RESEARCH PAPER

IN

CRIMINAL LAW AND COMMERCIAL AND COMPANY FRAUD

N.E.SAINSBURY

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CRIMINAL LAW AND COMMERCIAL AND COMPANY FRAUD

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SECTION 321 OF THE COMPANIES ACT 1955:

AN EXAMINATION OF THE TERM "MISFEASANCE" AS USED IN THAT SECTION, AND THE LIABILITY OF DIRECTORS AND AUDITORS FOR MISFEASANCE.

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CHAPTER ONE

INTRODUCTION

Companies legislation in England, Australia and New Zealand contain what is known as a "misfeasance" section. In the Companies Act 1955, the misfeasance section is Section 321, which provides as follows:

> "If in the course of winding up a company it appears that any person who has taken part in the formation or promotion of the company, or any past or present director, manager, or liquidator, or any other officer of the company, has misapplied or retained or become liable or accountable for any money or property of the company, or been guilty of any misfeasance or breach of trust in relation to the company, the Court may, on application of the Official Assignee, or of the liquidator, or of any creditor or contributory, examine into the conduct of the promoter, director, manager, liquidator or officer, and compel him to repay or restore the money or property or any part thereof respectively with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust as the Court thinks just."

This paper is concerned with the following matters:

1. There appears to be considerable confusion in the case-law as to the meaning of the term "misfeasance". Accordingly, an attempt will be made, based on an examination of the case-law, to determine what meaning the Courts have ascribed to the term, and the nature of the conduct following within it. The case-law in England, Australia, and New Zealand will be examined, in order to determine whether, in these countries, the Courts' interpretation of the term differs to any degree.

2. There is some indication that the Courts approach the question of liability of auditors for misfeasance on a different footing

from the question of the liability of directors. Again, the case-law will be examined to determine whether there is such a difference in approach. If such a difference is found to exist, an attempt will be made to explain it.

3. The Uniform Companies Amendment Act, 1971 (N.S.W.) appears to have removed some of the difficulties involved with the term "misfeasance". The Macarthur Committee would like to see similar legislation introduced into New Zealand. However, in Canada, proposed Business Corporations legislation appears to go much further than the Australian legislation in removing some of the problems. Accordingly, it is intended to examine both the Australian and proposed Canadian legislation, in order to determine whether it is preferable that legislation of the type proposed for Canada be introduced into New Zealand, rather than legislation of the Australian type.

CHAPTER TWO

THE MEANING OF "MISFEASANCE"

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1. THE POSITION IN ENGLAND -

A section equivalent in wording to Section 321 of the Companies Act 1955, has been part of legislation in England since 1862 [1], when it made its appearance for the first time as Section 165 of the Companies Act, 1862 (U.K.)

One of the earliest cases to be decided cases to be decided under Section 165 was In re County Marine Insurance Company (Rance's Case) (1871) 6 Ch. App. 104. In this case, the directors of the company had declared a bonus of 10 shillings per share. This declaration had been agreed to at a general meeting of the company, and the bonus had been paid. In the case of Mr. Rance, who was one of the directors of the company, and also a shareholder, the bonus was credited against arrears of calls due from him. Despite a direction in the articles of association to the contrary, the directors had not prepared a profit and loss account to be placed before the general meeting, but prepared only an account of the receipts and payments of the company, which made no allowance for the risks to which the company was liable, and from which no idea could be formed of the condition of the company. The bonus was, in fact, paid out of capital and not out of profits. The company subsequently resolved to wind up voluntarily, and in the winding up, the liquidator took out a summons against Mr. Rance under Section 165, calling upon him to refund the bonus received by him, on the ground that the bonus had been paid out of the capital, and not out of the profits of the company. Lord Romilly MR took the view that, although the declaration of the bonus was not justified having regard to the state of the company at the time, the bonus was declared , there was no proof that the directors had not acted bona fide, and he accordingly set aside the summons taken out against Mr. Rance. The liquidator appealed against this decision. In the Court of Appeal Sir W.M.James L.J. took a very dim view of the events that had taken place. He pointed out that the directors had made no attempt to comply with the articles of association. Speaking of the directors, he said

> "If the directors, by placing unfound reliance upon the representations of their servants or actuaries had arrived at the conclusion that they had made a divisible profit, this Court ought not, I say, to sit as a Court of Appeal from that conclusion, although it might afterwards be satisfactorily proved that there were very great errors in the accounts which would not have occurred if they had been made out with greater strictness, or with more scrutinising care ...."[2]

But of the document prepared by the directors in this case he said:

> "It purported to show something....which any man who applied his mind to the subject would say afforded no clue whatever to the profit, which had been made. They might as well have put before the meeting a sheet out of a newspaper...." [3]

He concluded that there had been "a gross neglect of duty" on the part of the directors with respect to their conduct in declaring the bonus, and held that the balance sheet was "delusive and fraudulent." Accordingly he gave judgment for the liquidator.

Sir G. Mellis LJ took a similar view to Sir W.M.James LJ, taking the view that a declaration of a bonus without any profit or loss account having been made out was

> " .... a mala fide proceeding on the part of the directors within Section 165" [4]

He also gave judgment in favour of the liquidator, and accordingly Mr. Rance was ordered to pay the bonus received by him.

Although this case has been cited for the proposition that a misfeasance summons is the proper mode of procedure where directors have improperly paid dividends out of capital [5], it is difficult to determine what the Court thought misfeasance actually consisted of. Nowhere in the judgment of Lord Romilly MR or the Court of Appeal is the word "misfeasance" referred to. However, the Court appears to have been concerned with a misapplication of the Company's money, and it may be that this was thought to constitute misfeasance. If that view is correct, then it would appear that the Court was not prepared to hold the directors liable unless it could be shown that they had grossly neglected their duties.

In <u>The Overend and Gurney Company v. Thomas Jones Gibb and John Darby Gibb</u> (1870) L.R. 5 H.L. 480, the facts were that the business of The Overend and Gurney Company had been carried on for many years and the firm was considered to be financially sound. In 1857, losses were incurred by the company, and it was found that the company was insolvent to the extent of £2,000,000. Business was carried on until 1865, when, in June 1865, a scheme was suggested for forming a joint stock company, which when established was to purchase the business of The Overend and Gurney Company. The joint stock company was formed on 12th July 1865. The state of affairs of that company were fully known to all those who took part in the formation of the joint stock company. The memorandum of association of the joint stock company empowered the company to carry on the business of The Overend and Gurney Company. The articles of association empowered the directors to purchase the business of The Overend and Gurney Company, and the directors proceeded to purchase the business. The joint stock company subsequently made substantial losses. The members of the joint stock Company, in the subsequent winding-up, sought to have the directors declared jointly and severally liable for the losses made by the company in consequence of the purchase of the business of The Overend and Gurney Company.

The House of Lords criticised the terms of the bill brought against the directors. In the words of Lord Chelmsford :

"Now there is no charge in the bill of any fraudulent conduct on the part of the directors, or of any breach of duty, or of any negligence, or of their not having honestly done what they considered to be their duty towards the company, the existing shareholders, and those who might become so. Then what is the ground upon which they are sought to be made liable for all the loss which has been sustained in consequence of the failure of the company a short time after it was incorporated? As I understand it, it is this : it is alleged that the directors were trustees for the company, and that in purchasing the business they did an act so improvident and imprudent that it amounted to what is called crassa negligentia and consequently to a breach of trust ...." [6]

After examining the facts of the case, Lord Chelmsford took the view that the directors had done what they were authorized to do honestly and fairly, believing that they were doing it in the discharge of their duty.

Lord Hatherley, L.C. said that the directors simply acted in the execution of what they believed to be their duty.

"....however mistaken they may now appear to have been in the view they took. That is, of course, a very great step towards the solution of the question one has to investigate, because the question is then simply reduced to this : whether or not the directors exceeded the powers entrusted to them, or whether if they did not so exceed their powers they were cognisant of circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into?" [7]

Lord Hatherley went on to say that he could not say that anything had happened which would justify the Court in coming to the conclusion that the directors, acting in good faith, although imprudently, acted with such an amount of clear and gross negligencea as would justify the finding that the directors were liable to refund moneys misappropriated in the purchase of the business.[8]

Their Lordships appear to have been unanimous in their view that the directors had done what they were authorised by the articles of association to do, and the headnote to this case accurately states the ratio of this case :

> "Facts which may show imprudence in the exercise of powers undoubtedly conferred upon directors will not subject them to personal responsibility; the imprudence must be so great and manifest as to amount to <u>crassa negligentia</u>."

Although this case is commonly cited in cases dealing with the question of liability for misfeasance, it is doubted whether this case can correctly be considered as having been decided under Section 165 of the Companies Act, 1862. Proceedings were brought by means of a bill rather than a summons, and nowhere in the case is any mention made of "misfeasance". It has been said that the case did not involve a misfeasance summons at all:

> "... but a bill in equity seeking the recovery of money from directors of a company as upon a breach of trust ......The case says nothing as to the scope of the relief available on a misfeasance summons." [9]

This appears, with respect, to be the correct view of the case. But in that the bill sought relief similar to that which would have been sought under a misfeasance summons, does the case contain guidance on the way in which the matter would have been approached had the case been brought before the Court on a misfeasance summons? On the assumption that the question may be answered in the affirmative, then it would appear that the House of Lords would not hold directors liable under a misfeasance summons, where they had acted within their powers, unless it could be shown that there was evidence of "crassa negligentia"

The next case to be considered is In re British Provident Life and Guarantee Association (De Ruvigne's Case) (1877) 5 Ch.D.306. In this case, the directors of the company, in its name, entered into an agreement with one Thomas Hunt that the capital of the company should be increased, and that he should endeavour to obtain subscribers for the new shares to be issued. It was agreed that Hunt would receive, by way of remuneration, a large commission on the nominal value of the new shares taken up, and also a number of shares issued as fully paid up to him or his nominee, of which 1000 were to be issued as soon as the directors had accepted four persons to be nominated by him as directors or trustees of the company. De Ruvigne on the nomination of Hunt agreed to become a director, and it was understood that he was to be qualified by holding 200 fully paid-up shares, which Hunt was to find for him. De Ruvigne was subsequently elected a director. A further agreement was entered into between Hunt and the company, to the effect that 2000 shares should be allotted to him or his nominees, as part of the consideration to which he was entitled under the first agreement. Subsequently, 200 of the specified shares were, at Hunt's request, allotted to De Ruvigne, and were, with his assent, registered in his name as fully paid-up. Nothing was, in fact, paid for them. In the subsequent winding up of the company, the liquidator took out a misfeasance summons against De Ruvigne under Section 165 of the Companies Act, 1862, seeking to hold him liable for the value of the 200 shares he had received. In the Court of Appeal, James L.J. said that without doubt the liquidator had proved very grave misconduct against De Ruvigne:

> "It is difficult to understand how people can lend themselves to transactions of this kind. But we have here an agreement by the company, however, it was then constituted or managed, with Mr. Hunt which was the merest sham I ever saw, and I cannot understand how any directors could have sanctioned such an agreement, or have

affixed the seal of the company to it.... It is a thing utterly ultra vires and void, besides being from its very nature a fraud if it was ever carried into effect ...." [10]

Brett, J.A. said, that he thought that De Ruvigne could only be liable under Section 165 if the Court could say that he had been guilty of a misfeasance. He defined the term misfeasance as

"...some act which amounts ot misconduct in relation to the company".[11]

He regarded both agreements as sham agreements, whose only effect was

"...to give money to Hunt and to keep money for De Ruvigne, that is, to keep it in the shape of shares paid up. I cannot help thinking, without wishing to use harsh words, that that is misconduct, the grossest misconduct, on the part of a person who assumes to be the director of a company and therefore that Colonel De Ruvigne is within the 165th Section - that he has been guilty of a misfeasance in the shape of misconduct by which he has wrongfully taken into his own hands 200 of the shares of this company ....." [12]

Amphlett J.A. took the same view of the facts of the case, but expressed the view that in taking the shares, De Ruvigne had committeed a fraud on the company.

"He took these shares for the purpose of giving him the appearance at least of having a qualification as director. These shares are described as paid-up shares, they are entered in his name in the company's register and cash is stated to have been paid for them, which is entirely untrue".[13]

Thus, the Court held De Ruvigne liable for misfeasance under Section 165, and ordered him to pay to the liquidator the value of the 200 shares he had obtained.

In this case, misfeasance was defined as

"some act which amounts to misconduct in relation to the company".

The "misconduct" on the part of De Ruvigne consisted in his taking the shares, and involved misapplication of the company's property.

In in re In re Englefield Colliery Company (1878) 8 Ch.D.388 a Mr. Sheridan agreed with a Mr. Edwards, that he (Sheridan) would form a company to purchase and work a colliery which Edwards had power to sell. It was agreed that Sheridan would sell the colliery to the company for a certain price in cash and shares, and that the balance, after payment of "preliminary expenses" would be equally divided between the two men. Sheridan proceeded to promote the formation of a company which would purchase the colliery for £25,000 in cash, and £25,000 in paid-up shares, and induced six men to become directors of the company, on the terms that they would not pay for their shares. The articles of association empowered the directors to pay the preliminary expenses attending the formation of the company, but left it as a matter for them, in the exercise of their discretion. However, the directors in fact entered into an agreement with Sheridan, that he would receive the sum of £3,500 for preliminary expenses. Sheridan subsequently received £3,200 from Edwards, and received £3,500 from the company, out of which he paid the calls on the qualification shares taken by the directors. In the subsequent winding-up, the liquidator took out a misfeasance summons under Section 165 of the Companies Act, 1862, seeking to hold the directors jointly and severally liable to the company for the sum paid to Sheridan by way of "preliminary expenses". Malins V.C. took the view that the transaction was "a mere trick".

> "It was a clear misfeasance on the part of the directors, and a gross breach of trust by them....."(14)

He held that the directors were jointly and severally liable to repay to the company the sum paid to Sheridan for preliminary expenses, on the ground that the money was paid in order to provide the directors' qualifications.

One of the directors appealed from the judgment of Malins V.C. to the Court of Appeal, which affirmed thejudgment of Malins V.C., except insofar as Malins V.C. had taken the view that there was fraud on the part of the directors. Jessel MR pointed out that Clause 81 of the articles of association conferred a discretion upon the directors with respect

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to the payment of preliminary expenses. Before paying him, the directors should have asked Sheridan what he had received, or was going to receive for promotion of the company from any other quarter, and to ensure that he would not be paid twice over. But by entering into the agreement with Sheridan, Jessel, MR said, they had bound themselves hand and foot, so that they could not exercise the discretionary power conferred on them by Clause 81, and the transaction could not be represented as an honest bona fide exercise of that discretion. [15]

Both Baggallay and Thesiger L.JJ took a similar view of the facts of the case. The Court of Appeal did not discuss the reference of Malins V.C. to "misfeasance and gross breach of trust." However, it would appear from the judgment of Malins V.C. that he regarded what he considered to be fraud on the part of the directors to amount to misfeasance. As mentioned, the Court of Appeal disagreed that there was fraud on the part of the directors. Although the term "misfeasance" was not discussed in the judgment of the Court of Appeal, it would appear that the Court regarded the misapplication of the company's money [16] as misfeasance, In that respect, therefore, therefore, the case is similar to <u>De Ruvigne's Case</u> (ante p.8)

In <u>In re Forest of Dean Coal Mining Company</u> (1878) 10 Ch.D 450, upon the winding up of the company, the liquidator took out a misfeasance summons under Section 165 of the Companies Act, 1862, seeking to hold a Mr. Barrett liable for misfeasance in not taking steps to recover for the company the sum of £10,000 improperly paid to the promoter of the company, on the formation of the Company, and of which transaction Mr. Barnett had been aware. Jessel MR refused to hold Barrett liable for misfeasance. At p. 459 he said:

> "... Again, directors are called trustees. They are no doubt trustees of assets which have come into their hands, or which are under their control, but they are not trustees of a debt due to the company...."

He went on to say that directors are bound to use fair and reasonable diligence

In the management of their company's affairs. But where, without fraud and without dishonesty, they omit to recover a debt due to the company, it by no means followed, as a matter of course, as it might in the case of ordinary trustees of trust funds or of a trust debt, that they were to be made liable. (17)

Jessel MR did not think that Section 165 applied to such as d case as this:

> "I do not think myself that the section applies to anything but what I may call fairly plain and ordinary cases of misconduct, and when I use the word 'ordinary' I mean ordinary as regards these companies, for many of them are certainly quite extraordinary as regards other transactions, or that it was intended to go beyond what was the settled law on the subject before the Statute was passed,so as to make that a case of misfeasance or breach of trust which would not have rendered a man as trustee before the passing of the Act." (18)

Why was this not a "fairly plain and ordinary case of misconduct?" There appear to be two reasons. Jessell MR pointed out that the impunged transaction took place in 1872, and Mr. Barrett became a director in 1875. The company went into liquidation in 1877. Jessel MR said that he had never heard that it had been held to be the duty of a director to communicate knowledge acquired by him years before, as to misconduct with reference to the affairs of the company on the part of other persons for which they may still be liable. (19) In any event, it was unlikely that Mr. Barrett would have succeeded in persuading his co-directors to take proceedings. As there was nooobligation upon him to tell his co-directors of the knowledge he had, so there was no obligation to initiate by resolution or otherwise any attempt to sue the promoters. Furthermore, it by no means followed that any money would have been forthcoming at the end of the protracted and very hostile litigation which would probably have resulted, as the debt was not admitted by the promoters. [20]

In In re Canadian Land Reclaiming and Colonizing Company (Coventry and Dixon's case) (1880) 14 Ch.D.660. Messrs. Coventry and Dixon were elected as directors of the company on 13th September 1876. Neither of them held any shares in the company, although by virtue of Clause 67 of the articles of association only a member holding not less than 100 shares in the company was eligible for appointment as a director. For some time, Coventry and Dixon acted as directors, although they never at any time held shares in the company. The company was not a successful venture, and just over a year after it had been registered a winding-up order was made against it. In the course of the winding-up, the liquidator took out a misfeasance summons under Section 165 of the Companies Act, 1862, seeking to hold Coventry and Dixon liable for misfeasance in having acted as directors without being qualified. Jessel MR held this to be

> "as plain a case of misfeasance or misconduct as you can possibly state..." [21]

He took the view that the fact that they were de facto and not de jure directors did not take them outside the scope of Section 165, and whether or not they could actually be described as directors, he thought they came within the term "officers" as used in Section 165. He ordered Coventry and Dixon to pay a sum equal to the nominal amount of the shares necessary to qualify them as directors. Coventry and Dixon appealed from this decision. In the Court of Appeal, James LJ stated what he considered was the effect of Section 165:

> "I am of the opinion that that section does not create any new liability or any new right but only provides a summary mode of enforcing rights which must otherwise have been enforced by the ordinary procedure of the Courts. In order to enable the Courts to apply that section, the liquidator, as it seems to me, must

show something which would have been the ground of an action by the company, if it had not been wound up. I am of the opinion also that the word 'misfeasance' means misfeasance in the nature of a breach of trust, that is to say it refers to something which the officers of such company have done wrongly by misapplying or retaining in his own hands any moneys of the company, or by which the company's property had been wasted, or the company's credit improperly pledged. It must be some act resulting in some actual loss to the company." (22)

He did not think that Coventry and Dixon in accepting nomination as directors without proper qualification had thereby been guilty of any such misfeasance or breach of trust in relation to the company. In addition, he could not see that any damage whatever had resulted to the company from anything that Coventry and Dixon had done or ommitted to do. (23) Baggallay and Bramwell L.J.J. joined with James L.J. in giving judgment for Coventry and Dixon.

Although James L.J. cited no authority, he would appear to be correct in his interpretation of the meaning of the term "misfeasance". It will be remembered that <u>De Ruvigne's Case</u> (ante p. 8) and <u>In re Englefield Colliery Co</u> (ante p. 10)both involved misapplication of companies money or property, with resultant loss. There was nomisapplication of the company's money or property in this case, but the question arises whether, in the words of Jessel MR <u>in In re Forest of Dean Coal Mining Co.</u> (ante p. 11) this was not "a fairly plain and ordinary case of misdonduct?" The answer to this question probably lies in the judgment of Baggallay L.J. in <u>Coventry and Dixon's Case.</u> On the authority of a previous case, he said that the circumstances in which Coventry and Dixon accepted office and acted as directors did not involve them in any contract to take the shares. Accordingly, the very foundation of the alleged misfeasance had been removed.

Although Coventry and Dixon's Case would appear to be correctly decided, James L.J.'s definition of the term "misfeasance" may be open to criticism. As Monahan states, the definition is not satisfactory, for he brings within the term misapplication or retainer of moneys of the company. These are, in fact dealt with by the express words of the earlier part of Section 165 [25]. It may be argued, on this view, that the definition of James L.J. renders the earlier part of Section 165 superfluous. However, even if reference to misapplication or retainer is eliminated from the definition, the reference to "misfeasance in the nature of a breach of trust" remains. [26]. It would seem from the passage taken from the judgment of James L.J. cited above that the words "in the nature of a breach of trust" refer to misapplication or retention of a company's money or property by a director. To some extent, however, the reference is confusing, as Section 165 referred to misfeasance or breach of trust. It would appear that the legislature intended"misfeasance "to be something quite distinct from "breach of trust".

In Re Wedgwood Coal and Iron Co. (1882) 47 L.T. 612, the Court held that directors of a company in liquidation could not be made liable for misfeasance under Section 165 of the Companies Act, 1862, for mere acts of nonfeasance. The Court in this case was faced with a failure on the part of the directors of the company to recover moneys due to the Company. Fry, J said -

> "...There is, however a difference, which the law recognises, between 'misfeasance' and 'nonfeasance': in other words, between sins of commission and sins of omission, and I think therefore that the legislature plainly did not refer to cases of mere non-feasance, except, of course, where there has in fact been a breach of trust. There was no intention of giving this power of

summary proceedings in such a case." (27)

The case is thus similar to In re Forest of Dean Coal Mining Co. (ante p. 11) and Fry J cited it as authority for the view he had taken of the present case. Fry L.J. exhibited a similar tendency to James L.J. in Coventry and Dixon's case (ante p.14) to limit the application of Section 165 to cases of active misfeasance, (28), although these may be said to be cases in which nonfeasance could well result, for example, in misapplication of a company's money or property. This may well explain Fry J's exclusion of nonfeasance from the scope of Section 165, except where there had been a breach of trust. It may be as well to point out, at this stage, that in In re Liverpool Household Stores Association Ltd. (1890) 59 L.J. Ch. 616 Kekewich, J. extended the scope of the term "misfeasance" one stage further than the scope of the term as seen by Fry,J. in Re Wedgwood Coal and Iron Co. and held that the misfeasance to which Section 165 of the Companies Act, 1862 was directed was not restricted to acts of commission, but extended to "all breaches of trust" in relation to a company through which loss is incurred.

In Cavendish-Bentick v. Fenn (1887) 12 A.C. 652, a director of a company, as the company's agent, purchased for the company a property in which, before he became a director he had acquired an interest. In the subsequent liquidation of the company, a shareholder, whose shares were fully paid up, took out a misfeasance summons under Section 165 of the Companies Act, 1862, seeking to hold the director liable for misfeasance on the ground that the director had allowed the company to purchase the property allegedly at a price far exceeding the value of the property, without disclosing his own interest. In the House of Lords it was held that the evidence failed to show either that the director had not disclosed his interest or that the purchase price had exceeded the value of the property. Lord Hersehell said that in order for the contributory to succeed, it was necessary for him not only to show a breach of duty, but a breach of duty which resulted in pecuniary loss to the company. The evidence did not disclose a breach of duty on the part of the director. [29]. Lord Macnaghton said that the contributory, to succeed, would also have to show a direct pecuniary interest in the success of the application. The contributory had no direct pecuniary interest in the success of the application, as his shares were fully a paid up. [30]. Speaking of Section 165, he said:

> "The 165th section of the Act has often come under discussion, and it has been settled, and I think rightly settled, that the Section creates no new offence, and that it gives no new rights, but only provides a summary and efficient remedy in respect of rights which apart from that section, might have been vindicated either at law or in equity. It has also been settled that the misfeasance spoken of in that section is not misfeasance in the abstract, but misfeasance in the nature of a breach of trust, resulting in loss to the company...."

This passage taken from the speech of Lord Macnaghten is, as was pointed out by Dixon J. in <u>Couve</u> v. <u>J. Pieere Couve Ltd. (In liquidation)</u> (1933) 44 C.L.R. 486 at 495, an allusion to what was laid down by James L.J. in <u>Coventry and Dixon's case</u> ante p. 14), but is not a complete allusion. Lord Macnaghton appears to have paraphrased the principle laid down by James L.J. There is some degree of conflict in the speeches of Lord Herschell and Lord Macnaghtan. It will be remembered Lord Herschell took the view that in order to succeed in a misfeasance summons under Section 165, the applicant must show

> "a breach of duty resulting in loss to the funds and assets of the company."

Lord Macnaghtan took the view that the misfeasance referred toin Section 165 was

> "...misfeasance in the nature of a breach of trust resulting in loss to the company."

Their Lordship's were both in agreement that loss must be shown, but appear to differ as to the nature of the misfeasance. Perhaps it is possible to reconcile the views on the basis that "misfeasance in the nature of a breach of trust" would appear to come within the slightly wider "breach of duty" referred to by Lord Herschell. On this view both definitions of the term "misfeasance" would appear to be correct, but it is Lord Macnaghtan's definition which has received attention, rather than Lord Herschell's definition, in subsequent cases.

In <u>In re New Mashonaland Exploration Company</u> (1892) 3 Cl. 577 Vaughan Williams, J. made it clear that directors could be held liable for negligence under a misfeasance summons taken out under S.10 of the Companies (Winding-Up) Act, 1890. (This section contained the same wording of Section 165 of the Companies Act, 1862) The case involved two resolutions passed by the directors of the company. Under the articles of association of the company, the directors were authorised to lend money and promote other companies. Under the first resolution, a cheque for £250 was drawn in favour of a Mr. Green, and handed to the company's solicitor, who gave it to Green without obtaining security for it, although it had been proposed in the resolution to require secutity. Under the second resolution, a cheque for £1000 was drawn in favour of Green, and passed to the solicitor, who again failed to obtain the security required by the resolution. The company subsequently obtained judgment against Green for the amount of the loans, but never realised anything under it. The company subsequently went into liquidation, and the liquidator brought a misfeasance summons under Section 10 of the Companies (Winding-up) Act, 1890, alleging that the directors were guilty of negligence of such a character as to be within Section 10. Vaughan Williams, J. said:

> "Now as I understand Mr. Cozens-Hardy, he does not say what the directors have done is within any of these words (in section 10) except 'misfeasance or breach of trust.' It has been said that you cannot bring directors within the section unless they have been guilty of a misfeasance in the nature of a breach of trust; but be that as it

may, it is plain that if directors are guilty of such negligence that it cannot be said that in doing what they did, they attempted to perform their duty as directors, then such directors are guilty of misfeasance....." [31]

He went on to say that in order to hold the directors liable for negligence under Section 10, it must be possible to deny that the directors exercised their discretion and judgment as agents of the company. But whatever the definition of misfeasance, he said, the directors could not be made liable unless some damage had resulted from what was complained of [32]. He took the view that the two resolutions did not amount to misfeasance.

"It was plainly within the powers of the directors to make such an advance to Green, if it was for the purposes within the very wide terms of the memorandum of association." [33].

The case is very similar to <u>The Overend and Gurney Company</u> v. <u>Gibb</u> (ante p. 5 .) Although, as mentioned, that case was not decided under Section 165 of the Companies Act, 1862; the two cases illustrate a reluctance on the part of the Courts either at equity or under Section 10 hold directors liable for negligence where they have acted within their powers. Although Vaughan Williams, J. did not use the expression, his judgment seems to indicate that the liquidator would have had to show "a gross neglect of duty" on the part of the directors, in order for them to be held liable under Section 10 of the Companies (Winding-up) Act, 1890.

In <u>Re Washington Diamond Mines</u> (1893) 3 Ch.95, two directors who had participated in what was held to be a fraudulent preference in favour of one of them, were held guilty of misfeasance under Section 10 of the Companies (Winding-Up) Act, 1890, although there appears to have been no argument as to the question whether there was loss to the company, and, indeed, there appears to have been no loss involved. The case provides, perhaps, an indication that the Courts take a narrow view of the pecuniary loss aspect.

In In re Kingston Cotton Mill Company (No.2) (1896) 1 Ch.331, it was sought to hold directors and auditors liable for misfeasance under Section 10 of the Companies (Winding-Up)Act, 1890, in respect of dividends allegedly paid out of capital on the strength of balance-sheets prepared by the auditors, which were, in fact, incorrect. The balance-sheets had been prepared by the auditors on the strength of certificates given by one Jackson, the manager of the company, who was also one of the directors. Vaughan Williams, J. held that the directors other than Jackson, were not, although the auditors and Jackson were, liable for the dividends. However he held that the damage s alleged to have resulted from continuing the company's business on the footing that the balance-sheets were correct was too remote, and accordingly neither the directors nor the auditors were liable. Vaughan Williams, J. said :

> "It seems to me that the word 'misfeasance' covers every misconduct by an officer of the company as such for which such officer might have been sued apart from the section. [34]"

As Vaughan Williams, J. pointed out, this was contrary to the dictum of James L.J. in Coventry and Dixon's case (ante p. 14) Vaughan Williams gave two reasons which supported the view he had taken:

(a) the dictum of James L.J. was not necessary to his decision

(b) the directors involved in Coventry and Dixon's case were de facto directors, and the Court of Appeal was there concerned with the liability of directors rather than of officers generally.

The auditors appealed from the decision of Vaughan Williams, J. The Court of Appeal disagreed with the view taken by Vaughan Williams, J. Lindley L.J.said that he agreed that Section 10 did not apply to all cases in which actions will lie by a company for the recovery of damages against the persons names, but

> ".....I am not aware of any authority to the effect that the section does not apply to the case of an officer who has committed a breach of his duty to the company, the direct consequence of which has been a misapplication of its assets, for which he could be made responsible by an action in law or in equity. Such a breach of duty, if established, is a 'misfeasance' within the meaning of the section, or to adopt the language used in <u>Bentinck</u> v. <u>Fenn</u> such a breach of duty is a misfeasance in the nature of a breach of trust...." (35)

Lopes, L.J. also disagreed with the view expressed by Vaughan Williams, J. He said that in his view, Vaughan Williams J's view was too wide:

> "It would cover any act of negligence - any actionable wrong by an officer of a company which did not involve any misapplication of the assets of the company. The object of this section is to enable the liquidator to recover any assets of the company improperly dealt with by any officer of the company, and must be interpreted bearing that object in view. It doubtless covers any breach of duty by an officer of the company in his capacity of officer resulting in any improper misapplication of the assets or property of the company." (36)

Although the Court of Appeal in this case was concerned with the liability of auditors for misfeasance under S.10 of the Companies (Winding-Up) Act, 1890, it is submitted that in that Lindley, Lopes L.J.J. referred to "officers" rather than merely "auditors" the passages set out above may be applicable to the liability of directors for misfeasance. In any event, by virtue of Section 2(1) of the Companies Act 1966, the term "officer" is defined to include a director. It is submitted that, with respect to the cases considered so far, the view expressed by members of the Court of Appeal appears to be correct, although it will be noted that the expression "misfeasance in the nature of a breach of trust" was abandoned in favour of the term "breach of duty."

Logunas Nitrate Company v. Lagunas Nitrate Syndicate (1899) 2 Ch.392 appears to be, like The Overend and Gurney Company a case which was not decided under Section 10 ? of the Companies (Winding-Up) Act, 1890, but is often cited for the principles applicable to a case calling for the interpretation of the term "misfeasance" under that section, or its modern equivalents. In this case, the company was promoted and formed by the directors of the syndicate for the purpose of purchasing part of the property of the syndicate, consisting of nitrate works. The directors of the syndicate nominated themselves as directors of the company, and prepared the company's prospectus and contract for the purchase of the nitrate works. Two years after the date of the contract and the completion of the purchase, the shareholders of the company, believing that their property had been purchased at an over-value, and that there had been misrepresentations in the contract and prospectus, appointed an independent board of directors, who, after investigating the facts and with the sanction of a general meeting of the shareholders,brought an action against the syndicate and directors for recision of the contract and damages on the grounds of misfeasance, misrepresentation, breach of trust, and concealment of material facts. Romer, J. dismissed the action. On appeal, the Court of Appeal dismissed the action. Lindley MR took the view that the directors had acted within their powers and fraud was not alleged:

> "The inquiry therefore, is reduced to want of care and bone fides with a view to the interests of the nitrate company. The amount of care to be taken is difficult to define, but it is plain that directors are not liable for all the mistakes they may make, although if they had taken more care they might have avoided them: see The Overend and Gurney Company v. Gibb (1872) L.R.5 H.L. 480. Their negligence must not be the omission to take all possible care; it must be much more blameable than that: it must be in a bsuiness sense culpable or gross. I do not know how better to describe it." (37)

The majority of the Court held that there had been no negligence on the part of the directors.

However, in a strongly worded dissenting judgment, Rugby L.J. said:

> "It is an equitable rule which has been guarded and enforced with the utmost jealousy, that no fiduciary agent shall....intentionally place himself in a position in which his interest may conflict with his duty. This rule was plainly violated in the present case, and I can hardly imagine a case in which the violation could be more flagrant. This violation of the rule was a distinct misfeasance and breach of duty on the part of each promoter, and I see no reason why each should not be liable for all the consequences of the misfeasance and breach."(38)

Dovey and The Metropilitan Bank of England and Wales Ltd. v. Cory (1901) A.C. 477 is a further case, although not decided under the Act it is cited for the guidance it gives as to the question of the liability of directors for misfeasance. In this case, a director of the bank, in assenting to the payment of dividends out of the capital of the company and to advances on improper security, honestly relied on the judgment, information and advice of the bank, by whose statements he was misled and whose integrity, skill and competence he had no reason to suspect. The appellant, as liquidator of the National Bank of Wales Ltd. took out a summons for a declaration that Cory was guilty of misfeasance or breach of trust as a director in respect of (i) dividends paid out of capital: (ii) improper advances to directors: (iii) improper advances to customers. The liquidator sought an order for repayment of the losses thereby caused. Wright, J. at first instance held that only (i) had been made out, and made the appropriate order. On appeal, the Court of Appeal held that none of the claims had been made out. On appeal to the House of Lords, the House of Lords (Earl of Halsbury, L.C. Lords Macnaghtan and Davey) affirmed the judgment of the Court of Appeal.

Lord Halsbury L.C. said:

"Dealing with the several heads of charge as they have been formulated in the judgment of Wright, J. namely, negligence, breaches of trust in respect of advances made contrary to the said articles of association and payment of dividends out of capital, I think each of all of them may be disposed of by the proposition that Mr. Cory was not himself conscious of any one of these things being done, and that unless he can be made responsible for not knowing these things, and, as Wright J. put it, he is shown to have exhibited a complete neglect of the duties he had undertaken, the charges are not made out " [39]

Lord Davey said that he thought Cory was bound to give his judgment as a man of business on the matters which were brought before the board at meetings which he attended, and that it had not been proved that he did not do so.

"But I think he was entitled to rely upon the judgment, information and advice of the chairman and general manager, as to whose integrity, skill and competence he had no reason for suspicion" [40]

Thus, in a decision in which Lord Macnaghtan concurred, the House of Lords held that Cory was not guilty of misfeasance or breach of trust as alleged by the liquidator.

<u>In re.Brazilian Rubber Plantations and Estates Ltd.</u> (1911) 1 Ch. 425, the liquidator of the company took out a misfeasance summons under Section 215 of the Companies (Consolidation) Act 1908 (which was expressed in the same terms as Section 165 of the Companies Act 1862, and Section 10 of the Companies (Winding-Up)Act, 1890), claiming damages against the directors for misfeasance consisting in gross negligence in entering into a contract for the purchase of a rubber plantation without proper examination, and in not repudiating the contract when they received a report from the manager of the company stating that there were erros in a report which had been

submitted to the directors, concerning the plantation by a member of a firm who had sold the plantation to a syndicate from whom the company was to purchase the plantation. The report was, in fact, fraudulent, but the directors believed it to be an honest report and accepted it without inquiry. The plantation had been purchased, notwithstanding the manager's report. The articles of association of the company contained a provision to the effect that no director was to be liable for any loss or damage occasioned by any error of judgment or oversight on his part or for any other loss, damage, or misfortune whatever which should happen in the execution of the duties of his office or in relation thereto, unless the same happened through his own dishonesty. Neville, J. said :

> "I have to consider what is the extent of the duty and obligation of directors towards their company. It has been laid down that so long as they act honestly they cannot be made responsible in damages unless guilty of gross negligence. There is admittedly a want of precision in this statement of a director's liability. In truth, one cannot say whether a man has been guilty of negligence, gross or otherwise, unless one can determine what is the extent of the duty which he is alleged to have neglected. A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance; while if he is acquainted with the rubber business he must give the company the advantage of his knowledge when transacting the company's business. He is not, I think, bound to take any definite part in the conduct of the company's business, but so far as he does undertake it he must use reasonable care in its despatch.
>
> Such reasonable care must, I think, be measured by the care an

ordinary man might be expected to take in the same circumstances on his own behalf. He is clearly, I think, not responsible for damages occasioned by errors of judgment...." (41)

After examining the facts of the case, Neville,J. reached the conclusion that the directors believed that the contract was a beneficial one for the company, and that notwithstanding the absence of an independent report, this conclusion was not arrived at by negligence on their part as directors (42), and that there was no negligence shown by the directors in carrying on the business after the contract became binding.(43). In any event, the directors were protected by the exemption clause in the articles.

In <u>In re Etic Limited</u> (1928)1 Ch. 861, the liquidator of the company took out a misfeasance summons under Section 215 of the Companies (Consolidation) Act, 1908, against the secretary of the company, seeking a declaration that the secretary was indebted to the comapny for the expenses of a visit by him to America, and for sums overdrawn on account of his salary. Maugham, J refused to make the declaration sought by the liquidator. The view taken by Maugham, J. of Section 215 was as follows:

"The conclusion at which I have arrived is that Section 215 is not applicable to all cases in which the company has a right of action against an officer of the company. It is limited to cases where there has been something in the nature of a breach of duty by an officer of the company, which has caused pecuniary loss to the company. Breach of duty of course would include a misfeasance or breach of trust in the stricter sense, and the section will apply to a true case of misapplication of money or property of the company, or a case where there has been retention of money or property of the company which the officer was bound to have repaid or return to the company." (44)

Maugham, J. thus refused to make the declaration sought on the ground that the claim was for repayment of an ordinary debt, being moneys which the secretary had had without any wrongful conduct on his part whatever. The secretary had contended that he has a right of set-off against the sums overdrawn. In Ex parte Petty (1882) 21 Ch. D.492, it has been decided that under no set-off was permissible to an officer of a company under Section 165 of the Companies Act, 1862. Maugham, J. accordingly took the view that the action should be brought in a different form, so as to allow the secretary to set up his right of set-off.

In forming the view of Section 215 set out above, Maugham,J . cited Coventry and Dixon's case, In re Wedgwood Coal and Iron Co., Cavendish - Bentinck v. Fenn and Ex parte Petty. However, Maugham, J. did not consider In re Kingston Cotton Mill Company (No.2) nor did he consider In re Liverpool Household Stores Association Ltd. (ante p.16). Now, the view of Section 215 taken by Maugham, J. seems to involve two "limbs":

(i) A breach of duty which must be a positive misfeasance or a breach of trust.

(ii) The breach must cause pecuniary loss to the company.

No issue is taken regarding the second limb, but something must he said regarding the first limb.

Maugham, J. limited the "breach of duty" to a positive misfeasance or breach of trust, and cited In re Wedgwood Coal and Iron Co. as authority for this proposition. However, it will be remembered that In re Liverpool Household Stores Association Ltd. Kekevich, J. held that Section 165 of the Companies Act, 1862 was not restricted to acts of commission, but extended to all breaches of trust in relation to a company through which loss is incurred. Thus, the section extended to cases of non-feasance involving a breach of trust which caused loss to a company. In limiting the scope of the breach of duty, to a positive misfeasance, it would appear that Maugham, J. sought to exclude liability for negligence from Section 215; whether such liability has been excluded, however is reserved for discussion later in this paper.

A further case in this area is In re B. Johnson and Co. (Builders) Ltd. (1955) 1 Ch. 634. In this case it was sought to hold a receiver and manager liable for misfeasance under section 333 of the Companies Act 1948 (the modern equivalent of the sections previously mentioned in this paper, and the equivalent, in wording, of Section 321 of the Companies Act 1955). The applicant alleged that the receiver of the company had, immediately on his appointment, not continued the company's business, but had sold certain building estates of the company with partially erected houses thereon. By this conduct, it was alleged, loss had resulted to the company. At first instance, judgment was given in favour of the applicant. On appeal to the Court of Appeal Evershed MR took the view that a receiver and manager of a company's property, appointed by a debenture holder was not an officer or a manager of the company within the meaning of the Companies Act. It was held that the matter would not be allowed to proceed, since the allegations did not amount to more than ordinary claims for negligence at law. However, he went on to discuss Section 333 of the Companies Act. His view of the section was

> "...that the section is a procedural section. There is no distinct wrongful act known to the law as "misfeasance". The acts which are covered by the section are acts which are wrongful according to the established rules of law or equity, done by the person charged in his capacity as 'promoter', 'director' etc. But it is clearly established that it is not every kind of wrongful act so done that is comprehended by the section. At one end of the scale, it may, I think, be taken as prima facie clear that a wrongful act involving misapplication of property in the hands of the person charged would be covered by its terms. At the other end of the scale, a claim based exclusively on common law negligence, an ordinary claim for damages for negligence simply, would not be covered by the section. Nor is such a claim

brought within the section by the mere expedient of adding epithets to the negligence charged, calling it "gross" or "deliberate". Nor, by that expedient, without more, can what in truth is mere negligence, be converted into something else, namely, breach of trust. But in between the two extremes that I have mentioned, there is obviously a large range of conduct which may (or may not) be within the section. I shall follow others in not attempting any precise definition or what does or does not fall within it. "[45]

Evershed MR quoted the passages from the judgments of Lindley and Lopes L.J. in <u>In re Kingston Cotton Mill Company</u> (No.2) set out in page 21 of this paper, and said:

> "These passages may, I think, be taken as authority, or as included among the authorities, establishing that a simple case of negligence at common law would not be within the section."[46]

With respect, however, it is submitted that these passages do not support this view, and it does not appear that Lindley or Lopes L.J.J. really gave serious consideration to the matter. Their judgments were concerned with what came within the section, rather than what did not, and Evershed MR recognised this:

> "But in my judgment, Lindlay and Lopes L.J.J. did not intend to lay it down by inference that any breach of duty, including a breach of trust, which did not involve a misapplication of assets, was outside the section. What they were saying was the converse : that, where a breach of duty had been committed, which did in fact result in a misapplication of the company's property, then such a transaction would be within the ambit of the section."[47]

Thus, the correct view would appear to be

> "...<u>In re B.Johnson</u> really does not consider the question of whether mere negligence comes within the scope of Section321, and Evershed MR claims that Lindley and Lopes L.J.J. in <u>In re Kingston Cotton Mill</u> (No.2) did not consider this question either. All that

the two cases decided was negatively that the argument that Section (333) covers mere negligence was not ruled against, and positively that if there is a breach of duty which results in a misapplication of the company's property that comes within Section (333)" (48)

If it is assumed, for the purposes of argument, that Evershed MR was correct in the view that

"a claim, based exclusively on Common Law negligence, an ordinary claim for damages simply would not be covered by the section."

This view is difficult to reconcile with those cases considered previously in which directors have been charged with misfeasance involving negligence. In re Kingston Cotton Mill (No.2) a case involving the liability of auditors for misfeasance, is probably reconcilable with In re B.Johnson (Builders) Ltd. in that there, the alleged breach of duty appears to have involved misapplication of the company's assets : dividends were paid out of capital on the strength of a balance sheet prepared by auditors, and which was subsequently proved to be incorrect.

In Selangor United Rubber Estates v. Cradock and Others (1967) 1 W.L.R. 1168, a case brought under Section 169 (4) of the Companies Act, 1948 (See Section 173 (4) of the Companies Act 1955), Goff, J. was faced with defining the word "misfeasance" in the phrase

"any fraud, misfeasance, or other misconduct...."

as it appears in Section 169 (4). Authorities which involved proceedings brought under Section 333 or its predecessors were cited as bearing on the question. In a previous case, S.B.A. Properties Ltd. v. Cradock (1967) a W.L.R. 716, Goff J. had held that "misfeasance" under Section 169 (4) necessarily involved "moral turpitude." However, in this case, he disagreed with that view, and, relying on In re Kingston Cotton Mill Company No.2 and In re Thomas Gerrard and Son Ltd. (1968) 1 Ch.455

1 Ch. 455 (a case which will be considered in Chapter 2), he said that misfeasance did not necessarily involve moral turpitude, but comprehended any breach of duty by an officer of the company as such involving a misapplication or wrongful retention of the company's moneys.

Goff J's definition of misfeasance is wider than that in In re Kingston Cotton Mill Company (No.2) in that the term "misfeasance" was defined by Goff J. as comprehending any breach of duty by an officer of the company as such involving a misapplication or wrongful retention of the company's moneys, it would now seem that the definition is wide enough to include negligence within its terms.

Since Selangor United Rubber Estates Ltd. v. Cradock was decided, there appear to have been no further cases bearing on the meaning of the term "misfeasance" as used in Section 333 of the Companies Act, 1948, apart from Wallersteiner v. Moir (1974) 3 All E.R. 217. It is apparent, however, from the judgment of the Court of Appeal in that case, that the Court gave little consideration to the question of liability for misfeasance as this was only one of many that arose for consideration. As the case offers little guidance on the meaning of the term "misfeasance", the case will not be considered further in this paper.

CONCLUSIONS:

From the foregoing survey of English case-law, we may conclude that -

(a) Section 333 of the Companies Act, 1948 (and thus Section 321 of the Companies Act 1955) creates no new rights but only provides a summary mode of enforcing rights which must otherwise have been enforced by the ordinary procedure of the Courts. It is, in other words, a procedural section.

(b) The Courts have encountered considerable difficulty in defining the term "misfeasance." In view of this, it is difficult to determine the exact meaning of the term. Strictly speaking the authorities tend to diverge : a slightly different meaning was given to the term in the cases dealing with directors (see for example, Cavendish-Bentinck v. Fenn) from that in In re Kingston Cotton Mill (No.2), a case dealing with "officers" ; although the judgment of Maugham, J. in In re Etic Ltd. tends to blur this distinction. It is submitted, however, that the meaning given to the term by the Court of Appeal in In re Kingston Cotton Mill Company (No.2) is expressed in terms wide enough to include directors, and it may be that the Courts will adopt the meaning ascribed to the term by Goff, J. in Selangor United Rubber Estates Ltd. v. Cradock, whether they are dealing with directors or other officers of a company. If this view is correct then the term may be defined as :

> "Any breach of duty by an officer of the company as such which involves a misapplication or wrongful retention of the company's money or property, the direct result of which is pecuniary loss to the company."

Whether this meaning will be adopted in any future case is uncertain. Much will depend on the facts of the case.

(c) That the phrase "pecuniary loss to the company" in the above definition must be given a wide construction.

(d) That liability for mere negligence, or "common law negligence" has not, it is submitted, been positively excluded from the ambit of Section 333.

(e), Section 333 applies in the situation where nonfeasance has resulted in pecuniary loss to a company.

2. THE POSITION IN AUSTRALIA.

An examination of the Australian authorities may conveniently begin with In the matter of Inland Motors Ltd. (Vetter and Mouritzen's case) (1931) 34 W.A.L.R. 104, a case decided under Section 181 of the Companies Act 1893 (W.A.) which is equivalent in wording to Section 333 of the Companies Act, 1948 (U.K.) and Section 321 of the Companies Act 1955 (N.Z.). Vetter and Mouritzen were directors of Inland Motors Ltd., and guarantors or sureties of the debts of the company to the Bank of New South Wales and one McManus. When the company was unable to repay its debts as they fell due, and was an the verge of winding up, the company paid in or towards the liquidation of these debts the sum of £1000 to the Bank of New South Wales and £1000 to McManus. The liquidator claimed that these payments were an undue or fraudulent preference of Vetter and Mouritzen under Section 95 of the Bankruptcy Act, 1924-30 (Fed.). The liquidator further claimed that Vetter and Mouritzen as directors of the company were guilty of misfeasance or breach of trust in relation to the company by reason of such payments and undue or fraudulent preference. The liquidator asked for an order that Vetter and Mouritzen should repay to him the sums of £1000 paid to the Bank and McManus respectively. Dwyer, J. refused to make the order sought. He took the view that so far as the company and its shareholders were concerned, it was not improper to apply its moneys in paying debts lawfully due to creditors, other than Vetter and Mouritzen. Dwyer, J. said that except in cases of property or moneys retained by or transferred to the officer concerned, a summary order on a misfeasance summons could not be made unless it was established that there was not only misconduct, but also resultant damages to the company.

In Couve v. J.Pierre Couve Ltd. (in Liquidation) and Another (1933) 49 C.L.R. 486, the appellant was the managing director of a company of which he was the only substantial shareholder. After the presentation of a petition for the winding up of the company, the appellant caused large supplies of the company's goods to be delivered to other businesses owned by him as a set-off, he claimed, for undrawn salary due to him by the company. This action was brought by the liquidator under Section 162 of the Companies Act 1899 (N.S.W.) (in the same terms as Section 333 of the Companies Act 1948 and Section 321 of the Companies Act 1955). The claim was for £569.12.9, being the amount debited to the appellant for goods supplied between 7th July 1932, the date when the petition was presented, and 2nd September 1932, the date of the winding up order. In the High Court of Australia, Dixon J. examined the authorities in order to determine what was meant by the term "misfeasance." He referred to Cavendish-Bentinck v. Fenn and Coventry and Dixon's Case, taking the view that the list of wrong-doings set out by James L.J. in Coventry and Dixon's Case (see ante, pp. 13 and 14), covered an improper dealing with assets by a director for his own personal advantage. He then cited In re Etic and without elaborating further on the point, said that he thought the appellant's conduct in this case appeared to come fairly within the language of Maugham, J. (see ante p.26). Dixon J. went on to say that the transaction which was carried out by the appellant was one intended to give him an advantage in the event of the winding-up order being made.

> "No difficulty was felt in In re Washington Diamond Mining Co. (1893) 3 Ch. 95 in treating a fraudulent preference as a misfeasance....The conduct of the appellant appears to merit the same description. In the event it amounted to an active breach of duty committed for the directors own benefit in administering the assets of the company. The fact that at the time it was committed its wrongful character was contingent upon the success of the petition did not seem material, inasmuch as it was done to protect the doer against that very event."[49]

Accordingly, Dixon,J. made the order sought by the liquidator.

Dixon, J. thus held that the impugned transaction was a fraudulent preference amounting to a misfeasance within the meaning of Section 162 of the Companies Act, 1899 (N.S.W.). Although the case appears to have been correctly decided, it perhaps was not necessary for Dixon, J. to have gone to the extent of finding that the impugned transaction was a fraudulent preference. He had previously decided that the transaction fell within the language of Maugham, J. in In re Etic, and, if that was the case, then that was sufficient for Dixon,J. to make the order sought by the liquidator.

Another case in which it was held that an impugned transaction was a fraudulent preference amounting to a misfeasance is Re Yorke (Stationers) Pty.Ltd. (in liquidation) (1965) N.S.W.R. 446. In this case the company, having leased certain business premises from the Leslie Corporation Pty. Ltd. subsequently fell into arrears under the lease, and in July 1961, the Leslie Corporation obtained judgment by default against the company for the sum of £560.16.6. The only shareholders of the company were Mr. and Mrs. Yorke, and they were also directors of the company. Early in 1961 it became evident that the company was in serious financial difficulties, and the company ceased to carry on business on 30th June, 1961. A balance sheet was drawn showing sundry creditors to the extent of £2155.17.0, but significantly, no account was taken of the moneys owed to the Leslie Corporation. On 6th July 1961, a meeting of the company's directors was held. It was resolved that Mr. and Mrs. Yorke would purchase the assets of the company for the sum of £2,155.17.0, the exact amount of the debt owed to the creditors, with the exception of the Leslie Corporation. It was further resolved that the purchase price was to be satisfied by the payment by Mr. and Mrs. Yorke to all the trade creditors of the company, 5A. SAINSBURY, N.E. Section 321 of the Companies Act 1955.

"...with the exception of any alleged liability for any premium which may be purported to become due under the terms of the lease of the premises."

Mr. and Mrs. Yorke subsequently admitted that at the time of the resolution dated 6th July 1961 was passed, they knew of the existence of the default judgment and of the company's continuing liability under the lease. On 11th September, 1961, the Leslie Corporation presented a petition for the winding up of the company, based on the unpaid judgment debt, and on 25th September 1961, an order for winding up was made. The liquidator brought a misfeasance summons under Section 308 of the Companies Act (N.S.W.) (equivalent to Section 333 of the Companies Act, 1948, and Section 321 of the Companies Act 1955) seeking restitution of the company's assets, or in the alternative, payment by Mr. and Mrs. Yorke to the company of the sum of £2155.17.00

This was a clear case of the creation of a fraudulent preference, and McLelland C.J. had no hesitation in reaching that conclusion. He dealt only briefly with the question of misfeasance saying merely -

> "I am of opinion that directors who deliberately create preferences which are void under Section 298 are guilty of misfeasance and can be made liable for such misfeasance under Section 308. It was so held under the equivalent English section by the Court of Appeal in Re Washington Diamond Mining Co. (1893) 3 Ch. 95" (50)

Can this be reconciled with Re Inland Motors Ltd.

He thus ordered Mr. and Mrs. Yorke to pay to the liquidator the sum of £3155.17.0.

McLelland C.J. did not consider whether the impugned transaction fell within the language of Maughan J. in In re Etic, but for the same reasons as those stated in Couve v. J. Pierre Couve Ltd. the transaction would appear to come within this language Dixon,J. in Couve v. J. Pierre Couve

Ltd. said of the impugned transaction in that case

> "In the event, it amounted to an active breach of duty committed for the directors' own benefit in administering the assets of the company."

The transaction in the present case was of the same character. It was carried out in an attempt to avoid the judgment debt due to the Leslie Corporation. This breach of duty appears to have resulted in pecuniary loss to the company, as it was left with no assets available to meet the judgment debt.

In In re Australasian Venezolana Pty. Ltd. (1962) 4 F.L.R. 60, Mr. Best, the managing director of Australasian Venezolana Pty. Ltd. (hereinafter referred to as "A.V.Pty.Ltd."), a company whose business it was to receive moneys from the United States on behalf of an Australian principal, instructed a Mr. Vogel, another director (who was also secretary of the company) to draw out of an account in which the moneys were held, three cheques totalling £19,475 (which were described as loans) in favour of American Export Corporation Pty Ltd. (hereinafter referred to as "A.E.C.Pty. Ltd.") another company of which Best was also managing director, and which was in financial difficulties. It was no part of the ordinary business of A.V.Pty. Ltd. to make loans, but Vogel acted on Best's instructions without requiring or receiving any explanation for the payments. Best knew that A.V.Pty. Ltd. was under an obligation to account to its principal for this money. The money was, however, used to meet the current liabilities of A.E.C.Pty. Ltd., and to release personal securities of Best. On the petition of its principal, A.V.Pty. Ltd. was wound up, and the liquidator took out a misfeasance summons under Section 308 of the Companies Act, 1936 (N.S.W.) against Best and Vogel seeking an order that they repay the sum of £19,475. Eggleston,J. dealt firstly with Vogel, and said that he was satisfied that Vogel ought to have known that the payments were unwarranted if he had taken reasonable steps to acquaint himself with the details of the company's business.

"But at the time of the first two payments, he had been with the company less than a month, and I am unable to conclude that at the time when the payments were made, he was aware that they were improper. This conclusion does not, in my opinion, relieve him of responsibility for any loss sustained by the company in respect to the transactions since, as I have said, if Vogel had made reasonable efforts to acquaint himself with the affairs of the company he would have known that the money should not have been lent to American Export Caporation. His liability, however, is a liability of failure to perform his duty as a director, and not that of a person who has deliberately misapplied the company's funds." [51]

Best's case was, however, a different matter. After considering the facts, Eggleston,J. said:

"...My conclusion therefore is that the three payments totalling £19,475 of which the liquidator complains in this case, represented an improper payment to the American Export Corporation, made on the respondent's instructions, and known by the respondent to be improper, of moneys which the company was under an obligation to pay to the petitioning creditor. The payment left the company without funds with which to pay the petitioning creditor, and enabled the American Export Corporation to apply a substantial portion of the moneys to release deposits made by him in New Zealand as security for advances to the American Export Corporation.

In these circumstances I think the advances must be treated not merely as an improvident or reckless loan, but as a deliberate misapplic ation of the Company's funds." [52]

It is interesting to note that the Court took a different approach to the liability of the two directors. It would seem that Vogel was held liable for gross negligence in that he failed to perform his duty as a director. By way of contrast, Best was held liable for a deliberate misapplication of the company's funds. The case would seem to be in accordance with English authorities. Eggleston,J., however, did not cite authorities during the course of his judgment, and thus gave no indication as to which authorities he relied upon to support the views expressed above.

In Re Tropic Isle Limited (In Liquidation) (1967) Qd.R.453, the fact were that a Mr. Hanlon was the promoter of the company. The directors, who were inexperienced as directors, very shortly after its incorporation purchased shares in Labrador Estates Pty. Ltd. (hereinafter referred to as "Labrador") which were not worth more than £1 per share, from Hanlon and certain associates of his for £2.10 per share. In purchasing the shares in Labrador, the directors had not made proper inquiries as to their value. In the subsequent winding-up of the company, the liquidator took out a misfeasance summons against the directors under Section 285 of the Companies Act, 1931 (Queensland) (equivalent to Section 333 of the Companies Act 1948, and Section 321 of the Companies Act 1955). At first instance, Hart, J. held that the directors were guilty of misfeasance, and were liable to make good the loss, to the liquadator, in the sum of £1.10 per share. The basis of his decision was that in acquiring the shares in Labrador, the directors were within the powers, but had neglected to exercise their judgment and discretion as directors, and were accordingly liable for the resulting loss. In reaching this decision, he relied on In re New Mashonaland Exploration Co. (ante p. 18) and In re City Equitable Fire Insurance Co. (1925) q Ch.407 (post p. 71). Two of the directors appealed from this decision. Lucas,J. in delivering the judgment of the Court, examined the judgment of Hart,J. and then referred to a number of the English authorities previously considered, which, he said, were by no means easy to reconcile.[53]. He cited In re New

Mashonaland Exploration Co., In re Etic Ltd., In re City Equitable Fire Insurance Co. and In re B.Johnson and Co (Builders) Ltd. and said:

> "It is my opinion clear, however, from the cases to which I have referred, that mere imprudent investment, which amounts to 'common law negligence' without more cannot impose liability on the directors in a misfeasance summons." [54]

He went on to say:

> "From the foregoing, it seems to me that in this case, the company's investment of its funds in buying the shares of Labrador cannot of itself be considered as bringing the directors within the provisions of Section 285 even if the circumstances were such that reasonably prudent directors would not have made it. Something more must be shown: either that the investment was made with a view to giving Hanlon a profit, and not at all with a view to the company's benefit, or that, in making the investment, the directors completely failed to exercise independent judgment and discretion, or, of course, it could be shown that both these circumstances were present." [55]

Lucas, J. was unable to draw from the evidence the inference that in buying the Labrador shares the appellants were acting solely, or even dominantly with the intention of giving Hanlon a secret profit, [56], and concerning the question of whether the appellants really did exercise their judgment and discretion, Lucas,J. thought that the evidence showed that they had exercised their judgment and discretion

> "...obviously it has turned out that their judgment and discretion were wrong, but that is not the point. I have said that they were Hanlon's dupes, but the evidence does not indicate to me that they acted as mere automata...." [57]

In order to summarise the finding of the Court, reference may be made to the headnote which reads:

"...Mere imprudent investment which amounts to 'common law negligence' without more cannot impose liability upon the directors in a misfeasance summons; the negligence must be accompanied by something more, something which amounts to a breach of trust, either because the act negligently done was *ultra vires*, or, if it was within power, because it could be said that it was an act in the performance of which the directors had completely failed to exercise the faculties of independent judgment and discretion."

Now, in reaching this conclusion, Lucas,J. placed strong reliance upon *In re B.Johnson and Co. (Builders) Ltd.* With respect, however, Lucas,J. gave insufficient attention to this case. He did not refer to the judgment of the English Court of Appeal in *In re Kingston Cotton Mill Company (No.2)* nor to the admission of Evershed MR that in his judgment

> "Lindley and Lopes LJJ did not intent to lay it down by inference that any breach of duty, including a breach of trust, which did not involve a misapplication of assets, was outside the section."

While Lucas J. positive excluded "common law negligence" from Section 285, it may well be that his interpretation of *In re B.Johnson and Co (Builders) Ltd.* does not support such a seemingly conclusive ruling.

The final Australian case to be considered is *Franklin* v. *Hurstville Finance Pty. Ltd.* (1968) N.S.W.R. 653. In this case, the facts were that between 27th September 1961 and 17th January 1962, Hurstville Finance Pty. Ltd. (hereinafter referred to as "Hurstville") received the sum of £12,387.13.0 representing the proceeds from the enforcement of a mortgage security, which was its only substantial asset. On various dates between 22nd September 1961 and 2nd March 1962, sums totalling £11,117.19.2. were withdrawn by the two directors of the company, Messrs. Wilson and Franklin. This sum was applied for the purposes of a number of companies in which

Wilson and Franklin were interested as directors. Hurstville had no interest in these companies, and the payments were, in effect, gifts of the funds of Hurstville. In the subsequent winding up of Hurstville, the liquidator took out a misfeasance cummons against Wilson and Franklin under Section 308 of the Companies Act, 1936 (N.S.W.) for the repayment of the sum of £11,117.19.2. At first instance, McLelland C.J. made the order sought by the liquidator. Wilson and Franklin appealed from this decision to the New South Wales Court of Appeal, which affirmed the decision of McLelland C.J. and dismissed the appeals.

Sugerman J.A. said:

> "Like Evershed MR in Re.B.Johnson and Co. (Builders) Ltd., I shall follow others in not attempting any precise definition of what does or does not fall within the scope of legislation such as Section 308. It is sufficient for the purposes of the present case that where a breach of duty has been committed which has in fact resulted in a misapplication of the company's money or property, such a transaction would be clearly within the ambit of the section." (59)

Sugerman J.A. considered that in carrying out the impugned transactions

> "...The appellants were guilty of a breach of duty to the respondent company, resulting in a plain misapplication of its funds." (60)

Asprey, J.A. took a similar view of the facts of the case. In his view, where there had been a misapplication of the assets of a company by its directors in breach of their duty to the company as its directors resulting in pecuniary loss to the company, such directors may be said to have committed a misfeasance within the meaning of Section 308 of the Companies Act, 1936. In the performance of their duties, he said, directors stand in a fiduciary relationship to the company and when they undertake the expenditure of the company's funds they are under a duty not to expend them otherwise than for the legitimate purposes of the company. [61]

> ",...The evidence plainly discloses that Messrs. Wilson and Franklin made no distinction between the legitimate business purposes of the various companies constituting the group in which they were directors. In the words of Wilson, they regarded all these companies as 'integrated into a common pool' and thus they felt themselves free to use and did use the assets of the company in derogation of the rights of its creditors and shareholders, to meeting pressing obligations of other companies whose only common relationship with the company was the controlling interest of Gerrard. [62]. No authority is needed for the proposition that no legal justification exists for such a course." [63]

It is clear from this case that the 'breach of duty' on the part of Wilson and Franklin was the breach of duty not to expend company funds otherwise than for the legitimate purposes of the company, and it was this breach of duty which led to the misapplication of the funds of the company.

CONCLUSIONS

It will be seen from the foregoing discussion that the position is Australia regarding the meaning of, and liability for misfeasance, corresponds to the position in England, due mainly, it would appear, to the fact that the Australian courts have tended to follow the English authorities.

The question of whether "common law negligence" falls within the misfeasance section is problemmatic, as is the case in England. It will be remembered that In re Tropic Isle Ltd. Lucas,J. sought to exclude common law negligence from the ambit of the misfeasance section. It is submitted, however, that

In re B. Johnson and Co. (Builders) Ltd. one of the cases upon which Lucas,J. relied, does not appear to support so positive a ruling.

In any event, so far as New South Wales is concerned, this question is largely of historical interest. Section 367B of the Uniform Companies Amendment Act, 1971 (N.S.W.) makes it clear that negligence falls within the ambit of the misfeasance section. There appear to be no cases on the interpretation of Section 367B, but it may be that the Courts will place a narrow construction on the term "negligence" in order to exclude those claims involving nothing more than what they may regard as "common law negligence".

3. THE POSITION IN NEW ZEALAND

The leading New Zealand case in the area presently under consideration is In re Dominion Portland Cement Co. Ltd. (In liquidation) (1921) N.Z.L.R. 667. In the liquidation of this company a number of contributories of the company took out a misfeasance summons against the directors of the company under Section 254 of the Companies Act 1908 (the predecessor of Section 321 of the Companies Act 1955). They alleged that the directors were liable to contribute to the assets of the company a sum of money by way of compensation in respect of misfeasance and breaches of trust allegedly committed by the directors. The application was based on the establishment by the company of a hydro-electric scheme of its own, shares in the company having been issued on the basis that power would be obtained from a proposed hydro-electric scheme of the Whangarei Borough: the conduct of the directors in entering into a contract for the supply and erection of a cement-mill without having first arranged the company's finances: and the conduct of the directors with regard to the allotment of certain preference shares. It was further alleged that by reason of the directors' negligence and misconduct the whole capital of the shareholders had been lost. In dealing with the allegations, Sim,J. discussed the Cavendish-Bentinck v. Fenn , Lagunas Nitrate Co v. Lagunas Nitrade Syndicate and Overend and Gurney Co v. Gibb, and adopted the test laid down by Lord Hatherley in the latter case : being the test to apply where directors are acting within their powers :

> "Were they cognisant of circumstances of such a character, so plain, so manifest, and so simple of appreciation that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into." (64)

Sim,J. said that it was clear that the directors acted quite honestly throughout and with the sole desire of promoting the interests of the company.

The charge made against the directors was that they displayed gross imprudence, negligence and recklessness [65]. Dealing with the allegations concerning the company's hydro-electric scheme, Sim, J. said that it was clear from the evidence that there was some uncertainty as to whether the company could have obtained power from the Council's proposed hydro-electric scheme. In those circumstances, Sim, J. said, the directors were prudent in not relying on the Council for the necessary power and in making other arrangements [66]. Concerning committing the company to the hydro-electric scheme, involving an estimated expenditure of £55,000, without having first made provision for the necessary funds, and without having made proper provision for securing and paying for the mill and plant required to carry on the company's business, Sim,J. said he did not think the directors were imprudent, in acting on the view held by them that they would be able to obtain the funds to pay for the electric installation either on debentures or by further capital, andin acting on the view that they would be able in due course to acquire for the mill and plant [67]. There was no imprudence on the part of the directors in entering into the contract for the supply and erection of the cement mill. The fact that the results were unfortunate for the shareholders did not lead to the conclusion that the conduct of the directors should be condemned. [68]. Furthermore, resolutions had been passed at general meetings of the company, concerning the proposed hydro-electric scheme and cement mill, and no complaint had been voiced by the shareholders during the meetings. [69]. Dealing with the allegations concerning the allotment of the preference shares, Sim,J. said:

> "That can be disposed of, I think, very shortly. If the holders of any of these shares ever had a right to rescind their contracts and get rid of their shares, that right had long since gone, and it is not suggested that any of the holders of these shares has a claim against the company for damages or anything else. The issue of these shares, therefore, has not

prejudiced the company; on the contrary, the company derived a benefit from the issue of the shares, because it got the money paid by the shareholders. In these circumstances, the company cannot have any claim against the directors. In order to establish a case of misfeasance under Section 254 of the Companies Act, it is necessary to prove that the act complained of resulted in some actual loss to the company. Coventry and Dixon's Case: Cavendish-Bentinck v. Fenn. That has not been proved, and this branch of the case fails."[70].

Thus, on an application of Lord Hatherley's test and the principles enunciated in Cavendish-Bentinck v. Fenn, Sim, J. held that the contributories had failed to establish that the directors had been guilty of any misfeasance in relation to the company.

The next case to be considered is In re H. Linney and Co. Ltd. (1925) N.Z.L.R. 907, in which Ostler, J. held that when a company is, to the knowledge of its directors, insolvent, and the directors cease payment of all but small and pressing accounts, and pay the remainder of the company's takings into the bank to wipe out the company's overdraft, without the intention to prefer the bank, but in order to wipe out the directors' own liability to the bank as sureties under their personal guarantee of the overdraft, these payments did not constitute a fraudulent preference ofthe bank, and were not a fraudulent preference of the directors themselves, as in New Zealand a surety was not a creditor within Section 79 of the Bankruptcy Act, 1908. Dealing with the question of whether the payments amounted to a misfeasance or breach of trust within the meaning of Section 254 of the Companies Act, 1908, Ostler,J. said:

> "Now, it has been well settled that the corresponding provision in the English Companies Act creates no new offence and confers no new rights, but its object is merely to provide a summary and efficient remedy in respect of rights which,

> apart from the section, might have been enforced in an ordinary action: Coventry and Dixon's Case, Cavendish-Bentinck v. Fenn,
>
> In my opinion the application of this principle must determine the question against the contention of Counsel for the liquidator. It has already been held that what was done did not amount to a fraudulent preference of themselves by the directors. It is not suggested that what was done was done in contravention of any other statutory provision, or that it was a breach of trust towards the creditors, or a breach of any contractual duty towards them. I fail, therefore, to see how this section can be invoked, or how the Court can be asked to declare that to be a misfeasance as against the creditors which it is not suggested is a breach of any legal duty towards them. Quite apart from this consideration, however, it has been held that "misfeasance" in this section means misfeasance in the nature of a breach of trust against the company for the directors of a company are not trustees for the company's creditors, but only for the company. The misfeasance must also be some act resulting in actual loss to the company, see per James L.J. in Coventry and Dixon's Case.
>
> In my opinion the acts of the directors in paying off the overdraft to protect themselves was not a misfeasance or breach of trust within the meaning of Section 254 of the Companies Act." [71]

This case may be contrasted with Couve v. J.Pierre Couve Ltd. (ante p. 33) and Re Yorke (Stationers) Pty. Ltd. (ante p. 35) in which it was held that the directors concerned had created fraudulent preferences, and they were accordingly guilty of misfeasance. There is a distinction between those cases and In re H. Linney and Co. in the motives of the directors in relation to the transactions in question in each of the three cases.

The next case in which the question of misfeasance arose is In re Buick Sales Ltd. (1926) N.Z.L.R. 24. However, this case did not really revolve around Section 254 of the Companies Act 19 58, but concerned the question whether "misfeasance claims " could be assigned. Accordingly, the case will not be considered further

In re Hamiltons (Australia and New Zealand) (In liquidation) (1946) G.L.R. 82 involved a misfeasance summons taken out against the directors of the company under Section 269 of the Companies Act 1933 (which was expressed in the same terms as Section 254 of the Companies Act 1908), in which the liquidator sought to recover from the directors, certain moneys, the greater part of which was lost the company. It was alleged that this was the result of the directors having failed to discover misappropriations on the part of the managing director, in whose hands was left practically the whole of the management of the business. It was alleged that the directors had been negligent in the performance of their duties. Fair,J. had thus to determine the standard of care and conduct required from the directors of this company. He referred to Re Forest of Dean Coal Mining Company and quoted the passage from the judgment of Jessel MR set out on page 11 of this paper, where Jessel MR referred to the standard of care required of directors and he also referred to In re Dominion Portland Cement Co. Ltd. (p. 45 ante), and approved Lord Hatherley's test, and quoted at length from the judgment of Romer,J. in In re The City Equitable Fire Insurance Company (1925) 1 Ch. 407 (see post p. 71) in which Romer, J. set out at length the standard of care required by directors in the performance of their duties. Fair,J. examined the facts of the case to determine whether the directors could be held to be negligent when judged by the standards set out in the above cases. He held that there was, in fact, negligence on the part of one of the directors only, a Mr. Burnard. Fair,J. said that knowledge on Mr. Burnard's part that one of the directors had retired, and that the company was experiencing difficulty in the carrying on of its business, that of share-selling in Australia and New Zealand, meant there was a duty incumbent upon Mr. Burnard to take all reasonable steps to ensure that the company was properly conducted (72) especially in view of the fact that Burnard took an active part in the management of the company after the retirement of the other director. However, the company was in fact carried on in a reckless fashion by the managing director, and Mr. Burnard failed to take steps to ensure that the business was properly carried on. Fair,J. held that this amounted to negligence on the part of Burnard (73). He then had to deal with the question whether the negligence amounted to a misfeasance or breach of trust within the meaning of Section 269. Fair,J. cited In re Wedgwood Coal and Iron Company and said that the passage from the judgment of Fry,J. on p.15 of this paper was a mere dictum inasmuch Fry J. held that there had been no negligence on the part of the directors charged.

> "It does not deal with non-feasance amounting to negligence but merely with the non-enforcement of a legal right held to be of no value" (74)

He proceeded to confine the decision in In re Wedgwood Coal and Iron Company to the facts of that particular case, holding it was not of general application

> "It dealt with a particular or isolated act of nonfeasance. It did not apply to nonfeasance extending over a considerable time in respect of a variety of acts coupled with the director taking an active part during that time in promoting the activities of a company, where such part involved carrying out the duty in respect of which there was negligence or nonfeasance. To allow and assist in a company's business being carried on in a reckless fashion without supervision is not only negligence but misfeasance in an active sense. It seems to me, therefore, that the term misfeasance in Section 269 includes negligence in the conduct of a director's duties." (75)

For Burnard, it was argued that his negligence, if any, was not the cause of the company's losses during his period of office as (1) most of them were due to the managing director's defalcations, and (2) Burnard had no power and no certainty of controlling the winding-up of the company's business even if he had wished to. Fair, J. dismissed the first of these contentions on the ground that what the managing-director had been doing was known to Burnard, and had jointly with the managing-director authorised a considerable portion of the expenditure and incurring of liabilities. The second contention was dismissed on the ground that upon an application the Court upon the facts which Burnard knew or ought to have known, the shareholders "probably", and the Court, " certainly" would have held that the Company should be wound up on the ground that the company was unable to pay the debts, or that it was just and equitable that it should be wound up.[76]

Fair, J. held that there was no liability on the part of the other directors.

In this case it was thus held that the term misfeasance included negligence in the conduct of a director's duties. Fair, J. thus took the opposite view to that taken by Evershed, MR in In re Johnson and Co. (Builders) Ltd. where Evershed MR sought to exclude "common law negligence without more" from the ambit of Section 333 of the Companies Act, 1948, and is difficult to reconcile with this case, unless the view which has been expressed earlier in this paper is correct, namely that in actual fact, the decision In re B.Johnson and Co (Builders) Ltd. cannot be taken to have positively excluded common law negligence from the ambit of the misfeasance section. If that view is not correct, then it is submitted that the two cases are irreconcilable, unless it can be argued that there was more than just negligence on the part of Burnard: his failure to ensure that the business of the company was properly conducted resulted in a misapplication of the company's money.

The question arises, however, as to whether Fair, J. was correct in distinguishing Re Wedgwood Coal and Iron Co. That case, it will be remembered involved the failure on the part of the directors of the company to recover a debt due to the company. Fry, J. held that, in the circumstances of the case, their failure to do so amounted to a case of mere nonfeasance and was nothing more than that. Fry,J. took the view that Section 165 did not apply to cases of mere nonfeasance, except where there had been a breach of trust. He did not define what conduct, in his view would amount to a breach of trust, but as Kekewich,J. in <u>In re The Liverpool Household Stores Association</u> the exception in the case of breaches of trust is important. Kekewich, J. accordingly extended Section 165 to cover not merely acts of commission, but to all breaches of trust through which loss to a company is incurred. In the present case, Fair,J. was faced with a situation in which loss to the company had resulted from a director's failure to ensure that the business of the company was properly conducted. This was not a case of the same nature as <u>Re. Wedgwood Coal and Iron Co.</u> in which no loss to the company had resulted from the director's failure to act, and appears to come within the language of Kekewich,J. in <u>In re The Liverpool Household Stores Association</u>. It is accordingly submitted that Fair, J. was correct in distinguishing <u>Re Wedgwood Coal and Iron Co</u>.

The question as to whether a director's failure to ensure that the business of a company is properly conducted falls within (now) Section 321 of the Companies Act again arose in <u>Re Maney and Sons De Luxe Service Station Limited</u> (1968) N.Z.L.R. 624. In this case a Mr. E.O. Maney and his three sons were the shareholders and directors of the company. E.O. Maney managed the business, and D.D.Maney (a son) was the company's secretary. As and when necessary he signed documents relating to the company. In 1964 the company went into voluntary liquidation. The liquidator, upon finding that the company had few assets found that it was in debt to the extent of £20,151. He proceeded to calculate what, in his estimation, should have been the net profit of the company taken over an

11 year period, and the deficiency in accounts was held to amount to £27,358. The liquidator found that 50 payments had been made from 1954 to 1959, which were wrongly included in the company's expenditure. These included payments for such items as a caravan, house repairs, furniture, clothing, a sewing machine, and dental attention, which apart from the caravan which was for D.D. Maney were for the benefit of E.O. Maney. The liquidator also found that the Inland Revenue Department had been defrauded because the company's nett assessable income was considerably lower than it should have been. In 1961, a firm of public accountants had reported to the company, that the sum of £13,520 was owing to Atlantic Union Oil Company which supplied the company with various products. E.O. Maney instructed another firm of accountants to look into the matter, but they found that the money was indeed owing and reported that either E.O. Maney or an office assistant could have misappropriated the sum of money. The office assistant was subsequently held in no way responsible for the misappropriation. The plain fact of the matter was that E.O.Maney took the company's takings home at night and did all the accounting in his room alone. He was thus in a position to misappropriate the company's money. D.D. Maney was aware of the practice of his father in regard to the accounting. The liquidator sought an order under Section 320 (fraudulent trading) and 321 of the Companies Act 1955. In the Supreme Court, Wild, C.J. held E.O. Maney liable under Section 320, and without elaborating, he also held that the liquidator was entitled to an order under Section 321 on the ground that E.O. Maney had misapplied or retained money of the company. As regards D.D. Maney, Wild C.J. refused to hold him liable under Section 320. He was confined substantially to physical work at the service station. In regard to Section 321, Wild C.J. cited what he considered to be th leading case, In re Etic Ltd. and Couve v. J. Pierre Couve Ltd. D.D. Maney had said in evidence that about 1960,

after he had talked to an Atlantic representative, it had entered his mind that his father might have been involved in the discrepancies. But he did nothing. As Wild C.J. put it, his hopes were that something would come right, and he had faith in his father. Though he knew that things were not right he was not prepared to take any action, he let matters drift along.[77] Wild C.J. termed this "highly reprehensible slackness on the part of a director"[78]. The question was, though, whether this conduct came within Section 321. He thought that D.D.Maney's part in the matter amounted to sins of omission rather than sins of commission:

> "In one of the early cases on the section, <u>In re Wedgwood Coal and Iron Co.</u> (1882) 47 L.T. 612, Fry, J. pointed to the difference between misfeasance and non-feasance, and said that the Legislature plainly did not refer to cases of mere non-feasance, except, of course, where there hasin fact been a breach of trust...... Maugham, J. in <u>In re Etic</u> said that Fry J's decision is 'that the section applies only to cases where there has been in some true sense . . . a positive misfeasance or breach of trust.' I do not wish to take this further because there is a second point, which arises from Maugham J's conclusion quoted above. It is that the breach of duty must have caused pecuniary loss to the company. Upon consideration of the evidence, I cannot say that D.D. Maney's inactivity must have had that result. The real cause of loss to the company was the fraud of E.D. Maney. The inactivity of D.D. Maney did not cause that loss, but rather, I think, failed to prevent its continuing. On that ground, I hold that D.D. Maney cannot be dealt with under Section 321. His conduct was deplorable, but the section does not empower the Court to fine a director for misconduct. The facts must fall within the words of the section."[79]

In approaching this case in the above manner, Wild C.J. ruled on the question of pecuniary loss without having to rule on the question whether D.D. Maney had committed a breach of his duty to the company, and the opportunity to give a definitive ruling on the question of whether negligence falls within the ambit of Section 321 was not taken. With respect, however, it is doubted whether Wild C.J. was correct in his application of the second limb of Maugham J's rationale to the facts of this case. Wild C.J. does not appear to have appreciated the fact that D.D. Msney's failure to do something does appear to have been the cause of loss to the company. If he had stepped in then the loss might have been avoided. However, it seems from the facts of the case that E.D. Maney was something of a tyrant in regard to his children, and fear of his father on the part of D.D. Maney might well explain why he did nothing to prevent the course of action of which he was aware.

The question arises whether, in the light of <u>In re Hamiltons (Australia and New Zealand) Limited</u> Re Maney was correctly decided. In that case, failure on the part of Mr. Burnard to ensure that the company's business was properly conducted was held to amount to "misfeasance in an active sense", and was the cause of loss to the company during Burnard's period in office. This case, however, was not referred to by Wild C.J. in <u>Re Maney</u>. In view of the fact that Farr, J in <u>In re Hamiltons</u> appears to have correctly distinguished <u>In re Wedgwood Coal and Iron Co.</u> whereas in <u>Re Maney</u> a case giving rise to a similar issue the case was applied it is doubted whether Wild C.J. correctly decided the issue in regard to D.D. Maney. It seems, however, that as Peter Barber has remarked [80] that Wild C.J. was not influenced by purely legal considerations, and the relationship between father and son appear to have had some bearing on Wild C.J's decision.

As a result of Wild C.J's decision in regard to D.D. Maney it would appear that a very narrow interpretation will be placed on the question of pecuniary loss, and this position may be compared with <u>In re Washington Diamond Mines</u> (ante p.19)

The last New Zealand case to be considered and the latest decision in the area of the law presently under consideration is <u>Re Day-Nite Carriers Ltd. (In liquidation)</u> (1975) 1 N.Z.L.R. 173. In this case, the company was incorporated on 26th November 1968 with a nominal capital of $4,000. The respondent director subscribed for all but two shares, which were held by his wife. During the subsequent winding up of the company, the Official Assignee alleged that the business of the compan y had been carried on with intent to defraud creditors of the company, and that the respondent director was knowingly a party thereto, and sought an order under Section 320 of the Companies Act 1955 making the respondent personally liable without any limitation of liability for all the debts of the company. Alternatively, the official Assignee alleged <u>inter alia</u> that the respondent had been guilty of misfeasance or breach of trust in relation to the company, and sought an order pursuant to Section 321 that the respondent contribute to the assets of the company by way of compensation. During the 3 years ended 31st March 1972, the directors were paid a salary, authorised by resolution of the shareholders, which in each year was approximately equal to the nett profit for that particular year. Regarding these amounts, the official Assignee said that it appeared that none of the book entries recording the amounts paid was made within the time prescribed by the Companies Act, 1955, and that in fact they were made shortly before winding up. He agreed that on that ground they were false and fraudulent, there being no contract authorising the payments, and no profit from which the payment could be made. On 16th April 1972, judgment had been given against the company in favour of Credit Services Investment Ltd. for the sum of $8,230. White J. said that although judgment had been given against the company on that date, it was clear the respondent drew out of the company until April,1973, sums larger than ever before, with the result that no money was left when the company was wound up. White, J. said that there was no doubt that the respondent intended to draw from the company any cash that was available to him according to the accounts prepared by his accountant. The respondent had treated profits appearing in his accounts as his profits, while virtually ignoring the indebtness to the finance company. The respondent had viewed this as a debt for which neither he nor the company should be responsible.

White, J. dismissed the official Assignee's application insofar as it related to Section 320, taking the view he was not satisfied that the action taken by the respondent, with the apparent approval of his accountant, whose honesty was not questioned, should be held to amount to fraud. Dealing with the question of whether this action amounted to misfeasance, White,J. said that it had been held that the word 'misfeasance' should be read in the sense of a breach of trust or duty resulting in loss to the company. He cited Cavendish-Bentinck v. Fenn and Re Dominion Portland Cement Co. Ltd. Directors were not, he said, liable for mere errors of judgment. He adopted as the test, that laid down by Romer J. in Logunas Nitrate Company v. Logunas Nitrate Syndicate (ante p. 22)

> "....Their negligence must be, not the omission to take all possible care; it must be much more blamable than that, it must be in a business sense culpable or gross."

White, J. refused to hold the respandent guilty of misfeasance in relation to the payment of salary [81] but regarding the judgment debt, it was a different matter. He said that the respondent, having adopted an attitude to the debt due to Credit Services Investment Ltd. which was unjustified, acted in a "culpable" manner in drawing all the profits of the company, and so failing to provide funds to meet, in part at least, the company's debt. In the opinion of White, J. the official Asignee had shown, pursuant to Section 321, that the respondent had been guilty of misfeasance or breach of trust in relation to the company in respect of drawings made during the final period of the company's existence.

CONCLUSIONS

The cases discussed abovethat in New Zealand, the question as to whether negligence falls within the ambit of Section 321, has arisen in an acute form. It appears, from In re Dominion Portland Cement Co. Ltd., In re Hamiltons, and Re Day-Nite Carriers Ltd. that negligence or "gross negligence" whatever meaning that term may have, falls within the ambit of Section 321, and this view accords with those cases decided in England in which a similar view was taken.

In In re Maney and Sons, Wild, C.J. did not, due to his approach in regard to the pecuniary loss aspect, have to decide whether negligence was within the ambit of Section 321. But in view of the decision of Fair, J. in In re Hamiltons it is submitted that In re Maney and Sons was not correctly decided on this point. It is submitted that Wild, C.J. should have held that D.D. Maney was guilty of negligence, and that his failure to act was the cause of loss to the company.

The New Zealand cases appear to conflict with In re B. Johnson and Co. (Builders) Ltd. and it is submitted, are irreconcilable with this case unless the view expressed earlier is correct - namely, that Evershed, M R in In re B. Johnson and Co (Builders) Ltd. did not positively exclude negligence from the ambit of the misfeasance section.

It is clear that a decision of the Supreme Court or Court of Appeal on this very point is desirable. It is submitted, however, that in the event that a Court is faced with a similar set of facts to those in In re Maney and Sons, the Court should follow In re Hamiltons in preference to In re Maney and Sons.

CHAPTER THREE

A COMPARISON OF THE COURTS' APPROACH TO THE QUESTION OF THE LIABILITY OF DIRECTORS AND AUDITORS FOR MISFEASANCE COMPARED

As mentioned in Chapter One, there is some indication that the Courts approach this question of the liability of directors and auditors for misfeasance upon a different footing : it may be that auditors are held liable for little more than "common law negligence", or that the courts have imposed perhaps a more exacting duty of care upon auditors. If auditors are held liable for little more than common law negligence, then it is difficult to reconcile this position with In re B. Johnson and Co. (Builders) Ltd. in which Evershed MR purported to exclude common law or mere negligence from the ambit of the misfeasance section. It is intended in this chapter to examine the cases to determine whether there is a difference in approach taken by the Courts, and to determine, if such a difference exists, the basis of that difference.

It will have been noticed, in the discussion of the cases in the preceding chapter, that it has often been held that where directors have acted within their powers, and honestly, they will not be held liable for mere errors of judgment: their negligence must amount to "culpable" or "gross" negligence. Perhaps something should be said concerning the phrase "gross negligence". It is clear that the Courts have some doubts about it. In Wilson v. Brett (1843) Kl 11 M. and W. 113, Rolfe B. expressed the view, that 'gross' negligence is the same thing as 'negligence' with the addition of what he referred to as " a vituperative epithet" [82]. In Grill v. General Iron Screw Collier Co. (1866) 35 L.J.C.P. 321, Erle, C.J. said of this term:

> "I advisedly abstained a word to which I can attach no definite meaning and no-one- as far as I know, ever was able to do so" [83]

It will be remembered that in In re Brazilian Rubber Plantations and Estates Ltd. (ante p. 24) Neville, J. complained of a lack of precision in the statement that so long as directors had acted honestly in the performance of their duties, they could not be held liable in damages unless guilty of "gross" negligence, and in Re The City Equitable Fire Insurance Co. (1925) Ch. 407, Romer, J. went so far as to reject the view that a director could only be held liable if he was grossly negligent, and reached the conclusion that there was not several abstract standards of negligence, but that, in the light of the surrounding facts, the duty of a director owed in one case may be different from that owed in another case. (84)

Thus, it may be that little significance can be attached to the term "gross" negligence except insofar as it appears to indicate a degree of judicial reluctance to impose liability on directors where it has been held that they have acted honestly and within their powers.

The first case brought against auditors under Section 10 of the Companies (Winding Up) Act 1890 was In re London and General Bank (No.2) (1895) 2 Ch. 166; 6 7 3. The facts were that the company was a banking company registered under the Companies Act 1879 (U.K.) By virtue of article 2 of the articles of association, "auditors" and "secretary" were defined to mean

"those respective officers from time to time of the company"

The company was formed for the purpose of making loans and otherwise assisting a number of building companies called the 'Balfour' group of companies, and its profits consisted mainly of interest and commission payable by them. It turned out that the balance-sheet sanctioned by the auditors and presented to the shareholders by the directors had been so drawn for some years that they did not show the true position of the bank, and dividends were declared and paid out of capital, and not out of profits. A petition was presented for winding up the company, and an order for winding up was made. The official liquidator took out a summons under Section 10 of the Companies (Winding Up) Act, 1890 against the directors and auditors, asking that they might be declared liable to make good the sums paid as half-yearly dividends during certain years, on the grounds that they had been paid out of capital and not out of income. Vaughan Williams, J. gave judgment against the directors and auditors. The directors and auditors appealed from this decision, and on a preliminary point as to whether an auditor of the bank could properly be regarded as an "officer" within the meaning of Section 10, the Court of Appeal took the view that having regard to the Company's articles of association and Section 10, the auditor was an "officer" of the company and his conduct might accordingly be within the "mischief" contemplated by Section 10.

Dealing with the substantive issues before the Court, Lindley L.J. set out what he considered to be the duty of an auditor:

> ". . . He must be honest - i.e., he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe businessmen select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary : but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required ...." (85)

Lindley, L.J. pointed out that the balance-sheet and auditors' certificate for the year 1891 was accompanied by a report by Mr. Theobald, the auditor, to the directors of the bank. Taking the balance-sheet, the certificate, and report together, Lindley, L.J. said Mr. Theobald stated to the directors the true financial position of the bank and if the report had been laid before the shareholders, Mr. Theobald would have completely discharged his duty to them. But the report had not been laid before the shareholders and Lindley L.J. said :

> "In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the balance-sheet of February, 1892, without any reference to the report which he had laid before the directors, and with no other warning than was conveyed by the words 'The value of the assets as shown on the balance-sheet is dependent upon realization.' "[86]

Mr. Theobald argued that he was induced to omit from his certificate all reference to the report which he made to the directors because Mr. Balfour, the Chairman, promised to mention the report in his speech to the shareholders. But, although Mr. Balfour alluded to the report, he did so in such a way as to avoid drawing attention to it. In the circumstances, Lindley L.J. held that the balance-sheet and profit and loss account were

> ". . . entirely misleading and misrepresented the real position of the company. Under these circumstances I am compelled to hold that Mr. Theobald failed to discharge his duty to the shareholders with respect to the balance-sheet and certificate of February, 1892. Possibly he did not realize the extent of his duty to the shareholders as distinguished from the directors, and he unfortunately consented to leave the Chairman to explain the true state of the company to the shareholders instead of doing so himself."[87]

The substance of the report with which Lindley L.J. was concerned was that the auditors had recommended that no dividend should be paid in the year 1892, the state of the company not warranting such a payment. Nevertheless, a dividend for that year had been paid.
Dealing (only very briefly) with the liability of the directors, Lindley, L.J. said :

> ". . . (T)here was a clear breach of trust by the directors, facilitated, and indeed, only rendered possible, by the auditor who failed in discharging his own duty to the shareholders; and I have no doubt that in equity both he and they could be properly declared jointly and severally liable for the misapplication of the company's money which constituted that breach of trust . . . with respect, therefore, to the sum of £8486.11.0 wrongfully paid as dividend in 1892, in respect of the alleged profits made in 1891, the appeal in my opinion, fails." [88]

Lindley, L.J. refused to hold Mr. Theodore liable in respect of a dividend paid in respect of the year 1890, as he was not satisfied that in respect of that dividend Mr. Theobald was guilty of more than an excusable error of judgment . [89]
Rigby L.J. took the same view as Lindley, J. In discussing the reports given to the shareholders by the auditors, i.e. merely that

> "The value of the assets as shown on the balance-sheet is dependent upon realization,"

without more, Rigby L.J. mentioned the argument of counsel for the auditors that a failure on the part of the auditor with regard to his duty towards the shareholders, would not amount to misfeasance but only to negligence, and that Mr. Theobald was not charged with negligence.
Rigby, L.J. disagreed with that argument and said :

> "I consider the giving of the certificates (assuming them to be to the knowledge of the auditors misleading certificates

> a question which I propose to consider separately) to be a misfeasance within the meaning of Section 10 of the Act of 1890 and not a mere act of negligence: and that this was the meaning of the charge contained in the summons." [90]

Rigby L.J. went on to hold that in reporting the balance-sheet of 1891 without explanation, the auditors were guilty of misfeasance within the meaning of Section 10, and were thoroughly alive to the unsatisfactory state of affairs of the bank [91], and that loss to the company was occasioned by the misfeasance of the auditors [92]. He agreed with Lindley L.J. that the auditors should be liable only in respect of the dividend paid for the year 1892. The auditors were thus jointly and severally liable to repay to the liquidator the sum of £8486.11.0.

At first glance, it would appear that the auditors in this case were held liable in respect of mere negligence, without more, and such a view might be justified in that Lindley L.J. was concerned mainly to establish the extent of an auditor's duty, and whether or not there had been a failure on the part of the auditors to comply with that duty.

It is submitted, however, that this view of the case does not appear to be correct. Rigby L.J. makes it clear, in his judgment that the Court was not concerned with "a mere act of negligence" but something more than that - a misfeasance within the meaning of Section 10. This is a recognition, it is submitted, that in this case, mere negligence was not enough. Now, this part of the case should be read in the light of the judgment of the Court of Appeal when concerned with the preliminary issue as to whether auditors were officers of the company. There, Lopes, L.J.said that he thought the term "misfeasance" meant "breach of duty" and that if the term meant "breach of duty" could well involve a misapplication of the assets of the company. [93]

It is submitted, that this case involved a misapplication of the

Company's money: the payment of a dividend out of capital, and that this fact was recognised by the Court of Appeal.(94) This is not to say that m re negligence would not have come within Section 10. This point was not ruled upon by the Court. In the circumstances of this case, however, mere negligence was not sufficient to bring the auditors within Section 10.

Lindley, L.J. laid down that the standard of care to be exercised by an auditor in the performance of his duties was that of "reasonable care and skill". The writer was unable to locate the judgment of Vaughan Williams J, dealing with the liability of directors. But it will be remembered that in In re Brazilian Rubber Plantations and Estates Ltd. (ante p.), Neville, J. laid down what he regarded to be the extent of the duty of directors towards their company. The standard of care, in the performance of those duties, was said to be that of "reasonable care". Thus the standard of care required of auditors and directors is similar, although it would appear from In re London and General Bank Limited (No.2) that the duties of an auditor are more extensive than those of a director.

The next case to be considered is In re Kingston Cotton Mill Company (No.2) (1896) 1 Ch. 331. In this case, which was also decided under Section 10 of the Companies (Winding-Up) Act, 1890, the facts were that for some years prior to the winding-up of the company, balance-sheets, signed by the Company's auditors, were published by the directors to the shareholders, in which: (a) the value of the company's mill and machinery and (b) the value of its stock-in-trade were greatly overstated, Thedirectors, and one of the two auditors, knew that (a) was an over-value, but none of them knew that (b) was. They had believed and relied on certificates, proved to be deliberately false, given by a Mr. Jackson, who was the manager of the company as well as a director. Dividends were for some years paid on the footing that the balance-sheets were correct. However, if the excess in value in respect of (a) and (b) or either of them, had been deducted, there would have been no profits available for dividend. If the auditors had compared the different books and added to the stock-in-trade at the beginning of the year the amounts purchased during the year, and deducted the amounts sold, they would have found that the statement of the stock-in-trade at the end of the year was so large as to require explanation. The auditors however, did not carry out this investigation. In the winding up of company, the liquidator took out a misfeasance summons under Section 10 of the Companies (Winding Up) Act, 1890, and sought to have the directors and auditors held liable (a) for the dividends: (b) for the damages alleged to have resulted from continuing the company's business on the footing that the balance sheets were correct.

At first instance, Vaughan Williams, J. as mentioned previously, held that misfeasance covered every misconduct by an officer of the company as such for which such officer might have been sued apart from Section 10.

> "The charge against the auditors here is that they, either knowingly, or through the failure to use reasonable skill and care, certified amounts which ought not to have been certified. This is misconduct for which, in my opinion, either the company when solvent or the company in liquidation, could have sued the auditors and recovered any pecuniary damage actually sustained by the company." [95]

He went on to say that if the charges against the auditors were proved and coupled with pecuniary loss to the company, this would constitute a misfeasance within the meaning of Section 10. [96]. There is no doubt that in the opinion of Vaughan Williams, J. an auditor could be held liable for misfeasance under Section 10, when all that was involved on the part of a director was mere negligence.

After examining the evidence, with regard to the liability of the directors, Vaughan Williams, J. reached the conclusion that the directors had acted reasonably in accepting Jackson's certificate [97]. He said there was no authority which bound him to hold that directors who pay away the funds of their company under an honest and reasonable belief in a state of facts which would justify the payments, must be held liable to replace those funds because it turns out that on the true facts the payments were <u>ultra vires</u>. They had honestly believed that profits had been earned, and they had no reason to suspect the statements of the manager to this effect.[98]. In any event the damages were too remote,[99] and the directors were accordingly not liable in respect of any of the charges mentioned in the misfeasance summons.

In dealing with the auditors, Vaughan Williams, J. said that they were entitled to the benefit of his decision with regard to the dividends and remoteness of damage. But in regard to the stock-in-trade, Vaughan Williams, J. said that their position was very different from the directors, for they were certainly not entitled to rely upon the manager's certificate if an ordinary careful examination of the books ought to have made them suspect that statement. He agreed that it was no part of an auditor's duty to take stock, but held it to be part of an auditor's duty to test the accuracy of the manager's certificate by a comparison of the figures in the books that require auditing [100]. Accordingly he held the auditors liable in respect of preference dividends which had apparently been paid as a result of the auditors failure to test the accuracy of the manager's statements.

The judgment of Vaughan Williams, J. poses a problem : why should auditors be held liable for failure to test the accuracy of a manager's statements when, on an identical fact situation, he held that the directors had no reason to suspect the manager's statements, and had acted reasonably in accepting them? The only explanation seems to be that Vaughan Williams J. drew a distinction between the standard of care required of directors, and that required of auditors, placing a more exacting standard on the shoulders of the auditors. At first sight, it would appear that the auditors were held liable for mere negligence under S.10 - failure to test the accuracy of the manager's statements. But it would appear that more than this was involved : as a result of the negligence of the auditors, preference dividends had been paid, at a time when the company was not in a position to pay them. It is submitted then, that the company's had been misapplied, and the case cannot be viewed as one involving liability under S.10 for little more than mere negligence on the part of the auditors.

In any event, the auditors appealed from the decision of Vaughan, Williams, J. It will be remembered that in the Court of Appeal, the view was taken that while Section 10 did not apply to all cases in which actions would by the company for the recovery of damages against officers, the Section did apply to the case of an officer who had committed a breach of his duty to the company, the direct result of which had been a misapplication of its assets, for which he could be made responsible by an action in law or in equity (101).

In the event, the Court of Appeal did not rule on the question whether there had been a misapplication of the assets of the company, due to its ruling on the question of whether there had been a breach of duty on the part of the auditors. Lindley, L.J. stated that the duty of an auditor had been very carefully considered in In re London and General Bank (No.2), and he could not usefully add anything to what was said there (102). However, Lindley L.J. could not see that the omission of the auditors to check the manager's returns was a breach of their duty to the company :

> "It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade on hand. In the case of a cotton mill, he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the balance sheet, In this case, the auditors

SA SAINSBURY, N.E. Section 321 of the Companies Act 1955.

relied on the manager. He was a man of high character and unquestioned competence. He was trusted by everyone who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter."[103]

Lindley L.J. had earlier rejected the notion that an auditor is bound to be suspicious as distinguished from reasonably careful.[104]. He went on

"...(C)an it be truly said that the auditors were wanting in reasonable care in not thinking it necessary to test the managing director's return? I cannot bring myself to think they were, nor do I think that any jury of businessmen would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to anyone before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier who has to account for the cash he receives, and whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry. The auditor's duty is not so onerous as the learned judge has held it to be. The order appealed from must be discharged, with costs."[105]

Lopes, L.J. stated the duties of an auditor to be as follows:

"It is the duty of an auditor to bring to bear on the work he had to perform that skill, care and caution which a reasonably

> competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a blood-hound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom: but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful." [106]

He thought that the auditors were justified in relying on the honesty and accuracy of Jackson, and were not called upon to make further investigation. [107] He went on to say that the duties of auditors must not be rendered too onerous. He did not want to see the liability of auditors extended any further than in <u>In re London and General Bank</u> (No.2). He had concurred in the judgment in that case, and said that he had only assented to the decision there on account of the inconsistency of the report made to the directors with the balance-sheet certified by the auditors and presented to the shareholders. It was clear, he said, that the auditors had deliberately concealed from the shareholders that which they had communicated to the directors, and it was difficult to say that that was not a breach of duty. [108]

Kay, L.J. also agreed that there had been no breach of duty on the part of directors.

The case is interesting because it appears to represent an attempt, on the part of the Court of Appeal, to prevent the demanding standard of care which resulted from the decision of Vaughan Williams,J. being imposed on auditors. Thus, both directors and auditors in the performance of their respective duties were required to exercise "reasonable care."

As mentioned, the Court did not determine whether there had been a misapplication of the Company's money, due to the ruling on the question of breach of duty. The question therefore remains open as to whether a misapplication of money was involved in this case. It is submitted, however, that had the Court of Appeal found that the auditors were in breach of their duty to the company, it is at least arguable that, in that dividends had been paid out of capital, there had been a misapplication of money. Accordingly it is doubtful whether the auditors would have been liable for mere negligence.

In <u>In re The City Equitable Fire Insurance Company Limited</u> (1925) 1 Ch 407, it was found, during the winding up of the company by the Court, as a result of an investigation of its affairs, that there was a shortage in the funds, of which the company should have been possessed, of over £1,200,000, due in part to depreciation of investments, but due mainly to the instrumentality of the managing director, a Mr. Bevan, and largely due to his deliberate fraud, for which he had been convicted and sentenced. On a misfeasance summons under Section 215 of the Companies (Consolidation) Act, 1908, the Official Receiver as liquidator sought to make the respondent directors all of whom (except Mr. Bevan) had admittedly acted honestly throughout, liable for negligence in respect of losses occasioned by investments and loans, and of payment of dividends out of capital. The Official Receiver under the same misfeasance summons sought to make the auditors liable for negligence and breach of duty with respect to the audit by them of the balance sheets for the three years immediately previous to the winding up.

Article 150 of the company's articles of association excluded the directors and auditors of the company from liability for loss occasioned by anything done by them in the course of their duties, unless the loss was occasioned by or through their own wilful neglect or default. Romer, J. held that there was no general case of misconduct or negligence established against the directors or auditors, but in certain particulars they had failed in their full duty to the company, but were excused from liability by Article 150.

Romer J. in dealing with the question of the liability of directors said that the authorities did not provide a very clear answer as to the particular degree of skill and diligence required as a director, in the performance of his duties. He pointed out that it had often been held that so long as a director acts honestly he could not be made responsible in damages unless guilty of gross or culpable negligence in a business sense. Romer, J. said that he found some difficulty in understanding the difference between negligence and gross negligence, except insofar as the expressions were used for the purpose of drawing a distinction between the duty that is owed in one case and the duty that is owed in another. If a director was only liable for gross or culpable negligence, this meant that he did not owe a duty to his company to take all possible care. It was some degree less than that. As Neville, J. said in <u>Re Brazilian Rubber Plantations and Estates Ltd.</u> the care a director was bound to take was 'reasonable care' to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf. There were, in addition, Romer, J. said, a number of other general propositions that were warranted by the cases : (a) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience; (b) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so. (c) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

Among the matters in respect of which Romer, J. found the directors to have been guilty of negligence were the following -

(a) failing to ensure that the company's moneys were from time to time in a proper state of investment. It was not for the directors to leave Bevan to discharge one of the most important of the duties that had been entrusted to the board as a whole, by the shareholders, however reasonable and safe it might have seemed to the directors to do so

(b) failing to prepare a list of investments for use in connection with and for the purposes of the balance-sheet in each year. Such a list would have shown in detail all the investments that were lumped together in the balance-sheet under general headings, in order that the directors might form some idea for themselves as to whether the total sum brought in as the value of the investments under each general heading was justified for the purpose of the balance-sheet, and of the dividend they were recommending.

(c) accepting assurances as to the value of the company's assets from Bevan and Mr. Lepine, the auditor. The directors, when presenting their annual report and balance-sheet to the shareholders, and when recommending the declaration of a dividend, ought not to have been satisfied by such assurances, even by a chairman as distinguished and honourable as Bevan appeared at the time to be, nor with the expression of the belief of an auditor, as competent and trustworthy as Mr. Lepine was.

Romer, J. held, however, that the instances of negligence on the part of the directors did not come within the words "wilful neglect or default in Article 150," and accordingly the directors were protected from liability by the Article, which went so far as to exclude liability under a misfeasance summons.

Dealing with the liability of the auditors, Romer, J. pointed out that if, in the course of a long and aurduous audit, an auditor, even in one instance fell short of the strict duty of an auditor, he could not be excused merely because in general he displayed the highest degree of care and skill. [109]. In determining the question of liability of the auditors raised by the summons, Romer, J. applied the principles enunciated by Lindley L.J. in In re London and General Bank and in addition took the view that an auditor is never justified in omitting ot make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left, whenever such personal inspection is practicable. Romer, J. found, that the auditors had committed a breach of duty in not personally inspecting the securities of the company which were in the hands of the stock-brokers of the company (who were not proper persons, however respectable and responsible they may have been to have custody of the securities), and in accepting from time to time the certificate of the brokers that they held large blocks of such securities, and in not either insisting upon those securities being put in proper custody, or in reporting the matter to the shareholders.

> "This was negligence, and, but for article 150, it would be my duty to declare and order Messrs. Langton and Lepine to make compensation for all the damages that such negligence caused to the company, directing an inquiry to ascertain what those damages were." [110]

Romer, J. held that the auditors negligence was not wilful. Throughout the audits Mr. Lepine had conducted, he had honestly and carefully discharged what he considered to be the whole of his duty to the company. If, in certain matters, he had fallen short of his real duty, it was because, in all good faith, he had a mistaken belief as to what that duty was. Romer, J. accordingly dismissed the application of the Official Receiver against Mr. Lepine and his partner.

The Official Receiver appealed from the decision of Romer, J. insofar as it affected the auditors. The Court of Appeal affirmed the judgment of Romer, J.

This case would appear to show that but for Article 150 the auditors would have been held liable under Section 215 of the Companies (Consolidation) Act 1908 for misfeasance involving little more than mere negligence : in that the auditors had failed in their duty to ensure that the securities of the company were in proper custody. It is submitted, however, that this case cannot be taken too far in this respect. It is clear that Romer, J. was primarily concerned to determine whether Article 150 afforded any protection to the auditors. In reaching the conclusion that Article 150 did afford this protection. Romer, J. did not have to consider whether the negligence of the auditors amounted to misfeasance within the meaning of Section 215. In any event, Warrington L.J. in the Court of Appeal, held that Article 150 modified the liability of the auditors :

> "....Plainly, when the true construction of Article 150 was ascertained, the effect of the article was to excuse the auditors from being answerable for loss occurring in relation to their office, except in the particular events which are therein specified - namely, those which happen by or through their own wilful neglect or default - and that it would be improper to describe as a misfeasance any act or omission of the

> auditors which, having regard to that article, would not result in their being answerable for the loss which may be occasioned thereby." (111)

Regarding Section 215, he said:

> ".... If I am right in what I have said, it is quite plain that nothing was referred to in that section as a misfeasance, except an act or default which would, having regard to the relations betweem the auditors and the company, be a misfeasance or a breach of trust, causing loss to the assets of the company, and if therefore there was some act or omission on the part of the auditors which having regard to the provisions of Article 150... does not give rise to any liability to the company, it gave rise to no liability under Section 215...." (112)

Warrington L.J. also pointed out that Romer, J. had come to the conclusion that but for Article 150, he would have held, and did hold, that there was negligence on the part of the auditors in regard to the inspection of the securities which were, in fact, in the possession, or ought to have been in the possession of the stockbrokers, and as to which that firm gave a certificate which was accepted by the auditors. (113). Both Warrington and Sargant L.J.J. pointed out (114) that quite apart from Article 150, the fact that the auditors were at all neglectful or were in default was arguable. However, as they had not heard any argument on that point on behalf of the auditors, that they would not say definitely that they thought Romer, J. was correct in his conclusion that apart from Article 150, the auditors would have been liable.

It is submitted that the case cannot be cited as an authority having any bearing on the question of the liability of auditors for misfeasance under Section 215, as the decision, in fact, centres on the construction of Article 150 of the company's articles. (N.B. such a provision is now declared to be of no effect : Section 204 of the Companies Act, 1955). Something must be said, however, concerning the a standard of care required of an auditor, as illustrated by this case. Romer, J. applied the principles enunciated by Lindley L.J. in In re London and General Bank (No.2) . There the standard required was that of reasonable skill and diligence, but it is clear that Romer, J. imposed a more exacting standard than that imposed in In re London and General Bank (No.2) taking the view that if, in the course of a long and arduous audit, an auditor even in one instance fell short of the strict duty of an auditor, he could not be excused merely because in general he displayed the highest degree of care and skill (emphasis mine). Although Romer, J. appears to have extended the scope of the duties of directors, he does not appear to have imposed a higher standard of care upon them than did Neville J. in Re Brazilian Rubber Plantations and Estates Ltd. - that of reasonable care, measured by the care an ordinary man might be expected to take in the circumstances on his own behalf. This apparent difference in the standard of care required of directors and auditors amounts to an acknowledgement on the part of Romer, J. that the respective duties of directors and auditors are quite different.

In In re Thomas Gerrard and Son Ltd. (1968) 1 Ch. 455, Mr. Croston, the managing director of the company falsified the company's books by three methods. The company's auditors obtained the information about the various matters on which they were required to report under Section 162 of the Companies Act, 1948 (see Section 166 of the Companies Act, 1955), principally from Croston, whom they believed to be of the highest integrity and they accepted his explanation of the alterations. The auditors certified the accounts, tax was paid on the inflated profits (the profits were inflated by reason of what Croston had done) and they recommended, and the shareholders confirmed, a payment of dividend during the financial years ending in March 1957-1962. The frauds were subsequently discovered, and the company went into liquidation. The liquidator took out a misfeasance summons under Section 333 of the Companies Act, 1948, against the auditors, claiming that they were guilty of or liable for negligence or breach of duty in respect of the audit of the accounts. The auditors contended that they were not in breach of their duty in that, <u>inter alia</u>, they were not given sufficient time to make their audit. Pennycuick, J. said that <u>In re Kingston Cotton Mill Company</u> (No.2) appeared at first sight, to be conclusive in favour of the auditors, as regards the falsification of stock taken in isolation :

> "Mr. Walton, for the liquidator, pointed out that before 1900 there wss no statutory provision corresponding to Section 162 of the Companies Act, 1948. That is so, but I am not clear that the quality of the auditors duty has changed in any relevant respect since 1896. Basically, that duty has always been to audit the company's accounts with reasonable care and skill. The real ground on which <u>In re Kingston Cotton Mill Company</u> (No.2) is, I think, capable of being distinguished, is that the standards of reasonable care and skill are, upon the expert evidence, more exacting today than those which prevailed in 1896. I see considerable force in this contention. It must, I think, be open, even in this Court, to make a finding that in all the particular circumstances the auditors have been in breach of their duty in relation to stock. On the other hand, if this breach of duty stood alone, and the fact were more or less the same as those in <u>In re Kingston Cotton Mill Company</u>(No.2) this Court would, I think, be very chary indeed of reaching a conclusion different from that reached by the Court of Appeal in <u>In re Kingston Cotton Mill Company</u> (No.2)" (115)

Croston had falsified the company's books by three methods:

(a) He had caused the half-yearly stock valuation to be inflated by the inclusion of non-existent stock. Pennycuick, J. said that he thought it better not to make a finding on what would be the position under this head if it stood alone.

(b) Croston had caused the price payable on purchase of stock made at the end of each half-yearly period to be included in the outgoings of the succeeding period by altering invoices in a manner immediately apparent to anyone looking at the invoices.

Pennycuick, J.[116] said that he found it impossible to acquit the auditors of negligence as regards this head. He said that assuming the auditors were entitled to rely on the managing-director and secretary of the company until they first came upon the altered invoices, once these were discovered, they were clearly put upon inquiry, and they were not then entitled to rest content with the assurances of these two men, however implicitly they may have trusted the managing director.

Pennycuick J. said that the conclusion was inescapable alike on the expert evidence and as a matter of business common sense, that at this stage they ought to have examined the suppliers' statements, and where necessary communicated with the suppliers. Having ascertained the precise facts so far as it was possible for them to do so, they should have then informed the board. It may have been, Pennycuick J. said that the board would then have taken some action. But whatever the board did, the auditors should, in each subsequent audit, have made such checks and such inquiries as would have ensured that any misattribution in the "cut-off" procedure was detected. Those steps were not taken, and the conclusion was that the auditors had failed in their duty.

(c) Croston had caused the price payable for sales made after the end of the relevant period to be included in the preceding period.

Pennycuick, J. said[117] that this head differed from the others in an important respect, in that there was no alteration of the documents involved. Croston had destroyed the copy invoices, and had given a plausible though untrue explanation for their absence. Pennycuick, J. again declined to make a finding on what would be the position under this head, if it stood alone.

He went on:

> "It was conceded that if breach of duty was found under any one of the three heads, the measure of compensation was the same as if the breach of duty had been found under either two or all three heads. This concession was clearly right. The three heads were closely interrelated, and once put on their guard under any one head, the auditors ought to have taken such steps as would have ensured that a fraud under either heads equally would not remain undetected. It was for this reason I thought it better not to make separate findings under heads (a) and (b). These were matters of some general importance and findings under either of them in isolation would be unnecessary and might be misleading."(118)

Pennycuick, J. held the auditors liable for the amount of the dividends paid, and the costs of recovering the excessive tax and any tax not recovered. Their allegations of insufficient time did not suffice to excuse them. It was held that if directors of a company do not allow auditors time to conduct such investigations as are necessary, the auditors must either refuse to make a report at all, or make an appropriately qualified report. They are not justified in making a report containing a statement the truth of which they have not had time to verify.

The auditors were thus held liable for negligence under Section 333 of the Companies Act, 1948. It is submitted, however, that the negligence in respect of which the auditors were held liable was not mere negligence, or in the words of Evershed MR "common law negligence". It appears that dividends were paid at a time when the company was, in fact, insolvent, and that dividends were paid out of capital. Such a payment, in the circumstances of the case, was, it is submitted, a misapplication of the money of the company, and it was in respect of that misapplication that the auditors were held liable.

The case is interesting in that Pennycuick, J. recognised the existence of a higher standard of care in relation to auditors than was recognized by the Court of Appeal in In re Kingston Cotton Mill Company (No.2) In re Thomas Gerrard and Son Ltd. would appear to be distinguishable from In re Kingston Cotton Mill Company (No.2) on the ground that in the latter case there was nothing giving rise to suspicion on the part of the auditors, whereas in the former case, the auditors should have been alerted by the altered invoices, and should have taken the appropriate steps.

CONCLUSIONS

From the foregoing discussion, it is apparent that there is a tendency on the part of the Courts to deal with directors and auditors differently under the misfeasance section. It has been noted previously in this paper, that the Courts have held that directors may only be held guilty of misfeasance in respect of their alleged negligence, when it can be shown that there has been "gross" or "culpable" negligence on their part. The cases discussed in this chapter, dealing as they do with the liability of auditors for misfeasance, are notable for the absence of any reference to a similar standard of proof in connection with misfeasance proceedings bought against auditors. The Courts in the cases discussed, have held auditors guilty of misfeasance when nothing more than "negligence" has been proved against them, although the cases seem to involve liability for misapplication of the funds of a company. This seems to take them outside the category of "common law negligence" mentioned by Evershed, MR. in In re B.Johnson and Co. (Builders) Ltd. In that case, Evershed MR appeared to have in mind cases of negligence not involving misapplication of funds. This is not to say, however, that an auditor would not be guilty of misfeasance in such a case: the approach taken by the

Courts in dealing with the question of an auditor's liability for misfeasance, makes this highly possible, at least, since the decision in In re Thomas Gerrard and Son Ltd. In the cases considered in this chapter, however, liability in respect of "common law negligence" or mere negligence without more, does not seem to have been in issue.

On what basis is this difference in approach explainable? It is probably explainable on the basis that the Courts have recognised that directors and auditors perform different duties, and although the same standard of care appears to be the same for both - that of reasonable care, the degree of care which must be exercised seems to differ. As Romer J. in In re The City Equitable Fire Insurance Co. Ltd.

> "...(I)f it be said that of two men, one is only liable to a third person for gross negligence, and the other is liable for mere negligence, this, I think, means no more than the duties of the two men are different. The one owes a duty to take a greater degree of care than does the other..." (119)

Speaking of the duties of a director, Neville, J. said in In re Brazilian Rubber Plantations and Estates Ltd. (p.24 ante):

> ".... A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifiactions to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance; while if he is acquainted with the rubber business, he must give the company the advantage of his knowledge when transacting the company's business. He is not, I think, bound to take any definite part in the conduct of the company's business, but so far as he does undertake it, he must use reasonable care in the despatch. Such reasonable

care must, I think, be measured by the care an ordinary man ought to be expected to take in the same circumstances on his own behalf..." (120)

Thus, while it has been recognised that a director need not be qualified in order to assume the duties of a director of a company, an auditor has always been regarded as a professional man. The Courts have given due recognition to this fact, and appear to have expected that an auditor will exercise a greater degree of care in the performance of his duties than a director, although the expectation as to the degree of care to be exercised may actually be determined by reference to current business practice. As Moffit, J. said in Pacific Acceptance Corporation Ltd. v. Forsyth (1970) 92 W.N. (N.S.W.) 29, a case which has come to be known as a leading case in this area :

> "...It is not a question of the Court requiring higher standards because the profession has adopted higher standards. It is a question of the Court applying the law, which, by its content expects such reasonable standards as will meet the circumstances of today, including modern conditions of business and knowledge concerning them. However, now as formerly, standards and practices adopted by the profession to meet current circumstances provide a sound guide to the Court in determining what is reasonable." (121)

It is accordingly submitted that the difference in the approach taken by he Courts with regard to the question of an auditor's liability for misfeasance, as compared with the approach taken by the Courts with regard to the question of a director's liability for misfeasance, as seen in this Chapter, is explainable on the ground that the Courts, in dealing with auditors, recognise that they are dealing with professional men, and therefore expect that they will exercise a greater degree of care in the performance of their duties than may be expected of directors.

Whether such a difference in approach could be justified in the prevailing conditions of the modern business world, is open to doubt. Pennycuick, J. in In re Thomas Gerrard and Son Ltd. was not, of course, concerned with the liability of directors for misfeasance, but had he been so, it would have been open for him to have held that the standards of reasonable skill and care required of directors are more exacting in 1968 than those prevailing in 1911 or even 1925, when In re The City Equitable Fire Insurance Co. Ltd. was decided.

It may be noted that the writer was unable to find any Australian or New Zealand cases in which proceedings were brought against auditors for misfeasance under the misfeasance section, apart from Re J.F. Hurdley Limited (1941) N.Z.L.R. 686. However, the case does not appear to raise the issues contained in the cases discussed, and has not been included in the discussion.

CHAPTER FOUR

LEGISLATIVE REFORM

It was seen in Chapter Two of this paper that the Courts have had considerable difficulty in the construction of the term "misfeasance". The fact that the misfeasance section, which is part of the Companies legislation in England, Australia, and New Zealand has been said to be a section which

> "... creates no new offence, and...gives no new rights, but only provides a summary and efficient remedy in respect of rights which apart from that section, might have been vindicated either at law or in equity...." (122)

does not appear to have been of assistance to the Courts in their construction of the term. In New Zealand, as elsewhere, the state of the case law is such it would appear that legislative intervention is required in order to reduce the amount of confusion that appears to have arise. Legislative intervention has actually occurred in Australia, and is proposed in Canada, where Courts have also encountered difficulty with the term "misfeasance." It is intended, in this chapter, to briefly examine the legislation in force in Australia, and proposed for Canada, in order to determine whether similar legislation should be introduced in New Zealand, and the form it should take.

1. Australia: The Uniform Companies Amendment Act (New South Wales) 1971

Section 9(h) of the Uniform Companies Amendment Act 1971 repealed Section 305 of the Uniform Companies Act 1961, this section corresponding to Section 333 of the Companies Act, 1948 (Eng.) and Section 321 of the Companies Act 1955. Section 367B is now the section giving the Court power to assess damages against delinquent officers, and provides as follows:

5A. SAINSBURY, N.E. Section 321 of the Companies Act 1955.

"(1) Where it appears to the Commission or a prescribed person that any other person . who has taken part in the formation, promotion, administration, management or winding up of a company to which this section applies -

(a) has misapplied or retained or become liable or accountable for any money or property of the company, or

(b) has been guilty of any negligence, default, breach of duty or breach of trust in relation to the company

the Commission, or a prescribed person, may apply to the Court for an order that the other person -

(c) repay or restore the money, or such part thereof as the Court thinks fit together with interest at such rate as the Court thinks just; of

(d) pay to the company such sum by way of damages in respect of the misapplication, retainer, negligence, default, breach of duty, or breach of trust, as the Court thinks just."

The Commission to which the section refers, is, of course, the Corporate Affairs Commission, and the "prescribed persons" who may apply to the Court for an order under the section are those set out in Section 1 367B 367B (1A) namely:

(a) a liquidator or provisional liquidator of the company

(b) a contributory of the company

(c) where the company is under official management - the official manager or a member of the company; and

(d) a person authorised by the Commission to make an application under subsection (1) of Section 367B.

By virtue of Section 367C, Section 367B applies to the following companies:

(a) those which are in the course of being wound up

(b) those which are under official management

(c) those in respect of the affairs of which there is an inspection within the meaning of Part VI of the Act.

(d) those in respect of which a receiver or manager has been appointed, whether by the Court or pursuant to the powers contained in any instrument; or

(e) those which have ceased to carry on business or are unable to pay their debts.

In New Zealand, the Macarthur Committee regarded Section 367B of the Uniform Companies Amendment Act 1971 as a great improvement upon Section 321 of the Companies Act 1955, and as entirely suitable for New Zealand conditions. (123). As the Committee pointed out, Section 367B is, in effect, a re-enactment of Section 305 of the Uniform Companies Act, 1961 (N.S.W.) although it is wider than Section 305, and, consequentially, wider than Section 321. The following points may be made concerning Section 367 B

(a) Receivers now come within the scope of the Section : this position may be compared with <u>In re B. Johnson and Co. (Builders) Ltd.</u>

(b) There is no reference to "misfeasance". Instead there is reference to "negligence, default, breach of duty or breach of trust." It is thus made clear that negligence falls within the section, and the section thus overturns <u>In re B. Johnson and Co. (Builders) Ltd.</u> However, while it appears that the section is aimed at "mere negligence", or "common law negligence", there is some doubt as to whether the term will be interpreted as widely as this. Although there do not appear to have been any cases on the interpretation of Section 367B(1)(b), it does not appear likely that the Courts will abandon the view that a director can only be held liable where gross negligence can be shown. It may also be necessary to show, in other cases, that the negligence involves misapplication of assets.

(c) It is unfortunate, in view of the fact that reference to the term "misfeasance" has been abandoned, that reference to the term "breach of trust" has been retained. This is a term which has also caused considerable difficulty, and in view of the inclusion of the term "breach of duty" in Section 267 (1) (b) reference to "breach of trust" may well be superfluous.

(d) The categories of those who may apply to the Court for an order under Section 367 B have been widened to include a provisional liquidator, an official manager or member of the company under official management, and a person authorised by the Commission to make an application under Section 367 B (1)

(e) It is no longer necessary that a company be in the course of winding up before action may be taken under Section 367 B

The position may be compared with Section 321 of the Companies Act 1955, where a company must be in the course of winding up before action may be taken under the Section.

See R v. Schildkamp

It is submitted that if Section 367 B were to be incorporated in the Companies Act 1955 in place of the present Section 321, a considerable improvement upon Section 321 would indeed be effected. In particular, the scope of the section would be widened, reference to the difficult term "misfeasance" would no longer be necessary, and it would be clear that negligence falls within the section. This would, in effect, give legislative affirmation to the view taken by the Courts in New Zealand. Although difficulties of interpretation might to some extent remain, these would not, it is submitted, be present to the same degree as in connection with Section 321. However, before any decision as to whether Section 367 B should become part of the Companies Act 1955 is made, the proposed Canadian legislation will be considered.

2. Canada - proposed reform -

In April, 1971, a Canadian Study Group, led by Dr. Robert Dickerson, presented its Report to the Minister of Consumer and Corporate Affairs. The Report was presented in two volumes, entitled "Proposals for a New Business Corporations Law for Canada". The first volume consisted of the Report *per se*, and the second volume consisted of a draft Federal Statute, which incorporated the proposals contained in the Report. Insofar as they are relevant, a number of the provisions contained in the draft statute are set out below.

It should be noted that a misfeasance section expressed in the same terms as section 321 of the Companies Act 1955 has been included in previous Canadian legislation. However, no such provision has been included in the draft statute. The following provisions appear to replace such a provision.

Section 9.16 of the draft statute provides that:

(a) Directors of a corporation who vote for or consent to a resolution authorizing

(a) a purchase, redemption, or other acquisition of shares contrary to section 5.08 or 5.09 or 5.10 (124)

(b) a commission, discount or allowance contrary to section 5.13 (125)

(c) a payment of a dividend contrary to section 5.14 (126)

(d) a loan, guarantee or financial assistance contrary to section 5.16 (127)

(e) a payment of an indemnity contrary to section 9.20 (128)

(f) a payment to a shareholder contrary to section 19.17 or 19.04 (129)

(g) an act contrary to Section 3.02 and in respect of which the corporation has paid compensation to any person (130)

are jointly and severally liable to restore to the corporation any amounts so distributed or paid and not otherwise recovered by the corporation."

Section 9.19 provides as follows:

"(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation, and

(b) exercise the care, diligence and skill of a reasonably prudent person

(2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws, and any unanimous shareholder agreement.

(3) No provision in a contract, the articles, the by-laws, or a resolution shall relieve an officer or director from the duty to act in accordance with this Act or the regulations or relieve him from liability for a breach thereof."

Speaking of this Section, the Dickerson Committee said that it represented a general Statutory formulation the fiduciary relationship between corporations and their directors.

SAINSBURY, N.E. Section 321 of the Companies Act 1955.

"...In so far as the general duty of loyalty and good faith is concerned, this Section is simply an attempt to distill the effect of a mass of case law illustrating the fiduciary principles governing the position of directors. Those principles have long since been accepted by the Courts in Canada ......Section 9.19 does not purport to answer in advance the manifold problems involved in assessing the facts of particular cases. The purpose is simply, and perhaps gratuitously, to give statutory support to principles that are as difficult to apply as they are well understood." [131]

The Committee went on to say that the formulation of the duty of care and diligence and skill owed by directors represented an attempt to upgrade the standard presently required of them. Recent experience had demonstrated how low the prevailing legal standard of care for directors was, and the Committee had sought to raise it significantly. [132]

Turning now to the question of the company in liquidation, Section 1716 (3) and (4) provide as follows:

"(3) If a liquidator has reason to believe that any person has in his possession or under his control, or has concealed, witheld, or misappropriated any property of the corporation, he may apply to the Court for an order that such person appear before the Court at the time and place designated, and be examined.

(4) If such examination discloses that a person has concealed, witheld, or misappropriated property of the corporation, the Court may order him to restore it or pay compensation to the liquidator."

Among the remedies which the draft Statute provides are the following. Section 19.02 provides:

(1) Subject to subsection (2) a complainant may apply to a Court for a consent to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene

in an action to which any such body corporate is a party for the purpose of prosecuting, defending, or discontinuing the action on behalf of the body corporate

(2) No action may be brought and no intervention may be made under subsection (1) unless the Court is satisfied that

(a) the complainant has made reasonable efforts to cause directors of the corporation or its subsidiary tobring diligently prosecute or defend or discontinue the action

(b) the complainant is acting in good faith, and

(c) it is a prima facie in the interests of the corporation or its subsidiary that the action brought, prosecuted, defended or discontinued."

Speaking of Section 19.02 (1), the Dickerson Committee said (133) that it confers upon a complainant (e.g. a shareholder or debenture holder) the right to apply to a Court for consent to bring or intervene in a derivative action in the name and on behalf of the company or one of its subsidiaries to enforce a right of the corporation. The Committee emphasised, however, that this provision related only to the enforcement of rights of the corporation. It is not available as a remedy to enforce rights of an individual shareholder, or even a group of shareholders, although as the Committee pointed out, a group of sharehalders may bring, in a representatigve form , a derivative action in the name of the corporation if they can characterize the issue as the enforcement of a right of the company. The Dickerson Committee said that Section 19.02(2) circumvents most of the procedural barriers that surround the present right to bring a derivative action. By requiring the complainant to establish that the action is"prima facie in the interest of the corporation" it blocks actions to recover small amounts, particularly actions instituted to harass or to embarrass directors or officers who have committed an act, which although unwise, is not material. In effect, the provision abrogates the "notorious rule" in Foss v. Barbottle, and substitutes for that rule a new regime to govern the conduct of derivative actions.

The provisions set out above, as contained in the draft Statute prepared by the Dickerson Committee, represent a radical departure from the provisions of the New Zealand Companies Act 1955, and the Uniform Companies Amendment Act, 1971 (N.S.W), although, it appears that the draft Statute has not yet become part of the law of Canada.
The most significant feature is the absence of any reference to the term "misfeasance". As mentioned in the introduction to this Chapter, the Courts in Canada appear to have found just as much difficulty with the term as have their counterparts in England, Australia and New Zealand, and no doubt this is a reason for the absence of any such provision in the draft Statute.

Having said that, it may be noted that, in effect, Sections 9.16 and 17.16 (3) and (4) are misfeasance sections. The point to note, however, is the fact that while this would seem to be so, the Dickerson Committee has detailed specific acts which would otherwise appear to amount to misfeasance, without reference to theglobal term, thus, to a considerable extent, reducing the difficulty of interpretation.

The Jenkins Committee opposed any attempt at the codification of director's duties, but expressed the view that a general statement was desirable on the basis that it would possibly be useful to directors and others concerned with company management.[134] Such a statement should serve to bring to the attention of "directors and others concerned with company management" the nature of their relationship to their company, something as to which, it would appear, a considerable number of directors and officers appear to have been unclear. The attempt to upgrade the standard of care required of directors acknowledges the fact that conditions in the business world have undergone considerable change since the early 1900's.

Section 19.02 (1) of the draft Statute is an important provision. Were it to become law, a complainant, or group of complainants, for example shareholders, could invoke it to bring an action against directors under section 9.16, or directors and/or officers for a breach of duty under Section 9.19, alleging self-dealing or negligence; or an action for an injunction to preclude a threstened inquiry (injury?) to the company, or an action to restrain an act outside the powers of the company, its directors, or its officers (135). Provided that the complainants could bring themselves within Section 19.02 (2) (a) - (c), Section 19.02 (1) could thus have a preventive effect, enabling complainants to restrain a course of action upon which the directors or officers of the company are embarked, before matters become serious.

CONCLUSIONS:

Section 321 of the Companies Act, 1955, like its counterparts in England and Australia, is fraught with difficulties, and the case-law on the interpretation of the term "misfeasance" is sufficiently confused to warrant legislative reform.

Legislation to replace Section 321 should be that which is designed to avoid the difficulties encountered with Section 321. Section 367B of the Uniform Companies Amendment Act, 1971 (N.S.W.) if enacted in place of the present Section 321, would, as mentioned, go some way toward achieving this goal. However, the provisions outlined above, contained in the proposed Canadian legislation, to a greater extent than Section 367 B, avoid many of the difficulties involved with Section 321, and have a preventive aspect, which Sections 321 and 367 B do not appear to have.

The writer would prefer to see legislation of the type proposed for

Canada enacted in New Zealand in preference to Section 367B. However, the Macarthur Committee regarded Section 367B as

"entirely suitable for New Zealand conditions" [136]

and it would appear that it is this provision that will replace Section 321, in preference to the legislation in the nature of that proposed for Canada. Whatever form the new legislation will take, it is to be hoped that reform will not be unduly delayed.

B I B L I O G R A P H Y

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3. (1871) 6 Ch. App. 104 at 118

4. (1871) 6 Ch. App. 104 at 122

5. Halsbury's Laws of England, Volume 7, "Companies" at para 1199

6. (1872) L.R. 5 H.L. 480 at 496

7. (1872) L.R. 5 H.L. 480 at 487

8. (1872) L.R. 5 H.L. 480 at 493

9. Lucas, J. in In re Tropic Isle Ltd. (In liquidation) (1967) Qd. R. 193 at 201

10. (1877) 5 Ch. D. 306 at 321

11. (1877) 5 Ch. D. 306 at 324

12. (1877) 5 Ch. D. 306 at 325

13. (1877) 5 Ch. D. 306 at 327

14. (1878) 8 Ch. D, 388 at 396

15. (1878) 8 Ch. D. 388 at 399-400

16. (1878) 8 Ch. D. 388 at 400: see the judgment of Jessel MR.

17. (1878) 10 Ch. D. 450 at 453

18. (1878) 10 Ch. D. 450 at 459

19. (1878) 10 Ch. D. 450 at 456

20. (1878) 10 Ch. D. 450 at 457

21. (1880) 14 Ch. D. 660 at 664

22. (1880) 14 Ch. D. 660 at 670

23. (1880) 14 Ch. D. 660 at 671

24. (1880) 14 Ch. D. 660 at 672

25. C.D. Monahan, "Company Law - Misfeasance Proceedings" (1937) (1937) A.L.J. 253 and 254.

26. C.D. Monahan, op. cit. at 254

27. (1882) 47 L.J. 612 at 618

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29. (1887) 12 A.C. 652 at 661-662

30. (1887) 12 A.C. 652 at 669

31. (1892) 3 Ch. 577 at 585

32. (1892) 3 Ch. 577 at 585-586

33. (1892) 3 Ch. 577 at 586

34. (1896) 1 Ch. 331 at 344.

35. (1896) 1 Ch. 279 at 283

36. (1896) 1 Ch. 279 at 288

37. (1899) 2 Ch. 392 at 442

39. (1901) A.C. 477 at 485

40. (1901) A.C.C. 477 at 492

41. (1911) 1 Ch. 425 at 436-437

42. (1911) 1 Ch. 425 at 438

43. (194) 1 Ch. 425 at 440

44. (1928) 1 Ch. 861 at 875

45. (1955) 1 Ch. 634 at 648

46. (1955) 1 Ch. 634 at 650

47. (1955) 1 Ch. 634 at 650

48. P.Barker Research Paper on Sections 321 320 and 364 of the Companies Act, 1955 (Victoria University of Wellington) o. 19.

49. (1933) 49 C.L.R. at 496

40. (1965) N.S.W.R. 446 at 451.

51. (1962) 4 F.L.R. 60 at 66

52. (1962) 4 F.L.R. 60 at 68

53. (1967) Qd. R. 193 at 201

54. (1967) Qd. R. 193 at 205

55. (1967) Qd. R. 193 at 205

56. (1967) Qd. R. 193 at 207

57. (1967) Qd. R. 193 at 209

58. ante p. 32

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59. (1968) 2 N.S.W.R. 653 at 656

60. (1968) 2 N.S.W.R. 653 at 660

61. (1968) 2 N.S.W.R. 653 at 660

62. Gerrard Holdings Limited was the parent company of the group of companies in which Wilson and Franklin were interested as directors. They were also directors of this company, and Gerrard Holdings Limited subsequently became a shareholder in Hurstville Finance Pty. Ltd.

63, (1968) 2 N.S.W.R. 653 at 662

64. (1921) N.Z.L.R. 667 at 687

65. (1921) N.Z.L.R. 667 at 687

66. (1921) N.Z.L.R. 667 at 688

67. (1921) N.Z.L.R. 667 at 689

68. (1921) N.Z.L.R. 667 at 691

69. (1921) N.Z.L.R. 667 at 698

70. (1921) N.Z.L.R. 667 at 693 - 694

71. (1925) N.Z.L.R. 907 at 922.

72. (1946) G.L.R. 82 at 94

73. (1946) G.L.R. 82 at 94

74. (1946) G.L.R. 82 at 94

75. (1946) G.L.R. 82 at 95

76. (1946) G.L.R. 82 at 95-96

77. (1968) N.Z.L.R. 624 at 630

78. (1968) N.Z.L.R. 624 at

80. op cit. p. 15

81. (1975) 1 N.Z.L.R. 173 at 183

82. (1843) 11 M and W 113 at 115-166

83. (1866) 35 L.J.C.P. 321 at 324-325

84. Palmers Company Law (21st Edition 1968). p. 580.

85. (1895) 2 Ch. 673 at 683

86. (1895) 2 Ch. 673 at 586

87. (1895) 2 Ch. 673 at 686.

88. (1895) 2 Ch. 673 at 689

89. (1895) 2 Ch. 673 at 690

90. (1895) 2 Ch. 673 at 695

91. (1895) 2 Ch. 673 at 696

92. (1895) 2 Ch. 673 at 697

93. (1895) 2 Ch. 166 at 172

94. see Lindley L.J. at 688.

95. (1896) 1 Ch. 331 at 344.

96. (1896) 1 Ch. 331 at 345

97. (1896) 1 Ch. 331 at 345

98. (1896) 1 Ch. 331 at 348

99. (1896) 1 Ch. 331 at 349

100. (1896) 1 Ch. 331 at 349

101. 1 Ch. 279 at 283 per Lindley L.J.

102. (1896) 1 Ch. 279 at 289

103. (1896) 1 Ch. 279 at 286

104. (1896) 1 Ch. 279 at 284

105. (1896) 1 Ch. 279 at 287

106. (1896) 1 Ch. 279 at 288-289

107. (1896) 1 Ch. 279 at 289

108. (1896) 1 Ch. 279 at 290

109. (1925) 1 Ch. 407 at 480

110. (1925) 1 Ch. 407 at 498

111, (1925) 1 Ch. 407 at 520

112. (1925) 1 Ch. 407 at 525-526

113. (1925) 1 Ch. 407 at 527

114. (1925) 1 Ch. 407 at 527 and 531 respectively

115. (1968) 1 Ch. 455 at 475

116. (1968) 1 Ch. 455 at 475 - 476

117. (1968) 1 Ch. 455 at 476

118. (1968) 1 Ch. 455 at 476

119. (1925) 1 Ch. 407 at 429

120. (1911) 1 Ch. 425 at 436 - 437

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121. (1970) 92 W.N. (N.S.W.) 29 at 74

122. Cavendish-Bentinck v. Fenn (1887) 12 A.C. 652 at 669 per Lord Macnaghtan.

123. Final Report of the Special Committee to Review the Companies Act (March 1973) para. 328.

124. Sections 5.08 and 5.09 relate to the purchase or acquisition by a company of shares in its holding company, and limitations upon such purchase or acquisition; Section 5.10 relates to the purchase or redemption of redeemable shares, and the limitations upon such purchase or redemption.

125. Section 5.13 requires that directors act in good faith and in the best interests of a company in authorizing payment of a commission, discount, or allowance to any person in consideration of his agreei to purchase shares in the company.

126. Section 5.14 prohibits payment of a divident in certain circumstances if the company is, or would be after payment thereof, unable to pay its liabilities as they become due.

127. Section 5.16 prohibits the making of a loan or the giving of financial assistance to any person for the purchase of shares in a company, and places limitations on the making of or guaranteeing of a loan for a sharehaolder, director or officer.

128. Section 9.20 places limitations upon the indemnification of a director or officer or former director or officer.

129. Sections 14.17 and 19.04 place limitations on payments by the compa in certaian circumstances, to shareholders.

130. Section 3.02 relates to the powers of a company.

131. Proposals for a New Business Corporations Law for Canada, Volume 1, paras. 236 - 237.

132. Op. cit para. 242.

133. Op. cit paras 481 - 482.

134. Report of the Company Law Committee (Cmnd. 1749, H.M.S.O. 1962) para. 87.

135. Proposals for a New Business Corporations Law for Canada, Volume 2, para. 481.

136. Final Report of the Special Committee to Review The Companies Act (March, 1973) para. 328.

rXSA SAINSBURY, N.E. Section 321 of the Companies Act 1955.