### Consequences of contravention

There are consequences in civil law as follows.

A loan which contravenes the provisions set out above is voidable at the instance of the company but no one else (CA 2006, s 213). In consequence, the company will be able to recover the funds from those into whose hands they have passed and there would appear to be no limit in time for avoiding the transaction. However, there are exceptions where:

- it is no longer possible to make restitution, as where the loan has been spent on a cruise;
- the company has been indemnified, e.g. by the borrowing director;
- avoidance of the loan would affect rights which were acquired in good faith and for value and without actual notice by a person other than the person for whom the loan was made. This is the usual protection for third parties and would, for example, cover the shipping company which had provided the cruise referred to above so that the loan would not be recovered from such a company.

It appears from case law that the existence of the above-mentioned tracing of funds remedies depends upon whether or not the company has actually avoided the contract of loan.

#### *Ciro Citterio Menswear plc* v *Thakrar* [2002] 2 All ER 717

In this case the High Court ruled that an illegal loan to a director which had been used to purchase a house could not be recovered by the company's administrator by an order for a sale of the property to extract the amount of the loan from the proceeds. At the time the property was purchased the company had not rescinded the loan so that the director was still the owner of the loan. Therefore no tracing remedy was available.

**Comment**

The administrator presumably did not rate highly his chances of getting repayment from the director and went instead for a tracing remedy into the property purchased with the loan. It would seem that the tracing remedy could be used if the loan was used to buy the property *after* the company had provided evidence, e.g. a board resolution that it had rescinded the loan.

In addition, whether or not the transaction has been rescinded, the director who is a party to it is liable to account to the company for any gain made from the loan and to indemnify the company against any loss or damage it has suffered which has not been put right by rescinding the loan. This liability is extended also to any other director who authorised the transaction, though such a person will not be liable if he can show that he did not know the relevant circumstances constituting the contravention at the time the transaction was made.

As an example of the above-mentioned civil remedies, the Court of Appeal has decided that a company is entitled under CA 1985 to demand from a director immediate repayment of an illegal loan made to the director, regardless of any other terms of the contract of loan which may provide differently.

#### *Tait Consibee (Oxford) Ltd* v *Tait* [1997] 2 BCLC 349

On 1 February 1994 the claimant company made a loan of £10,000 to the defendant, who was at that time a director of the company. In July 1994 the defendant's employment terminated and in October 1994 he ceased to be a director. By a letter dated 9 January 1995 the company demanded repayment of the loan. The defendant admitted that he received that letter of demand. Since the loan was not repaid, the company commenced an action for its recovery. The defendant said that it was agreed that the loan was to be repaid from dividends declared by the company, and since no dividends had been declared the loan was not repayable, at least at the relevant point in time.

The terms of the loan agreement, which was not recorded in writing, were disputed by the company. However, the company also contended in support of its claim that the loan was recoverable anyway, regardless of the terms of any agreement (in this case, repayment from dividends), since the loan was illegal under s 330 and therefore recoverable under s 341. The Court of Appeal accepted the company's contention. The only section that might have applied to make the loan valid was s 334 which exempts loans of small amounts but applies only to loans which do not exceed £5,000. The loan in this case, being £10,000, was prohibited and recoverable. The decision of the lower court which gave the company judgment for that sum plus interest was affirmed by the Court of Appeal.

### Shadow directors

By reason of CA 2006, s 223, shadow directors are included in both the civil and criminal sanctions.

### Material interests

Material interests of directors and their connected persons must also be disclosed in a note to the accounts. A material interest could be, for example, a contract to build a new office block which the company had entered into with a building firm run by a director, or by the spouse of a director. It might also be a loan to the brother of a director. A brother is not a connected person but the loan might be a material interest.

## The treatment of directors' loan accounts

The materials set out above may have to be applied in regard to a not uncommon feature of private companies: the directors' loan accounts. Two situations may arise as follows.

### (a) The loan account is overdrawn

In this case the directors owe money to the company and problems may arise either during the company's lifetime, as on a director's resignation, and even more likely on its insolvent liquidation. The directors may have made drawings against the company's funds that have been allocated to a loan account. Consideration needs to be given to the following matters:

- Are the drawings to be regarded as loans to directors? If so, then there are issues to be addressed in terms of compliance with company law requirements. If the drawings are unlawful loans the company or a liquidator can set them aside and require repayment to the company by the director.
- Are the drawings dividends received by the director in regard to a shareholding? If so, the distribution rules in company law must be addressed. Drawings may sometimes be justified on the basis that they are made in expectation of dividends though this is a risky strategy if the dividends do not materialise and it is a pointless strategy if the company was not in a position to pay dividends.
- Are the drawings remuneration? If they are, as where the director has carried out work or given services to the company, then the drawings are perfectly permissible given that the work or services have been rendered, though issues of taxation must be addressed.

- Are the drawings a misappropriation of corporate assets? If so, the company and its liquidator can seek recovery of the sums paid.

### (b) The loan account is in credit

In this case the directors have lent money to the company which has not repaid it fully or at all. The problems that arise here are in connection with impending insolvency where the directors have arranged for the repayment of the loans and have been required to repay the sums to the company upon commencement of its liquidation as preferences. Since the directors are connected persons for the purposes of the repayment any repayment that is made within two years immediately prior to the commencement of winding-up may well amount to a preference that can be challenged by the liquidator.

### The case law

There is instructive case law on the above matters as follows.

#### ***First Global Media Group Ltd*** **v** ***Larkin*** [2003] All ER (D) 293 (Nov)

In this case a director tried to establish his drawings as remuneration but this was not acceptable to the court because there was a directors' agreement that in order to minimise tax no remuneration would be paid to directors. A further attempt to establish the drawings as dividends failed since, at the time the sums were drawn, the company was incurring losses and there were no distributable profits. The drawings were repayable to the liquidator.

#### ***Currencies Direct Ltd*** **v** ***Ellis*** [2003] 2 BCLC 482

Here a director was successful in establishing drawings as remuneration. He had done work and rendered services to the company and the Court of Appeal was satisfied that the drawings were the consideration. The court also stated that remuneration could take different forms and need not be in the nature of a regular wage or salary cheque or credit. Remuneration might consist in payment of the consideration to a third party in discharge of the debts of the person who had done or was to do the work or render services. It could take the form of commissions, fees or bonuses. It could be a lump sum payment or be spread over a period and the payment need not be backed by a formal contract. It might arise from the company's obligation to pay reasonable remuneration under an implied contract. The company could not recover the sums paid. They were not loans.

#### ***Re Conegrade Ltd*** [2003] BPIR 358

In this case the directors' loan account was in credit to the extent of some £65,000. At a time when the company was insolvent the directors purchased an asset from the company at the market value of £125,000. The consideration was a payment by the directors of £60,000 to the company and the cancellation of the credit balance on the loan account. The company went into insolvent liquidation and the liquidators challenged the transaction as a preference. The High Court ruled that it was. The directors were put in a better position in terms of their loans to the company of £65,000 than they would have been if they had been reduced to proving for that sum as unsecured creditors in the liquidation. The directors were ordered to pay the sum of £65,000 to the company. They would then have to prove as unsecured creditors in the liquidation for that sum.

## Advice to directors

The following are some major points for consideration:

- Directors who have lent money to the company through a loan account should be appraised of the legal rules regarding preference. They should not repay any amounts due to them in the two years immediately prior to an insolvency.
- With regard to drawings made by directors it is important to ensure:
  (a) that the date and amount of the drawings are properly documented; and
  (b) that the basis on which they have been made is clearly stated.

### Directors' contracts with the company

Under CA 2006, s 182 which replaces CA 1985, s 317, a director must declare the nature and any direct or indirect interest that he has in any transaction or arrangement entered into by the company. In ***Guinness*** v ***Saunders*** [1990] 1 All ER 652 the House of Lords ruled that disclosure had to be made at a full meeting of the board and not at a meeting of a committee of the board.

If the director is a member of another concern which is doing business with the company, he may give a general notice of interest, either orally to the board, or in writing to the company, and this will cover a series of contracts made with the other concern. If a director fails to make proper disclosure of his interest, he is liable to a fine.

The provisions are extended to cover any transaction or arrangement of the type set out under the loans, quasi-loans and credit heading and it should be noted that the interest of a connected person, unless the connected person is also a director, is treated for these purposes as an interest of the director. The above rules are extended to shadow directors.

Although the major sanction is a default fine, the company can in any case rescind the contract made with the director because of the fiduciary duty that exists, but it must be possible to restore the status quo (*per* Lord Denning MR in ***Hely-Hutchinson*** v ***Brayhead*** [1968] 1 QB 549). The articles may provide otherwise or the members in general meeting may, by ordinary resolution, waive the company's rights to rescind, but there can be no waiver by the board.

In this regard, ***Craven Textile Engineers Ltd*** v ***Batley Football Club Ltd***, Transcript: B2 99/1127, CA is of interest. A director of the claimant company was also a former director of the football club. The claimant did work for and supplied goods to the football club during the period of the dual directorship. The football club purported to avoid the contract because it appeared that the director concerned had not declared his interest in the contracts to the companies. The Court of Appeal noted that s 317 does not deal with the civil consequences of a breach but at common law the contracts could be avoided by the company. However, it must be possible to restore the parties to their pre-contractual positions before this could be done. In this case that was not possible as the goods and services had already been supplied. The claimant was therefore entitled to payment of the invoices.

In ***Re Neptune (Vehicle Washing Equipment) Ltd*** (1995) *The Times*, 2 March, the High Court had to decide whether a sole director must hold a board meeting and formally declare his interest in a contract with the company and record it in the minutes. The High Court said he must and if not the company could rescind the contract. So, in effect, s 317 applies in this situation even though the director is disclosing what he already knows to himself.

It should also be noted that under *Table A* a director who has disclosed an interest cannot count towards the quorum of the board on the item in which he is interested nor vote upon it. These provisions of *Table A* should be amended or excluded where a private company intends to operate through a sole director since otherwise he cannot approve any transaction in which he is interested.

In addition, in the absence of disclosure, a director who has received a payment under an undisclosed contract with his company is regarded as holding that payment in the capacity of a constructive trustee for the company and is bound to repay the sum received although he may have a claim for compensation for any services actually rendered under the undisclosed contract (***Guinness*** v ***Saunders*** [1990] 1 All ER 652).

### Substantial property transactions

Under CA 2006, ss 190–196, in both public and private companies, the approval of the members by ordinary (or written) resolution of any contract to transfer to, or receive from, a director (or connected person) a non-cash asset, e.g. land, exceeding £100,000 or exceeding 10 per cent of the company's net assets, whichever is the lowest, is required. The provision does not apply, however, to non-cash assets of less than £5,000 in value.

Thus a company whose assets less its liabilities amounted to £200,000 would have to comply with this provision in respect of a transaction with a director or connected person for a non-cash asset worth more than £20,000.

The provisions are designed to prevent directors (at least without member approval) from buying assets from the company at less than their true value or transferring their own property to the company at more than market value. At least if they are to do this the members must be aware of it and approve by ordinary (or written) resolution. If the above provisions are infringed the contract is voidable by the company but not by the director.

The asset would not require valuation by an independent accountant (see Chapter 12) unless it was the acquisition of a non-cash asset by the company from a director; the company was a plc; and the consideration to the director was shares in the company.

### Board minutes

Disclosure of material transactions is the responsibility of the director concerned. Such matters must be disclosed to the board of directors and recorded in board minutes. Inspection of directors' minute books should identify such transactions and any discussion that took place regarding materiality. CA 2006, s 177 requires directors to declare their interests in transactions or arrangements which are proposed but have not yet been entered into by the company. CA 2006, s 182 covers declaration of interests in relation to existing transactions or arrangements that the company has already entered into. The declaration must be of both the nature and extent of the director's direct or indirect interest. In other words, a further declaration must be made if an earlier declaration proves to be or becomes inaccurate or incomplete.

There is no need to make a declaration of interest if the interest cannot reasonably be regarded as likely to give rise to a conflict of interest. Similarly, there is also no need to disclose anything the other directors already know about or ought reasonably to have known. A declaration of an interest in an existing transaction or arrangement must be made as soon as reasonably practicable. In the last resort, if materiality cannot be agreed between the auditor and the directors, legal advice must be sought.

## Essay questions

**1** Dives is chairman and controlling shareholder of Cashloans plc. You are company secretary. Dives informs you he wishes to buy a seaside cottage for himself and his wife and that, to finance the transaction, he will propose to the next board meeting that the company lend him £60,000 for 10 years at 9 per cent per annum on a mortgage of the property. He asks for your comments.

Advise Dives and the board. (*The Institute of Company Accountants*)

**2** The Companies Act 2006 contains provisions regulating 'substantial property transactions' between a company and any of its directors. What are 'substantial property transactions' and what procedure is required to approve such transactions?

(*The Institute of Chartered Accountants in England and Wales*)

**3** How does s 994 of the Companies Act 2006 provide an alternative remedy to a winding-up order for the minority shareholders in a company?

(*The Chartered Institute of Management Accountants*)

**4** In what circumstances may a shareholder bring a derivative action on behalf of his company? What procedure is available to deal with the procedural problems presented by such actions?

(*The Institute of Chartered Secretaries and Administrators*)

## Test your knowledge

*Four alternative answers are given. Select ONE only. Circle the answer which you consider to be correct. Check your answers by referring back to the information given in the chapter and against the answers at the back of the book.*

**1** Test Ltd is reducing the size of the board and Fred is to leave it. Test Ltd wishes to pay Fred compensation for loss of office. This payment must be approved by:

- **A** The Inland Revenue.
- **B** The shareholders by ordinary or written resolution.
- **C** The board of directors.
- **D** The creditors.

**2** Tees Ltd is engaged in the catering business. It has lent John, a director, £6,000 interest free, to buy a car. It has also lent Jane, another director, £10,000 at 8 per cent per annum interest to assist in the purchase of her place of residence. What is the legal status of the loans?

- **A** The loans are valid.
- **B** The loan to Jane is valid because the company has charged interest. The loan to John is voidable because it is interest free.
- **C** The loan to John is void since a director cannot borrow from his company. The loan to Jane is valid because it is for house purchase on commercial terms.
- **D** Both loans are illegal because each of them exceeds £5,000.

3 Windermere Ltd has entered into a transaction with one of its directors to purchase from him freehold land exceeding £100,000 in value. Given that the transaction has not been approved by the members it is:

A Void.
B Valid.
C Voidable at the instance of the company.
D Voidable at the instance of the director.

4 Coniston Ltd holds board meetings once a month, on the first day of the month. At the August meeting the board discussed a contract with Ullswater Ltd. On 15 August John, a director of Coniston, bought shares in Ullswater. The contract was eventually signed between Coniston and Ullswater on 12 October. When should John declare his interest?

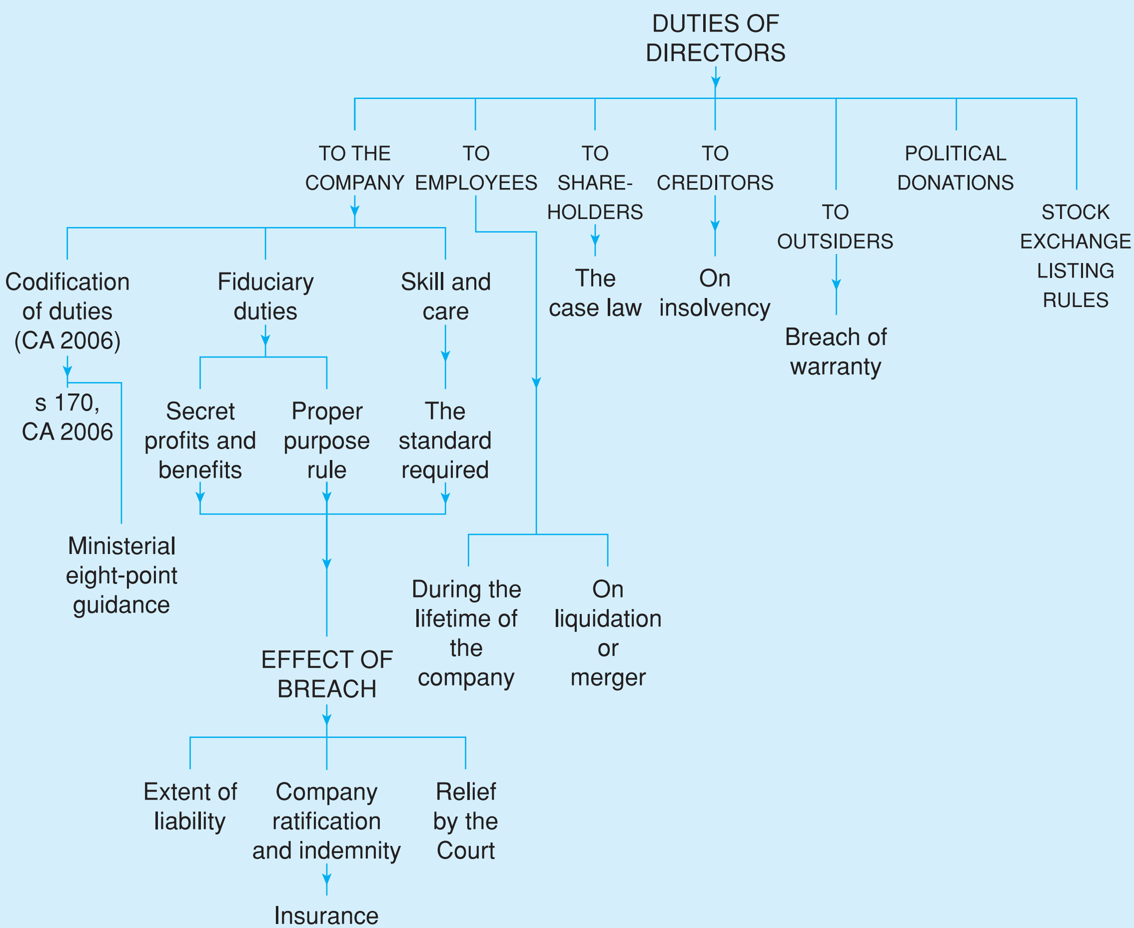
A On 12 October B On 1 October C On 1 September D On 15 August

5 Manfred is a director of Thames Bank plc. He has borrowed £40,000 under the bank's directors' and employees' cheap loans scheme to carry out repairs to his main residence. His son, Adolf, who is aged 30 and is employed by the bank, has also got a loan under the scheme and his wife has borrowed money at normal commercial rates to set up a hairdressing salon. In order to calculate whether the CA 2006 borrowing limits have been exceeded, which do you include?

A Manfred's loan only.
B Manfred's loan plus Adolf's.
C Manfred's loan plus that of his wife.
D All three loans.

*Answers to test your knowledge questions appear on p. 616.*

# 19 The duties of directors



## The CA 2006 codifies the general duties of directors

In this chapter, we shall consider the duties which directors owe to the company, to employees, to individual shareholders and to outsiders. The CA 2006 has taken a major step forward to codify the general duties of directors. For instance, directors' fiduciary and common law duties have now been partly codified and governed by the CA 2006. In twelve sections applying to directors, Chapter 2 of Part 10 of the CA 2006 sets out their general duties. These general duties now are a code of conduct for how directors must behave. They are not however all the duties that directors owe his or her company as a number are found elsewhere in the CA 2006 and in other statutes. Other duties are still not codified although commonly accepted.

Section 170 of the CA 2006 explains that the statutory duties are based on and have effect in place of certain common law rules and principles of equity. It also explains that the general duties should be interpreted and applied in the same way as common law rules and equitable principle. Moreover, when interpreting and applying the statutory duties, the common law rules and equitable principles that the general duties replaced should be consulted. Finally, s 170 also identifies that the civil consequences of breach of the statutory duties are the same as those that would apply if the corresponding common law rule or equitable principles were applied.

## Scope and nature of general duties

Section 170 of the Companies Act 2006 provides the context for the newly codified duties of directors.

1 The general duties specified in ss 171 to 177 are owed by a director of a company to the company.
2 A person who ceases to be a director continues to be subject:
   (a) to the duty in s 175 (duty to avoid conflicts of interest) as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director, and
   (b) to the duty in s 176 (duty not to accept benefits from third parties) as regards things done or omitted by him before he ceased to be a director.

   To that extent those duties apply to a former director as to a director, subject to any necessary adaptations.
3 The general duties are based on certain common law rules and equitable principles as they apply in relation to directors and have effect in place of those rules and principles as regards the duties owed to a company by a director.
4 The general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties.
5 The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply.

It is clear from s 170(1) that these general duties are owed by a director to the company. Thus, only the company or members acting on behalf of the company (derivative claims such as those contained in Part 11 of the CA 2006) can enforce them. The duties apply to directors of the company, *de facto* directors and, in some cases, to former directors.

It is important to note a number of key issues at this stage. First of all, s 170(3) emphasizes the fact that these general duties are based on common law rules and equitable principles and, as such, should be interpreted and applied in the same way as the previous rules. This is not only significant in terms of using the case law so as to support the implementation of these codified duties of directors but also suggests a rather smoother transition from one era to another (i.e. common law to statute) in this area. Secondly, when considering the consequences of any breach of these statutory duties, or the way in which they are to be enforced, s 187 provides:

1 The consequences of breach (or threatened breach) of ss 171–177 are the same as would apply if the corresponding common law rule or equitable principle applied.
2 The duties in those sections (with the exception of s 174 (duty to exercise reasonable care, skill and diligence)) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors.

Consequently, in order to appreciate fully the general duties embodied in the Companies Act 2006, as well as to gain an insight into how the courts are likely to interpret and subsequently apply these statutory legal obligations, it is necessary to review the fiduciary duties which, until recently, bound directors. In this regard, a review of the common law duties which have led to the development of Chapter 2 of Part 10 of the Companies Act 2006 will be undertaken alongside the statutory duties of directors.

## Duty to act within powers

### The statutory duty

Section 171 of the Companies Act 2006 states:

> A director of a company must:
> (a) act in accordance with the company's constitution, and
> (b) only exercise powers for the purposes for which they are conferred.

### The related common law and equitable principles

One of the main considerations to be borne in mind is that directors use their powers for the proper purpose (i.e. for the benefit of the company and not to further their own interests). Consideration has already been given to this rule which is illustrated by the decisions in the ***Rolled Steel*** case (see Chapter 6), ***Clemens*** v ***Clemens*** (see Chapter 15) and ***Galloway*** v ***Hallé Concerts Society*** (see Chapter 17) among others.

See pp. 129 and 289
See p. 334

A further example of improper use of power by directors is to be found in situations where directors have issued new shares to persons who were their nominees, e.g. the company's pension trustees, not because the company needed more capital (the proper purpose of a company's directors issuing shares) but to defeat a genuine takeover bid by another company. The nominees they knew would not accept the bid so that the bidder would not get an adequate majority of shares and so not proceed with the bid, thus keeping the directors in power (see ***Hogg*** v ***Cramphorn*** [1966] 3 All ER 420). There is, of course, statutory protection in this area in that the directors require the authority of the members to allot shares, and there are also pre-emption rights given to existing shareholders unless the shareholders have disapplied them. Nevertheless, cases such as ***Hogg*** have a continuing relevance since in private companies these rights may be disapplied by the articles. In such a situation, the case law would have to be used to render the allotment of shares to the nominees invalid. A further 'poison pill' device was before the High Court in the following case.

### ***Criterion Properties plc*** **v** ***Stratford UK Properties LLC*** [2002] 2 BCLC 151

The managing director of the claimant company made an agreement with a substantial shareholder that required the company to buy out the shareholder at a high price should there be a change of control or composition of the board of directors of the company. The managing director was later removed from office and the company asked the court to set aside the agreement because it was entered into for an improper purpose. The High Court ruled that the agreement, which was intended to put off an unwelcome bidder, in a predatory takeover, had been made for an improper purpose. The damage that would be caused to the company by making the substantial shareholder buy-out would be greater than any harm likely to be inflicted on it by an acquisition. The agreement was not a proper exercise of a director's powers and could not be enforced against the company.

**Comment**

A 'poison pill' is North American jargon for a legal device of any form put in place by the management of a company that feels vunerable to predatory acquisition, designed as a defence mechanism to eliminate or reduce that risk. Other expressions such as 'shark repellant' are also used.

See p. 94

Therefore, a director has a duty to exercise the company's powers for the purposes for which they were allocated to him and the Board of Directors (see discussion in Chapter 4). This is reinforced by Turner LJ's statement in ***Re Cameron's Coalbrook Steam Coal, and Swansea and Kougher Railway Co, Bennett's Case*** (1854) 5 De GM & G 284,

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

The question naturally arises as to where the limits of a director's powers end and when an individual starts to overstep what is deemed to be an acceptable use of their powers. In many instances, a common sense approach will suffice as a company's articles should outline the various powers/day-to-day decision-making activities which have been given to the board of directors. However, this will not always be the case and, in those instances, it will be necessary to look at the specific facts of the case and for the court to decide if a power has been exercised for a proper or improper purpose and as to whether the director has acted in accordance with the company's constitution (***Howard Smith Ltd*** v ***Ampol Petroleum Ltd*** [1974] AC 821).