the company.*" It is very specific in its terms and may not apply in all cases of third parties dealing with a company. Clause 112 only applies where the limitation on the power to bind the company is set out in relevant documents.

11. Clause 112(2)(b) provides for a presumption of good faith. Therefore, it is for the other party to prove that there was bad faith. Clause 112(2)(c) also provides that a person dealing with a company is not to be regarded as acting in bad faith by reason only of the person's knowing that an act is beyond the directors' powers.

12. As clause 112 and clause 452 apply to different circumstances, it is considered that they could be relied on as an alternative or a further ground to each other. If a party seeks to rely on clause 112 to bind the company, then the provisions under clause 112(2) shall apply in respect of the party's reliance on the clause. If however the party seeks to rely on clause 452 as a further ground or as an alternative, then the provisions of clause 452 and the relevant case law shall apply. Clause 112 provides a statutory version of the indoor management rule, and so similar to the position for *Turquand's* rule noted at paragraph 8 above, clause 112 has a different area of focus

[13] "Relevant document", in relation to a company, means (a) the company's articles; (b) any resolutions of the company or of any class of members of the company; or (c) any agreements between the members, or members of any class of members, of the company.

compared with clause 452.

Australia and Singapore

13. In Australia, sections 201M(1) and 204E(1) of the Corporations Act 2001 ("ACA") provide that an act done by a director or a secretary is effective even if their appointment, or the continuance of their appointment, is invalid because the company, director or secretary did not comply with the company's constitution (if any) or any provision of the ACA. According to the notes to the sections, the kinds of acts they validate are those that are only legally effective if the person doing them is a director or a secretary.[14] Sections 201M(2) and 204E(2) limit the application of the sections by stating that they do not deal with the question whether an effective act by a director or secretary binds that company in its dealings with other people or makes the company liable to another person. Such matters are dealt with by sections 128 to 130 which contain rules about assumptions which people are entitled to make when dealing with a company and its officers.[15]

14. In Singapore, section 151 of the Companies Act (Cap 50) provides that "the acts of a director or manager or secretary shall be valid notwithstanding any defect that may afterwards be discovered in his appointment or qualification". The section is similar to section 157 of the CO except that it also applies to a secretary.

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[14] In respect of directors, the notes to section 201M ACA give the examples of calling a meeting of the company's members or signing a document to be lodged with the Australian Securities and Investments Commission ("ASIC") or minutes of a meeting. In respect of secretaries, the notes to section 204E ACA give the examples of signing and sending out a notice of a meeting of directors if the company's constitution authorizes the secretary to do so or signing a document to be lodged with ASIC.

[15] Sections 128 to 129 of the ACA represent a statutory form of the "indoor management rule" found in *Turquand's* case. The rule has been largely replaced by the statutory assumptions an outsider is entitled to make under section 129 which are based on the common law rule and subject to the limitations contained in section 128(4). The limitations are based on the common law exceptions to the *Turquand's* rule but appear to differ in some respects.

Annex B

Note on Clause 456(2) of the Companies Bill

Background

1. The current position in Hong Kong of the standard of directors' duty of care, skill and diligence, the common law position in the United Kingdom ("UK") before the enactment of the statutory duty of care, skill and diligence in section 174 of the Companies Act 2006 ("CA 2006") and the judicial trend in other comparable jurisdictions towards the adoption of a dual objective and subjective standard have been discussed in the following Bills Committee Papers –

   (1) Annex A to the Administration's paper on Part 10 and Part 11 of the Companies Bill (LC Paper No. CB (1) 2280/10 – 11(01)) ("Paper 1").

   (2) The Administration's response to issues raised by members at the meetings on 3 and 10 June 2011 (LC Paper No. CB (1) 2577/10 – 11(01)) ("Paper 2").

2. In the absence of a clear ruling in Hong Kong on the standard of duty of directors' care, skill and diligence, we consider it appropriate to clarify the standard of the duty by introducing a statutory statement in clause 456(2) of the Companies Bill ("CB") to provide appropriate guidance to directors.[1]

Clause 456(2) of the CB : A dual objective and subjective standard

3. Clause 456(2), which follows section 174(2) of the CA 2006, sets out a dual objective and subjective standard for the statutory duty of a director to exercise reasonable care, skill and diligence under clause 456(1).

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[1] See paragraphs 14 and 15 of Paper 1.

4. In the UK, the duty of care, skill and diligence was made statutory and the dual objective and subjective standard was adopted (in section 174 of the CA 2006) as recommended by the Law Commission. After public consultation, the Law Commission recommended in 1999 that –

(1) There should be a statutory statement of a director's duty of care, skill and diligence as it would make company law more coherent and more accessible.

(2) The standard of the duty should be judged by a twofold objective and subjective test as it was of the view that the standard, based on the dual standard for considering whether or not a director is liable for wrongful trading under section 214(4) of the Insolvency Act 1986, represented the law and would be followed by the higher courts in cases of the directors' duty of care, skill and diligence.[2]

5. The test for a dual objective and subjective standard under clause 456(2) requires the acts of directors to be judged both objectively and subjectively as follows –

(1) Clause 456(2)

The core question is what standard of care, skill and diligence would be exercised by a reasonably diligent person having both the general knowledge, skill and experience as stated in clause 456(2)(a) and the general knowledge, skill and experience that the director in question has (clause 456(2)(b)). In deciding whether a director of a company has breached the duty of care, skill and diligence owed by him to the company, his conduct is compared to the standard that would be exercised by such a reasonably diligent person.

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[2] Law Commission, Report on Company Directors : Regulating Conflicts of Interests and Formulating a Statement of Duties (September 1999), Law Commission No. 261 ("**Law Commission Report**"), paragraphs 4.48, 5.1, 5.6 to 5.8.

(2) Clause 456(2)(a)

The general knowledge, skill and experience under clause 456(2)(a) refers to the knowledge and experience that may reasonably be expected of a person in the **same position** and with the **same functions** as the director in question. This involves taking account of the particular role of the director in the specific company. This allows the court to take account of the factual differences in the responsibilities of directors of different types and in different situations, for example between what executive directors and non-executive directors are expected to do and also the types and sizes of company.[3]

(3) Clause 456(2)(b)

Clause 456(2)(b) refers to the knowledge, skill and experience that the director in question has.

6. In a purely subjective test, a director owes a duty to his company to exercise the care, diligence and skill that would be exercised by a reasonable person having his knowledge and experience. This is effectively the older traditional view of the standard of care under the common law.[4] It will lead to a low standard of care if the director has little knowledge and experience although for directors with special expertise it would be higher than a purely objective standard.[5]

7. Under the test of a dual objective and subjective standard, the objective limb (clause 456(2)(a)) prescribes for the minimum standard on the basis of "reasonable expectations". Therefore, a director should not be able to rely on his own lack of knowledge or experience to avoid liability. This reflects the modern common law position on the standard of directors' duty of care, skill and diligence in the UK. In the 1990's, the court had explicitly adopted the dual objective and subjective standard under section 214(4) of the

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[3] Paragraph 5.7 of the Law Commission Report. See also paragraph 4 of Paper 2.

[4] See *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407 at 428.

[5] Paragraph 5.3 of the Law Commission Report.

Insolvency Act 1986 as an accurate expression of the common law on the directors' duty of care, skill and diligence (see paragraph 4 of Annex A to Paper 2 and paragraphs 8 to 12 below). The dual objective and subjective test is also applicable in Australia (section 180(1) of the Australia Companies Act 2001) and Singapore (section 157(1) of Singapore Companies Act). They have both adopted the objective test in the statute, which are judicially interpreted to incorporate subjective elements[6].

Cases on a dual objective and subjective standard

8. Section 174 of the CA 2006 only came into operation on 1 October 2007 but the dual standard was adopted from section 214(4) of the Insolvency Act 1986. It is therefore useful to see how the courts have applied section 214(4) of the Insolvency Act 1986 in practice, so as to have a better understanding of the meaning and application of clause 456(2)(a) and (b) of the CB.

9. An earlier case decided under section 214(4) of the Insolvency Act 1986 was *Re Produce Marketing Consortium Ltd* (1989) 5 BCC 569.[7] In connection with the objective test under section 214(4) for deciding whether a director of an insolvent company knew or ought to have known, within the meaning of section 214, that there was no reasonable prospect of the company avoiding an insolvent liquidation, Knox J. stated that **the director in question was to be judged by the standards of what can be expected of a person fulfilling his functions, and showing reasonable diligence in doing so** and accepted a submission that **the requirement to have regard to the functions carried out by the director in question in relation to the company, involves having regard to the particular**

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[6] Australia : *Daniels v Anderson* (1995) 16 ACSR 607 at 668; *ASIC v Rich* (2009) 75 ACSR 1 at [7202], [7205]; *Morley v ASIC* (2010) 274 ALR 205 at [819]. Singapore : *Lim Wing Kee v PP* [2002] 4 SLR 327.

[7] The liquidator of the company applied for an order under section 214 of the Insolvency Act 1986 declaring that two directors were liable to contribute to the company's assets. The issue was whether at the material time the two directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. The directors conceded that that question had to be answered by the objective standards in section 214(4).

company and its business, so 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.[8] This approach could give scope for the courts to make allowances in the case of different types of directors and types of companies.[9]

10. In *Re Continental Assurance Co of London Plc (in liquidation)* [2001] BPIR 733, the liquidators of an insurance company which had gone into insolvent liquidation sought relief from the company's former directors and submitted, in respect of the allegation of wrongful trading pursuant to section 214 of the Insolvency Act 1986, that the directors ought to have known that certain accounting adjustments need to be made but had not been made. The court expressed the view that **the accounting concepts involved were of a particularly specialized and sophisticated nature and it would set the standard required of the directors at an unrealistically high level for them to have been expected to know the level of accounting expertise as submitted by the liquidators.**[10] In respect of the two directors who had chartered accountancy qualifications, the court stated that it would be **correct to regard them as laymen rather than professional accountants for the purpose of section 214 and they would have been expected to be intelligent laymen**.[11]

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[8] *Re Produce Marketing* (1989) 5 BCC 569 at 594 to 595.

[9] *Annotated Guide to the Insolvency Legislation*, by Sealy and Milman, 13th Edition, Volume 1 at page 209.

[10] *Re Continental Assurance* [2001] BPIR 733 at paragraphs 255 and 256.

[11] Ibid, at paragraphs 257 and 258 –
"257. ….. In my judgment it is correct to regard as laymen for this purpose the two respondents who have chartered accountancy qualifications. ….. They were experienced businessmen. They were financially aware and numerate. They were familiar with the lay-out and analysis of balance sheets and profit and loss accounts. But in the very specialized area of insurance company accounting their accountancy qualifications gave them a good start but not much more than that.
258. When I make the point that the directors (other than Mr Davis) were layman so far as the accounting issues in the case are concerned, I am not suggesting that it would have been acceptable for them to be totally ignorant of accounting concepts as applied to an insurance company. In my view they would have been expected to be intelligent laymen. They would need to have a knowledge of what the basic accounting principles for an insurance company were, such as IBNR. They would be expected to be able to look at the company's accounts and, with the guidance which

11. In *Bairstow & Ors v Queens Moat Houses plc & Ors.*[12], the judge adopted the test set out under section 214 of the Insolvency Act 1986 as the test at common law for a director's duty of skill and care generally and stated that –

> *"**This modern objective test requires that a director is judged not merely by that which he knows, but also that which he ought to know as a reasonable diligent person having the knowledge, skill and experience expected of a person carrying out his task. I am satisfied that this is so whether his acts or omissions are being considered in the context of the general duty of skill and care, or his specific duties in relation to the payment of dividends."**[13]*

The court found a breach of directors' duty of skill and care in paying dividends when there were insufficient company reserves.[14]

12. *Abbey Forwarding Limited (in liquidation) v Hone* [2010] EWHC 2029 (Ch) is a recent case which considered section 174 of CA

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they could reasonably expect to be available from the finance director and the auditors, to understand them. They would be expected to be able to participate in a discussion of the accounts, and to ask intelligent questions of the finance director and the auditors. 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 …….".

[12] [2000] BCC 1025. The defendant company (listed on the London Stock Exchange) counter claimed for damages for breach of contract on the basis that dividends authorised by the company's directors had been paid in breach of the Companies Act 1985. The defendant alleged that the dividends had been paid at a time when there were insufficient company reserves and on the basis of accounts which did not present a true and fair view of the company's trading position, whilst the directors maintained that any breaches were of a technical nature and that they had acted honestly and reasonably. It was held that the defendant's submissions were well founded and that the directors were therefore liable for breach of trust, breach of fiduciary duty and breach of their duty to take reasonable skill and care under their individual contracts of employment.

[13] Ibid, at page 1033.

[14] Ibid, at page 1042. The judge held that –
"*whilst I have treated the breach as technical, I am satisfied that a reasonably diligent director should have known that dividends should not be paid out of capital and should have known that the code of the Act was provided in order to ensure that such a breach was avoided. Further, each claimant knew, or ought to have known, that the accounts on their face showed insufficient funds in the company itself as opposed to the group and hence knew or ought to have known of the facts which established that the dividends were paid in contravention of the Act.*
They were thereby in breach of their duty of skill and care."

2006.[15] The court expressed the view that in deciding whether directors have fallen short of their duty of skill and care, particularly where the breach of duty concerned the precise way in which the business was run, **evidence of what was normal in the field of commerce in which the company operates is of considerable relevance.** The court ruled that taking various factors together, and in the absence of evidence about industry practice, it was not prepared to find the directors were in breach of their duty of skill and care to the company.

[15] The company (in liquidation) brought the action against its four former directors alleging that they had been negligent in allowing the company to be exposed to the liability to Her Majesty's Revenue & Customs in respect of excise duty and VAT.