

Corporate finance and management issues in company law

Section C: Corporate management I

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Chapter 1	Introduction	1
1.1	Corporate finance and management issues in company law	2
1.2	Reforming company law	3
1.3	Approaching your studies	4
1.4	Reading for this course	5
Chapter 2	The management of the company	9
	Introduction	9
2.1	Defining the term 'director'	10
2.2	The position of the board of directors	10
2.3	Appointment of directors	12
2.4	Categories of directors	13
2.5	Directors' remuneration	15
2.6	Removal of directors	16
2.7	Disqualification of directors	17
2.8	Fraudulent trading	22
2.9	Wrongful trading	25
2.10	Misfeasance proceedings	28
2.11	Avoidance of floating charges	29
Chapter 3	Directors' duties	33
	Introduction	33
3.1	Background to the CA 2006, Part 10	35
3.2	To whom are the duties owed?	36
3.3	Directors' duties: CA 2006 Part 10 restatement	38
3.4	Remedies for breach	54
3.5	Consent, approval or authorisation by members	56
3.6	Duties have cumulative effect	57

3.7	Relief from liability	58
3.8	Specific statutory duties	59
Chapter 4	Liquidation	65
	Introduction	65
4.1	Liquidating the company	65
4.2	Voluntary winding-up	66
4.3	Compulsory winding-up	67
4.4	Public interest winding-up	68
4.5	The liquidator	68
4.6	Directors of insolvent companies	70

Re Lo-Line Electric Motors Ltd [1988] Ch 477.

Morphitis v Bernasconi [2003] 2 WLR 1521.

Learning outcomes

By the end of this chapter and the relevant readings you should be able to:

define the term 'director'

discuss the role of the board of directors and its relationship with the general meeting

describe the various types of director

explain the process for awarding remuneration

describe how the general meeting can remove a director from the board

explain how directors can be disqualified from holding office

discuss:

§ the liability of directors for fraudulent and wrongful trading

§ the misfeasance procedure available to liquidators

§ the avoidance of floating charges.

2.1 Defining the term 'director'

A company is an artificial legal entity. As such, it must operate through its human organs. The management of the company is vested in the board of directors who are expected to act on a collective basis, although the articles may, and in large companies generally do, provide for delegation of powers to smaller committees of the board and individual directors.

It should be borne in mind that in small private companies the same individuals may fulfil a number of roles within the business as directors, workers and shareholders.

In large companies, however, there is generally a clear division between the board and shareholders.

The Companies Act 2006 does not define the term 'director' beyond stating in s.250 that the term 'includes any person occupying the position of director, by whatever name called.'

Thus, whatever title the articles of association adopt to describe the members of the company's board (e.g. 'governors'), the law will nevertheless view them as directors. Section 154 lays down the minimum number of directors that companies must have:

two for public companies

one for private companies.

2.2 The position of the board of directors

The CA 2006 does not attribute specific roles to company directors. The Act is also silent with respect to the structure and form of corporate management, leaving such matters to the company's constitution.

Although it is now accepted that in the modern company the board enjoys a position of management autonomy, this has not always been the case. During the nineteenth century directors were viewed as largely symbolic appointments; executive power was vested in the general meeting. A company in a general meeting had constitutional supremacy – the board of directors was viewed as its agent and had to act in accordance with its decisions.

However, this changed dramatically from the early part of the twentieth century with the emergence of the professional director. Shareholding became more dispersed and directors began to be appointed on the basis of particular skills and managerial competence rather than social standing. Articles of association were drafted to give boardrooms greater independence.

Consequently, the judicial response was that the board should **not** be viewed as the agent or servant of the general meeting.

In *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34 (Sealy and Worthington, p.176) the question for the Court of Appeal was whether the directors were bound to give effect to an ordinary resolution of the general meeting requiring them to sell the company's undertaking to a new company incorporated for the purpose. The company's articles of association provided that 'the management of the business and the control of the company' was in the hands of its directors.

Collins MR, having reviewed the relevant article, explained that:

[I]t is not competent for the majority of the shareholders at an ordinary meeting to affect or alter the mandate originally given to the directors by the articles of association...the mandate which must be obeyed is not that of the majority – it is that of the whole entity made up of all the shareholders.

A further illustration is to be found in *Quin & Axtens Ltd v Salmon* [1909] AC 442 (Sealy and Worthington, p.178), where Lord Loreburn LJ, having reviewed the company's articles of association, observed:

The bargain made between the shareholders is contained in...the articles of association, and it amounts for the purpose in hand to this, that the directors should manage the business; and the company, therefore, are not to manage the business unless there is provision to that effect.

See also:

2006 is silent on boardroom appointments, leaving the issue to the articles of association.

Although first directors are appointed in accordance with ss.9 and 16, their successors are elected by the shareholders in a general meeting. For example, Table A, Article 73 provides that at the first annual general meeting (AGM):

all the directors shall retire from office
at every subsequent AGM one-third of the directors who are
subject to retirement by rotation¹ shall retire from office.

If there is only one director who is subject to retirement by rotation, he shall retire. It should be noted that in small private owner-managed companies, the articles will often provide for the permanent appointment of directors.

Summary

Sections 154–67 of the CA 2006 govern the appointment and registration of directors. The principal requirements for appointment are:

Every private company is to have at least one director, and every public company at least two (s.154).

The minimum age for a director to be appointed is (as in Scotland) 16 (s.157).

The appointment of a director of a public company is to be voted on individually, unless there is unanimous consent to a block resolution (s.160).

The acts of a person acting as a director are valid notwithstanding that it is afterwards discovered that there was a defect in his appointment, that he was disqualified from holding office, that he has ceased to hold office, or that he was not entitled to vote on the matter in question (s.161, replacing s.285 of the CA 1985). See the construction given to this provision in *Morris v Kanssen* [1946] AC 459, Lord Simonds.

2.4 Categories of directors

There is a clear division of roles between executive and non-executive directors. It should also be noted that because the law imposes strict duties on directors (discussed in Chapter 3), the courts will nevertheless treat persons who act as directors, while not being formally appointed as such, as being subject to these duties. In this way the law prevents avoidance of the onerous obligations that the office of director carries.

2.4.1 Executive and non-executive directors

Executive directors are full-time officers who generally have a service contract with the company. The articles will normally provide for the appointment of a managing director, sometimes called a chief executive, who has overall responsibility for the running of the company (Table A, Article 72).

Non-executive directors are normally appointed to the boards of larger companies to act as monitors of the executive management. Typically, they are part-time appointments.

The de jure and de facto directors of the company are identifiable.

The person in question directed those directors on how to act in relation to the company's affairs, or was one of the persons who did.

The directors did act in accordance with his instructions.

They were accustomed so to act.

Millet J explained that a pattern of behaviour must be shown 'in which the board did not exercise any discretion or judgment of its own but acted in accordance with the directions of others.'

However, merely controlling one director is not sufficient; a shadow director must exercise control over the whole board, or at least a governing majority of it.

See *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 and *Re Unisoft Group Ltd (No. 2)* [1993] BCLC 532.

Activity 2.3

Read *Secretary of Trade for Trade and Industry v Deverell* [2001] Ch 340.

What was the court's approach to the determination of whether or not the respondent was a shadow director?

Feedback: see page 30.

2.5 Directors' remuneration

As with trustees, a director is not entitled as of right to be paid for his services unless the articles of association or a service contract between him and the company provide otherwise: *Re George Newman & Co* [1895] 1 Ch 674. Table A, Article 82 provides that the directors shall be entitled to such remuneration as the company may, by ordinary resolution, determine.

A formal resolution is not required if all the members entitled to vote on the matter give their informal assent: *Re Duomatic Ltd* [1969] 2 Ch 365.

Generally:

The power to decide executive directors' remuneration is delegated to the board (see Table A, Article 84) or a sub-committee of the board.

The scope of its power depends upon the proper construction of the articles.

Where the board has power to set its own remuneration, issues of transparency and accountability obviously arise. The temptation for directors to vote themselves 'fat cat' (i.e. extravagant) awards has generated much debate over the past 20 years or so.

It should be noted that the DTI has published a number of proposals for reinforcing the accountability of directors to shareholders over boardroom pay awards. See the DTI consultative documents *Directors' Remuneration* (URN 99/923) (London: DTI, 1999) and (URN 01/1400) (London: DTI, 2001).

A significant proposal was that there should be a mandatory requirement for the company's annual report to contain:

- a statement of remuneration policy
- details of the remuneration of each director.

This was implemented for all quoted companies for financial years ending on or after 31 December 2002 by statutory instrument (the Directors' Remuneration Report Regulations 2002, SI 2002/1986). This came into force on 1 August 2002 and has now been incorporated into the CA 2006, ss.420–422.

The remuneration report must be approved by the board of directors and signed on behalf of the board by a director or secretary of the company (s.422(1)). Where a directors' remuneration report is approved but does not comply with the statutory requirements, every director of the company who knew of its non-compliance, or was reckless as to whether it complied, and failed to take reasonable steps to secure compliance or to prevent the report from being approved, commits an offence punishable by fine (s.422). Section 439 goes on to provide that prior to the accounts meeting, a quoted company must give to those members entitled to receive it notice of its intention to move an ordinary resolution approving the directors' remuneration report for the financial year. Failure to comply with this requirement is an offence punishable by fine (s.440).

Activity 2.4

Read *Guinness plc v Saunders* [1990] 2 AC 663 (Sealy and Worthington, p.249).

What were the material terms of the company's articles of association?

Why did the House of Lords order Mr Ward to repay the company the £5.2m awarded him by way of remuneration?

Feedback: see page 31.

2.6 Removal of directors

Section 168 CA 2006 provides that a company may, by ordinary resolution, remove a director before the expiration of his period of office. This can be done notwithstanding anything in any agreement between him and the company.

Special notice must be given of the resolution, that is, at least 28 days' notice must be given before the meeting at which the resolution is to be moved (ss.168 and 312).

The director concerned is entitled to address the meeting at which it is proposed to remove him (s.169(2)). He may also require the company to circulate to the shareholders his representations in writing (providing they are of a reasonable length), unless the court is satisfied that this right is being abused to secure needless publicity for defamatory matter (s.169(3)).

Although the power contained in s.168 cannot be removed by the articles, it is possible for a director to entrench himself by including in the articles a clause entitling him to weighted voting in the event of a resolution to remove him.

In Bushell v Faith

2.7.2 Mandatory disqualification orders for unfitness

Section 6(1) of the CDDA 1986 provides that the court shall make a disqualification order against a person in any case where it is satisfied that he is or has been a director of a company which has at any time – whether while he was a director or subsequently – become insolvent and his conduct as a director of that company – either taken alone or taken together with his conduct as a director of any other company or companies – makes him **unfit** to be concerned in the management of a company.

The minimum period of disqualification is two years and the maximum period is 15 years (s.6(4)). In contrast with the other grounds for disqualification noted above, s.6 is restricted to directors or shadow directors, including de facto directors.

The policy underlying s.6 was explained by Dillon LJ in *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164 (Sealy and Worthington, p.266) as being to ‘to protect the public, and in particular potential creditors of companies, from losing money through companies becoming insolvent when the directors of those companies are people unfit to be concerned in the management of a company.’

An insolvent company is defined as including a company which goes into liquidation at a time when its assets are insufficient to meet the payment of its debts, liabilities and liquidation expenses (s.6(2)).

An application under s.6 must be brought by the Secretary of State² if it appears to him that it is expedient in the public interest that a disqualification order should be made against any person (s.7(1)).

The meaning of ‘unfitness’

Section 6 provides that the court must be satisfied that the director ‘has been a

the extent of the director's responsibility for any failure by the company to comply with the numerous accounting and publicity requirements of the CA 2006 (paras. 4 and 5).

Those matters to which regard is to be had when the company is insolvent are listed in Part II of Schedule 1. They include:

the extent of the director's responsibility for the causes of the company becoming insolvent (para. 6)

the extent of the director's responsibility for any failure by the company to supply any goods or services which have been paid for, in whole or in part (para. 7).

In *Re Lo-Line Electric Motors Ltd* [1988] Ch 477 Sir Nicholas Browne-Wilkinson VC said that while ordinary commercial misjudgment is not in itself sufficient to establish unfitness, certain conduct would be sufficient to justify disqualification. Examples of such conduct include conduct:

which displays 'a lack of commercial probity'

which is grossly negligent

which displays 'total incompetence'.

See also:

Re Dawson Print Group Ltd [1987] BCLC 601

Secretary of State for Trade and Industry v Ettinger, Re Swift 736 Ltd [1993] BCLC 896.

An interesting recent decision is *Secretary of State for Trade and Industry v Swan (No. 2)* [2005] EWHC 2479, in which Etherton J subjected the responsibilities of a non-executive director, against whom an application for disqualification under s.6 had been brought, to detailed consideration. N, a senior non-executive director and deputy chairman of the board and chairman of the audit and remuneration committees of Finelist plc, together with S, the company's CEO, were disqualified for three and four years respectively. N's reaction upon being informed by a whistle-blower of financial irregularities ('cheque kiting') going on within the group was held to be entirely inappropriate. He failed to investigate the allegations properly, nor did he bring them to the attention of his fellow non-executive directors or to the auditors. The judge held that N's conduct fell below the level of competence to be expected of a director in his position and he was therefore 'unfit' to be concerned in the management of a company.

Activity 2.5

Read *Secretary of State for Trade and Industry v TC Stephenson* [2000] 2 BCLC 614.

What allegations were made against the director by the Secretary of State? What was the decision of the court?

Feedback: see page 31.

Summary

The courts will look for abuses of the privilege of limited liability as evidenced by capricious disregard of creditors' interests or culpable commercial behaviour amounting to gross negligence.

Non-executive directors who lack corporate financial experience may rely on the advice and assurances provided by the company's accountants, although they should be vigilant and raise objections whenever they have concerns about the financial operation of the company.

2.7.3 Disqualification undertakings

The Insolvency Act 2000 amends the CDDA 1986 by introducing a procedure whereby in the circumstances specified in ss.7 and 8 of the 1986 Act, the Secretary of State may accept a disqualification undertaking by any person that, for a period specified in the

2.8 Fraudulent trading

the facts did not disclose the requisite intent to defraud the creditors. Indeed, they were consistent with the parent company having an honest intent, at the time it made the statements, to support its subsidiary. The fact that it later changed its mind did not prove that its original intent was fraudulent.

On the other hand, a clear example of fraudulent intent appears from the facts of *Re William C Leitch Brothers Ltd* [1932] 2 Ch 71, in which the liquidator sought declarations that the director of the company had been knowingly a party to carrying on the business of the company with intent to defraud its creditors and he was therefore personally liable for all the company's debts.

The company had owed around £6,500 for goods on 1 March 1930 and it lacked the means to pay off these debts. Subsequently, the director ordered goods worth £6,000. These became subject to a charge contained in a debenture held by him. He also lent sums of money to the company after this date which were paid off in part by the company. Later, he appointed a receiver on the ground that the company had defaulted on interest payments.

The company's account with the Midland Bank was overdrawn by around £800. He had guaranteed this sum and had deposited title deeds with the bank. Between April and June 1930 £684 of the overdraft was paid off. It also emerged that the goods which the director had ordered were greatly in excess of the company's requirements.

In holding the director liable, Maugham J observed:

[I]f a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment of those debts, it is, in general, a proper inference that the company is carrying on business with intent to defraud.

Similarly, in *Re Gerald Cooper Chemicals Ltd* [1978] Ch 262 it was held that accepting advance payment for the supply of goods from one creditor where the directors knew that there was no prospect of the goods being supplied and the payment returned amounted to fraud committed in the course of carrying on business. See also *Morris v State Bank of India* [2003] EWHC 1868 (Ch), in which Patten J stated that knowledge included 'blind-eye' knowledge (i.e. deliberately shutting one's eye to the obvious).

The 'parties' to the carrying on of the business

The term **parties to the carrying on of the business** contained in s.213 is expansive in effect so that any person who takes a positive step in the fraudulent trading can be liable. Contrast s.214 below, the scope of which is limited to directors and shadow directors.

In *Re Maidstone Building Provisions Ltd* [1971] 1 WLR 1085 it was held that the failure of a company secretary to advise the directors that the company is insolvent is not sufficient to render him a party to the carrying on of the business in a fraudulent manner. As Pennycuik VC defined 'parties' as those who participate in, take part or concur in fraudulent trading, it thus involves some 'positive steps.'

But it has been held that a creditor who knowingly accepts money fraudulently obtained by the company is a party to the carrying on of the business in a fraudulent manner: *Re Gerald Cooper Chemicals Ltd*.

The nature of the liability

The extent of liability under s.213 is subject to the court's discretion. In *Re William C Leitch Brothers Ltd* Maughan J noted that s.213 carries a punitive element and a director may therefore be ordered to pay more under the section than is actually owed to the creditors who have been defrauded.

See *Re a company* (No. 001418 of 1988) [1991] BCLC 197, in which the director was ordered to pay an additional sum of £25,000 by way of punitive element.

However, in determining the issue of liability Chadwick LJ in *Morphitis v Bernasconi* observed that:

The power under section 213(2) is to order that persons knowingly party to the carrying on of the company's business with intent to defraud make 'such contributions (if any) to the company's assets' as the court thinks proper. There must, as it seems to me, be some nexus between (i) the loss which has been caused to the company's creditors generally by the carrying on of the business in the manner which gives rise to the exercise of the power and (ii) the contribution which those knowingly party to the carrying on of the business in that manner should be ordered to make to the assets in which the company's creditors will share in the liquidation. An obvious case for contribution would be where the carrying on of the business with fraudulent intent had led to the misapplication, or misappropriation, of the company's assets. In such a case the appropriate order might be that those knowingly party to such misapplication or misappropriation contribute an amount equal to the value of assets misapplied or misappropriated. Another obvious case would be where the carrying on of the business with fraudulent intent had led to claims against the company by those defrauded. In such a case the appropriate order might be that those knowingly party to the conduct which had given rise to those claims in the liquidation contribute an amount equal to the amount by which the existence of those claims would otherwise diminish the assets available for distribution to creditors generally; that is to say an amount equal to the amount which has to be applied out of the assets available for distribution to satisfy those claims.

Further, notwithstanding *Re William C Leitch Brothers Ltd* and *Re a company* (No. 001418 of 1988), it is noteworthy that the Court of Appeal doubted whether in civil proceedings under s.213 it had the power to include a punitive element, given that such power is contained in s.993 CA 2006. In this regard Chadwick LJ stated:

I am not persuaded that there is power to include a punitive element in the amount of any contribution which, in the exercise of the power conferred by section 213(2) of the 1986 Act, a person should be declared liable to make to the assets of the company. As I have said, I think that the principle on which that power should be exercised is that the contribution to the assets in which the company's creditors will share in the liquidation should reflect (and compensate for) the loss which has been caused to those creditors by the carrying on of the business in the manner which gives rise to

On the facts, both respondents were described as consultants but the company's board were accustomed to act in accordance with their directions and 'suggestions'. They were therefore shadow directors.

Where a director has died, the liquidator can maintain the claim against his estate: *Re Sherbourne Associates Ltd* [1995] BCC 40. The liquidator must prove that the director in question allowed the company to continue to trade, at some time before the commencement of its winding-up, when he knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. An **awareness** that creditors are exerting pressure for payment or refusing to make further deliveries will be sufficient: *Re DKG Contractors Ltd* [1990] BCC 903.

2.9.2 Culpability

In determining whether a director ought to have concluded that an insolvent liquidation was **unavoidable**, s.214(4) provides:

the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonable diligent person having both—

- (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
- (b) the general knowledge, skill and experience that that director has.

The first reported case under s.214 was *Re Produce Marketing Consortium Ltd* [1989] BCLC 520 (Sealy and Worthington, p.671), in which two directors were each held liable to contribute £75,000 to the company's assets. Knox J held that the time at which they ought to have realised that the company's liquidation was unavoidable was the latest possible date on which the annual accounts for that year ought to have been delivered. The fact that the directors had not seen them was irrelevant and in any case they had acquiesced in the delay of their delivery.

Construing s.214(4), Knox J took the view that its objective and subjective elements required each director to be judged on the facts actually known to them but also according to those facts which **should have been known** had the accounts been duly delivered as required by the Companies Act.

Accepting counsel's submission that there was a requirement to have regard to the functions being carried out by the particular director in relation to the company in question, which would involve having regard to the particular company and its business, Knox J stated:

It follows that the general knowledge, skill and experience postulated will be much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures.

examine the conduct in question and compel the person to repay or restore or account for the money or property, or to contribute such sum to the company's assets by way of compensation as the court thinks just.

Section 212 is a procedural rule which enables property or compensation to be recovered in a winding-up. It covers breaches of fiduciary duty and the common law duties of care and skill.

2.11 Avoidance of floating charges

Section 245 of the Insolvency Act 1986 invalidates a floating charge created within 12 months (termed 'the relevant time') prior to the onset of insolvency, unless it was created in consideration for money paid, or goods or services supplied, at the same time as or subsequent to the creation of the charge. The 'relevant time' is extended to two years where the charge is created in favour of a connected person.

However, s.245(4) provides that a floating charge created in favour of a non-connected person within the 'relevant time' (i.e. 12 months) will not be invalidated if the company was able to pay its debts at the time the charge was created and did not become unable to do so as result of creating the charge.

It should be noted that this provision does not extend to charges created in favour of **connected persons**. The term 'connected person' is defined by s.249 as meaning:

- a director or shadow director of the company
- an associate of a director or shadow director of the company
- an associate of the company.

The object of s.245 is to prevent an unsecured creditor obtaining a floating charge to secure his existing loan at the expense of other unsecured creditors.

We look at floating charges, and

Useful further reading

Axworthy, C.S. 'Corporate directors – who needs them?' [1988] *MLR* 273.

Bradley, C. 'Enterprise and entrepreneurship: the impact of director disqualification' [2001] *JCLS* 53.

Cooke, T.E. and A. Hicks 'Wrongful trading – predicting insolvency' [1993] *JBL* 338.

Finch, V. 'Disqualification of directors: a plea for competence' [1990] *MLR* 385.

Hicks, A. 'Disqualification of directors – 40 years on' [1988] *JBL* 27.

MacKenzie, J. 'Who controls the company? The interpretation of Table A' [1983] *Co Law* 99.

Milman, D. 'Personal liability and disqualification of company directors: something old, something new' [1992] *MLQ* 1.

Prentice, D. 'Corporate personality, limited liability and the protection of creditors' in Grantham, R. and C. Rickett (eds)

Oxford, Hart, 2009, 227-238, 238-239, 239-240, 240-241, 241-242, 242-243, 243-244, 244-245, 245-246, 246-247, 247-248, 248-249, 249-250, 250-251, 251-252, 252-253, 253-254, 254-255, 255-256, 256-257, 257-258, 258-259, 259-260, 260-261, 261-262, 262-263, 263-264, 264-265, 265-266, 266-267, 267-268, 268-269, 269-270, 270-271, 271-272, 272-273, 273-274, 274-275, 275-276, 276-277, 277-278, 278-279, 279-280, 280-281, 281-282, 282-283, 283-284, 284-285, 285-286, 286-287, 287-288, 288-289, 289-290, 290-291, 291-292, 292-293, 293-294, 294-295, 295-296, 296-297, 297-298, 298-299, 299-300, 300-301, 301-302, 302-303, 303-304, 304-305, 305-306, 306-307, 307-308, 308-309, 309-310, 310-311, 311-312, 312-313, 313-314, 314-315, 315-316, 316-317, 317-318, 318-319, 319-320, 320-321, 321-322, 322-323, 323-324, 324-325, 325-326, 326-327, 327-328, 328-329, 329-330, 330-331, 331-332, 332-333, 333-334, 334-335, 335-336, 336-337, 337-338, 338-339, 339-340, 340-341, 341-342, 342-343, 343-344, 344-345, 345-346, 346-347, 347-348, 348-349, 349-350, 350-351, 351-352, 352-353, 353-354, 354-355, 355-356, 356-357, 357-358, 358-359, 359-360, 360-361, 361-362, 362-363, 363-364, 364-365, 365-366, 366-367, 367-368, 368-369, 369-370, 370-371, 371-372, 372-373, 373-374, 374-375, 375-376, 376-377, 377-378, 378-379, 379-380, 380-381, 381-382, 382-383, 383-384, 384-385, 385-386, 386-387, 387-388, 388-389, 389-390, 390-391, 391-392, 392-393, 393-394, 394-395, 395-396, 396-397, 397-398, 398-399, 399-400, 400-401, 401-402, 402-403, 403-404, 404-405, 405-406, 406-407, 407-408, 408-409, 409-410, 410-411, 411-412, 412-413, 413-414, 414-415, 415-416, 416-417, 417-418, 418-419, 419-420, 420-421, 421-422, 422-423, 423-424, 424-425, 425-426, 426-427, 427-428, 428-429, 429-430, 430-431, 431-432, 432-433, 433-434, 434-435, 435-436, 436-437, 437-438, 438-439, 439-440, 440-441, 441-442, 442-443, 443-444, 444-445, 445-446, 446-447, 447-448, 448-449, 449-450, 450-451, 451-452, 452-453, 453-454, 454-455, 455-456, 456-457, 457-458, 458-459, 459-460, 460-461, 461-462, 462-463, 463-464, 464-465, 465-466, 466-467, 467-468, 468-469, 469-470, 470-471, 471-472, 472-473, 473-474, 474-475, 475-476, 476-477, 477-478, 478-479, 479-480, 480-481, 481-482, 482-483, 483-484, 484-485, 485-486, 486-487, 487-488, 488-489, 489-490, 490-491, 491-492, 492-493, 493-494, 494-495, 495-496, 496-497, 497-498, 498-499, 499-500, 500-501, 501-502, 502-503, 503-504, 504-505, 505-506, 506-507, 507-508, 508-509, 509-510, 510-511, 511-512, 512-513, 513-514, 514-515, 515-516, 516-517, 517-518, 518-519, 519-520, 520-521, 521-522, 522-523, 523-524, 524-525, 525-526, 526-527, 527-528, 528-529, 529-530, 530-531, 531-532, 532-533, 533-534, 534-535, 535-536, 536-537, 537-538, 538-539, 539-540, 540-541, 541-542, 542-543, 543-544, 544-545, 545-546, 546-547, 547-548, 548-549, 549-550, 550-551, 551-552, 552-553, 553-554, 554-555, 555-556, 556-557, 557-558, 558-559, 559-560, 560-561, 561-562, 562-563, 563-564, 564-565, 565-566, 566-567, 567-568, 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790-791, 791-792, 792-793, 793-794, 794-795, 795-796, 796-797, 797-798, 798-799, 799-800, 800-801, 801-802, 802-803, 803-804, 804-805, 805-806, 806-807, 807-808, 808-809, 809-810, 810-811, 811-812, 812-813, 813-814, 814-815, 815-816, 816-817, 817-818, 818-819, 819-820, 820-821, 821-822, 822-823, 823-824, 824-825, 825-826, 826-827, 827-828, 828-829, 829-830, 830-831, 831-832, 832-833, 833-834, 834-835, 835-836, 836-837, 837-838, 838-839, 839-840, 840-841, 841-842, 842-843, 843-844, 844-845, 845-846, 846-847, 847-848, 848-849, 849-850, 850-851, 851-852, 852-853, 853-854, 854-855, 855-856, 856-857, 857-858, 858-859, 859-860, 860-861, 861-862, 862-863, 863-864, 864-865, 865-866, 866-867, 867-868, 868-869, 869-870, 870-871, 871-872, 872-873, 873-874, 874-875, 875-876, 876-877, 877-878, 878-879, 879-880, 880-881, 881-882, 882-883, 883-884, 884-885, 885-886, 886-887, 887-888, 888-889, 889-890, 890-891, 891-892, 892-893, 893-894, 894-895, 895-896, 896-897, 897-898, 898-899, 899-900, 900-901, 901-902, 902-903, 903-904, 904-905, 905-906, 906-907, 907-908, 908-909, 909-910, 910-911, 911-912, 912-913, 913-914, 914-915, 915-916, 916-917, 917-918, 918-919, 919-920, 920-921, 921-922, 922-923, 923-924, 924-925, 925-926, 926-927, 927-928, 928-929, 929-930, 930-931, 931-932, 932-933, 933-934, 934-935, 935-936, 936-937, 937-938, 938-939, 939-940, 940-941, 941-942, 942-943, 943-944, 944-945, 945-946, 946-947, 947-948, 948-949, 949-950, 950-951, 951-952, 952-953, 953-954, 954-955, 955-956, 956-957, 957-958, 958-959, 959-960, 960-961, 961-962, 962-963, 963-964, 964-965, 965-966, 966-967, 967-968, 968-969, 969-970, 970-971, 971-972, 972-973, 973-974, 974-975, 975-976, 976-977, 977-978, 978-979, 979-980, 980-981, 981-982, 982-983, 983-984, 984-985, 985-986, 986-987, 987-988, 988-989, 989-990, 990-991, 991-992, 992-993, 993-994, 994-995, 995-996, 996-997, 997-998, 998-999, 999-1000, 1000-1001, 1001-1002, 1002-1003, 1003-1004, 1004-1005, 1005-1006, 1006-1007, 1007-1008, 1008-1009, 1009-1010, 1010-1011, 1011-1012, 1012-1013, 1013-1014, 1014-1015, 1015-1016, 1016-1017, 1017-1018, 1018-1019, 1019-1020, 1020-1021, 1021-1022, 1022-1023, 1023-1024, 1024-1025, 1025-1026, 1026-1027, 1027-1028, 1028-1029, 1029-1030, 1030-1031, 1031-1032, 1032-1033, 1033-1034, 1034-1035, 1035-1036, 1036-1037, 1037-1038, 1038-1039, 1039-1040, 1040-1041, 1041-1042, 1042-1043, 1043-1044, 1044-1045, 1045-1046, 1046-1047, 1047-1048, 1048-1049, 1049-1050, 1050-1051, 1051-1052, 1052-1053, 1053-1054, 1054-1055, 1055-1056, 1056-1057, 1057-1058, 1058-1059, 1059-1060, 1060-1061, 1061-1062, 1062-1063, 1063-1064, 1064-1065, 1065-1066, 1066-1067, 1067-1068, 1068-1069, 1069-1070, 1070-1071, 1071-1072, 1072-1073, 1073-1074, 1074-1075, 1075-1076, 1076-1077, 1077-1078, 1078-1079, 1079-1080, 1080-1081, 1081-1082, 1082-1083, 1083-1084, 1084-1085, 1085-1086, 1086-1087, 1087-1088, 1088-1089, 1089-1090, 1090-1091, 1091-1092, 1092-1093, 1093-1094, 1094-1095, 1095-1096, 1096-1097, 1097-1098, 1098-1099, 1099-1100, 1100-1101, 1101-1102, 1102-1103, 1103-1104, 1104-1105, 1105-1106, 1106-1107, 1107-1108, 1108-1109, 1109-1110, 1110-1111, 1111-1112, 1112-1113, 1113-1114, 1114-1115, 1115-1116, 1116-1117, 1117-1118, 1118-1119, 1119-1120, 1120-1121, 1121-1122, 1122-1123, 1123-1124, 1124-1125, 1125-1126, 1126-1127, 1127-1128, 1128-1129, 1129-1130, 1130-1131, 1131-1132, 1132-1133, 1133-1134, 1134-1135, 1135-1136, 1136-1137, 1137-1138, 1138-1139, 1139-1140, 1140-1141, 1141-1142, 1142-1143, 1143-1144, 1144-1145, 1145-1146, 1146-1147, 1147-1148, 1148-1149, 1149-1150, 1150-1151, 1151-1152, 1152-1153, 1153-1154, 1154-1155, 1155-1156, 1156-1157, 1157-1158, 1158-1159, 1159-1160, 1160-1161, 1161-1162, 1162-1163, 1163-1164, 1164-1165, 1165-1166, 1166-1167, 1167-1168, 1168-1169, 1169-1170, 1170-1171, 1171-1172, 1172-1173, 1173-1174, 1174-1175, 1175-1176, 1176-1177, 1177-1178, 1178-1179, 1179-1180, 1180-1181, 1181-1182, 1182-1183, 1183-1184, 1184-1185, 1185-1186, 1186-1187, 1187-1188, 1188-1189, 1189-1190, 1190-1191, 1191-1192, 1192-1193, 1193-1194, 1194-1195, 1195-1196, 1196-1197, 1197-1198, 1198-1199, 1199-1200, 1200-1201, 1201-1202, 1202-1203, 1203-1204, 1204-1205, 1205-1206, 1206-1207, 1207-1208, 1208-1209, 1209-1210, 1210-1211, 1211-1212, 1212-1213, 1213-1214, 1214-1215, 1215-1216, 1216-1217, 1217-1218, 1218-1219, 1219-1220, 1220-1221, 1221-1222, 1222-1223, 1223-1224, 1224-1225, 1225-1226, 1226-1227, 1227-1228, 1228-1229, 1229-1230, 1230-1231, 1231-1232, 1232-1233, 1233-1234, 1234-1235, 1235-1236, 1236-1237, 1237-1238, 1238-1239, 1239-1240, 1240-1241, 1241-1242, 1242-1243, 1243-1244, 1244-1245, 1245-1246, 1246-1247, 1247-1248, 1248-1249, 1249-1250, 1250-1251, 1251-1252, 1252-1253, 1253-1254, 1254-1255, 1255-1256, 1256-1257, 1257-1258, 1258-1259, 1259-1260, 1260-1261, 1261-1262, 1262-1263, 1263-1264, 1264-1265, 1265-1266, 1266-1267, 1267-1268, 1268-1269, 1269-1270, 1270-1271, 1271-1272, 1272-1273, 1273-1274, 1274-1275, 1275-1276, 1276-1277, 1277-1278, 1278-1279, 1279-1280, 1280-1281, 1281-1282, 1282-1283, 1283-1284, 1284-1285, 1285-1286, 1286-1287, 1287-1288, 1288-1289, 1289-1290, 1290-1291, 1291-1292, 1292-1293, 1293-1294, 1294-1295, 1295-1296, 1296-1297, 1297-1298, 1298-1299, 1299-1300, 1300-1301, 1301-1302, 1302-1303, 1303-1304, 1304-1305, 1305-1306, 1306-1307, 1307-1308, 1308-1309, 1309-1310, 1310-1311, 1311-1312, 1312-1313, 1313-1314, 1314-1315, 1315-1316, 1316-1317, 1317-1318, 1318-1319, 1319-1320, 1320-1321, 1321-1322, 1322-1323, 1323-1324, 1324-1325, 1325-1326, 1326-1327, 1327-1328, 1328-1329, 1329-1330, 1330-1331, 1331-1332, 1332-1333, 1333-1334, 1334-1335, 1335-1336, 1336-1337, 1337-1338, 1338-1339, 1339-1340, 1340-1341, 1341-1342, 1342-1343, 1343-1344, 1344-1345, 1345-1346, 1346-1347, 1347-1348, 1348-1349, 1349-1350, 1350-1351, 1351-1352, 1352-1353, 1353-1354, 1354-1355, 1355-1356, 1356-1357, 1357-1358, 1358-1359, 1359-1360, 1360-1361, 1361-1362, 1362-1363, 1363-1364, 1364-1365, 1365-1366, 1366-1367, 1367-1368, 1368-1369, 1369-1370, 1370-1371, 1371-1372, 1372-1373, 1373-1374, 1374-1375, 1375-1376, 1376-1377, 1377-1378, 1378-1379, 1379-1380, 1380-1381, 1381-1382, 1382-1383, 1383-1384, 1384-1385, 1385-1386, 1386-1387, 1387-1388, 1388-1389, 1389-1390, 1390-1391, 1391-1392, 1392-1393, 1393-1394, 1394-1395, 1395-1396, 1396-1397, 1397-1398, 1398-1399, 1399-1400, 1400-1401, 1401-1402, 1402-1403, 1403-1404, 1404-1405, 1405-1406, 1406-1407, 1407-1408, 1408-1409, 1409-1410, 1410-1411, 1411-1412, 1412-1413, 1413-1414, 1414-1415, 1415-1416, 1416-1417, 1417-1418, 1418-1419, 1419-1420, 1420-1421, 1421-1422, 1422-1423, 1423-1424, 1424-1425, 1425-1426, 1426-1427, 1427-1428, 1428-1429, 1429-1430, 1430-1431, 1431-1432, 1432-1433, 1433-1434, 1434-1435, 1435-1436, 1436-1437, 1437-1438, 1438-1439, 1439-1440, 1440-1441, 14

the common feature of 'guidance'. The critical factor is whether the person has real influence over the company's affairs.

Although it is sufficient to show that in the face of 'directions or instructions' from the alleged shadow director the properly appointed directors or some of them cast themselves in a subservient role or surrendered their respective discretions, this is not necessary in all cases. Such a requirement would be to put a gloss on the statutory requirement that the board are 'accustomed to act' 'in accordance with such directions or instructions'.

Activity 2.4 (a) Article 90 provided that the board would fix the annual remuneration of the directors subject to the proviso that, without the consent of

responsible for any policy of not paying Crown monies. H was entitled to rely on the assurances of the accountant that the finances of the company were being properly managed.

The court held, taking H's lack of experience in operating corporate finances together with his non-executive status, that he was entitled to rely on the accountants to prepare the accounts and their assurances that the finances were being properly run.

A cheque signatory is not a finance director and is therefore not expected to possess such expertise. With respect to the cheques for school fees, H had acted on the advice of the accountant and he had also reported the payments to the board.