

## DIRECTORS' FIDUCIARY DUTIES

**Were the statutory duties in the Companies Act 2006 intended to be simply a replacement without change?**

**Is the CA giving effect to Parliament's intentions?**

### **A presentation by Julian Wilson**

Under the codification measures in Chapter 2 of the Companies Act 2006, a director's general duties to the company are now statutory:

- s.172 sets out the duty to promote the success of the company for the benefit of its members having regard to Enlightened Shareholder Value considerations.
- s.175 sets out the duty to avoid conflicts of interest unless pre-authorised by unconflicted board members.
- s.176 sets out the duty not to accept benefits from third parties.
- s.177 sets out the duty to declare interests in a proposed transaction

The codified duties replace the common law rules and principles: section 170 (3) provides that the general duties in Chapter 2 "...*have effect in place of those rules and principles as regards the duties owed to a company by a director.*"

According to section 170 (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.*"

But is this a replacement without change?

The CA seems to have thought so in the recent case of Towers –v- Premier Waste [2011] EWCA Civ 923 in which Mummery LJ stated of the statutory rules that: "*They extract and express the essence of the rules and principles which they have replaced*".

The case concerned the liability of a director (Mr Towers) of a waste disposal and treatment company who received, without the knowledge of the company's board, the free loan of some old and dilapidated excavating machinery from one of the company's customers which he used to renovate buildings belonging to him and his wife. The loan to him from the customer was arranged indirectly by an employee of the company who also arranged for the company to advance the cost of replacing tracks on the excavator which the customer later repaid, a matter of which the director had not been aware at the time. The litigation started when the customer who had never taken back the hired equipment invoiced the company for the cost of hire. The company brought an action for a negative declaration and joined Mr. Towers seeking an account of profits. The company and the customer settled leaving the company's claim against Mr. Towers.

Mr. Towers contended that the situation was not one of any real conflict and there was no loss to, or effect on, the Company's business. However, the Trial Judge readily found Mr. Towers liable for breach of fiduciary duty and awarded the company equitable compensation in the amount of the benefit to him of the cost of hire, some £5,200 plus interest.

Arden L.J. granted Mr. Towers permission to appeal to the CA. On appeal, Mr. Towers' Counsel contended that the Trial Judge had adopted a strict and technical approach to the

application of the fiduciary principle when it was in fact a broad flexible principle that covered diverse situations ranging from the corruption of a bribe to harmless hospitality gifts.

The Trial Judge had, he argued, misapplied the proper test of "*a real sensible possibility of conflict*"<sup>1</sup> having regard to a number of factors such as the small amount involved, the dilapidated condition of the plant and equipment; and the informal nature of the relationship with the customer. These could, he argued, be distinguished from things done by Mr Towers in his capacity as director of Company so that there was no real sensible possibility of conflict.

Although the case did not actually engage the new statutory duties because the facts predated their coming into force, Mummery L.J. thought it would be unrealistic to ignore them and took the opportunity, in his judgment dismissing Mr. Towers' appeal (with which Etherton and Wilson LJ agreed) to restate the universality and strictness of the fiduciary doctrine as being the basis for the interpretation and application of the statutory duties in ss.172, 175 and 176:

"Lord Cranworth LC in *Aberdeen Railway Co v. Blaikie* 1 Macq 461 at 471 explained how potential conflicts of interest are to be avoided by those who are committed as directors to be loyal to the company:- " *And it is a rule of universal application, that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interest of those whom he is bound to protect. So strictly is this principle adhered to, that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.*"

"In *Boulting v Association of Cinematograph, Television and Allied Technicians* [1963] 2 QB 606 at 636 Upjohn LJ said that the principle has nothing to do with establishing that the director is guilty of fraud or corruption. In the case of a company director the principle recognises the primacy of the interests of the company which he is trusted not to betray. Thus a company is entitled, in the words of Upjohn LJ, "*to the undivided loyalty of its directors.*"

In his submissions on the appeal, Counsel for Mr. Towers had reminded the CA that Upjohn LJ had in the same case (at pp 636 and 638) referred to the rule as being a broad and flexible one to be fashioned according to changing circumstances and to be applied with common sense and realistically. If that submission had been intended to invite any reappraisal in light of codification, it was an invitation Mummery L.J declined:

"That approach to the formulation and the application of the principle does not... undermine the strict nature of the liability enshrined in the principle where it applies. The rationale and the justice of the principle lie in its strict regard for the protection for those interests potentially at risk from a director who does not give his undivided loyalty to the company.

Thus a director's liability for disloyalty in office does not depend on proof of fault or proof that a conflict of interest has in fact caused the company loss: *Foster Bryant Surveying Ltd v Bryant* [2007] EWCA Civ 200."

Mummery L.J. continued by referring to the principle that a director who takes a business opportunity for himself is liable even where he acts in good faith and where the opportunity is not one which the company itself would have exploited:

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<sup>1</sup>"The phrase 'possibly may conflict' requires consideration. In my view it means that the reasonable man looking at the relevant facts and circumstances of the particular case would think that there was a real sensible possibility of conflict; not that you could imagine some situation arising which might, in some conceivable possibility in events not contemplated as real sensible possibilities by any reasonable person, result in a conflict." Words of Lord Upjohn in *Boardman v Phipps* [1967] 2 AC 46, 124. Though Lord Upjohn was in dissent in *Boardman*, his dissent was on the facts only and his opinion is generally regarded as an accurate statement of the law.

“A director's potential conflict of interest may arise, for example, in connection with a business opportunity. If a director obtains the opportunity for himself, he will be liable to the company for breach of duty regardless of the fact that he acted in good faith or that the company could not, or would not, take advantage of the opportunity. As explained by Lord Russell of Killowen in *Regal (Hastings) Ltd v Gulliver* [1967] AC 134 at 144 the liability of a fiduciary to account for the profit made by use of his position- “...in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of a profit having, in the stated circumstances, been made. The profiteer, however honest and well intentioned, cannot escape the risk of being called upon to account.” Equity's response of strict liability to account for breach of a fiduciary duty is similar whether the liability is triggered by an event which breaches the loyalty duty, or the "no conflict principle", or the "no profit principle.”

He held that submissions, addressed to the scope of Mr. Towers' duty, that there was no significant profit or benefit to Mr. Towers and that the plant and equipment in their poor condition would have been of no value to the company, missed the point. The “no conflict” duty extended to preventing Mr Towers from “*disloyally depriving the Company of the ability to consider whether or not it objected to the diversion of an opportunity offered by one of its customers away from itself to the director personally*”.

None of the factors of the absence of evidence that the company would have taken the opportunity itself, of any loss to it, of any corrupt motive of Mr. Towers, of any evidence Mr. Towers would have hired the equipment in the market absent the free loan, were held to support the contention that there was no breach of loyalty or the non-conflict duty.

Mr. Towers' attempt to be relieved of liability under s.1157 CA 2006 was also dismissed on essentially similar grounds.

#### **Comment on *Towers*: did it ignore intended changes and an intended reasonableness test?**

The CA proceeded on the basis that the provisions in ss. 172, 175 and 176 of the 2006 Act restate previous law.

Was that right?

Most observers regard the s.172 duty - as a development of the law, albeit a modest one. Indeed, Margaret Hodge MP who was responsible for its gestation presented the section as being “part of a wider recognition and encouragement of change”.

And what about ss.175 (4) (a) and 176 (4) which provide that the no conflict and no profit duties are not infringed “*if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; and “if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest.*”

In Parliament, Lord Goldsmith, then Attorney General, in the Lords Grand Committee, on 6 February 2006 (Hansard, column 293) explained that these provisions introduced a reasonableness test:

“Following consultation, the Government have already adjusted the provision...to use instead the expression “*if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest*”. This introduces the concept of reasonableness which makes the situation easier from the point of view of a director and avoids a very harsh test, although it is still a heavy duty and intended to be so.”

It is difficult to read the decision in *Towers* as consistent with any reasonableness test.

Overall, *Towers* seems to this observer be an odd case. Whilst the director ought to have disclosed the benefit, this was at most only a potential conflict situation. The hire of the dilapidated plant and equipment was not something it seems likely the company would have ever wished to exploit. Although there was evidence that Mr. Towers had signed off transactions with the customer, there was no evidence that the loan had influenced the terms in any way. There was no diversion of a business opportunity which it was realistic to assume the company should have enjoyed. However one looks at it, it seems that the benefit derived by the director was relatively *de minimis*. It was hardly worthy of the description of a secret profit. Mummery LJ himself commented on the modest amounts at stake and his surprise at the absence of a settlement.

Why was it argued in the CA at all? Why did Mummery LJ address it against the background of the statutory duties in the 2006 Act when the old law was applicable?

Is it evidence of a divergence of views within the Lord Justices in the CA as to whether the strictness of the fiduciary enforcement principle, requiring a director to account to the company for benefits derived in situations of potential conflict of interest even where he acted in good faith and the company suffered no loss, is overdue for relaxation?

Lady Justice Arden who gave Mr. Towers permission to appeal in *Towers* is known for dicta to that effect. She has said :

“it may be that in the current day and age such a rule is too harsh for modern circumstances”: John Taylors v Masons [2001] EWCA Civ 2106 at [41]

“It may be that the time has come when the court should revisit the operation of the inflexible rule of equity in harsh circumstances, as where the trustee has acted in perfect good faith and without any deception or concealment, and in the belief that he was acting in the best interests of the beneficiary. I need only say this: it would not be in the least impossible for a court in a future case, to determine as a question of fact whether the beneficiary would not have wanted to exploit the profit himself, or would have wanted the trustee to have acted other than in the way that the trustee in fact did act. Moreover, it would not be impossible for a modern court to conclude as a matter of policy that, without losing the deterrent effect of the rule, the harshness of it should be tempered in some circumstances. In addition, in such cases, the courts can provide a significant measure of protection for the beneficiaries by imposing on the defaulting trustee the affirmative burden of showing that those circumstances prevailed.” Murad v Al-Saraj [2005] EWCA Civ 959 at [82].

In the same case, Lord Justice Jonathan Parker supported Arden L.J.’s view:

“there can be little doubt that the inflexibility of the ‘no conflict’ rule may, depending on the facts of any given case, work harshly so far as the fiduciary is concerned. It may be said with force that that is the inevitable and intended consequence of the deterrent nature of the rule. On the other hand, it may be said that commercial conduct which in 1874 was thought to imperil the safety of mankind may not necessarily be regarded nowadays with the same depth of concern. So, like Lady Justice Arden, I can envisage the possibility that at some time in the future the House of Lords may consider that the time has come to relax the severity of the ‘no conflict’ rule to some extent in appropriate cases.” Murad –v- Al-Saraj [2005] EWCA Civ 959 at [121].

Did Mr. Towers get lucky in having the Lady Justice allocated to his permission application but get unlucky in the members of the CA allocated to hear his appeal?!

**In enacting s. 175 (4) (a) “if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest” did Parliament intend a change to the “no conflict rule” in determining the scope of the duty owed by a director?**

Lord Goldsmith told the Lords Grand Committee of the codification of the “no conflict duty” on 9 May 2006, (Hansard column 864):

“...the duty does not apply if the situation cannot reasonably be regarded as being likely to give rise to a conflict of interest. If the matter falls outside the ambit of the company’s business, a real conflict of interest is unlikely”.

The CA does not agree.

In Re Allied Business and Financial Consultants Ltd: O’Donnell -v- Shanahan [2009] EWCA Civ 75; [2009] B.C.C. 822, a case about directors’ conduct prior to the coming into force of the statutory duties, but decided afterwards, the CA (Rimer LJ with whom Waller and Aikens LJJ agreed) held that a director who takes personal advantage of information or an opportunity which comes to him in his capacity as a director will be liable to account to the company for the benefit he derives even if the information or opportunity regards a matter outside the scope of the company’s business.

This is because the nature of a director’s fiduciary duties is unlimited and akin to a general trusteeship. Where a company has general objects in its memorandum so that the scope of the company’s business is in no manner relevantly circumscribed by its constitution, it is fully open to it to engage in areas of business other than those in which it is trading if the directors so choose. Therefore, considerations of improbability that the company could or would want or be able to take up an opportunity outside its main area of business are irrelevant. If the opportunity was there for the company to consider and, if so advised, to reject, it is no answer to the claimed breach of the “no profit” rule that the business opportunity offered was something that the company did not do.

In *Re. Allied*, the company was jointly owned and controlled by 3 shareholder directors and its business was the provision of financial and business advice and assistance. The conduct of two company directors in purchasing a property for investment purposes on their own behalf rather than through the company was alleged to have unfairly prejudiced a third director.

At first instance the Deputy Judge held that as the acquisition of property for investment had not been within the scope of the company’s business and there was no real sensible possibility of a conflict with their fiduciary duties owed to the company as directors, there was no unfair prejudice. Although the authorities made clear that, if a breach of the no conflict or no profit rules was made out, it did not matter if the company could not of itself have proceeded with the transaction, it did appear to be permissible to take into account when determining the scope of the directors’ duties and in deciding whether there was a “real sensible possibility of conflict” the inherent likelihood in fact of the company extending its existing scope of business into areas of business which might give rise to a conflict.

The CA held that the Deputy Judge had been led into error by relying on a partnership authority to that effect in which the partnership agreement circumscribed the partnership business and the partners’ duties. The authorities relating to directors’ accountability not only did not support the “scope of business” exception in relation to the “no profit” rule, they were contrary to it: Keech v Sandford (1726) Sel. Cas. Ch. 61 ; Parker v McKenna (1874–75) L.R. 10 Ch. App. 96 ; Furs Ltd v Tomkies (1936) 54 C.L.R. 583 ; Regal (Hastings) Ltd v Gulliver [1967] 2 A.C. 134n applied.

According to Rimer LJ:

“The statements of principle in the authorities about directors’ fiduciary duties make it clear that any inquiry as to whether the company could, would or might have taken up the opportunity itself is irrelevant; so also, therefore, must be a “scope of business”

inquiry. The point is that the existence of the opportunity is one that it is relevant for the company to know and of which the director has a duty to inform it. It is not for the director to make his own decision that the company will not be interested and to proceed, without more, to appropriate the opportunity for himself. His duty is one of undivided loyalty and this is one manifestation of how that duty is required to be discharged” at [70]

### **Comment on *Re.Allied***

*Re Allied* was decided on facts arising before the 2006 Act came into force but can be referred to as a guide to the interpretation of the statutory provisions including the meaning of the phrase “*if the situation cannot reasonably be regarded as giving rise to a conflict of interest*”.

Yet, is the CA’s decision consistent with Parliament’s intention as regards s. 175?

Or did Lord Goldsmith merely mis-state the existing law?

### **Policy?**

The policy behind the CA’s judgments in *Re Allied* and *Towers* appears to be to give precedence to the duty of disclosure and the seeking of informed consent above any considerations of reasonableness or scope of duty.

As the whole basis of the fiduciary principle is to preclude the fiduciary from being swayed by considerations of personal interest and from misusing his position for personal profit, is the CA’s approach the pragmatic one. Could fiduciaries be relied upon to make sound judgments of reasonableness and scope of duty?

### **Back to replacement without change**

If the appeal in *Towers* amounted to a failed attempt following the codification of the duties to remould the equitable rules in favour of the director, the application made in the recently reported case of *Thermascan-v-Norman* [2011] B.C.C. 535; [2009] EWHC 3694 (Ch) can perhaps be regarded a failed attempt to remould them in favour of the company.

### ***Thermascan*: s.170 (2) read with s.175 provides no basis to extend the pre-existing law against the exploitation of business opportunities by directors after resignation**

The case concerned an application for an interim injunction to restrain Mr. Norman, a former director, from soliciting the business of any of the company’s clients.

Mr. Norman’s contract of employment contained a covenant that he would not without the prior consent of the company, for six months after the termination of his employment canvass, solicit or approach for orders any person with whom he had dealt at any time during the 12 months preceding the termination date as a client or customer of the company.

Even though that covenant had expired by the time of the company’s application, the company sought the injunction restraining Mr. Norman from soliciting or canvassing any of its clients on the basis that this prohibition could be derived from Mr. Norman’s statutory duties as a former director.

The company relied on s.175 under which a director has a duty to avoid a situation in which he has a direct or indirect interest that conflicts with the interests of the company (including the exploitation of the company’s property, information or opportunity and s. 170 (2) which provides that the s.175 duty as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director, applies also to a former director.

The company's application was dismissed after Counsel for the company accepted that those sections of the 2006 Act did not alter the pre-existing law.

CMS Dolphin Ltd v Simonet [2002] B.C.C. 600 , Hunter Kane Ltd v Watkins [2003] EWHC 186 (Ch) and Foster Bryant Surveying Ltd v Bryant [2007] EWCA Civ 200 provided a line of authority which analysed and described the fiduciary obligation of directors and former directors to their companies. They showed that a director was precluded from taking any property or business advantage of the company, especially where he was a participant in the negotiations, even after his resignation, if the resignation was prompted or influenced by a desire to acquire for himself any maturing business opportunities sought by the company. However, a director was entitled to resign from his company and after ceasing the relationship by resignation or otherwise a director was in general (and subject to any terms of the contract of employment) not prohibited from using his general fund of skill and knowledge acquired while a director, even including such things as business contacts and personal connections made as a result of his directorship.

This line of authority was the basis for the statutory provisions and provided no grounds for any blanket prohibition on canvassing or soliciting the business of any client of the company.

Whilst it might be right that it was not necessary for the company to show that there were formal negotiations underway at the time of the resignation of Mr. Norman, it was hard to see how the company could demonstrate the existence of a "maturing business opportunity" if there had been no actual discussion of the potential business. Further, Mr. Norman's resignation had not been prompted or influenced by any desire to acquire any maturing business opportunities sought by the company at the time of the resignation.

#### **End note on the codification of director's duties**

The more things change, the more they stay the same.

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